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STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION, FIRST AND SECOND REVIEWS UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT, REQUESTS FOR WAIVERS OF NONOBSERVANCE OF PERFORMANCE CRITERIA, EXTENSION OF THE ARRANGEMENT, AND REPHASING OF DISBURSEMENTS—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR NEPAL

In the context of the Nepal—Staff Report for the 2023 Article IV Consultation, First and Second Reviews under the Extended Credit Facility Arrangement, Requests for Waivers of Nonobservance of Performance Criteria, Extension of the Arrangement, and Rephasing of Disbursements, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board and summarizing the views of the Executive Board as expressed during its May 1, 2023, consideration of the staff report on issues related to the Article IV Consultation and the IMF arrangement.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 1, 2023, following discussions that ended on February 28, 2023, with the officials of Nepal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 12, 2023.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Statement by the Executive Director** for Nepal.

The documents listed below have been or will be separately released.

Selected Issues
Poverty Reduction Strategy Paper
Joint Staff Advisory Note on the Poverty Reduction Strategy Paper
*Also included in Staff Report

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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Washington, D.C.

IMF Executive Board Concludes 2023 Article IV Consultation with Nepal and Completes First and Second Reviews under the Extended Credit Facility

FOR IMMEDIATE RELEASE

- *Completion of the first and second reviews under the Extended Credit Facility (ECF) provides Nepal with access to SDR 39.20 million (about US$52.8 million).*
- *Following a strong post-pandemic recovery, external shocks and necessary policy adjustment led to a softening of GDP growth. The much-needed monetary policy tightening helped stabilize the external position and lower inflation, while the recent mid-year budget review is expected to address near-term fiscal risks.*
- *Sustainable medium-term growth will require preserving macroeconomic stability and fiscal reforms in line with debt sustainability, advancing reforms on banking regulations and supervision, reducing the cost of doing business and barriers to FDI, and enhancing governance and the social safety net.*

Washington, DC – May 1, 2023: The Executive Board of the International Monetary Fund (IMF) completed the first and second reviews under the Extended Credit Facility (ECF) for Nepal, allowing the authorities to withdraw the equivalent to SDR 39.20 million (about US$52.8 million). This brings total disbursements under the ECF for budget support thus far to SDR 117.70 million (about US$157.4 million). The Executive Board also concluded the 2023 Article IV consultation with Nepal.[1]

The ECF arrangement for Nepal was approved by the Executive Board on January 12, 2022 (see Press Release No. 22/6) in an amount equivalent to SDR 282.42 million (180 percent of quota or about US$384.8 million). The ECF arrangement has helped mitigate the impact of the pandemic and global shocks on economic activity and aims at protecting vulnerable groups, preserving macroeconomic and financial stability, and supporting sustained growth and poverty reduction. The program is also helping to catalyze additional financing from Nepal's development partners.

Despite a challenging global and domestic environment last year, including the impact of Russia's war in Ukraine, Nepal continued to make progress with the implementation of the ECF-supported program. The Nepali authorities have taken decisive actions to maintain a stable macroeconomic environment in the context of the post-COVID-19 recovery and global shocks. The much-needed monetary policy tightening last year, together with the gradual unwinding of COVID support measures, helped moderate credit growth and lower inflation. In addition, to preserve fiscal discipline and debt sustainability, the government has rationalized spending in its mid-year budget review in response to weaker-than-expected tax collections in

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

the first half of the year. Bank asset quality has deteriorated as higher lending rates depress borrowers' repayment capacity, though bank capital adequacy ratios are above the regulatory minima.

Real GDP growth is forecast to soften to 4.4 percent in FY2022/23, but continues to be supported by the ongoing recovery of tourism, strong agriculture sector performance and resilient remittances. Inflation remains elevated, but is projected to decline to the Nepal Rastra Bank's 7 percent target by the end of FY2022/23. The overall fiscal deficit is expected to reach 4.5 percent of GDP in FY2022/23. Revenue collection has been disappointing, owing largely to lower import-related taxes, but substantial expenditure rationalization announced in the midyear budget review is expected to help contain the deficit. The current account deficit is expected to narrow to 5.2 percent of GDP in FY2022/23 due to weaker import demand, lower commodity prices, a recovery in tourism and buoyant remittances that reflect a post-pandemic increase in outward migration. Risks to the outlook are on the downside. Over the medium term, the ECF-supported program will help Nepal's economy respond to shocks and achieve sustainable and inclusive growth, while maintaining adequate levels of international reserves and keeping public debt at a sustainable level.

Following the Executive Board's discussion, Mr. Bo Li, Deputy Managing Director and Acting Chair, issued the following statement:

"Nepal's reform program supported by the Extended Credit Facility (ECF) has helped to mitigate the impact of the pandemic and global shocks on economic activity, while protecting vulnerable groups, preserving macroeconomic and financial stability, and sustaining growth and poverty reduction. While reform implementation has been slower than expected, in a difficult environment, the Nepali authorities remain committed to their economic reform program.

"Fiscal policy is focused on promptly addressing near-term fiscal pressures, while supporting the most vulnerable against elevated food and energy prices. Maintaining momentum on governance reforms is critical to cement recent gains in fiscal transparency. Fiscal consolidation and further structural reforms are needed to support medium-term fiscal sustainability. Revenue mobilization, advancing fiscal federalism, addressing fiscal risks, and strengthening public investment management are important measures.

"A cautious, data-driven approach to monetary policy, supported by macroprudential tools, is appropriate to maintain external stability and address elevated inflation. The Nepal Rastra Bank is prioritizing the asset quality of banks, including through regulatory initiatives to ensure appropriate classification of loans, and is focused on advancing the financial sector reform agenda. Measures to improve the autonomy and accountability framework of the central bank and strengthen the AML/CFT framework and its effectiveness remain crucial.

"Structural reform priorities include lowering the cost of doing business, removing barriers for foreign investment, improving governance, and strengthening anti-corruption institutions. Policies to reduce vulnerability to climate change, including through better-targeted social assistance, investment in climate-resilient infrastructure and boosting agricultural productivity are important."

Executive Board Assessment[2]

Directors agreed with the thrust of the staff appraisal. They noted the impact that global shocks have had on Nepal through higher commodity prices, and that while the outlook is favorable, inflation remains elevated, and risks are to the downside. Directors recognized that program performance was mixed, in the context of the difficult environment, and that while there was continued progress on reforms, the pace of implementation was slower than desired. They emphasized that strong program ownership and Fund capacity development are central to achieving program objectives. Directors underscored the importance of safeguarding macroeconomic stability and supporting sustainable, inclusive, and green growth.

Directors agreed that fiscal policy should focus on addressing near-term fiscal pressures through expenditure rationalization, while protecting high-quality infrastructure and social spending. They noted the need to support medium-term fiscal sustainability through fiscal consolidation and continued progress on fiscal structural reforms. Important measures include advancing revenue mobilization reforms, strengthening the fiscal federalism framework, and improving public investment management. Directors stressed that maintaining momentum on governance reforms is critical to cementing recent gains in fiscal transparency and that strengthening the financial oversight and governance of public enterprises would help to limit fiscal risks.

Directors agreed that monetary policy, supported by macroprudential measures, should take a cautious, data driven approach to maintain external stability and address elevated inflation. They noted that while capital adequacy ratios remain above regulatory minima, non-performing loans are increasing. Directors thus concurred that the central bank should prioritize bank asset quality. They recommended advancing the financial sector reform strategy and implementing the outstanding 2021 safeguards assessment recommendations, including to improve the autonomy and accountability of the central bank. Directors noted the importance of improving financial inclusion through digitalization. They stressed the need to strengthen efforts to enhance the AML/CFT framework and its effectiveness.

Directors highlighted the importance of an ambitious structural reform agenda and recommended reforms to reduce the cost of doing business, lower barriers to foreign investment, and enhance governance and anti-corruption. Noting Nepal's vulnerability to climate shocks and natural disasters, which can hamper poverty reduction and exacerbate food insecurity, Directors stressed the need for better targeted social assistance, enhanced agricultural productivity, and investment in climate resilient infrastructure.

It is expected that the next Article IV Consultation with Nepal will be held in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

Nepal: Selected Economic Indicators 2019/20-2027/28 1/

	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
				Est.			Projections		
Output and Prices (annual percent change)									
Real GDP	-2.4	4.2	5.8	4.4	5.1	5.2	5.2	5.2	5.2
Headline CPI (period average)	6.1	3.6	6.3	7.8	6.3	5.6	5.4	5.4	5.4
Headline CPI (end of period)	4.8	4.2	8.1	7.1	5.8	5.5	5.4	5.4	5.4
Fiscal Indicators: Central Government (in percent of GDP)									
Total revenue and grants	22.2	23.7	23.5	21.6	22.9	23.6	24.8	25.5	25.4
of which: Tax revenue	18.0	20.3	20.3	18.4	19.3	20.1	21.3	22.0	22.0
Expenditure	27.6	27.7	26.8	26.1	26.9	27.1	27.5	28.0	27.9
Expenses	22.7	22.4	22.3	21.1	21.0	21.2	21.6	22.1	22.0
Net acquisition of nonfinancial assets	4.9	5.4	4.5	5.0	5.9	5.9	5.9	5.9	5.9
Operating balance	-0.5	1.3	1.2	0.5	1.9	2.4	3.2	3.5	3.4
Net lending/borrowing	-5.4	-4.0	-3.3	-4.5	-4.1	-3.5	-2.7	-2.4	-2.5
Statistical discrepancy	-0.8	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	4.6	4.0	3.3	4.5	4.1	3.5	2.7	2.4	2.5
Net acquisition of financial assets	1.9	3.9	2.7	1.4	1.4	1.4	1.4	1.4	1.4
Net incurrence of liabilities	6.5	7.9	6.0	5.9	5.4	4.9	4.1	3.8	3.9
Foreign	2.4	3.5	2.2	2.2	2.4	2.2	2.2	1.9	1.9
Domestic	4.1	4.4	3.8	3.7	3.0	2.7	1.9	1.9	1.9
Money and Credit (annual percent change)									
Broad money	18.1	21.8	6.8	10.8	11.8	10.5	10.9	10.9	10.9
Domestic credit	14.6	26.8	17.9	10.5	11.7	11.3	9.9	10.2	10.1
Private sector credit	12.6	26.3	13.3	7.4	10.4	10.4	10.2	10.3	10.4
Saving and Investment (in percent of nominal GDP)									
Gross investment	30.4	35.8	37.3	36.0	36.8	36.6	35.8	35.1	34.1
Gross fixed investment	30.5	29.9	29.4	28.4	29.0	28.8	28.3	27.7	26.9
Private	25.6	24.5	23.9	23.3	23.1	22.9	22.3	21.8	21.0
Central government	4.9	5.4	5.5	5.0	5.9	5.9	5.9	5.9	5.9
Change in Stock	0.0	5.9	7.9	7.6	7.8	7.7	7.6	7.4	7.2
Gross national saving	29.4	27.9	24.4	30.8	31.8	32.1	31.4	30.8	30.0
Private	30.5	27.5	23.7	31.0	31.0	30.7	29.2	28.3	27.6
Central government	-1.1	0.4	0.7	-0.2	0.8	1.4	2.2	2.5	2.5
Balance of Payments									
Current account (in millions of U.S. dollars)	-339	-2,844	-5,175	-2,185	-2,325	-2,235	-2,415	-2,550	-2,626
In percent of GDP	-1.0	-7.8	-12.9	-5.2	-5.0	-4.5	-4.4	-4.3	-4.1
Trade balance (in millions of U.S. dollars)	-9,186	-11,510	-13,759	-12,035	-13,205	-13,839	-14,710	-15,491	-16,286
In percent of GDP	-27.5	-31.7	-34.3	-28.6	-28.6	-27.6	-27.0	-26.2	-25.3
Exports of goods (y/y percent change)	-6.4	30.0	43.9	-14.0	6.6	6.3	7.2	6.9	7.6
Imports of goods (y/y percent change)	-18.2	25.7	21.9	-12.7	9.4	5.0	6.4	5.5	5.4
Workers' remittances (in millions of U.S. dollars)	7,533	8,150	8,325	8,919	9,384	9,846	10,310	10,776	11,263
In percent of GDP	22.5	22.5	20.7	21.2	20.3	19.6	18.9	18.2	17.5
Gross official reserves (in millions of U.S. dollars)	10,559	10,884	8,953	9,090	9,234	9,597	10,155	10,631	11,183
In months of prospective imports	9.0	7.5	7.0	6.5	6.3	6.1	6.1	6.1	6.0
Memorandum Items									
Public debt (in percent of GDP)	43.3	44.0	43.8	47.8	48.8	49.8	50.2	50.0	49.9
Nominal GDP (in billions of U.S. dollars)	33.4	36.3	40.1	42.1	46.2	50.2	54.5	59.2	64.3
Nominal GDP (in billions of Nepalese Rupees)	3,889	4,277	4,852	5,459	6,101	6,779	7,520	8,340	9,252
Net International Reserves (in millions of U.S. dollars)	10,291	10,620	8,821	8,647	8,707	8,995	9,557	10,087	10,702
Primary Deficit (in billions of Nepali Rupees)	183	138	115	176	167	153	115	108	128
Primary Deficit (in percent of GDP)	4.7	3.2	2.4	3.2	2.7	2.3	1.5	1.3	1.4
Tax Revenue (in billions of Nepalese Rupees)	700	870	984	1,002	1,180	1,361	1,599	1,837	2,036
Tax Revenue (In percent of GDP)	18.0	20.3	20.3	18.4	19.3	20.1	21.3	22.0	22.0
Health Expenditure (in percent of GDP)	1.0	1.2	2.3	3.7	3.7	1.7	1.7	1.7	1.7
Social Protection/Assistance (in percent of GDP)	1.7	1.7	3.8	3.7	3.7	2.8	2.8	2.8	2.8
CCRT debt relief (in millions of SDR) 2/	2.9	7.1	3.6	...	...	...	...	...	...
Private sector credit (in percent of GDP)	84.3	96.8	96.6	92.3	91.1	90.6	90.0	89.5	89.0
Exchange rate (NPR/US$; period average)	116.3	117.9	120.8	...	...	...	...	...	...
Real effective exchange rate (average, y/y percent change)	1.9	-2.9	1.6	...	...	...	...	...	...

Sources: Nepali authorities; and IMF staff estimates and projections.

1/ Fiscal year ends in mid-July.

2/ CCRT debt relief is included in grants and net incurrence of liabilities (foreign). The first tranche of CCRT debt relief covering the period April 14, 2020 to October 13, 2020 for SDR 2.9 million in FY 2019/20 was approved on April 13, 2020. The second tranche of CCRT debt relief covering the period October 14, 2020 to April 13, 2021 for SDR 3.6 million was approved on October 2, 2020. The third tranche of CCRT debt relief covering the period April 14, 2021 to October 15, 2021 for SDR 3.6 million was approved on April 1, 2021. The fourth and fifth (final) tranche of CCRT debt service relief covering the period from October 16, 2021 to January 10, 2022 and January 11 to April 13, 2022 was approved on October 6, 2021 and December 15, 2021 respectively for SDR 3.6 million.

Note: Current baseline forecast is as of March 07, 2023.

NEPAL

April 12, 2023

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION, FIRST AND SECOND REVIEWS UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT, REQUESTS FOR WAIVERS OF NONOBSERVANCE OF PERFORMANCE CRITERIA, EXTENSION OF THE ARRANGEMENT, AND REPHASING OF DISBURSEMENTS

EXECUTIVE SUMMARY

Context. Global developments have impacted Nepal's import-dependent economy—particularly through higher commodity prices. The current account weakened and reserves declined in the first half of 2022. Pressure on reserves has subsided since then, thanks in part to monetary policy tightening and cooling domestic demand, but inflation remains elevated. Fiscal policy has been less expansionary than projected, but a recent fall in revenues is adding to near-term fiscal pressures. Non-performing loans are increasing, while capital adequacy ratios remain above regulatory minima. Risks are on the downside.

Program developments. The ECF has helped mitigate the impact of the pandemic and global shocks on economic activity and achieve program objectives of protecting vulnerable groups, preserving macroeconomic and financial stability, and sustaining growth and poverty reduction. While reform progress has been slower than expected, overall program performance has continued in a difficult environment. The first and second review quantitative performance criteria on net international reserves (floor) and the indicative targets on the fiscal deficit (ceiling) were met, and all but one of the structural benchmarks scheduled to be assessed for the first review were either met or implemented with delay. However, no structural benchmarks scheduled to be assessed for the second review were met, though one was implemented with delay. Extension by 10 months, rephasing of the arrangement and adjustments to program conditionality are proposed to allow for more time to complete reforms. The authorities request waivers of nonobservance of the continuous performance criteria on exchange restrictions, multiple currency practices, and import restrictions, which have since been removed.

Article IV discussions. Article IV discussions center around: (i) safeguarding fiscal resilience to deal with short- and medium-term pressures; (ii) implementing monetary and financial sector policies to preserve macroeconomic and financial stability; and (iii) pursuing structural reforms to foster sustainable and inclusive growth and increase resilience to climate change.

Policy recommendations.

- **Fiscal policy**. Policies should focus on promptly addressing near-term fiscal pressures, while supporting the most vulnerable against elevated food and energy prices. Fiscal consolidation is needed to ensure medium-term fiscal sustainability. Maintaining momentum on governance reforms is critical to cementing recent gains in fiscal transparency. Fiscal consolidation and further structural reforms, including to advance fiscal federalism, address fiscal risks and strengthen public investment management, are needed to support medium-term fiscal sustainability.

- **Monetary and financial sector policies**. Monetary policy, supported by macroprudential tools, should take a cautious, data-driven approach to maintaining external stability and addressing elevated inflation. The Nepal Rastra Bank should prioritize the asset quality of banks, including through regulatory initiatives to ensure appropriate classification of loans, and progress towards advancing the financial sector reform agenda should continue. Advancing digitalization can play an important role in improving financial inclusion. Strengthening ongoing efforts to improve the anti-money laundering/combatting the financing of terrorism (AML/CFT) framework and its effectiveness remain crucial.

- **Structural reforms**. An ambitious structural reform agenda can help establish long-run sustainable growth following the pandemic. Reform priorities include lowering the cost of doing business and removing barriers for foreign investment, and improving governance and strengthening anti-corruption institutions. Policies should aim to reduce vulnerability to climate change impacts, including through better-targeted social assistance, investment in climate-resilient infrastructure and boosting agricultural productivity.

Approved By
Anne-Marie Gulde-Wolf (APD) and Maria Gonzalez (SPR)

Discussions took place in Kathmandu during February 15-28, 2023. The staff team comprised J. Turunen (Head), R. Green, J. Spray (all APD), Y. Aydin (MCM) G. Huang (FAD), M. Ivanyna (SPR), T. Daban (Resident Representative for Nepal), S. Dulal and S. Sharma (local office). R. Lim and T. Khatiwada (OED) also participated in some meetings. S. Sanya (APD) contributed to the report and M. Conde-Panesso, A. Goel and F. Li (APD) supported the preparation of the report. The team met with Prime Minister P. Dahal, Deputy Prime Minister and Minister of Finance B. Paudel, Nepal Rastra Bank Governor M. Adhikari, National Planning Commission Vice-Chairman M. Shrestha, other senior government and central bank officials, development partners and representatives of the business community.

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BACKGROUND

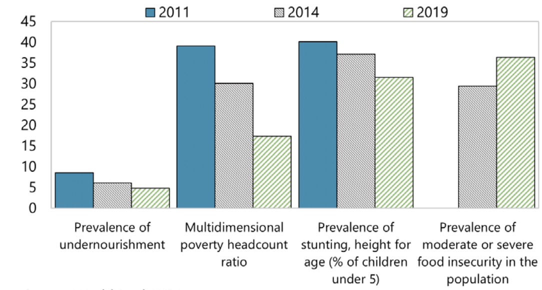
1. **Global developments have impacted Nepal's recovery from the COVID-19 pandemic mainly through higher commodity prices**. The pandemic took a heavy toll on the economy and some sectors, such as tourism, may take longer to fully recover. The health crisis has now receded. However, the increase in global energy and food prices stemming from Russia's war in Ukraine coupled with the strong U.S. dollar has exerted inflationary and balance-of-payments pressures (Annex I). While inflation remains elevated, external sector pressures have subsided, thanks to the authorities' policy response, including monetary policy tightening. Reform progress has been slower than expected owing in part to political uncertainty, including the process leading up to the November 2022 elections and subsequent changes in the government coalition.

2. **The post-pandemic recovery allows renewed focus on poverty reduction, strengthening macroeconomic institutions and addressing vulnerability to climate change**. Nepal is a landlocked low-income country that relies heavily on income from remittances to overcome domestic growth hurdles. Remittances helped reduce poverty dramatically over the last decade, but there remains substantial scope to improve living standards. Climate change is already exacerbating poverty and food inequality, and strengthening institutions is needed to help the population adapt.

Key Medium-Term Challenges

Poverty has fallen, but remains high.

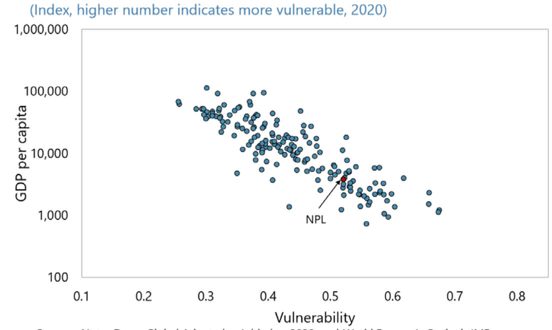
Social Economic Indicators
(Percent of population)



Source: World Bank WDI.
Note: Data for prevalence of moderate or severe food insecurity start from 2015 and are not available in 2011.

Nepal is in the top quartile of climate vulnerability.

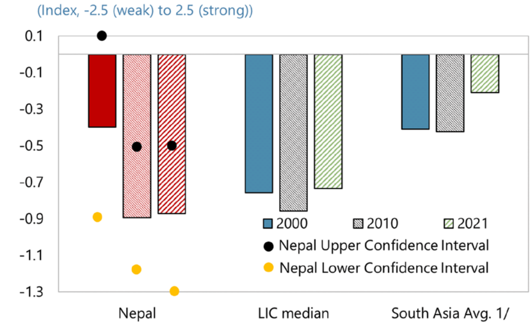
Climate Vulnerability and Gross Domestic Product
(Index, higher number indicates more vulnerable, 2020)



Sources: Notre Dame Global Adaptation Initiative, 2020; and *World Economic Outlook*, IMF.
Note: Vulnerability measures a country's relative exposure, sensitivity, and capacity to adapt to the negative effects of climate change on a scale of 0 to 1 (lower is better).

Government effectiveness is weaker than peers.

Government Effectiveness
(Index, -2.5 (weak) to 2.5 (strong))



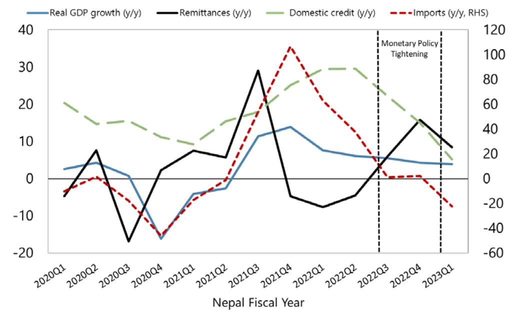
Sources: Worldwide Governance Indicators; and IMF staff calculations.
1/ Includes Pakistan, Bangladesh, India and Sri Lanka.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS AND PROGRAM PERFORMANCE

A. Recent Developments

3. The economy has stabilized, thanks in part to monetary policy tightening, although inflation remains elevated. Real GDP growth is estimated at 5.8 percent in fiscal year (FY) 2021/22 (from July 16, 2021 to July 15, 2022), reflecting a strong post-pandemic rebound in credit growth and domestic demand, a return of tourists, and new hydropower supply coming online. While the direct impact from the war in Ukraine has been relatively modest, higher global commodity prices and strong domestic demand created external and inflationary pressures in FY2021/22. Headline inflation averaged 6.3 percent during the last fiscal year. High frequency indicators for FY2022/23 show that domestic demand has slowed down and credit growth, a leading indicator of output growth, has fallen to single digits as the authorities tightened monetary policy and unwound pandemic-related support measures. Remittances—a key driver of consumption and growth—have been buoyed by high oil prices and a post-pandemic pickup in outward migration. Inflation remains elevated at 7.9 percent in February 2023, down from a peak of 8.6 percent in September 2022.

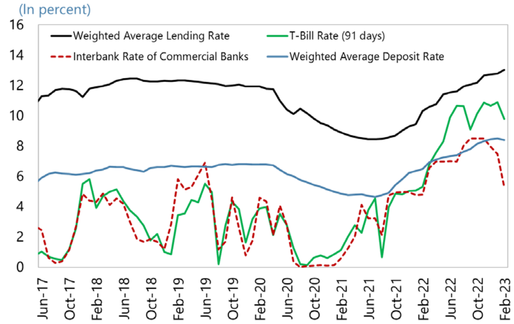
High Frequency Indicators
(Year-on-year growth)



Sources: Nepal authorities; and IMF staff calculations.

4. Monetary policy tightening began in February 2022 amid external pressures and rising inflation. The post-pandemic resumption of economic activity increased demand for credit and banks' appetite for credit risk. This increased demand for central bank liquidity and pushed up the weighted average lending rate. To support external stability (see ¶7) and control inflation, the Nepal Rastra Bank (NRB) raised the interest rate corridor (IRC) in February 2022 and again in July (by 350 bps in total) and increased the cash reserve ratio (CRR) in August, further raising lending rates.[1]

Interest Rates
(In percent)



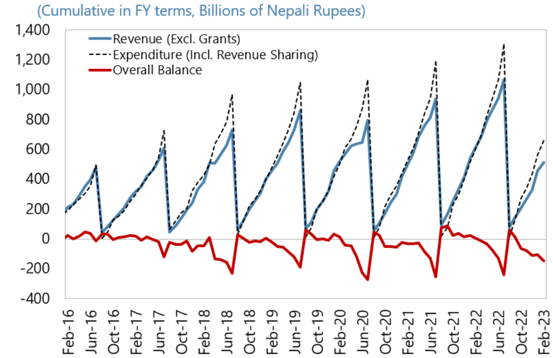
Source: NRB.

[1] In July, the NRB also raised the statutory liquidity ratio (SLR) from 10 to 12 percent for commercial banks effective from January 2023.

5. Macroprudential tools have effectively complemented monetary policy, but non-performing loans (NPL) are increasing. Monetary policy tightening and introduction of a 90 percent cap on the credit-to-deposit (CD) ratio contributed to a decline in credit growth.[2] Bank deposits have increased, aided by remittance inflows, allowing NRB to reduce liquidity provided through the Standing Liquidity Facility (SLF). Pandemic-related support measures such as payment moratoria and forbearance contributed to already low, but owing to long-standing evergreening practices, likely understated, NPL levels. NPLs increased to 2.6 percent as of January 2023, reflecting the slowdown in domestic demand and decline in the repayment capacity of borrowers due to rising lending rates. Further rise in NPLs could raise concerns about capital-adequacy ratios, which are currently above regulatory minimum.

6. Fiscal policy in FY2021/22 was less expansionary than expected, but a fall in revenues this fiscal year is adding to fiscal pressures. While fiscal revenue growth was strong in FY2021/22 (at 14.2 percent y-o-y), expenditures grew by less (9.5 percent), resulting in a fiscal deficit at 3.3 percent of GDP, much smaller than expected. The revenue increases were driven mainly by an overperformance in import-related taxes. On the expenditure side, capital expenditure significantly underperformed with only 57.2 percent of the budgeted amount executed in FY2021/22 as political uncertainty and the third wave of the pandemic affected execution rates. However, revenue collection has significantly slowed thereafter. In the first six months of FY2022/23, revenues declined by 16.5 percent, mostly driven by a slowdown of import-related taxes, which declined by 30.9 percent. At the same time, expenditures increased by 11.2 percent, reflecting an increase in public wages, more goods and service purchases, and surging interest payments.

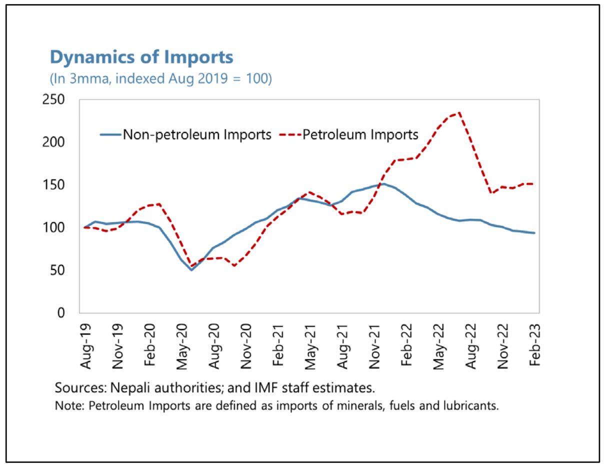
Central Government Finances
(Cumulative in FY terms, Billions of Nepali Rupees)



Sources: Nepali authorities; and IMF staff calculations.

[2] The NRB announced the new CD ratio in August 2022 and, in addition (in July), lowered loan-to-value ratios for real estate loans and overdrafts.

7. The current account weakened substantially in FY2021/22, leading to a loss of reserves, but external sector dynamics have improved since then. Imports surged in FY2021/22 amid strong credit growth and elevated commodity prices. Exports also increased but remain an order of magnitude smaller than imports. Remittance growth was slower, providing less support for the deteriorating trade balance, and resulting in a current account deficit of 12.9 percent of GDP in FY2021/22 and a loss of international reserves. The external position in FY2021/22 was assessed to be substantially weaker than implied by fundamentals and desirable policies (Annex II). The external sector dynamics improved later in the year and in FY2022/23. Both oil and non-oil imports declined. Remittances have picked up and gross reserves have stabilized at around 6.8 months of prospective imports, above the estimated reserve adequacy level.

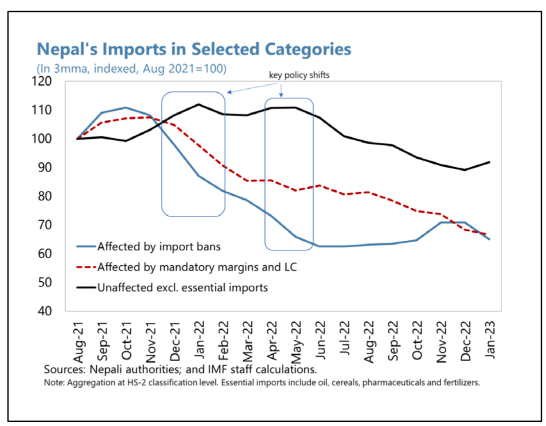


8. The authorities introduced import bans and mandatory use of letters of credit (LCs) and cash margins for a broad set of imports in FY2021/22. While these measures likely slowed down import growth somewhat, they are distortionary and not a sustainable solution to external pressures (Box 1). These measures were gradually eased in the first half of FY2022/23 and the remaining restrictions removed completely in January 2023.

Box 1. Economic Impact of Import Restrictions

To arrest the loss of reserves, the authorities introduced a number of import restrictions between December 2021 and April 2022. These included mandatory use of letters of credit (LC) and cash margins for a broad set of imports, as well as outright import bans for several items, including luxury goods.

Recorded imports affected by the import restrictions slowed in 2022. Evidence from trade data suggests that total imports excluding essential goods slowed after the monetary policy tightening in February and July, but imports in the categories impacted by restrictions slowed more than other imports (text figure).[1] A simple difference-in-difference regression controlling for category-specific trends suggest that the bans reduced imports by about 22 percent, and the mandatory LC and margins by about 11 percent since these restrictions were first enacted.



Import restrictions cannot be a sustainable solution to balance of payments pressures. The restrictions affect a relatively small share of goods imports. The banned import items comprise at most 5 percent of total imports, and imports affected by the mandatory LC and margins about 23 percent of total imports. Overall, the difference-in-difference regressions suggest that the restrictions reduced imports by about USD 80 million per month.[2] This is not enough to arrest the

Box 1. Economic Impact of Import Restrictions (concluded)

FY2021/22 loss of international reserves, which amounted to USD 220 million per month in the first half of the year. Enforcing the restrictions is also likely to get harder over time as the restricted items, such as vehicles or smartphones, become scarcer in the economy. Likewise, the effectiveness of the mandatory LC and margins may be undermined by under-invoicing as importers are incentivized to use informal payments mechanisms. The import restrictions also do not address the fundamental drivers of the external pressures: global commodity prices that are expected to remain elevated throughout 2023, and booming domestic demand. Overall, research from other countries confirms that trade barriers have no discernible effect on trade balances over the medium term.[3]

Trade barriers have adverse macroeconomic implications, lead to lower government revenue and provide opportunities for rent-seeking. Larger trade barriers are associated with persistent declines in domestic output and productivity, increasing resource misallocation, uncertainty, and the cost of production for businesses.[4] In Nepal, import restrictions also erode an important source of government revenue. While vehicles represent a small share of imports, they yield more than one third of custom duty revenues. As a result, while overall customs revenue remained buoyant in FY2021/22, they fell 51 percent short of the Department of Customs target in the first six months of FY2022/23. The restrictions also add to inflation and create opportunities for misreporting and rent-seeking, contributing to corruption and social distrust.

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1 At the HS-2 imports classification level, for reasons of data availability, whereas some restrictions are more granular (HS-6).

2 Likely an upper boundary as the restrictions were introduced at about the same time as the monetary policy tightening, and some restricted imports, e.g. durable consumption items such as vehicles, are more likely to be purchased on credit, and so are more responsive to higher lending rates than other imports.

3 Furceri D. et al. 2022. "The Macroeconomy After Tariffs". The World Bank Economic Review 36(2).

4 Estefania-Flores J. et al. 2022. "Measurement of Aggregate Trade Restrictions and their Economic Effects". IMF Working Paper WP/22/1.

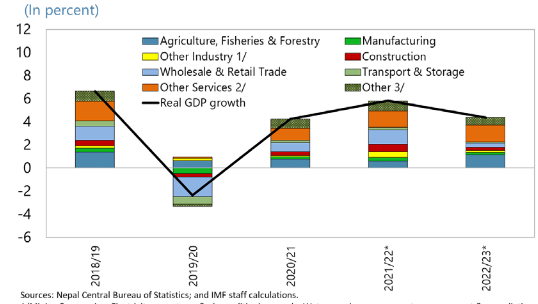
B. Outlook and Risks

9. Growth is projected to moderate in FY2022/23, but the medium-term outlook remains broadly favorable.

- *Growth and inflation*. Real GDP growth is forecast to moderate to 4.4 percent in FY2022/23 before increasing to 5.1 percent in FY2023/24 as headwinds from global commodity prices dissipate, creating space for gradual domestic policy normalization. Tighter monetary policy, lower global oil and food prices, moderating Indian inflation and slowing domestic demand is expected to pull Nepal inflation down to 7.1 percent, close to the NRB target of 7 percent, by the end of FY2022/23. In the medium-term, public infrastructure and development spending, hydropower projects and the ongoing recovery in tourism are projected to generate growth close to potential (estimated at just above 5 percent).

Contribution to Real GDP Growth by Sector

(In percent)



Sources: Nepal Central Bureau of Statistics; and IMF staff calculations.
1/Mining & quarrying; Electricity, gas, steam & air conditioning supply; Water supply, sewage, waste management & remediation activities. 2/Accommodation & food service activities; Information & communication; Financial & Insurance Activities; Real Estate activities; Professional, scientific & technical activities; Administrative & support service activities; Public administration & defence, compulsory social security; Education; Human health & Social work activities; Arts, entertainment and recreation; Other service activities. 3/ Includes taxes, subsidies and statistical discrepancy.
*IMF staff estimates.

- *Fiscal.* The overall fiscal deficit is expected to reach 4.5 percent of GDP in FY2022/23. Revenue collection has been disappointing, owing largely to lower import-related taxes, and interest payments are surging driven by higher interest rates on short-term domestic borrowing (with treasury bills accounting for one third of domestic debt). Nonetheless, lower capital spending and substantial expenditure rationalization announced in the mid-year budget review is expected to help contain the deficit.

- *External*. The current account deficit is expected to narrow to 5.2 percent of GDP in FY2022/23 due to weaker import demand, lower commodity prices, and buoyant remittances reflecting a post-pandemic increase in outward migration. Tourism is projected to recover, but is more than counterbalanced by an increase in students leaving to study overseas. Reserve coverage is expected to remain above estimated adequacy levels through the medium term.

10. The Debt Sustainability Analysis shows that both external and overall debt remain at low risk of debt distress. Despite a challenging global environment, developments since the ECF request had limited effect on public debt dynamics, as the increase in the current account deficit in FY2021/22 has been absorbed by a drawdown in reserves rather than accumulation of external debt. Public debt is projected to stabilize (at about 50 percent of GDP) in the medium term, and present values of both the public debt-to-GDP and external debt-to-GDP ratios are projected to remain below their indicative thresholds. The results are nevertheless sensitive to growth, exports, and natural disaster shocks, underscoring the importance of reforms to diversify Nepal's economy and increase its resilience. The sustainability of public debt is also contingent upon prudent execution of the medium-term fiscal consolidation strategy, and continued utilization of external borrowing at concessional terms as envisaged in the Medium-Term Debt Management Strategy.

11. The outlook remains uncertain and subject to downside risks (Annex III).

- **External risks**. High and volatile commodity prices, including from a protracted war in Ukraine, could slow down the recovery in energy-intensive sectors, aggravate food insecurity, and impose high fiscal costs. At the same time, Nepal's limited direct trade and financial linkages with Russia, Ukraine and global financial markets could buffer against spillovers. A global growth slowdown, especially in India or the Gulf Cooperation Council (GCC) countries, could weigh on remittances, trade and growth. On the upside, a decline in global commodity prices would have a large impact, relieving fiscal, external and inflationary pressures.

- **Domestic risks**. Slow public expenditure execution for growth enhancing capital projects could weigh on economic activity. Nepal remains vulnerable to natural disasters and climate shocks. Further, macro-financial risks—likely to have accumulated during the pandemic- related monetary accommodation, rapid credit growth and regulatory forbearance—could materialize in response to tightening in financial conditions or slowdown in remittances. Finally, social and political instability could weigh on the economic outlook.

12. The authorities largely shared staff's economic outlook and risk assessment. The authorities agreed that growth will slow down in FY2022/23 but expect growth to recover next year and over the medium-term. The government's macro forecast does not differ substantially from staff projections, though the Ministry of Finance expects that a stronger rebound in revenue will result in a somewhat lower fiscal deficit in FY2022/23. The authorities considered that domestic risks are most salient, as they aim to avoid financial sector stress and a further slowdown in economic activity.

C. Program Performance

13. Program implementation has been mixed, given a difficult environment. The ECF has helped mitigate the impact of the pandemic and global shocks on economic activity and achieve program objectives of protecting vulnerable groups, preserving macroeconomic and financial stability, and sustaining growth and poverty reduction.

- **Performance criteria (PCs), indicative targets (ITs)**: The first review PC on net international reserves (floor) and the IT on the fiscal deficit (ceiling) based on the January 14, 2022 test date were met comfortably (Table 8). Three of the standard continuous PCs—on imposition of import restrictions, exchange restrictions, and multiple currency practices (MCPs)—were not observed.[3] The second review net international reserves PC based on the July 14, 2022 test date, as planned at program approval, was met, albeit with support from the import restrictions that violated the continuous PCs. The ITs for the test date were also met. The continuous PC on external payments arrears was met.

- **Structural benchmarks (SBs)**: The authorities made progress towards implementing structural conditionality for the first review with one prior action and two SBs met and four SBs implemented with delay. This includes commissioning the external audit of the NRB in September 2022. The SB on the Financial Comptroller General Office's (FCGO) consolidation of operational funds was not ready for inclusion in the FY2020/21 annual financial statements published in May 2022, so it will be reset for completion by end-August 2023. None of the second review SBs with October 2022 test dates, as planned at program approval, were met, though the Poverty Reduction and Growth Strategy paper was issued with delay.

[3] The PC on non-imposition or non-intensification of import restrictions for BOP reasons was breached by the import restrictions imposed by the authorities. The mandatory use of LCs and cash margins for a broad set of importers resulted in non-observance of the continuous PCs on exchange restrictions and MCPs. The condition that the LC was the sole means of payment for imports constituted a direct limitation on current payments, and as a result the LC requirement is considered an exchange restriction. Additionally, the unremunerated nature of the cash margin requirement is considered as part of the effective exchange rate and thus gives rise to an MCP.

TOWARDS A MORE RESILIENT, INCLUSIVE, AND GREENER ECONOMY

After waves of external shocks, the Article IV discussions center around three main longer-term themes: (i) safeguarding fiscal resilience to deal with short- and medium-term pressures; (ii) developing monetary policy and financial sector practices that will preserve macroeconomic and financial stability; and (iii) pursuing reforms that foster sustainable and inclusive growth and increase resilience to climate change. Some topics cut across multiple themes. Efforts to improve governance and reduce corruption vulnerabilities—key to inclusive growth—cuts across fiscal (e.g. procurement) and monetary/financial (e.g. NRB governance) policies. Likewise, improving public investment management can expedite efforts to build climate change resilience.

14. Nepal's significant capacity developments (CD) needs frame the policy discussions (Box 2). Since the start of the program, extensive technical assistance (TA) has been provided—along with development partners—to support the program objectives and reforms in multiple areas, such as tax policy, fiscal transparency, central bank governance, monetary policy implementation, financial regulation/supervision and strengthening statistics.

Box 2. Capacity Development

Approval of the ECF-supported program has catalyzed extensive Fund CD support. A large CD agenda has facilitated achieving program objectives. TA activities have ramped up significantly since January 2022, under different modalities. IMF departments (FAD, MCM, FIN and LEG) conducted 6 TA missions, and provided desk reviews on multiple issues. SARTTAC, based in New Delhi, India, conducted 4 TA missions in the areas of monetary policy, statistics, and fiscal risks.

The CD agenda supports the ECF objectives by accelerating reform progress in key areas. (Table 1) TA on tax policy, tax and customs administration helps support the fiscal structural reform agenda on revenue mobilization and public financial management reforms. Fiscal transparency and measures to enhance governance and combat corruption are aided by TA on aligning fiscal reporting with GFS standards and strengthening the central bank's governance. These projects help sustain growth and poverty reduction over the medium-term. TA on asset classification and the LOLR facility bolsters the strategy to strengthen financial sector regulation and supervision, while the FSSR is expected to provide a roadmap for financial sector TA looking forward.

Other development partners have also provided support, in coordination with the Fund. Coordination and discussion on TA needs was strengthened through thematic working groups, with participation by the IMF Resident Representative. On the financial sector, the UK Foreign, Commonwealth and Development Office (FCDO) has supported development of the SIS, critical to enhancing supervisory framework. The World Bank and IMF support amendments to the asset classification regulation. The World Bank also provides TA on related-party lending and consolidated supervision. The World Bank also provided TA on VAT exemptions and financed the TADAT mission together with the Fund and ADB. Germany's Gesellschaft für Internationale Zusammenarbeit (GIZ) promotes digitalization of the tax system. The ADB supports PFM reforms (i.e., debt management, SOE restructuring, among others) and trade facilitation.

Box 2. Capacity Development (concluded)

Fund CD continues to support reforms guided by the ownership and preferences of the authorities. In the near term, CD will include workshop on NRB risk management with NRB Board Members on identification of risks and design of mitigation strategies, and SARTTAC TA on a cash flow monitoring and forecasting framework and a full-fledged Medium-Term Fiscal Framework. The FSSR CD roadmap will result in additional financial sector TA. The authorities have also expressed interest in receiving TA on areas that are not directly related to the ECF-supported program, including the adoption of a CBDC. The authorities have expressed significant appreciation for Fund CD support. However, the timing and sequencing of TA activities should fully account for absorptive capacity and ensure appropriate follow up to maintain reform momentum.

