INTERNATIONAL MONETARY FUND

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NEPAL

2012 ARTICLE IV CONSULTATION

December 2012

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Nepal, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on September 24, 2012, 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 November 2, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex** prepared by the IMF.
- **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its November 16, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Nepal.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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NEPAL

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

November 2, 2012

KEY ISSUES

Macroeconomic situation: Recent performance has been strong, but risks are rising. Agriculture, services, and remittances strengthened growth and the external accounts in 2011/12. Inflation moderated year-on-year, but is again on the rise. External risks—particularly India's slowdown—will pose challenges in 2012/13. Strong remittances and accommodative monetary policy have eliminated last year's liquidity crunch and facilitated modest improvement in some financial sector indicators. However, risks remain elevated from exposure to a post-boom real estate sector, and may be higher in smaller financial institutions.

Medium-term prospects: Medium-term prospects remain clouded by political uncertainty, low levels of investment, and dependence on remittances. Higher growth and progress in poverty reduction could be enabled by political consensus, policy stability, an easier labor environment, and higher utilization of external support.

Political situation: The constituent assembly (CA) was dissolved after failing to meet an end-May deadline for a new constitution. A new consensus government will likely be formed, followed by CA elections in April 2013. Political delays are complicating macroeconomic management. A full-year budget for 2012/13 has yet to be passed.

Policy recommendations: On the fiscal side, a full budget for 2012/13 consistent with macroeconomic and debt sustainability should be passed by presidential ordinance as soon as possible, supported by public financial management reforms to ensure full execution of the capital budget. Given the rise in non-food inflation and divergence of interest rates vis-à-vis India, monetary policy should be tightened. An acceleration of financial sector reform is warranted, with a focus on those institutions likely to be most affected by exposure to the real estate sector.

Exchange rate regime: Nepal maintains a peg with the Indian rupee. Nepal has accepted the obligations of Article VIII, Sections 2, 3, and 4. Nepal maintains an exchange restriction under Article VIII, arising due to the limit of 75 percent placed by the Industrial Enterprise Act on conversion and transfer to foreign currency of salaries on non-residents from countries where convertible currencies circulate.

Approved By
Laura Papi and Christian Mumssen

The Article IV Consultation Discussions were held September 10–24, 2012, in Kathmandu, Nepal. Staff team: T. Schneider (head), J. Yu, A. Mohommad, and T. Richardson (APD), M. Yanase (MCM). R. Pokharel and C. Poonpatpibul (OED) joined some discussions.

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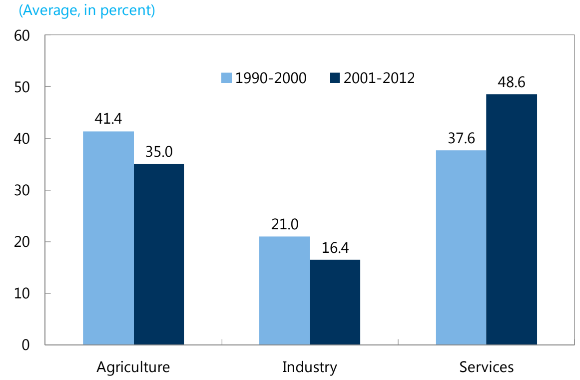
CONTEXT

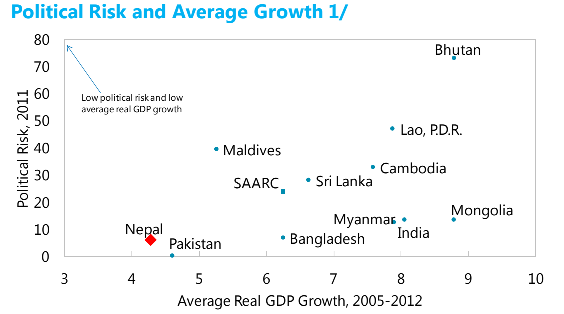
1. Nepal is a post-conflict state seeking to formalize democracy in a challenging environment. Significant headway toward a new state has been made since the 2006 peace accord. Progress on a range of technical issues (including public financial management, monetary policy, and financial sector supervision) has also been achieved. However, the failure of the constituent assembly to meet an end-May 2012 deadline to ratify a new constitution is a serious setback, and a major impediment to macroeconomic management and prospects for growth. The subsequent dismissal of the constituent assembly in June 2012 has left day-to-day operations in the hands of a caretaker government. New elections are notionally slated for April 2013, but will require fractured political parties to agree on an interim consensus government. In the meantime, key articles of legislation (such as the government budget) have been delayed. More broadly, the lack of a consensus government and functioning parliament appear to be dampening investment (foreign and domestic), keeping potential donor support at bay, and undermining prospects for sensitive financial sector and state enterprise reforms.

2. The political transition and a gradual approach to reform in some areas appear to have come at some macroeconomic cost. Real GDP growth has slowed from an average of 5 percent over 1990–2000 to around 4 percent over 2001–2012. Concurrently, the share of industry in GDP has fallen by nearly 5 percentage points—with most of the decline in the manufacturing sector. In the meantime, services have grown, and now account for nearly 50 percent of total real GDP, with the remainder in agriculture. Progress has been made on the Millennium Development Goals (MDGs), but an important adjunct to reform efforts in social services has been the rise in inward remittances—which has also fueled some of the growth in the services sector. While there are some benefits from emigration and remittances (knowledge transfer and higher household incomes) the scale of remittances—doubling since 2001 to almost one-quarter of GDP—also represents a source of vulnerability in times of external shocks.

Sectoral Share of GDP
(Average, in percent)



Political Risk and Average Growth 1/



Sources: IMF, *World Economic Outlook*; and World Bank, *Worldwide Governance Indicators.*
1/ Political risk represents the political stability and absence of violence/terrorism ranking from the Worldwide Governance Indicators database. SAARC is calculated as a simple average of data in South Asian Association for Regional Cooperation member countries.

RECENT DEVELOPMENTS AND OUTLOOK

3. Growth accelerated while average inflation declined. Real GDP growth rose to 4.6 percent in 2011/12 compared with 3.9 percent in 2010/11. A timely monsoon boosted agricultural output, while the services sector benefitted from robust growth in remittances. Industrial sector performance remained lackluster, however, largely reflecting a sharp drop in construction activity following the sharp drop in real estate prices. Average inflation declined to 8.3 percent, due largely to lower food prices. However, non-food and core inflation remained persistently high throughout the year—hovering around 9 percent on average. Rising non-food prices appear to have been driven by multiple increases in administered fuel prices, exchange-rate depreciation, and rising wages and salaries.

4. The overall budget deficit was less than expected. Revenue gains were notable, particularly in the second half of the year as tax administration reforms bore fruit. Customs, VAT, and income tax all exceeded budget targets. An early surge in current spending was contained through austerity measures, while capital spending continued to underperform the budgeted level due to capacity constraints.[1] Disbursement of foreign aid was similarly lower than budgeted, mirroring the performance of recent years and reflecting lower-than-anticipated implementation of capital projects. Finally, while the official fiscal deficit was modest, quasi-fiscal liabilities continued to rise through ongoing financial losses at the Nepal Electricity Authority (NEA) and the Nepal Oil Corporation (NOC)[2]—the latter financed by borrowing from public pension schemes.[3]

Nepal Oil Corporation: Financial Losses and Price Adjustments

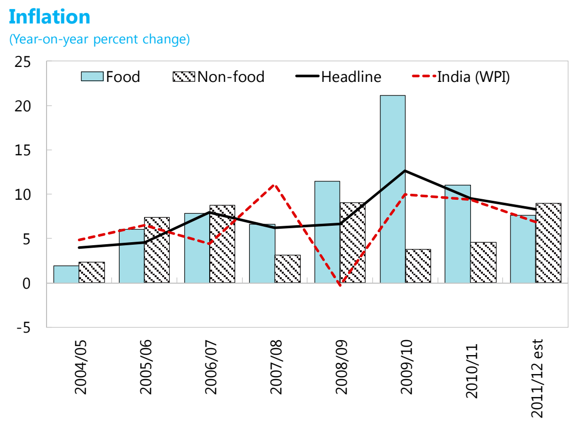
Fuel products	LPG	Diesel	Kerosene	Petro	ATF
Contribution to losses in 2011/12 (%)	45	74	0	-1	-18
Price increases in 2011/12 (%)	8	37	37	18	19
Price adjustment needed for cost recovery as of August 2012 (%)	20	7	--	--	--

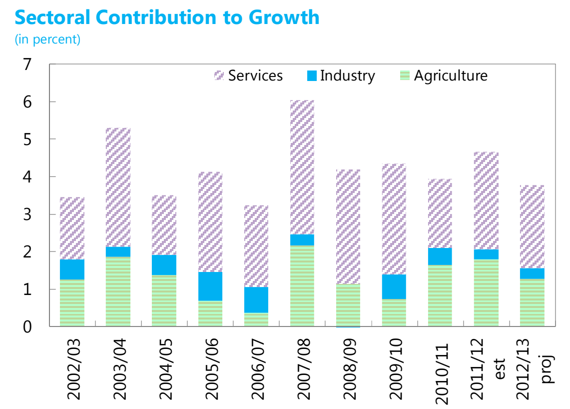
Source: NOC and staff estimates.

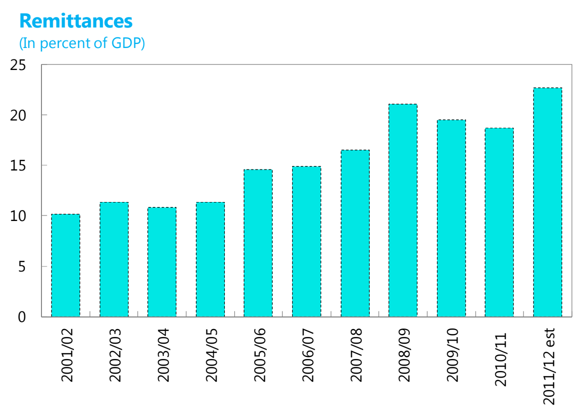
[1] Over-performance relative to the budget was due mainly to a small over-performance in revenue (0.2 percent of GDP more than projected in tax and non-tax revenues), combined with a shortfall of 1.3 percent of GDP in current spending (mainly goods, services, and operations and maintenance), lower-than-budgeted capital expenditure (2 percent of GDP less than expected)—offset by lower grant disbursements. Staff estimates the 2011/12 capital budget execution at about 73 percent, compared with 81 percent in 2010/11.

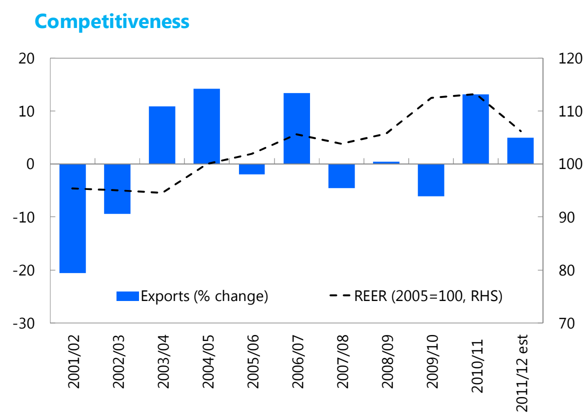
[2] NOC and NEA incurred losses of Nrs 13 billion (0.8 percent of GDP) and Nrs 6 billion (0.4 percent of GDP) in 2011/12, respectively. NOC's debts stand at Nrs 27 billion (1.7 percent of GDP), including Nrs 10 billion owed to the government, and Nrs 10 billion borrowed from pension funds with a government guarantee. The NOC has stopped servicing the loans owed to the government and the pension funds, and requested to write off these debts. NEA's debts stand at Nrs 61 billion (3.9 percent of GDP), which is owed to the government and not serviced.

[3] The pension schemes include the Provident Fund and Citizen Investment Trust, both backed by government guarantees.









5. **The balance of payments ended the fiscal year with a record surplus**. The trade balance remained flat as a share of GDP in 2011/12, reflecting modest export growth and weaker-than expected imports (possibly tied to the slowdown in the construction sector and lower demand for imported building supplies). Remittances were unexpectedly strong—rising by nearly 25 percent year-on-year to a level equivalent to about 23 percent of GDP. As a result, the external current account shifted to a sizeable surplus—facilitating an increase in Nepal Rastra Bank (NRB) foreign exchange reserves to $4.3 billion (6.8 months of imports). The real effective exchange rate depreciated by 4.6 percent, in line with the decline of the Indian rupee (Box 1).

Box 1. Exchange Rate Assessment and Competitiveness

Recent depreciation of the Nepali rupee (NR) may have contributed to lower import growth in 2011/12 and a current account surplus of 4.7 percent of GDP. However, a sharp decline in construction and low execution of government infrastructure projects may be more important factors. Exports remained subdued and market share in India, the main trade partner, continued to decline. The medium term current account balance is projected to remain in deficit.

Application of select methodologies suggests the NR is modestly overvalued, albeit less than last year's assessment. ***The macroeconomic balance (MB) approach*** suggests an overvaluation of 9 percent (compared to 14 percent in the previous assessment), and the ***external sustainability (ES) approach*** shows an overvaluation of around 11 percent (compared to a previous assessment of 20 percent), largely due to the smaller projected current account deficit in the medium term.[4] ***The PPP approach*** shows a decline in overvaluation from 19 to 16 percent—with due caveats on the difficulty in estimating equilibrium PPP rates.

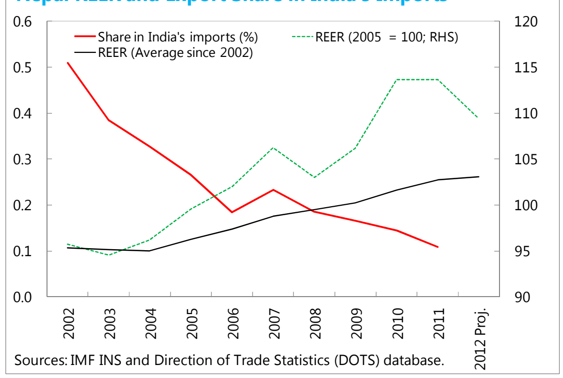
Overvaluation resonates with Nepal's small export base and large trade gap. On the other hand, the NRB has accumulated reserves of six months of import cover, the balance of payments is in record surplus, and interventions to support the peg are few.

Nepal: Estimated Exchange Rate Misalignment
(in percent)

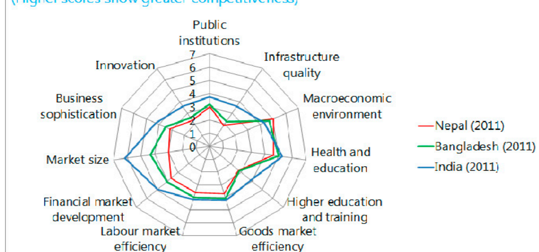
	Misalignment (+ is overval.)
MB approach [1]	9.1
ES approach under alternative benchmarks (mean) [2]	11.6
Stabilize NFL-to-GDP at 3.4 percent	2.0
Stabilize ext. debt-to-GDP at 24.1 percent	17.1
Stabilize ext. debt-to-GDP at 26.9 percent	15.6
PPP approach	16.3

[1] The current account norm underpinning the derived misalignment is an average estimate from pooled and fixed-effect models in CGER.

[2] The benchmarks of 3.4, 24.1, and 26.9 represent end-2011 ratios to GDP of Nepal's NFL, its ext. debt, and average ext. debt of LICs.



Sources: IMF INS and Direction of Trade Statistics (DOTS) database.