CD in Support of Program Objectives and Conditionality

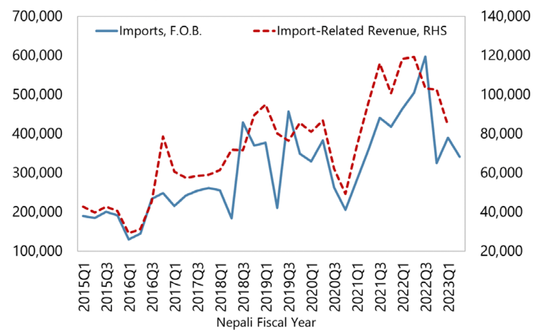
Priority TA Area	Main Activities Done/Planned	Objective/Conditionality
Tax and Customs Administration and Revenue Mobilization	FAD mission on tax systems and administration, tax exemptions and a mobilization plan **(August-September 2022)**; TADAT mission assessed tax administration **(December 2022)**.	Fiscal Structural Reforms and Revenue Mobilization
Strengthening Fiscal Risks Management and Fiscal Framework	FAD/SARTTAC mission on fiscal risk register development **(April 2022)** followed by SARTTAC mission for MOF officials' capacity building **(September 2022)**; SARTTAC training on the design of a full-fledged Medium-Term Fiscal Framework **(February 2023)**.	Fiscal Sustainability and Fiscal Risks Management
Public Debt and Cash Management	Forthcoming SARTTAC mission on development of a cashflow forecasting and monitoring framework to be shared with PDMO and NRB on a regular basis.	Fiscal Sustainability and Public Financial Management
Expenditure Quality and Climate Resilience	FAD mission conducted a PIMA Climate Change Module, a basis for the action plan on public investment efficiency **(March-April 2021)**.	Public Financial Management Reforms Equitable and Sustainable Growth
Improve Governance and Fiscal Transparency	SARTTAC mission on adoption of GFS 2014 standards, including consolidation of operational extra-budgetary funds into annual financial statements **(July 2022)**.	Enhance Fiscal Transparency and Governance and Reduce Vulnerability to Corruption
Strengthening NRB Governance	LEG mission on amending the NRB Act **(July 2022)**; FIN desk review for the Auditor General Office on conducting the NRB audit through international auditors **(July, October 2022)**.	Enhance Governance and Reduce Vulnerability to Corruption
Strengthening financial sector regulation and supervision	MCM desk review of the draft amendments to asset classification regulation and the LOLR facility **(May and November 2022)**; FSSR mission on banking regulation and supervision, payment systems, stress-testing, financial inclusion, and crisis management **(November 2022)**; MCM workshop with NRB Board members on identification of risks and design of mitigation strategies **(April 2023)**.	Financial Sector Regulation and Supervision

A. Safeguarding Fiscal Resilience

Near-Term

15. The government is addressing near-term fiscal pressures through expenditure rationalization. The announced deficit target in the FY2022/23 budget is aligned with program objectives. However, given the significant portion of import-related taxes in revenues (45.9 percent in the FY2022/23 budget), the decline in imports has reduced revenue collection and led to near-term fiscal pressures.[4] At the same time, implementation of capital projects remains slow (14.1 percent of the annual target in the first six months of FY2022/23) and is expected to result in significant under-execution for the year as a whole. In response to near-term pressures and to maintain fiscal discipline in line with program objectives, the government has announced, in the February 2023 mid-year budget review, expenditure rationalization to reduce administrative and non-essential recurrent spending (estimated at about 1.4 percent of GDP); lower fiscal transfers to subnational governments that are slow to execute (about 1.6 percent of GDP); and set aside capital expenditures which lack sufficient preparation and are unable to be spent (about 1.2 percent of GDP).

Imports and Import-Related Revenue
(In millions of Nepali Rupees)



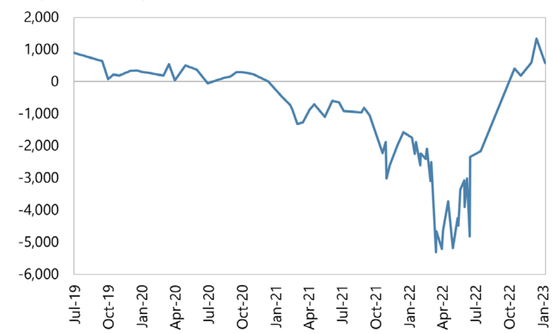
Sources: Nepali authorities; and IMF staff estimates.

16. Policies should focus on prudent formulation of the FY2023/24 budget, while protecting high-quality infrastructure and social spending. A revenue advisory committee has been established to advise the government on tax reforms. Clearing tax arrears can help partly offset revenue shortfalls in the near term. Furthermore, the development of a comprehensive revenue mobilization plan should be advanced to guide subsequent steps and identify tax reforms (see ¶18). In the FY2023/24 budget, building on efforts in the mid-year budget review, the federal government should accelerate its efforts to reduce expenditures that are duplicated with subnational governments, which will likely reduce budgeted grants and subsidies, spending on goods and services and the wage bill. The remaining COVID-19 relief measures (mainly tax rebates to small taxpayers and business severely impacted by pandemic) should be removed in the FY2023/24 budget. High quality infrastructure and social spending should be protected to support economic growth and enhance social inclusion. Seeking more concessional financing and enhancing debt management will help reduce financing risks.

[4] The changes in personal income tax schedule in the FY2022/23 budget (not envisaged in the original program) have reduced the average tax rate for most taxpayers, adding to pressure on revenue collection. Other revenue-enhancing measures announced in the FY2022/23 budget are not expected to offset the decline in import related taxes. On the spending side, the government also increased public sector wages by 15 percent in the FY2022/23 budget.

17. Supporting the most vulnerable against elevated food and energy prices remains a near-term priority. In the context of the international food price shock, measures were announced in the FY2022/23 budget to increase agriculture production, including establishing a fund to provide agriculture credit to farmers and increasing fertilizer subsidies (to 0.7 percent of GDP). In response to the increase in global oil prices, the government limited price passthrough, resulting in large Nepal Oil Corporation (NOC) losses (estimated at 1 percent of GDP), and provided NOC a loan (0.15 percent of GDP). Recently NOC has started to make profits again as international fuel prices have come down faster than domestic sale prices. The social safety net can be strengthened through better-targeted, temporary and transparent measures, with priority given to cushioning households from the adverse effects of elevated food and energy prices.

Nepal Oil Corporation Fifteen Days Profits/Losses
(In NPR Millions)



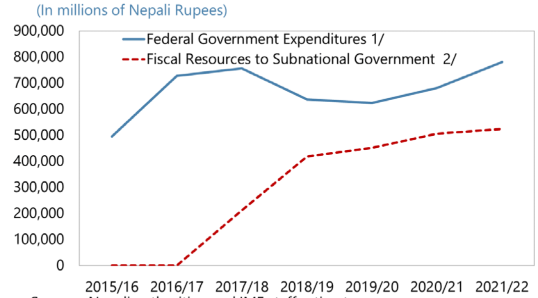
Source: Nepal Oil Corporation website.

18. The authorities have continued to make progress on fiscal transparency. The authorities published their fourth COVID-19 Active Response and Expenditure (CARES) report (end-April 2022 SB, met).[5] The authorities have also begun collecting and publishing beneficial ownership information for COVID-19-related health procurement (first review prior action, met).[6] Maintaining momentum on governance reforms will be critical to cementing recent gains. The full use of the electronic government procurement system would ensure real-time monitoring of contractual commitments, time and cost overruns, and better control of the contracting process. Regular publication of procurement reports online would further enhance transparency.

Medium-Term

19. Fiscal consolidation is needed to ensure medium-term fiscal sustainability. While public debt is still assessed at low risk of distress, debt has increased rapidly in recent years, largely due to an expansionary fiscal stance since the transition to fiscal federalism coupled with the 2015 earthquake and pandemic shocks. A significant portion of fiscal resources and responsibility have been transferred to subnational governments. However, federal government expenditures have not come down sufficiently to fully offset the transfer. Reducing federal government deficits to around the

Fiscal Federalism
(In millions of Nepali Rupees)



Sources: Nepali authorities; and IMF staff estimates.
1/ Federal government expenditures are calculated as the redisual by substracting fiscal transfers and revenue sharing from total expenditure.
2/ includes fiscal transfers and revenue sharing.

[5] https://www.mof.gov.np/site/publication-category/65

[6] https://dohs.gov.np/letter-of-intention-to-award/

pre-fiscal federalism level will help put public debt on a medium-term downward trajectory and is critical to ensuring fiscal resilience. Based on Fund TA, estimates suggest that full implementation of the revenue mobilization effort could raise an additional 3.7-4.1 percentage points of GDP of revenue over the next five years. This reform should be guided by a comprehensive revenue mobilization strategy with an appropriate balance of tax policy, law, and revenue administration reforms (end-April 2024 SB).[7] Staff currently projects a conservative 1.7 percentage point of GDP tax revenue increase over the next five years, assuming gradual implementation of reforms on value added tax, personal and corporate income taxes, and excises.

Impact of Tax Reforms (percent of GDP)

Personal income tax: Broadening tax base and enhancing income tax progressivity	**0.8**
Corporate income tax: removing tax holidays; curtailing tax incentives; introducing a minimum alternative tax to place a floor under CIT; reducing tax rates; allowing full expensing for capital expenditure and indefinite carry forward of losses	**0.5 ~ 0.85**
Value added tax: Broadening tax base; adopting a single, high compulsory registration threshold; removing the exemption on capital inputs, while keeping a single positive rate	**1.7**
Trade tax: Reducing highest tariff rates and removing those excises that are de facto tariffs	**-0.8**
Excise tax: Simplifying the excise regime by limiting excise to tobacco, alcohol, sugar, and single use plastics while introducing excises on fuels, vehicles, coal, and cement approximating their external costs	**1.0**
Property tax: Increasing property tax rates and periodically revising threshold exemptions	**0.5**
Total	**3.7 ~ 4.05**

20. Further actions are needed to continue progress on the structural fiscal reform agenda. The authorities have received Fund TA on strengthening fiscal risk management and revenue mobilization, which underpin the program's structural reform agenda. To capture major fiscal risk of the central government, the Ministry of Finance (MoF) is currently preparing to implement a fiscal risk registry (end-October 2022 SB, reset to end-August 2023). The Inland Revenue Department has also estimated non-customs tax exemptions which can be published later (end-October 2022 SB, reset to end-August 2023). MoF will publish a comprehensive report on tax expenditures (end-April 2024 SB) and has established a working group to develop cash flow forecasting (end-October 2022 SB, reset to end-September 2023).

21. The fiscal federalism framework needs to be strengthened. The fiscal reporting of subnational governments has improved. All provincial and local governments have now implemented their financial management information systems, which represents a step forward towards expanding fiscal data to cover the general government. Due to capacity constraints subnational governments have been underspending their budgets, resulting in a cash balance of 2.8 percent GDP by the end of FY2021/22. Nevertheless, the Public Debt Management Act approved in 2022 has laid out provisions for subnational government borrowings, which require federal government's approval. The establishment of a fiscal risk monitoring system for subnational governments (end-April 2024 SB) will support federal government decision making in this regard and improve identification and management of emerging risks.

[7] IMF technical assistance report, 2022, Developing a Revenue Mobilization Strategy.

22. Some public enterprises (PEs) have been negatively impacted by the pandemic as well as global commodity price shocks. NOC incurred large, but temporary, losses, while the pandemic-related travel restrictions negatively impacted the already-struggling Nepal Airline Corporation (NAC). While the profits of the largest PE, Nepal Electricity Authority (NEA), reached a record high in FY2021/22 due to increased electricity sales and generation, its unfunded liabilities (mainly pension fund liabilities) increased (Selected issues paper: Public Enterprises and Fiscal Risks). This has resulted in fiscal costs (e.g. mainly through increased subsidies, reduced taxes and dividends as well as erosion of government equity holdings) and increased fiscal risks (e.g. additional risk exposure through loans and loan guarantees). PEs' selling prices should be gradually adjusted to reflect their full costs, and any policy-driven price reductions should be compensated transparently through the budget. For NOC, the automatic fuel price adjusting mechanism should be revised to accommodate large scale commodity price shocks and to avoid the emergence of protracted and elevated cost-recovery gaps. These reforms should be accompanied by improvements in the social safety net to protect vulnerable groups. The financial oversight and governance frameworks should be strengthened to limit fiscal risks, and to enhance operational autonomy, efficiency, and transparency. Having the four priority nonfinancial PEs (NEA, NOC, NAC, and Nepal Telecom's) FY2022/23 financial statements audited (end-April 2024 SB) and all PEs' annual financial statements published (end-April 2024 SB) will support achieving these reform objectives. [8]

23. Public Investment management needs to be strengthened to enhance capital expenditure efficiency and climate resilience. The 2021 public investment management assessment (PIMA) found that Nepal scores lower than peers in terms of the perceived quality of infrastructure. Estimates suggest that with the same capital spending, infrastructure outcomes could be almost twice as high if investment efficiency was enhanced. The FY2022/23 budget announced several measures to expedite project implementation. However, in addition to slow project implementation, issues stem also from lack of adequate planning and effective resource allocation. A more comprehensive reform action plan should be developed to ensure that the underlying weakness are addressed (end-October 2022 SBs, reset to end-April 2024). Furthermore, the public investment management process should further integrate climate considerations to support building climate change resilience.

24. The authorities agreed with the need to address near-term fiscal pressures and to implement medium-term fiscal consolidation. They acknowledged on-going revenue pressures and viewed stronger revenue mobilization as important to funding priority spending and ensuring debt sustainability. The government aims to address near-term fiscal pressures by rationalizing administrative expenditures while protecting social spending and prioritizing capital spending for projects that are critical for growth. The authorities expressed concerns about the high interest burden of domestic debt and plan to access more external concessional financing. They agreed that

[8] All PEs covered in the Annual Status Review of Public Enterprises 2022, except those PEs not in operation.

it is important to closely monitor fiscal risks from PEs and have identified six high priority PEs to be included in the fiscal risk register. They requested IMF technical assistance to support their reforms.

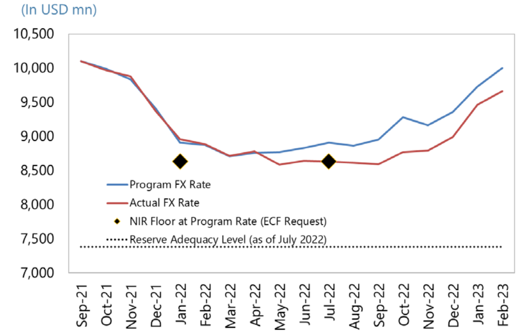
B. Preserving Macroeconomic and Financial Stability

Near-Term

25. Monetary policy, supported by macroprudential tools, should take a cautious, data-driven approach to maintaining external stability and addressing elevated inflation. Headline inflation is expected to decline towards the NRB's target of 7 percent by year end, domestic credit growth to the private sector to stabilize at 7.4 percent in FY2022/23, and pressure on reserves to subside further. Nonetheless, inflation remains elevated. A cautious and data-driven monetary policy stance, supported by macroprudential measures, can help avoid large boom-bust credit cycles, which can create financial sector instability and are not supportive of sustainable growth. The NRB plans to implement the Basel III liquidity coverage ratio to help strengthen banks' liquidity risk management. A countercyclical capital buffer (CCyB) originally intended to be introduced in 2019 is now slated to take effect in July 2023 (starting at the default level of zero). Going forward, gradually phasing in the CCyB can help moderate credit cycles where necessary and discourage excessive risk taking.

26. Net international reserves have stabilized and remain adequate. The tightening monetary policy stance helped moderate domestic demand, eased pressure on reserves and supported the exchange rate peg. A cautious and data-driven monetary policy stance alongside ECF financing and budget support by development partners should continue to help replenish foreign exchange reserves going forward without the need to resort to distortionary trade restrictions.

Net International Reserves
(In USD mn)



Sources: NRB; and IMF staff calculations.

27. The NRB should prioritize the asset quality of banks, ensuring appropriate reclassification of loans and discouraging evergreening practices. Prudent monitoring of the impact of unwinding pandemic-related support measures and deterioration in repayment capacity of borrowers on asset quality is critical. The NRB should ensure banks vigorously differentiate viable borrowers with temporary liquidity shortages from nonviable ones. This will help the NRB to get a better overview of the health of the loan portfolio of Class A banks prior to launching loan portfolio reviews of the ten largest banks assisted by independent international auditors (end-April 2024 SB). Streamlining the prompt corrective action framework with a clear escalation process across various states of distress and early interventions can help avoid any delays in addressing possible weaknesses. The authorities need to assess the impact of directed lending on the business models of banks and on financial stability, closely monitor loan quality and consider gradually reducing them as needed. Furthermore, given the concerns about the ability of the Deposit Credit and

Guarantee Fund to meet future bank claims on guaranteed loans, the authorities should effectively redesign the credit guarantee mechanism, enhance governance and increase funding through guarantee fees (Selected issues paper: Public Enterprises and Fiscal Risks).

28. Efforts to ensure asset quality in the banking system require support by regulatory initiatives. The NRB drafted amendments to asset classification regulations to improve definitions and clarify concepts (end-April 2022 SB, implemented with delay) and is expected to publish the asset classification regulation, in line with IMF recommendations (end-October 2022 SB, reset to end-August 2023). The delay in introducing the asset classification regulation entails tradeoffs, including a deferred assessment of the full health of the banking system. In order to mitigate risks, the NRB should implement a strong supervisory framework to ensure robust lending standards to avoid buildup of vulnerabilities, combined with timely deployment of crisis management tools. The NRB also issued working capital loan guidelines effective from October 2022 and amendments to the guidelines in January 2023.[9] The NRB should ensure that implementation of the new working capital guidelines is fully in line with the amended asset classification regulations.

29. Significant progress has been made towards advancing the financial sector reform strategy. In addition to the amendments to asset classification regulations, the NRB approved the Supervisory Information System (SIS) action plan in December 2022 (end-April 2022 SB, implemented with delay). The implementation of the SIS components is progressing at different paces, with implementation among class A banks—strengthened to include class B, and C banks—for supervisory follow up, regulatory reporting and publication of financial data purposes expected by August (end-Oct 2022 SB, reset to end-August 2023), and the onsite module for Class A banks expected by April 2024 (end-October SB, reset to end-April 2024). The recent Financial Sector Stability Review (FSSR) report has identified several areas where further reforms are needed, with support from IMF CD.

30. While progress has been made, most of the 2021 safeguards assessment recommendations remain outstanding. Progress on most safeguards assessment recommendations related to internal audit and controls in key operations has been limited.[10] The NRB has been strengthening its financial reporting practices. The contract to commission the external audit of the NRB was signed in September 2022 (end-April 2022 SB, implemented with delay), therefore outsourcing the FY2021/22 audit to international auditors with experience in applying International Standards on Auditing. As envisaged, this was later finalized by the Office of the Auditor General in November 2022. Going forward it will be important for the NRB to have its annual financial statements independently audited by external auditors in accordance with international standards on auditing (MEFP ¶30). Amendments to the NRB Act were drafted, in consultation with the Fund, to modernize the NRB Act and strengthen its autonomy and governance practices in line with SGA recommendations in July 2022. The amendments are undergoing internal

[9] The purpose of the guidelines is to ensure the transparency and proper utilization of working capital loans.

[10] 4 out of 16 recommendations have been fully implemented and the others are in progress.

review and, following review by Fund staff, should be submitted to the Parliament (end-October 2022 SB, reset to end-August 2023).

Medium-Term

31. The evolving array of instruments used to implement monetary policy requires refinement. (Box 3) The IRC consists of a 150-basis point band bounded by liquidity facility rates, plus another 50-basis point band bounded by repo/reverse repo auction triggers. In addition to the IRC, the NRB actively adjusts foreign exchange intervention, the CRR and Statutory Liquidity Ratio, limits on lending to deposit interest rate spreads and base rate premia, and parameters for use of refinance and a lender-of-last-resort (LOLR) framework, though not all are binding. Frequent use of regulatory and administrative measures also impacts overall monetary conditions. The NRB continues to refine its instruments, including efforts to reduce reliance on the SLF as a source of liquidity to meet banks' demands. Greater reliance on open market operations to balance liquidity conditions has improved the NRB's ability to steer the interbank rate towards the midpoint of the band. Less active use of instruments other than the IRC would further improve the clarity and effectiveness of monetary policy. This will help reduce the volatility of short-term interest rates, encourage interbank market development and facilitate commercial banks' liquidity management practices.

Box 3. Monetary Policy Implementation

NRB is operating in a complex environment. The NRB operates in a context of a peg to the Indian rupee; a largely closed financial account; constraints on capacity and operational independence; and multiple instruments to support multiple objectives. The economic policy response to recent global shocks has relied heavily on monetary measures, creating challenges implementing the IRC and strong monetary and credit cycles.

Monetary policy targeting of both quantities (money and credit) and prices (interest rates) has produced volatile domestic interest rates. The IRC framework is formally the main tool of monetary policy. However, monetary policy aims at several objectives including external, price and financial stability; sectoral credit allocation; and foreign exchange reserves, credit and broad money growth targets, amongst others.[1] Pursuing multiple targets with multiple instruments and incomplete implementation of the IRC contributes to a misalignment of (short-term) interbank market interest rates with the announced policy rate. For instance, during the pandemic in 2020 substantial prudential loosening compounded reductions in policy rates, leading to excess liquidity in the financial system and interbank rates falling below the floor of the IRC. Starting in 2021, resumption of economic activity helped to drain excess liquidity from the system. Interbank rates spiked in the absence of active liquidity provision through open market operations, and have since been pinned at the SLF rate as borrowings under the SLF increased.

The NRB has reiterated its commitment to the IRC framework in line with recent IMF recommendations. The NRB has begun implementing Fund TA recommendations on monetary policy implementation. Specifically, the NRB is strengthening its technical capacity in high-frequency forecasting of liquidity needs and key macroeconomic indicators to help set the policy rate consistently with its objectives of price stability and maintaining the peg. Second, the NRB has begun taking a more active liquidity management framework, using repo auctions to steer the interbank rate closer to the policy interest rate under both a liquidity surplus and deficit. Further, the amendment of the NRB Act will enhance the autonomy of the NRB in making monetary policy decisions and streamline its objectives.

Box 3. Monetary Policy Implementation (concluded)

To improve interest rate transmission, the NRB should reduce the frequency of regulatory and administrative adjustments. The effect on credit conditions of adjusting regulations on interest rate levels, spreads, and directives to channel credit to select sectors can be inconsistent with the direction of monetary policy. Active use of instruments other than the IRC can effectively undo "headline" monetary policy decisions via other measures. These measures can lead to mixed signals about the monetary policy stance and impede monetary policy transmission, ultimately necessitating larger interest rate changes.

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[1] The NRB publishes its annual monetary policy statement and periodic reviews within the fiscal year, e.g. NRB 2022, "Monetary Policy for 2022/23". https://www.nrb.org.np/contents/uploads/2022/08/Monetary-policy-in-English-2022_23-Full-text.pdf.

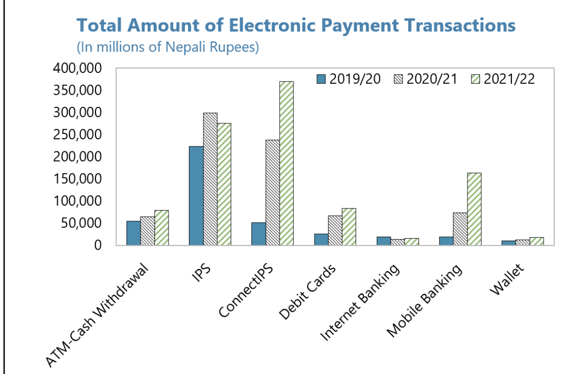
32. **Advancing digitalization can play an important role in enhancing financial inclusion and modernizing the financial system**. Access to financial services has more than doubled to 54 percent over the past ten years, reflecting the efforts of the NRB and financial service providers to reach the unbanked population. The role of microfinance institutions (MFIs) and credit cooperatives as financial service providers is increasing, calling for closer monitoring of risks, including through linkages to banks and other financial institutions. Payment system modernization has gained momentum, reflecting the Payments and Settlement Act and the implementation of real time gross settlement system, but more needs to be done (text table). The NRB also issued a concept paper on Central Bank Digital Currency (CBDC) for public consultation in August 2022. NRB's key policy goals for a CBDC are better access to payments, increasing payment system resilience and reducing cash handling costs. The potential financial stability implications require prudent consideration and measures to safeguard financial integrity.

Next Steps on Financial Inclusion and Payments Systems

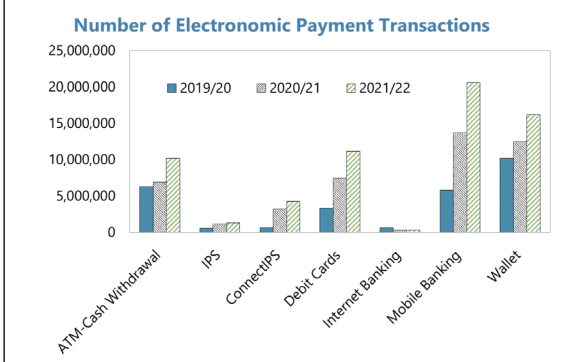
Enhancing financial inclusion	*Modernizing payment systems*
• Improving data collection efforts, including availability of comprehensive credit information, and moving towards a more market-driven approach to inclusive financial services	• Strengthening prudential supervision, oversight and user protection of e-money and emerging payments
• Establishing a prudent oversight framework for large Savings and Credit Cooperatives and MFIs	• Improving the cybersecurity and operational resilience of key payments systems
• Implementing a comprehensive financial consumer protection regime	• Enhancing the RTGS system

33. **Nepal should step up efforts to enhance effectiveness of the AML/CFT framework**. The Asia/Pacific Group on Money Laundering is currently undertaking a mutual evaluation (peer review) to assess Nepal's compliance with global AML/CFT standards, with the results due to be published in mid-2023. More progress is needed to amend AML/CFT laws and regulations to ensure compliance with the international standards. Steps to ensure that a robust legal framework is in place should be prioritized, along with measures to address gaps in the effectiveness of the AML/CFT regime.

34. The authorities shared the emphasis on strengthening the toolkit for preserving macroeconomic and financial stability. The NRB plans to maintain a cautious and data-driven approach to monetary policy. The NRB remains committed to prudently monitoring banks to ensure that loans are appropriately classified and adequately provisioned, and that banks remain well capitalized. They expect these efforts to be supplemented by the ongoing regulatory and supervisory reforms under the ECF-supported program. The authorities requested Fund support in identifying development partner financing for implementation of the in-depth loan portfolio review of the largest ten banks assisted by an international audit firm. They underscored the importance of directed lending for access to finance in priority sectors, including agriculture. The authorities recognize emerging risks associated with MFIs and large cooperatives and plan to enhance monitoring. The authorities underlined their efforts to amend laws to ensure compliance with international standards, but agreed on the need to improve the effectiveness of implementing the AML/CFT framework.



Source: NRB (FY2021/22).



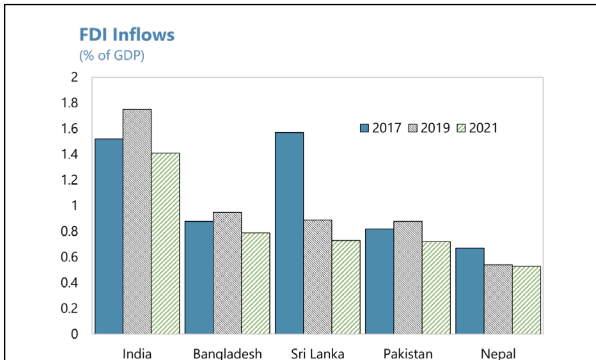
Source: NRB (FY2021/22).

C. Fostering Sustainable, Inclusive and Green Growth

35. An ambitious structural reform agenda can help establish sustainable long-run growth following the pandemic.

- *Business/Investment Climate*. Despite significant potential for growth, the cost of doing business remains high. Reforms to improve the business climate could focus on reducing the cost of land, strengthening the framework for insolvency and bankruptcy, improving logistics and reducing transportation costs, as well as strengthening anti-corruption efforts. Full implementation and enforcement of the Competition Act, higher public investment, creating a conducive environment for private investment, and strengthening the regulatory framework would help boost competition and growth.

- *Foreign Direct Investment (FDI)*. Nepal has the lowest level of FDI as a proportion of GDP in the region. Taking a positive step forward,



Source: UNCTAD.

regulations to implement the Foreign Investment and Technology Transfer Act were completed in January 2021. More recently, the authorities removed a minimum limit required for foreign investment for non-resident Nepalis and lowered the limit for foreign investors. Removing other barriers including burdensome regulatory approval procedures and restrictions on foreign investment in sectors including agriculture, tourism and consultancy services as well as gradually reducing capital controls would help increase investment.

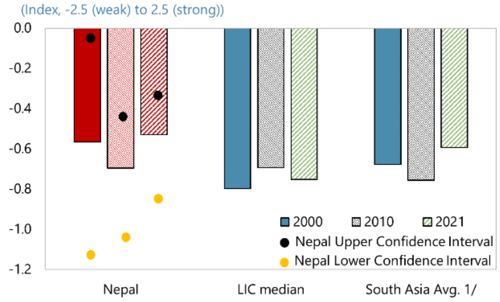
- *Remittances.* To boost domestic investment and address AML/CFT concerns related to informal means of money transfer, the authorities have incentivized sending remittances via the formal financial system, including use of mandatory bank accounts, migrant bond and deposit schemes, and by allowing cross-border digital transactions and mobile banking for smaller transactions. Further reforms could include developing financial instruments tailored to migrant workers, strengthening the AML/CFT framework (including risk-based supervision of financial institutions), better access to finance, and efforts to improve digital and financial literacy.

- *Governance.* Recent positive governance reforms include commissioning an external audit of the NRB by a reputable audit firm with international experience (¶29) and improving fiscal transparency and procurement (¶17-20). Future reforms could include a greater use of digital public services, single window systems, and strengthening anti-corruption institutions. The SGA (2021) recommends strengthening NRB independence, mandates, transparency and accountability, and the oversight role of the NRB Board, addressed in the amendments to the NRB Act (¶29).

Governance Indicators

Control of Corruption

(Index, -2.5 (weak) to 2.5 (strong))

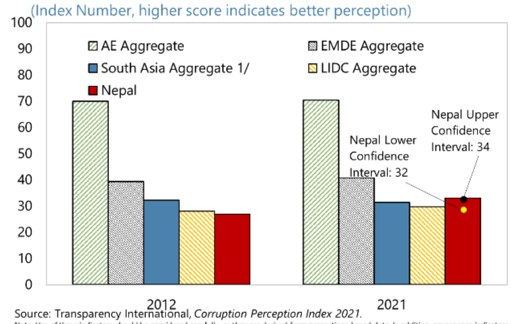


Sources: Worldwide Governance Indicators; and IMF staff calculations.

Note: Use of these indicators should be considered carefully, as they are derived from perceptions-based data. In addition, governance indicators on corruption should not be interpreted as providing independent confirmation of one another. Ranges are for a 90 percent confidence interval; intervals for peer groups are negligible. 1/ Includes Pakistan, Bangladesh, India and Sri Lanka.

Corruption Perceptions Index

(Index Number, higher score indicates better perception)



Source: Transparency International, *Corruption Perception Index 2021.*

Note: Use of these indicators should be considered carefully, as they are derived from perceptions-based data. In addition, governance indicators on corruption should not be interpreted as providing independent confirmation of one another. Ranges are for a 90 percent confidence interval; intervals for peer groups are negligible. 1/ Includes Pakistan, Bangladesh, India and Sri Lanka.

36. Nepal is vulnerable to the impact of climate change, climate shocks and natural disasters, which can hamper poverty reduction and exacerbate food insecurity. Average annual temperatures have risen, rainfall has become increasingly unpredictable, and the frequency and cost of climate-related shocks is on the rise (Figure 1). Households rely on remittances, access to imports, and drawing down savings to cope.[11] However, shocks have persistent effects on poverty and food

[11] De Stefani, Laws and Sollaci. 2022. "Household Vulnerability to Income Shocks in Emerging and Developing Asia: the Case of Cambodia, Nepal and Vietnam". IMF Working Paper 2022/064.

security and disproportionately harm vulnerable households, including those not able to access finance, living in remote areas, and unable to migrate (Selected Issues Paper: Climate Change, Food Insecurity and Remittances in Nepal). The government plays a large role in the agricultural sector, including through fertilizer subsidies, a minimum support price and a government monopoly on fertilizer imports and distribution which can create shortfalls. Economic policy can focus on:

- Better-targeted social assistance (e.g. through the child grant scheme).
- Boosting agricultural productivity through adoption of modern farming practices and efficient allocation of fertilizers, including by removing restrictions on private sector provision of agricultural inputs.[12]
- Climate-resilient infrastructure to facilitate trade and migration.
- Diversifying the domestic economy to rely less on remittances and agriculture.

37. Despite relatively low carbon emissions, pollution from industry and transportation harms health outcomes and lowers productivity. Although overall emissions are relatively low and most electricity is produced via hydropower, Nepal's mountainous geography worsens pollution outcomes. Pollution damages health outcomes, lowers productivity, and could affect tourism and FDI. Encouraging the use of electric vehicles and restrictions on waste burning, brick kilns and construction sites could lower impacts. As a fossil fuel importer with a high share of renewables in total energy production and consumption, Nepal is not directly vulnerable to a global transition to a low carbon economy. However, fewer employment opportunities in the GCC countries during the transition could significantly lower remittances, contributing to poverty and food insecurity.

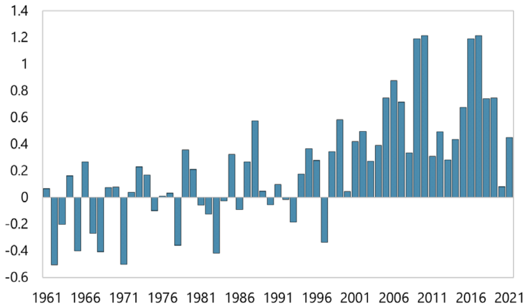
The authorities concurred that structural reforms will be needed to foster sustainable, inclusive and green medium-term growth. The authorities emphasized new strategies, including the Trade Logistics Policy and forthcoming Trade Policy and Nepal Trade Integration Strategy, and argued that Nepal's trade openness has helped address competition issues. The authorities highlighted business-climate reforms including removing the threshold on foreign investment, increased use of digital platforms and a one-stop center for investment-related business services, but acknowledged that their full benefits will take time to be realized. The authorities are making efforts to improve migrants' financial and digital literacy and to encourage greater use of formal remittance channels. The authorities acknowledged Nepal's climate vulnerability and stressed the need for comprehensive reforms, including on agriculture and food security, outlined in the National Adaptation Plan. To address food insecurity and poverty, the authorities highlighted broad-based grants, subsidies, and concessional loans to farmers and social support to vulnerable groups. They plan to improve social assistance targeting through an integrated social registry and making use of survey information.

[12] Reforms can be informed by the World Bank's forthcoming agriculture public expenditure review.

Figure 1. Nepal: Climate Change and Pollution in Nepal

Average temperatures have risen in Nepal.

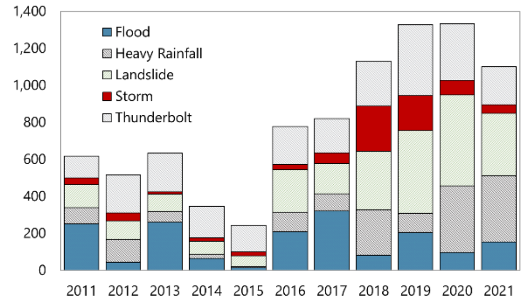
Mean Temperature Change of Meteorological Year
(Change centigrade from 1951-1980 baseline)



Sources: FAO; and IMF Climate Dashboard.

The country is subject to significant and growing climate related shocks including landslides, floods, and storms.

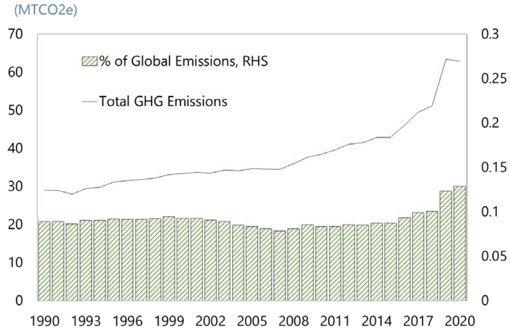
Number of Climate Related Incidents
(Count)



Sources: BIPAD Government of Nepal; and IMF staff calculations.

Total GHG emissions are growing, but represent a small percentage of global emissions.

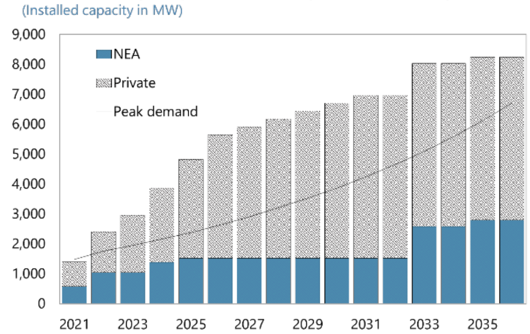
Total GHG Emissions
(MTCO2e)



Source: IMF Climate Dashboard.

Hydropower accounts for 90 percent of current electricity production and is set to become a major export.

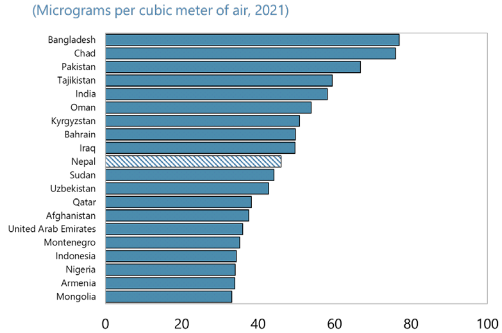
Forecast of Hydropower and Projected Electricity Demand
(Installed capacity in MW)



Source: World Bank CCDR 2022.

Pollution is trapped by Nepal's mountainous geography making it one of the top 10 most polluted countries.

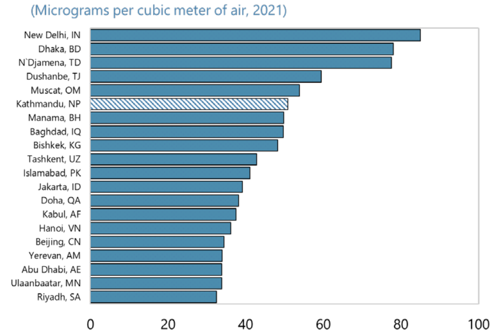
PM2.5 Concentration of the Most Polluted Countries
(Micrograms per cubic meter of air, 2021)



Source: 2021 World Air Quality Report.

Kathmandu is among the top 10 most polluted capital cities.

PM2.5 Concentration of the Most Polluted Capitals
(Micrograms per cubic meter of air, 2021)



Source: 2021 World Air Quality Report.

FINANCING AND PROGRAM MODALITIES

38. The authorities have requested a 10-month extension of the ECF arrangement with unchanged total access. To accommodate the delays in program implementation and to provide additional time for the government to design and implement reforms under the ECF-supported program, the authorities are requesting an extension of the current arrangement until January 11, 2026.

39. Given the program extension, a rephasing, as well as modifications and waivers to program conditionality are proposed:

- *Waivers* for nonobservance of the standard continuous PCs on exchange restrictions, MCPs, and import restrictions are requested.

- *Rephasing the program* with new test dates starting from July 16, 2023 and availability in November 2023, with semi-annual reviews. Starting with the amount of SDR 39.20 million originally envisaged for disbursement at the second review, the original profile of disbursements is proposed to shift out by one review, with the addition of one final review (Table 8). The present combined first and second review would therefore entail a disbursement of amount of SDR 39.20 million originally envisaged for the first review.

- *Establishment of new quantitative PCs and ITs* for all relevant indicators through January 14, 2024 test date (Table 9). The primary deficit, currently an IT, is proposed as a quantitative PC from the January 14, 2024 test date onwards. The revised quantitative PC targets on net international reserves reflect the revised and uncertain global outlook, including to account for significant oil price volatility (Annex 1).

- *Resetting and modifying some pending SBs, to allow for time to implement reforms, and introducing new SBs (Table 11).*

- *Modification of the primary deficit target and adjustors.* Longer than expected lags in collecting data on grants and foreign-financed project loans pose a misreporting risk going forward. To mitigate this risk, grants, which are a relatively small share of financing, have been removed from the definition of the primary balance from the July 16, 2023 test date onwards. In addition, the adjustors to the primary deficit target are proposed to be modified by (1) making the adjustor for foreign-financed project loans symmetric from the January 14, 2024 test date onwards and (2) as the major uncertainty from exogeneous shocks diminishes, by narrowing the symmetric revenue adjustor.

40. Capacity to repay remains adequate. IMF credit outstanding is projected to peak at 262.3 percent of quota in FY2024/25 (SDR 411.6 million), within the cumulative normal access limit. This amount corresponds to 16.2 percent of exports and 1.2 percent of GDP (Table 10). The authorities’ track record of servicing IMF debt is strong.

41. The program is fully financed, with firm commitments in place for the next 12 months, and there are good prospects for the remainder of the program. Pledges of budget support financing for FY2022/23 through FY2024/25 are above the level recorded at the ECF approval stage, narrowing the near-term balance of payment need and supporting the proposed program extension and rephasing of disbursements. The World Bank expects to provide an additional USD 80 million, while the planned budget support by the ADB has been largely unchanged (text table and Table 5). The slow execution of capital spending has reduced actual disbursements of programmed project financing, and other inflows, including FDI, have been small in FY2022/23. Additional concessional financing would reduce the need for domestic financing, which may be particularly constrained by higher domestic interest rates, and help authorities replenish reserves. The authorities intend to use ECF financing for budget support. The limited available external financing and continued need for budget support suggest the overall access level remains appropriate under the proposed phasing of the program.

Projected Financing Gap (in percent of GDP)

External financing need	FY2022/23	FY2023/24	Fiscal financing need	FY2022/23	FY2023/24
External financing requirement	**4.4**	**4.7**	Total revenue and grants	21.6	22.9
of which:			Expenditure	26.1	26.9
current account balance[1/]	5.9	6.1	**Fiscal deficit**	**4.5**	**4.1**
Available Financing	**3.0**	**4.3**	**Total financing**	**3.6**	**3.4**
of which:			Net acquisition of financial assets	1.4	1.4
Foreign borrowing	1.9	2.3	Net incurrence of liabilities	5.0	4.7
Current and capital grants	1.1	1.7	Foreign borrowing	1.3	1.7
FDI, net	0.1	0.4	Domestic borrowing	3.7	3.0
External financing gap	**1.4**	**0.3**	**Fiscal financing gap**	**0.9**	**0.7**
Financing commitments so far:	**0.4**	**0.3**	Financing commitments so far:	**0.9**	**0.7**
IMF: ECF	0.1	0.2	IMF: ECF	0.1	0.2
Asian Development Bank	0.4	0.1	Asian Development Bank	0.4	0.1
World Bank	0.4	0.4	World Bank	0.4	0.4
Drawdown of foreign reserves	-0.5	-0.3			

Sources: Nepali authorities; and IMF staff estimates.
1/ Current account excludes official transfers.
Note: Current baseline forecast is as of March 07, 2022.

42. The program continues to face important external and financial risks. A large commodity price shock would require monetary policy tightening if the shock is not expected to be short-lived. Fiscal restraint, following the guardrails provided by the program, would help preserve macro stability. Should external concessional financing fall short of expectation, further reduction of low priority expenditures would be needed. Likewise, a significant reduction in remittances related to disruptions in external labor markets could lead to an inter-linked decline in growth, reserves and revenues. The program includes some flexibility through adjustors on program targets. Nonetheless, a large remittance and/or a large natural disaster decline would require greater external support from development partners to help replace lost income among vulnerable populations without risking unsustainable fiscal outcomes. The NRB has been maintaining tight macro-prudential measures and developing liquidity facilities to stave off potential problems, but an episode of elevated bank stress due to rising NPLs could raise solvency problems. The NRB stands ready to provide liquidity support to prevent wider systemic concerns. Such a scenario may require government intervention with significant fiscal implications, but intervention should ensure that investors bear the burden of costs appropriately.

STAFF APPRAISAL

43. **Global shocks have impacted Nepal's import-dependent economy through higher commodity prices**. Following a strong post-pandemic recovery, the current account weakened, and reserves declined in the first half of 2022. Pressure on reserves has since subsided, thanks in part to monetary policy tightening, strong remittances and cooling domestic demand. However, inflation remains elevated. Risks are on the downside. Reform progress has continued in a difficult environment, albeit at a slower than expected pace.

44. **Fiscal policies should focus on addressing near-term fiscal pressures, while protecting high-quality infrastructure and social spending**. In response to lower-than-expected revenue collection and to maintain fiscal discipline in line with program objectives, the government has announced expenditure rationalization focused on administrative spending and fiscal transfers to subnational governments. Fiscal consolidation and further structural reforms, including to advance tax reforms, strengthen the fiscal federalism framework, address fiscal risks and strengthen public investment management, are needed to support medium-term fiscal sustainability. Maintaining momentum on governance reforms is critical to cementing recent gains in fiscal transparency.