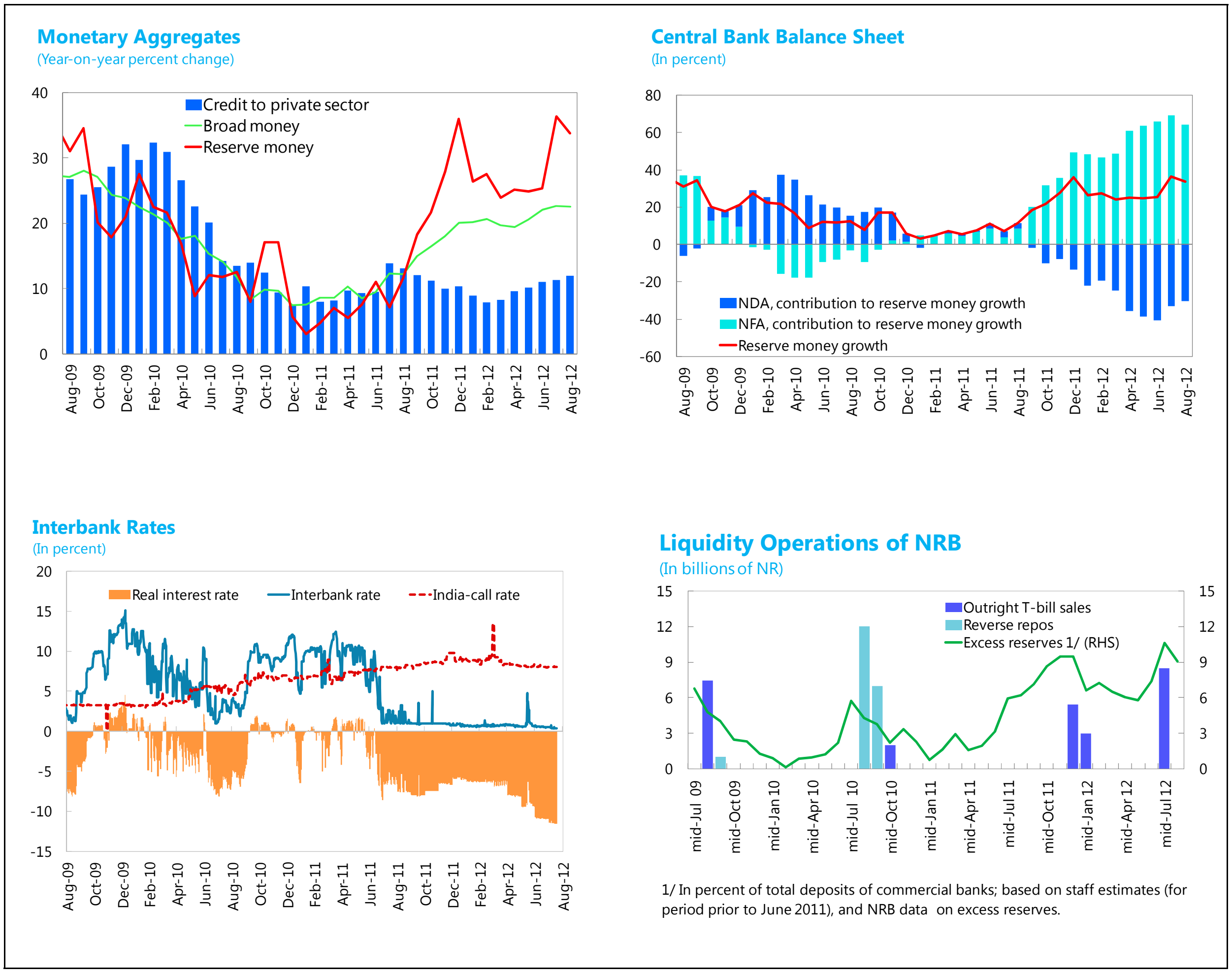


Source: Global Competitiveness Report 2011-12.

6. **Monetary policy was largely passive in 2011/12, signaling support for balance sheets and private credit**. The influx of remittances was only partly sterilized, and the growth in net foreign assets contributed to reserve and broad money growth of 36.4 and 22.7 percent, respectively—well above nominal GDP growth of 14 percent. Excess reserves (held as non-remunerated deposits at the NRB) climbed, and interest rate spreads vis-à-vis India widened considerably. Despite ample

[4] These results should be interpreted with caution, due to data limitations and variation in norms across methodologies. The MB approach yields a norm of ½ percent of GDP, while the ES norm is 1¼ percent of GDP.

liquidity, bank credit was weak, reflecting elevated balance sheet risks following the sharp decline in real estate prices and weak demand.



7. Strong inward remittances provided breathing space for the financial sector in 2011/12, but many of the underlying balance sheet weaknesses highlighted in the 2011 Article IV remain. Following a sharp liquidity squeeze in 2010/11, a surge in remittances boosted domestic deposits and allowed banks to simultaneously unwind liquidity loans from the NRB and boost interest earnings through a wider deposit/loan spreads. Reported data suggest some improvement in financial sector indicators[5]. However, doubts remain about the quality of this data and balance sheet risks[6]. The system-wide capital adequacy ratio (CAR) is reported above the

[5] Reported data covers Class A (commercial banks) only. Aggregate financial sector indicators for Class B (development banks) and Class C (finance companies) are not yet available.

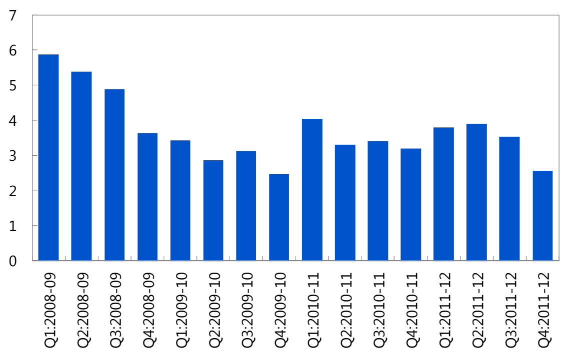
[6] The accounting framework for non-performing assets in Nepal, in which interest payment is a primary factor in loan classification, may partly explain this lack of impact on financial outcome. If an interest payment is overdue up to 3 months, the loan is classified as "good" and provisioning rate is 1 percent; overdue interest of 3 to 6 months, the loan

(continued)

regulatory minimum, and rising. Reported NPLs are low and falling. Abundant liquidity lowered banks' funding costs, allowing for some recovery in interest-based profits. However, the level of profitability remains low overall, reflecting weak credit growth and a prolonged slump in the real estate market. Given the magnitude of the real estate decline, a higher NPL ratio might have been expected, raising some doubts as to reported data.

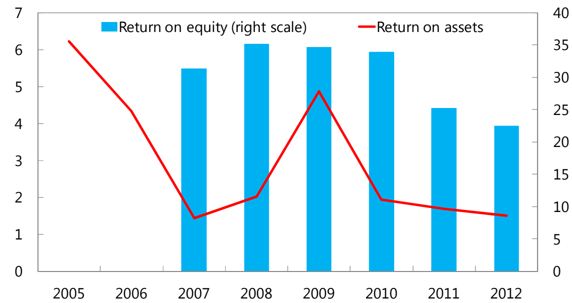
Nepal Banking Sector Indicators: NPLs

(In percent)



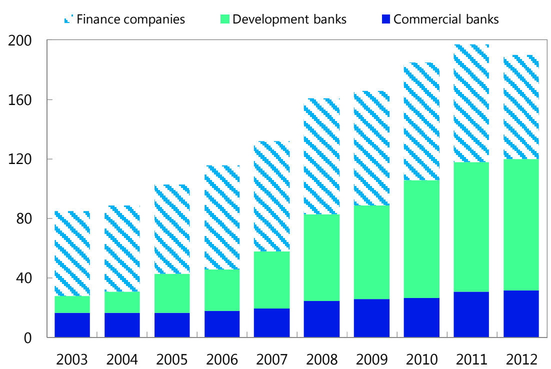
Nepal Banking Sector Indicators: Profitability 1/

(In percent)



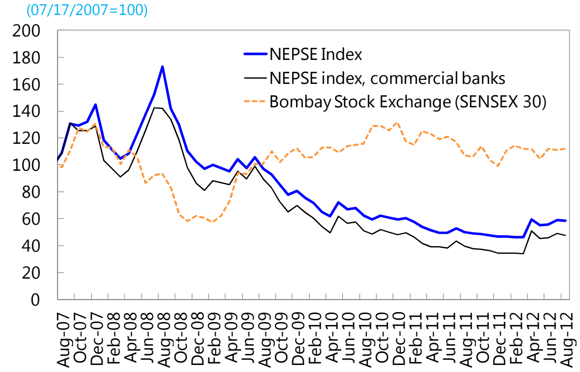
1/ Excluding state-owned Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB).

Number of Banks in Nepal



Stock Market Performance

(07/17/2007=100)



8. The outlook for 2012/13 is challenging. Growth is projected to decline to 3.8 percent for 2012/13. A weaker monsoon may lower agricultural production, while continued political uncertainty, a delayed budget, and potentially weak private sector credit will likely inhibit both investment and consumption. Externally, outflows of migrant workers appear to have peaked. Combined with a softening global outlook, this suggests that remittance growth will slow, and in turn dampen some service sector activities and reduce the current account surplus in the coming

is "substandard" (25 percent provisioning); for 6 months to 1 year, "doubtful" and 50 percent provisioning; more than 1 year is "bad", with 100 percent provisioning. The term non-performing loans cover all loans except "good".

year.[7] India's slowdown—which increasingly appears to be a medium-term phenomenon driven by declining domestic investment—will negatively impact Nepal via lower export demand, weaker inward investment, and possibly through the remittances channel. Inflation is also projected to rise, in line with developments in India in the coming months.

9. Medium-term prospects hinge on reaching a political consensus that would serve as a base for reform and facilitate higher levels of confidence and investment. Nepal has significant potential in services, hydroelectric power generation, and basic manufacturing, but a stable policy regime backed by sound macroeconomic policies and continued reforms to the investment environment are needed. Current macroeconomic projections (Tables 1–4) are based on the status quo—incorporating only modest improvements to growth and investment.

MANAGING DOWNSIDE MACROECONOMIC RISKS

The past year has provided breathing space, but macroeconomic and financial pressures are once again on the rise. Spillover effects from a slowing Indian economy, combined with the dampening effect of continued political impasse will likely dampen growth. Inflation pressures are also likely to rise in the coming months. Continued fiscal prudence, more effective use of budgetary and donor resources, and a tighter monetary policy are warranted to maintain stability.

A. Fiscal Policy and Public Financial Management

10. Continued fiscal prudence is needed to maintain fiscal and external sustainability[8] over the medium-term. Given potentially large quasi-fiscal liabilities in the SOE and financial sectors, the baseline fiscal strategy should aim to keep public debt roughly constant as a share of GDP—implying annual net domestic financing of about 2 percent of GDP. Once key vulnerabilities are addressed (and their fiscal cost assessed), there may be room to moderately increase borrowing to finance key investment and social protection schemes. Scaling up should be done only if the schemes are well designed, however, and implemented on the basis of continued improvements in public financial management.

11. The near-term priority is to pass a full-year budget. Delays in passing a full-year budget could further damage business confidence, lead to under-execution of key capital projects, and create additional pressure on the banking system. Recent experience (the 2010/11 budget was passed seven months late, resulting in significant under-spending on capital projects) highlights this risk. Line ministries are reluctant to undertake expenditures in the absence of a full and approved

[7] Growth in outgoing workers slowed to 8 percent in 2011/12, and the growth rate of remittances in 2012/13 is thus expected to moderate. Import growth fell sharply last year, but is expected to normalize in relation to remittances (there is also a strong lagged relationship between import growth and remittances, which suggests a recovery in imports in 2012/13). In addition, given the interest rate gap vis-à-vis India, there is a risk of capital flight (including through unrecorded channels), which is reflected in reversal of other investments (net) on the financial account.

[8] The debt sustainability analysis framework (see Appendix) classifies Nepal has having a moderate risk of debt distress.

budget. In addition to under-spending, delays also appear to exaggerate a tendency toward bunching of expenditures near the end of the year, complicating liquidity and macroeconomic management. A late-year rush to spend can also adversely affect the quality of public expenditures. In line with medium-term fiscal objectives, an overall deficit consistent with a net domestic financing of no more than 2 percent of GDP is needed. Near term measures to support these goals include:

- **Bolstering revenues through continued tax and customs administration**. The three-year reform plan and the five-year strategic plan by the Internal Revenue Department (IRD) are welcome, as is the initiative to update the 2009/13 reform plan by the Department of Customs (DOC) in line with IMF TA.

- **Collecting arrears and reducing non-compliance**. Further action is needed to collect arrears identified in the recently completed fraud investigation (Nrs 6.5 billion), and tax arrears (Nrs 29 billion). The large share of non-filers (22 percent for VAT, 56 percent for income tax) indicates a need to improve compliance management.

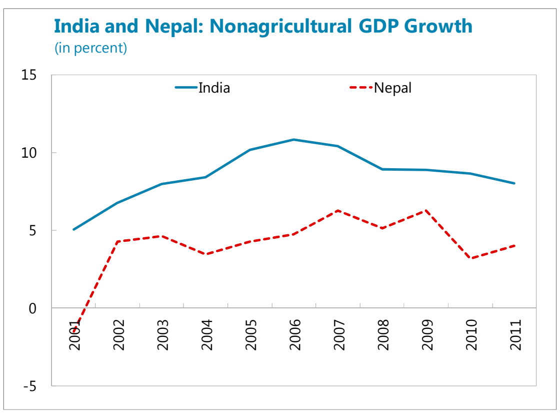
- **Using the Treasury Single Account to improve budget execution and management**. With the TSA covering 95 percent of revenue and expenditure transactions, closer monitoring and more frequent adjustment is possible. The staff recommends publication of monthly financial statements and regular reviews of budget execution.

Box 2. Nepal: Potential Spillover Risks

The slowdown in India and increasing global risks raise the specter of spillover effects on Nepal. Other risks include a slowdown or loss of confidence feeding through the financial sector.

Key channels through which negative external developments might spill over to Nepal include:

- **Trade.** India is Nepal's dominant trade partner—accounting for 67 percent of Nepal's exports and 65 percent of imports in 2011/12, up about 20 percentage points from a decade ago.
- **Remittances**. Remittances are the main source of Nepal's foreign exchange receipts, equivalent to about ¼ of GDP. GCC countries, Malaysia, and India are the main hosts of Nepalese migrant workers.
- **Financial linkages.** FDI and cross-border lending may also be a conduit for India-related shocks. Reports indicate extensive involvement or interest of Indian investors in key hydroelectric projects. Most of Nepal's financial flows (a surplus of about 1½ percent of GDP in 2011/12) take the form of trade credit and therefore are likely to be associated with India.
- **Confidence shocks**—inspired by India or other events—could trigger capital flight as seen in 2009–10, possibly forming a feedback loop between external sector deterioration and escalating banking sector risks.



Macroeconomic simulations highlight the potential spillover effects of three scenarios: (i) a further decline in India's growth; (ii) slowing remittances against the backdrop of increasing global uncertainty; and (iii) a major banking sector stress (potentially triggered by external shocks) stemming from preexisting financial sector fragilities. Although India's slowdown is the main (i.e., most likely) downside risk, the three episodes are potentially additive as elevated global uncertainty could trigger decline of remittances, and external shocks could be amplified by vulnerabilities in the financial sector. The simulations indicate external shocks represent substantial risks, and could cause a visible output loss, a rapid decline of foreign exchange reserves, and a moderate increase in public debt. Financial sector distress would instead result in a large output loss over the medium term and substantial rescue costs incurred to the public sector, ultimately leading to unsustainable debt. (See Appendix I for details).

	Baseline	India Slowdown 1/	Remittance Weaken 2/	Financial Stress 3/
Medium-term Output loss compared to baseline	--	1.0%	0.1%	30.0%
Current account balance by 2016/17 (% GDP)	-1.2%	-1.4%	-2.1%	-1.6%
Gross international reserves by 2016/17	$5.0 bn	$4.7 bn	$4.0bn	$3.9 bn
Net domestic financing, 2013-17 average (% GDP)	2.3%	2.5%	2.6%	6.9%
Public Debt/GDP ratio by 2016/17	30.4%	31.1%	31.6%	97.2%

1/ Assumes a one percentage point decline in India's growth.
2/ Assumes a one standard deviation decline in remittance growth.
3/ Assumes an output loss of 30 percent, and a fiscal cost of 23 percent of GDP in bank rescue.

12. Over the medium-term, continued progress needs to be made on increasing the government's ability to implement the budget (particularly capital expenditures), effectively utilize donor resources, and eliminate quasi-fiscal liabilities. Important steps in this regard could include:

- **Simplifying the budget release process for capital spending**. The requirement for the National Planning Commission (NPC) to assess high priority projects after budget approval could be eliminated. Instead, information regarding performance benchmarks (currently addressed through the NPC's post-budget approval assessment) would be included in budget submissions and endorsed by NPC prior to formal budget approval.

- **Implementing an automatic adjustment mechanism for fuel prices, and handling interim losses through the budget**. Fuel prices should be increased gradually to levels at least consistent with cost recovery, followed by an automatic price adjustment as the final objective[9]. NOC's interim financial losses should be accommodated within the 2012/13 budget (with a supplemental budget later in the year). NOC's outstanding debts/arrears should be cleared, conditional on an audit of past claims and a strategy to prevent accumulation of new arrears.

- **Strengthening the on-budget pension system**. The current public (on-budget) pension scheme is defined benefits only. Funding for this scheme needs to be secured (for example, by government employee contributions), the coverage streamlined, and an actuarial analysis undertaken.

Authorities' Views

13. The authorities broadly agreed with staff's recommendations, and highlighted in particular the need to pass a full-year government budget. They noted the urgency of providing line ministries with a full-year allocation for expenditures, and with the need to target net domestic financing of no more than 2 percent of GDP. A full-year budget has been prepared[10], and the MOF is actively seeking support to pass this budget by presidential ordinance before the end of November. They expressed optimism that continued gains in VAT, income tax, and customs collection could be made, and highlighted the need for continued reforms at IRD and DOC, the importance of targeted incentive schemes at these agencies, and further technical assistance from the Fund. The authorities also concurred on the need for an automatic pricing mechanism for fuels, but noted that such decisions required a careful political consensus and supporting measures for public welfare. Future pension liabilities were also a shared concern. The authorities noted that an employee contribution system had been initiated in 2006, but was terminated in 2009 after public protest.