45. **Monetary policy should take a cautious, data-driven approach to maintain external stability and address elevated inflation**. The much-needed monetary policy tightening by the NRB last year helped stabilize the external position and is contributing to lower inflation. Looking forward, a cautious and data-driven monetary policy stance supported by macroprudential measures will help avoid large boom-bust credit cycles, which can create financial sector instability and are not supportive of sustainable growth.

46. **The NRB should prioritize bank asset quality, including through regulatory initiatives to ensure appropriate classification of loans**. Capital adequacy ratios remain above regulatory minima, but non-performing loans are increasing. Progress towards advancing the financial sector reform strategy and improving the autonomy and accountability framework of the NRB should continue. Advancing digitalization can play an important role in improving financial inclusion. Strengthening ongoing efforts to improve the anti-money laundering/combatting the financing of terrorism (AML/CFT) framework and its effectiveness remain crucial.

47. **An ambitious structural reform agenda is needed to achieve sustainable long-run growth following the pandemic**. Sustainable growth will require fiscal reforms in line with debt

sustainability, advancing reforms on banking regulations and supervision, reducing the cost of doing business, lowering barriers to FDI and enhancing governance and anti-corruption efforts. Nepal is vulnerable to climate shocks and natural disasters, which can hamper poverty reduction and exacerbate food insecurity. Policies can focus on better-targeted social assistance, boosting agricultural productivity and climate-resilient infrastructure to facilitate trade and migration and diversify the domestic economy.

48. Staff recommends completion of the first and second reviews of the ECF and supports the authorities request for extension of the arrangement and rephasing of disbursements. Staff supports the request for waivers of nonobservance of performance criteria as the deviations were temporary and corrective action was taken through removal of the measures.

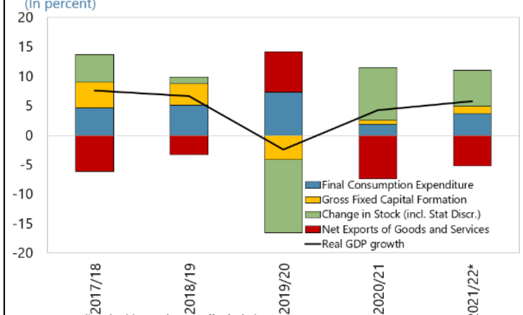
49. Staff recommends that the next Article IV consultation for Nepal be held on the 24-month cycle in accordance with the Executive Board decision on consultation cycles for members with Fund arrangements.

Figure 2. Nepal: Recent Macro-Economic Developments

The recovery in FY2021/22 saw broad-based growth led by strong final consumption.

Contribution to Real GDP Growth by Expenditure

(In percent)

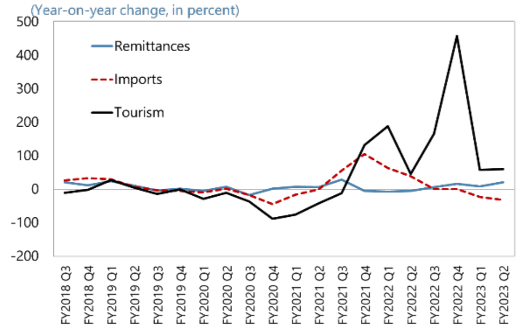


Sources: Nepali authorities; and IMF staff calculations.
*IMF staff estimates. There is a large statistical discrepancy between the GDP from expenditure approach, and the headline GDP from the industry approach.

Import growth peaked in FY2020/21 Q4 due to higher global commodity prices but has been negative in FY 2022/23. The tourism sector continues to recover, driven by the large base effect.

External Sector Developments

(Year-on-year change, in percent)

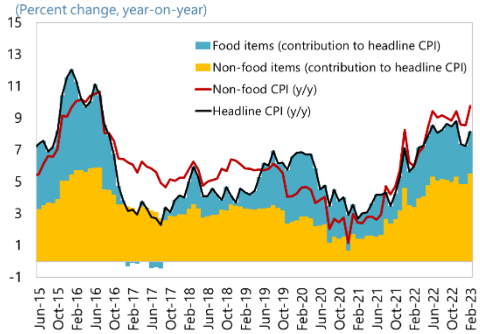


Sources: Nepali authorities; and IMF staff calculations.
Note: Nepal fiscal year begins in mid-July.

Inflation peaked at 8.6 percent in Sept 2022 and remains elevated at 7.9 percent in Feb 2023.

Consumer Price Index

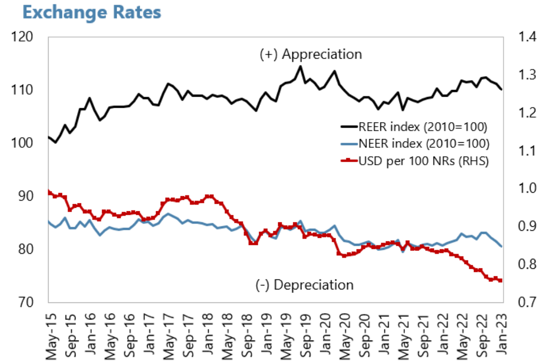
(Percent change, year-on-year)



Sources: Nepali authorities; and IMF staff estimates.

Despite US dollar strength in 2022, depreciation of the renminbi and euro drove an overall appreciation of the NEER and REER.

Exchange Rates

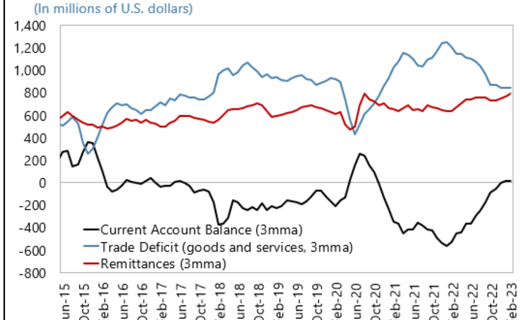


Sources: Nepali authorities; and IMF staff estimates.

Driven by a drop in import demand, the trade deficit shrank in the first five months of FY2022/23 after a post-pandemic surge, while remittances remain buoyant.

Current Account Balance

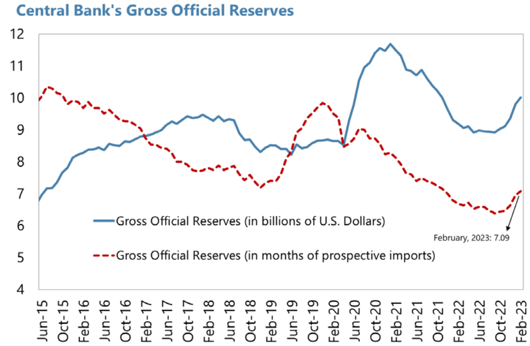
(In millions of U.S. dollars)



Source: Nepali authorities.

After a rapid drawdown in FY2021/22, gross official reserves have begun trending back up.

Central Bank's Gross Official Reserves

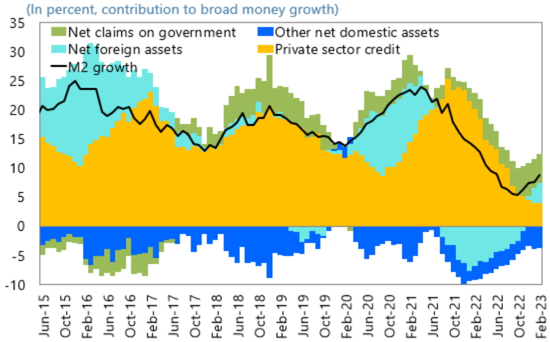


Sources: Nepali authorities; and IMF staff calculations.

Figure 3. Nepal: Recent Monetary Sector Developments

Broad money growth was at 8.8 percent (y-o-y) in Feb 2023, as private sector credit growth has slowed.

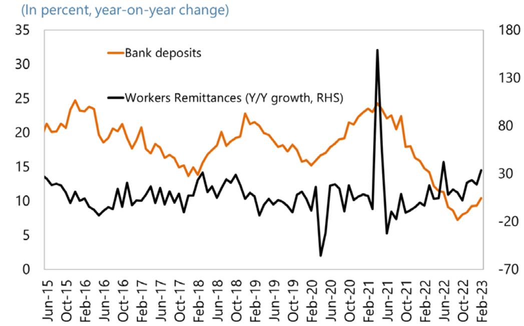
Broad Money Growth
(In percent, contribution to broad money growth)



Sources: Nepali authorities; and IMF staff estimates.

Bank deposit growth slowed to 10.4 percent (y-o-y), while remittances grew by 33.5 percent (y-o-y) in Feb 2023.

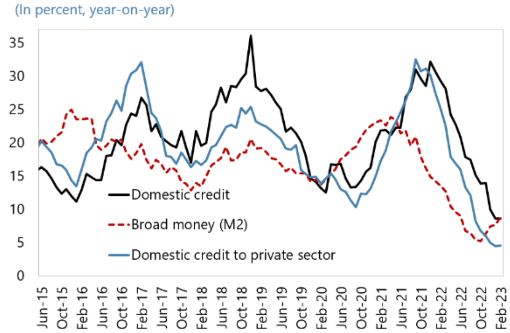
Bank Deposits and Remittances
(In percent, year-on-year change)



Sources: Nepali authorities; and IMF staff calculations.

Private sector credit growth has fallen to single digits from a recent peak of 32.5 percent (y-o-y) in Sept 2021.

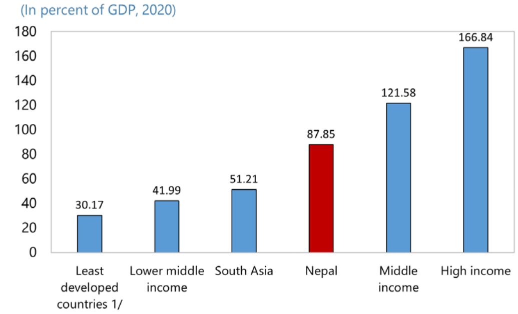
Credit and Money Growth
(In percent, year-on-year)



Sources: NRB; and IMF staff calculations.

Private sector credit-to-GDP ratio remains among the highest in its peer group.

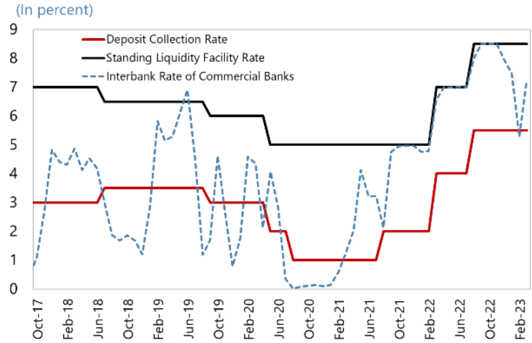
Domestic Credit to Private Sector
(In percent of GDP, 2020)



Source: World Bank, *World Development Indicators*.
1/ UN Classification.

The interbank rate stayed at the top of the interest rate corridor in 2022 but the NRB has since largely maintained it in the middle.

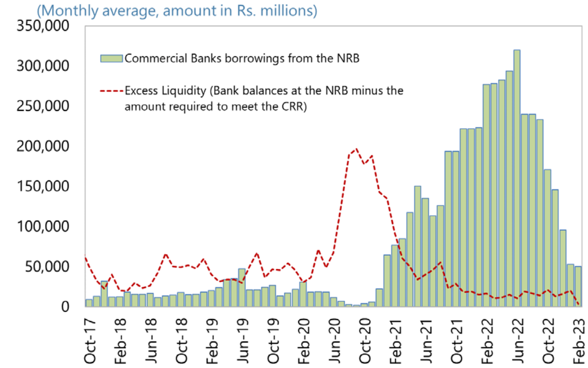
Short-term Interest Rates
(In percent)



Source: NRB.

Excess liquidity remains low, though bank borrowing from the Standing Liquidity Facility has come down with the fall in credit growth.

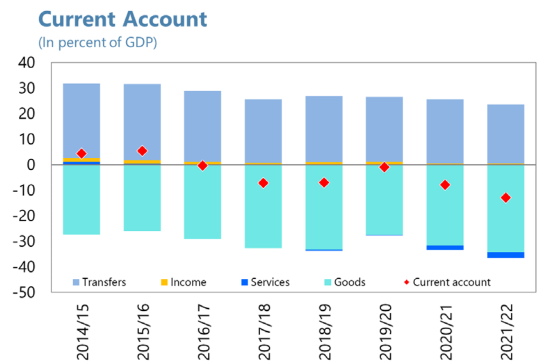
Liquidity Conditions
(Monthly average, amount in Rs. millions)



Sources: NRB; and IMF staff calculations.

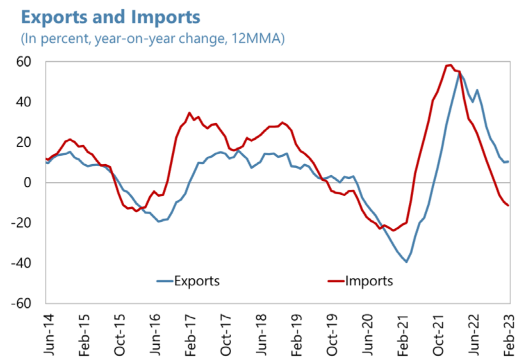
Figure 4. Nepal: External Sector Developments

The FY2021/22 current account deficit deteriorated to 12.9 percent of GDP, driven by a surge in imports.



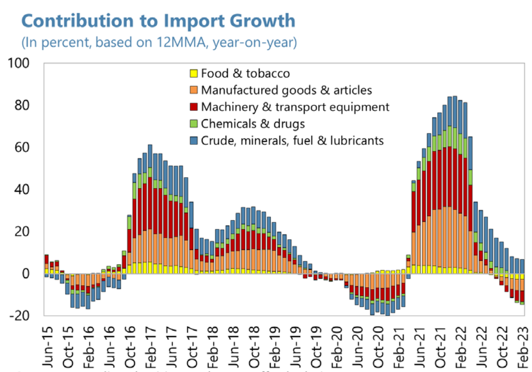
Sources: Nepali authorities; and IMF staff estimates.

Imports and exports rebounded strongly in FY2021/22, but growth declined lately, with imports falling since Dec 2022.



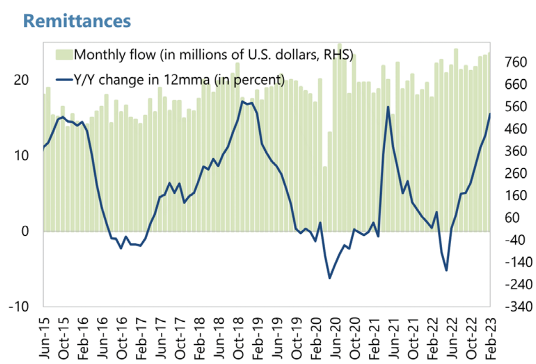
Sources: NRB; and IMF staff calculations.

The decrease in imports is driven mainly by manufactured goods and equipment.



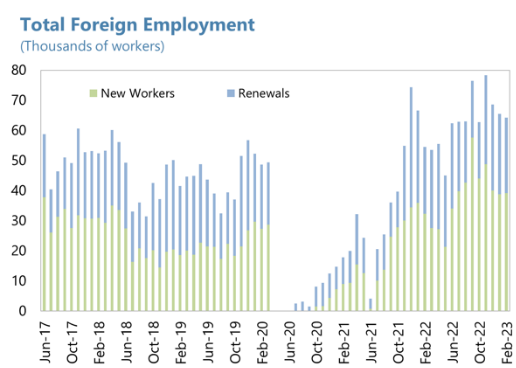
Sources: Nepali authorities; and IMF staff calculations.

Remittances are picking up in FY2022/23 after a stagnant FY2021/22.



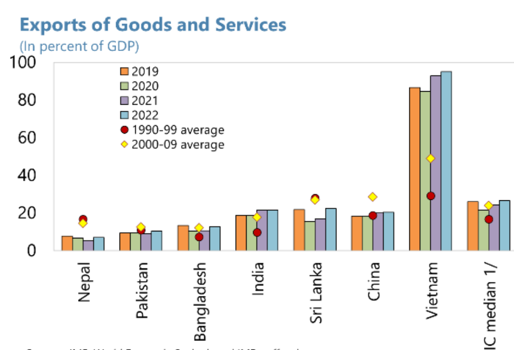
Sources: Nepali authorities; and IMF staff estimates.

The growth in remittances is driven by a strong recovery in foreign employment above pre-pandemic levels.



Sources: Nepali authorities; and IMF staff estimates.

Exports as a percentage of GDP have rebounded since 2020, but remain well below the 1990-2009 levels, and below peers.



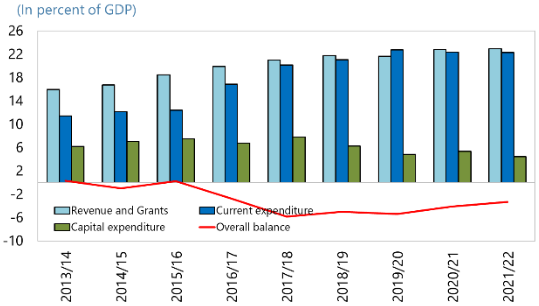
Sources: IMF, *World Economic Outlook*; and IMF staff estimates.
1/ LIC: Low Income Countries are defined by the World Bank as those with a GNI per capita between $1,025 or less in 2018.

Figure 5. Nepal: Recent Fiscal Developments

Increase in import related taxes and underspending of capital expenditures led to a narrowing of the fiscal deficit in FY2021/22.

Central Government Fiscal Performance

(In percent of GDP)

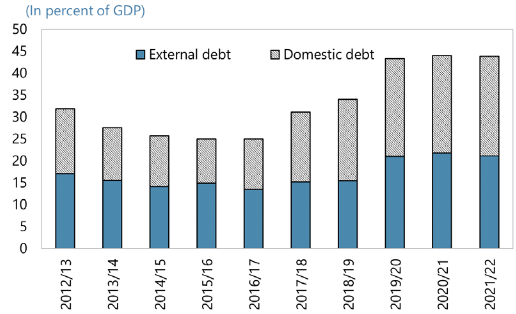


Sources: Nepali authorities; and IMF staff estimates.
Note: Overall balance calculated as total revenue and grants minus expenditure.

Total public debt increased to 43.8 percent of GDP in FY2021/22, lower than previously envisaged.

Public Debt

(In percent of GDP)

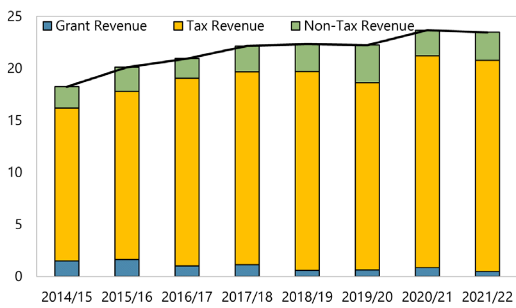


Sources: Nepali authorities; and IMF staff estimates.

Total revenue and grants in FY2021/22 reached a similar level as FY2020/21 even though grants fell short.

Central Government Fiscal Revenues (Incl. Grants)

(In percent of GDP)

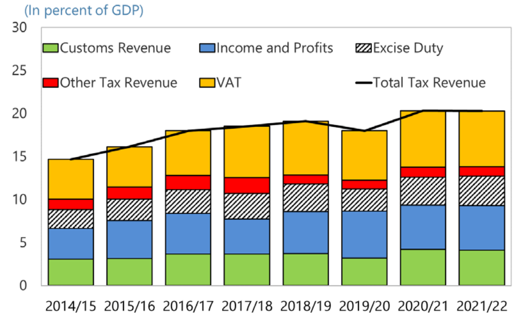


Sources: Nepali authorities; and IMF staff estimates.

Excise duty saw the biggest increase in FY2021/22, mainly driven by the surge of related imports.

Central Government Tax Revenues

(In percent of GDP)

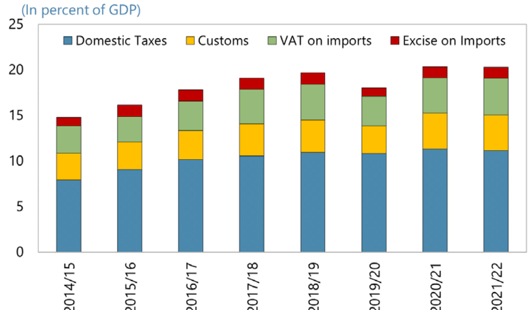


Sources: Nepali authorities; and IMF staff estimates.

Both the import-related and domestic tax revenue were comparable between FY2021/22 and FY2020/21.

Tax Revenue by Source

(In percent of GDP)

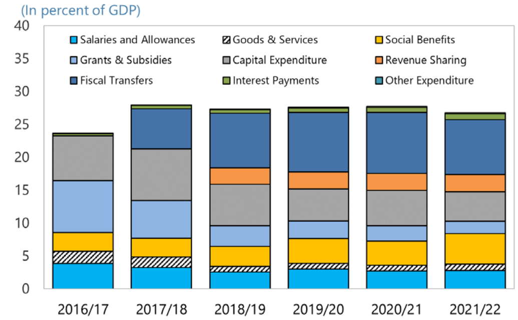


Sources: Nepali authorities; and IMF staff estimates.
Note: Domestic taxes are calculated as the residual by subtracting customs, VAT on imports and excise on imports from total tax revenue.

Capital expenditure continued to underperform while social benefits expenditures achieved the biggest increase.

Central Government Fiscal Expenditure

(In percent of GDP)

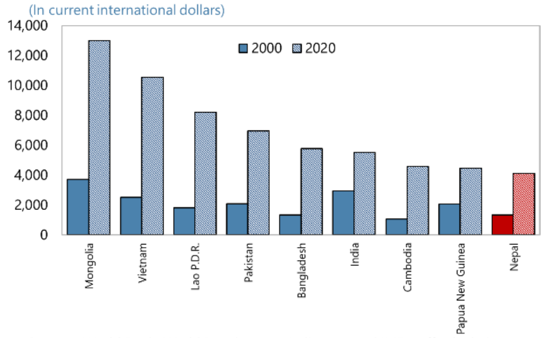


Sources: Nepali authorities; and IMF staff estimates.

Figure 6. Nepal: Socio-Economic Indicators

Nepal is among the lowest income countries in South Asia.

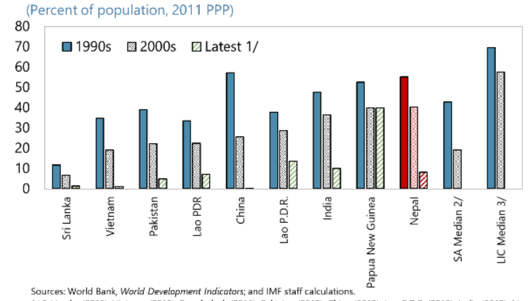
Per Capita GDP (PPP)
(In current international dollars)



Sources: World Bank, *World Development Indicators*; and IMF staff calculations.

Poverty has fallen significantly in the last decade.

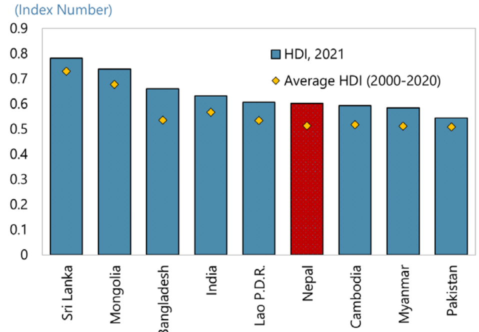
Poverty Headcount Ratio at $1.90 a day
(Percent of population, 2011 PPP)



Sources: World Bank, *World Development Indicators*; and IMF staff calculations.
1/ Sri Lanka (2016), Vietnam (2018), Bangladesh (2016); Pakistan (2018), China (2019); Lao P.D.R. (2018); India (2019); Nepal (2010); Papua New Guinea (2009).
2/ South Asia (SA) includes India, Nepal, Bhutan, Bangladesh, Maldives and Sri Lanka.
3/ LIC: Low Income Countries are defined by the World Bank as those with a GNI per capita between $1,025 or less in 2018.

The decline in poverty is reflected in an improvement in Nepal's UNDP Human Development Index.

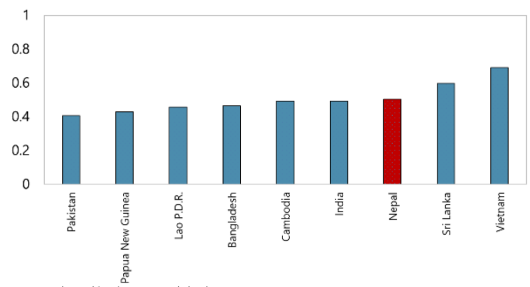
Human Development Index (HDI)
(Index Number)



Sources: UNDP; and IMF staff calculations.

Although human capital levels are similar to comparators, there is scope for improvement.

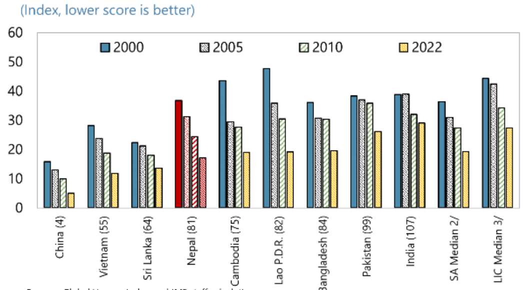
Human Capital Index 1/
(Index, as of 2020; higher is better)



Source: The World Bank, *Human Capital Project*.
1/ Measures the human capital that a child born today can expect to attain by her 18th birthday, given the risks of poor health and poor education in the country where she lives. Units represent productivity relative to a benchmark of complete education and full health, on a scale of 0 to 1.

There is substantial scope and need to improve living standards, including relating to hunger.

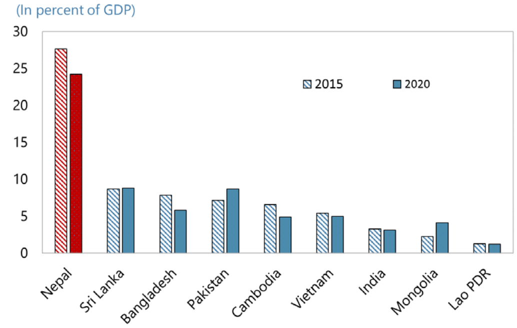
Global Hunger Index 1/
(Index, lower score is better)



Sources: Global Hunger Index; and IMF staff calculations.
1/ The Global Hunger Index is a multidimensional indicator that captures undernourishment, child wasting, child stunting, and child mortality. Number in parenthesis represents the country's 2022 rank out of 112 countries.
2/ South Asia (SA) includes only India, Nepal, Bangladesh and Sri Lanka.
3/ LIC: Low Income Countries are defined by the World Bank as those with a GNI per capita between $1,025 or less in 2018.

One of Nepal's most important safety nets comes from remittances.

Remittances Received
(In percent of GDP)



Source: World Bank, *World Development Indicators*.

Table 1. Nepal: Selected Economic Indicators 2019/20-2027/28 1/

	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
				Est.	Projections				
Output and Prices (annual percent change)									
Real GDP	-2.4	4.2	5.8	4.4	5.1	5.2	5.2	5.2	5.2
Headline CPI (period average)	6.1	3.6	6.3	7.8	6.3	5.6	5.4	5.4	5.4
Headline CPI (end of period)	4.8	4.2	8.1	7.1	5.8	5.5	5.4	5.4	5.4
Fiscal Indicators: Central Government (in percent of GDP)									
Total revenue and grants	22.2	23.7	23.5	21.6	22.9	23.6	24.8	25.5	25.4
of which: Tax revenue	18.0	20.3	20.3	18.4	19.3	20.1	21.3	22.0	22.0
Expenditure	27.6	27.7	26.8	26.1	26.9	27.1	27.5	28.0	27.9
Expenses	22.7	22.4	22.3	21.1	21.0	21.2	21.6	22.1	22.0
Net acquisition of nonfinancial assets	4.9	5.4	4.5	5.0	5.9	5.9	5.9	5.9	5.9
Operating balance	-0.5	1.3	1.2	0.5	1.9	2.4	3.2	3.5	3.4
Net lending/borrowing	-5.4	-4.0	-3.3	-4.5	-4.1	-3.5	-2.7	-2.4	-2.5
Statistical discrepancy	-0.8	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	4.6	4.0	3.3	4.5	4.1	3.5	2.7	2.4	2.5
Net acquisition of financial assets	1.9	3.9	2.7	1.4	1.4	1.4	1.4	1.4	1.4
Net incurrence of liabilities	6.5	7.9	6.0	5.9	5.4	4.9	4.1	3.8	3.9
Foreign	2.4	3.5	2.2	2.2	2.4	2.2	2.2	1.9	1.9
Domestic	4.1	4.4	3.8	3.7	3.0	2.7	1.9	1.9	1.9
Money and Credit (annual percent change)									
Broad money	18.1	21.8	6.8	10.8	11.8	10.5	10.9	10.9	10.9
Domestic credit	14.6	26.8	17.9	10.5	11.7	11.3	9.9	10.2	10.1
Private sector credit	12.6	26.3	13.3	7.4	10.4	10.4	10.2	10.3	10.4
Saving and Investment (in percent of nominal GDP)									
Gross investment	30.4	35.8	37.3	36.0	36.8	36.6	35.8	35.1	34.1
Gross fixed investment	30.5	29.9	29.4	28.4	29.0	28.8	28.3	27.7	26.9
Private	25.6	24.5	23.9	23.3	23.1	22.9	22.3	21.8	21.0
Central government	4.9	5.4	5.5	5.0	5.9	5.9	5.9	5.9	5.9
Change in Stock	0.0	5.9	7.9	7.6	7.8	7.7	7.6	7.4	7.2
Gross national saving	29.4	27.9	24.4	30.8	31.8	32.1	31.4	30.8	30.0
Private	30.5	27.5	23.7	31.0	31.0	30.7	29.2	28.3	27.6
Central government	-1.1	0.4	0.7	-0.2	0.8	1.4	2.2	2.5	2.5
Balance of Payments									
Current account (in millions of U.S. dollars)	-339	-2,844	-5,175	-2,185	-2,325	-2,235	-2,415	-2,550	-2,626
In percent of GDP	-1.0	-7.8	-12.9	-5.2	-5.0	-4.5	-4.4	-4.3	-4.1
Trade balance (in millions of U.S. dollars)	-9,186	-11,510	-13,759	-12,035	-13,205	-13,839	-14,710	-15,491	-16,286
In percent of GDP	-27.5	-31.7	-34.3	-28.6	-28.6	-27.6	-27.0	-26.2	-25.3
Exports of goods (y/y percent change)	-6.4	30.0	43.9	-14.0	6.6	6.3	7.2	6.9	7.6
Imports of goods (y/y percent change)	-18.2	25.7	21.9	-12.7	9.4	5.0	6.4	5.5	5.4
Workers' remittances (in millions of U.S. dollars)	7,533	8,150	8,325	8,919	9,384	9,846	10,310	10,776	11,263
In percent of GDP	22.5	22.5	20.7	21.2	20.3	19.6	18.9	18.2	17.5
Gross official reserves (in millions of U.S. dollars)	10,559	10,884	8,953	9,090	9,234	9,597	10,155	10,631	11,183
In months of prospective imports	9.0	7.5	7.0	6.5	6.3	6.1	6.1	6.1	6.0
Memorandum Items									
Public debt (in percent of GDP)	43.3	44.0	43.8	47.8	48.8	49.8	50.2	50.0	49.9
Nominal GDP (in billions of U.S. dollars)	33.4	36.3	40.1	42.1	46.2	50.2	54.5	59.2	64.3
Nominal GDP (in billions of Nepalese Rupees)	3,889	4,277	4,852	5,459	6,101	6,779	7,520	8,340	9,252
Net International Reserves (in millions of U.S. dollars)	10,291	10,620	8,821	8,647	8,707	8,995	9,557	10,087	10,702
Primary Deficit (in billions of Nepali Rupees)	183	138	115	176	167	153	115	108	128
Primary Deficit (in percent of GDP)	4.7	3.2	2.4	3.2	2.7	2.3	1.5	1.3	1.4
Tax Revenue (in billions of Nepalese Rupees)	700	870	984	1,002	1,180	1,361	1,599	1,837	2,036
Tax Revenue (In percent of GDP)	18.0	20.3	20.3	18.4	19.3	20.1	21.3	22.0	22.0
Health Expenditure (in percent of GDP)	1.0	1.2	2.3	3.7	3.7	1.7	1.7	1.7	1.7
Social Protection/Assistance (in percent of GDP)	1.7	1.7	3.8	3.7	3.7	2.8	2.8	2.8	2.8
CCRT debt relief (in millions of SDR) 2/	2.9	7.1	3.6	…	…	…	…	…	…
Private sector credit (in percent of GDP)	84.3	96.8	96.6	92.3	91.1	90.6	90.0	89.5	89.0
Exchange rate (NPR/US$; period average)	116.3	117.9	120.8	…	…	…	…	…	…
Real effective exchange rate (average, y/y percent change)	1.9	-2.9	1.6	…	…	…	…	…	…

Sources: Nepali authorities; and IMF staff estimates and projections.

1/ Fiscal year ends mid-July.

2/ CCRT debt relief is included in grants and net incurrence of liabilities (foreign). The first tranche of CCRT debt relief covering the period April 14, 2020 to October 13, 2020 for SDR 2.9 million in FY 2019/20 was approved on April 13, 2020. The second tranche of CCRT debt relief covering the period October 14, 2020 to April 13, 2021 for SDR 3.6 million was approved on October 2, 2020. The third tranche of CCRT debt relief covering the period April 14, 2021 to October 15, 2021 for SDR 3.6 million was approved on April 1, 2021. The fourth and fifth (final) tranche of CCRT debt service relief covering the period from October 16, 2021 to January 10, 2022 and January 11 to April 13, 2022 was approved on October 6, 2021 and December 15, 2021 respectively for SDR 3.6

Note: Current baseline forecast is as of March 07, 2023.

Table 2. Nepal: Summary of Central Government Operations 2019/20-2027/28 1/

	2019/20	2020/21	2021/22	2022/23		2023/24	2024/25	2025/26	2026/27	2027/28
			Current Baseline Proj.	Budget	Current Baseline Proj.	Projections				
	(In billions of Nepalese rupees)									
Total revenue and grants	865	1,013	1,139	1,459	1,181	1,396	1,601	1,863	2,130	2,354
Total revenue	841	976	1,115	1,403	1,144	1,331	1,530	1,786	2,045	2,266
Tax revenue	700	870	984	1,295	1,002	1,180	1,361	1,599	1,837	2,036
of which: Income and profits tax	213	222	252	339	267	323	386	459	542	601
Customs	124	179	199	274	188	210	226	250	278	308
Excise duty	101	137	167	217	177	210	244	284	330	363
VAT	224	282	314	398	316	377	438	531	606	672
Other	38	50	52	67	54	60	67	74	82	91
By source: Domestic taxes	421	484	541	701	587	717	865	1,050	1,231	1,365
Import-related taxes	279	386	443	595	415	462	496	549	607	670
Non-tax revenue & Other Receipts	141	106	131	108	141	152	169	187	208	230
Of which: Non Tax Revenue	94	66	82	108	98	115	142	172	191	212
Other Receipts	48	40	49	0	44	37	27	15	17	18
Grants 2/	24	36	24	55	37	65	71	78	85	88
Expenditure	1,074	1,186	1,299	1,727	1,427	1,644	1,837	2,068	2,334	2,584
Recurrent expenditure	884	957	1,083	1,346	1,153	1,283	1,436	1,623	1,840	2,036
Of which: Interest payments	26	35	45	54	71	80	83	89	96	102
Salaries and allowances	117	118	136	189	189	205	221	245	272	301
Grants & subsidies	104	101	90	144	118	107	112	117	121	135
Social benefits	147	156	225	253	253	283	314	349	387	429
Goods & services	35	37	47	58	42	29	32	35	39	43
Fiscal transfers	350	395	406	430	342	413	480	555	657	729
Revenue sharing 3/	100	111	128	163	132	158	185	224	258	286
Other current expenditure	5	5	5	55	7	8	9	10	11	12
Capital expenditure	189	229	216	380	274	361	401	445	494	547
Operating balance	-19	56	56	112	27	114	165	240	290	318
Net lending/borrowing	-209	-173	-160	-268	-247	-247	-236	-205	-204	-230
Statistical discrepancy	-29	-2	0	0	0	0	0	0	0	0
Net financial transactions	179	171	160	268	247	247	236	205	204	230
Net acquisition of financial assets	75	166	129	97	75	84	93	103	114	127
Foreign	0	0	0	0	0	0	0	0	1	1
Domestic (net)	74	166	128	97	74	83	92	102	114	126
Sale of equity	12	27	36	22	20	23	25	28	31	34
Lending minus repayment	48	34	37	74	54	61	67	75	83	92
Change in cash/deposit	14	104	55	0	0	0	0	0	0	0
Net incurrence of liabilities	254	337	289	365	321	331	329	307	318	356
Foreign	93	150	107	200	121	145	147	164	162	179
Domestic	161	187	182	165	201	186	182	143	156	177
	(In percent of GDP, unless otherwise indicated)									
Total revenue and grants	22.2	23.7	23.5	26.7	21.6	22.9	23.6	24.8	25.5	25.4
Total revenue	21.6	22.8	23.0	25.7	21.0	21.8	22.6	23.7	24.5	24.5
Tax revenue	18.0	20.3	20.3	23.7	18.4	19.3	20.1	21.3	22.0	22.0
of which: Income and profits tax	5.5	5.2	5.2	6.2	4.9	5.3	5.7	6.1	6.5	6.5
Customs	3.2	4.2	4.1	5.0	3.4	3.4	3.3	3.3	3.3	3.3
Excise duty	2.6	3.2	3.4	4.0	3.2	3.4	3.6	3.8	4.0	3.9
VAT	5.8	6.6	6.5	7.3	5.8	6.2	6.5	7.1	7.3	7.3
Other	1.0	1.2	1.1	1.2	1.0	1.0	1.0	1.0	1.0	1.0
By source: Domestic taxes	10.8	11.3	11.2	12.8	10.8	11.8	12.8	14.0	14.8	14.8
Import-related taxes	7.2	9.0	9.1	10.9	7.6	7.6	7.3	7.3	7.3	7.2
Non-tax revenue & Other Receipts	3.6	2.5	2.7	2.0	2.6	2.5	2.5	2.5	2.5	2.5
Of which: Non Tax Revenue	2.4	1.5	1.7	2.0	1.8	1.9	2.1	2.3	2.3	2.3
Other Receipts	1.2	0.9	1.0	0.0	0.8	0.6	0.4	0.2	0.2	0.2
Grants 2/	0.6	0.9	0.5	1.0	0.7	1.1	1.0	1.0	1.0	1.0
Expenditure	27.6	27.7	26.8	31.6	26.1	26.9	27.1	27.5	28.0	27.9
Recurrent expenditure	22.7	22.4	22.3	24.7	21.1	21.0	21.2	21.6	22.1	22.0
Of which: Interest payments	0.7	0.8	0.9	1.0	1.3	1.3	1.2	1.2	1.1	1.1
Salaries and allowances	3.0	2.8	2.8	3.5	3.5	3.4	3.3	3.3	3.3	3.3
Grants & subsidies	2.7	2.4	1.9	2.6	2.2	1.8	1.7	1.6	1.5	1.5
Social benefits	3.8	3.7	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Goods & services	0.9	0.9	1.0	1.1	0.8	0.5	0.5	0.5	0.5	0.5
Fiscal transfers	9.0	9.2	8.4	7.9	6.3	6.8	7.1	7.4	7.9	7.9
Revenue sharing 3/	2.6	2.6	2.6	3.0	2.4	2.6	2.7	3.0	3.1	3.1
Other current expenditure	0.1	0.1	0.1	1.0	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure	4.9	5.4	4.5	7.0	5.0	5.9	5.9	5.9	5.9	5.9
Operating balance	-0.5	1.3	1.2	2.1	0.5	1.9	2.4	3.2	3.5	3.4
Net lending/borrowing	-5.4	-4.0	-3.3	-4.9	-4.5	-4.1	-3.5	-2.7	-2.4	-2.5
Statistical discrepancy	-0.8	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	4.6	4.0	3.3	4.9	4.5	4.1	3.5	2.7	2.4	2.5
Net acquisition of financial assets	1.9	3.9	2.7	1.8	1.4	1.4	1.4	1.4	1.4	1.4
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic (net)	1.9	3.9	2.6	1.8	1.4	1.4	1.4	1.4	1.4	1.4
Sale of equity	0.3	0.6	0.7	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Lending minus repayment	1.2	0.8	0.8	1.4	1.0	1.0	1.0	1.0	1.0	1.0
Change in cash/deposit	0.4	2.4	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	6.5	7.9	6.0	6.7	5.9	5.4	4.9	4.1	3.8	3.9
Foreign	2.4	3.5	2.2	3.7	2.2	2.4	2.2	2.2	1.9	1.9
Domestic	4.1	4.4	3.8	3.0	3.7	3.0	2.7	1.9	1.9	1.9
Memorandum items										
Primary balance (billions of Nepali Rupees)	-183	-138	-115	-214	-176	-167	-153	-115	-108	-128
Primary balance (in percent of GDP)	-4.7	-3.2	-2.4	-3.9	-3.2	-2.7	-2.3	-1.5	-1.3	-1.4
Public debt (in percent of GDP)	43.3	44.0	43.8	47.8	47.8	48.8	49.8	50.2	50.0	49.9
External (in percent of GDP)	21.1	21.9	21.1	23.5	23.5	23.8	24.2	24.6	24.6	24.6
Domestic (in percent of GDP)	22.2	22.2	22.7	24.4	24.4	25.0	25.6	25.5	25.4	25.2
Resources for sub-national governments (billions of Nepalese Rupees)	451	505	534	593	474	571	665	778	915	1,015
(in percent of GDP)	11.6	11.8	11.0	10.9	8.7	9.4	9.8	10.4	11.0	11.0
Nominal GDP (billions of Nepalese Rupees)	3,889	4,277	4,852	5,459	5,459	6,101	6,779	7,520	8,340	9,252

Sources: Nepali authorities; and IMF staff estimates and projections.

1/ Fiscal year ends mid-July.

2/ CCRT debt relief is included in grants and net incurrence of liabilities (foreign). The first tranche of CCRT debt relief covering the period April 14, 2020 to October 13, 2020 for SDR 2.9 million in FY 2019/20 was approved on April 13, 2020. The second tranche of CCRT debt relief covering the period October 14, 2020 to April 13, 2021 for SDR 3.6 million was approved on October 2, 2020. The third tranche of CCRT debt relief covering the period April 14, 2021 to October 15, 2021 for SDR 3.6 million was approved on April 1, 2021. The fourth and fifth (final) tranche of CCRT debt service relief covering the period from October 16, 2021 to January 10, 2022 and January 11 to April 13, 2022 was approved on October 6, 2021 and December 15, 2021 respectively for SDR 3.6 million.

3/ 30 percent of VAT and domestic excise revenues are shared with sub-national governments.

Note: Current baseline forecast is as of March 07, 2023. FY2022/23 budget is as of May 29, 2022.

Table 3. Nepal: Monetary Indicators 2019/20-2023/24 1/

	2019/20	2020/21	2021/22	2022/23	2023/24
				Est.	Projections
	(In billions of Nepalese rupees, end-period)				
Nepal Rastra Bank					
Reserve money	886	932	826	877	923
Net domestic assets	-388	-367	-319	-332	-314
Claims on public sector	-74	-137	-175	-163	-163
Claims on private sector	4	3	7	5	5
Claims on banks & financial institutions	7	123	270	232	232
Other items (net)	-326	-356	-420	-405	-388
Net foreign assets	1,274	1,299	1,145	1,209	1,237
Monetary Survey					
Broad money	4,231	5,155	5,505	6,098	6,817
Narrow money	856	1,049	948	919	970
Quasi-money	3,375	4,105	4,557	5,180	5,847
Net domestic assets	2,903	3,804	4,267	4,835	5,524
Domestic credit	3,793	4,811	5,672	6,267	7,002
Credit to public sector	516	671	983	1,231	1,442
of which : Credit to central government	461	593	744	935	1,111
Credit to private sector	3,277	4,140	4,689	5,036	5,561
Other items(net)	-890	-1,007	-1,404	-1,432	-1,478
Net foreign assets	1,328	1,351	1,238	1,263	1,292
	(Twelve-month percent change)				
Reserve money	26.7	5.2	-11.4	6.2	5.3
Broad money	18.1	21.8	6.8	10.8	11.8
Net domestic assets	11.8	31.1	12.2	13.3	14.3
Domestic credit	14.6	26.8	17.9	10.5	11.7
Credit to public sector	29.3	30.1	46.4	25.3	17.1
Credit to private sector	12.6	26.3	13.3	7.4	10.4
Net foreign assets	34.9	1.7	-8.3	2.0	2.3
Memorandum items					
Private credit (in percent of GDP)	84.3	96.8	96.6	92.3	91.1
Net international reserves (in mil. U.S. dollars) 2/	10,291	10,620	8,821	8,647	8,707
Net Foreign Assets, NRB (in percent of GDP)	32.8	30.4	23.6	22.2	20.3
Nominal GDP (in billions of Nepalese Rupees)	3,889	4,277	4,852	5,459	6,101

Sources: Nepali authorities; and IMF staff estimates and projections.
1/ Fiscal year ends mid-July.
2/ Net international reserves program definition, see Technical Memorandum of Understanding.
Note: Current baseline forecast is as of March 07, 2023.