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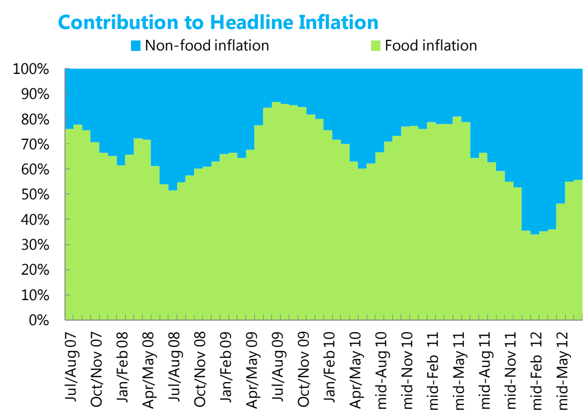
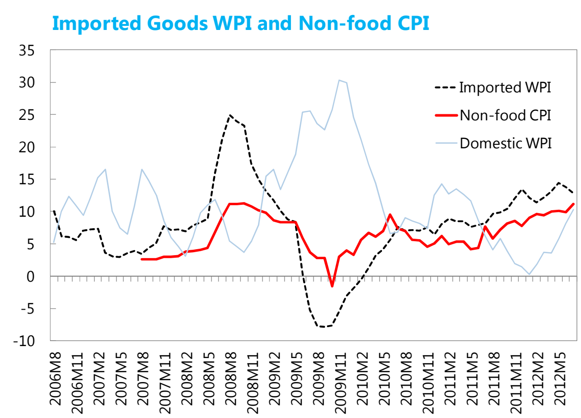
[9] A move to market cost would need to be accompanied by measures to protect the poor. There is not currently in place the administrative architecture needed to enact a direct cash transfer system.

[10] The draft full-year budget was not shared with the mission. However, the major spending and financing elements were discussed, and these are reflected in the projections for 2012/13 in Table 2.

B. Monetary and Exchange Rate Policy

14. Accommodative monetary policy in 2011/12 allowed banks additional space to rebuild profitability, but inflation and exchange risks are on the rise—suggesting the need to tighten. Weak credit demand and the overhang of banks' excess reserves at the NRB suggest that, while money growth was excessive, upward pressure on prices from monetary policy was moderate. Rather, the bulk of inflation stemmed from factors noted earlier (administered prices, higher import prices through exchange rate depreciation, and the effect of wage and salary increases). However, prices have continued to climb since the end of the fiscal year, with headline inflation reaching just under 12 percent, year-on-year, in August—the ninth consecutive year-on-year increase. Real interest rates have been negative for over a year, and the wedge between domestic and India's one-month interbank rate has widened to almost 900 basis points on a sustained basis—suggesting a powerful financial incentive for capital flight, and a risk to the exchange rate peg. The NRB shifted policy in July 2012, signaling its intent to bring broad money growth to 15 percent in the coming year, consistent with a targeted average inflation rate of 7.5 percent.[11]





15. The exchange rate peg has served as a pillar of stability, and although quantitative estimates suggest some overvaluation, the rupee does not appear fundamentally misaligned. The peg continues to provide a widely visible nominal anchor and support macroeconomic stability. Adjusting the peg may curb imports, but (depending on accompanying monetary and fiscal policy adjustments) could also stoke inflation. More meaningful adjustment is likely through structural reforms to address a weak business climate—particularly infrastructure and labor relations. However, the peg also complicates macroeconomic management in times of external shocks, by limiting room for adjustment. In this context, consideration should be given to exit options should external shocks bring unsustainable pressures on the external accounts. There is some evidence that while fixed

[11] Reserve requirements were raised in July (one percentage point for commercial banks and a half percentage point for development banks), and NRB reverse repurchase operations have absorbed some NR 8.5 billion between July and September 2012. More frequent open market operations, would serve to mop up excess liquidity,

regimes better control inflation, flexibility can be growth promoting, and help cope with real shocks better than a fixed rate regime.[12]

Authorities' Views

16. The authorities concurred that monetary policy had been relatively loose in the past year, and that tightening was needed. They argued that from a macroprudential point of view, it had been important to provide banks with room to recover from the sharp downturn in real estate prices. They also saw inflation developments as being largely driven by external factors, supply bottlenecks (particularly the effect of strikes on movement of food products), and exchange-rate induced changes in import prices. However, they agreed that with prices already rising and the inflation already high in India, monetary tightening was needed. They noted that the interest rate wedge vis-à-vis India was a concern, and that it was important to reassert support for the exchange rate peg, which continues to serve Nepal well as a clear and widely accepted anchor.

ADDRESSING FINANCIAL SECTOR RISKS

The influx of remittances eliminated the 2010/11 liquidity squeeze that pressured banks' balance sheets, and accommodative monetary policy and gradual financial sector reform have allowed some improvement in financial soundness indicators. However, risks should not be underestimated. It is unclear whether the real estate market has bottomed out. Further, little is yet understood about the inter-connectedness of financial institutions and contagion risk. Underlying balance sheet weaknesses related to real estate exposure remain—particularly in smaller institutions. A targeted acceleration of ongoing reforms, combined with a medium-term strategy for consolidation is warranted.

17. Reported financial sector indicators (Class A banks only) show modest improvement, but the sharp decline in real estate prices since 2009 continues to pose risks. Direct exposure to real estate remains above 10 percent of total assets for all classes of banks, and higher still among smaller financial institutions. Moreover, indirect exposure through collateral is nearly two-thirds of total assets. Though official data are lacking, real estate prices are said to have declined by 30 percent or more off their peak, which may have significantly damaged banks' balance sheets but is not being reflected in reported NPLs. This raises concerns about the quality and integrity of reported data, and possible ever-greening of loans.[13] Balance sheet risks may therefore be substantially higher than suggested by reported data.

[12] Occasional Paper #270, *Exchange Rate Regimes and the Stability of the International Monetary System*.

[13] An additional factor weakening the reliability of reported data is the relative strength of supervisory resources. With over 200 financial institutions under its purview, the NRB is stretched to adequately monitor the financial system. Each supervisory department has only about 40 personnel. For development banks, on-site inspections tend to cover the top 20–30 borrowers. For commercial banks coverage of their loan assessment is around two percent, which is comparatively low.

18. The NRB has taken a gradual approach to financial sector reform. Some forbearance measures to address the fall in real estate and capital market are still in place. These include easing conditions for restructuring real estate and margin loans, increasing the loan-to-value ratio ceiling for loans against promoter shares, and postponement of a reduction in the limit on real estate sector loans to 25 percent of total loans. On the other hand, efforts have been made to strengthen regulation and supervision, and to facilitate mergers and credit diversification. Specifically:

- **Minimum capital adequacy will be strengthened** by introducing a 1 percent capital buffer. Some Basel III elements—including 4.5 percent common equity Tier 1—are also under consideration.

- ***An amended NRB Act***—allowing for swift resolution of problem banks—is in the final stages of drafting by the NRB and will be submitted to the government. Nonetheless, in the absence of a constituent assembly it is unclear when this legislation could go into effect.

- ***The prompt corrective action framework is being broadened*** to include liquidity and non-performing asset ratio triggers. Stress test guidelines were issued as well as guidelines on Internal Capital Adequacy Assessment Process (ICAAP).

- ***A single department supervising both class-B and C banks was split into two dedicated departments***[14]. On-site inspection practices have improved in line with IMF recommendations. Macroprudential monitoring has been strengthened by creation of a Financial Stability Unit in the NRB, which will create semi-annual financial stability reports.

- ***The government injected capital*** (as part of the partial 2012/13 budget) into the two insolvent state-owned commercial banks that would partially cover their capital deficiency.[15]

- ***The NRB introduced a requirement that banks extend at least 10 percent of total credit*** to the agriculture and/or energy sector. Work is also proceeding on establishment of a base (minimum) lending rate for banks, based on cost of funds.

- ***A moratorium on licensing new commercial banks, development banks and finance companies*** will be continued for another year. To encourage mergers, regulatory forbearance and tax incentives have been extended.[16]

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[14] Class B banks are "development banks" and Class C banks are "financial companies". They have broadly similar operations as Class A banks (commercial banks) but are generally smaller in scale.

[15] According to latest available data (June 2012), Nepal Bank Limited and Rastriya Banijya Bank have net negative capital of NR 4.4 billion and NR 8.7 billion, respectively. The government recently injected NR 1.4 billion via subscription to a rights issue in NBL, and NR 4.3 billion in RBB. NBL and RBB are 45.5 percent and 100 percent government owned, respectively.

[16] Since May 2011, 40 out of nearly 200 financial institutions have approached NRB for approval to merge, of which 19 cases have been approved.

19. Recent efforts to bolster supervision and regulation are welcome, but there is a need for a targeted, well sequenced acceleration of financial sector reform. The influx of liquidity via remittances has bought time, and allowed banks to accumulate a liquidity cushion, but potentially serious balance sheet and other vulnerabilities remain. Real estate exposure remains the primary risk. However, the lack of clarity on the interconnectedness of banks is another source of concern as some banks are reported to share the same promoters (initial capital contributors). Given the wide-spread practice of providing loans to promoters with banks' shares as collateral, there is a risk that problems in one bank may cause contagion in the system. The current gradual approach runs the risk of a disorderly adjustment in the financial sector, which could be magnified by banks' inter-linkages. Reforms should proceed with a short- and medium-term vision for increasing financial sector safety and soundness. In the near-term:

- ***Amendment of the NRB Act should be completed as soon as possible*** to strengthen the NRB's powers to swiftly resolve banks. Enactment of a modified Deposit Guarantee Act to expedite the repayment process is also a priority. These two actions provide the necessary pre-conditions to decisively address problem banks.

- ***Planned diagnostic reviews with World Bank and DFID assistance need to be "deep dive"***, with decisive follow-up to deal with problematic banks, including resolution in case of non-viable banks. Mergers may be an option to resolve viable banks, but should not be used as an excuse for less-than-optimal restructuring and recapitalization. Thorough post-merger assessments should be conducted to assess the viability and effectiveness of the merger.

- ***Supervision should continue to be strengthened, and the new PCA framework needs to be implemented***. Transition to IFRS-based accounting standards for loan classification and provisioning should also proceed as planned. Supervisory resources need to be increased and new staff trained to provide sufficient resources for broader and deeper on-site inspection as well as managing bank resolutions.

- ***NRB should avoid directed credit policies***. Cross country experience suggests that—in the absence of bank capacity to adequately assess credit risk in targeted sectors—directed lending can decrease bank efficiency and undermine bank soundness.[17] At a minimum, targets for specific sectors should only be indicative.

20. Over the medium term, a comprehensive review of financial sector policies should be considered. To this end, the liberal licensing policy that has resulted in a large number of banks needs review, even as the current moratorium on licensing is maintained. The current legal framework, with three categories of financial institutions without clear differences in their scope of

[17] Experience with directed lending in the transition and Central Asian countries is potentially relevant for Nepal, given some similarities. See Zoli, IMF Working Paper 01/157, *Cost and Effectiveness of Banking Sector Restructuring in Transition Economies*.

business, also needs review. Supervisory resources should be increased. A possible roadmap is presented in Table 6. However, an FSAP could be useful in setting priorities.

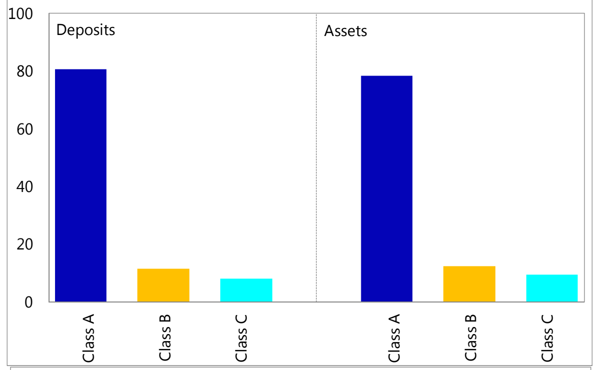
Authorities' Views

21. The authorities emphasized that the gradual approach to financial sector reform was deliberate, but that action would be taken as needed to ensure financial system stability. Legislative reform to strengthen the NRB's resolution powers is recognized as a key priority in accelerating efforts to address weak banks. Work on amendments to the NRB Act is in an advanced stage, and will be delivered to the Government in October 2012. However, lack of a parliament is viewed as a setback, and the authorities are hesitant to implement amendments to the NRB Act and other financial sector legislation via presidential ordinance. The quality of data reporting is recognized as a problem. The authorities are more confident about Class A Banks, but the NRB is pushing for more frequent on-site examinations among Class B and C banks, as well as requiring daily liquidity reporting. The authorities expressed interest in an FSAP.

22. The authorities view a minimum level of credit to 'productive sectors' as a useful policy. They argued that diversification of bank credit is justified on the grounds that lending to agriculture and the power sector will support growth in these important sectors and also help diversify banks' portfolios, which are too highly exposed to real estate. Moreover, the 10 percent requirement is broadly defined to include project finance, insurance, and refinance. Work is also underway to support directed lending with credit insurance, though further development of micro-insurance for agricultural credit would be useful. In the energy sector, risks are perceived to be already contained via power purchase agreements.

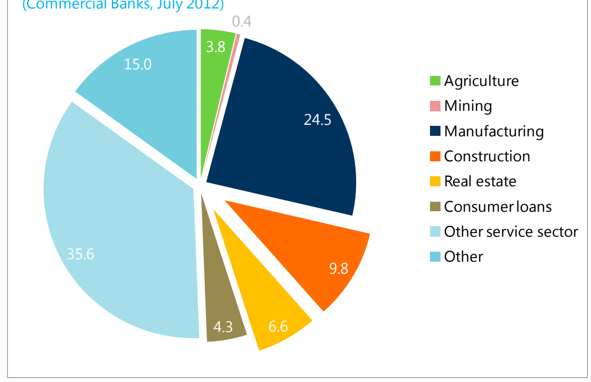
Box 3. Financial Sector Vulnerabilities

Despite recent mergers, Nepal's financial sector still has nearly 200 entities overseen by the NRB, including 32 commercial banks, 88 development banks, 70 finance companies, and 22 micro-credit institutions. Weak licensing rules and supervision in previous years led to a proliferation of banks with unsound lending practices, resulting in high exposure to a booming real estate sector that subsequently corrected, and remains stagnant.



Share of Various Bank Classes in Banking Sector
(In percent)

Bank assets have stabilized at around 80 percent of GDP, after spiking to above 100 percent during the 2009/10 credit boom. The system is dominated by commercial banks—accounting for nearly 80 percent of assets and deposits. The remainder is split between development banks and finance companies.



Sector Share of Credit
(Commercial Banks, July 2012)

Recent stress tests conducted by NRB (for commercial banks only) echo the improvement in reported FSIs, particularly liquidity and capital adequacy indicators. Liquidity improved on the back of strong remittance inflows, and compared to 2011, commercial banks are more resilient to deposit withdrawal shocks, and to withdrawals by large individual and institutional deposits. There is also a slight improvement in response to credit shocks, particularly those calibrated to real estate loans. Direct exposure to construction and real estate has declined from 19½ percent over 2009/2010 to around 16½ percent in 2011/12. Indirect exposure through collateral has also declined from 66 percent to 56 percent over the same period. However, overall exposure is still high. A third of commercial banks see their capital drop below the regulatory minimum under a shock in which a quarter of all performing real estate loans are reclassified as loss loans.

Stress Testing Results for Commercial Banks

	2012	2011
Credit shocks	*No. of banks with CAR < 10% regulatory minimum*	
Standard credit shock[1]	20	22
25 percent of performing loans of real estate & housing sector directly downgraded to loss loans	11	15
Liquidity shocks	*No. of banks illiquid after 5 days*	
Standard withdrawal shock[2]	14	19
	No. of banks with liquid assets to deposits ratio < 20%	
Withdrawal of deposits by 20%	26	27
Withdrawal of deposits by top 3 institutional depositors.	18	27
Withdrawal of deposits by top 5 individual depositors.	1	6

Source: Nepal Rastra Bank

[1] 15 percent performing loans deteriorated to substandard, 15 percent substandard loans deteriorated to doubtful, 25 percent doubtful loans deteriorated to loss, 5 percent of performing loans deteriorated to loss.

[2] Withdrawal of customer deposits by 2%, 5%, 10%, 10%, and 10% for five consecutive days respectively.

OTHER ISSUES

23. Discussions continued on the potential for closer engagement with the Fund, including through an ECF or other program. The authorities continued to express interest in a program, noting the potential benefits for advancing the reform agenda, catalyzing donor support, and providing another anchor of stability in an uncertain environment. However, they noted that, in the absence of a consensus government and constituent assembly, the risks to program performance would be high. Given the absence of an urgent balance of payments need, they suggested that further time be given to come to a political situation conducive to a consistent policy framework and ambitious reform agenda. In the interim, they expressed interest in continued coordination on policy advice and technical assistance, and emphasized that the dialogue on a potential program be kept open.

24. Investment and trade policies remain open, but significant impediments remain. The current government has continued a liberal trade and investment policies. A number of significant sectors, including hydropower, have been opened to foreign investment and ownership. The government has dedicated 2012/13 to be an "investment year", and recently created an Investment Board to coordinate domestic and foreign investors. The Board will focus on large investment projects worth more than Rs 10 billion (USD 130 million) and certain key sectors, and could help cut through bureaucratic delays and improve interagency coordination. Despite these positive steps, political instability, labor unrest, bureaucratic delays and inefficiencies, perceived corruption, and perennial power shortages create an uncertain environment for foreign and private investment.