Table 4. Nepal: Balance of Payments 2019/20-2027/28 1/

	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
				Est.			Projections		
				(in millions of US dollars)					
Current account	-339	-2,844	-5,175	-2,185	-2,325	-2,235	-2,415	-2,550	-2,626
Current account (excluding official transfers)	-552	-3,052	-5,313	-2,471	-2,817	-2,761	-2,978	-3,153	-3,239
Trade balance	-9,186	-11,510	-13,759	-12,035	-13,205	-13,839	-14,710	-15,491	-16,286
Exports, f.o.b.	938	1,219	1,754	1,509	1,609	1,711	1,834	1,961	2,110
Imports, f.o.b.	-10,124	-12,729	-15,513	-13,544	-14,813	-15,549	-16,544	-17,453	-18,396
Services (net)	-10	-618	-894	-497	-166	41	129	159	259
Receipts	1,354	671	1,006	1,355	1,812	2,170	2,427	2,635	2,927
Of which : tourism	530	62	266	463	693	954	1,090	1,184	1,287
Payments	-1,364	-1,290	-1,900	-1,852	-1,978	-2,128	-2,298	-2,476	-2,669
Income	399	198	237	398	399	354	384	417	453
Credit	588	517	474	659	695	726	788	855	929
Debit	-189	-318	-237	-260	-296	-372	-403	-438	-476
Current transfers	8,459	9,086	9,240	9,948	10,647	11,209	11,782	12,365	12,948
Credit, of which:	8,506	9,137	9,303	10,002	10,706	11,273	11,851	12,441	13,030
General government	213	208	138	286	492	526	563	603	613
Workers' remittances	7,533	8,150	8,325	8,919	9,384	9,846	10,310	10,776	11,263
Debit	-47	-51	-64	-54	-59	-64	-70	-76	-82
Capital account 2/	123	130	102	157	281	274	281	301	306
Financial account	1,963	2,139	2,544	1,824	2,205	2,374	2,742	2,777	2,926
Direct investment	169	166	155	36	178	294	374	406	441
Portfolio investment	0	0	0	0	0	0	0	0	0
Other investment (net)	1,794	1,974	2,389	1,788	2,027	2,080	2,368	2,372	2,485
Of which: Trade credit	635	856	858	447	521	585	710	766	799
Official loans 3/	1,176	881	760	930	1,101	1,089	1,192	1,151	1,244
Errors and omissions	561	553	982	429	0	0	0	0	0
Overall balance	2,309	-22	-1,547	225	161	412	608	529	606
				(in percent of GDP)					
Current account	-1.0	-7.8	-12.9	-5.2	-5.0	-4.5	-4.4	-4.3	-4.1
Current account (excluding official transfers)	-1.7	-8.4	-13.2	-5.9	-6.1	-5.5	-5.5	-5.3	-5.0
Trade balance	-27.5	-31.7	-34.3	-28.6	-28.6	-27.6	-27.0	-26.2	-25.3
Exports, f.o.b.	2.8	3.4	4.4	3.6	3.5	3.4	3.4	3.3	3.3
Imports, f.o.b.	-30.3	-35.1	-38.6	-32.2	-32.1	-31.0	-30.3	-29.5	-28.6
Services (net)	0.0	-1.7	-2.2	-1.2	-0.4	0.1	0.2	0.3	0.4
Receipts	4.0	1.9	2.5	3.2	3.9	4.3	4.5	4.5	4.6
Of which: tourism	1.6	0.2	0.7	1.1	1.5	1.9	2.0	2.0	2.0
Payments	-4.1	-3.6	-4.7	-4.4	-4.3	-4.2	-4.2	-4.2	-4.1
Income	1.2	0.5	0.6	0.9	0.9	0.7	0.7	0.7	0.7
Credit	1.8	1.4	1.2	1.6	1.5	1.4	1.4	1.4	1.4
Debit	-0.6	-0.9	-0.6	-0.6	-0.6	-0.7	-0.7	-0.7	-0.7
Current transfers									
Credit, of which:	25.4	25.2	23.2	23.8	23.2	22.5	21.7	21.0	20.3
General government	0.6	0.6	0.3	0.7	1.1	1.0	1.0	1.0	1.0
Workers' remittances	22.5	22.5	20.7	21.2	20.3	19.6	18.9	18.2	17.5
Debit	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Capital account 2/	0.4	0.4	0.3	0.4	0.6	0.5	0.5	0.5	0.5
Financial account	5.9	5.9	6.3	4.3	4.8	4.7	5.0	4.7	4.5
Direct investment	0.5	0.5	0.4	0.1	0.4	0.6	0.7	0.7	0.7
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment (net)	5.4	5.4	6.0	4.2	4.4	4.1	4.3	4.0	3.9
Of which: Trade credit	1.9	2.4	2.1	1.1	1.1	1.2	1.3	1.3	1.2
Official loans	3.5	2.4	1.9	2.2	2.4	2.2	2.2	1.9	1.9
Errors and omissions	1.7	1.5	2.4	1.0	0.0	0.0	0.0	0.0	0.0
Overall balance	6.9	-0.1	-3.9	0.5	0.3	0.8	1.1	0.9	0.9
Memorandum items									
Imports (y/y percent change)	-18.2	25.7	21.9	-12.7	9.4	5.0	6.4	5.5	5.4
Exports of G&S (in percent of GDP)	6.9	5.2	6.9	6.8	7.4	7.7	7.8	7.8	7.8
Imports of G&S (in percent of GDP)	34.4	38.6	43.4	36.6	36.3	35.2	34.6	33.7	32.7
Remittances (y/y percent change)	-3.0	8.2	2.1	7.1	5.2	4.9	4.7	4.5	4.5
Total external debt (in percent of GDP)	23.5	25.9	27.0	26.8	27.2	27.8	28.6	28.8	29.0
Gross official reserves (in mil U.S. dollars)	10,559	10,884	8,953	9,090	9,234	9,597	10,155	10,631	11,183
In months of prospective imports	9.0	7.5	7.0	6.5	6.3	6.1	6.1	6.1	6.0
As a share of broad money (in percent)	30.1	25.2	20.8	19.8	18.2	17.5	17.0	16.4	15.9
Net international reserves (in mil. U.S. dollars) 3/	10,291	10,620	8,821	8,647	8,707	8,995	9,557	10,087	10,702
Nominal GDP (in mil U.S. dollars)	33,434	36,289	40,149	42,097	46,207	50,211	54,523	59,198	64,328

Sources: Nepali authorities; and IMF staff estimates and projections.

1/ Fiscal year ends mid-July.

2/ The first tranche of CCRT debt relief covering the period April 14, 2020 to October 13, 2020 for SDR 2.9 million in FY 2019/20 was approved on April 13, 2020. The second tranche of CCRT debt relief covering the period October 14, 2020 to April 13, 2021 for SDR 3.6 million was approved on October 2, 2020. The third tranche of CCRT debt relief covering the period April 14, 2021 to October 15, 2021 for SDR 3.6 million was approved on April 1, 2021. The fourth and fifth (final) tranche of CCRT debt service relief covering the period from October 16, 2021 to January 10, 2022 and January 11 to April 13, 2022 was approved on October 6, 2021 and December 15, 2021 respectively for SDR 3.6 million.

3/ Net international reserves program definition, see Technical Memorandum of Understanding.

Note: Current baseline forecast is as of March 07, 2023.

Table 5. Nepal: External Financing Requirements and Sources, FY2021/22-2024/25

(In millions of U.S. dollars)

	2021/22	2022/23	2023/24	2024/25
		Projections		
Gross external financing requirements	**3922**	**1865**	**2163**	**2056**
Current account excluding official transfers (+ = deficit)	5313	2467	2813	2752
Amortization of medium- and long-term debt	238	256	277	295
Other net capital flows (- = outflow) 1/	1630	859	927	992
Available financing	**1059**	**1283**	**2010**	**2144**
Current and capital grants 2/	240	443	773	800
Medium- and long-term borrowing excluding exceptional financing	664	804	1059	1050
FDI, net	155	36	178	294
Portfolio investment, net	0	0	0	0
Financing gap	**2863**	**582**	**154**	**-88**
Exceptional/additional financing 3/	**2085**	**153**	**154**	**-88**
IMF: ECF arrangement	110.0	52.3	94.1	83.7
Asian Development Bank	0	150	25	50
World Bank	145	180	200	200
Other development partners 4/	79	0	0	0
Gross reserves accumulation (+ = decrease)	1751	-229	-165	-422
Memorandum items				
Gross official reserves (in millions of U.S. dollars)	8953	9094	9243	9615
In months of prospective imports	7.0	6.5	6.3	6.1

1/ Other includes currency and deposits, trade credits and other financial flows.
2/ CCRT debt relief is included in grants and net incurrence of liabilities (foreign). The first tranche of CCRT debt relief covering the period April 14, 2020 to October 13, 2020 for SDR 2.9 million in FY 2019/20 was approved on April 13, 2020. The second tranche of CCRT debt relief covering the period October 14, 2020 to April 13, 2021 for SDR 3.6 million was approved on October 2, 2020. The third tranche of CCRT debt relief covering the period April 14, 2021 to October 15, 2021 for SDR 3.6 million was approved on April 1, 2021. The fourth and fifth (final) tranche of CCRT debt service relief covering the period from October 16, 2021 to January 10, 2022 and January 11 to April 13, 2022 was approved on October 6, 2021 and December 15, 2021 respectively for SDR 3.6 million.

3/ Exceptional financing includes firm financing assurances for the next 12 months of the program and good prospects of financing over the program and projection period.

4/ Debt Service Suspension Initiative (DSSI) of US$52.6 million in FY2020/21. In line with the Revised Paris Club MOU, repayments are projected to start in FY2022/23 for a period of five years with a one-year grace period.

Note: Current baseline forecast as of March 07, 2022.

Table 6. Nepal: Financial Soundness Indicators, 2019/20-2022Q2

	2019/20	2020/21	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2
Capital adequacy								
Regulatory capital to risk weighted assets	13.71	13.76	13.59	14.17	13.4	13.3	13.5	13.1
Tier 1 capital to risk weighted assets	11.79	11.33	10.91	10.92	10.4	10.4	10.6	10.2
Asset quality								
NPLs to total gross loans	1.66	1.68	1.37	1.37	1.2	1.2	1.3	2.6
Loan loss provisions to NPLs	65.90	70.24	70.30	67.97	70.6	71.4	66.8	98.8
Deposits and credits								
Credit to deposit ratio	83.20	88.08	88.77	91.09	92.9	91.4	90.5	86.6
Credit to core capital cum deposit	69.60	76.32	77.05	78.64	81.7	85.5	...	...
Liquidity								
Cash & bank balance to total deposits	12.20	9.51	8.19	7.97	7.8	6.9	7.0	7.9
Total liquid assets to total deposits	27.90	26.18	24.01	24.84	23.6	21.6	23.4	24.3
Exposure to real estate								
Share of real estate and housing loans	11.96	10.95	10.72	10.74	10.8	11.3	12.2	11.9
Share of loans collateralized by fixed assets	76.20	74.70	75.47	74.68	74.2	74.8	75.3	76.0
Revolving loans								
Overdraft	15.00	15.20	15.13	15.29	15.2	16.2	16.4	16.1
Demand & working capital loans	21.50	21.10	21.41	21.28	22.9	20.2	21.6	21.8

Source: Nepali authorities.

Table 7. Nepal: Current Access and Phasing Under the Extended Credit Facility 1/

Review	Available from	Conditions	Disbursement SDR Million	Disbursement Percent of Quota
	January 12, 2022	Board approval of the Arrangement	78.50	50%
First Review	June 12, 2022	Observance of mid-Jan 2022 performance criteria, completion of first review	39.20	25%
Second Review	January 12, 2023	Observance of mid-July 2022 performance criteria, completion of second review	39.20	25%
Third Review	July 12, 2023	Observance of mid-Jan 2023 performance criteria, completion of third review	31.40	20%
Fourth Review	January 12, 2024	Observance of mid-July 2023 performance criteria, completion of fourth review	31.40	20%
Fifth Review	July 12, 2024	Observance of mid-Jan 2024 performance criteria, completion of fifth review	31.40	20%
Sixth Review	January 12, 2025	Observance of mid-July 2024 performance criteria, completion of six review	31.32	20%
Total			**282.42**	**180%**

Source: IMF staff estimates.

1/ Nepal's quota is SDR 156.9 million.

Table 8. Nepal: Proposed Access and Phasing Under the Extended Credit Facility 1/

Review	Available from	Conditions	Disbursement SDR Million	Disbursement Percent of Quota
	January 12, 2022	Board approval of the Arrangement	78.50	50%
First Review	June 12, 2022	Observance of performance criteria on Jan 14, 2022, completion of first review	19.60	13%
Second Review	January 12, 2023	Observance of performance criteria on Jul 14, 2022, completion of second review	19.60	13%
Third Review	November 1, 2023	Observance of performance criteria on Jul 16, 2023, completion of third review	39.20	25%
Fourth Review	May 1, 2024	Observance of performance criteria on Jan 14, 2024, completion of fourth review	31.40	20%
Fifth Review	November 1, 2024	Observance of performance criteria on Jul 15, 2024, completion of fifth review	31.40	20%
Sixth Review	May 1, 2025	Observance of performance criteria on Jan 13, 2025, completion of sixth review	31.40	20%
Seventh Review	November 1, 2025	Observance of performance criteria on Jul 15, 2025, completion of seventh review	31.32	20%
Total			**282.42**	**180%**

Source: IMF staff estimates.

1/ Nepal's quota is SDR 156.9 million.

Table 9. Nepal: Quantitative Performance Criteria (PC) and Indicative Targets (IT) 1/

(Cumulative Rs. million unless otherwise indicated)

	FY2020/21	FY2021/22								FY2023/24	
	15-Jul-21	14-Jan-22				16-Jul-22				16-Jul-23	14-Jan-24
	Initial level	Program target	Adjusted target	Outturn	Status	Program target	Adjusted target	Outturn	Status	Program target	Program target
Quantitative performance criteria:											
Primary deficit of the federal government (ceiling; in NPR million) 1,3,4,6,7/	181,841										435,959
Stock of NBR's net international reserves (floor; in U.S. dollars million) 1,8/	10,884	8,640	8,640	8,870	met	8,640	8,344	8,821	met	8,038	8,038
Accumulation of external payments arrears (ceiling) 2/	0	0	0	0	met	0	0	0	met	0	0
Indicative targets:											
Primary deficit of the federal government (ceiling; in NPR million) 1,3,4,6,7/	181,841	417,248	404,316	-50,786	met	333,591	296,329	163,470	met	256,523	..
Indicative target: federal government spending on child allowance (floor; in NPR million) 5/	4,200					5,300	5,300	6,987	met	6,987	3,092
Memorandum items:											
Budget support from development partners (in U.S. dollars million) 1,10/	182	150		224		641		345		330	443
Revenues of the budgetary central government under the program (in NPR million) 1,3/	827,012	278,030		481,062		926,767		938,280		968,166	341,044
Revenue targets of the budgetary central government (in NPR million) 1,3,9/	889,618	475,757		..		1,050,821		..		1,066,000	NA
Primary deficit adjustor for revenue (in NPR million)	..	..		-5,305		..		0		..	..
Ceiling of primary deficit adjustor for revenue shortfalls (in NPR million)	..	71,804		..		124,003		..		109,170	61,009
Foreign-financed project loan disbursements (in NPR million) 1,3/	129,773	19,482		11,854		129,883		92,621		104,207	13,977
Primary deficit adjustor for foreign-financed project loan disbursements (in NPR million) 1,3/	..	..		-7,628		..		-37,262		..	..

Sources: Nepali authorities; and IMF staff estimates/projections based on the Nepali fiscal year and calendar.

1/ The quantitative targets, indicative targets, program exchange rates and adjustors are defined in the Technical Memorandum of Understanding (TMU). Foreign currency deposits of commercial banks and other financial institutions held at the NRB are considered reserve related liabilities and excluded.

2/ This quantitative target is applied on a continuous basis.

3/ Cumulative from the beginning of the fiscal year.

4/ Excludes interest payments.

5/ The social spending indicative target will initially be a floor on spending on the child protection grant. This indicative target will start in the second review with the test dates beginning in January 2024. The initial floor will be FY2020/21 outturns plus an additional amount to reflect the announced one third increase in budget.

6/ The program targets for the primary deficit include adjustors for the level of revenue collection. The upward adjustment to the ceiling is capped at NPR 124,003 million for FY2021/22.

7/ The program targets for the primary deficit include adjustors for foreign-financed project loan disbursements on concessional terms. Foreign-financed project loan disbursements is the difference between total external financing and budget support from development partners.

8/ The program targets for net international reserves include adjustors for budget support from development partners and for revenue collection. Any downward adjustment to the NIR floor will be capped at USD 688 million for the next 12 months to maintain reserve adequacy.

9/ Authorities have not yet informed their FY2023/24 revenue targets.

10/ For the July 16 2023 and January 14 2024 testing dates the figures are cumulative of the period from July 17, 2022 to July 16 2023 and July 17 2023 to January 14, 2024 respectively.

Table 10. Nepal: Indicators of Capacity to Repay the Fund, FY2022/23-2035/36 1/

	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32	2032/33	2033/34	2034/35	2035/36
Fund obligations based on existing credit (millions of SDR) 2/														
Principal	7.1	7.1	7.1	35.0	39.2	47.1	47.1	47.1	15.7	7.9	0.0	0.0	0.0	0.0
Charges and interest	0.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Fund obligations based on existing and prospective credit (millions of SDR)														
Principal	7.1	7.1	7.1	35.0	39.2	47.1	58.8	72.2	53.4	48.6	40.8	29.0	15.7	3.1
Charges and interest	0.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Total obligations based on existing and prospective credit														
Millions of SDR	7.8	9.8	9.8	37.6	41.9	49.7	61.5	74.8	56.0	51.3	43.4	31.7	18.3	5.8
Billions of Nepali Rupees	1.3	1.7	1.8	6.9	7.9	9.6	11.9	14.5	10.9	9.9	8.4	6.1	3.6	1.1
Percent of exports of goods and services	0.4	0.5	0.4	1.3	1.3	1.5	1.7	1.9	1.3	1.1	0.9	0.6	0.3	0.1
Percent of debt service	1.1	0.9	0.8	2.8	2.8	3.1	3.6	4.0	2.7	2.3	1.8	1.2	0.6	0.2
Percent of GDP	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Percent of government revenue	0.1	0.2	0.1	0.5	0.4	0.5	0.5	0.6	0.4	0.3	0.2	0.2	0.1	0.0
Percent of quota	4.9	6.2	6.2	24.0	26.7	31.7	39.2	47.7	35.7	32.7	27.7	20.2	11.7	3.7
Outstanding IMF credit based on existing and prospective drawings														
Millions of SDR	292.4	355.9	411.6	407.9	368.7	321.6	262.8	190.6	137.3	88.6	47.8	18.8	3.1	0.0
Billions of Nepali Rupees	49.1	62.6	74.0	75.3	69.8	62.4	51.0	37.0	26.6	17.2	9.3	3.7	0.6	0.0
Percent of exports of goods and services	14.2	16.7	16.2	14.2	11.8	9.5	7.1	4.8	3.2	1.9	0.9	0.3	0.1	0.0
Percent of debt service	42.7	32.1	32.7	30.3	24.9	20.3	15.3	10.2	6.7	4.0	2.0	0.7	0.1	0.0
Percent of GDP	1.0	1.1	1.2	1.1	0.9	0.7	0.6	0.4	0.2	0.1	0.1	0.0	0.0	0.0
Percent of government revenue	4.4	5.5	5.6	4.9	3.9	3.1	2.2	1.5	1.0	0.6	0.3	0.1	0.0	0.0
Percent of quota	186.4	226.8	262.3	260.0	235.0	205.0	167.5	121.5	87.5	56.5	30.5	12.0	2.0	0.0
Net use of IMF credit (millions of SDR)	35.6	63.5	55.7	-3.6	-39.2	-47.1	-58.8	-72.2	-53.4	-48.6	-40.8	-29.0	-15.7	-3.1
Disbursements	42.8	70.6	62.8	31.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments and repurchases	7.1	7.1	7.1	35.0	39.2	47.1	58.8	72.2	53.4	48.6	40.8	29.0	15.7	3.1
Memorandum items:														
Exports of goods and services (millions of SDR)	2,058	2,131	2,539	2,869	3,138	3,373	3,697	4,006	4,341	4,705	5,099	5,526	5,989	6,491
Debt service (billions of NPR)	115.1	194.7	226.2	248.4	279.8	307.1	333.4	362.9	395.7	425.3	465.0	509.3	560.1	615.1
Nominal GDP (at market prices, billions of NPR)	4,852	5,459	6,101	6,779	7,520	8,340	9,252	10,258	11,374	12,612	13,984	15,506	17,193	19,064
Government revenue (billions of NPR)	1,115	1,144	1,331	1,530	1,786	2,045	2,266	2,510	2,780	3,079	3,411	3,779	4,186	4,637
Quota (millions of SDR)	156.9	156.9	156.9	156.9	156.9	156.9	156.9	156.9	156.9	156.9	156.9	156.9	156.9	156.9

Source: IMF staff estimates and projections.

1/ Reporting Year: August to July.

2/Nepal received debt relief of SDR 3.6 million in FY2020/21 covered by grants from the CCRT. The fourth and fifth (final) tranche of CCRT debt service relief covering the period from October 16, 2021 to January 10, 2022 and January 11 to April 13, 2022 was approved on October 6, 2021 and December 15, 2021 respectively .

Table 11. Nepal: Structural Benchmark Status, Modifications and New Structural Benchmarks: January 2023-July 2024

Measure	Original Target Date	Status	Proposal
Cross-Cutting Institutional Reforms to Enhance Fiscal Transparency and Governance, and Reduce Vulnerability to Corruption			
Implementing agency publishes on a government website large public procurement documentation, ex-post validation of delivery, name of awarded companies, and name of beneficial owner(s) for all new, large, COVID-19 related procurement contracts consistent with the December 2021 public information notice (as of December 9, 2021).	Prior Action	**Met**	
The MOF publishes the 4th COVID-19 Active Response and Expenditure Support Program (CARES) report which includes federal government budget expenditures related to COVID-19 on a government website.	End-April 2022	**Met**	
An external audit of the NRB financial statements for FY2021/22 is commissioned, consistent with the recommendation in the 2021 Safeguards Assessment	End-April 2022	**Not met, implemented September 2022**	
The FCGO reports the consolidated financial information of all operational funds in annual financial statements, starting with FY2020/21	End-May 2022	**Not met**	Reset and modified below
The FCGO reports the consolidated financial information of all operational funds in annual financial statements, starting with FY2021/22		**Modified and reset**	Reset to end-August 2023
The MOF submits to Parliament amendments to modernize the NRB Law, addressing key recommendations of the 2021 Safeguards Assessments Report	End-October 2022	**Not met**	Reset to end-August 2023
Revenue mobilization			
The MOF publishes a report on tax exemptions related to customs	End-April 2022	**Not met, implemented May 2022**	
The MOF publishes a report on tax exemptions for all other non-customs related taxes	End-October 2022	**Not met**	Reset to end-August 2023
MOF approval of a revenue mobilization strategy covering tax policy, law, and revenue administration reforms		**New**	End-April 2024
The MOF publishes a comprehensive report on tax expenditures		**New**	End-April 2024
Fiscal Sustainability and Fiscal Risk Management			
The MOF implements a fiscal risk register to capture various dimensions of major fiscal risks	End-October 2022	**Not met**	Reset to end-August 2023
The MOF develops cash flow forecasting to be shared with the PDMO and NRB on a regular basis	End-October 2022	**Not met**	Reset to end-September 2023
All PEs will publish their annual financial statements		**New**	End-April 2024
The four priority nonfinancial PEs (Nepal Electricity Authority, Nepal Oil Corporation, Nepal Airlines Corporation and Nepal Doorsanchar Company (Nepal Telecom)) will have their FY2022/23 financial statements audited		**New**	End-April 2024
Advance fiscal federalism in a fiscally prudent manner, for better delivery of public services			
Cabinet approval of fiscal risk monitoring system for subnational government		**New**	End-April 2024

Table 11. Nepal: Structural Benchmark Status, Modifications and New Structural Benchmarks: January 2023-July 2024 (concluded)

Equitable and Sustainable Growth			
The National Planning Commission (NPC) issues a Poverty Reduction and Growth Strategy Paper	End-October 2022	**Not met, implemented March 2023**	
Cabinet approves an action plan to improve the efficiency of public investment spending and strengthen climate resilience, drawing on recommendations of a Public Investment Management Assessment (PIMA)	End-October 2022	**Not met**	Reset to end-April 2024
Financial Sector Regulation & Supervision			
The NRB enhances and customizes its current bank reporting template to enhance the timely monitoring of the impact of COVID-19 impact on the financial sector	End-April 2022	**Met**	
The NRB Board approves an action plan for full implementation of the Supervisory Information System (SIS) for class A banks	End-April 2022	**Not met, implemented December 2022**	
The NRB drafts amendments to the regulations to (1) strengthen the identification criteria of non-performing loans (e.g. unlikeliness to repay in full, debt servicing with another loan); (2) clarify the rules of asset classification and reclassification, including for revolving loans; and (3) provide a clear guidance on restructuring and rescheduling	End-April 2022	**Not met, implemented May 2022**	
The NRB issues the updated regulation on asset classification	End-October 2022	**Not met**	Reset to end-August 2023
The NRB completes the full implementation of the SIS among class A, banks, including the onsite module	End-October 2022	**Not met**	Reset and modified below
The NRB completes the full implementation of the SIS among class A, B and C banks, excluding the onsite module		**Modified and reset**	End-August 2023
The NRB completes implementation of the onsite module of the SIS among class A banks		**Reset**	End-April 2024
Launch for 10 largest Banks in-depth on-site inspections assisted by independent international third-party auditors		**New**	End-April 2024

Annex I. Spillovers from Russia's War in Ukraine

Higher global commodity prices have exacerbated balance of payment difficulties and resulted in reserve loss, notwithstanding Nepal's limited direct trade, migration and financial linkages with Russia and Ukraine. Even as authorities began to tighten monetary policy in the second half of the fiscal year, Net International Reserves (NIR) fell by 22 percent in FY2021/22, with about a third of the fall attributed to a post-invasion increase in oil imports. Given the high level of global uncertainty, staff propose that future quantitative PCs reflect the revised and uncertain outlook. This would ensure the authorities can avoid taking sharp and undesirable policy measures to affect the current account and meet future targets. In the medium term, the implementation of ECF-supported reforms and financing pledged by development partners alongside lower global commodity prices, will help facilitate a more durable current account adjustment.

1. **The economic recovery is experiencing headwinds from global shocks**. Nepal has limited direct economic and financial linkages with Russia and Ukraine. Only 2 percent of Nepal's total imports originate in Russia and Ukraine and restrictions to equity and portfolio investment limit spillovers through the financial sector. Further, Ukraine and Russia make up less than 1 percent of tourist arrivals and are outside the top 20 destinations for Nepali migrants. However, the indirect impact is large because the economy is dependent on key commodities affected by the war. In 2021, global prices for food and fuel (approximately one third of total imports) increased by 26 and 66 percent, respectively. In 2022, these prices again rose at double digit growth rates. Further, commodities including fuel, fertilizer and chemicals are essential inputs into the agriculture and manufacturing sectors, which drive growth, employment, and poverty reduction. Higher prices have depressed output growth, exerted inflationary pressures, and exacerbated balance of payment difficulties, and lead to an additional reserve loss through FY2021/22 estimated at USD 610 million.[1]

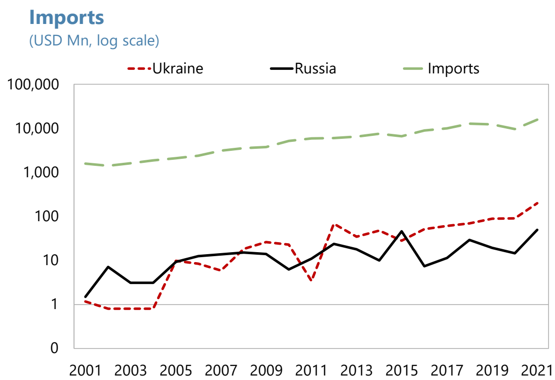
2. **Staff propose to reset the NIR target to reflect the revised outlook**. The NIR quantitative PC for the July 14, 2022 test date of USD 8,640 million was set at the time of the ECF request using a roughly US$1 billion buffer between forecast and target NIR to allow for global uncertainty. NIR at program exchange rates was USD 8,821 million at the test date, so the target was met even with higher-than-projected commodity prices, albeit with support from the import restrictions that violated the continuous PCs. The July 16, 2023 NIR target is set to USD 8,038 million (an equivalent of 6.1 month of import cover of gross international reserves), which is below the end-year FY2022/23 projected amount by roughly USD 610 million—approximately equivalent to the shock from higher-than-expected oil price in 2022 as a buffer in case of additional volatility (see text chart on reserve loss).

3. **Policies will help smooth the adjustment to the global price shocks**. A drawdown of Nepal's buffers provides an important first line of defense against shocks. The steadfast implementation of fiscal and monetary policy measures as envisaged in the ECF will help facilitate a durable current account adjustment in the medium term.

[1] Obtained by using actual FY2021/22 oil imports minus imports estimated using FY2021/22 volumes and prices as projected in January 2022 for the ECF request.

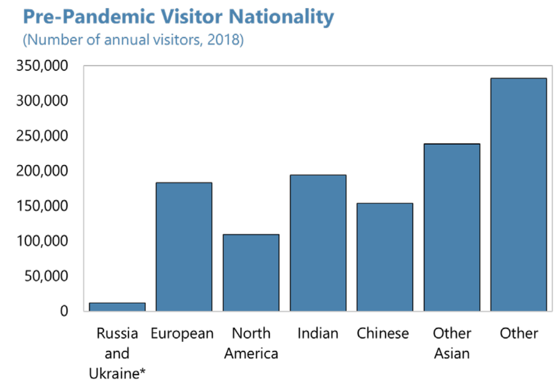
Nepal: Spillovers from the War in Ukraine

Imports from Ukraine and Russia make up a small fraction of total imports…



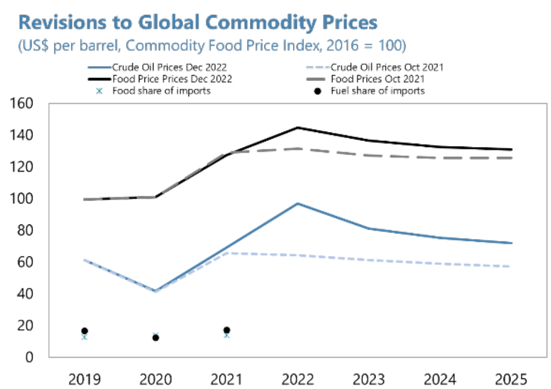
Source: CEIC.

…and less than 1 percent of pre-pandemic tourists.



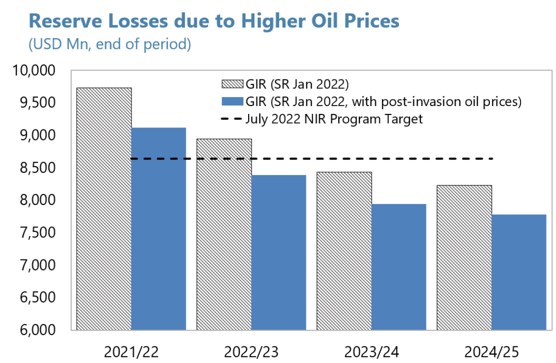
Source: CEIC.

However, imports of food and oil make up a third of the import basket and were substantially revised up in 2022.



Source: International Monetary Fund.

Consequently, adjusting for the impact of higher oil prices implies a substantial decline in reserves compared to forecasts at the time of the program request.



Sources: Nepal authorities; and IMF staff calculations.
Note: Blue bars show GIR as would have been projected in January 2022, but with post-invasion oil prices and no changes to other assumptions.

Annex II. External Sector Assessment[1]

Overall Assessment*: The external position in FY2021/22 was substantially weaker than the level implied by fundamentals and desirable policies, with a large current account deficit driven by accommodative monetary policy, strong credit growth, and elevated commodity prices. Despite a substantial drawdown in FY2021/22, the current level of foreign reserves is assessed to be adequate, supporting the peg to the Indian rupee. The current account gap is projected to shrink in FY2022/23 as a result of monetary policy tightening and unwinding of pandemic-related support measures, that have already been taken by authorities.*

Potential Policy Responses*: Prudent implementation of the FY2022/23 budget and maintaining a cautious and data-driven monetary policy stance are crucial to reducing the current account gap and preserving external stability. In the medium term, the peg to the Indian rupee serves as a reliable anchor for inflation expectations and reduces exchange rate uncertainty for trade and investment with Nepal's main trading partner. Nevertheless, real appreciation of the Nepali rupee can negatively affect competitiveness. Structural reforms to improve competitiveness—for example, through investing in resilient and sustainable infrastructure, reducing market frictions, investing in human capital, adopting modern agricultural techniques, and promoting trade and foreign investment— along with maintaining low and stable inflation can help address medium- and long-term external vulnerabilities and stimulate economic development.*

Foreign Assets and Liabilities: Position and Trajectory

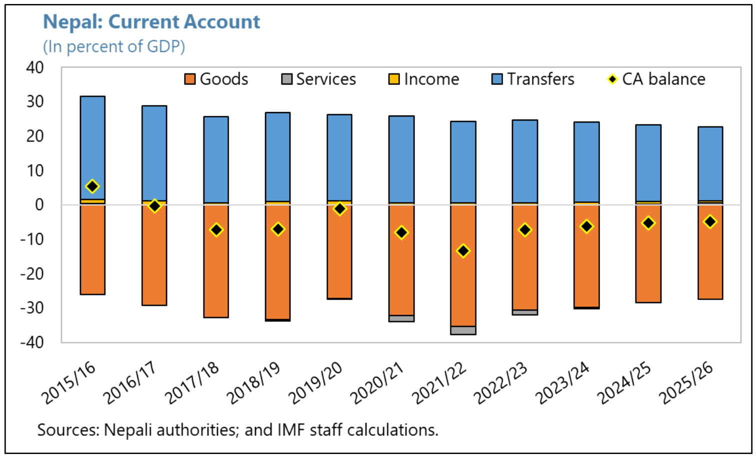
Background. The net IIP was estimated at USD -2,065 million (-5.3 percent of GDP) at the end of FY2021/22 (mid-July 2022). As in many developing economies, the majority of external assets (more than 85 percent) were in the form of reserve assets held by the NRB. External liabilities were mostly concessional loans from multilateral and bilateral sources at around 65 percent, and the share of foreign direct investment (FDI) was still relatively small at 16 percent owing to a weak business climate and barriers to investing across borders. Reflecting persistently large current account deficits, the net IIP has declined substantially in recent years, from 17 percent of GDP in FY2015/16, and notably so in FY2021/22 when Nepal turned from a net creditor to net borrower.

Assessment. The declining trend in net IIP is likely to continue in the coming years, albeit at a slower pace as current account deficits are projected to decrease. At present, the net IIP is small, and there are no immediate sustainability concerns.

FY2021/22 (% GDP)	NIIP: -5.3	Gross Assets: 27.4	Debt Assets: 0.0	Gross Liab.: 32.7	Debt Liab.: 25.7

[1] The assessment is based on FY2021/22 (mid 2022) data for Nepal and end 2021 data for other countries.

Current Account



Background. Driven by reconstruction after the 2015 earthquake, Nepal ran large current account (CA) deficits in FY2017/18 and FY2018/19, respectively at 7.1 and 6.9 percent of GDP. The CA deficit narrowed to 1.0 percent in FY2019/20 during the first wave of the pandemic, but then widened back to 7.9 percent as the economy recovered in FY2020/21. Imports soared, while remittances have not kept up. The deficit widened further in FY2021/22 amid accommodative monetary policy and strong credit growth, compounded by elevated commodity prices, driven in part by the Russia's war in Ukraine. Imports are projected to fall, and CA deficit to shrink in FY2022/23 after the authorities tightened monetary policy and began unwinding pandemic support measures in the financial sector, gradually increased domestic energy prices to align them with global developments, and introduced a number of administrative measures to restrict imports.[1]

Nepal: EBA-lite Model Results, 2022

	CA model 1/	**REER model** 1/
	(in percent of GDP)	
CA-Actual	**-12.9**	
Cyclical contributions (from model) (-)	-1.8	
COVID-19 adjustors (-) 2/	-0.9	
Additional temporary/statistical factors (-)	0.0	
Natural disasters and conflicts (-)	-0.5	
Adjusted CA	**-9.7**	
CA Norm (from model) 3/	**-5.1**	
CA Gap	**-4.6**	**-2.4**
o/w Relative policy gap	-1.2	
Elasticity	-0.1	
REER Gap (in percent)	**34.8**	**18.6**

1/ Based on the EBA-lite 3.0 methodology
2/ Additional cyclical adjustment to account for the temporary impact of the tourism (0.6 percent of GDP) and remittances (0.3 percent of GDP).
3/ Cyclically adjusted, including multilateral consistency adjustments.

Assessment. Reflecting a significant widening of the CA deficit in FY2021/22, the EBA-lite CA model indicates a CA gap of -4.6 percent of GDP, with an adjusted CA deficit of 9.7 percent of GDP and adjusted CA norm of 5.1 percent of GDP. The adjusted CA deficit accounts for the terms-of-trade gap (a cyclical component of -1.8 percent of GDP), and for a pandemic-induced slowdown in tourism and remittances (COVID-19 adjustors of -0.9 percent of GDP). The CA gap estimate from the CA model indicates an external position that is substantially weaker than implied by fundamentals and desirable policies. Assuming the elasticity of the trade balance with respect to the REER of -0.14, the model implies a REER gap of 34.8 percent. The estimate is, however, subject to elevated uncertainty as the country is hit by the two consecutive major shocks of COVID-19 and the war in Ukraine. Furthermore, the gap is projected to narrow in FY2022/23 as a result of monetary policy tightening and other policy measures that have already been taken by the authorities.

Real Exchange Rate

Background. After a period of continued appreciation (2014-2017), the real effective exchange rate (REER) had been broadly stable prior to and during the COVID-19 pandemic (2017-2020). The Nepali rupee depreciated against the US dollar by about five percent in FY21/22 as a result of monetary policy tightening in the US. However, the nominal effective exchange rate (NEER) and the REER did not change much as inflation in Nepal has been generally higher than in its main trading partners, and their currencies depreciated against the US dollar too.

Assessment. The EBA-lite IREER model indicates a REER gap of 18.6 percent over the equilibrium level in FY2021/22. This implies a CA gap of -2.4 percent - consistent with the EBA-Lite CA model. The overall assessment of the external position is based on the CA model.

Capital and Financial Accounts: Flows and Policy Measures

Background. The financial account remains mostly closed, and portfolio flows are negligible. Net capital and financial account inflows increased considerably though, from 0.3 percent of GDP in FY2015/16 to 6.3 percent of GDP in FY2021/22, driven mostly by higher official loans and trade credits (1.9 and 2.1 percent of GDP respectively). External borrowing by banks and other sectors and non-resident deposits are small but picked up in the last quarter of FY2021/22 and in FY2022/23, possibly due to increasing bank deposit rates. FDI remained small at only 0.4 percent of GDP in FY2021/22. Official loans are expected to remain strong in the coming years, as support from multilateral and bilateral sources helps Nepal fight against the COVID-19 pandemic, finance climate action, and advance socio-economic development.

Assessment. As the financial account remains mostly closed and financial inflows consist of mostly long-term concessional loans from multilateral and bilateral development partners, vulnerabilities related to capital flows are limited.

FX Intervention and Reserves Level

Background. Nepal is a landlocked country and relies heavily on India for trade with the rest of the world. According to the trade treaty with India, Nepal can settle trade with India in Indian rupees and foreign direct investment from India can be made in Indian rupees. About a quarter of official reserves are held in Indian rupees. The reserves reached US$11.7 billion (11.5 months of prospective imports of goods and services) in mid-January 2021, on the back of a sharp drop in imports, resilient remittance performance, and continued financing inflows from development partners including the IMF. The reserves then dropped to US$8.9 billion in mid-May 2022—driven primarily by a surge in imports amid accommodative monetary policy, strong credit growth, and elevated commodity prices—but have remained stable since then, and still above the reserve adequacy metric, as a result of monetary policy tightening and other policy measures.

Assessment. For the purpose of Assessing Reserve Adequacy (ARA), and given that it rarely borrows from international capital markets, Nepal is classified as a "credit constrained" non-resource rich economy with a fixed exchange rate regime. The ARA methodology balances the benefits of holding reserves, e.g. reducing the probability of an external stress event and smoothing its impact, against the opportunity cost, assuming sovereign borrowing at 6.2 percent—an average estimate for low income countries. The model mechanically puts the optimal level of reserves at 4.4 months of prospective imports of goods and services. The estimate is subject to high uncertainty, given the turbulent macroeconomic indicators since the onset of the COVID-19. Given Nepal's high vulnerability to natural disasters and changes in remittances, a modification to the ARA methodology raises the optimal level of reserves to 5.2 months by assuming an additional absorption loss of 2 percentage points of GDP - about equivalent to 90^{th} percentile damage from natural disasters and drops in remittances in the last ten years. This is down from 5.5 months in the last ESA given the program with the IMF and improved Country Policy and Institutional Assessment (CPIA) score.

[1] LC and margin requirements were imposed on the import of 20 items by Circular No. 15/2021-22 dated December 20, 2021. Circular No. 20/2021-22 dated February 9, 2022 extended the requirement to 47 items. With the second Circular, mandatory cash margins were tightened from 15 percent of the imports value to 50-100 percent on a broad set of import commodities; overall 41 out of 97 2-digit Harmonized System (HS) product categories affected. It also proscribed payment of interest on the margin deposits for the import of 47 items. The import bans were imposed by Notification of Nepal Gazette (Part 72) dated April 26, 2022 on SUVs, cars and vans; mobile phones with the price above USD 600; color TVs with a large diagonal; and few other items, with informal guidance issued to banks already in February.

Annex III. Risk Assessment Matrix

Source of Risks	Likelihood/Time Horizon	Expected Impact on Economy	Policy Response
Potential Domestic Shocks			
Frequent and/or severe natural disasters	Medium **Medium to long term**	High. Earthquakes, flooding, climate and other disasters cause severe damage and economic disruption. Fiscal deficits and debt ratios increase in response.	• Focus on risk management and resilience in infrastructure, building codes and public investment. • Build and maintain fiscal and reserve buffers • Maintain and strengthen social safety nets
Financial sector vulnerabilities intensify	Medium **Short to Medium Term**	High. Financial sector risks are likely to have accumulated during the extended period of accommodative monetary policy. The impact of unwinding of pandemic-related support measures and deterioration in repayment capacity of borrowers or other catalytic domestic and external events, risk triggering financial sector stability concerns.	• Implement risk-based supervision to limit potential financial sector consequences. • Focus on the repayment capacities of borrowers, deterioration in the loan portfolios and wide use of working capital and other revolving loans. • Ensure relevant asset classification of loans and sufficient provisioning • Committed implementation of the financial sector reforms under the program. • Protect fiscal policy space to allow for an appropriate response if downside risks occur.
Political instability	Medium **Short to Medium Term**	Medium. The political cycle generates governance instabilities, restricting policy making and delivery. Economic activity is disrupted.	• Secure policy continuity if political instability occurs. • Ensure transparency, accountability, and inclusion in policy implementation.
Risks from poor implementation capacity and pressure for loose fiscal and monetary stance	Medium **Medium Term**	Medium. This would lead to higher budget deficits, increased debt ratios, ineffective public services delivery, inflation, external sector pressure and ultimately weaker growth.	• Remain committed to fiscal targets and reforms under the program. • Maintain cautious and data-driven monetary policy
Low public expenditure execution for growth enhancing capital projects	Medium **Short to Medium Term**	Medium. This would lead to lower growth and investment.	• Remain committed to fiscal targets and reforms under the program.

Source of Risks	Likelihood/Time Horizon	Expected Impact on Economy	Policy Response
			• Improve public investment management
Potential External Shocks			
Abrupt global slowdown or recession in major trading partners, particularly India and GCC	**Medium** **Short to Medium Term**	**High**. Nepal is heavily dependent on trading partners for exports (including tourism), imports and remittances. A slower than expected recovery will impact macroeconomic stability and growth.	• Maintain adequate reserve levels and fiscal policy space as buffers.
Commodity price volatility	**Medium** **Short to Medium Term**	**High**. Balance of payment pressures, as well as a drag on energy-intensive sectors (agriculture, tourism, transportation, infrastructure development) increase. High food inflation and food insecurity further impacts vulnerable populations. Fiscal pressure to mitigate higher energy prices for NOC.	• Continue to develop hydropower to diversify energy sources. • Maintain adequate reserve levels and fiscal policy space as a buffer. • Ensure convergence between domestic and global commodity prices, while protecting the vulnerable

Annex IV. Nepal's Development Strategy

1. Nepal adopted a new Poverty Reduction and Growth Strategy (PRGS) in March 2020— the Fifteenth Plan (Fiscal Year 2019/20 -2023/24) with the long-term vision of fulfilling the shared national aspiration for "Prosperous Nepal, Happy Nepali". It lays out long-term objectives for poverty alleviation, education, health, gender equality, and development of physical infrastructure and the energy sector. The formulation of the PRGS was carried out following an inclusive process, including discussions with about 4,500 stakeholders: representatives of major political parties, academic and sectoral experts, office bearers of national, provincial and local governments, development partners, civil society organizations and private individuals representing the breadth of diversity in Nepal.

2. The PRGS is structured around 10 national goals with impact, effect, and outcome level indicators and annual quantitative targets. Special priority is given to the infrastructure construction, information technology, agriculture, industry, education, and health sectors. The goals are supported by comprehensive programs in eight sectors, as well as a set of "national pride" projects and transformational projects.

3. The goals and strategies of the PRGS are well-aligned with the ECF-supported program. The strategies focus on achieving sustainable and equitable, employment-oriented economic growth. The programs that support the strategies aim to alleviate poverty, raise productivity and competitiveness, provide quality health care and education and promote governance reforms. The program set out for the macroeconomic sector, in particular, includes tax reforms aimed to promote fiscal space for development initiatives and a vision for monetary policy that supports financial stability.

4. The pandemic disrupted implementation of the PRGS, but the strategies and complementarities with the ECF-supported program remain valid. The pandemic shock to economic activity slowed progress on capital expenditure and hence also progress on the specific development objectives as the authorities focused on addressing the immediate demands of the shock. Nonetheless, having identified key actions to advance the national development agenda, the PRGS still provides a useful roadmap for poverty alleviation and equitable growth. Likewise, the program's fiscal-structural reform and governance reform elements can improve the effectiveness of the authorities' efforts.

Annex V. Response to Past Fund Policy Advice

Recommendation	Implementation
Monetary Policy	
Strengthening Monetary Policy Implementation	The NRB has moved towards a price-signaling monetary policy framework in recent tightening moves in February and July 2022, as per Fund staff advice. The authorities have tightened banks' access to Standard Liquidity Facility. They are beginning to implement TA recommendations provided by SARTTAC in early 2022, such as operationalizing the interest rate corridor.
Modernizing NRB governance framework	The NRB has prepared a set of draft amendments in line with recommendations of the TA LEG mission of mid-2022. MCM will conduct a workshop for NRB Board members on good practices on central bank risk management, scheduled for April 2023, in line with MCM TA of early 2022.
Improving Quality of Internal and External NRB Audits	In November 2022, the Auditor General Office has finalized an audit of NRB outsourced to international auditors in line with Safeguard Assessment's recommendations.
Financial Sector	
Strict Enforcement of Macroprudential Measures	Macroprudential measures were relaxed during 2020-21 as a response to the COVID shock, leading to a boom in credit to the private sector. The NRB has unwound most of the relaxations and forbearance measures. Credit growth has moderated.
Close Monitoring of Asset Quality and Curtailing Evergreening Practices	In line with ECF conditionality, NRB has prepared amendments to asset quality regulations with Fund and World Bank's technical assistance. In addition, NRB has issued regulations to curtail widespread misuse of working capital loans.
Enhanced Monitoring of Concentration Risks	Still in progress. The World Bank is providing technical assistance on consolidated supervision and amendments to regulations on related-party lending.
Strengthening Risk-Based Off-site Banking Supervision	The NRB has developed a web-based Supervision Information System (SIS) to enhance off-site supervision, with support by FCDO. The NRB Board approved an Action Plan for the SIS in December 2022.
Enhancing Financial Inclusion Through Fintech	Financial inclusion has improved significantly in recent years. Important gaps in financial services provision remain in rural areas, women, and underprivileged groups. The November FSSR mission provided recommendations on how to improve financial inclusion further.
Fiscal Policy	
Maintaining a Neutral Fiscal Stance to Contain External and Domestic Shocks	Budget execution has been prudent in recent years, mostly a reflection of under-execution of capital expenditure. The FY2023 Budget envisages a fiscal deficit consistent with ECF

Recommendation	Implementation
	recommendations and the mid-year budget aims to rationalize expenditures.
Anchoring Budget Formulation with a Medium-Term Fiscal Framework (MTFF)	A well-defined and full-fledged MTFF still needs to be developed to strengthen commitments to debt sustainability included in the Budget Speech. MOF has requested SARTTAC TA to develop a MTFF.
Strengthening Fiscal Federalism Framework	Several donors, among them the World Bank, are providing technical assistance, with progress so far limited to assessing current situation and identifying priorities areas for reforms. Reforms on the areas of planning, budgeting and human development services, and monitoring remain pending.
Improving Public Financial Management (PFM) and Budget Implementation across Levels of Government	The authorities have conducted several diagnostic tools, such as the PIMA and PEFA. Translation into actions is pending. Under the ECF MOF is expected to prepare an Action Plan to improve the execution of capital projects.
Fostering Growth	
Bolstering Foreign and Private Sector Investment	FDI and domestic private investment remain low. The threshold of a minimum investment has been reduced by 40 percent recently, but it is not applicable to non-residents investing through an investment company.
Improving Public Procurement Process	The authorities remain engaged with the World Bank on public procurement process reforms. The main achievement has been the training of 1,200 government officials. However, other important reforms remain pending (including the modernization of the public procurement rules and regulations).
Climate-change Adaptation and Mitigation Policies	World Bank has just finished the formulation of a Country Climate Development Report for Nepal. The authorities and donors have pledged commitments to implement climate-change-related investment projects under the Growth Resilience and Inclusive Development (GRID) framework.
Strengthening Statistics	
Rebasing National Account and BPM6	The Central Bureau of Statistics is working on rebasing the GDP time series. Progress is quite advanced, but not finished yet; no timeline for publication has been announced.
AML/CFT	
Addressing AML/CFT Highest Deficiency Priority Ahead of Asia Pacific Group (APG) Mutual Evaluation	The APG undertook a Mutual Evaluation October-December 2022. The final report will be ready July 2023. Challenges exist in the approval of much-needed amendments to AML/CFT legislation to fill important gaps in technical compliance (implementation was delayed because of November 2022 elections) and ensuring effectiveness in implementation.

Annex VI. Progress in Implementing High-Priority Recommendations in the 2014 FSAP

Recommendations	Responsible Authority	Timeline	Progress to Date
Financial Stability			
Refocus monetary policy operations on domestic liquidity management to reduce excess reserves, and especially their volatility, with appropriate burden sharing of costs between the financial system and the budget. Introduce Treasury sterilization bonds.	NRB	Short term (ST)	**Partially done** The NRB is still in the process of increasing the effectiveness of the IRC as a policy tool in line with IMF recommendations (TA report on implementation of monetary policy, May 2021). The NRB is strengthening its technical capacity in high frequency forecasting of liquidity needs and key macroeconomic indicators to help set the policy rate consistent with its objectives of price stability and defending the exchange rate peg. There are ongoing efforts on establishing a more active liquidity management framework, critical to the ability to consistently steer the Weighted Average Interbank Rate close to the policy interest rate.
Undertake a thorough Asset Quality Review (AQR) to identify the extent of problem loans in banks' balance sheets (with TA support).	NRB	ST	**Fully Implemented** AN AQR was conducted in 2015.
Conduct an in-depth review and financial analysis of loan portfolios during bank examinations.	NRB	ST/Medium term (MT)	**In process** Loan portfolio reviews are performed on a regular basis during on-site inspections by the Supervision department of the NRB. The Supervisory Information System (SIS) action plan is approved by the NRB. The quality of reviews would be enhanced by the full implementation of the SIS in the supervisory framework of Class A banks and other BFIs.
Reinforce efforts to address financial infrastructure shortcomings in the Payments System, clearing, credit information, collateral registry, and debt recovery areas.	NRB/MOF	ST/MT	**In process** Payment systems modernization has gained momentum, and further progress is needed to improve their soundness and support for financial stability. Key reforms include the passing of the Payments and Settlement Act (PS Act) and its bylaws, and the implementation of the real-time gross settlement (RTGS) system in 2019. Rapid developments in retail payment systems have included instant payments and explorations into central bank digital currency. Further efforts are needed for strengthening prudential supervision, oversight and user protection of e-money and emerging payments, improving the cybersecurity and operational resilience of key payments systems and enhancing the RGTS system.

Recommendations	Responsible Authority	Timeline	Progress to Date
Financial Sector Oversight			
A. Banking Sector			
Redefine supervisory approach by: integrating risk-based off-site and on-site supervision; increasing analytical capacity through training; introducing supervisory management information systems (MIS); developing a dedicated human resources (HR) rotation policy; and streamlining the NRB board participation in operational decisions.	NRB	ST/MT	**In process** The NRB has made progress in implementing risk-based supervision. NRB received SARTTAC TA for onsite and offsite supervision. The SIS action plan has been approved and the SIS will be fully implemented for Class A bank which will help enhance the supervisory framework. Regular training is being provided for on-site and off-site supervisors, but additional efforts are needed for enhancing training programs to strengthen risk specialization. The NRB needs to extend rotation policy for banking supervision for a more permanent commitment of staff in Bank Supervision Department. No action taken on streamlining the NRB Board's participation in operational decisions.
Ensure effective compliance with supervisory directives and guidelines by: performing a thorough follow up of the implementation of supervisory recommendations; proactive, earlier, and stronger corrective actions.	NRB	MT	**In process** The onsite inspection and enforcement unit in the Banking Supervision Department continue to follow up on the implementation of supervisory recommendations, but the framework for PCAs needs to be streamlined with a more structured link between the assessed risk and the scale of supervisory attention receives. Additional efforts are needed to strengthen NRB's capacity for the early detection of bank stress with a more forward-looking focus.
Review licensing regulations and policy to strengthen the licensing process and support a consolidation of the sector. Once completed, re-license all Classes A, B, and C banks that meet the new reinforced requirements, with an appropriate phase-in period, into a single-license category.	NRB	MT	**Not done** The NRB received a TA on licensing procedures in 2016.
Granting the NRB explicit consolidated supervision powers, amending the legal framework to incorporate a comprehensive definition of related parties and controlling interests.	NRB	MT	**In process** The Bank and Financial Institutions Act (BAFIA), 2016 has defined the term "Related Party" and "Controlling Interest". However, neither the BAFIA nor the NRB Act has assigned explicit powers to NRB for consolidated supervision of bank and financial institutions including their related parties and entities with controlling interest.
B. Non-banking Sector			
Divide the CIT into two separate legal entities, segregating the capital market business, to be placed under the supervision of the Securities Board of Nepal (SEBON), from the pension fund business.	MOF/SEBON	ST	**Not done**
Place the EPF and CIT pension fund business under the joint supervision of the Insurance Board (IB) and NRB.	IB/NRB/MOF	MT	**Not done**
Strengthen the operational independence of the IB and SEBON.	SEBON/IB/ MOF	ST	**Not done**

Recommendations	Responsible Authority	Timeline	Progress to Date
Crisis Management			
Revise Prompt Corrective Action (PCA) policy to require stronger supervisory action, including designation of problematic status at an earlier stage of capital depletion.	NRB	ST	**In process** Progress has been made, but the PCA framework requires streamlining by providing specific and better structured guidance via clear escalation processes under and between various states of distress and early interventions. Further efforts are needed to strengthen NRB's capacity for the early detection of bank stress with a more forward-looking focus.
Develop and implement a banking financial institution (BFI) Supervision Enforcement policy that presumes certain enforcement action based on CAMELS ratings.	NRB	MT	**In process** The supervisory adjustments in risk weighted assets are currently tied up with CAMELS ratings.
Revise NRB Act to clarify emergency liquidity assistance (ELA) provisions.	NRB/MOF	ST	**In process** Amendments to the NRB Act have been proposed to revise the provision related to loans and refinancing and lender of last resort function in section 49, with a new section 49A, and the LOLR regulation is drafted. Further enhancements are needed such as the clarification in the LOLR regulation about the incorporation of reliable solvency, viability, and capital assessments processes in ELA procedures and provision of the ELA at penalty rates.
Revise NRB Act to grant it special resolution regime powers.	NRB/MOF	ST	**Fully implemented**
Establish a national financial crisis coordinating committee comprised of all financial sector, regulatory, and supervisory agencies. Develop each individual agency's crisis contingency plans and roll up individual agency plans into a national crisis contingency plan.	MOF/NRB/IB/ SEBON	ST/MT	**Partially done** Crisis Management Co-ordination Committee has been formed with the chairmanship of the Deputy Governor, including representative from the Ministry of Finance, the Securities Exchange Board of Nepal, and the Insurance Board. However, interagency cooperation should be strengthened via formalizing the work of the high- level Coordination Committee. MOF involvement and cooperation with NRB should be enhanced in systemic crisis preparedness
Crisis simulations should be conducted periodically.	MOF/NRB/IB/ SEBON	MT	**Not done**

Appendix I. Letter of Intent

Kathmandu, Nepal
April 10, 2023

Ms. Kristalina Georgieva
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Georgieva,

1. In the attached update to the Memorandum of Economic and Financial Policies (MEFP) that was signed by the authorities of Nepal on December 22, 2021, we confirm the commitment of Nepal to the policies and objectives of the economic program supported by an IMF arrangement under the Extended Credit Facility (ECF). The ECF-supported program is fully consistent with the Nepal government's objective of keeping the interests of Nepal and the Nepali people close to our hearts. We also describe the progress that has been made so far, the challenges that were overcome, and the further policy steps and reform initiatives we will undertake to meet the ECF-supported program's objectives.

2. Although the economy recovered strongly after the COVID pandemic and external sector has stabilized, Nepal continues to face important macroeconomic challenges. The strength of the post-COVID recovery and the impact of the war in Ukraine contributed to a significant increase in inflation and imports towards the end of 2021 and the first part of 2022. Despite resilient remittance inflows, important external imbalances emerged, putting pressure on international reserves, one of Nepal's most precious buffers. This required temporary measures to discourage imports, as well as the normalization of monetary policy by gradually unwinding the COVID-related support measures. Unfortunately, the ensuing slowdown in imports has dampened tax collections, which has required the implementation of a substantial austerity package to preserve fiscal discipline and debt sustainability.

3. We are confident that our commitment to preserving macroeconomic stability will bear fruit. With global commodity prices finally softening after last year's price shock, our prudent monetary policy stance, and the fiscal discipline introduced by our mid-year budget review, will help bring inflation down to the FY2022/23 target of 7 percent and narrow the current account deficit. Thanks to the ongoing normalization of tourism and strong remittances, Nepal's economy will be able to grow at close to its potential of 4-5 percent, without placing undue pressure on our international reserves, and without the need to resort to distortionary import restrictions.

4. We are aware that the global outlook remains subject to an unusually high level of uncertainty. We are also aware that Nepal remains vulnerable to shocks, from volatile and higher global

commodity prices—especially for fuel and food—to natural disasters and weather variability which can impact food production, poverty, and growth. In that connection, we remain committed to catching up on the implementation of the policies and reforms envisaged in the ECF. As detailed in the attached MEFP, this includes (i) data-driven monetary and fiscal policy responses and standing ready to adjust the policy stance, in consultation with the Fund; (ii) strengthening the Nepal Rastra Bank's (NRB's) independence, accountability, transparency and governance, by amending its legal framework and improving its risk management capacity; (iii) enhancing tax revenue collections by developing a Revenue Mobilization Strategy and enhancing revenue and expenditure transparency; (iv) developing an action plan to improve the efficiency of public investment spending and strengthen climate resilience; and (v) ensuring the asset quality of the banking system by continuing to advance reforms on the regulatory and supervisory framework. In addition, we remain committed to diligently implementing recommendations from the AML/CFT Mutual Evaluation conducted by the APG.

5. We believe that the commitments outlined in the MEFP are adequate to achieve the objectives of the ECF-supported program and promote sustainable and equitable growth in Nepal. The implementation of the program will also help support macroeconomic stability and the resilience needed for the implementation of our goals under the Common Minimum Program. We commit to take any additional measures that may become appropriate for this purpose. We will consult with the IMF in advance of any revisions to the policies and reforms contained in the MEFP, in accordance with the Fund's policies. In the name of the Government of Nepal and the NRB, we are very grateful for the technical assistance and capacity development support provided by the Fund to Nepal, especially since the approval of the ECF. That support was critical for progress on important reform areas such as the external audit of the NRB by the Office of the Auditor General—outsourced to international auditors. We intend to remain in close consultation with Fund staff and provide timely information necessary for monitoring economic developments and implementation of policies under the ECF-supported program.

6. Though our macroeconomic program remains broadly in line with our original plans, additional time is needed to complete the critical structural reforms. We request the completion of the combined first and second reviews under the ECF, while also requesting a program extension of 10 months with no changed access. To meet rephasing needs, we are requesting that an amount of SDR 39.20 million (originally envisaged for disbursement at the first review at program approval) is made available for the combined first and second reviews, with the original profile of disbursements shifting by one review thereafter, with the addition of one final review. We believe that this rephasing will strongly support our ability to successfully meet our program's objectives, including by allowing us to complete our reform agenda.

7. We do not intend to introduce measures or policies that would exacerbate the current balance-of-payments difficulties, or which are inconsistent with Article VIII of the IMF's Articles of Agreement. We do not intend to accumulate external or domestic arrears. In line with our commitment to transparency, we hereby consent to the publication of this letter, the attached

MEFP and Technical Memorandum of Understanding (TMU), the staff report and other ECF-related documents, on the IMF's website.

Sincerely yours,

/s/	/s/
Dr. Prakash Sharan Mahat	Mr. Maha Prasad Adhikari
Finance Minister	Governor, Nepal Rastra Bank

Attachment I. Memorandum of Economic and Financial Policies

We remain fully committed to the economic reform program supported by the arrangement under the Extended Credit Facility (ECF) of the International Monetary Fund approved in January 2022. This memorandum outlines in detail the progress we have made toward meeting the objectives of the economic reform program and our policy plans to advance these objectives. Tables 1 and 2 summarize performance to date and how we plan to update the quantitative targets and structural benchmarks going forward.

A. Background

1. **Economic activity has strengthened after COVID-19 and the economy has weathered the subsequent shocks stemming from higher commodity prices**. The recovery has taken place against the background of declining COVID cases, a successful public vaccination campaign, and the reopening of the economy contributing to a gradual recovery in tourism and sustained remittances. This has supported a broad-based economic recovery. As a result, the government has rolled back most of its pandemic-related stimulus measures, including in the financial sector, where pandemic-related payment moratoria and relaxations in asset classification have been removed. Nevertheless, rising demand and credit growth, combined with a strong US dollar and headwinds from higher global food and fuel prices, caused imports to spike and inflation to rise in FY2021/22. These additional shocks, which arose after COVID, have been successfully absorbed by drawing down international reserves, and through policy adjustment including gradual monetary policy tightening and fiscal support to vulnerable households.

2. **We remain committed to the ECF to support our efforts to preserve macroeconomic and financial stability and transition towards sustainable and inclusive growth**. The macroeconomic framework and reform agenda underpinning the ECF will help support an effective response to the current economic challenges and promote a sustained recovery, while preserving the gains in external stability achieved last year. The program will contribute to strengthening our institutional frameworks and will help build capacity. The ECF is also catalyzing additional financing from development partners. Since program approval in January 2022, Nepal has faced a challenging environment. The first review quantitative performance criterion and indicative targets were met comfortably, alongside significant progress made against most of the structural benchmarks. The second review quantitative performance criterion and indicative targets were also met. Progress on our second review structural agenda suffered setbacks, as none of the structural benchmarks for the second review were met, and while some progress has been made, it will require more time to complete. In addition, the continuous PC on external payments arrears was met, but three other continuous performance criteria—on imposition of import restrictions, exchange restrictions, and multiple currency practices—have not been observed for both the first and the second reviews. We have removed such measures since January 2023 and are therefore requesting waivers for non-observance.

B. Recent Macroeconomic Developments and Outlook

3. The economy grew at a robust rate in FY2021/22 despite external pressures, but recent data suggests that growth is slowing down. Real GDP growth is estimated at 5.8 percent in FY2021/22, supported by strong demand growth, ample credit, new electricity capacity and a return of tourists. High commodity prices lifted headline inflation to an average 6.3 percent. Imports increased significantly in FY2021/22 due to robust domestic demand, availability of credit, and compounded by a surge in commodity prices, driven in part by Russia's war in Ukraine. Exports grew too but remain much smaller than imports, while incoming remittances were not enough to cover the deteriorating trade balance. As a result, the current account deficit increased to 12.9 percent of GDP in FY2021/22 and international reserves declined by almost US$2 billion. Available high frequency indicators for FY2022/23 suggest that domestic demand is slowing with lower credit growth, falling imports and a decline in government revenue. International reserves have stabilized in the last six months and remain well above the estimated reserve adequacy level. Inflation has peaked in September 2022 at 8.6 percent, falling to 7.9 percent in February 2023.

4. The outlook is broadly positive given expected normalization in global commodity prices and new infrastructure investment which will support domestic growth. We expect global commodity prices to ease further during FY2022/23 and inflation in India to gradually decline, helping to lower inflationary pressure in Nepal. The cautious monetary policy stance and the fiscal discipline introduced by our mid-year budget review will bring inflation to the FY2023 target of 7 percent by the end of the fiscal year. Lower commodity prices and domestic monetary policy tightening are expected to lower imports, resulting in a narrower current account deficit of about 5.6 percent of GDP in FY2022/23. In the context of cautious monetary policy and disciplined fiscal policy, the recent removal of import and foreign exchange restrictions is expected to boost business activity—especially private investment—without placing pressure on our international reserves. We expect growth to moderate in FY2022/23 to about 4½ percent, supported by the agriculture sector, continuation of key infrastructure projects, the gradual post-pandemic normalization of tourism and services sector activity and strong remittance inflows.

5. The outlook is subject to unusually high uncertainty. Volatile and higher global commodity prices — especially for fuel and food— would have a pronounced negative impact on inflation, food security and economic activity with a disproportionate impact on the poor and vulnerable. A rising import bill would exacerbate balance of payment pressures and cause reserve loss, which would require further macroeconomic policy adjustment. On the upside, lower global commodity prices would help bring down inflation, lower balance of payments pressures and allow a faster normalization in domestic policy. Nepal is vulnerable to natural disasters and weather variability which can impact food production, poverty reduction and growth. To help manage these risks, we intend to take data-driven responses to monetary and fiscal policy and stand ready to adjust the policy stance.

C. Economic and Financial Policies

Fiscal Policy

6. Our fiscal position has been anchored by the program targets, despite a challenging environment. The overall fiscal deficit narrowed considerably from 5.3 percent of GDP in FY2019/20 to 3.3 percent of GDP in FY2021/22, mostly reflecting lower-than-allocated execution of capital spending. Public debt rose to 43.8 percent of GDP in FY2021/22.[1] Although revenues were strong in FY2021/22 (growing by 14.2 percent yoy), expenditures were much lower than budgeted (only 82.8 percent of the budget). In order to smooth domestic fuel price increases, we made full use of the resources in the Fuel Price Stabilization Fund and provided loans to the Nepal Oil Corporation (NOC).

7. Lower revenue growth this year is contributing to near-term fiscal pressures. The budgeted fiscal deficit for FY2022/23 conforms to the fiscal path of the program, but the revenue and expenditure envelopes require adjustment. The decline in imports thus far this fiscal year has lowered import-related tax revenues, which are 45.9 percent of total tax revenue collection in our FY2022/23 budget. In the first half of FY2022/23, revenue collection declined by 16.5 percent (yoy). This was mostly due to a slowdown in import-related taxes—down by 30.9 percent (yoy)—and to a lesser extent lower domestic tax revenue collection. Lower, domestic revenues were largely driven by changes to personal income tax which reduced the average tax rate for most taxpayers, plunging capital gain income taxes due to declining real estate and stock markets, and weak corporate income tax revenues as the profitability of the financial sector, a major contributor, weakened. Expenditures increased by 11.2 percent (yoy) in the first half of FY2022/23, driven by more goods and service purchases, higher interest payments and public sector wages, and better capital expenditures (from a low base). However, the execution of capital projects continues to lag below budgeted amounts (at 14.1 percent of the annual budget target in the first half year).

8. We remain committed to the consolidation path set out in the program framework. To counteract near-term fiscal pressures, we have conducted an expenditure rationalization in the mid-year budget review, and will: (1) reduce administrative and non-essential recurrent spending by 1.4 percent of GDP; (2) lower fiscal transfers to subnational governments by 1.6 percent of GDP, focusing on programs that subnational governments have been slow to execute; and (3) set aside 1.2 percent of GDP of capital expenditures which lack sufficient preparation and are unable to be spent. On the revenue side, we will reduce the stock of tax arrears which is currently estimated at around 1.2 percent of GDP. In the meantime, we will seek more concessional external financing and will strengthen debt management to reduce financing risks. In FY2023/24, we will reduce expenditures that duplicate subnational government spending, including grants and subsidies and spending on goods and services. We will also phase out the remaining COVID-19 relief measures, including tax rebates to small taxpayers and businesses severely impacted by the pandemic.

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[1] The coverage of public debt includes general government debt (including the negative Treasury Single Account (TSA) balance), government guarantees, and central bank borrowing on behalf of the government.

9. We are gradually reducing fiscal deficits to stabilize debt and protect fiscal sustainability over the medium term. Public debt is assessed to be at low risk of distress notwithstanding the increase in debt in recent years that helped cover our response to recurring major global shocks. Larger fiscal deficits since the transition to fiscal federalism in FY2017/18, exacerbated by additional COVID-19-related spending, have played a primary role in the rise in debt. Along with the spending responsibility devolution, a large share of grants and revenue have been transferred to subnational governments. The objective of this devolution is that federal government expenditures would decline commensurately to offset the transfer to subnational governments. However, in practice this has not fully occurred—in part because of capacity gaps—and the transfer of resources have contributed to higher fiscal deficits. In order to improve fiscal resilience, we commit to reducing the deficits of the federal government to 4 percent of GDP in FY2023/24 and around 2.5 percent of GDP by the end of the ECF program in FY2025/26. This will stabilize public debt at 50 percent of GDP and place it on a downward trajectory over the medium term. On the expenditure side, we expect to achieve savings by continuing the rationalization of low-priority administrative expenditures and redundant spending in both the federal and subnational governments. At the same time, we will prioritize high quality infrastructure expenditure and social spending, which support economic growth and enhance social inclusion.

10. We have worked to cushion the most vulnerable from the adverse impact of higher global food and fuel prices. The FY2022/23 budget set the transformation of the agriculture sector at the forefront in order to address the international food price shocks. A set of measures to increase domestic agriculture production were introduced, amounting to 0.6 percent of GDP. These measures include broad-based grants, subsidies, concessional loans, and support for farmers on access to seeds, fertilizers, technology and irrigation facilities. Fertilizer subsidies have more than doubled to NPR 39 billion (0.7 percent of FY2022/23 GDP). Although the oil price pass-through mechanism aims to limit fiscal exposure to global oil price volatility, the recent shock was too drastic for consumers to immediately absorb. We therefore limited the amount of oil price pass-through undertaken by NOC, and to compensate, the government provided a NPR 7 billion loan (0.1 percent of FY2022/23 GDP) to NOC with 5 percent interest and 5-year maturity. Recently international fuel prices have fallen faster than domestic sale prices, supporting cost-recovery at NOC and therefore reducing the cost to the government. We aim to further close the gaps to allow private fuel consumption to adjust gradually and to mitigate its climate impact. To reduce fiscal costs, we will also explore ways to improve targeting of food and fertilizer subsidies and implicit fuel subsidies over time. Strengthening the social safety net to protect the vulnerable is an important government priority. We commit to identifying high-quality measures that are better-targeted, temporary, and transparent to support households and firms facing the adverse effects of rising food and energy prices. With the support of the World Bank, we are establishing an integrated national social registry for social assistance programs that can facilitate coordination and reduce duplication, and plan to leverage the recent national population census results and electronic fund transfers to enhance benefit targeting.

Revenue Mobilization

11. The government has enhanced taxation transparency by disclosing tax exemption information, which can also support more effective policy making. The government estimated the cost of tax exemptions at the Department of Customs and published customs-related tax exemptions and their cost in a Ministry-wise Progress Details report in May (Table 1 #7, end-April 2022 structural benchmark, implemented with delay). The government has conducted an initial assessment on the costs of non-customs-related tax exemptions. We will publish their costs by August 2023 (Table 1 #8, end-October 2022 structural benchmark, not met and proposed to be reset for end-August 2023). To further enhance transparency and allow for an evidence-based approach to policy formulation, we will publish a comprehensive report on tax expenditure evaluation (Table 1 #10, end-April 2024 structural benchmark) covering tax allowances, credits, deferrals and reliefs in addition to tax exemptions. We will request IMF technical assistance (TA) to support this reform.

12. In the medium term, we will pursue a comprehensive revenue mobilization strategy to sustainably finance our national development efforts. The weakness of revenues in the current fiscal year highlights the fragility of our tax base's reliance on import-related revenue and underscores the urgency of undertaking reforms. The government has received IMF TA to develop a revenue mobilization strategy, enhance tax policy, and assess tax administration performance. Our tax policies can be greatly simplified to minimize distortions as well as to ease administration and compliance and eliminate opportunities for discretion. While our revenue administration has made great progress including providing e-services for taxpayers, there are still weaknesses in compliance risk management and in enforcing taxpayer obligations (such as registration, filing, reporting and payment). Based on IMF TA recommendations, we will develop and approve a comprehensive revenue mobilization strategy (Table 1 #9, end-April 2024 structural benchmark) covering tax policy, law, and revenue administration reforms. The reform proposals will draw in part on the results of the TADAT diagnostic conducted in late 2022. Such reforms can significantly enhance our revenue collection to finance national development and contribute to fiscal consolidation.

Expenditure Reforms

13. We will improve our public investment management process to enhance the efficiency of capital spending. According to the public investment management assessment (PIMA) conducted by the IMF in 2021, there is significant room to improve the efficiency of our public investment management system. The weaknesses in this system, especially those related to resource allocation and project implementation, have contributed to the low efficiency. Given our high vulnerability to climate change and natural disasters, the climate change module of the PIMA also highlighted opportunities to further integrate climate change considerations in public investment management. The FY2022/23 budget included several measures aimed at improving the speed of project implementation, such as expediting construction, strengthening implementation monitoring and enhancing the accountability of department heads and project heads for project implementation. However, we recognize that slow project implementation is only one aspect of low public investment efficiency. Deficiencies also result from inadequate project planning and resource allocation, for example insufficient project preparatory work, low use of the project bank, and poor inter-agency coordination. Resolving these issues will not only strengthen project implementation, but also enhance the efficiency of capital expenditures, thus achieving better results with limited resources. The National Planning Commission had committed to developing an action plan to improve the efficiency of public investment spending and strengthen climate resilience, but will require more time to complete it (Table 1 #17, end-October 2022 structural benchmark, not met and proposed to be reset to end-April 2024), drawing on recommendations from the PIMA.

14. Advancing fiscal federalism will continue to be on the top of our reform agenda. The legal framework governing fiscal federalism has been largely established, including the enacted Intergovernmental Fiscal Arrangement Act (IFAA), the Local Government Operation Act (LGOA), and the Federal, Provincial and Local Level (Coordination and Interrelation) Act 2020. We will review and amend the IFAA and LGOA based on five years of experience in implementing fiscal federalism. In addition, the regulation of the Financial Procedures and Fiscal Responsibility Act guides budget formulation and incentivizes fiscal responsibility of subnational governments. All seven provincial governments have implemented the Provincial Line Ministry Budget Information System, and all 753 local governments have implemented the Subnational Treasury Regulatory Application, which will support reporting and monitoring of subnational governments' fiscal situation. As announced in the FY2022/23 budget, the government has further handed over small projects to subnational governments and provided more flexibility on the use of fiscal transfers. Legislation authorizes subnational governments to borrow but this is subject to pre-approval by the federal government and subject to certain limits that are set by the National Natural Resources and Fiscal Commission every year. The Public Debt Management Act approved in 2022 has further laid out provisions governing subnational government borrowings. To manage spending pressures, create adequate incentives for fiscal discipline among subnational governments, and contain possible fiscal risks, we agree to adopt a framework that will allow the government to closely monitor and contain possible fiscal risks from subnational governments, with the specific measures to be based on recommendations from IMF technical assistance by end-April 2024 (Table 1 #15, end-April 2024 structural benchmark).

15. We have made significant strides on expenditure transparency. The government has published a fourth COVID-19 Active Response and Expenditure (CARES) report with support from the Asian Development Bank (Table 1 #2, end-April 2022 structural benchmark, met), part of a series of comprehensive reports on COVID-19 spending and strategy. To ensure the continued, frequent, timely and easily accessible publication of COVID-19-related procurement contracts and related information, we have also now begun the collection and publication of beneficial ownership (BO) information for COVID-19-related health procurement on the Ministry of Health and Population's website. Further, the government has established a legal framework which mandates an open and competitive public procurement process, and the rollout is ongoing. We aim to achieve full use of the electronic government procurement system in order to improve procurement management considerably. Full adoption will allow greater flexibility; real-time monitoring of contractual commitments, time and cost overruns; and control over every aspect of the contracting process. In order to further enhance transparency, the Public Procurement Monitoring Office aims to regularly publish procurement reports on its website.

16. The government is making progress in enhancing fiscal risk management. The public purse faces explicit and/or contingent liabilities from an array of sources that are not always fully visible. Among them are PPPs, public enterprises, subnational governments and the various loan and loan guarantee programs of the government. To better understand our fiscal risk exposure, the FY2022/23 budget proposed to develop a fiscal risk registry to capture the major fiscal risks, and the Ministry of Finance is currently preparing to implement it (Table 1 #11, end-October 2022 structural benchmark, not met and proposed to be reset to end-August 2023), drawing on the technical assistance provided by IMF in October 2022. Subsequently, we will prepare and publish a comprehensive fiscal risk statement to systematically analyze the sensitivity of budget estimates and public debt projections to various fiscal risks.

17. The deteriorating financial performance of public enterprises (PEs) has increased fiscal risks (e.g. through loans and loan guarantees). Necessary fiscal support to critical high-risk PEs, including the Nepal Airlines Corporation (NAC), would be needed to control negative spillovers.[2] In the medium term, we intend to ensure that PE product prices reflect at least the full costs and affirm the principle that losses due to prices set below cost for policy purposes be compensated transparently through budget. We will endeavor to limit fiscal risks by strengthening the financial oversight of PEs and enhance their governance framework to ensure they can operate independently, efficiently, and effectively. We will require all PEs to publish their annual financial statements (Table 1 #13, end-April 2023 structural benchmark). [3] The four priority nonfinancial PEs (Nepal Electricity Authority, Nepal Oil Corporation, Nepal Airlines Corporation and Nepal Doorsanchar Company (Nepal Telecom)) will also have their FY2022/23 financial statements audited by April 2024. (Table 1 #14, end-April 2024 structural benchmark). We will prioritize completion of audits of the FY2022/23 financial statements of all other PEs by the end of FY2023/24.

18. We will continue to enhance debt transparency and debt risk management by revamping our public debt and cash management. The government has prepared the medium-term debt management strategy that weighs the cost and risk of the government's entire debt portfolio. We are updating it to reflect recent developments and plan to request TA from the IMF. The government has published quarterly debt bulletins on the website of the Public Debt Management Office (PDMO), including details on individual borrowings, to provide more timely and comprehensive information to the public. In line with the program, and the provisions of the recently approved Public Debt Management Act, we will complete the transfer of the domestic debt management function from the NRB to the PDMO to further delineate monetary policy and fiscal policy. Although extra-budgetary operational funds were not reported in FY2020/21 annual financial statements (Table 1 #4, end-May 2022 structural benchmark, not met and proposed to be reset to

[2] The NAC borrowed from the EPF and CIT, NPR 22 billion and 12 billion, respectively, guaranteed by the government.

[3] All PEs covered in the Annual Status Review of Public Enterprises 2022, except those PEs not in operation.

end-August 2023), we have taken stock of those funds in the latest public expenditure and financial accountability (PEFA) assessment in order to incorporate them in the financial statements for this fiscal year. By August 2023, and with the technical assistance support from IMF, we will also develop cash flow forecasting by the Ministry of Finance to be shared with the Financial Comptroller General Office (FCGO), PDMO and NRB on a regular basis (Table 1 #12, end-October 2022 structural benchmark, not met and proposed to be reset to end-September 2023).

Social Spending

19. Social spending has played a key role in helping households respond to shocks. Needs have grown due to the confluence of global shocks. The pandemic resulted in job and income losses, which may contribute to higher poverty and vulnerabilities in the near term. Further, unpredictable weather patterns damage crops and cause persistent poverty. One initiative the government took to address these needs is the increase in coverage of the child grant to all 25 districts with a low human development index and to all Dalit children. We will ensure that spending on the child grant does not decline in FY2023/24. We will ensure food security through cash transfer programs and the expanded Prime Minister's Employment Program. To support the vulnerable, the Old Age Allowance eligibility age was reduced from 70 to 68. The Nepal Food Management and Trading Company received subsidies to help distribute food nationwide.

20. We are committed to further enhance our social safety net to support our poverty alleviation efforts. Consistent with the commitments under the Poverty Reduction and Growth Trust (PRGT), the National Planning Commission issued a Poverty Reduction and Growth Strategy (PRGS) paper based on our 15th National Development plan in March 2023 (Table 1 #16, end-October 2022 structural benchmark, implemented with delay), which will outline the priorities for poverty reduction. We are developing a National Social Registry (NSR), including a system of national identification cards, supported by the World Bank. We are also rolling out the Poverty Identification Program (PIR) registry. The NSR and PIR will facilitate the identification of vulnerable households and allow for more efficient targeting of social transfers. We will also preserve social spending, in particular the child grant.

Monetary and Exchange Rate Policy

21. We have tightened the monetary policy stance to preserve price stability and reserve adequacy. The resumption of economic activity in early 2021, accommodated by COVID-19 support measures, increased bank appetite for credit risk significantly, and domestic credit grew above 25 percent in FY2021/22. The NRB met the increased liquidity demand mainly through the Standing Liquidity Facility (SLF), and interbank rates rose to the SLF rate at the ceiling of the interest rate corridor (IRC). To dampen demand, control inflation, and support external stability, the NRB raised the IRC by 2 and 1.5 percentage points in February and July 2022 (350bps in total). In August 2022 the cash reserve ratio was increased from 3 to 4 percent and NRB refinancing facilities were brought to pre-COVID levels.[4] Introduction of the cap on the Credit to Deposit (CD) ratio also contributed to limiting credit growth in the banking system. These measures were followed by a rapid decline in domestic credit and import growth. Liquidity has increased since September 2022, reflecting strong remittance inflows, which have helped increase bank deposits, and NRB liquidity operations.[5] Accordingly, liquidity injection through the SLF, at rates at the top of the IRC, declined to NPR 126 billion (2.6 percent of GDP) in December 2022 compared with an average of about NPR 700 billion per month in the first three months of FY2022/23. As a further indication of adequate liquidity, as of January 2023, all class A banks comfortably comply with the regulatory liquidity ratios. We continued our cautious policy stance in our mid-year monetary policy review in February 2023.

22. We stand ready to take further action in line with our overarching monetary policy objectives of price and external sector stability. While there is some evidence that inflation may have peaked, we will adjust macroeconomic policies as needed to address inflation, balance of payment pressures and reserve loss. We will continue to preserve the credibility of the exchange rate peg by using monetary policy to maintain an adequate level of reserves. We remain committed to improving the effectiveness of the interest rate corridor to manage short-term liquidity and provide a credible anchor for short-term interest rates. To this end, the NRB will continue to prudently manage liquidity in the system, where necessary, through open market operations, the SLF and repo facilities. We welcome the recommendations from recent IMF technical assistance which will shape our reform strategy in this area.

23. We request waivers of non-observance of the continuous performance criteria regarding not imposing or intensifying import restrictions and exchange restrictions and not introducing or modifying multiple currency practices on the basis that the nonobservance was temporary. For selected goods mandatory letters of credit and cash margin requirements were intensified on February 9, 2022 and import bans were introduced on April 26, 2022 to address external sector pressures and loss of international reserves. The NRB removed the requirement for mandatory letters of credit and cash margins for a subset of imports as of December 2, 2022 and for the remaining imports on January 19, 2023. The government did not extend the import bans when their last extension lapsed on December 15, 2022. Recognizing that they are distortionary, encourage informal trade and have minimal sustained impact on the trade balance, we do not intend to impose new or intensify (i) existing restrictions on the making of payments and transfers for current international transactions, (ii) import restrictions for balance of payments reasons, or (iii)

[4] In July, the NRB also raised the statutory liquidity ratio (SLR) from 10 to 12 percent for commercial banks effective from January 2023.

[5] In November 2022 the NRB lowered the spread rate between deposit and lending rates for commercial banks from 4.4 to 4 percent and introduced differential interest rates to certain productive and commercial sectors. The NRB also announced that the penalties imposed on the banks and financial institutions in case of the noncompliance credit to deposit (CD) ratio will be reviewed to account for the liquidity risk in imposing these penalties. Additionally, in January 2023, the NRB allowed the commercial banks to count to 80 percent (from 50 percent) of the reserve funds of the local governments deposited in commercial banks as deposit until the end of the fiscal year, and then extended this until the end of July 2023. The primary purpose was to allow banks to use such funds for lending to the productive sector.

introduce or modify multiple currency practices, or (iv) enter into bilateral payments agreements which are inconsistent with Article VIII of the IMF's Articles of Agreement.

Financial Sector Policies

24. Despite the recent increase, bank-reported non-performing loan (NPL) levels are still relatively low, and capital adequacy ratios are above the regulatory minimum, but concerns remain. Pandemic-related support measures—including debt service moratoria, extension of grace periods and relaxations in provisioning levels and asset classification rules—provided important relief to the economy, and helped maintain relatively low NPL levels. NPLs increased from 1.3 percent in July 2022 to 2.6 percent as of January 2023, reflecting the decline in the repayment capacity of borrowers. NPLs may increase further and we remain committed to prudently monitoring the banking sector to ensure that loans are appropriately classified, and that provisioning and capital remain adequate for all banks.