Nepal: Governance and Doing Business Indicators

Governance Indicators (percentile rank; a higher value indicates better performance)

	2007	2008	2009	2010	2011	2012	
Governance Indicators							
Political Stability / Absence of Violence	5.8	5.7	6.6	5.7	6.1	...	→
Voice and Accountability	30.3	30.8	31.3	31.3	31.5	...	→
Government Effectiveness	29.1	23.8	21.5	25.8	22.7	...	↓
Regulatory Quality	33.3	30.1	29.1	26.3	24.9	...	↓
Rule of Law	30.1	26.0	19.4	16.6	17.4	...	↓
Control of Corruption	25.7	26.2	28.2	28.7	23.7	...	↓
Doing Business Indicators (out of 183 rated countries -- a lower rank is a better performance)							
Doing Business (overall rating)	100	111	121	123	116	107	↑
Starting a Business	49	60	73	87	96	102	↓
Dealing with Licenses / Construction Permits [1]	127	125	129	131	130	88	...
Registering Property	25	25	28	26	25	23	→
Getting Credit	101	97	109	113	89	67	↑
Protecting Investors	60	64	70	73	74	79	→
Trading Across Borders	136	151	157	161	164	170	↓
Enforcing Contracts	105	123	121	122	123	136	↓

Source: Worldwide Governance Indicators, World Bank; Doing Business reports for 2007-2012, World Bank. Additional data and periodic revisions available on the Doing Business website.

1\ Reflects a change in methodology in 2012.

25. Nepal's last anti-money laundering and combating the financing of terrorism (AML/CFT) assessment in September 2010 revealed serious deficiencies. This led the Financial Action Task Force's International Cooperation Review Group to agree on an action plan with Nepal to improve its compliance with the international AML/CFT standard—which is being supported through IMF technical assistance. This TA resulted in the adoption of an AML/CFT National Strategy in 2011. Current assistance focuses on drafting amendments to the AML/CFT law, developing the capacity of the financial intelligence unit, and creating a risk-based tool for offsite supervision.

STAFF APPRAISAL

26. Economic outturns for the past year have been favorable, and progress on a range of structural reforms has been achieved in a difficult political environment. On the fiscal side, maintaining spending discipline, bolstering revenues, and completing reforms to public financial management (including implementation of a Treasury Single Account (TSA) during a political transition are notable achievements. Monetary policy was accommodative, but reflected a conscious decision to reduce pressure on balance sheets, and does not appear to have fueled inflation or put immediate pressure on the exchange rate peg. Financial sector reform has progressed, albeit gradually, and financial sector indicators show some modest improvement.

27. Most signs point to a more difficult year in 2012/13. On the domestic side, the continued political impasse will continue to have a dampening effect on investment and consumption. A late monsoon is likely to lower agricultural output, and negative spillover effects from India's slowdown will also exert some negative pressure on Nepal over the coming year. The potential for lower remittances—which provided respite to fragile financial sector balance sheets and boosted services activity—also looms as a chronic risk.

28. Room for counter-cyclical macroeconomic policies is limited, and efforts should focus on more effective budget implementation. Further delays in enacting a full-year budget will complicate macroeconomic management and add to downside risks. The mission urges the authorities to move as quickly as possible to pass a full 2012/13 budget by ordinance, and to follow up with line ministries on month-to-month execution of spending plans. To maintain fiscal and debt sustainability, the budget should be consistent with net domestic financing of no more than 2 percent of GDP, and set a suitably ambitious target for investment spending. The draft full-year budget appears to be in line with this advice. However, achieving these objectives will require continued progress on tax and customs reform, as well as efforts to utilize the TSA as a tool for increasing the transparency of public financial management and highlighting areas where budget implementation may be weak.

29. Fiscal policy has generally been prudent and medium-term sustainability hinges more on maintaining space to deal with quasi-fiscal liabilities in state enterprises, public pension schemes, and potentially the financial sector. Nepal does not have a history of fiscal profligacy. However**,** losses at the NOC and NEA represent a current and future drain on public resources—including a large stock of outstanding arrears. The current public pension scheme, while not currently in arrears, is growing in cost and is without an independent source of funding—suggesting a steadily increasing need for budgetary resources in the years ahead. Restructuring and reform of NEA needs to proceed quickly, and an automatic adjustment mechanism for fuel prices is a necessary first step in bringing NOC to a cost-recovery basis. Complementary actions to protect the most vulnerable could be key in forging a political consensus around these reforms, and Fund technical assistance could prove useful in this regard. Similarly, a review of the public pension scheme, supported by an actuarial analysis is warranted as means of reviving discussion of sustainable financing mechanisms.

30. **Monetary policy needs to be tightened to signal a clear intention to price stability and support of the exchange rate peg**. Nine consecutive months of rising inflation risk embedding inflation expectations and creating additional pressures on the exchange rate peg—on top of a large interest rate differential vis-à-vis interest rates in India. Open market operations and regular auction of T-bills should be used to mop up excess liquidity (which remains high even after recent interventions). The establishment of a base rate for banks, and publication of this information, is a welcome step in increasing transparency in the financial sector.

31. **A targeted acceleration of financial sector reform is needed**. The staff sees the financial sector as the greatest potential source of risk, particularly if external shocks noted above exacerbate existing balance sheet vulnerabilities. Stability is important, but the mission believes the current gradual approach runs the risk of a disorderly adjustment, which could be magnified by inter-linkages between banks. Any strategy needs to be well-sequenced, as it would require the capacity-constrained supervisor to carry out multiple complicated tasks. Such key reforms as the expanded prompt corrective action framework and the amended NRB Act should be given clear priority. The latter should be enacted as soon as possible to complete an essential pillar in the authorities' crisis resolution framework. Upcoming diagnostic reviews should be used for deep-dive assessments of the most vulnerable institutions (i.e., those most exposed to the real estate sector), and the NRB should be prepared to intervene and resolve problem institutions where necessary.

32. **Tackling long-standing structural problems is essential to achieve higher, more inclusive growth over the medium term and to increase Nepal's resilience to external shocks**. The poor business climate, power shortages, weak governance, and difficult labor relations remain major impediments to growth and investment. A political consensus is essential for moving ahead in several of these areas. Progress can be made in a range of areas, and in this context the establishment of the Investment Board is a welcome step, particularly given the focus on potentially growth-enhancing infrastructure projects.

33. **A renewed effort to increase transparency and good governance** could give a welcome boost to government credibility and public confidence. One key step in this regard would be regular publication of fiscal, monetary, and financial sector data on the MOF and NRB websites. Another would be the appointment of an Auditor General. Finally, there are a large number of quasi fiscal operations and tax expenditures that are used to promote policy objectives, but are not transparent and often unmeasured. These include the price subsidies to fuel and electricity (estimated at 1.2 percent of GDP in 2011/12), interest rate subsidies for agriculture and other priority sectors, tax exemptions for specific industries. These should be quantified and reported, and preferably entered on the budget explicitly as expenditures. Continued progress on AML/CFT issues is encouraged.

34. **Staff welcomes the authorities' continued interest in close engagement with the Fund, including through a potential program**. A political consensus and common view on economic and

structural reform priorities would be an essential pre-requisite for a successful engagement. In the meantime, the staff will continue to offer advice, as needed, and facilitate technical assistance to key areas.

35. It is recommended that the next Article IV consultation takes place on the standard 12 month cycle.

Table 1. Nepal: Selected Economic Indicators, [1] 2009/10-2016/17

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
			Est.			Proj.		
Output and prices (annual percent change)								
Real GDP	4.8	3.9	4.6	3.8	3.9	3.9	4.0	4.0
CPI (period average)	9.5	9.6	8.3	8.3	8.1	7.9	6.9	6.1
CPI (end of period)	9.0	9.7	11.5	8.2	7.7	7.2	6.7	5.5
Non-food CPI (end of period)	7.4	7.6	11.2	...	...	...	...	...
Fiscal Indicators (in percent of GDP)								
Total revenue and grants	18.0	17.7	18.3	18.1	17.9	17.9	18.1	18.5
Expenditure	18.8	18.6	18.2	18.6	18.6	18.8	19.0	19.3
Expenses	15.6	15.2	15.1	15.7	15.3	15.5	15.7	15.8
Net acquisition of Nonfinancial Assets	3.2	3.4	3.1	2.9	3.3	3.3	3.3	3.5
Net lending/borrowing	-0.8	-1.0	0.1	-0.5	-0.7	-0.9	-0.9	-0.8
Net acquisition of Financial Assets	1.0	1.0	1.5	1.6	1.6	1.7	1.7	1.7
Net Incurrence of Liabilities	1.8	2.0	1.4	2.1	2.3	2.5	2.5	2.5
Foreign	0.0	-0.3	-0.1	-0.2	0.0	0.2	0.2	0.2
Domestic (above the line)	1.7	2.3	1.4	2.3	2.3	2.3	2.3	2.3
Money and credit (annual percent change)								
Broad money	14.1	12.3	22.7	12.5	...	...	...	...
Domestic credit	16.8	14.6	8.0	14.4	...	...	...	...
Private sector credit	14.2	13.9	11.3	13.0	...	...	...	...
Velocity	1.5	1.5	1.4	1.4	...	...	...	...
Investment and saving (in percent of nominal GDP)								
Gross investment	37.1	32.5	32.8	32.9	33.4	33.6	33.9	34.1
Private	30.0	25.3	25.7	26.0	26.0	26.1	26.3	26.3
Central government	7.1	7.3	7.1	6.9	7.4	7.5	7.6	7.8
Gross national saving	34.7	31.6	37.5	33.5	33.1	33.0	33.0	32.9
Private	32.6	29.6	34.4	31.0	30.0	30.0	29.8	29.4
Central government	2.1	2.0	3.1	2.6	3.1	3.1	3.2	3.5
Balance of payments								
Current account (in millions of U.S. dollars)	-378	-181	909	128	-63	-142	-221	-318
In percent of GDP	-2.4	-1.0	4.7	0.6	-0.3	-0.6	-0.9	-1.2
Trade Balance (in millions of U.S. dollars)	-4,078	-4,470	-4,605	-5,540	-6,042	-6,596	-7,178	-7,774
In percent of GDP	-25.6	-23.6	-23.7	-27.3	-27.4	-27.6	-27.9	-28.2
Exports value growth (percent change)	-6.1	13.2	5.0	6.9	8.1	7.9	7.7	7.9
Imports value growth (percent change)	36.4	10.2	3.4	17.9	8.9	9.0	8.6	8.2
Gross official reserves (in millions of U.S. dollars)	2,844	3,085	4,307	4,595	4,770	4,930	5,020	5,045
In months of imports of goods and services	5.4	5.8	6.8	6.6	6.3	6.0	5.7	5.3
Memorandum items								
Public debt (percent of GDP)	35.4	33.3	33.3	31.3	30.7	30.4	30.5	30.4
GDP at market prices (in billions of Nepalese rupees)	1,193	1,368	1,557	1,750	1,965	2,202	2,449	2,704
GDP at market prices (in billions of U.S. dollars)	16.0	19.0	19.4	20.3	22.0	23.9	25.8	27.6
Exchange rate (Nrs/US$; period average)	74.8	72.1	80.2	...	...	...	...	...
Real effective exchange rate (eop, y/y percent change)	7.0	1.4	-4.6	...	...	...	...	...

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

[1] Fiscal year ends mid-July.

Table 2. Nepal: Summary of Government Operations, 2009/10-2012/13 1/

	2009/10	2010/11	2011/12		2012/13	
			Budget	Est.	Est. Budget	Proj.
	(In billions of Nepalese rupees)					
Total revenue and grants	214.7	241.6	311.8	285.1	374.0	316.7
Total revenue	176.2	197.1	241.7	244.4	288.4	277.2
Tax revenue	154.7	171.8	209.2	211.7	249.8	244.9
Non-tax revenue	21.5	25.3	32.5	32.6	38.5	32.4
Grants	38.5	44.5	70.1	40.7	85.7	39.5
Expenditure	224.0	255.0	339.1	283.5	382.8	325.3
Expenses	186.2	208.2	268.9	234.4	299.7	274.3
of which:						
Interest payments	10.0	12.7	16.6	15.2	18.8	16.4
Salaries and allowances	41.9	44.8	55.4	51.4	62.3	57.8
Net Acquisition of Nonfinancial Assets	37.8	46.8	70.3	49.0	83.1	51.0
Operating balance	28.5	33.4	42.9	50.7	74.3	42.3
Net lending/borrowing	-9.2	-13.4	-27.3	1.7	-8.8	-8.6
Net Financial Transactions	9.2	13.4	27.3	-1.7	8.8	8.6
Net Acquisition of Financial Assets	12.1	13.8	19.4	22.7	39.1	27.3
Net Incurrence of Liabilities	21.3	27.2	46.8	21.0	47.9	35.9
Foreign	0.5	-4.3	16.0	-1.2	16.9	-4.1
Domestic (above the line)	20.8	31.5	30.8	22.2	31.0	40.0
	(In percent of GDP)					
Total revenue and grants	18.0	17.7	20.9	18.3	21.3	18.1
Total revenue	14.8	14.4	16.2	15.7	16.4	15.8
Tax revenue	13.0	12.6	14.0	13.6	14.2	14.0
Non-tax revenue	1.8	1.8	2.2	2.1	2.2	1.9
Grants	3.2	3.3	4.7	2.6	4.9	2.3
Expenditure	18.8	18.6	22.7	18.2	21.8	18.6
Expenses	15.6	15.2	18.0	15.1	17.1	15.7
of which:						
Interest payments	0.8	0.9	1.1	1.0	1.1	0.9
Salaries and allowances	3.5	3.3	3.7	3.3	3.5	3.3
Net Acquisition of Nonfinancial Assets	3.2	3.4	4.7	3.1	4.7	2.9
Operating balance	2.4	2.4	2.9	3.3	4.2	2.4
Net lending/borrowing	-0.8	-1.0	-1.8	0.1	-0.5	-0.5
Net Financial Transactions	0.8	1.0	1.8	-0.1	0.5	0.5
Net Acquisition of Financial Assets	1.0	1.0	1.3	1.5	2.2	1.6
Net Incurrence of Liabilities	1.8	2.0	3.1	1.4	2.7	2.1
Foreign	0.0	-0.3	1.1	-0.1	1.0	-0.2
Domestic (above the line)	1.7	2.3	2.1	1.4	1.8	2.3
Memorandum items:						
Primary Balance (in percent of GDP)	-0.9	-1.1	-2.0	-0.4	-1.7	-1.1
Net Domestic Financing (below the line, in percent of GDP)	2.6	3.0	--	-0.1		
Public debt (in percent of GDP)	35.4	33.3	33.7	33.3	32.2	31.3
Domestic	13.4	14.6	15.5	12.7	13.0	13.6
External	22.1	18.7	18.2	20.5	19.2	17.7
GDP (in Billion of Nrs)	1,193	1,368	1,492	1,557	1,757	1,750

Sources: Data provided by the Nepalese authorities, and Fund staff estimates and projections.

1/ Fiscal year ends in mid-July. Table refers to central government operations as contained in the budget.

Table 3. Nepal: Reserve Money and Monetary Survey, 2009/10-2012/13[1]

	2009/10	2010/11	2011/12 (Est.)	2012/13 (Proj.)
	(In billions of Nepalese rupees, end-period)			
Reserve money	218.5	234.2	319.3	358.4
Net domestic assets of NRB	15.5	22.6	-54.3	-36.9
Claims on public sector	50.8	55.0	17.2	27.1
Claims on private sector	3.5	4.4	4.5	4.5
Claims on banks & financial institutions	4.8	8.3	0.5	7.6
Other items (net)	-43.6	-45.1	-76.6	-76.2
Net foreign assets of NRB	203.0	211.5	373.7	395.4
	(Contribution to reserve money growth)			
Reserve money (y/y percent change)	11.7	7.2	36.4	12.3
Net domestic assets of NRB	19.8	3.9	-32.9	5.4
Net foreign assets of NRB	-8.0	3.3	69.2	6.8
	(In billions of Nepalese rupees, end-period)			
Broad money	719.6	922.0	1,131.0	1,272.5
Narrow money	218.2	223.1	264.4	384.8
Quasi-money	501.4	699.0	866.6	887.7
Net domestic assets	506.6	706.0	756.3	870.6
Domestic credit	649.3	912.6	985.9	1,127.4
Credit to public sector	148.6	185.3	176.1	212.6
Credit to private sector	500.7	727.3	809.8	914.8
Other items(net)	-142.7	-206.6	-229.6	-256.9
Net foreign assets	213.0	216.0	374.6	401.9
	(Twelve-month percent change)			
Broad money	14.1	12.3	22.7	12.5
Net domestic assets	24.8	16.2	7.1	15.1
Domestic credit	16.8	14.6	8.0	14.4
Credit to public sector	26.7	17.2	-4.9	20.8
Credit to private sector	14.2	13.9	11.3	13.0
Net foreign assets	-5.1	1.3	73.4	7.3
	(Contribution to broad money growth)			
Broad money (y/y percent change)	14.1	12.3	22.7	12.5
Net domestic assets	16.0	12.0	5.5	10.1
Domestic credit	14.8	14.1	8.0	12.5
Credit to public sector	5.0	3.3	-1.0	3.2
Credit to private sector	9.9	10.8	8.9	9.3
Net foreign assets	-1.8	0.3	17.2	2.4

Source: Nepalese authorities; and IMF staff estimates and projections.
[1] Prior to July 2010, broad money survey consists of central bank and commercial banks only. After July 2010, broad money survey includes development banks and finance companies as well.