25. We have taken further steps to strengthen bank regulation and supervision. We are currently implementing our risk-based supervision manual for both onsite and offsite supervision purposes. We successfully enhanced and customized our current reporting template to enhance the timely monitoring of the impact of COVID-19 on the financial sector (Table 1 #2, end-April 2022 structural benchmark, met). We have received IMF TA on adoption of the Basel simplified standardized approach, assessment of credit risk and strengthening the effective implementation of the interest rate corridor and improving the interest rate transmission mechanism. We expect to receive TA on the development of guidelines on the internal ratings based (IRB) approach and calculation of expected credit loss under International Financial Reporting Standards (IFRS) 9. We have started to receive TA from the IMF to enhance the risk management capacity of the NRB. We hosted a Financial Sector Stability Review (FSSR) mission that covered banking regulation and supervision, payment systems, stress-testing, financial inclusion, and crisis management, in November 2022. We look forward to reviewing the FSSR TA Roadmap which will be crucial for financial sector capacity development. We had originally aimed to require banks to build up 2.5 percent countercyclical capital buffer (CCyB) by July 2020, but this requirement has been suspended until July 2023 due to the pandemic. We will gradually phase-in the CCyB to moderate credit cycles where necessary and discourage excessive risk taking. We plan to implement the Basel III Liquidity Coverage Ratio (LCR) Framework to help strengthen banks' liquidity risk management. We stand ready to use our macroprudential tools effectively for the oversight of the banking system liquidity and loan growth and to mitigate the buildup of financial vulnerabilities.[6]

26. The envisaged amendments to the asset classification regulation will encourage banks to engage in restructuring of loans to firms that are viable but have temporary liquidity shortages. We have taken steps to enhance our regulatory framework to provide clear guidance on restructuring, encourage banks to watch for the creditworthiness of the borrowers on an ongoing

[6] The NRB implements several macroprudential measures: (1) single obligor limits (between 25 to 50 percent of capital depending on the sector), (2) credit to deposit ratio (90 percent), (3) debt service to income ratio (50 percent), (4) debt-to-equity ratio (4:1) and (5) loan to value ratios (between 30 and 70 percent depending on the loan).

basis, and lay out the rules of asset classification and reclassification that enables accurate assessment of banks' asset quality. With a short delay, we drafted, in May 2022, amendments to the asset classification regulation to (1) strengthen the identification criteria of non-performing loans (e.g., unlikeliness to repay in full, debt servicing with another loan); (2) clarify the rules of asset classification and reclassification; and (3) provide a clear guidance on restructuring and rescheduling with guidance from the IMF (Table 1 #20, end-April 2022 structural benchmark, implemented with delay). By end-August 2023, we will issue the amended regulation (Table 1 #21, end-October 2022 structural benchmark, not met and proposed to be reset to end-August 2023) in line with IMF recommendations, allowing for an appropriate phase-in period for the banks to implement. We issued Working Capital Loan Guidelines to be effective from October 2022 and issued amendments to the guidelines in January 2023. The purpose of the guidelines is to ensure the transparency in and proper utilization of working capital loans. We remain committed to ensuring the timely implementation of the regulation in line with IMF recommendations and confirm that amendments and implementation of the guidelines will not contradict the amendments to asset classification regulations.

27. We remain committed to ensuring a stable and well-capitalized banking system that can support the recovery by effectively monitoring and supervising the health of the financial system. We will assess the impact of directed lending[7] on the business models of banks and on financial stability, closely monitor the quality of these loans and consider gradually reducing them as needed. Additionally, we will monitor the impact of interest rate regulations on the monetary policy transmission and gradually move to more market-based determination of interest rates with the goal of more effective monetary policy transmission. Enhanced monitoring and the updated regulatory framework will facilitate an accurate assessment of the health of the financial sector. We will improve our internal processes to allow for a more forward-looking risk assessment and earlier detection of stress. We are in the process of enhancing our stress testing framework. We will streamline our prompt corrective action framework with a clear escalation process across various states of distress and early interventions, avoiding any delays in addressing the deficiencies in the system. To ensure effectiveness of these processes, we stand ready to take relevant and timely enforcement actions where necessary. If any bank becomes undercapitalized, the NRB will use the set of relevant early intervention measures, including suspension of dividend payments where necessary.

28. We are committed to the full implementation of the Supervisory Information System (SIS). We have made significant progress in the implementation of the SIS to enable timely and reliable collection and analysis of supervisory data. The input—onsite and offsite modules of the SIS—have already been completed. The NRB Board approved the SIS Action Plan in December 2022 (Table 1 #19, end-April 2022 structural benchmark, implemented with delay). We plan to fully rely on the SIS for supervisory follow up, regulatory compliance and publication of financial data purposes for Class A, B and C banks by April 2023. The SIS will be implemented for class A, B and C banks,

[7] The NRB requires banks to gradually extend a certain percentage of their total loans to agricultural and energy sectors and MSMEs. These loans correspond to 29 percent of Class A banks' total loan portfolio as of January 2023.

excluding the onsite module for inspections, by August 2023 (Table 1 #21, end-October 2022 structural benchmark, not met and proposed to be reset to end-August 2023). The SIS onsite module will be implemented for class A banks by April 2024 (Table 1 #23, April 2024 structural benchmark). SIS will be crucial for further enhancing the supervisory framework for the BFIs, making it possible to access highly disintegrated data and to use analytical tools and historical data, and strengthening the feedback and cooperation between onsite and offsite supervision.

29. We will continue to ensure banks' compliance with prudential requirements. By end-April 2024, we will launch in-depth on-site inspections for the largest 10 banks assisted by independent international third-party auditors (Table 1 #25, end-April 2024 structural benchmark) to review loan portfolios in line with the new regulatory framework and paying special attention to loan and collateral valuation, evergreening, group borrowing, and concentration risks. We will seek IMF support for the preparation of the terms of reference for the hiring of the third-party international audit firm and the design of the loan portfolio reviews, which we expect to complete by August 2024. We will develop a plan to deal with the review's findings, and any bank with capital shortfalls will be required to submit capital management plans setting out how they will return to full compliance with regulatory requirements.

30. We are committed to further enhancing the autonomy and accountability framework of the NRB. We will continue to implement the recommendations of the 2021 Safeguards Assessments (SGA).[8] The contract to commission the external audit of the NRB was signed on September 12, 2022 (Table 1 #3, end-April 2022 structural benchmark, implemented with delay), and the Office of the Auditor General finalized an audit of NRB—outsourced to international auditors—in November 2022. We will have the annual NRB financial statements independently audited by external auditors appointed by the Auditor General in accordance with international standards on auditing. We drafted the amendments to the NRB Act, guided by key recommendations from the SGA. We will submit the NRB Act to the Parliament by end-August 2023 (Table 1 #6, end-October 2022 structural benchmark, not met and proposed to be reset to end-August 2023). The amendments will clarify the primacy of the NRB's domestic price stability objective, strengthen the NRB's institutional and financial autonomy, clarify the roles and responsibilities of the NRB's governance bodies, strengthen oversight over the NRB, and establish the independence of the Board's Audit Committee. Limits on the government's borrowing from the NRB as defined in the NRB Act will be maintained.

Governance and Other Reforms to Support the Business Environment

31. We have efforts underway to improve governance across many fronts of the ECF program agenda. On the fiscal front, efforts to improve transparency in taxation (MEFP ¶11), expenditure (MEFP ¶15) and debt (MEFP ¶17) facilitate public awareness of government affairs, and therefore improve accountability. Likewise on the monetary side, the independent audit of the NRB and proposed amendments to the NRB Act consistent with the IMF safeguards assessment (MEFP

[8] 4 out of 16 recommendations have been fully implemented and the others are in progress.

¶29) follow best practice. Further, reforms of NRB independence and governance embodied in the NRB Act amendments can improve the effectiveness of its operations. More broadly, we aim to increase the implementation of digital public services and single window systems, and to strengthen anti-corruption institutions like the Commission for the Investigation of Abuse of Authority (CIAA). All of these measures should help to reduce the scope for corruption and lower the cost of doing business, thus facilitating higher investment and growth rates.

32. Strengthening the AML/CFT framework remains a priority. The Asia/Pacific Group on Money Laundering (APG) on-site mission took place in early December 2022. The report is expected to be submitted to the FATF plenary in mid-2023, with final publication later this year. We recognize the importance of Nepal not being listed by the FATF as a jurisdiction with strategic AML/CFT deficiencies. We are aware of the potential impact that this could have on Nepal's correspondent banking relationships and access to the global financial network. We commit to implementing the AML/CFT measures by internalizing them as part of good governance and bringing them in line with international standards, including the enactment of the proposed amendments to the legal framework. We remain vigilant and stand ready to act upon any new or emerging AML/CFT risks and will undertake further measures to strengthen governance and combat corruption as necessary. We will also seek technical assistance from development partners on these matters, as needed.

33. We will continue our efforts to increase access to financial services and to develop financial markets, while maintaining financial stability. We will establish a prudent oversight framework for large Savings and Credit Cooperatives and microfinance institutions and closely monitor them, including their increasing role as financial services providers and their linkages to banks and financial institutions. We will improve data collection efforts, including the availability of comprehensive credit information, and implement a comprehensive financial consumer protection regime. Payment systems are an integral part of monetary policy implementation and capital market development. We will continue our effort to develop safe and efficient payment system infrastructure and practices, with a special focus on the retail side, and to strengthen the legal and regulatory framework. We will strengthen the prudential supervision, oversight and user protection of e-money and emerging payments. We remain committed to improving the cybersecurity and operational resilience of key payments systems and enhancing the RTGS system. The NRB issued a concept paper on Central Bank Digital Currency (CBDC) for public consultation in August 2022. Our key policy goals for a CBDC are better access to payments, increasing payment system resilience and reducing cash handling costs. We will prudently consider the financial stability implications of the CBDC.

D. Risks and Contingencies

34. Large downside risks and global uncertainty remain, but we remain committed to adjusting policy as needed to respond. Should a commodity price shock like the one seen last year occur, further tightening of monetary policy may be needed to maintain external stability and keep inflation in check. In this context, the fiscal path will continue to provide an important anchor for fiscal policy to support macroeconomic stability. We relied on foreign exchange reserves as part of the response last year, and our buffers remain adequate to backstop further commodity price shocks or declines in remittances. In the event of a shock too large to be offset exclusively with our buffers and needed policy adjustment, we will seek assistance from our development partners for increased external support. Our ability to mobilize additional resources from development partners is aided by our low risk of debt distress, strong track record of repayment and anchored by our ECF-supported program commitments. Finally, the NRB has been improving its tools and remains vigilant to prevent potential problems in the banking system. In the event of elevated bank stress, the NRB stands ready to provide systemic liquidity support while triaging deeper solvency problems.[9]

E. Financing and Program Monitoring

35. We will continue to mobilize resources from international development partners to support our economic stabilization and recovery program. In addition to mobilizing domestic resources, the government estimates that remaining financing needs for the FY2021/22-FY2024/25 program will be covered by assistance from the IMF, the World Bank, the Asia Development Bank, and other development partners. We will continue to work with our international development partners, especially the IMF and the World Bank, to successfully implement the reforms outlined above. IMF disbursements will be made available to the budget during the program period.

36. The program will be closely monitored through quantitative performance criteria, indicative targets, and structural benchmarks as listed in Tables 1 and 2. The Technical Memorandum of Understanding (TMU) describes the definitions as well as data provision requirements. The ECF program is monitored on a semi-annual basis by the IMF Executive Board. As noted in the Letter of Intent (LOI ¶6), a 10-month extension is being requested with no change in access, and we are therefore requesting that an amount of SDR 39.20 million (envisaged for disbursement at the first review at program approval) is made available for the combined first and second reviews, with the original profile of disbursements shifting by one review thereafter, with the addition of one final review. As a result, the third and fourth reviews are scheduled to be completed in November 1, 2023 and May 1, 2024; these reviews will be based on July 15, 2023 and January 15, 2024 test dates respectively, with the rephased availability, as per Table 2. The government undertakes to adopt, in consultation with IMF staff, any new financial or structural measures, which may be necessary for the success of the program.

[9] Triaging refers to addressing solvency problems through (i) solving the problems using banks' own resources, (ii) restructuring, or (iii) resolution/liquidation.

Table 1. Nepal: Structural Benchmark Status, Modifications and New Structural Benchmarks: January 2023-July 2024

Measure	Original Target Date	Status	Proposal
Cross-Cutting Institutional Reforms to Enhance Fiscal Transparency and Governance, and Reduce Vulnerability to Corruption			
1. Implementing agency publishes on a government website large public procurement documentation, ex-post validation of delivery, name of awarded companies, and name of beneficial owner(s) for all new, large, COVID-19 related procurement contracts consistent with the December 2021 public information notice (as of December 9, 2021).	Prior Action	**Met**	
2. The MOF publishes the 4th COVID-19 Active Response and Expenditure Support Program (CARES) report which includes federal government budget expenditures related to COVID-19 on a government website.	End-April 2022	**Met**	
3. An external audit of the NRB financial statements for FY2021/22 is commissioned, consistent with the recommendation in the 2021 Safeguards Assessment	End-April 2022	**Not met, implemented September 2022**	
4. The FCGO reports the consolidated financial information of all operational funds in annual financial statements, starting with FY2020/21	End-May 2022	**Not met**	Modified and reset in #5
5. The FCGO reports the consolidated financial information of all operational funds in annual financial statements, starting with FY2021/22		**Modified and reset**	End-August 2023
6. The MOF submits to Parliament amendments to modernize the NRB Law, addressing key recommendations of the 2021 Safeguards Assessments Report	End-October 2022	**Not met**	Reset to end-August 2023
Revenue mobilization			
7. The MOF publishes a report on tax exemptions related to customs	End-April 2022	**Not met, implemented May 2022**	
8. The MOF publishes a report on tax exemptions for all other non-customs related taxes	End-October 2022	**Not met**	Reset to end-August 2023
9. MOF approval of a domestic revenue mobilization strategy covering tax policy, law, and revenue administration reforms		**New**	End-April 2024
10. The MOF publishes a comprehensive report on tax expenditure evaluation		**New**	End-April 2024
Fiscal Sustainability and Fiscal Risk Management			
11. The MOF implements a fiscal risk register to capture various dimensions of major fiscal risks	End-October 2022	**Not met**	Reset to end-August 2023
12. The MOF develops cash flow forecasting to be shared with the PDMO and NRB on a regular basis	End-October 2022	**Not met**	Reset to end-September 2023
13. All PEs will publish their annual financial statements		**New**	End-April 2024
14. The four priority nonfinancial PEs (Nepal Electricity Authority, Nepal Oil Corporation, Nepal Airlines Corporation and Nepal Doorsanchar Company (Nepal Telecom)) will have their FY2022/23 financial statements audited		**New**	End-April 2024
Advance fiscal federalism in a fiscally prudent manner, for better delivery of public services			
15. Cabinet approval of fiscal risk monitoring system for subnational government		**New**	End-April 2024

Table 1. Nepal: Structural Benchmark Status, Modifications and New Structural Benchmarks: January 2023-July 2024 (concluded)

Equitable and Sustainable Growth			
16. The National Planning Commission issues a Poverty Reduction and Growth Strategy (PRGS) Paper	End-October 2022	**Not met, implemented March 2023**	
17. Cabinet approves an action plan to improve the efficiency of public investment spending and strengthen climate resilience, drawing on recommendations of a Public Investment Management Assessment (PIMA)	End-October 2022	**Not met**	Reset to end-April 2024
Financial Sector Regulation & Supervision			
18. The NRB enhances and customizes its current bank reporting template to enhance the timely monitoring of the impact of COVID-19 impact on the financial sector	End-April 2022	**Met**	
19. The NRB Board approves an action plan for full implementation of the Supervisory Information System (SIS) for class A banks	End-April 2022	**Not met, implemented December 2022**	
20. The NRB drafts amendments to the regulations to (1) strengthen the identification criteria of non-performing loans (e.g. unlikeliness to repay in full, debt servicing with another loan); (2) clarify the rules of asset classification and reclassification, including for revolving loans; and (3) provide a clear guidance on restructuring and rescheduling	End-April 2022	**Not met, implemented May 2022**	
21. The NRB issues the updated regulation on asset classification	End-October 2022	**Not met**	Reset to end-August 2023
22. The NRB completes the full implementation of the SIS among class A banks, including the onsite module	End-October 2022	**Not met**	Modified and reset in #23 and #24
23. The NRB completes the full implementation of the SIS among class A, B and C banks, excluding the onsite module		**Modified and reset**	End-August 2023
24. The NRB completes implementation of the onsite module of the SIS among class A banks		**Reset**	End-April 2024
25. Launch for 10 largest Banks in-depth on-site inspections assisted by independent international third-party auditors		**New**	End-April 2024

Table 2. Nepal: Indicators Proposed for Quantitative Targets[1/]

(Cumulative Rs. million unless otherwise indicated)

	FY2020/21	FY2021/22								FY2023/24	
	15-Jul-21	14-Jan-22				16-Jul-22				16-Jul-23	14-Jan-24
	Initial level	Program target	Adjusted target	Outturn	Status	Program target	Adjusted target	Outturn	Status	Program target	Program target
Quantitative performance criteria:											
Primary deficit of the federal government (ceiling; in NPR million) 1,3,4,6,7/	181,841										435,959
Stock of NBR's net international reserves (floor; in U.S. dollars million) 1,8/	10,884	8,640	8,640	8,870	met	8,640	8,344	8,821	met	8,038	8,038
Accumulation of external payments arrears (ceiling) 2/	0	0	0	0	met	0	0	0	met	0	0
Indicative targets:											
Primary deficit of the federal government (ceiling; in NPR million) 1,3,4,6,7/	181,841	417,248	404,316	-50,786	met	333,591	296,329	163,470	met	256,523	..
Indicative target: federal government spending on child allowance (floor; in NPR million) 5/	4,200					5,300	5,300	6,987	met	6,987	3,092
Memorandum items:											
Budget support from development partners (in U.S. dollars million) 1,10/	182	150		224		641		345		330	443
Revenues of the budgetary central government under the program (in NPR million) 1,3/	827,012	278,030		481,062		926,767		938,280		968,166	341,044
Revenue targets of the budgetary central government (in NPR million) 1,3,9/	889,618	475,757		..		1,050,821		..		1,066,000	NA
Primary deficit adjustor for revenue (in NPR million)	..	..		-5,305		..		0		..	..
Ceiling of primary deficit adjustor for revenue shortfalls (in NPR million)	..	71,804		..		124,003		..		109,170	61,009
Foreign-financed project loan disbursements (in NPR million) 1,3/	129,773	19,482		11,854		129,883		92,621		104,207	13,977
Primary deficit adjustor for foreign-financed project loan disbursements (in NPR million) 1,3/	..	..		-7,628		..		-37,262		..	..

Sources: Nepali authorities; and IMF staff estimates/projections based on the Nepali fiscal year and calendar.

1/ The quantitative targets, indicative targets, program exchange rates and adjustors are defined in the Technical Memorandum of Understanding (TMU). Foreign currency deposits of commercial banks and other financial institutions held at the NRB are considered reserve related liabilities and excluded.

2/ This quantitative target is applied on a continuous basis.

3/ Cumulative from the beginning of the fiscal year.

4/ Excludes interest payments.

5/ The social spending indicative target will initially be a floor on spending on the child protection grant. This indicative target will start in the second review with the test dates beginning in January 2024. The initial floor will be FY2020/21 outturns plus an additional amount to reflect the announced one third increase in budget.

6/ The program targets for the primary deficit include adjustors for the level of revenue collection. The upward adjustment to the ceiling is capped at NPR 124,003 million for FY2021/22.

7/ The program targets for the primary deficit include adjustors for foreign-financed project loan disbursements on concessional terms. Foreign-financed project loan disbursements is the difference between total external financing and budget support from development partners.

8/ The program targets for net international reserves include adjustors for budget support from development partners and for revenue collection. Any downward adjustment to the NIR floor will be capped at USD 688 million for the next 12 months to maintain reserve adequacy.

9/ Authorities have not yet informed their FY2023/24 revenue targets.

10/ For the July 16 2023 and January 14 2024 testing dates the figures are cumulative of the period from July 17, 2022 to July 16 2023 and July 17 2023 to January 14, 2024 respectively.

Attachment II. Technical Memorandum of Understanding

This memorandum reflects understandings between the Nepali authorities and the IMF staff in relation to the Extended Credit Facility (ECF). It specifies valuation for monitoring quantitative performance criteria under the program (Section A), performance criteria and indicative targets (Section B), and data reporting (Section C). The authorities will consult with the IMF before modifying measures contained in this TMU or adopting new measures that would deviate from the goals of the program.

A. Program Exchange Rates and Gold Valuation

1. **Program exchange rates are used for formulating and monitoring quantitative performance criteria**. All assets and liabilities denominated in U.S. dollars (USD) will be converted into Nepali Rupees (NPR) at a program exchange rate of NPR 132.368 per one USD, which corresponds to the exchange rate on December 30, 2022. Gold holdings will be valued at USD 1797.4 per troy ounce, the price in December 2022 from the IMF website on primary commodity prices. Assets and liabilities denominated in SDRs and in foreign currencies not in USD will be converted into USD at the December 30, 2022 exchange rates reported in the Table 1:

Table 1. Nepal: Program Exchange Rates[1/]

Currency	Program Exchange Rate
U.S. dollars / Nepali rupee	0.008
U.S. dollars / U.K. pound	1.207
U.S. dollars / Indian rupee	0.012
U.S. dollars / Chinese Yuan	0.143
U.S. dollars / Euro	1.067
U.S. dollars / Japanese yen	0.008
U.S. dollars / Brunei dollar	0.740
U.S. dollars / Korean won	0.001
U.S. dollars / Kuwaiti dinar	3.267
U.S. dollars / Malaysian ringgit	0.227
U.S. dollars / Australian Dollar	0.678
U.S. dollars / Bahrain Dinar	2.660
U.S. dollars / Canadian Dollar	0.735
U.S. dollars / Danish Krone	0.133
U.S. dollars / Hong Kong Dollar	0.128
U.S. dollars / Swedish Krona	0.096
U.S. dollars / Swiss Franc	1.083
U.S. dollars / Omani rial	2.601
U.S. dollars / Qatari riyal	0.275
U.S. dollars / Russian ruble	0.014
U.S. dollars / Saudi Arabian riyal	0.267
U.S. dollars / Thai baht	0.029
U.S. dollars / U.A.E. dirham	0.272
U.S. dollars / Singapore dollar	0.744
U.S. dollars / SDR	1.331

1/The reference date for Nepali Rupee is December 30, 2022.

2. For purposes of this TMU, "external" and "domestic" shall be defined on a residency basis.

B. Performance Criteria and Indicative Targets

3. The quantitative performance criteria and indicative targets for relevant test dates are specified in Table 2 of the Memorandum of Economic and Financial Policies.

Quantitative Performance Criteria on Net International Reserves of the Nepal Rastra Bank

4. Net international reserves (NIR) are defined as reserve assets minus reserve related liabilities of Nepal Rastra Bank (NRB) expressed in U.S. dollars.

- Reserve assets of the NRB, as defined in the sixth edition of the Balance of Payments Manual (BPM6), are claims on nonresidents denominated in foreign convertible currencies and Indian rupee controlled by the NRB and are readily and unconditionally available to the NRB for meeting balance of payments financing needs, intervention in exchange markets, and other purposes. They include NRB holdings of monetary gold, SDRs, Nepal's reserve position in the IMF, foreign currency cash (including foreign exchange banknotes in the vaults of NRB), and readily available deposits abroad (including balances on accounts maintained with overseas correspondent banks). Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered; claims on residents; precious metals other than monetary gold; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options).

- Reserve related liabilities are defined as foreign exchange liabilities of the NRB to nonresidents; Nepal's outstanding credit to the IMF; foreign currency reserves and deposits of commercial banks and other financial institutions held at the NRB; commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options); and all arrears on principal or interest payments to commercial banks, suppliers, or official export credit agencies.

- To measure the program NIR, all foreign-currency related assets and liabilities will be converted into USD at the exchange rates specified in paragraph 1, Table 1.

5. Targets for the program NIR are set as a floor.

6. The program targets for net international reserves include adjustors for budget support from development partners and for revenue collection.

- *Budget support from development partners.* Should the actual disbursement of budget support from development partners be below the projections under the program, the NIR floor will be adjusted downward by the difference between the actual level and the projected level of disbursements under the program. The projections of budget support from development partners for the next 12 months are presented in Table 2.

- *Revenue collection. The program targets for NIR include adjustors for revenue collection, reflecting* the strong link between the revenue base to remittances and other foreign exchange flows. In case revenue collection is below the level projected under the program, the NIR target will be adjusted by the equivalent USD amount of the revenue adjustor to the primary deficit ceiling described in paragraph 10 below.

- *Cap on downward adjustment.* Any downward adjustment to the NIR floor for the conditions described in the two preceding bullets will be capped at USD 688 million.[1]

Table 2. Nepal: Budget Support from Development Partners Projected Under the Program

Date	Cumulative over the period from July 16, 2022 to January 15, 2024 (USD million)
July 16, 2023	330
January 14, 2024	443

Indicative Target and Quantitative Performance Criterion on the Primary Deficit of the Budgetary Central Government

7. The terms described in paragraphs 7-11 apply to both the indicative target on the primary deficit for the third review and quantitative performance criterion on the primary deficit for the fourth review and all subsequent reviews.

8. The budgetary central government, for the purpose of the program, consists of all the entities listed in the Administrative Expenditure Estimate table of the budget (Table 3).

[1] The NIR adjustor cap is the minimum of: (i) the revenue cap converted to USD at program exchange rates; and (ii) the difference between the NIR floor and NIR adequacy levels. The cap ensures that any downward adjustment maintains reserve adequacy levels.

Table 3. Nepal: Institution Coverage of Budgetary Central Government

President
Deputy President
Chief of Provinces
Federal Parliament
Courts
Commission for Investigation of Abuse of Authority
Office of the Auditor General
Public Service Commission
Election Commission
National Human Rights Commission
Council of Justice
National Natural Resources and Fiscal Commission
National Women Commission
National Dalit Commission
National Inclusion Commission
Indigenous Nationalities Commission
Madhesi Commission
Tharu Commission
Muslim Commission
Office of Prime Minister and Council of Ministers
Ministry of Finance
Ministry of Industry, Commerce and Supply
Ministry of Energy, Water Resources and Irrigation
Ministry of Law, Justice and Parliamentary Affairs
Ministry of Agriculture and Livestock Development
Ministry of Water Supply
Ministry of Home Affairs
Ministry of Culture, Tourism and Civil Aviation
Ministry of Foreign Affairs
Ministry of Forest and Environment
Ministry of Land Management, Cooperative and Poverty Alleviation
Ministry of Physical Infrastructure and Transport
Ministry of Women, Children and Senior Citizen
Ministry of Youth and Sports
Ministry of Defense
Ministry of Urban Development
Ministry of Education, Science and Technology
Ministry of Communications and Information Technology
Ministry of Federal Affairs and General Administration
Ministry of Health and Population
Ministry of Labour, Employment and Social Security
National Planning Commission
MOF- Domestic Debt Service
MOF- External Debt Service (Multilateral)
MOF- External Debt Service (Bilateral)
MOF Staff Benefits and Retirement Benefits
MOF Miscellaneous
Province (Equalization, Special and Complementary)
Local Level (Equalization, Special and Complementary)

9. The primary deficit of the budgetary central government is defined as primary expenditures minus revenues.

- Primary expenditures include capital expenditures and recurrent expenditures except interest payments. Financing expenditures (the amortization of domestic and external borrowing, loan and share investment in public enterprises and other enterprises, and foreign share investments) are excluded. Capital expenditures are the same as the capital expenditures defined in the budget. Recurrent expenditures (excluding interest expenditure) include the following items in the budget: compensation of employees, use of goods and services, subsidies, grants, social security, other current expenditure. Revenue sharing for province and local levels is excluded.

- Revenues of the budgetary central government are those revenues to be deposited in the Federal Treasury. They include all taxes and non-tax revenue as defined in the budget. Revenue sharing for province and local levels is excluded. Other receipts are also excluded.

- Revenues and primary expenditures should be recognized on a cash basis.

- The Financial Comptroller General Office monthly reports will be used as the basis for program monitoring.

10. Targets for the primary deficit of the budgetary central government are set as a ceiling. Targets are set for cumulative flows from the end of the previous fiscal year.

11. The program targets for the primary deficit include adjustors for revenue collection.

- *Adjustor for revenue shortfalls*. Should the revenue outturn be below the projected level under the program, the primary deficit ceiling will be adjusted upward (higher deficit) by the difference between the revenue outturn and the level of revenues projected under the program. The upward adjustment to the ceiling is capped at NPR 109,170 million for July 15, 2023 and NPR 61,009 million for January 15, 2024. This adjustor would prevent having to unduly tighten fiscal policy under the program if the economy is weaker than projected.

- *Adjustor for revenue windfalls*. Should revenue outturn be above the projected level under the program but below the MOF revenue collection targets, there would be no adjustment to the primary deficit target (implying that expenditure could be higher by the equivalent amount of the revenue overperformance, keeping the overall primary deficit target unchanged). Should the revenue outturn exceed the MOF revenue collection targets, the primary deficit ceiling will be adjusted downward (lower deficit) by the difference between the revenue outturn and the MOF revenue collection target. This adjustor would allow for higher spending if revenues are higher than the program projection, while promoting a buildup of fiscal buffers if revenues overperform by a large amount.

- The level of revenues projected under the program and MOF revenue collection targets for the following 2 test dates are presented in Table 4.

Table 4. Nepal: Revenues of the Budgetary Central Government Projected Under the Program and Revenue Collection Targets		
Date	**Revenues Projected under the Program, Cumulative over the Respective Fiscal Year (NPR million)**	**MOF Revenue Collection Targets, Cumulative over the Respective Fiscal Year (NPR million)**
July 16, 2023	968,166	1,066,000
January 14, 2024	341,044	N/A

12. The program targets for the primary deficit include adjustors for foreign-financed project loan disbursements on concessional terms.

- *Adjustor for higher than projected foreign-financed project loan disbursements on concessional terms*. Should the actual disbursement of foreign-financed project loans be above the projections under the program, the primary deficit ceiling will be adjusted upward (higher deficit) by the difference between the actual level and the projected level of disbursements under the program. The upward adjustment to the ceiling is capped at the difference between the budget amount and the projected level of disbursement for the indicative target for the 3rd review. This cap does not apply for the quantitative performance criteria for the 4th and all subsequent reviews. This adjustor means that the program does not constrain foreign-financed project loan disbursements on concessional terms.

- *Adjustor for lower than projected foreign-financed project loan disbursements on concessional terms.* Should the actual disbursement of foreign-financed project loans be below the projections under the program, the primary deficit ceiling will be adjusted downward (lower deficit) by the difference between the actual level and the projected level of disbursements under the program. This adjustor would align project spending with the actual disbursement of foreign-financed project loans on concessional terms.

- The projections of foreign-financed project loan disbursements for the following 2 test dates are presented in Table 5.

Table 5. Nepal: Foreign-Financed Project Loan Disbursements Projected Under the Program	
Date	**Cumulative over the respective fiscal year (Million NPR)**
July 16, 2023	104,207
January 14, 2024	13,977

Indicative Target on Social Spending of the Budgetary Central Government

13. **The indicative target will focus on the child grant spending**. The child grant reaches vulnerable households, is implemented by the federal government, and is monitorable in a timely way. Health and education spending, while key pillars of social spending, are being devolved to local and provincial governments and implementation is not fully under control of the federal government. Indicative targets on the child grant, including the activity code 7.1.1.10 (dalit children), 7.1.1.41 (areas designated children), and 7.1.1.43 (areas designated children), are set as a floor for: (1) Cumulative flows from the end of the previous fiscal year. Spending should be recognized on a cash basis and flows should be recorded when cash is paid.

Continuous Performance Criteria

14. **A continuous quantitative performance criterion applies to the non-accumulation of new external payments arrears on external debt contracted or guaranteed by the budgetary central government or NRB**. External payment arrears consist of the total amount of external debt service obligations (principal and interest)—deriving from loans arranged or guaranteed by the central government and the NRB, penalties, and interest charges deriving from these loans not paid at maturity—falling due to nonresidents after approval of this arrangement and that have not been paid when due in accordance with the relevant contractual agreements (including any contractual grace period). Excluded from the prohibition on the accumulation of new arrears are (i) external arrears that are subject to debt rescheduling agreements or negotiations and/or (ii) disputed external debt service obligations.

15. **Debt will be understood to mean**—as specified in paragraph 8 of the Guidelines on Public Debt Conditionality in Fund Arrangements, adopted by the Decision No. 16919-(20/103) of the Executive Board of the IMF on October 28, 2020—a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, according to a specific schedule; these payments will discharge the obligor of the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows: (i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers' credits) and temporary exchanges of assets, that are equivalent to fully collateralized loans, under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided; and (iii) leases, i.e., arrangements under which property is provided that the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property , while the lessor retains the title to the property. For the purpose of this guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement, excluding those payments necessary for the operation, repair,

or maintenance of the property. Under the definition of debt set out above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

16. Standard continuous performance criteria include: (1) prohibition on the imposition or intensification of restrictions on making of payments and transfers for current international transactions; (2) prohibition on the introduction or modification of multiple currency practices; (3) prohibition on the conclusion of bilateral payments agreements that is inconsistent with Article VIII; and (4) prohibition on the imposition or intensification of import restrictions for balance of payments reasons.

C. Provision of Information to the IMF

17. Performance under the program will be monitored using data supplied to the IMF by the Ministry of Finance (MOF) and the NRB as specified in Table 6 below, consistent with the program definitions above and within the time frame specified. The authorities will transmit promptly to the IMF staff any data revisions within 14 days after being made. Any data and information indicating the non-observance of the continuous performance criteria will be provided immediately. In addition, the authorities will transmit to IMF staff any information or data not defined in this TMU but pertinent for assessing or monitoring performance relative to the program objectives. All reports and data should be transmitted to the IMF electronically and in English.

18. The authorities will inform IMF staff of the creation of any new extra-budgetary funds or programs immediately. This includes any new funds, or other special budgetary and extra-budgetary programs that may be created during the program period to carry out operations of a fiscal nature as defined in the IMF's Manual on Government Finance Statistics 2014.

Table 6. Nepal: Data Reporting Requirements [1/]		
Data	**Frequency**	**Submission Lag[2/]**
Ministry of Finance		
Summary of budgetary central government accounts, including revenues (broken down by economic classification) and grants, expenditures (broken down by economic classification), and net acquisition of financial assets (broken down by loan investment and share investment) on a cash basis, consistent with the presentation in budget. The Financial Comptroller General Office (FCGO) monthly reports will be used as the basis for program monitoring.	M	30 calendar days
Summary of budgetary central government's net incurrence of liabilities (broken down by domestic borrowing disbursement and principal repayment, as well as external borrowing disbursement and principal repayment) consistent with the presentation in budget. Foreign-financed project loan disbursements and budget support disbursements. The Public Debt Management Office (PDMO) monthly reports will be used as the basis for program monitoring.	Q	30 calendar days
Domestic and external public debt stock (broken down by currency, maturities, creditors, and instruments), disbursements, and debt service costs of the budgetary central government, including interest payments and amortization schedules until full loan repayment. The PDMO quarterly reports will be used as the basis for program monitoring.	A	60 calendar days
Debt guarantees issued by budgetary central government and the NRB. The PDMO and NRB quarterly reports will be used as the basis for program monitoring.	Q	45 calendar days
Audited Financial statements of public enterprises.	A	210 calendar days
Social spending data on: (1) the amount budgeted, (2) the amount dispersed, (3) the number of recipients. Data provided separately for each of the following programs: old age pension, widows grant, indigenous allowance, disabled persons allowance and Prime Minister's Employment program (PMEP).	H	30 calendar days
Data on the child grant program: (1) the amount budgeted, (2) the amount dispersed, (3) the number of recipients.	H	30 calendar days
The Annual Budget. The Budget speech (with annex) and MOF budget reports will be used as the basis for program monitoring.	A	30 calendar days[3/]
Mid-year budget review. The MOF Mid-year budget review reports will be used as the basis for program monitoring.	A	30 calendar days[4/]
Annual budget execution report. The FCGO annual reports will be used as the basis for program monitoring.	A	90 calendar days
National accounts data.	A, Q	90 calendar days

Table 6. Nepal: Data Reporting Requirements (continued)		
Data	**Frequency**	**Submission Lag**
Public Debt Management Office		
Stock of outstanding external debt payment arrears of the general government (if any) by creditor.	Q	30 calendar days
Nepal Rastra Bank		
Exchange rate data: (i) Monthly official exchange rates NPR/$ (data to be submitted once a week for the previous week). (ii) Monthly average buy and sell exchange rates NPR/$ as quoted by foreign exchange bureaus and banks.	M	5 working days after the end of the month
Monthly consumer price indexes (CPIs).	M	30 calendar days
Program net international reserves and its components (foreign reserve assets, deposits from banks and financial institutions in foreign currency, and foreign reserve-related liabilities of the NRB) at program and current exchange rates.	M	7 working days
Breakdown of gross foreign assets and liabilities (including foreign currency liabilities to residents) of the NRB by currency at actual and program exchange rates.	M	15 calendar days
Balance of payments consistent with the 6th edition of the Balance of Payments Manual (BPM6).	M	30 calendar days
International investment position and private and public external debt data.	Q	90 calendar days
Data on remittances including remittance flows in USD by country, and total approved Nepali migrant workers permit by new/renewed permits and if possible, by destination country.	M	30 days
Tourist arrivals by nationality and country of residence.	M	30 days
Imports and exports data by commodity at HS-2 classification level.	M	30 days
Central bank balance sheet in NPR (Summary).	M	30 calendar days
Balance of government's accounts/funds at NRB, including treasury accounts, pre-funding accounts, VAT refund, custom fund, federal divisible fund, and other funds outside treasury operation. The FCGO and NRB monthly reports (after reconciliation) will be used as the basis for program monitoring.	M	30 calendar days
Data on monetary operations in NPR.	M	30 calendar days
Interbank rates, Treasury bill rates, and volumes of Treasury bills and treasury bonds issued.	M	30 calendar days
Central bank liquidity data: (1) BFI's balance at the NRB; (2) amount required to meet cash reserve ratios in NPR.	M	30 calendar days
Central bank daily purchases and sales of foreign exchange by counterparts (commercial banks, government).	W	2 working days after the end of the week
Daily interbank turnover in the FX spot market.	W	15 working days

Table 6. Nepal: Data Reporting Requirements (concluded)		
Data	**Frequency**	**Submission Lag**
Commercial bank-by-bank data: i) balance sheet by currency (foreign exchange and Nepali Rupee); ii) income statements; iii) breakdown of loan classification and provisioning levels for borrower types (corporate, commercial, retail, SMEs, etc.), product type (overdrafts, working capital loans, demand loans, etc.), economic sectors, and restructured loans; iv) loan write-offs; v) information on forborne loans (payback, reclassification and provisioning) by type of forbearance (deductions in interests, payment deferrals, restructuring of performing loans, restructuring of non-performing loans); vi) breakdown of deposits and net open positions; vii) FSI indicators (capital, asset quality, liquidity, earnings).	M	75 calendar days
Data on foreign currency loans and deposits. Commercial bank-by-bank data: i) breakdown of foreign currency loans for borrower types (corporate, commercial, retail, SMEs, etc.), product types (overdrafts, working capital loans, demand loans etc.), economic sectors, and restructured loans; ii) share of foreign currency deposits by deposit types (current, call, fixed, savings etc.). Other depository corporations survey data in NPR.	M M	75 calendar days 30 calendar days
Condensed assets and liabilities of commercial banks and all BFIs in NPR.	M	30 calendar days
Data specific to class A and B banks: (i) CAMEL rating for class A and B banks (ii) Ratio of Cash & Bank Balance/Total Deposit (iii) Ratio of Investment in Government Securities/Total Deposit (iv) Total Liquid Assets/Total Deposit ratios	M	30 calendar days
NRB's claims on the government with breakdown by type (debt types, loan type, including the gross amounts of overdrafts).	M	30 calendar days
Banks and financial institutions' claims on the government with breakdown by type (debt types, loan types including the gross amount of overdrafts).	M	30 calendar days

Note: A = Annually; Q = Quarterly; H=Half-yearly; M = Monthly; W = Weekly.
1/ Reports and data are provided in English. Data are provided in excel files.
2/ After the end of respective week, month, quarter, or fiscal year in Nepali calendar, unless otherwise indicated.
3/ 30 calendar days after the delivery of the budget speech.
4/ 30 calendar days after January 15.

INTERNATIONAL MONETARY FUND

NEPAL

April 12, 2023

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION, FIRST AND SECOND REVIEWS UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT, REQUESTS FOR WAIVERS OF NONOBSERVANCE OF PERFORMANCE CRITERIA, EXTENSION OF THE ARRANGEMENT, AND REPHASING OF DISBURSEMENTS—INFORMATIONAL ANNEX

Prepared By | Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of February 28, 2023)

Membership Status: Joined September 6, 1961; accepted Article VIII, Sections 2, 3, and 4 on May 30, 1994.

General Resources Account:

	SDR Million	Percent Quota
Quota	156.90	100.00
Fund holdings of currency	140.92	89.82
Reserve position in Fund	15.98	10.19

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	218.48	100.00
Holdings	144.88	66.31

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
RCF Loans	174.73	111.36
ECF Arrangements	78.50	50.03

Financial Arrangements: (In SDR Million)

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
ECF	01/12/22	03/11/25	282.42	78.50
ECF[1]	11/19/03	11/18/07	49.90	49.90
ECF[1]	10/05/92	10/04/95	33.57	16.79
SAF	10/14/87	10/13/90	26.11	26.11

1/Formally PRGF

Outright Loans: (In SDR Million)

Type	Date of Commitment	Date Drawn/Expired	Amount Approved	Amount Drawn
RCF[1]	05/06/20	May 08, 2020	156.90	156.90
RCF[1]	07/31/15	Aug 10, 2015	35.65	35.65

1/ Undrawn outright disbursements (RFI and RCF) expire automatically 60 days following the date of commitment, i.e., Board approval date.

Overdue Obligations and Projected Payments to the Fund[1]:
(In millions of SDRs; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2023	**2024**	**2025**	**2026**	**2027**
Principal	3.57	7.13	22.82	31.38	39.23
Charges/interest	1.89	2.53	2.53	2.53	2.53
Total	5.45	9.66	25.35	33.91	41.76

1/ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Implementation of HIPC Initiative: Not Applicable

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

Implementation of Catastrophe Containment and Relief (CCR)[1]: (In SDR Million)

Date of Catastrophe	Board Decision Date	Amount Committed	Amount Disbursed
N/A	04/13/20	2.85	2.85
N/A	10/02/20	3.57	3.57
N/A	04/01/21	3.57	3.57
N/A	12/15/21	3.57	3.57

1/ As of February 4, 2015, the Post-Catastrophe Debt Relief Trust has been transformed to the Catastrophe Containment and Relief (CCR) Trust.

Exchange Rate Arrangement

The currency of Nepal is the Nepalese rupee. The exchange rate arrangement of Nepal is a conventional peg to a single currency unit. The Nepalese rupee is pegged to the Indian rupee at a rate of NRs 1.6 per Indian rupee. As of February 28, 2023, the exchange rate of the Nepalese rupee (NR) was US$1=NRs. 132.24.

The Industrial Enterprises Act 2020 places a 70 percent limit on the conversion and transfer to foreign currency of salaries of non-residents from countries where convertible currency is in circulation. Since the limit applies to amounts that may be less than net salaries, it gives rise to an exchange restriction under Article VIII.

For selected goods, mandatory letters of credit and cash margin requirements were temporarily intensified on February 9, 2022 to address external sector pressures and loss of international reserves, which give rise to an exchange restriction and an MCP, respectively. The NRB removed the requirements for mandatory letters of credit and cash margins for a subset of imports as of December 2, 2022, and for the remaining imports on January 19, 2023. Waivers of nonobservance of the continuous performance criteria on exchange restrictions and MCPs are requested as the measures have since been removed."

Safeguards Assessments

An updated safeguards assessment of the Nepal Rastra Bank (NRB) was completed in 2021. It found limited progress in addressing prior recommendations from the 2016 assessment and the 2018 safeguards monitoring mission. It also confirmed weaknesses in governance and oversight practices at the NRB, and important control vulnerabilities in key areas that are perpetuated by frequent rotation of staff and department heads, which hinders specialization and weakens management ownership and accountability.

The 2021 safeguards assessment made recommendations in key areas including: (i) a comprehensive modernization of the central bank legal framework to strengthen the NRB's governance, autonomy, and accountability; (ii) to enhance transparency of the NRB by aligning its financial reporting with international standards; (iii) to improve the quality of external audit of the NRB through engagement of reputable international auditors with experience in auditing central banks in accordance with International Standards on Auditing; (iv) to enhance the internal audit's autonomy, capacity, and audit practices; and (v) to improve internal controls in key areas, including in foreign reserves management, lending to banks, and reporting of monetary data to prevent the risk of misreporting to the Fund.

Since then, the NRB has implemented four out of the sixteen recommendations including by engaging experienced and reputable international auditors to audit the NRB under the auspices of the Auditor General of Nepal, addressing departures in financial reporting from international standards, and timely publication of the NRB's financial statements. While work is ongoing on other recommendations, progress remains slow and continues to be hampered by human resource management practices which the NRB is in process of reviewing. The NRB has made progress in drafting amendments to modernize its legal framework and has benefited from Fund technical assistance in 2022.

2020 Article IV Consultation

The last Article IV Consultation discussions before COVID-19 were held in Kathmandu during January 5-17, 2020, and the Executive Board concluded the consultation on March 19, 2020 (IMF Country Report No. 20/96). It is proposed that the next Article IV consultation with Nepal takes place on a 24-month cycle in accordance with the Decision on Article IV Consultation Cycles for members with Fund arrangements.

Technical Assistance (since 2020 Article IV Consultation)

	Purpose	Year
FAD	Tax policy reform for revenue mobilization	2022
	TADAT Assessment	2022
	Fiscal risk register development	2022
	PIMA and Climate-PIMA (Virtual Mission)	2021
FAD/MCM	Debt Management, Virtual Mission	2020
MCM	Liability Management and Institutional Arrangements (Virtual Mission)	2020
MCM	Financial Sector Stability Review (FSSR) Main Mission-Onsite	2022
	Nepal-FSSR-Financial Sector Assessment	2022
	FSSR Main Mission-Offsite	2022
	FSSR Scoping Mission	2022
LEG/FIN	Review of the Central Bank Legislation (Field Mission)	2022
	Review of Central Bank Legislation (Desk Review), Virtual Mission	2022
SARTTAC	Fiscal Risk Register – Virtual training	2023
	GDP-Improvement of National Accounts	2023
	MTFF & macro-fiscal forecasting, initial mission	2023
	TADAT Training	2022
	NAC-Symmetric Input Output Tables	2022
	Fiscal Risk Register Training	2022
	GFS-Expanding coverage to CG by working on EBUs	2022
	GDP Data Sources Review (Scoping)	2022
	IRC under an exchange rate peg, (Virtual Mission)	2021
	Webinar on Credit Risk Supervision (Virtual Mission)	2021
	GFS&PSDS-Coverage and Consolidation (Virtual Mission)	2021
	Strengthening Off-Site Supervisory Capacity	2021
	Monetary Policy Operations (Virtual Mission-COVID)	2021
	GFS/PSDS TA Mission (Virtual Mission)	2020
	Training (in-country): PSDS Training Mission (Virtual Mission)	2020
	GFS and PSDS TA and Training mission	2020
STA	Compilation of MFS for OFCs	2023
	Improve the FSI compilation (Virtual Mission)	2021

Resident Representative

Ms. Teresa Daban Sanchez has been the Resident Representative since May 1, 2022. She is based in Kathmandu, Nepal.

INFORMATION ON THE ACTIVITIES OF OTHER IFIS

Information on the activities of other IFIs in Nepal can be found at:

- World Bank: http://www.worldbank.org/en/country/nepal/overview
- Asian Development Bank: https://www.adb.org/countries/nepal/main

STATISTICAL ISSUES

(As of February 28, 2023)

I. Assessment of Data Adequacy for Surveillance
General: Economic and financial data are broadly adequate for surveillance, with scope for improvement especially in updating the base year of the national accounts, more detailed price statistics, the timeliness and quality of balance of payments data, the inclusion of extrabudgetary operational funds in the federal government's consolidated financial statements, and the extension of monetary and financial statistics to include non-banking financial institutions.
National Accounts: The National Statistics Office (NSO) compiles **national accounts** using the 2008 SNA standard with base year 2010/11. Key estimates include annual GDP by production and by expenditure categories (in current and constant prices), and gross national income and savings. Some expenditure categories continue to be affected by limited source data, particularly for household final consumption, and the current and constant price discrepancies with GDP by production have become very large in recent years. Therefore, the NSO needs to prioritize the updating of the GDP base year and the development of data sources including household consumption expenditure to improve consistency of the national accounts aggregates. National quarterly GDP and seasonally adjusted quarterly GDP are compiled and published by economic activities at basic prices 2010/11.
Price Statistics: The NRB compiles the **Consumer Price Index** (CPI). Data (October 2015=100) is published on 12 different food and beverage items and 9 non-food and services items. The food and beverage index and non-food and services index are published for four regions of the country. The transfer of the responsibility of compiling the CPI from the NRB to the NSO has not been completed yet. A core inflation series is not published, although underlying data necessary to calculate such a series appear to be available. The NRB also publishes a **Wholesale Price Index**, with weights based on 2017/18 data. Broadly, the index covers primary commodities (33.6 percent), domestic manufactured goods (57.7 percent), and fuel and power (8.8 percent). The NSO compiles a quarterly **Producer Price Index** for industrial products. It covers mining and quarrying, manufacturing, electricity, gas and water. In addition, the manufacturing portion is further disaggregated into twenty-nine separate industries. The sample and weights are based on the census of manufacturing establishments 2011/2012 and should be updated.
Government Finance Statistics: The authorities compile fiscal data for the budgetary central government in accordance with IMF's Government Finance Statistics Manual (GFSM) 2001 and, with the support of SARTTAC, are currently adopting GFSM 2014. Annual data on government operations are reported to STA. However, further improvements are needed for the fiscal data to better support surveillance. For example, financing transactions should be excluded from the functional classification of expenditure; a clearer distinction needs to be made in the Chart of Accounts (COA) between revenue and expense transactions and transactions in nonfinancial assets; clarifications are needed as to whether transfers are correctly classified: as social benefits, as subsidies, or as capital payments to enterprises. There may also be cases where the latter represents acquisitions of financial assets (equity stakes). Compilation of below-the-line financing transactions needs improvement and the government's financial balance sheet needs further

development. Efforts are underway that will allow for more timely and accurate reporting and monitoring of consolidated general government operations (operations of extra- budgetary entities and local governments). Work is underway for compilation of quarterly GFS data and aligning the COA to the GFSM 2014.

Monetary and Financial Statistics: The NRB reports the Standardized Report Forms (SRFs) for the central bank, for other depository corporations, and for monetary aggregates for publication in the IMF's *International Financial Statistics* on a monthly basis with a lag of about one month. These data include development banks and finance companies, which allows the NRB to compile and publish an expanded broad money survey. A monetary and financial statistics mission took place in March 2023 to assist the NRB in compiling the SRF and a survey for other financial corporations (OFCs), covering insurance corporations, pension funds, non-deposit taking microfinance institutions, and two other financial intermediaries.

The NRB reports data on some key series of the Financial Access Survey, including mobile and internet banking, mobile money, and the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals.

Financial Soundness Indicators: the NRB reports the 13 core financial soundness indicators (FSIs) and 7 of the 13 encouraged FSIs for deposit takers, 2 FSIs for the OFCs, one FSI for households, and 2 FSIs for real estate markets—on a quarterly basis—for posting on the IMF's FSI website. FSIs are reported with a lag of about one quarter. The NRB plans to report FSIs using the new FSIs templates to be in line with the 2019 FSIs Compilation Guide starting with FSIs for the fourth quarter of 2022.

External Sector Statistics: The NRB compiles and disseminates balance of payments (BOP) statistics in conformity with the fifth edition of the *Balance of Payments Manual* (*BPM5*). In parallel, the NRB has been publishing country's BOP as per BPM6 manual for the first time in FY2020/21. In February 2015, the NRB started reporting international investment position (IIP) data following the sixth edition of the *Balance of Payments and International Investment Position Manual* (BPM6). Nepal's BOP keeps recording large positive net errors and omissions, which adds to the uncertainty of the external sector projections, complicating surveillance. IIP data reporting to STA is lagging. Key shortcomings in external sector statistics identified during the latest TA mission in 2019 were: (i) overestimation of imports of goods; (ii) underestimation of exports of travel services; (iii) underestimation of remittances, especially those coming through informal channels; (iv) inclusion of commercial banks' assets in reserve assets; (v) incompleteness of data on foreign grants, making it difficult to classify current vs. capital, and official vs. private grants; (vi) incompleteness of data on trade credit making it difficult to reconcile flows and stocks, and (vii) potential under-coverage of external debt statistics.

Overall, the quality of BOP data has improved with the support of IMF STA TA and training of the NRB staff through External Sector Statistics IMF HQ and regional courses.

II. Data Standards and Quality	
Nepal is still working on implementing the recommendations of enhanced General Data Dissemination System (e-GDDS). Its National Summary Data Page was launched in June 2017 and is available at https://www.nrb.org.np/nsdp/	No Report on the Observance of Standards and Codes: Data Modules has been published.

Nepal—Table of Common Indicators Required for Surveillance

(As of March 15, 2023)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	02/23	03/23	D and M	W and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	02/23	03/23	M	M	M
Reserve/Base Money	02/23	03/23	M	M	M
Broad Money	02/23	03/23	M	M	M
Central Bank Balance Sheet	02/23	03/23	M	M	M
Consolidated Balance Sheet of the Banking System	02/23	03/23	M	M	M
Interest Rates[2]	02/23	03/23	D and M	W and M	W and M
Consumer Price Index	02/23	03/23	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2020/21	05/22	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	02 2022/23	03/23	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2/23	03/23	Q/A	Q/A	Q/A
External Current Account Balance	02/23	03/23	M	M	M
Exports and Imports of Goods and Services	02/23	03/23	M	M	M
National Accounts: GDP at basic prices, producer prices, by economic activity, GNI	2020/21	04/22	A	A	A
GDP at basic prices	Q1 2022/23	02/23	Q	Q	Q
Gross External Debt	2021/22	11/22	A	A	A
International Investment Position[6]	Q2 2022/23	03/23	Q	Q	Q

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND

NEPAL

April 12, 2023

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION, FIRST AND SECOND REVIEWS UNDER THE EXTENDED CREDIT FACILITY ARRANGEMENT, REQUESTS FOR WAIVERS OF NONOBSERVANCE OF PERFORMANCE CRITERIA, EXTENSION OF THE ARRANGEMENT, AND REPHASING OF DISBURSEMENTS—DEBT SUSTAINABILITY ANALYSIS

Approved By
Anne-Marie Gulde-Wolf and Maria Gonzalez (IMF) and Manuela Francisco and Mathew Verghis (IDA)

Prepared by the staffs of the International Monetary Fund and the International Development Association.

Joint Bank-Fund Debt Sustainability Analysis	
Risk of External Debt Distress	Low
Overall Risk of debt Distress	Low
Granularity in the Risk Rating	No Applicable
Application of Judgment	Yes

Both external and overall public debt in Nepal are assessed at low risk of debt distress.[1] Present value (PV) of external debt-to-exports ratio breaches the indicative threshold under an export and a combined shock scenarios, suggesting a mechanical rating of moderate risk of debt distress. Still, similar to last year's DSA, staff has applied judgement to assess external debt to be at low risk of debt distress due to Nepal's unusually high level of remittances, making exports—and hence debt-to-exports ratios—a less relevant indicator than for most economies. Remittances are the major source of foreign exchange earnings in Nepal, which along with concessional external financing, help the country maintain an adequate level of reserves and meet its debt obligations despite a sizeable trade deficit. All other external debt indicators are below their respective indicative thresholds in all stress-tests. The PV of public

[1] Nepal's debt carrying capacity remains strong, based on Nepal's composite indicator (CI) score. The CI is calculated at 3.17, based on the October 2022 World Economic Outlook (WEO) and the 2021 World Bank Country Policy and Institutional Assessment (CPIA) index.

debt-to-GDP ratio does not breach the indicative threshold under any scenario. Public debt stood at 44 percent of GDP in FY2020/21: lower than projected in the last year's DSA due to higher-than-projected GDP growth and better-than-expected fiscal outturns. The debt is projected to peak at 50 percent of GDP in FY2025/26 and gradually subside afterwards. The assessment nevertheless is contingent upon prudent execution of the medium-term fiscal consolidation strategy (as envisaged in the ECF-supported program), including tax revenue and spending reforms, and continued utilization of external borrowing at concessional terms as envisaged in Nepal's Medium Term Debt Management Strategy (MTDS). The assessment also stresses the importance of reforms to diversify Nepal's exports, improve productivity and competitiveness, and enhance resilience to shocks, in particular natural disasters.

PUBLIC DEBT COVERAGE

1. **Public debt in this DSA comprises debt from general government, central bank (borrowing on behalf of the government), as well as government's guarantees** (Text Table 1). Nepal's provincial and local governments have no debt, but their borrowing is now regulated by the Public Debt Management Act, enacted in October 2022, and should be monitored carefully. The social security fund and extra budgetary funds currently are not allowed to borrow and thus do not have debt either. IMF disbursements in 2020-2022 were used for direct budget support, and bond issuances by the central bank were only for the purpose of monetary policy operations. The government has provided guarantees for the debts of State-Owned-Enterprises (SOEs), and the current stock of guarantees—totaling NPR 34 billion (0.8 percent of GDP)—is included in the debt stock. SOEs cannot borrow externally. On domestic borrowings by SOEs, the majority of the medium- and long-term loans are from the central government, and thus are already covered under central government debt. SOE liabilities not covered by public debt are part of the contingent liability stress test as the government is working to improve its debt statistics, including that of SOEs.

2. **Public debt is defined in the LIC DSF to include the negative balance of the Treasury Single Account (TSA).**[2] According to the Government Finance Statistics Manual and Public Sector Debt Statistics Guide, the negative cash balance of the TSA should be considered as government gross debt. While there are positive cash balances in other bank accounts under the control of the Financial Comptroller General Office (FCGO) and the net balance across all government accounts was positive, those other cash balances cannot be used to offset the negative cash balance of the TSA for the purposes of measuring gross debt in the LIC DSF. The negative TSA balance is estimated at 1.2 percent of GDP in FY2021/22, down from 2.6 percent of GDP in FY2020/21.

Text Table 1. Nepal: Public Debt Coverage

	Subsectors of the public sector	Check box
1	Central government	X
2	State and local government	X
3	Other elements in the general government	X
4	o/w: Social security fund	X
5	o/w: Extra budgetary funds (EBFs)	X
6	Guarantees (to other entities in the public and private sector, including to SOEs)	X
7	Central bank (borrowed on behalf of the government)	X
8	Non-guaranteed SOE debt	

1	The country's coverage of public debt	The general government, central bank, government-guaranteed debt	
		Default	Used for the analysis
2	Other elements of the general government not captured in 1.	0 percent of GDP	0
3	SoE's debt (guaranteed and not guaranteed by the government) 1/	2 percent of GDP	2
4	PPP	35 percent of PPP stock	2.11
5	Financial market (the default value of 5 percent of GDP is the minimum value)	5 percent of GDP	5
	Total (2+3+4+5) (in percent of GDP)		9.1

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). If it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, a country team may reduce this to 0%.

3. **The contingent liability stress test is based on the default setting and includes contingent liabilities stemming from SOE debt (2 percent of GDP), PPP projects (2.1 percent of GDP) and**

[2] Negative TSA balance is not part of the public debt as reported by the authorities.

financial market (5 percent of GDP). PPP projects have not been formally compiled by the government. According to the PPI database of the World Bank, Nepal's PPP contracts are estimated to account for 6 percent of GDP as of 2021. Already incorporated in the baseline debt figures is the Net Acquisition of Financial Assets (NAFA), which represents mostly loans and capital injections to SOEs from the government. The NAFA has averaged 1.5 percent of GDP annually since 2009 and the program baseline assumes NAFA of this size will continue in the foreseeable future. The stress test on contingent liabilities from SOE debt is thus in addition to the NAFA assumed in the baseline. The size of SOE sector in Nepal is comparable to other middle-income countries, but the SOE debt risks may extend beyond those explicitly guaranteed or covered under the central government debt—for example, an SOE defaulting on a loan from an extra budgetary fund—so the contingent liability tailored test still includes the standard SOE default risk of 2 percent of GDP. The SOE risks have been rising in the last few years and need to be carefully monitored, but the standard default risk is appropriate at this stage, as it covers about a fifth of total financial liabilities in all non-financial SOEs.[3] Likewise, Nepal's private credit-to-GDP ratio is above the average among middle-income countries, and the financial sectors risks are showing signs of increase. Those risks should be monitored, but given that Nepal's banks are adequately capitalized at the moment, the standard financial market default risk of 5 percent of GDP remains appropriate.

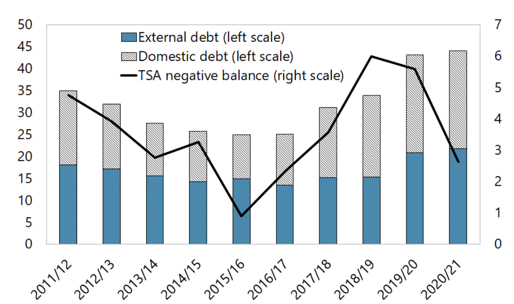
4. **The Public Debt Management Act is an important step to improve the debt management practices, but there is still ample space for progress**. The act further consolidates debt management functions in the Public Debt Management Office (PDMO), including taking over the front-office functions for domestic debt from the Nepal Rastra Bank (NRB) within two years. The act also establishes a legal framework for borrowing operations by sub-national governments and SOEs, and it sets a limit on external debt (at 33 percent of GDP). Despite the progress, further strengthening fiscal risk and public debt management remains critical, including through the development of a fiscal register to identify, disclose, and manage fiscal risks, including those emanating from SOEs and guarantees, and through strengthening the financial oversight of SOEs. The middle and back-office functions could be improved too, including annual updates of Medium-Term Debt Strategy, and publishing annual borrowing plans and forward-looking debt maturity profiles.

BACKGROUND ON DEBT

5. **Nepal's total public debt has been increasing over recent years, particularly in FY2019/20 due to the COVID-19 pandemic (Text Figure 1)**. Following a gradual decline in the early 2010s, and against the background of the country's transition to fiscal federalism and the need to rebuild after the earthquake of 2015, Nepal's public debt has risen over the last five years. Debt has increased from

Text Figure 1. Evolution of Public Debt

(In percent of GDP)



Sources: Nepal authorities; and IMF staff estimates.

[3] For more details on SOE risks in Nepal, see background paper on "Public Enterprises and Fiscal Risks".

25 percent of GDP in FY2015/16 to 44 percent in FY2020/21, with the largest increase in FY2019/20 as the pandemic begun.

6. External public debt is owed to official development partners at concessional terms. Multilateral creditors, such as the World Bank's International Development Association (IDA) and the Asian Development Bank (ADB) represent most of Nepal's external debt (87 percent of the total external debt). Their loans have low interest rates (1 percent on average) and long maturities (around 36 years on average). The net present value (PV) of external debt is estimated at 13.1 percent of GDP in FY2021/22, reflecting a high degree of concessionality. For the bilateral loans, Japan was the largest bilateral creditor, followed by India, China, and Korea (Text Table 2).

Text Table 2. Nepal: Decomposition of Public Debt and Debt Service by Creditor, 2021-23

	Debt Stock (end of period)			Debt Service					
	2021			2021	2022	2023	2021	2022	2023
	(In million US$)	*Percent total debt)*	*(Percent GDP)*	*(In million US$)*			*(Percent GDP)*		
Total[1]	15,767	100	44.0	2,310	611	691	6.45	1.7	1.93
External	7,813	49.5	21.8	266	304	315	0.74	0.85	0.88
Multilateral creditors[2]	6,871	43.6	19.2	231	254	265	0.65	0.71	0.74
IMF	274	1.7	0.8						
World Bank	3,938	25.0	11.0						
ADB	2,456	15.6	6.9						
Other Multilaterals	202	1.3	0.6						
Bilateral Creditors	942	6.0	2.6	35	50	49	0.10	0.14	0.14
Paris Club	408	2.6	1.1	1	15	15	0.00	0.04	0.04
o/w: JICA	344	2.2	1.0						
EXIM Bank of Korea	55	0.3	0.2						
Non-Paris Club	534	3.4	1.5	33	35	35	0.09	0.10	0.10
o/w: EXIM Bank of China	261	1.7	0.7						
EXIM Bank of India	257	1.6	0.7						
Bonds	0	0.0	0.0	0	0	0	0	0	0
Commercial creditors	0	0.0	0.0	0	0	0	0	0	0
Other international creditors	0	0.0	0.0	0	0	0	0	0	0
Domestic	7,955	50.5	22.2	2,044	307	376	5.70	0.86	1.05
Held by residents, total	7,955	50.5	22.2	2,044	307	376	5.70	0.86	1.05
Held by non-residents, total	0	0.0	0.0	0	0	0	0	0	0
T-Bills	2,343	14.9	6.5	1,770	0	0	4.94	0.00	0.00
Bonds	4,363	27.7	12.2	274	307	376	0.76	0.86	1.05
Loans[3]	1,248	7.9	3.5	0	0	0	0	0	0
Memo items:			0.0						
Collateralized debt[4]	0	0.0	0.0						
o/w: Related	0	0.0	0.0						
o/w: Unrelated	0	0.0	0.0						
Contingent liabilities	288	1.8	0.8						
o/w: Public guarantees	288	1.8	0.8						
o/w: Other explicit contingent liabilities[5]	0	0.0	0.0						
Nominal GDP	35,841								

1/ As reported by country authorities according to their classification of creditors, including by official and commercial. Debt coverage is the same as the DSA. Debt levels in this table may differ from those in other tables as the calculations here are based on US$.

2/ Multilateral creditors" are simply institutions with more than one official shareholder and may not necessarily align with creditor classification under other IMF policies (e.g. Lending Into Arrears)

3/ Loans here refer to the negative Treasury Single Account (TSA) balance and SOE debt guarantees

4/ Debt is collateralized when the creditor has rights over an asset or revenue stream that would allow it, if the borrower defaults on its payment obligations, to rely on the asset or revenue stream to secure repayment of the debt. Collateralization entails a borrower granting liens over specific existing assets or future receivables to a lender as security against repayment of the loan. Collateral is "unrelated" when it has no relationship to a project financed by the loan. An example would be borrowing to finance the budget deficit, collateralized by oil revenue receipts. See the joint IMF-World Bank note for the G20 "Collateralized Transactions: Key Considerations for Public Lenders and Borrowers" for a discussion of issues raised by collateral.

5/ Includes other-one off guarantees not included in publicly guaranteed debt (e.g. credit lines) and other explicit contingent liabilities not elsewhere classified (e.g. potential legal claims, payments resulting from PPP arrangements).

7. Domestic public debt has been increasing faster than external debt in recent years. Domestic public debt rose from 10.1 percent of GDP in FY2015/16 to 22.2 percent in FY2020/21. This increase is larger than the increase in external public debt from 14.9 to 21.8 percent of GDP over the same time period, and with most of the increase during the first wave of the pandemic in FY2019/20. About one-third of domestic debt is in short-term treasury bills with a maturity of up to 1 year, and close to sixty percent of domestic debt is in medium- to long-term development bonds with maturities of 3-15 years (Text Table 2). The debt is held mainly by domestic financial institutions. The negative TSA balance was estimated at 5.5 percent of GDP by the end of FY2019/20, but has substantially declined since then to 2.6 percent of GDP in FY2020/21, and estimated at 1.2 percent of GDP in FY2021/22. As all domestic public debt is held by residents, it is unlikely that there would be a material difference between currency- and residency-based measures of external debt.

8. The stock of private external debt in Nepal is relatively low, but has been on the rise lately. While the government and the NRB are encouraging commercial banks to access external loans to alleviate Balance of Payments (BOP) pressures, bank external borrowing has been constrained by limited access and high relative cost, and regulations by authorities, such as a maximum spread limit on banks' foreign loans and limits on the set of potential lenders. Apart from trade credit, the external debt by banks and other sectors in FY2019/20 was relatively low at about 0.5 percent of GDP, but the external borrowing picked up in FY2020/21 and FY2021/22, with the debt reaching estimated 1.8 percent of GDP in FY2021/22, driven by the NRB's monetary policy tightening and increased cost of funding in Nepal versus the rest of the world. Reflecting this recent trend, private medium-and long-term external debt is assumed to increase to 3.3 percent of GDP in the long term, with the total private external debt (including trade credit) reaching 5 percent of GDP. Most of the private external borrowing so far has been by banks and hydropower projects, which is likely well-covered in the standard contingent liabilities stress test for financial market and PPPs.

BACKGROUND ON MACRO FORECASTS

9. Just as Nepal began recovering from the COVID pandemic, the country was hit by another major shock—Russia's war on Ukraine—and is facing significant structural challenges going forward. The direct spillovers from the war have been small, but oil and food imports have almost doubled in FY2021/22 due to a surge in commodity prices, exerting significant BOP pressures on top of those induced by domestic factors, such as accommodative monetary policy and rapid credit growth. The external pressure subsided later in the year and in the first half of FY2022/23, thanks in part to monetary policy tightening, but inflation remains elevated. Macroeconomic challenges posed by the pandemic and later by the war were compounded by Nepal's structural constraints such as slow domestic job creation, vulnerability to natural disasters including those caused by climate change and environmental degradation, and large infrastructure gaps.

10. The Extended Credit Facility (ECF) is designed to support Nepal's post-COVID recovery and adjustment to the recent BOP shocks in the near term and to pave the way for sustained growth and poverty reduction over the medium term. The ECF and financing from other development partners, particularly the World Bank and the ADB, will help fill the external and fiscal financing gaps that have emerged due to the pandemic and the war. The ECF accommodates spending to support to the economy, and to protect the most vulnerable, with fiscal deficits gradually declining to stabilize public debt and create fiscal space for public investment in education, health, and infrastructure and for strengthening the social safety net. The program also supports a comprehensive fiscal structural reform agenda, particularly in the areas of revenue mobilization and public financing management. The program follows a carefully sequenced strategy to further strengthen financial sector regulation and supervision.

11. Growth and inflation: Despite the global challenges, the economy grew faster than anticipated a year ago—at 4.2 percent in FY2020/21 and estimated at 5.8 percent in FY2021/22 —buoyed by lifted pandemic containment measures, partial recovery in tourism, as well as booming domestic demand amid accommodating monetary policy and strong credit growth (Text Table 3). Inflation has picked up too - from 3.6 percent in FY2020/21 to 6.3 percent in FY2021/22 - and peaking 8.4 percent in September 2022, as the booming domestic demand combined with the global surge in commodity prices. Authorities responded by tightening monetary and prudential policies, and staff now estimate inflation to subside to 7.8 percent in FY2022/23, and further moderate to around 5.4 percent in FY2027/28. In turn, growth is projected to slow down to 4.4 percent in FY2022/23 - amid tighter credit conditions and a worsening global economic outlook.

12. Medium term growth drivers. Growth is projected to gradually revert back to around 5.2 percent over the medium - to long-term. The growth forecast is contingent upon Nepal's steady progress on structural reforms, including those envisaged by the ECF, as well as adequate take-up of concessional external financing to boost the level of high quality social and capital spending. Drivers of growth in the medium term include further expansion of hydroelectric power generation. As significant installed capacity becomes available, the comparative advantage of the country is expected to shift as firms and households throughout Nepal benefit from access to more reliable electricity provision. The opportunity to export electricity seasonally during the monsoon season is a further boost to the country's exports and the country's trade balance. A second driver of growth is the continuation of robust remittance inflows in the medium term. Outmigration by Nepali workers has gained steam following the COVID-19 pandemic movement restrictions, with the number of Nepalese receiving permits for foreign employment surging 57 percent in the first seven months of FY23. In addition to funding a large share of Nepal's trade deficit, analysis points to important welfare gains from remittances inflows among households. Remittances directly accounted for 27 percent of all poverty reduction from 1996 to 2011.[4] A key challenge ahead remains low labor productivity across sectors; boosting productivity would enable the economy to grow faster and more equitably.

[4] World Bank Group, 2021 "Risks to Poverty, Vulnerability, and Inequality from COVID-19: Nepal Light Poverty Assessment

Text Table 3. Nepal: Selected Macroeconomic Assumptions 1/

	Previous DSA 2/			Current DSA				Current vs. Previous	
	20/21	**MT**	**LT**	**20/21**	**21/22**	**MT**	**LT**	**MT**	**LT**
Real growth (%)	2.7	5.3	5.2	4.2	5.8	5.0	5.2	-0.3	0.0
CPI (period average, %)	3.6	5.7	5.0	3.6	6.3	6.0	5.1	0.3	0.1
Revenues and grants (% GDP)	24.2	26.5	26.8	23.7	23.5	23.7	25.4	-2.8	-1.4
Grants (% GDP)	0.7	0.9	0.7	0.9	0.5	1.0	1.0	0.0	0.2
Primary expenditure (% GDP)	27.6	29.7	28.9	26.9	25.8	25.9	26.8	-3.8	-2.1
Net acquisition of non-financial assets (% GDP)	5.5	6.1	5.8	5.4	4.5	5.7	5.9	-0.3	0.1
Primary balance (% GDP)	-3.4	-3.2	-2.1	-3.2	-2.4	-2.2	-1.5	1.0	0.7
Net incurrence of liabilities (% GDP)	7.6	5.4	4.2	7.9	6.0	4.8	3.8	-0.6	-0.4
Net domestic financing (% GDP)	4.5	3.0	2.8	4.4	3.8	2.6	1.8	-0.4	-1.0
Exports of G&S (y/y growth)	-17.5	19.2	9.5	-17.5	46.0	10.9	8.5	-8.4	-1.0
Imports of G&S (y/y growth)	22.0	4.7	6.6	22.0	24.2	3.0	5.7	-1.7	-0.9
Remittances (y/y growth)	8.2	3.3	5.8	8.2	2.1	5.3	4.5	2.0	-1.3
Current account balance (% GDP)	-8.2	-6.0	-1.6	-7.8	-12.9	-4.7	-2.7	1.3	-1.1

Note: MT (medium term) is the average over the next 5 years, and LT (long term) is the average over the following 6-19 years.

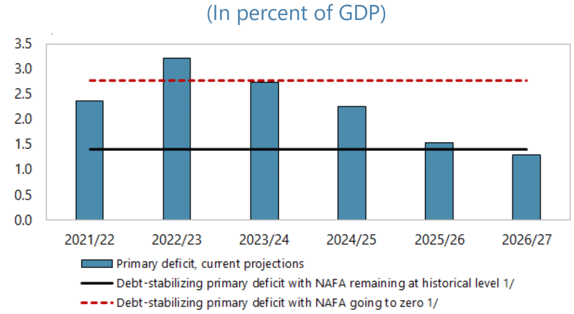
Sources: Nepalese authorities; and IMF staff estimates

1/ Nepal's fiscal year starts in mid-July. For example, FY2020/21 runs from mid-July 2020 to mid-July 2021.

2/ Previous DSA refers to ECF Request IMF CR 22/024.

Text Figure 2. Debt-Stabilizing Primary Deficits

(In percent of GDP)



Source: IMF staff estimates.
1/ Average of FY2008/09-FY2021/22.

13. **Fiscal**: The primary deficit in FY2020/21 came in at 3.2 percent of GDP, down from 4.7 percent in FY2019/20, reflecting stronger-than-expected revenue collection and a moderate spending increase compared to the last year DSA's projection. The deficit is estimated to have shrunk further to 2.4 percent in FY2021/22, as import-related tax revenue overperformed amid booming domestic demand, and capital spending significantly underperformed. In FY2022/23, the revenue growth is projected to moderate amid slower economic growth and declining imports, and the deficit is projected to increase to 3.2 percent of GDP, before gradually subsiding over the medium term to 1.3 percent of GDP—consistent with the consolidation path set out in the ECF program framework (Text Figure 2). The improvements in fiscal balances are contingent upon continued revenue mobilization efforts by the government—guided by the revenue mobilization strategy, under preparation by the authorities as agreed under the ECF arrangement—and less duplication of spending responsibilities across levels of government, while capital spending is projected to pick up over the medium term. The debt dynamics of the existing debt stock and the fiscal path suggest a debt-stabilizing primary deficit of around 2.8 percent of GDP, but the continuation of the sizeable NAFA implies a much lower level of about 1.3 percent. The proposed fiscal path is expected to stabilize public debt assuming the NAFA remains at historical average—consistent with the levels observed in the last few years (net of the changes in the TSA balance).

14. External sector: The current account deficit deteriorated from 7.8 percent of GDP in FY2020/21 to 12.9 percent FY2021/22 - significantly more than anticipated last year - reflecting primarily a substantial increase in imports, amid booming domestic demand and the surge in commodity prices. Remittances grew only by 2 percent after the outward migration was brought to a halt by the pandemic; and exports, while growing fast, remained an order of magnitude smaller than imports. The current account is projected to revert to 5.2 percent of GDP in FY2022/23—amid tighter monetary policy and declining imports, as well as buoyant remittances—and moderate gradually to 4.1 percent by FY2027/28. Exports as a share of GDP are expected to gradually recover to around 7.8 percent of GDP, with over forty percent of these being tourism services.[5] Remittances are expected to decline as a percent of GDP—including because of growth underperformance in migrant-hosting countries, return migration, and fewer new workers traveling abroad— but will remain sizeable at about 19 percent of GDP over the medium term. International reserves are projected to remain stable in the medium term at about 6.1 months of prospective imports.

15. Financing: The current account deficit increase in FY2021/22 was largely financed by reserves, which went down by almost US$2 billion or 0.8 months of prospective imports over the course of one year. External financing did not grow much, and official loan disbursements even decreased by 7.4 percent. Yet, concessional loans from development partners, mainly multilateral development banks, are expected to remain the key source of funding to cover the BOP and fiscal financing needs next year and in the medium term, as envisaged in the Medium-Term Debt Strategy (Text Table 4). As Nepal gradually deepens its financial markets, domestic borrowing is projected to cover about half of fiscal financing needs over the medium and long term, while remaining a costlier alternative to the concessional funding from abroad. Reflecting an uptick in inflation and consequent monetary policy tightening in FY2021/22, the interest rates on the new domestic borrowing are projected to increase by 6 percentage points in FY2022/23 compared to FY2020/21, then gradually decline, but still remain 1 percentage point higher than in FY2020/21 - in line with the projected inflation and the assumption of financial market deepening. About a third of the newly-issued domestic debt is assumed to be short-term—in line with the recent trend and current government practices, and subject to a significant refinancing risk.

Text Table 4. Nepal: External Borrowing Program, FY2021/22

PPG external debt contracted or guaranteed	Volume of new debt, US$ million 1/	Present value of new debt, US$ million 1/
Sources of debt financing	1,125	593
Concessional debt, of which 2/	939	463
Multilateral debt	760	380
Bilateral debt	179	83
Non-concessional debt, of which 2/	186	130
Semi-concessional debt 3/	186	130
Commerical terms 4/	0	0
Uses of debt financing	1,125	593
Project financing	780	
Budget financing	345	
Memorandum items		
Indicative projection FY2022/23	1,186	636
Indicative projection FY2023/24	1,472	809

Sources: Nepalese authorities; and IMF staff estimates.

1/ Contracting and guaranteeing of new debt. The present value of debt is estimated using the terms of recent individual loans and applying the 5 percent program discount rate.
2/ Debt with a grant element that exceeds 35 percent.
3/ Debt with a positive grant element which is lower than the minimum grant element of 35 percent.
4/ Debt without a positive grant element.

[5] A one-off projected reduction of 2 percent in FY2022/23 is due to a halt of palm oil re-export because of the change in trade tariffs between India (final palm oil importer) and Indonesia (original exporter).

16. Realism of the baseline is corroborated by the realism tools (Figures 3 and 4). The debt-creating flows over the next five years are similar to the 5-year historical average, with a larger current account deficit covered by a residual (the drawdown in reserves), and future GDP growth being somewhat higher considering that the 5-year historical average includes the pandemic. Unexpected changes in debt over the last five years are well within the 25-75 interquartile range in the distribution across LICs. The projected 3-year fiscal adjustment is within the 25-75 interquartile range too. The projected fiscal adjustment in FY2021/22 and expansion in FY2022/23 largely reflect cyclical fluctuations in imports and import-related tax revenue, and hence are projected to have little impact on economic growth. Finally, the projected impact of public investment on economic growth is more conservative than what has been likely the case historically.

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TESTS

17. Nepal's debt carrying capacity is strong. A composite indicator (CI) is used to capture the different factors affecting a country's debt carrying capacity. The CI is a weighted average of the World Bank's Country Policy and Institutional Assessment (CPIA) score, the country's real GDP growth, remittances, foreign exchange reserves, and world growth. The calculation of the CI is based on 10-year averages of the variables, across 5 years of historical data and 5 years of projections. Nepal's CI score is calculated at 3.17, based on the October 2022 World Economic Outlook and the 2021 World Bank CPIA index, which lies in a range of a *strong* rating (Text Table 5).

18. Tailored stress tests: The revised LIC-DSF includes stress tests to assess the sensitivity of projected debt burden indicators to adverse changes in the baseline projections as well as to materialization of contingent liabilities. All stress tests were kept at their default settings. In addition, to reflect Nepal's vulnerability to natural disasters, such as the 2015 earthquakes, a natural disaster shock was applied as one of the stress tests. A one-off shock of 10 percentage points of GDP to the debt-to-GDP ratio in the second year of the projection period (FY2021/22) is assumed, and real GDP growth and exports were lowered by 1.5 and 3.5 percentage points, respectively, in the year of the shock for the stress test.

Text Table 5. Nepal: Debt Carrying Capacity and Thresholds

Debt Carrying Capacity and Thresholds

Country	Nepal
Country Code	558

Debt Carrying Capacity	Strong

Final	Classification based on current vintage	Classification based on the previous vintage	Classification based on the two previous vintage
Strong	Strong 3.17	Strong 3.19	Strong 3.18

Calculation of the CI Index

Components	Coefficients (A)	10-year average values (B)	CI Score components (A*B) = (C)	Contribution of components
CPIA	0.385	3.404	1.31	41%
Real growth rate (in percent)	2.719	4.997	0.14	4%
Import coverage of reserves (in percent)	4.052	55.214	2.24	71%
Import coverage of reserves^2 (in percent)	-3.990	30.486	-1.22	-38%
Remittances (in percent)	2.022	15.494	0.31	10%
World economic growth (in percent)	13.520	2.898	0.39	12%
CI Score			3.17	100%
CI rating			Strong	

Applicable thresholds

APPLICABLE	
EXTERNAL debt burden thresholds	
PV of debt in % of	
Exports	240
GDP	55
Debt service in % of	
Exports	21
Revenue	23

APPLICABLE	
TOTAL public debt benchmark	
PV of total public debt in percent of GDP	70

New framework	Cut-off values			
Weak		CI <	2.69	
Medium	2.69	≤ CI ≤		3.05
Strong		CI >	3.05	

EXTERNAL DEBT SUSTAINABILITY

19. **All external debt indicators remain below their indicative thresholds under the baseline (Figure 1, Table 1, Table 3)**. Short and medium-term external debt dynamics slightly improved compared

to the last year's DSA due to a larger-than-expected GDP growth and primary balances in FY2020/21 and estimated FY2021/22. PPG external debt is projected to increase gradually and peak at around 25 percent of GDP—within the external borrowing limit set by the Public Debt Management Law.[6] The PV of PPG external debt-to-exports ratio is projected to increase from 191 in FY2021/22 to 203 in FY2022/23 - relatively close to but below the indicative threshold of 240 - and gradually subside after that. The improvement of the ratio in FY2021/22 relative to last year's DSA is due to larger projected exports, as informed by actual developments. Other indicators (PV of external debt-to-GDP ratio, debt service-to-exports ratio, and debt service-to-revenue ratio) are all below the respective thresholds.

20. External debt is most vulnerable to shocks to exports. The PV of PPG external debt-to-exports ratio breaches the threshold in two out of eight stress test scenarios: with a shock to exports and with a combined shock, where the culprit is again exports. The shock to exports is particularly large for Nepal as it is calibrated based on the exports' volatility in the last ten years - a period, which includes the earthquake in 2015 and the pandemic in 2020 with both having a devastating effect on the country's tourism sector. The shock is also applied to FY2022/23 and FY2023/24, essentially undoing the projected post-pandemic tourism recovery during these two years. Other indicators are all below the respective thresholds even in their most extreme stress tests.

OVERALL RISK OF PUBLIC DEBT DISTRESS

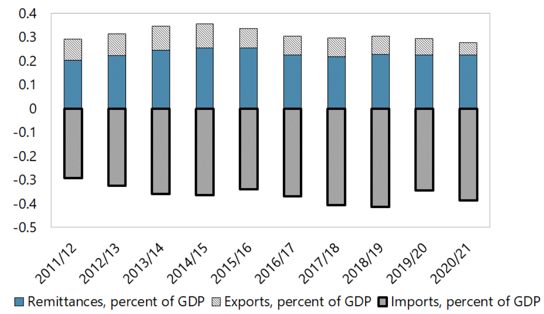
21. Under the baseline scenario, the PV of public debt-to-GDP ratio remains firmly below the 70 percent benchmark during the projection period (Figure 2, Table 2, Table 4). Public debt is projected to peak at around 50 percent of GDP in FY2025/26, and gradually subside after. The PV of the debt-to-GDP ratio is expected to increase from 35 and peak at 40—well below the 70 percent benchmark.

22. Public debt is most vulnerable to a growth shock. The growth shock is defined as a temporary shock to real GDP growth in the second and third year of the projection period and is set to either 10-year historical average growth minus one standard deviation or projected growth minus one standard deviation, whichever is lower. The shock would raise the PV of debt-to-GDP ratio close to the threshold of 70 percent in the last year of the projection period, 2032. The PV of debt-to-revenue ratio and debt service-to-revenue ratio also rise significantly under such a shock. Like with exports, the shock to growth is calibrated to be particularly large for Nepal as the calibration period includes both the earthquake of 2015 and the pandemic. Under all other shock scenarios, the PV of debt-to-GDP ratio remains well below the indicative thresholds.

[6] The law states that the PPG external debt should not exceed 33 percent of GDP.

OTHER FACTORS TO ACCOUNT FOR

Text Figure 3. Remittances: Key Source of Foreign Exchange



Sources: Nepal authorities; and IMF staff estimates.

23. **Judgment is applied in interpreting the risk signal from stress tests on the PV of debt-to-exports in light of the unusually high ratio of remittances to exports and the resilience to shocks of all other debt burden metrics**. Remittances are the major source of foreign exchange in the country (Text Figure 3). The remittance-to-GDP ratio (averaging 22.4 percent of GDP in 2017-2021) is the fourth largest in the world, and its remittance-to-exports ratio is by far the largest in the world (2017-21 averages), indicating an exceptionally high role of remittances in the economy. Remittances have also been less volatile than exports—with standard deviation of remittance growth being 7.4 percent versus 13.4 percent for export growth in the last 10 years—providing an important cushion in times of economic adversity.[7] This, combined with the fact that all other debt burden metrics remain below their sustainability thresholds in all stress scenarios, mitigates the risk signal from stress tests on the PV of debt-to-exports. Nepal's low level of exports and their volatility is, however, a major vulnerability requiring immediate policy action.

RISK RATINGS AND VULNERABILITIES

24. **The risk of both public external debt distress and overall debt distress are assessed as low**. All debt indicators remain below the indicative thresholds under the baseline. The PV of public debt remains below the threshold under all stress tests. The PV of external debt-to-exports ratio breaches the indicative threshold under two shock scenarios, suggesting a mechanical rating of medium risk of debt distress. However, staff applied judgment to assess both external and public debt to be at low risk of debt distress given the unusually high level of remittances, the major source of foreign exchange to balance the current account and service external debt. The fact that the PV of PPG external debt is 13.1 percent of GDP in FY2020/21, well below the indicative threshold of 55, is reassuring. External debt is also below thresholds in baseline and shock scenarios across all other metrics (e.g., debt service-to-exports ratio, PV of debt-to-GDP and external debt service-to-revenues), reflecting to a large extent high level of concessionality of external borrowing and the low cost of debt servicing.[8] Nepal's adequate level of international reserves, projected to remain so in the medium and long-term, also supports the assessment.

[7] High level of remittances is also a major contributor to Nepal's Composite Indicator and the country's *strong* rating of debt carrying capacity. However, the current level is well above 7 percent of GDP – the minimum that is needed, everything else equal, to maintain the *strong* rating.

[8] In reference to the LIC DSF guidance note, the use of staff judgement is based on both the general provision to take into account country specific factors that are not fully accounted for in the model and the specific provision for marginal breach considerations.

Nevertheless, uncertainty around the baseline projections, calibration of the shocks, and the debt risk assessments is exceptionally high in light of the major global shocks that hit Nepal in the last couple of years, and in light of climate-related shocks that are bound to increase in size in the future.

25. While debt remains sustainable, a number of steps could be taken to mitigate any potential risks. To build resilience to shocks, the authorities should continue to make efforts to improve productivity and competitiveness through stepping up investment in resilient and sustainable infrastructure, as well as streamlining regulations and administrative processes. It is also important to pursue rigorous analysis of the risks related to contingent liabilities, for example, related to non-guaranteed commercial SOE debt or unfounded pension liabilities, PPP projects, and budget support for the financial sector. The authorities will also need to make significant progress in updating and implementing the MTDS—developing the government bond market to facilitate domestic borrowing, while continuing to utilize external borrowing at concessional terms. Improvements are needed in subnational governments' public financial management and reporting, along with the implementation of a prudent framework for subnational borrowing. Finally, the findings in this assessment are contingent upon prudent execution of medium-term fiscal consolidation strategy, including tax revenue and spending reforms envisaged in the ECF arrangement.