Table 4. Nepal: Balance of Payments, 2009/10–2016/17

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
			Est.			Proj.		
				(in million US dollars)				
Current account	-378.0	-180.9	908.9	128.1	-62.6	-142.4	-221.1	-317.6
Current account (excluding official transfers)	-678.7	-500.7	514.9	-209.0	-312.1	-402.7	-484.5	-585.6
Trade balance	-4,077.9	-4,469.6	-4,604.8	-5,539.6	-6,041.6	-6,596.3	-7,177.7	-7,774.3
Exports, f.o.b.	848.8	960.6	1,008.4	1,077.5	1,164.2	1,255.9	1,353.1	1,459.5
Imports, f.o.b.	-4,926.7	-5,430.2	-5,613.2	-6,617.1	-7,205.8	-7,852.2	-8,530.8	-9,233.7
Services (net)	-220.1	-121.3	175.1	-98.5	-152.1	-175.4	-183.7	-187.2
Receipts	686.8	741.2	892.8	877.0	950.0	1,029.8	1,112.4	1,196.7
Of which: tourism	378.1	344.1	380.3	410.7	443.6	480.0	519.8	563.0
Payments	-907.0	-862.5	-717.7	-975.5	-1,102.1	-1,205.2	-1,296.1	-1,383.9
Income	122.5	105.6	146.6	162.2	176.1	191.2	206.1	192.9
Credit	200.4	244.7	273.8	304.1	330.2	358.6	386.5	385.8
Debit	-77.9	-139.2	-127.2	-141.9	-154.1	-167.3	-180.3	-192.9
Current transfers	3,797.5	4,304.5	5,192.1	5,604.0	5,955.0	6,438.1	6,934.2	7,450.9
Credit, of which:	3,866.3	4,350.6	5,254.3	5,653.2	6,008.5	6,496.2	6,996.8	7,517.9
General government	300.7	319.8	394.0	337.1	249.5	260.3	263.4	268.0
Workers remittances	3,113.3	3,545.2	4,413.8	4,789.0	5,186.5	5,614.4	6,063.5	6,533.5
Debit	-68.8	-46.1	-62.2	-49.3	-53.5	-58.1	-62.6	-67.0
Capital account	169.0	222.4	221.2	254.0	189.0	192.3	196.3	200.9
Financial account	60.5	108.1	302.7	-80.6	62.6	121.9	134.1	158.9
Direct investment	38.3	90.0	112.5	101.4	132.1	155.4	167.5	179.1
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment (net)	22.2	18.1	190.3	-182.0	-69.5	-33.5	-33.4	-20.2
Errors and omissions	46.2	-49.1	-193.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-102.3	100.5	1,239.9	301.4	189.0	171.8	109.3	42.2
Financing	102.3	-100.5	-1,239.9	-301.4	-189.0	-171.8	-109.3	-42.2
Change in reserve assets (- =increase) 1/	62.4	-96.0	-1,233.4	-288.0	-175.0	-160.0	-90.0	-25.0
Use of IMF resources (net)	39.9	-4.5	-6.5	-13.4	-14.0	-11.8	-19.3	-17.2
IMF Disbursements	42.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IMF Repayment	2.2	4.5	6.5	13.4	14.0	11.8	19.3	17.2
Memorandum items:								
Current account (in percent of GDP)	-2.4	-0.9	4.7	0.6	-0.3	-0.6	-0.9	-1.2
Current account, excl. grants (in percent of GDP)	-4.3	-2.6	2.7	-1.0	-1.4	-1.7	-1.9	-2.1
Trade balance (in percent of GDP)	-25.6	-23.6	-23.7	-27.3	-27.4	-27.6	-27.9	-28.2
Exports (in percent of GDP)	5.3	5.1	5.2	5.3	5.3	5.3	5.3	5.3
Imports (in percent of GDP)	30.9	28.6	28.9	32.6	32.7	32.8	33.1	33.5
Remittances (in percent of GDP)	19.5	18.7	22.7	23.6	23.6	23.5	23.5	23.7
Exports (y/y percent change)	-6.1	13.2	5.0	6.9	8.1	7.9	7.7	7.9
Imports (y/y percent change)	36.4	10.2	3.4	17.9	8.9	9.0	8.6	8.2
Remittances (y/y percent change)	14.8	13.9	24.5	8.5	8.3	8.3	8.0	7.8
Non-oil real GDP growth of GCC countries 2/	3.4	5.7	6.1	5.5	5.3	5.3	5.5	5.6
Debt service (in percent of current account receipts)	3.2	3.0	2.4	2.8	2.6	2.5	2.3	2.2
Gross official reserves (in millions of U.S. dollars)	2,844	3,074	4,307	4,595	4,770	4,930	5,020	5,045
In months of imports	5.4	5.8	6.8	6.6	6.3	6.0	5.7	5.3
As a share of broad money (in percent)	25.9	23.8	34.1	31.7	30.3	28.8	27.7	25.6
ratio over remittances	0.9	0.9	1.0	1.0	0.9	0.9	0.8	0.8
Nominal GDP (in millions of U.S. dollars)	15,956	18,977	19,415	20,273	22,017	23,904	25,764	27,556

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

1/ 2010/11 figure excludes valuation changes.

2/ Real GDP-weighted average.

Table 5. Nepal: Commercial Banks' FSIs (2001–12) 1/

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012 1/
Capital adequacy												
Capital fund to risk weighted assets	-5.5	-9.9	-12.0	-9.1	-6.3	-5.3	-1.7	4.0	7.2	9.6	10.6	11.5
Tier 1 capital to risk weighted assets	...	...	...	...	...	...	...	1.8	5.2	7.9	9.1	10.0
Asset quality												
NPLs to total loans	...	2.4	28.8	22.8	18.9	13.2	10.6	6.1	3.6	2.5	3.2	2.6
Loan loss provision to total loans	...	...	...	...	20.0	15.1	12.4	8.2	5.9	4.6	4.0	3.6
Earnings and profitability												
Return on equity (ROE) 2/	...	...	...	...			31.4	35.2	34.7	33.9	25.3	22.5
Return on assets (ROA) 2/	...	...	...	...	6.2	4.3	1.4	2.0	4.9	1.9	1.7	1.5
Interest income to gross income	...	...	75.0	71.8	68.5	69.5	70.4	68.3	73.9	77.9	81.4	82.4
Non-interest expenditures to gross income	...	...	65.1	66.3	71.9	70.9	70.3	70.4	60.1	60.2	53.2	48.0
Employees expenses to non-interest expenditures	...	...	12.8	24.8	18.6	16.6	19.0	18.7	25.1	23.7	22.2	21.5
Liquidity												
Liquid assets to total assets	22.1	18.2	12.5	13.6	9.4	9.1	9.0	11.8	26.0	13.1	11.2	13.0
Liquid assets to demand and savings deposits	52.4	46.2	30.3	31.3	23.3	20.5	20.1	25.0	31.1	31.7	31.6	36.6
Liquid assets to total deposits	31.0	27.3	18.9	20.0	15.4	13.5	13.2	15.9	18.3	16.0	14.3	16.3
Exposure to real estate												
Share of real estate and housing loans	...	...	...	...	...	...	...	...	19.4	20.7	18.5	16.9
Share of loans collateralized by land and buildings	...	...	...	...	...	...	...	...	71.7	58.4	68.4	55.9

1/ Capital adequacy, NPLs, loan loss provisioning, ROE, ROA, and exposure to real estate indicators as of July 2012; liquidity indicators as of June 2012; and other earnings and profitability indicators as of April 2012.
2/ Excluding state-owned banks.

Table 6. A Roadmap for Financial Sector Reform

	Identify problems among banks and FIs	Strengthen institutional capacity	Restructure financial institutions	Maintain systemic stability
Identify systemically important banks and take appropriate resolution actions. Conduct "deep-dive" assessments, focusing on banks exposed to real estate, and large public sector banks, preferably by reputed international firms; with NRB to follow up with appropriate corrective strategies.	→	→	→	
Revise legal framework, including:				
Implement amendments to NRB Act to help streamline intervention and resolution procedures	→	→		
Implement revised Deposit Guarantee Act.	→	→		
Remove gaps, inconsistencies, and overlaps among various legislations governing the financial sector.		→	→	→
Strengthen prudential standards and enhance enforcement, including higher capital adequacy for systemic banks.		→	→	→
Strenghthen deposit guarantee, including:				
Conduct deposit survey, assess capital requirements of deposit insurance corporation and strengthen its capacity.	→	→		
Establish action plan for government intervention in failed banks, specifying roles and responsibilities, as well as use of deposit insurance.		→	→	→
Restructure insolvent state owned banks after conducting independent audits and diagnostic reviews	→	→	→	
Phase out regulatory forbearance granted in 2010/11, reduce exposures to real-estate, tighten margin lending.		→	→	→
Step up on-site inspection and enhance supervisory capacity		→	→	→
Review and rationalize licensing framework		→	→	→
Review and strengthen accounting / provisioning standards, in conjunction with implementation of IFRS. Implement over selected time frame (to allow for adjustment).		→	→	→

Table 7. Will Nepal Achieve it's Millennium Development Goals?	On Target	Close to Target	Far from Target	No Data
Goal 1: Eradicate Extreme Poverty and Hunger.				
1a: Halve the proportion of people whose income is less than $1.25 a day.		x		
1b: Achieve full and productive employment and decent work for all.			x	
1c: Reduce by half the proportion of people who suffer from hunger.		x		
Goal 2: Achieve Universal Primary Education.		x		
Goal 3: Promote Gender Equality and Empower Women.	x			
Goal 4: Reduce Child Mortality.	x			
Goal 5: Improve Maternal Health.				
5a: Reduce the maternal mortality ratio by three-quarters.		x		
5b: Achieve universal access to reproductive health.			x	
Goal 6: Combat HIV/AIDS, Malaria and Other Diseases.				
6a: Halt and reverse the spread of HIV/AIDS.	x			
6b: Achieve universal access to treatment for HIV/AIDS for all those who need it.		x		
6c: Halt and reverse the incidence of Malaria and other major diseases.	x			
Goal 7: Ensure Environmental Sustainability.				
7a: Cliamte change and GHG emission.				x
7b1: Reverse loss of forest.		x		
7b2: Reduce biodiversity loss.				x
7c1: Halve proportion of population without sustainable access to improved water source.	x			
7c2: Halve proportion of population without sustainability access to improved sanitation.		x		
7d: Improve lives of slum dwellers.				x
Goal 8: Develop a Partnership for Development.				x

Sources: Global Monitoring Report, World Bank 2011 and 2010 Progress Report of Nepal's MDGs, UNDP.

APPENDIX I. BACKGROUND ON SPILLOVER AND FINANCIAL SECTOR RISKS

Spillover Risks

1. **Economic links between Nepal and the rest of the world, notably India, have deepened in recent years.** Growing economic integration has benefited Nepal in terms of economic development, stability, and poverty reduction (including through remittance-based increases in household income). These links, however, can also facilitate transmission of adverse shocks to Nepal.

2. **This paper discusses potential spillover effects from three scenarios:** (i) India's slowing growth; (ii) slowing remittances against the backdrop of softening global outlook; and (ii) a banking sector distress that could be triggered by external shocks considering preexisting financial sector fragilities. As shown below, slower growth in India represents substantial risks to Nepal's output, while remittance shocks could weaken the balance of payments. Financial sector distress would result in a large output loss over the medium term; substantial rescue costs incurred to the public sector, and potentially lead to unsustainable debt dynamics.

A. Links to India and Other Countries

3. **India is Nepal's single most important trading partner and also accounts for a significant share of Nepal's remittance inflows**[1]. The open border between the two countries allows cross-border transactions to be conducted with few restrictions. The peg of Nepalese rupee to India's currency also provides a nominal anchor for Nepal's monetary policy and a steady basis for cross-border exchange (the Indian rupee is common in circulation, particularly in border areas). India is also a source of know-how, providing access to better education for students from neighboring countries including Nepal.

- **Trade**. India is Nepal's dominant trading partner. Some 60–70 percent of Nepal's exports and imports were associated with India in 2011/12, compared to below 50 percent a decade ago. Even these figures may be underestimated. Transactions across the open border tend to be underreported and there is thought to be significant unofficial trade. Some observers estimate that unofficial trade between India and Nepal was more than their official trade in the 1990s. These close links can also serve as a conduit for shocks, however. Dabla-Norris et al (2012) indicate significant spillover effects through the trade channel: a 100 percent increase in trade openness increases the elasticity to partners' growth by 0.56.

[1] Remittance inflows from India are not well covered by official statistics, but it is generally believed that there are 1½–2 million Nepalese workers in India, who account for about 20 percent of Nepal's receipts of remittances.

- **Financial linkages**. FDI[2] and cross-border lending may also serve as a conduit for India-related shocks. India is the most important source of foreign investment to Nepal. Although bilateral data is not available, most of Nepal's financial flows (a surplus of about 1½ percent of GDP in 2011/12) take the form of trade credit and therefore are likely to be associated with India. The size of direct bank lending across the border seems limited[3], but a slowdown in India could negatively impact Indian banks' credit lines to Nepalese banks as well as to exporters and importers. Moreover, a confidence shock could trigger capital flight. In recent years, a shock to confidence led to reserve losses reached about $400 million (15 percent of reserves at the time) within few months—forming a feedback loop between external sector deterioration and escalating banking sector risks.

- **Remittances**. Remittances are the main source of Nepal's foreign exchange receipts, equivalent to about ¼ of GDP. The GCC countries, Malaysia and India are the main host countries, although anecdotal evidence suggests that Nepali workers in India receive lower salaries than those in GCC countries and Malaysia. Although remittances are essential to smoothing consumption and supporting Nepal's balance of payments, their impact on potential growth may be less significant.[4] One explanation for the weak link is that the bulk of remittances finance consumption rather than investment and leak out through imports. Although remittances could boost consumption of non-tradable goods, inflationary pressures on these goods tend to rise as a result and jeopardize competitiveness, which are commonly seen in the cases of "Dutch disease".

4. **Nepal's nonagricultural real GDP growth largely follows the trend of India's**, but has been consistently lower because of structural impediments such as low institutional capacity, political instability, insufficient infrastructure, impaired competitiveness, and financial system vulnerabilities. Ding and Masha (2012)[5] estimate that a one percentage point decrease in India's per capita real GDP growth would cause real per capita GDP growth in South Asian economies to fall by

[2] According to government statistics there were 2,108 foreign investment projects in Nepal at the end of 2010/11, worth a total of approximately $2.6 billion. India was the most important foreign investor with 501 ventures, accounting for nearly 47.6 percent of total foreign investment. Ten of the 20 largest foreign enterprises in Nepal had Indian investment. China with 401 ventures ranked second, accounting for 10.3 percent, and U.S. with 174 ventures ranked third, accounting for 7.3 percent of total foreign investment.

[3] BIS data shows foreign bank loans and deposits with Nepalese banks amount to $80 million (0.4 percent of GDP).

[4] A stream of literature suggests that remittances have marginal impact on economic growth (Jonwanich (2007) and Barajas et al (2009)). Data limitations hinder meaningful empirical work, but staff estimates of the relationship between remittances and growth in Nepal suggest that a shock to these inflows would have a limited impact on growth.

[5] Ding, Ding and I. Masha, "India's Growth Spillovers to South Asia," IMF Working Paper 12/56 (Washington: International Monetary Fund).

0.77 percentage points. Dabla-Norris et al. (2012)[6] indicate that Asian LIC's growth will lose 0.71 percentage points over a two-year horizon given a one percentage point decrease of real GDP growth in major emerging market leaders (India in this case). A recent study by IMF staff on a few major remittance recipients including Nepal also finds visible business cycle synchronization between remittance source countries and recipients.[7]

B. Shock Scenarios

Scenario 1: India's Slowdown

5. **This scenario considers a further decline of India's growth by 1 percentage point from the baseline scenario (5.6 percent) in 2012/13[8]**. In this context, Nepal's growth path could experience an output loss of 1 percent over the medium term (although uncertainty regarding remittances and the impact on Indian investment suggests the dampening effect on growth could be higher). The current account balance would decline to a deficit of about 1½ percent of GDP over the medium term compared to a deficit of less than 1¼ percent of GDP under the baseline scenario as a result of slowing exports and remittances. Import cover of reserves is expected to fall to 5 months compared to 5¼ months in the baseline scenario by end 2016/17. Fiscal revenue and foreign grants and loans would also decline, leading to an increase of net domestic financing (NDF—the financing of the government budget deficit) to 2½ percent of GDP compared to 2¼ percent in the baseline scenario over the medium term.

Scenario 1. India Slowdown

	Baseline	India Slowdown
Medium-term Output loss compared to baseline 1/	--	1.0%
Current account balance by 2016/17 (% GDP)	-1.2%	-1.4%
Gross international reserves by 2016/17 (amount and import cover)	$5.0 bn (5.3 months)	$4.7 bn (4.9 months)
Net domestic financing, 2013-17 average (% GDP)	2.3%	2.5%
Public Debt/GDP ratio by 2016/17	30.4%	31.1%

1/ Calculated as cumulative losses of real GDP as a percent of baseline real GDP over the medium term.

[6] Dabla-Norris, Era, R. Espinoza and S. Jahan, "Spillovers to Low-income Countries: Importance of Systemic Emerging Markets," IMF Working Paper 12/49 (Washington: International Monetary Fund).

[7] A. Barajas et al (2012), "Remittances and Business Cycle Synchronization: Evidence from Aggregate and Bilateral Panel Data," IMF Working Paper (to be published).

[8] This is a one-off shock rather than a step-decrease in growth. It assumes a dip in India's growth by 1 percentage point in 2013 compared to the baseline, with growth recovering gradually to the baseline level of 6.9 percent by 2016. In the medium term, the output loss in India would be 1.3 percent (calculated as cumulative losses of real GDP in 2013-2016 as a percent of the 2013–16 baseline real GDP).

Scenario 2: Decline in Remittance Growth

6. A sudden slowdown in remittance growth, which could possibly be triggered by a slump in oil prices affecting GCC countries (through lower non-oil GDP growth, depending on the policy response) could weaken national income (through lower transfers, which effectively decreases household income), the current account balance, foreign exchange reserves, and fiscal performance.

7. Under this scenario, an assumed decline of remittance growth by one standard deviation (4 percentage points) would give rise to a widening of current account deficit over time to 2 percent of GDP by 2016/17, and a decline of import cover of reserves to 4¼ months by then. The impact of lower remittance inflows would be partly self-corrected, as imports would likely slow in the face of lower remittance inflows. Fiscal revenue will decline due to slower imports and weaker activity, leading to an increase of NDF to just above 2½ percent of GDP compared to 2¼ percent in the baseline scenario over the medium term.

Scenario 2. Weakening Remittances

	Baseline	Remittances Weaken
Medium-term Output loss compared to baseline 1/	--	0.1%
Current account balance by 2016/17 (% GDP)	-1.2%	-2.1%
Gross international reserves by 2016/17 (amount and import cover)	$5.0 bn (5.3 months)	$4.0bn (4.2 months)
Net domestic financing, 2013-17 average (% GDP)	2.3%	2.6%
Public Debt/GDP ratio by 2016/17	30.4%	31.6%

1/ Calculated as cumulative losses of real GDP as a percent of baseline real GDP over the medium term.

Scenario 3: Financial Sector Distress

8. As indicated in the second section of this appendix, Nepal's financial sector harbors significant vulnerabilities. These vulnerabilities were highlighted in recent years during downturns in remittances that contributed to a squeeze on bank liquidity. Despite a robust recovery in remittances (which relieved the liquidity stress on banks in 2012), numerous institutions remain under stress—low profitability, weak capital base, and substantial exposure (either directly or through loan collateral) to a frozen real estate market.

9. A major financial dislocation could potentially be very costly. The table below indicates the international experiences of financial crises that took place in the past few decades:

Table 1. Nepal: Impact of Banking Crises and Cost of Intervention Country

Country	Start	Fiscal cost 1/	Reserve Loss 2/	Depreciation 3/	Output loss /4
Benin	1988	17.0			1.9
Brazil	1994	13.2	31.6	72.6	
Dominican Republic	2003	22.0			15.5
Ecuador	1998	21.7	11.8	17.6	6.5
Indonesia	1997	56.8	44.0	39.2	67.9
Jamaica	1996	43.9	15.2	-3.1	30.1
Malaysia	1997	16.4	20.6	10.5	50.0
Mexico	1994	19.3	33.9	43.1	51.3
Nicaragua	2000	13.6	7.2	2.9	
Senegal	1988	17.0			25.4
Sri Lanka	1989	5.0	49.2	9.9	2.2
Thailand	1997	43.8	15.8	36.3	97.7
Uruguay	2002	20.0	52.7	43.5	28.8
Venezuela	1994	15.0	39.4	36.5	9.6
Vietnam	1997	10.0			19.7
Russia	1998		19.5	72.6	
Average		22.0	28.0	32.0	31.0
Maximum		57.0	53.0	73.0	98.0
Nepal scenario		23.0	50.0	33.0	30.0

Source: "Systemic Banking Crises: A New Database", IMF Working Paper 08/224, November 2008; and IMF staff estimates.

1/ In percent of GDP

2/ Cumulative loss over first 2 quarters of reserve losses in the crisis year.

3/ Total depreciation over first 2 quarters of depreciation in the crisis year (in percent).

4/ Cumulative loss of real GDP over 3 years after crisis against trend.

10. **A middle range estimate suggests that real GDP loss could reach 30 percent in the first four years of a financial crisis before growth recovers to the baseline trend.**[9] Reserves would fall by half in the first two quarters of the crisis through the widening current account balance[10] and capital flight, though foreign borrowing could reverse partially the reserve losses later. The fiscal cost would be about ¼ of GDP, leading to rapid deterioration of debt dynamics. Even though the fiscal cost could be largely assumed domestically at the onset of the crisis (for bank resolution and deposit coverage), NDF has to be gradually brought down to 2¾ percent of GDP in outer years considering the capacity of domestic financial system, and foreign borrowing would be heavy over the long run.

[9] The assumption of output loss is based on the average level of crisis episodes in the past few decades. In low income countries, macro-financial linkages tend to be lower compared to more advanced economies, and therefore output loss may be smaller. However, Nepal's financial sector is relatively large, standing at 80 percent of GDP, which is comparable to many emerging economies.

[10] The widening of the current account balance is consistent with recent experience in Nepal. Remittances appear to decline in times of uncertainty. Further, when there is "flight to safety" the general population tends to import gold as a store of value—increasing imports.

Scenario 3. Financial Sector Stress

	Baseline	Financial Stress
Medium-term Output loss compared to baseline 1/	--	30%
Current account balance by 2016/17 (% GDP)	-1.2%	-1.6%
Gross international reserves by 2016/17	$5.0 bn (5.3 months)	$3.9 bn (4.1 months)
Net domestic financing, 2013-17 average (% GDP)	2.3%	6.9%
Public Debt/GDP ratio by 2016/17	30.4%	97.2%

1/ Calculated as cumulative losses of real GDP as a percent of baseline real GDP over the medium term.

11. The joint Bank-Fund Debt Sustainability Analysis Framework (DSA) indicates substantial worsening of debt carrying capacity after the financial stress unfolds. The present value of external debt in relation to GDP plus remittances would reach 40½ percent over the medium term, compared to the pre-stress level of 15¼ percent. The present value of external debt to revenue would more than double to 337¾ percent over the medium term. Present value of total public debt would rise to more than 90 percent of GDP or almost six times of revenue over the medium term.

Financial Sector Vulnerabilities

A. Background and Recent Developments

12. Financial sector vulnerabilities in Nepal have built up over the past several years and risks remain elevated.[11] Dramatic proliferation of banks took place in an environment of weak supervision, accommodative monetary policy, and excessive lending in the real estate market driven by unsterilized remittance flows. The collapse of the real estate bubble after reaching a peak in 2008, coupled with a subsequent slowdown in remittance growth in early 2011 led to a severe liquidity squeeze in April–May 2011—bringing these vulnerabilities into sharper focus and driving fears of a potential banking crisis. Rather than intervening and closing weak and insolvent banks, the Nepal Rastra Bank (NRB) responded with large-scale liquidity support through multiple lending windows, and regulatory forbearance.[12]

[11] See IMF Country Reports 10/184 and 08/182 for a description of the evolution of banking sector problems.

[12] Twenty banks accounting for 26 percent of banking system deposits received liquidity assistance. Prudential criteria relating to real estate lending, margin loans, and loans against promoter shares were relaxed, and a 13-month accounting year in FY 2010/11 was allowed for banks to report income, without which two-thirds of the banks would not have reported a profit for the financial year. Intervention options were rarely exercised even though solvency concerns are likely widespread; two finance companies were placed under Prompt Corrective Action (PCA), one development bank was declared problematic, and one finance company was liquidated.

13. A financial crisis was avoided with due largely to an influx of remittances that boosted bank liquidity, but also for reasons specific to Nepal. Regulatory forbearance, liquidity support, and generally loose monetary policy allowed breathing room for banks to rebuild capital and remain profitable as interest rates declined and spreads widened (though credit growth did not respond strongly to low interest rates). A closed capital account helped contain the risk of capital outflows despite low interest rates vis-à-vis India. In addition, general lack of investor education and low financial sector literacy among the population may have contributed to the absence of pressure on banks.

14. Structural weaknesses remain. These include: (i) resource and capacity constraints at the NRB, undermining the ability to effectively supervise nearly 200 financial institutions; (ii) the NRB's authority to resolve weak banks is hampered by the legal framework; (iii) a potentially extended timeframe for returning two large state-owned banks to minimum capital adequacy; (iv) the real estate market remains relatively static, impairing bank assets; (v) the inter-linkages between financial institutions are not well understood, nor is ownership / interests in subsidiaries such as insurance companies; and (vi) data quality / accounting are weak, and may understate the extent of balance sheet problems.

15. The NRB has made efforts to address vulnerabilities and strengthen the financial system, but progress is slow. Recapitalization plans have been announced (and partially implemented) for two insolvent state banks.[13] The NRB has sought to encourage mergers, including through regulatory forbearance,[14] as a way of strengthening capital adequacy in the system. The monetary policy statement for FY2012/13 adds prompt corrective action (PCA) triggers on NPLs and liquidity ratios in addition to capital adequacy. Amendments to the NRB Act empowering the central bank to swiftly resolve problematic banks appear to be in final stages of drafting, but implementation is hampered by the lack of a Parliament. Nepal has received intensive technical assistance (TA) from the IMF to help strengthen the financial sector (Box 1). However, effective implementation will be required.

[13] NBL, RBB, and Agricultural Development Bank of Nepal (ADBN) are the three major state owned commercial banks. Only ADBN meets minimum CAR.

[14] An NRB bylaw on mergers relaxed capital requirements, extended grace periods to bring violations of limits on promoter shares, loans to single borrowers, loan to deposit ratios, and controlling ownership into conformity. Some of the forbearance extends beyond prudential considerations, and includes liberalized refinancing conditions with the NRB. Restrictions on opening new branches within Kathmandu valley, as well as requirements for lending to "deprived sectors" have also been relaxed, along with tax breaks for merging institutions. Forty banks have approached the NRB for approval to merge so far, of which 19 have been granted approval to merge since May 2011, and the remaining are in various stages of the approval process.

Box 1. IMF Technical Assistance in the Financial Sector

Nepal has been an intensive user of IMF technical assistance on financial sector issues. TA has focused on (i) improving monetary operations, including liquidity management and the monetary policy framework; and (ii) financial sector supervision, including prudential regulations and the legal framework for the banking sector. TA in the past year has been provided in the context of the acute liquidity stress of early 2011, including:

Crisis management framework: Focused on building capacity to respond to a financial crisis, through enhanced regulation and supervision, and clarification of legal authority of the central bank to intervene and resolve banks.

Banking supervision and diagnostics: A resident advisor provides guidance on supervision and coordinates/oversees a program to conduct diagnostic reviews of banks.

Guidance on deposit insurance: Focused on identifying key areas for strengthening deposit insurance, including preparation of deposit profiles and assessment of funding adequacy.

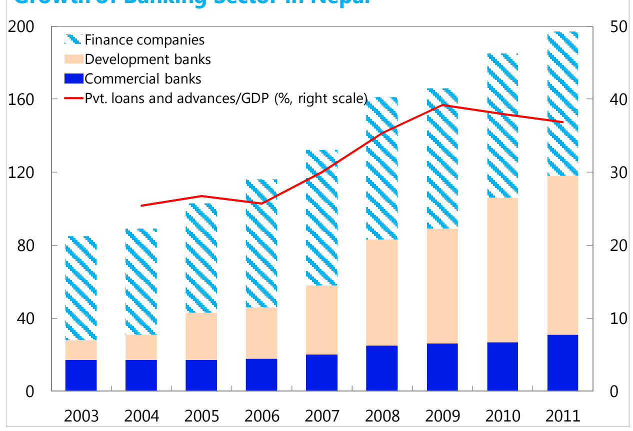
Legal framework for bank resolution: Focused on assisting authorities in establishing an effective legal framework for bank resolution, by providing drafting suggestions for amendments to laws and acts delineating the central bank's powers.

Anti-money laundering and combating the financing of terrorism (AML/CFT): Assisting the development of a National Strategy; currently focused on amending AML/CFT legislation, improving supervision and enhancing capacity of financial intelligence unit.

B. Structure of the Financial System

16. The number of banks in Nepal increased from 85 to nearly 200 between 2002 and 2012. "Banks" refer to commercial banks (Class A), development banks (Class B), and finance companies (Class C). Other than different capital adequacy requirements and some operational restrictions on Class B and Class C institutions (foreign exchange and international transactions), there is little operational difference between these three classes. In this paper Class A, B and C institutions are referred to as the "banking system/sector". In addition, there are 22 Class D micro-credit institutions that report to the NRB and thousands of rural credit cooperatives that are under the purview of the Ministry of Agriculture. Other financial services are available through insurance companies and the Nepal Stock Exchange.

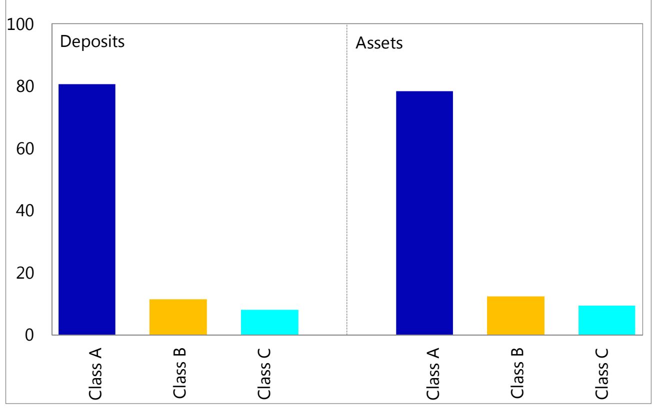
Growth of Banking Sector in Nepal



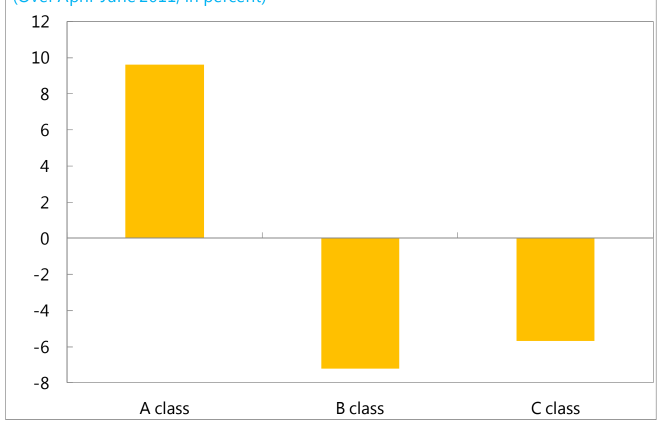
There are 24 insurance companies and 225 listed companies, of which 80 percent are banks or non-bank financial institutions. More than 50 remittance agencies are overseen by NRB's foreign exchange department.

17. Banking sector assets have grown rapidly—from 60 percent of GDP in 2001 to a peak of 100 percent during the height of the credit boom in 2009, before stabilizing at around 80 percent at present. Loans and advances to the private sector spiked up from 25 percent of GDP in 2004 to nearly 40 percent over the same period. The concurrent rise in inward remittances and the associated impact on the real estate market helped fuel banking sector growth.

Share of Various Bank Classes in Banking Sector
(In percent; as of May 2012)



Change in Banks' Deposits During Liquidity Squeeze
(Over April-June 2011; in percent)



18. The banking sector is dominated by commercial banks, which account for four-fifths of banking sector assets and deposits. Commercial banks, particularly large banks, are perceived to be safer (or subject to an implicit guarantee), as evidenced by the flight to safety during the 2011 liquidity stress. Deposits increased in almost all Class A banks, whereas nearly half the Class B and most of the Class C institutions saw deposits decline. NBL and RBB, two major state-owned Class A banks that account for 13 percent of deposits and 11 percent of banking sector assets, have been operating with negative capital for the past decade. The remainder of assets and deposits is split about evenly between Class (B) development banks and Class C (finance companies). These are smaller and more numerous than commercial banks. Problems in these banks are less well understood, but there is a commonly held perception that Class B and C institutions suffer from weaknesses in governance and asset quality.

19. Regulation is split along industry lines—the NRB licenses, regulates and supervises deposit taking institutions; the Securities and Exchange Board of Nepal (SEBON) oversees stock brokers, merchant banks, and other capital market participants; and the Insurance Board under the Ministry of Finance supervises and regulates insurance companies. A government-backed deposit guarantee scheme is run by the Deposit and Credit Guarantee Corporation (DCGC), which in its present form may have limited effectiveness in maintaining public confidence in the banking system in the event of a bank closure.[15] Finally, there is a High Level Coordination Committee consisting of representatives of financial sector regulators, chaired by the NRB, tasked with coordinating regulators and policy formulation.