AUTHORITIES' VIEWS

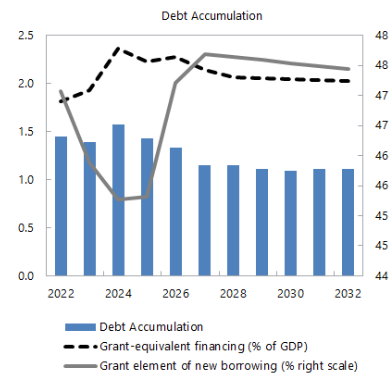
26. The authorities broadly agreed with the assessment. They reiterated their commitment to stabilizing debt over the medium term and pointed to the legislative limit on external debt set by the Public Debt Management Act (at 33 percent of GDP), as well as to the annual limits on domestic borrowing set by the Natural Resource Commission as key anchors. The authorities were concerned about the short average maturity of domestic debt and the risk that higher domestic interest rates could result in a more persistent increase in interest costs. They acknowledged the importance of utilizing concessional external borrowing, while noting risks associated with the exchange rate and uncertainties about disbursements of development partner financing. The authorities also noted the focus of the DSA on gross public debt or government's financial liabilities only and pointed to significant financial assets on the government's balance sheet.

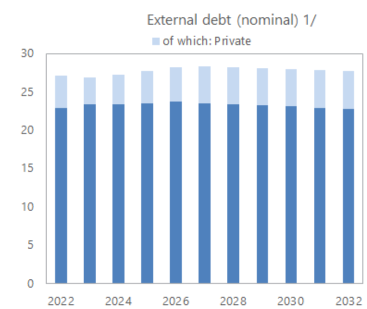
Table 1. Nepal: External Debt Sustainability Framework, Baseline Scenario, 2019-2042

(In percent of GDP, unless otherwise indicated)

	Actual			Projections								Average 8/	
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2032	2042	Historical	Projections
External debt (nominal) 1/	17.0	23.4	25.9	27.1	26.9	27.2	27.7	28.2	28.3	27.7	25.6	18.4	27.8
of which: public and publicly guaranteed (PPG)	15.2	20.9	21.8	22.9	23.4	23.3	23.5	23.7	23.5	22.8	22.3	16.6	23.3
Change in external debt	0.3	6.4	2.5	1.2	-0.2	0.3	0.5	0.6	0.1	-0.2	-0.3		
Identified net debt-creating flows	6.1	0.9	5.5	11.1	4.0	3.4	2.6	2.4	2.3	1.2	-0.4	-1.0	3.1
Non-interest current account deficit	6.7	0.8	7.7	12.6	4.9	4.8	4.2	4.2	4.0	2.9	-37670.6	0.1	4.7
Deficit in balance of goods and services	33.7	27.5	33.4	36.5	29.8	28.9	27.5	26.7	25.9	21.5	15.0	27.8	26.5
Exports	7.8	6.9	5.2	6.9	6.8	7.4	7.7	7.8	7.8	7.8	7.6		
Imports	41.5	34.4	38.6	43.4	36.6	36.3	35.2	34.6	33.7	29.3	22.6		
Net current transfers (negative = inflow)	-25.7	-25.3	-25.0	-23.0	-23.6	-23.0	-22.3	-21.6	-20.9	-17.6	-13.0	-26.6	-20.8
of which: official	-0.9	-0.6	-0.6	-0.3	-0.7	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0		
Other current account flows (negative = net inflow)	-1.2	-1.4	-0.7	-0.9	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	-37672.7	-1.2	-1.0
Net FDI (negative = inflow)	-0.3	-0.5	-0.5	-0.4	-0.1	-0.4	-0.6	-0.7	-0.7	-0.7	-0.7	-0.4	-0.6
Endogenous debt dynamics 2/	-0.3	0.6	-1.7	-1.1	-0.8	-1.0	-1.0	-1.1	-1.1	-1.0	37670.9		
Contribution from nominal interest rate	0.2	0.2	0.2	0.3	0.3	0.2	0.3	0.3	0.3	0.3	37672.2		
Contribution from real GDP growth	-1.1	0.4	-0.9	-1.4	-1.1	-1.3	-1.3	-1.3	-1.4	-1.3	-1.2		
Contribution from price and exchange rate changes	0.6	0.0	-0.9	...	...	...	...	...	...	...	...		
Residual 3/	-5.8	5.5	-3.0	-10.0	-4.1	-3.1	-2.1	-1.9	-2.2	-1.3	0.1	1.8	-2.9
of which: exceptional financing	0.0	-2.3	-0.5	-0.6	-0.9	-0.7	-0.4	0.0	0.0	0.0	0.0		
Sustainability indicators													
PV of PPG external debt-to-GDP ratio	...	...	13.1	13.1	13.8	14.0	14.2	14.3	14.3	13.8	13.7		
PV of PPG external debt-to-exports ratio	...	...	250.6	190.7	203.3	189.5	184.1	183.3	183.6	177.8	181.1		
PPG debt service-to-exports ratio	8.0	10.0	12.8	11.0	11.4	10.4	9.9	10.5	10.7	10.5	9.4		
PPG debt service-to-revenue ratio	2.9	3.2	2.9	3.3	3.7	3.5	3.4	3.4	3.4	3.3	2.9		
Gross external financing need (Million of U.S. dollars)	2925.2	696.3	3577.4	6243.1	3387.1	3039.7	2958.5	3203.9	3485.0	4080.4	#######		
Key macroeconomic assumptions													
Real GDP growth (in percent)	6.7	-2.4	4.2	5.8	4.4	5.1	5.2	5.2	5.2	5.2	5.2	4.4	5.2
GDP deflator in US dollar terms (change in percent)	-3.2	0.2	4.1	4.5	0.4	4.4	3.3	3.2	3.2	3.3	3.3	1.0	3.2
Effective interest rate (percent) 4/	1.2	1.1	0.8	1.3	1.2	1.0	1.0	1.0	1.1	1.1	157773.6	1.0	1.1
Growth of exports of G&S (US dollar terms, in percent)	2.5	-13.7	-17.5	46.0	3.8	19.4	13.4	9.8	7.9	8.4	8.4	1.9	13.0
Growth of imports of G&S (US dollar terms, in percent)	5.6	-19.0	22.0	24.2	-11.6	9.1	5.3	6.6	5.8	5.7	5.9	9.3	6.1
Grant element of new public sector borrowing (in percent)	...	...	...	47.1	45.9	45.3	45.3	47.2	47.7	47.4	47.0	...	46.9
Government revenues (excluding grants, in percent of GDP)	21.8	21.6	22.8	23.0	21.0	21.8	22.6	23.7	24.5	24.4	24.7	18.7	23.5
Aid flows (in Million of US dollars) 5/	202.9	203.9	309.5	751.7	840.4	1064.2	1091.5	1210.9	1261.0	1787.1	3903.1		
Grant-equivalent financing (in percent of GDP) 6/	...	...	...	1.8	1.9	2.4	2.2	2.3	2.1	2.0	2.0	...	2.1
Grant-equivalent financing (in percent of external financing) 6/	...	...	...	55.1	56.7	60.1	61.0	62.1	63.4	63.0	63.1	...	61.2
Nominal GDP (Million of US dollars)	34,186	33,434	36,289	40,149	42,097	46,207	50,211	54,523	59,198	89,555	204,823		
Nominal dollar GDP growth	3.2	-2.2	8.5	10.6	4.9	9.8	8.7	8.6	8.6	8.6	8.6	5.5	8.6
Memorandum items:													
PV of external debt 7/	...	...	17.1	17.3	17.4	17.9	18.4	18.9	19.0	18.7	17.1		
In percent of exports	...	...	329.2	251.6	255.5	241.9	237.7	241.5	244.6	240.8	225.0		
Total external debt service-to-exports ratio	27.9	25.7	51.0	48.6	47.7	29.5	29.6	30.7	32.9	30.2	8772819.2		
PV of PPG external debt (in Million of US dollars)			4737.9	5263.9	5822.1	6483.0	7142.6	7810.2	8439.5	12353.4	28142.6		
(PVt-PVt-1)/GDPt-1 (in percent)				1.4	1.4	1.6	1.4	1.3	1.2	1.1	1.2		
Non-interest current account deficit that stabilizes debt ratio	6.5	-5.6	5.1	11.4	5.1	4.5	3.7	3.6	4.0	3.1	-37670.3		

Definition of external/domestic debt	Residency-based
Is there a material difference between the two criteria?	No





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) + Εα (1+r)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, ρ = growth rate of GDP deflator in U.S. dollar terms, Ε=nominal appreciation of the local currency, and α= share of local currency-denominated external debt in total external debt.

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

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

6/ 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).

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

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

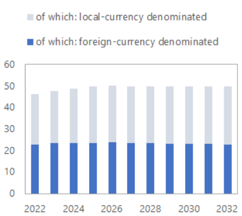
Table 2. Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2019-2042

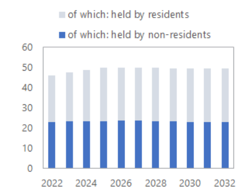
(In percent of GDP, unless otherwise indicated)

	Actual			Projections												Average 6/	
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2042	Historical	Projections
Public sector debt 1/	33.9	43.1	44.0	46.3	47.8	48.7	49.8	50.0	49.9	49.8	49.7	49.7	49.7	49.7	50.6	32.2	49.2
of which: external debt	15.2	20.9	21.8	22.9	23.4	23.3	23.5	23.7	23.5	23.4	23.2	23.1	22.9	22.8	22.3	16.6	23.3
Change in public sector debt	2.8	9.2	0.9	2.3	1.5	0.9	1.1	0.2	-0.1	-0.1	-0.1	-0.1	0.0	0.0	-0.2		
Identified debt-creating flows	1.4	8.4	3.5	0.6	1.3	1.4	1.2	0.5	0.2	0.3	0.3	0.4	0.3	0.4	0.0	1.4	0.6
Primary deficit	4.5	4.7	3.2	2.4	3.2	2.7	2.3	1.5	1.3	1.4	1.4	1.4	1.5	1.5	1.1	1.4	1.9
Revenue and grants	22.4	22.2	23.7	23.5	21.6	22.9	23.6	24.8	25.5	25.4	25.4	25.4	25.4	25.3	25.7	20.0	24.4
of which: grants	0.6	0.6	0.9	0.5	0.7	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0		
Primary (noninterest) expenditure	26.8	26.9	26.9	25.8	24.9	25.6	25.9	26.3	26.8	26.8	26.8	26.8	26.8	26.8	26.8	21.4	26.3
Automatic debt dynamics	-2.8	1.8	-3.6	-4.5	-3.3	-2.7	-2.4	-2.4	-2.4	-2.5	-2.4	-2.5	-2.5	-2.5	-2.5		
Contribution from interest rate/growth differential	-2.4	0.5	-3.2	-4.5	-3.3	-2.7	-2.4	-2.4	-2.4	-2.5	-2.4	-2.5	-2.5	-2.5	-2.5		
of which: contribution from average real interest rate	-0.5	-0.3	-1.5	-2.0	-1.4	-0.4	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0		
of which: contribution from real GDP growth	-1.9	0.8	-1.8	-2.4	-1.9	-2.3	-2.4	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5		
Contribution from real exchange rate depreciation	-0.4	1.2	-0.4	...	...	...	...	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	-0.3	1.9	3.9	2.7	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.6	1.5
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	0.0	0.0	0.0	0.0		
Recognition of contingent liabilities (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	0.0	0.0	0.0	0.0		
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other debt creating or reducing flow (please specify)	-0.3	1.9	3.9	2.7	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4		
Residual	1.4	0.8	-2.6	1.7	0.3	-0.5	-0.1	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.3	-0.2	-0.3	-0.1
Sustainability indicators																	
PV of public debt-to-GDP ratio 2/	...	...	35.4	37.3	38.6	39.6	40.7	40.9	40.8	40.8	40.8	40.8	40.8	40.9	42.2		
PV of public debt-to-revenue and grants ratio	...	...	149.6	158.7	178.7	173.1	172.3	164.9	159.8	160.3	160.4	160.5	160.8	161.2	164.3		
Debt service-to-revenue and grants ratio 3/	4.2	4.9	26.6	30.7	23.1	23.6	23.7	23.3	24.1	23.4	29.5	28.4	27.6	27.6	29.8		
Gross financing need 4/	5.1	7.7	13.4	12.2	9.6	9.5	9.2	8.7	8.8	8.7	10.3	10.0	9.8	9.9	10.2		
Key macroeconomic and fiscal assumptions																	
Real GDP growth (in percent)	6.7	-2.4	4.2	5.8	4.4	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	4.4	5.2
Average nominal interest rate on external debt (in percent)	0.8	0.8	0.4	0.8	0.8	0.8	0.8	0.8	0.9	0.9	1.0	1.0	1.0	1.0	1.1	0.9	0.9
Average real interest rate on domestic debt (in percent)	-2.3	-1.0	-3.1	-3.9	-3.1	-0.3	0.8	1.1	1.2	1.1	0.9	0.9	0.7	0.7	0.8	-3.0	0.0
Real exchange rate depreciation (in percent, + indicates depreciation)	-2.8	8.0	-2.1	...	...	...	...	...	...	...	...	...	...	...	...	1.5	...
Inflation rate (GDP deflator, in percent)	4.7	3.2	5.5	7.2	7.8	6.3	5.6	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4	6.0	5.9
Growth of real primary spending (deflated by GDP deflator, in percent)	3.8	-1.9	4.2	1.6	0.4	8.4	6.2	7.0	7.3	5.2	5.2	5.2	5.2	5.2	5.2	10.8	5.2
Primary deficit that stabilizes the debt-to-GDP ratio 5/	1.7	-4.5	2.3	0.1	1.7	1.8	1.2	1.3	1.4	1.5	1.5	1.5	1.5	1.5	1.4	-0.2	1.4
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Definition of external/domestic debt	**Residency-based**
Is there a material difference between the two criteria?	**No**

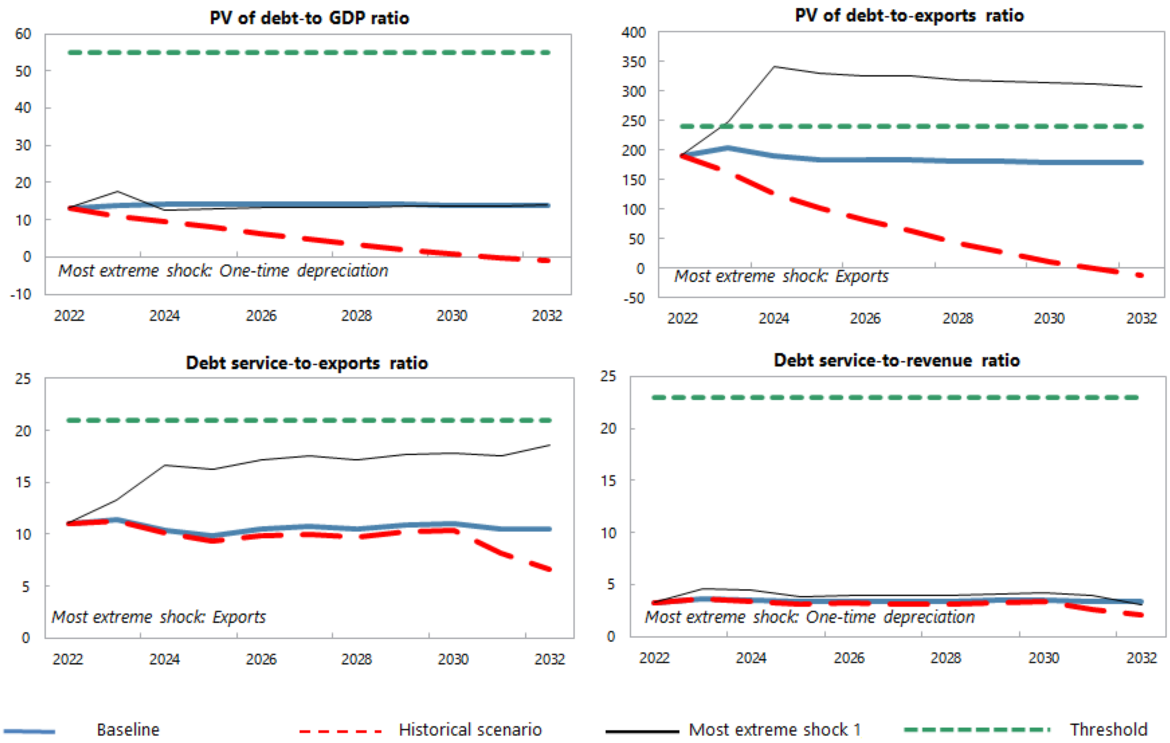
Public sector debt 1/





Sources: Country authorities; and staff estimates and projections.
1/ Coverage of debt: The general government, central bank, government-guaranteed debt. Definition of external debt is Residency-based.
2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.
3/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.
4/ 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 and other debt creating/reducing flows.
5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilizes the debt ratio only in the year in question.
6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Figure 1. Nepal: Indicators of Public and Publicly Guaranteed External Debt Under Alternatives Scenarios, 2022-2032



Customization of Default Settings		
	Size	Interactions
Tailored Stress		
Combined CL	No	
Natural disaster	No	No
Commodity price	n.a.	n.a.
Market financing	n.a.	n.a.

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing assumptions on additional financing needs resulting from the stress tests*		
	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	1.0%	1.0%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	31	31
Avg. grace period	7	7

* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2032. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Figure 2. Nepal: Indicators of Public Debt Under Alternatives Scenarios, 2022-2032

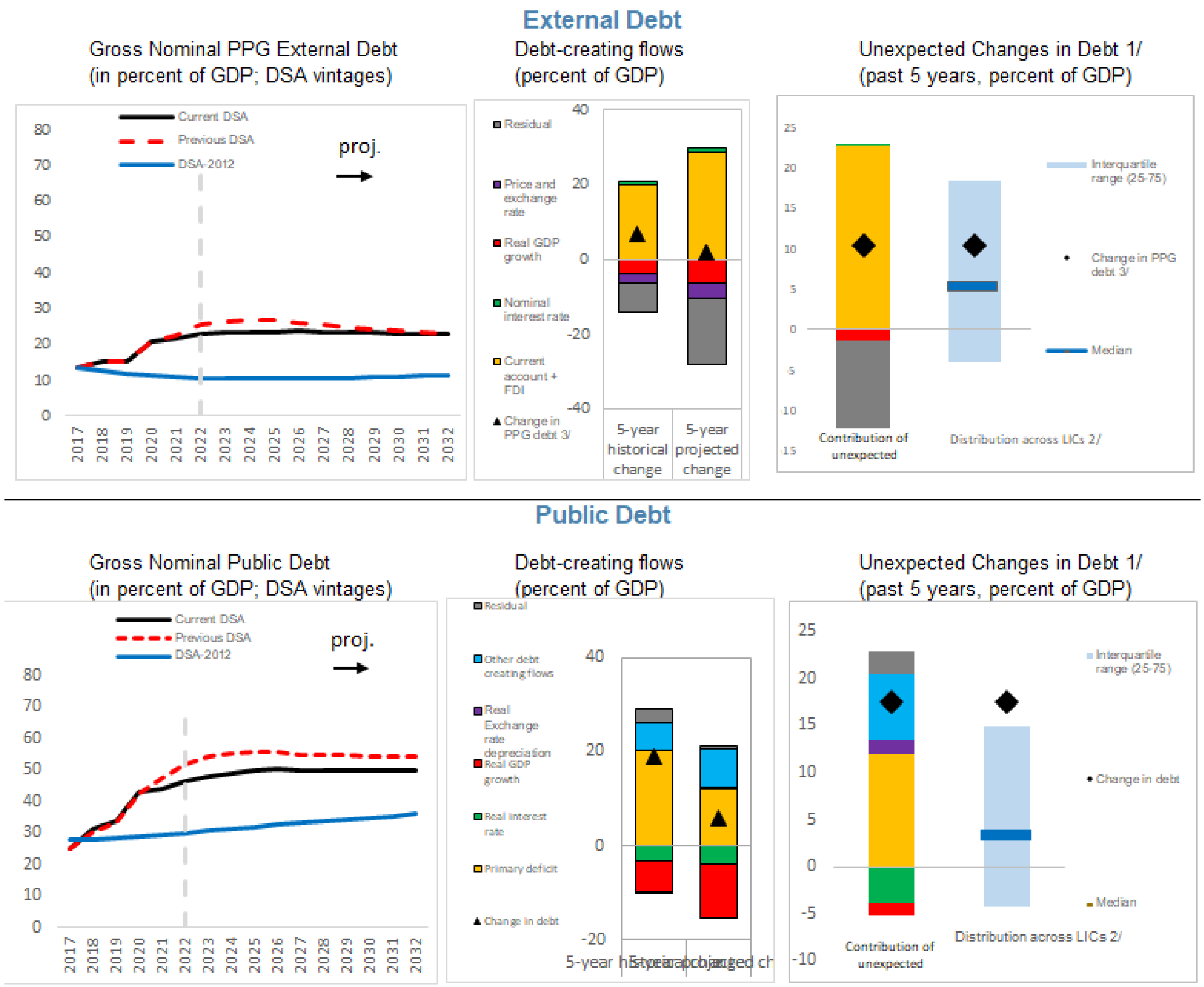
Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	26%	26%
Domestic medium and long-term	50%	50%
Domestic short-term	24%	24%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	1.0%	1.0%
Avg. maturity (incl. grace period)	31	31
Avg. grace period	7	7
Domestic MLT debt		
Avg. real interest rate on new borrowing	1.2%	1.2%
Avg. maturity (incl. grace period)	6	6
Avg. grace period	4	4
Domestic short-term debt		
Avg. real interest rate	0.5%	0.5%

* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2032. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most exterme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Figure 3. Nepal: Drivers of Debt Dynamics—Baseline Scenario



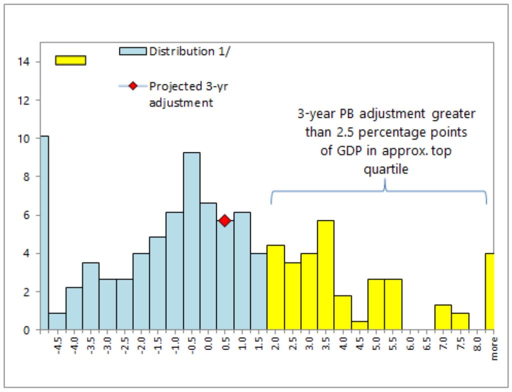
1/ Difference between anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for which LIC DSAs were produced.

3/ Given the relatively low private external debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

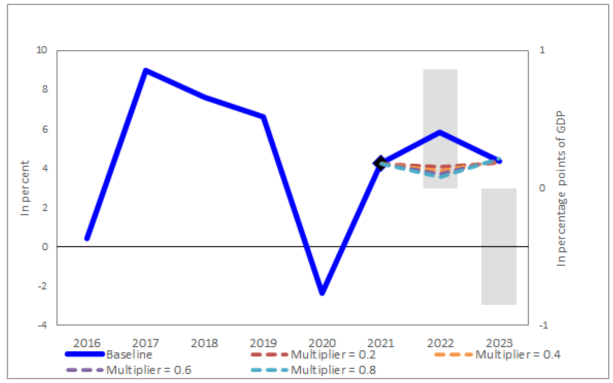
Figure 4. Nepal: Realism Tools

3-Year Adjustment in Primary Balance (Percentage points of GDP)



1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

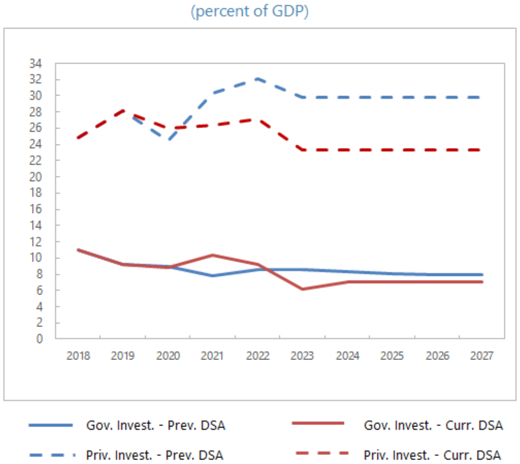
Fiscal Adjustment and Possible Growth Paths 1/



1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

Public and Private Investment Rates

(percent of GDP)



Contribution to Real GDP growth

(percent, 5-year average)

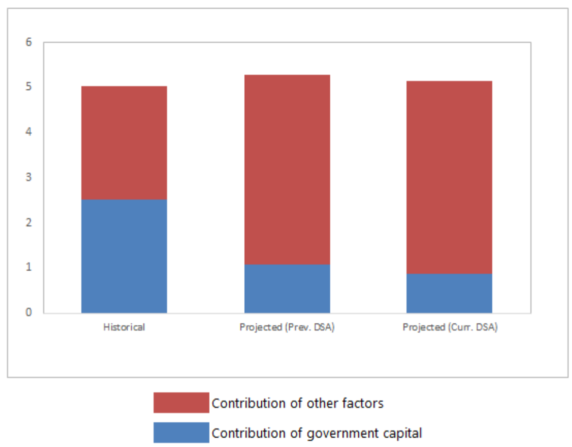


Table 3. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed Debt Under 2022-2032

(In percent)

	Projections 1/										
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
PV of debt-to GDP ratio											
Baseline	13.1	14	14	14	14	14	14	14	14	14	14
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	13	11	9	8	6	5	3	2	1	0	-1
B. Bound Tests											
B1. Real GDP growth	13	15	16	16	16	16	16	16	16	16	16
B2. Primary balance	13	14	15	15	15	15	15	15	15	15	15
B3. Exports	13	14	16	16	16	16	16	16	16	15	15
B4. Other flows 3/	13	15	16	16	16	16	16	16	16	16	15
B5. Depreciation	13	17	12	13	13	13	13	13	14	14	14
B6. Combination of B1-B5	13	16	17	17	17	17	17	16	16	16	16
C. Tailored Tests											
C1. Combined contingent liabilities	13	15	16	16	16	16	16	16	16	16	16
C2. Natural disaster	13	15	16	16	16	16	17	17	17	17	17
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	55	55	55	55	55	55	55	55	55	55	55
PV of debt-to-exports ratio											
Baseline	191	203	190	184	183	184	181	180	179	178	178
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	191	162	126	102	82	62	43	26	10	-2	-11
B. Bound Tests											
B1. Real GDP growth	191	203	190	184	183	184	181	180	179	178	178
B2. Primary balance	191	209	202	197	196	197	195	196	196	195	194
B3. Exports	191	**248**	**342**	**330**	**326**	**326**	**320**	**317**	**314**	**312**	**308**
B4. Other flows 3/	191	220	220	212	210	209	205	204	202	199	197
B5. Depreciation	191	203	133	132	134	136	136	137	137	138	141
B6. Combination of B1-B5	191	**245**	205	**271**	**269**	**269**	**264**	**263**	**260**	**258**	**256**
C. Tailored Tests											
C1. Combined contingent liabilities	191	222	210	204	203	203	203	205	205	204	203
C2. Natural disaster	191	232	220	215	215	216	216	219	220	221	221
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	240	240	240	240	240	240	240	240	240	240	240
Debt service-to-exports ratio											
Baseline	11.0	11	10	10	10	11	10	11	11	11	10
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	11	11	10	9	10	10	10	10	10	8	7
B. Bound Tests											
B1. Real GDP growth	11	11	10	10	10	11	10	11	11	11	10
B2. Primary balance	11	11	10	10	11	11	11	11	11	11	11
B3. Exports	11	13	17	16	17	18	17	18	18	18	19
B4. Other flows 3/	11	11	11	10	11	11	11	11	11	11	12
B5. Depreciation	11	11	10	9	10	10	10	10	10	10	8
B6. Combination of B1-B5	11	12	15	14	15	15	15	15	15	16	15
C. Tailored Tests											
C1. Combined contingent liabilities	11	11	11	10	11	11	11	11	11	11	11
C2. Natural disaster	11	12	11	11	11	12	11	12	12	11	11
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	21	21	21	21	21	21	21	21	21	21	21
Debt service-to-revenue ratio											
Baseline	3	4	4	3	3	3	3	3	3	3	3
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	3	4	3	3	3	3	3	3	3	3	2
B. Bound Tests											
B1. Real GDP growth	3	4	4	4	4	4	4	4	4	4	4
B2. Primary balance	3	4	4	3	4	3	3	4	4	4	4
B3. Exports	3	4	4	4	4	4	4	4	4	4	4
B4. Other flows 3/	3	4	4	4	4	4	3	4	4	4	4
B5. Depreciation	3	5	4	4	4	4	4	4	4	4	3
B6. Combination of B1-B5	3	4	4	4	4	4	4	4	4	4	4
C. Tailored Tests											
C1. Combined contingent liabilities	3	4	4	3	4	4	3	4	4	3	3
C2. Natural disaster	3	4	4	4	4	4	3	4	4	4	4
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	23	23	23	23	23	23	23	23	23	23	23

Sources: Country authorities; and staff estimates and projections.
1/ A bold value indicates a breach of the threshold.
2/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
3/ Includes official and private transfers and FDI.

Table 4. Nepal: Sensitivity Analysis for Key Indicators of Public Debt, 2022-2032

	Projections 1/										
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
PV of Debt-to-GDP Ratio											
Baseline	37.3	38.6	39.6	40.7	40.9	40.8	40.8	40.8	40.8	40.8	40.9
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	37.25	37.62	37.88	38.47	38.74	38.97	39.16	39.36	39.53	39.70	39.84
B. Bound Tests											
B1. Real GDP growth	37.25	41.68	47.74	51.12	53.51	55.62	57.64	59.52	61.27	62.96	64.58
B2. Primary balance	37.25	41.25	44.64	45.41	45.36	45.12	44.85	44.54	44.26	44.09	43.98
B3. Exports	37.25	39.19	41.60	42.59	42.68	42.55	42.45	42.37	42.30	42.26	42.18
B4. Other flows 3/	37.25	39.83	41.92	42.89	42.97	42.83	42.72	42.63	42.55	42.47	42.37
B5. Depreciation	37.25	39.26	38.09	38.17	37.18	36.07	35.03	34.18	33.36	32.51	31.73
B6. Combination of B1-B5	37.25	39.27	41.03	41.64	41.65	41.51	41.41	41.33	41.21	41.12	41.11
C. Tailored Tests											
C1. Combined contingent liabilities	37.25	46.61	46.96	47.65	47.49	47.14	46.65	46.15	45.80	45.58	45.41
C2. Natural disaster	37.25	48.22	48.79	49.70	49.77	49.64	49.35	49.02	48.84	48.78	48.77
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
TOTAL public debt benchmark	70	70	70	70	70	70	70	70	70	70	70
PV of Debt-to-Revenue Ratio											
Baseline	159	179	173	172	165	160	160	160	161	161	161
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	159	174	165	163	156	152	154	155	155	156	157
B. Bound Tests											
B1. Real GDP growth	159	192	207	215	215	217	225	233	240	247	254
B2. Primary balance	159	191	195	192	183	177	176	175	174	174	174
B3. Exports	159	181	182	180	172	167	167	167	167	167	166
B4. Other flows 3/	159	184	183	182	173	168	168	168	168	167	167
B5. Depreciation	159	182	167	162	151	142	138	135	132	129	126
B6. Combination of B1-B5	159	182	179	176	168	163	163	163	162	162	162
C. Tailored Tests											
C1. Combined contingent liabilities	159	215	205	202	192	185	183	182	180	180	179
C2. Natural disaster	159	223	213	210	201	194	194	193	192	192	192
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt Service-to-Revenue Ratio											
Baseline	31	23	24	24	23	24	23	29	28	28	28
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2022-2032 2/	31	23	22	22	22	24	22	27	26	26	27
B. Bound Tests											
B1. Real GDP growth	31	24	28	30	30	32	32	41	42	43	44
B2. Primary balance	31	23	27	28	25	26	26	35	33	30	29
B3. Exports	31	23	24	24	23	24	23	30	28	28	28
B4. Other flows 3/	31	23	24	24	23	24	24	30	28	28	28
B5. Depreciation	31	22	23	21	22	23	22	27	26	26	26
B6. Combination of B1-B5	31	23	24	25	24	24	24	31	30	28	28
C. Tailored Tests											
C1. Combined contingent liabilities	31	23	34	27	25	26	30	38	33	30	30
C2. Natural disaster	31	23	36	29	27	27	32	41	35	32	32
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities; and staff estimates and projections.

1/ A bold value indicates a breach of the benchmark.

2/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.

3/ Includes official and private transfers and FDI.

Statement by Rosemary Lim, Executive Director for Nepal,
Raja Anwar, Alternate Executive Director
and Tika Khatiwada, Advisor to Executive Director
May 1, 2023

Introduction

On behalf of our Nepali authorities, we would like to thank Mr. Turunen (Mission Chief), Ms. Daban (Resident Representative) and the entire country team for the in-depth and constructive engagement with our authorities.

The Nepali economy weathered the shock from the COVID-19 pandemic benefitting from the robust macroeconomic fundamentals and immediate policy responses of the authorities. However, headwinds from spillovers of the war in Ukraine, tighter global financial conditions, and the slowdown in global trade weighed heavily on the performance of the economy - particularly through the impact of higher commodity prices. The combination of strong domestic demand and increase in credit growth weakened the current account and resulted in substantial decline in reserves in FY 2021/22. Consequently, the authorities had to temporarily impose fiscal and monetary measures to moderate rising domestic demand and tame the deteriorating trade balance. These measures had the effect of helping to narrow down the trade deficit and restore international reserves from the second half of the 2022 and have since been removed.

The authorities consider the Extended Credit Facility (ECF) program as an instrumental policy anchor to help ensure fiscal and debt sustainability and facilitate implementation of comprehensive governance and economic reforms, in line with Nepal's growth and poverty reduction agenda. Notwithstanding the difficult domestic and external environment, the authorities have sustained reform efforts and kept the ECF arrangement on track.

Program Performance

Overall program performance is satisfactory, even in a difficult environment. The first and second review quantitative performance criteria on net international reserves and indicative targets on the fiscal deficit have been met. All the structural benchmarks scheduled to be assessed for the first review were also met, albeit a few with delays. One structural benchmark scheduled to be assessed for the second review was met with delay. The authorities are progressing the implementation of remaining structural benchmarks due on second review, where legislative procedures have been delayed in the context of recently held elections of federal, provincial, and local government.

The authorities are requesting for an extension of the program by 10 months, rephasing of the arrangement and adjustments to program conditionality to allow for more time to complete reforms. The authorities have removed exchange restrictions, multiple currency practices and import restrictions since January 2023, and are also requesting waivers for temporary non-observance of the continuous performance criteria.

The authorities remain committed to the ECF arrangement as a catalyst to preserve macroeconomic and financial stability and transition towards sustainable and inclusive growth. The authorities expect that the macroeconomic framework and reform agenda underpinning the ECF program will continue to support effective response to the current economic challenges and promote sustainable and inclusive growth. The program will contribute to strengthening institutional frameworks and help build economic and financial resilience of the country. Nepal also expects to catalyze existing arrangement to expedite support from international development partners in its endeavors to achieve national aspirations.

Recent Macroeconomic Developments and Outlook

Economic activities have strengthened despite pressure on the external sector and the pass-through effect on domestic prices. GDP growth is projected at 5.8 percent in FY 2021/22 with reopening of the economy and booming domestic demand. The growth is projected to moderate to around 4.5 percent in FY 2022/23 owing to already existing resource constraints exacerbated by global headwinds and less-than-expected domestic economic activity, before accelerating slightly over the medium-term.

Despite tighter monetary policy, inflation remains moderately elevated. Appreciation of the US dollar and higher global food and commodity prices pass-through significantly affected the domestic price level causing headline inflation to rise to 8.6 percent in mid-September 2022, before gradually easing to 7.4 percent in mid-March 2023. By virtue of gradual tightening of monetary policy, inflation is expected to remain around the central bank target of 7 percent by the end of FY 2022/23, and at about 5 percent over the medium term. The ensuing spillover-impact on growth and inflation have resulted in significant setback on food security and economic performance and dampened the plan to graduate Nepal to developing country status by 2022 as outlined in the Fifteenth Plan (2019-2024).

Fiscal Policy

The authorities are cognizant of the need for fiscal discipline in public finances to ensure macroeconomic stability and build policy buffers to deal with the multitude of risks. Though public expenditure increased due to the surge of the wage bill and social spending, the fiscal deficit remains within tolerable limits, which conforms to the fiscal path of the program. Public debt remains at low risk of debt distress registering at 43.8 percent of GDP at the end of FY 2021/22, albeit moderately elevated since FY 2017/18 due mainly to reconstruction after the 2015 earthquake and adoption of fiscal federalism which is further exacerbated by pandemic-resistant spending targeted toward protecting most vulnerable since the onset of COVID-19 pandemic. The authorities are conscious of the need to gradually reduce fiscal deficits as elucidated in Medium-Term Debt Management Strategy to stabilize debt and protect fiscal sustainability.

The authorities are committed to developing a revenue mobilization strategy and to advance an action plan to address the public investment efficiency gap. Nepal's external sector is pre-dominantly dependent on workers' remittances and tourism, which were badly hit by the pandemic and global slow down. By the first half of FY 2021/22, the current account deteriorated significantly. Measures to stem further fall of international reserves adversely dropped collection of import-related tax revenues in the current fiscal year, which accounts for about 49 percent of budgeted revenue collection for the current year. The fragility of tax base reliant on import-related revenue underscores the urgency of undertaking the reforms. The authorities will pursue a comprehensive revenue mobilization strategy to sustainably finance national development efforts, which is being formulated under Fund technical assistance. While Nepal's revenue administration has made great progress including providing e-services for taxpayers, efforts continue apace to strengthen compliance risk management and enforce taxpayer obligations. With the aim of reforming revenue management, the Revenue Advisory Committee has been established with the mandate of advising the government on revenue policies, tax, and revenue administration. Several measures including broadening the tax base, controlling revenue leakage, and reforming the revenue system and tax administration are progressing. The path of fiscal consolidation is in progress to rationalize recurrent expenditures, reprioritize investments, and enhance revenue mobilization.

The authorities are committed to initiate significant public financial management reforms, including the development of a fiscal risk register and establishment of a fiscal risk monitoring system for subnational governments, initiatives that are very much aligned with the country's broader shift towards fiscal federalism. Medium-term Expenditure Framework (MTEF) has been made effective to maintain fiscal discipline. Leveraging recommendations from the Fund's recent Public Investment Management Assessment (PIMA), and its climate change component (C-PIMA), the authorities are committed to develop an action plan to address the public investment efficiency gap and strengthen climate resilience, which is especially critical given Nepal's high vulnerability to climate change and natural disasters.

Monetary and Exchange rate Policy

Nepal Rastra Bank's (NRB) cautiously tight monetary policy stance has helped contain inflation and preserve external buffers. The NRB remains fully committed to maintaining price and external sector stability as the overarching objectives of monetary policy and preserving credibility of Nepal's exchange rate peg by keeping an adequate level of reserves. Against this backdrop, the NRB unwound its accommodative monetary policy stance amidst heightened inflationary risks, triggered by the depreciation of the Indian rupee against the US dollar and increases in food and fuel prices owing to global surge of commodity prices and climate change factors. Considering the pressure on prices and international reserves, and for ensuring macroeconomic stability, the NRB has gradually tightened its monetary policy stance by raising policy rates two times in six months in February and July 2022 under the interest rate corridor by 350 basis points, that helped cool inflation to 7.4 percent, close to the NRB's target ceiling. Monetary policy actions will remain data-dependent to keep inflation within NRB's target. The NRB is pursuing measures to reduce the volatility of short-term interest rates by encouraging reliance on open market operations and the overnight liquidity facility to balance liquidity conditions and improve NRB's ability to steer interest rate at the desired path via interbank market development.

Financial sector Policy

The financial sector is broadly sound and resilient. Capital adequacy ratios, measured under Basel II framework and the liquidity ratios are higher than the regulatory minimum. Despite pandemic related shocks, non-performing loans are within an acceptable limit (2.6 percent) albeit slightly elevated owing to the slowdown in domestic economic activities and increase in interest rates. The NRB is pursuing rigorous regulatory and supervisory frameworks to mitigate buildup of vulnerabilities and strengthen the health of the financial system, including addressing the practice of window dressing of financial assets. The NRB is committed to streamline crisis management framework, including prompt corrective action, stress testing and continue strengthening the deposit insurance mechanism. The NRB hence welcomes the proposed structural benchmarks to help enhance its financial sector regulation and supervisory capabilities, including through collecting adequate and timely supervisory data. Given the peculiarity of the Nepali economy, the authorities consider directed lending as an anchor to ensure employment and inclusive and sustainable development. The authorities expect additional technical assistance and capacity developments in streamlining robust crisis management framework and on the areas identified by the Financial Sector Stability Review 2022 (FSSR).

The authorities are committed to strengthening NRB's autonomy and governance. Amendments to modernize the NRB Act are drafted, in consultation with all stakeholders including the Fund, to strengthen the NRB's autonomy and governance practices. The amendments are undergoing internal review by the line ministries and will be submitted to Parliament soon. Implementation of 2021 safeguard assessment recommendations is also progressing.

Governance and Transparency

Improving governance and strengthening anti-corruption institutions remain key priorities for the authorities. Nepal has introduced several promotional, preventive, and punitive measures in an endeavor to improve governance and strengthen anti-corruption efforts. It has ratified the UN Convention Against Corruption (UNCAC) in 2011 and enforced several anti-corruption legislations including Prevention of Corruption Act, Commission for the Investigation of Abuse of Authority Act, Judicial Council Act, Revenue Leakage (Investigation and Control) Act, Good Governance Act, Anti-money Laundering Act and Public Procurement Act along with several regulations as delegated legislations. Commission for Investigation of Abuse of Authority (CIAA), an apex body to curb corruption and its tentacles in the country, is proactively working as per its mandate and responsibilities. The National Vigilance Centre, Office of Auditor General, Revenue Leakage Investigation Department, Department of Money Laundering Investigation are some of the institutional set up functioning to ensure anti-corruption. The four-year Corporate Strategic plan of the CIAA is under implementation and a zero-tolerance policy is adopted. The amendment bill to expand jurisdiction of CIAA to investigate and prosecute corruption cases in private hospitals, medical college, banks, and insurance companies is under final verse of enforcement after concluding parliamentary discussion. The authorities aim to increase the implementation of digital public services, one-window system and continue strengthening electronic government procurement systems to ensure transparency in public services and reduce the cost of doing business. The authorities are committed to continue further efforts in improving governance, ensuring fiscal transparency, and reducing corruption vulnerabilities that are key to private sector led and inclusive growth.

The authorities fully commit to implementing the AML/CFT measures including effective implementation of five-year national strategy as part of good governance and bringing them in line with international standards. The authorities have submitted amendments to 19 laws in parliament to strengthen the legal framework. The authorities are committed to act upon any new or emerging AML/CFT risks and will undertake further measures to strengthen governance and combat corruption as necessary. The authorities would welcome technical assistance from development partners on these matters.

Conclusion

Nepali authorities reiterate their commitment to the ongoing program's objectives and request for completion of the first and second ECF review. Nepal has a strong track record both in terms of servicing IMF debts[1], and adherence to policy prudence to create resilience to deal with the materialization of a variety of risks that the country confronts. The ongoing program has helped mitigate the impact of the pandemic and global shocks on economic activities and protect vulnerable groups, as well as preserving macroeconomic and financial stability. The authorities regard fiscal consolidation, through higher revenue mobilization, expenditure rationalization and structural reforms as critical for ensuring fiscal and debt sustainability. They will also step-up efforts to strengthen the financial sector resilience and bolster monetary policy operations.

Successful completion of the first and second review will further help Nepal catalyze external financing to secure buffers for the country's reserve level and fiscal policy space. The accompanying structural reforms are also well-aligned with the country's domestic policy priorities, and the authorities look forward to greater Fund support for technical assistance and capacity development to sustainably address the country's pre-existing institutional and capacity constraints. The authorities would also like to take the opportunity to thank the Executive Board, IMF management and international partners for their continued support.

[1] These include a three-year arrangement under the Poverty Reduction and Growth Facility that concluded in 1995 and 2007 and disbursements from the Rapid Credit Facility in 2015 and 2020.