20. There is uncertainty regarding the nature and magnitude of interconnectedness in the financial system. Due to weak licensing practices, the ownership structure of banks, as well as affiliates, subsidiaries and other related parties has not been fully identified, though the NRB has better information on ownership structure of relatively new banks. Moreover, liberal lending rules with respect to bank shares may have given further impetus to cross-shareholding. Three quarters of the margin loans in the system are against such shares, and may constitute 2 percent of total loans.[16]

C. Financial Stability Indicators

21. Reported financial sector indicators (FSIs) for commercial banks suggest some improvement. The shortcomings in data quality must be kept in mind while interpreting these figures. Capital adequacy among commercial banks (including NBL and and RBB) declined to the regulatory minimum of 10 percent in the past year, but has recovered subsequently to over 11 percent.[17] All private commercial banks report capital at or above the regulatory minimum. Among the Class B and C institutions, most report capital levels well in excess of the regulatory requirement, although one Class B and three Class C institutions reported levels below the required minimum in January 2012.

22. Non-performing loans. Reported NPLs among all commercial banks declined to 2.6 percent in July 2012 from just over 3 percent at the end of FY 2010/11[18]. Among private commercial banks, NPLs are reported to be quite low at around 2.4 percent. NPLs at state owned banks are much higher: around 11 percent at RBB, 9 percent at ADBN, and 6 percent at NBL. Among development banks, NPLs increased from 4.4 percent to 5.7 percent over the same period. Data for finance companies are not as current and contain gaps. Between April and September 2011, NPLs in finance companies went up from 2.8 percent to nearly 5 percent. It is likely that actual NPLs are higher for all classes of banks, due to concerns about data quality, as well as possible ever-greening of loans.

22. Profitability. Return on equity (ROE) and return on assets (ROA) exhibited a declining trend over the past three years, likely reflecting the consequences of the real estate market bust. Credit

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[15] At present, the repayment process is subject to delays and could take several months. An important legislation to expedite the process of repayment, which follows recommendations made by the World Bank, is on hold due to the current political circumstances.

[16] NRB estimates that margin loans could be as high as 5 percent of total loans, but due to data issues and possible misreporting, the cited number is the best estimate based on available data.

[17] Based on data up to January 2012.

[18] The fiscal year in Nepal ends in mid-July.

growth has been weak despite accommodative monetary policy. Thus, even though net interest margins are relatively high at 3.8 percent in 2012, profitability is weak.

Table 2. Nepal: Commercial Banks' FSIs (2008–12)

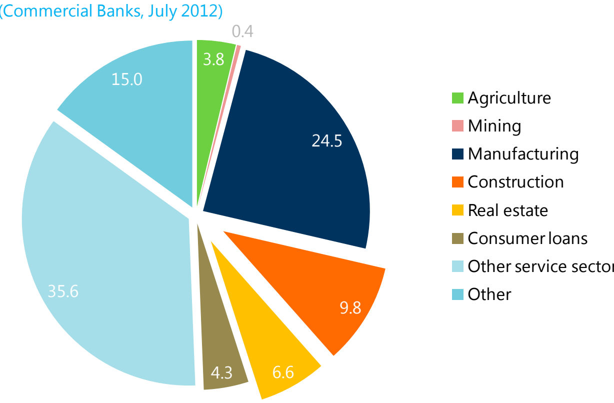
	2008	2009	2010	2011	2012 1/
Capital adequacy					
Capital fund to risk weighted assets	4.0	7.2	9.6	10.6	11.5
Tier 1 capital to risk weighted assets	1.8	5.2	7.9	9.1	8.8
Asset quality					
NPLs to total loans	6.1	3.6	2.5	3.2	2.6
Loan loss provision to total loans	8.2	5.9	4.6	4.0	3.6
Earnings and profitability					
Return on assets (ROE) 2/	35.2	34.7	33.9	25.3	22.5
Return on equity (ROA) 2/	2.0	4.9	1.9	1.7	1.5
Interest income to gross income	68.3	73.9	77.9	81.4	82.4
Non-interest expenditures to gross income	70.4	60.1	60.2	53.2	48.0
Employees expenses to non-interest expenditures	18.7	25.1	23.7	22.2	21.5
Liquidity					
Liquid assets to total assets	11.8	26.0	13.1	11.2	13.0
Liquid assets to demand and savings deposits	25.0	31.1	31.7	31.6	36.6
Liquid assets to total deposits	15.9	18.3	16.0	14.3	16.3
Exposure to real estate					
Share of real estate and housing loans	...	19.4	20.7	18.5	16.9
Share of loans collateralized by land and buildings*	...	71.7	58.4	68.4	55.9

1/ Capital adequacy, NPLs, loan loss provisioning, ROE, ROA, and exposure to real estate indicators as of July 2012; liquidity indicators as of June 2012; and other earnings and profitability indicators as of April 2012.
2/ Excluding state-owned banks.

D. Vulnerabilities

23. Exposure to real estate. One of the main issues confronting the banking system is over-exposure to the real estate sector. Loans for housing and non-housing construction, together with real-estate loans account for 15 percent of the loan portfolio of commercial banks—going up to 20 and 30 percent for development banks and finance companies, respectively. Taking into account both direct lending and indirect exposure through collateral, more than two-thirds of the loan portfolio of commercial banks, and up to 90 percent of that of development banks and finance companies is exposed to real estate. Real estate transactions continued to fall last year, after dropping sharply in 2010/11. Real estate prices are reported to

Sector Share of Credit
(Commercial Banks, July 2012)



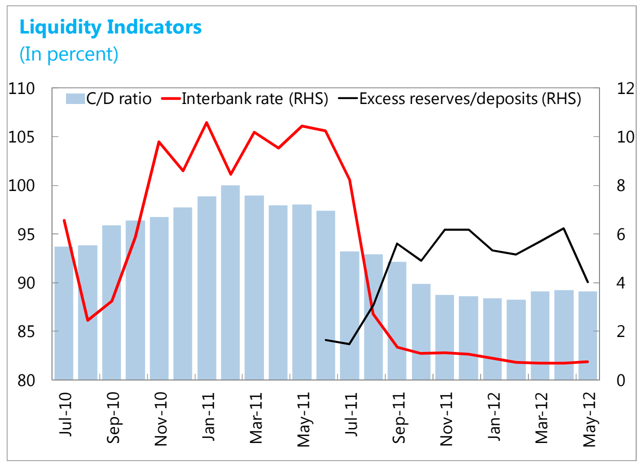
have dropped by 30 percent from their peak, and more for poorer quality projects. This gives reason to be cautious about reported NPLs.[19]

Table 3. Kathmandu Real Estate Market Trends[1]

	2009/10	2010/11	Q1:2010/11	Q1:2011/12
Transactions (sale/purchase)	135900	65545	16824	12544
% change	-14.0	-51.8		-25.4
Residential construction permits	6316	5118	1221	958
% change	-8.5	-19.0		-21.5

[1] As of December 2011

24. Liquidity. Supported by increased remittances, systemic liquidity is currently high. Banks' excess reserves with the NRB are nearly 90 percent of required reserves (compared to 28 percent a year ago), and interbank rates hover at or below 1 percent. Credit/deposit (C-D) ratios have also declined on account of weak credit growth and remittance-fueled deposits, but remain high. Further, liquidity conditions can change rapidly in response to external shocks, such as a decline in remittances. Unlike some LICs, the Nepali banking system intermediates and benefits from the flow of inward remittances. A negative shock to remittances, due to a slowdown in India and/or the GCC states could lead a re-intensification of liquidity stresses observed last year. Moreover, on account of weak assets, and a tiered interbank market, liquidity management can be a problem for banks in times of stress.



25. Stress tests. The latest stress tests conducted by the authorities for commercial banks show some improvement compared to the previous year's results, but weaknesses persist. Among the 32 existing commercial banks, a standard credit shock would push capital below the regulatory minimum in 20 banks, and a third of commercial banks would be under-capitalized if real estate and housing loans are downgraded[20]. Sustained deposit withdrawals over five consecutive days would render 14 banks illiquid, and liquidity ratios at a number of banks would fall below 20 percent in the event of sudden large withdrawals, or withdrawals by institutions.

[19] Previous stress tests revealed that a 30 percent fall in real estate prices could lead to a 20 percentage point increase in NPLs. See IMF Country Report 10/184 for details.

[20] This refers to the scenario in which 25 percent of performing loans of real estate and housing are directly downgraded to loss loans.

Table 4. Stress Testing Results for Commercial Banks

	2012	2011
Credit shocks	*No. of banks with CAR < 10% regulatory minimum*	
Standard credit shock[1]	20	22
25 percent of performing loans of real estate & housing sector directly downgraded to loss loans	11	15
Liquidity shocks	*No. of banks illiquid after 5 days*	
Standard withdrawal shock[2]	14	19
	No. of banks with liquid assets to deposits ratio < 20%	
Withdrawal of deposits by 20%	26	27
Withdrawal of deposits by top 3 institutional depositors.	18	27
Withdrawal of deposits by top 5 individual depositors.	1	6

Source: Nepal Rastra Bank

[1] 15 percent performing loans deteriorated to substandard, 15 percent substandard loans deteriorated to doubtful, 25 percent doubtful loans deteriorated to loss, 5 percent of performing loans deteriorated to loss.

[2] Withdrawal of customer deposits by 2%, 5%, 10%, 10%, and 10% for five consecutive days respectively.

E. Fiscal Impact of Banking Stress[21]

26. International experience has shown that fiscal costs of a banking crisis can be severe.[22] In Nepal, the magnitude of fiscal costs including recapitalization of banks could be as high as one-quarter of GDP, based on experience in other countries that have endured financial crises. A crisis in Nepal could be triggered by another liquidity squeeze, depending on the relative strength of balance sheets one year on from the last liquidity crunch, and three years on from the sharp drop in the real estate market. The intensity of such a crisis would also depend on whether the impact is contained among Class B and C institutions (where exposure to real estate is the heaviest), or whether it spreads to Class A banks as well. The former, which account for a fifth of all deposits, are especially prone to flight, as evidenced during the 2010/11 liquidity crisis.

27. If only those Class B and Class C institutions with liquidity levels below the median for their respective class were subject to deposit flight, roughly NR 100 billion ($1.2 billion, about 6 percent of GDP) of deposits could be at risk. Assuming that all of the banks' liquid assets

[21] These scenarios are based on estimates specific to the Nepal banking system, taking into account estimated values for liquid assets and resources of the deposit insurance scheme before calculating residual fiscal cost associated with coverage of remaining deposits in the event of a crisis. The fiscal cost in the previous section is an average based on cross-country experience.

[22] For known cases in developing Asia, fiscal costs were estimated to be 5 percent of GDP in Sri Lanka in 1989, and 10 percent of GDP in Vietnam in 1997. However, costs can be much higher, as seen during the East Asian crisis (see Laeven and Valencia, IMF WP 08/224).

are exhausted in paying out deposit withdrawals, and institutional deposits are not paid, this would still leave about half the deposits (NR 40-50 billion, about 3 percent of GDP) in depositor's claims which the deposit insurance scheme could not cover without further capitalization.

28. **Should a genuine crisis materialize, it is unlikely that damage would be contained to only Class B and Class C institutions.** A sudden drop in remittances is likely to squeeze liquidity across the banking system. Moreover, systemic financial crises can be triggered by failures in a few institutions that spread quickly due to erosion of confidence and interconnectedness among banks. While the extent of interconnectedness is currently unknown, contagion effects could substantially raise the price tag of a financial crisis.

29. **Costs would increase dramatically if the crisis spreads to Class A banks.** Table 5 shows the potential fiscal costs of a scenario where an escalating financial crisis initially afflicts smaller and weaker banks, causing deposit runs, and then spreads to larger banks. This represents an extreme loss of confidence, given past history of deposit flight to Class A institutions (including the two net negative state banks) during times of distress. However, to illustrate magnitude, deposit runs at NBL and RBB alone could add more than 5 percent of GDP to fiscal costs. If all banks including large Class A institutions were affected, initial fiscal costs could rise to as high as one-third of GDP. Though final costs to the government will depend on recoveries from problem loans and collateral, weaknesses and inefficiency in the bankruptcy process may significantly erode prospects of good cost recovery.

Table 5. Potential Liquidity Needs During Crisis

Affected group:	Share in System Deposits (%)	Liquidity Needs (% GDP)
Deposits in all B and C class banks outside top 10 by assets	11.7	5.0
Deposits in all B and C class banks outside top 10 by assets, NBL and RBB	24.6	11.3
Deposits in all banks outside top 10 by assets, NBL and RBB	51.9	26.1
Deposits in all banks outside top 10 by assets, and 50 percent of deposits in top 10 banks	75.8	36.2

Source: Staff calculations.

INTERNATIONAL MONETARY FUND

NEPAL

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 2, 2012

Prepared By

Asia and Pacific Department

CONTENTS

ANNEX I. FUND RELATIONS

(As of September 30, 2012)

I. Membership Status: Joined 9/06/61; Article VIII, Sections 2, 3, and 4 on May 30, 1994.

II. General Resources Account:

	SDR Million	Percent Quota
Quota	71.30	100.00
Fund holdings of currency	71.28	99.98
Reserve position in Fund	0.02	0.03

III. SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	68.10	100.00
Holdings	55.09	80.90

IV. Outstanding Purchases and Loans:

	SDR Million	Percent Allocation
RCF Loans	28.52	40.00
ECF arrangements	39.92	55.99

V. Financial Arrangements: (In SDR Million)

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
ECF	11/19/03	11/18/07	49.90	49.90
ECF	10/05/92	10/04/95	33.57	16.79
SAF	10/14/87	10/13/90	26.11	26.11

VI. Projected Obligations to Fund:
(in millions of SDRs; based on existing use of resources and present holdings of SDRs):

			Forthcoming		
	2012	2013	2014	2015	2016
Principal	3.92	9.98	8.55	9.98	12.83
Charges/interest	0.00	0.01	0.14	0.12	0.09
Total	3.92	9.99	8.69	10.10	12.92

VII. Exchange Rate Arrangement

In February 1993, Nepal unified its exchange rate and eliminated the multiple currency practice associated with the previous dual exchange rate arrangement. In October 1997, the exchange arrangement of Nepal was reclassified as that pegged to a single currency unit from pegged to a currency composite. The Nepalese rupee is pegged to the Indian rupee at a rate of 1.6. Currently, all merchandise imports (except for a few goods restricted for security or related reasons) are freely available through an open general license system, with foreign exchange provided through the banking system at the market exchange rate. As of October 4, 2012, the exchange rate for the Nepalese rupee (Nr) was US$1=Nrs. 82.79.

The restriction on quantitative limits on foreign exchange for leisure travel was removed in early 2011. The Industrial Enterprises Act places a 75 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. Staff is investigating whether this measure is also discriminatory.

VIII. Safeguards Assessments

A safeguards assessment of the NRB was concluded in May 2011. The assessment noted that the external audit mechanism needed improvement, since the audit procedures did not meet international standards. Transparency of the financial statements should be enhanced by resolving qualifications raised by the external auditors.

IX. 2011 Article IV Consultation

The Executive Board discussed the staff report for the 2011 Article IV consultation (IMF Country Report No. 11/318) on October 19, 2011. It was proposed that the Article IV consultations take place on the 12-month cycle.

X. Technical Assistance Since 2001

	Purpose	Year
MCM	Accounting	2004–06
	Central Bank and Banking Reform	2001–02
	Internal Audit	2004–07
	Monetary Policy	2003
	Monetary Operations	Continuous
	Strengthening Central bank Accounting and Controls	2005
	Foreign Exchange Reserves Management	2003–07
	Financial Sector Supervision	2006–07
	Liquidity Management	2003
	Monetary Policy Operations and Enhancing Banking Supervision	2010
	Bank Supervision and Crisis Management	2011
	Conduct Bank Diagnostics	2012
	Banking Supervision and Regulation	2012
	Migration to GFSM 2001	2012

FAD	Implementation of a Large Tax Payer Unit	2003
	Review of Tax Policy and VAT Administration	2003
	Tax and Customs Administration Reforms/Modernization	2003–04, 2006–12
	Follow up on the LTO and Customs Administration Reform	2004, 2006–07, 2010
	Tax/Customs Policy (fiscal reform)	2003, 2007
	Revenue Administration	2007, 2009, 2011–12
	Fiscal Transparency Legislation	2007
	Peripatetic LTU Advisor	2007–08
	Treasury Single Account	2008–09
	Capacity Building Workshop	2009–10
	Extension of LT Treasury Advisor	2011
	PFM Stocktake	2010
	Long Term Revenue Administration	2011
	Side trip of LT Advisor to Kailali, Kanchanpur	2011
	Side trips to Bhairwah and Palpa: implementation of TSA	2011
	Side trip to Gorkha, Tanahu and Kaski	2011
	Treasury Roadmap	2011
	Visiting district Lomjun-discussions with the DTCO's and staffs relating to TSA progress	2012
	Visiting districts Pokhara, Kasi, Tanahu, and Sindhupal Chowk	2012
LEG	Redrafting of Income Tax Laws	2000–01, 2007
	Income Tax Act	2003
	Banking Law	2004–05
	Fiscal Law	2007
	Fiscal Transparency	2007
	AML/CFT National Strategy	2010, 2011
	AML/CFT Legal Drafting Mission	2012
	AML/CFT Structures and Tools	2012
	Work-at-Home Assignment	2011
STA	Multisector Statistics	2001, 2003, 2008–09
	Balance of Payments Statistics	2002–04, 2010
	Producer Prices Statistics	2002–05
	Monetary Statistics	2003, 2009, 2011
	National Accounts	2003, 2005–06, 2008

XI. Resident Representative

Mr. Thomas Richardson has been the Senior Resident Representative since August 6, 2012. He is based in New Delhi.

ANNEX II. RELATIONS WITH THE WORLD BANK GROUP

(As of October 8, 2012)

A. Partnership in Nepal's Development Strategy

Nepal is passing through a momentous and prolonged political transition following a 10-year violent conflict that ended in 2006. This transition entails multiple interrelated processes: maintaining peace through the integration of armies; rehabilitation, truth and reconciliation; power sharing between the major parties; and developing a new constitution. The constitution, which was supposed to lead to a major restructuring of Nepal into a federal state, has recently experienced a setback as the Constituent Assembly failed to deliver the new constitution by the deadline of May 27, 2012.

The prolonged transition has eroded the effectiveness of some key institutions. However, even during the height of the conflict, state institutions by and large continued to function and innovate. Perhaps paradoxically, the country even produced impressive results on various levels:
Nominal Gross Domestic Product (GDP) per capita has doubled from US$350 in 2006 to US$735 in 2011. The percentage of people living below the international poverty line (people earning less than US$1.25 per day) has halved in only seven years. At this measure of poverty, the percentage of poor people declined from 53.1 percent in 2003/2004 to 24.8 percent in 2010/2011.

Net Primary Enrollment in schools has increased from 81 percent in 2002 to 94.5 percent in 2010. Gender parity has been achieved in primary education, but full caste inclusion is still outstanding. The Gender Parity Index for secondary school net enrollment has also increased from 0.87 (2007) to 0.98 (2010). The Maternal Mortality Rate declined from 538 in 1996 to 380 per 100,000 live births, earning Nepal the MDG Millennium Award in 2010. The Infant Mortality Rate dropped from 79 in 1996 to 39 in 2010. At least one-third of deliveries are now in the presence of trained health workers. Full immunization coverage rose from 43 percent in 1996 to 87 percent in 2011.

B. IMF-World Bank Collaboration in Specific Areas

Areas in which the Bank leads and there is no direct IMF involvement

The areas in which the Bank leads the policy dialogue and there is no direct IMF involvement are the social sectors, infrastructure, environment, and agriculture.

In education, the Bank has encouraged Nepal’s decentralization efforts to achieve more effective delivery of public services and has played a pivotal role in supporting the transfer of public schools to community management. Along with other donors, the Bank is actively supporting Nepal’s well-formulated, ten-year primary education reform program through the ongoing School Sector

Reform Project (SSRP). This Sector Wide Approach (SWAp) brings together GON and 12 development partners – of which 9 partners pool their resources with those of the GON, and 3 development partners who support the program directly. The Second Higher Education Project supports (a) enhanced quality, efficiency and relevance of higher education through a set of systemic reforms, and incentives to selected institutions; and (b) improved access for academically qualified students from disadvantaged groups in (i) higher education and (ii) higher secondary education. The objective of the Enhanced Vocational Education and Training Project is to expand the supply of skilled and employable labor by increasing access to quality training programs, and by strengthening the technical and vocational education and training system in Nepal.

In health sector, the Bank has been working closely with the government and development partners in supporting the government's sector program since 2004 through a SWAp, similarly to its engagement in the health sector. The Second HNP and HIV/AIDS Project is assisting the Government in improving the equitable delivery of health care services, specifically by increasing access to essential health care services and their utilization by the underserved and the poor. The Community Action for Nutrition Project (Sunaula Hazar Din) aims to improve attitudes and practices known to improve nutritional outcomes of women ofreproductive age and children under the age of 2. Changes in attitudes and practices would address the key risk factors for child malnutrition and create demand for nutrition related services and products. T he supply of these services and products will be provided through existing public sector and donor-funded programs, the private sector and, to a limited extent, financed through the Project.

To support broad-based growth, the Bank supports investments in several key infrastructure sectors. The Road Sector Development Project provides all-season road access in select hill districts. The Bridges Improvement and Maintenance Program provides innovative financing by utilizing a new financing instrument (Program-for-Results), which links disbursements of funds directly to the delivery of verifiable results. It is the first Program-for-Results to be approved by the World Bank's Board under IDA and supports the vision behind Nepal's Bridge Policy and Strategy of 2004 to provide "safe, reliable and cost effective" bridges. The Bank is also strongly engaged in the energy sector where, however, progress continues to be slow. The Power Development Project aims to develop the country's hydropower potential to meet electricity demand, improve access of rural areas to electricity services and promote private sector participation. However, the project will have to close by the end of calendar year 2012 with 45 percent of commitments remaining undisbursed. The Kabeli Transmission Project aims (i) to support the addition of transmission capacity to the Integrated Nepal Power System; and (ii) to provide access to electricity and cooking fuel to communities in the area of the Kabeli 132 kV transmission line.

To address issues arising from rapid urbanization in Nepal, IDA also provides support to improve municipal governance, including municipal services, through the Urban Government and Development Program: Emerging Towns Project.

To support rural development, the Nepal Irrigation and Water Resources Management Project aims to improve irrigated agriculture productivity and management of selected irrigation schemes, and enhance institutional capacity for integrated water resources management. At the same time, project finance is supporting decentralization to improve service delivery by promoting grassroot-driven, bottom-up planning and community-based management. The Modernization of Rani Jamara Kulariya Irrigation Scheme aims to improve irrigation water delivery to, and management in, the command area. The Rural Access Improvement and Decentralization Project (RAIDP) helps to improve governance and service delivery for rural infrastructure, while at the same time promoting agricultural and rural economic growth, and generating employment through direct project investments in rural transport infrastructure. The Rural Water Supply and Sanitation Project aims to improve rural water supply and sanitation sector institutional performance and mainstream the "Board" (Rural Water Supply and Sanitation Fund Development Board) approach into the Government's system. It also supports communities to form inclusive local water supply and sanitation user groups that can plan, implement, and operation drinking water and sanitation infrastructure that delivers sustainable health, hygiene, and productivity benefits to rural households.

After a long gap, the Bank re-engaged in the agriculture sector through the Agriculture Commercialization and Trade Project. It aims to improve the competitiveness of smallholder farmers and the agribusiness sector in selected commodity value chains and 25 districts supported by the project. To address the food insecurity issues, a Social Safety Net Project is under implementation. It addresses the short and medium term implications of the global food crisis for the country by strengthening the agricultural production and safety net mechanisms on a broad scale. The objective is to ensure access to food and basic needs for vulnerable households in the short term in food insecure districts.

Recognizing that Nepal's development agenda is closely intertwined with peace building, a Peace Support Project is under implementation. The project aims to contribute to the peace process by providing interim cash transfers and services to conflict-affected groups.

While many of the Bank's investment/sector operations mentioned above also support social inclusion, a more direct initiative in this area that received Bank support is the Poverty Alleviation Fund (PAF). PAF channels resources to the poorest groups in rural communities by creating infrastructure, employment and income-generating opportunities.

Areas in which the Bank leads and its analysis serves as input into the IMF program

The Bank takes the lead in assisting Nepal with public expenditure analysis. The Bank takes the lead in assisting Nepal with public expenditure analysis. In addition, the Bank's intensive dialogue and technical assistance have been supporting the reforms, including the development of a credible Medium Term Expenditure Framework (MTEF). This framework has applied since FY04 to the prioritization of the development budget to ensure efficient budget allocations for priority projects.

Areas of shared responsibility

The Bank and the IMF continues to provide assistance in the overall management of the country's macroeconomic aggregates. The Bank and the IMF have assisted in debt management through technical assistance, joint Debt Sustainability Analysis and policy dialogue to ensure that the overall debt stock and fiscal deficits are within reasonable limits. To sustain the impressive revenue growth, in addition, the Bank and the IMF continue to provide policy advise and technical assistance.

C. World Bank Group Strategy and Lending Operations

Given the transitional nature of Nepal's situation the World Bank Group prepared an ***Interim Strategy Note*** covering fiscal years 2012 and 2013, which was discussed by the Bank's Board on September 15, 2011. It proposes development programs that are consistent with the government of Nepal's Three-Year Plan.

Nepal has been selected as a pilot country to implement an enhanced joint strategy to leverage IDA and IFC resources and realize synergies. The strategy reflects considerable continuity, building on programs with successful track records that are adapted to local conditions. It also emphasizes greater selectivity, focusing on areas considered vital to Nepal's development and complementing programs supported by other development partners.

Supporting the government of Nepal's overarching goal to build a peaceful, prosperous and just Nepal, the strategy is organized around three "pillars" that emerged during consultations within the Bank Group and with the government, donor partners, and key stakeholders.

The first pillar intends to enhance connectivity and productivity for growth. The second focuses on reducing vulnerabilities and improving resilience. The third pillar concentrates on promoting access to better-quality services. Governance, accountability, gender equality, and social inclusion are themes that run across all three pillars.

Within each of these pillars, the strategy identifies specific areas where the Bank Group can make a difference. For IDA, these include roads, food security and livelihood vulnerability, education, health, urban services, and disaster management. For IFC, these include improving access to finance and investment climate, trade facilitation, lending to Small and Medium Enterprises, and trade finance facilities for local banks. IDA and IFC expect to work together on power development, agriculture, and climate change.

FY12 Lending Program: In FY2012, IDA approved US$143 million in new commitments, including the Modernization of Rani Jamara Kularia Irrigation Project (US$43 million), the Sunaula Hazar Din Multi-Sector Nutrition Project (US$40 million), the Bridges Improvement and Maintenance Program (US$60 million).

Bank Assistance Program in Nepal: The Nepal country portfolio includes 18 IDA funded projects with a net commitment value of about US$1.3 billion. We also oversee implementation of 17 Trust Funded recipient-executed operations (US$170 million).

Economic and Sector Work: The World Bank Group is also engaged in analytical and knowledge dissemination exercises. It provides regular economic updates and advises the Nepalese authorities on key economic policies. It also works with partners and the government on analyzing poverty trends in Nepal. For example, with support from the U.K.'s Department for International Development and Denmark, the Bank worked closely with the Central Bureau of Statistics to complete the latest Living Standards Survey (NLSS 3), to provide core data on poverty trends and access to services.

Strong IFC/private-sector engagement in the creation of the Nepal Business Forum is facilitating public-private sector dialogue and pragmatic problem-solving. Other areas of attention have included analysis of migration and remittances trends, medium-term public expenditure management, assessment of the investment climate, financial sector risk management, and implementation of the Right to Information and food security and nutrition challenges. In addition, teams have disseminated information on international experience on specialized topics (such as fiscal decentralization and civil service transition) at the request of Constituent Assembly committees and other government bodies.

Other areas of analytic focus include water resource management, where the Bank team is working with the Water and Energy Commission Secretariat to establish a geo-referenced water resources information system, develop river basin models, build capacity within the GON for river basin modeling, and support the formation of a Trans-boundary Waters Cell. A recently completed Ganges Strategic Basin Assessment built a knowledge base and promoted an open, evidence-based dialogue on the shared opportunities and risks of cooperative management of the Ganges River Basin. Analytical support to understand governance issues in the forestry sector and support to the REDD Readiness Plan preparation are under way.

Other ongoing IDA/IFC work is laying the foundation for carbon-based trading and financial support from the Pilot Program for Climate Resilience and other climate investment funds. Joint work on disaster management (in collaboration with the United Nations, Asian Development Bank (ADB), Red Cross and others) is expected to lay the basis for future program support from the Global Fund for Disaster Risk Reduction. In partnership with the government and other donors, the Bank continues to provide advice on ways to improve existing social protection systems and on the design of a national social protection framework.

Table II.1. FY11 IDA Projects

(Amounts in US$million)

Project Name	Board Approval	Closing Date	Net Comm. Amt.	Disb. FY13	Total Undisb. Balance
Irrigation &Water Resources Mgmt. Projects	12/06/2007	06/30/2013	64.24	0	22.67
Social Safety Nets Project	09/30/2008	09/30/2013	64.47	0	15.49
PAF II	12/06/2007	06/30/2014	164.97	6.17	37.93
Agriculture Commercialization and Trade Project	06/04/2009	06/30/2015	20.00	0.06	15.88
Rani Jamara Kulariya Irrigation Project	07/05/2011	09/30/2016	43.00	0	36.42
Power Development Project	05/22/2003	12/31/2012	164.09	5.20	74.40
Kabeli Transmission Project	05/10/2011	06/30/2015	38.00	0.07	34.18
Rural Access Improve. & Decentraliz	06/21/2005	12/31/2013	77.00	0.90	38.36
Road Sector Development Project	12/06/2007	06/30/2015	117.60	0	44.78
Rural Water Supply & Sanitation Proj	06/01/2004	08/31/2012	48.49	0	4.50
Emerging Towns	05/10/2011	07/31/2016	25.00	0	19.27
Second Higher Education Project	02/22/2007	01/15/2014	60.00	3.42	27.43
School Sector Reform Program	09/22/2009	12/15/2014	130.00	4.67	44.14
Enhanced Vocational Educ & Trng	04/21/2011	10/30/2015	50.00	0	41.84
Second HNP and HIV/AIDS Project	04/20/2010	07/15/2015	129.15	0	94.53
Peace Support Project	05/06/2008	06/30/2014	50.00	1.28	22.77
Community Action for Nutrition Project (Sunaula Hazar Din)	06/26/2012	06/30/2017	40.00	0	39.42
Bridges Improvement and Maintenance Program Support	06/28/2012	07/15/2017	60.00	0	58.90
Total			**1,346.01**	**21.77**	**672.91**
Regional Projects					
Northeast Regional Electricity Transmission	06/21/2011	12/31/2016	99.00	0	91.66
Regional Wildlife Protection: BD and NP	04/07/2011	05/31/2016	3.00	0.61	2.26

Activities of the International Finance Corporation (IFC) in Nepal

Investment Services: IFC's committed investment portfolio in Nepal stood at US$27 million as of March 2011, consisting of three power generation projects, one airline, one tourism project, one microfinance institution, one Financial Sector ICT service company, and four trade finance facilities. In FY2011, IFC provided four trade finance facilities (for US$9 million in total) and signed one additional facility (of US$5 million) under IFC's Global Trade Finance Program to date. In FY2010 and FY2009, IFC committed US$14 million and US$15 million, respectively, including IFC's first power investment in Nepal in a decade (for US$6.5 million), IFC's first ever investment in microfinance in Nepal (for US$0.3 million), a US$10 million long-term debt in aviation as well as GTFP trade facilities. After having a low level of activity during FY2002-FY2007 due mainly to the conflict, IFC re-opened an office in Kathmandu in January 2008 with the objective of scaling up both investment and advisory operations. IFC's program successfully rebounded, focusing on increased access to finance and infrastructure, as well as support to help improve investment climate.

IFC Advisory Services: IFC is engaged broadly in four areas, including investment climate, financial market and access to finance, sustainable business, and Public-Private Partnerships (PPPs) and has been more active in the former three areas thus far. IFC's work on Investment Climate Reform Project (ICRP) began in Nepal in 2007. In FY11, IFC, with funding support from DFID, embarked on a new three-year ICRP that consists of three mutually-reinforcing components: (i) Public Private

Dialogue (PPD); (ii) Regulatory Reforms; and (iii) Special Economic Zones (SEZ). Through this program, IFC has assisted with the establishment of Nepal Business Forum (NBF). As a Public Private Dialogue (PPD) mechanism, NBF helps the government set up reforms at the national and sub-national level. IFC's Financial Markets and Access to Finance (A2F) advisory work focuses on financial infrastructure, sustainable energy financing and SME lending, microfinance, credit information bureaus, secured transaction registries and support to long-term lending institutions. IFC increasingly plays a key advisory role in diverse areas, including credit bureau and collateral registry, sustainable energy and water finance project, microfinance project, SME finance project, and in particular "Payments, Remittances and Securities Settlement Systems (PRSSS)". Furthermore, IFC is providing advisory support to promote sustainable business practices in the private sector, helping to strengthen environment, social and governance aspects and SMEs through linkages to IFC's investments. In the area of climate change, IFC, in partnership with the World Bank and ADB, is implementing the Strategic Program on Climate Resilience (SPCR) and Scaling up Renewable Energy (SREP) projects in benefit for the private sector in Nepal.

Going forward, IFC will seek to continue the programs aligned with the three strategic pillars of IFC's regional South Asia Strategy which include: (a) Inclusive Growth; (b) Climate Change; and (c) Regional and Global Integration. IFC continues to focus on investment climate to lay the ground for attracting investments, access to finance and financial sector development to promote efficient and innovate ways of financial access, and infrastructure strengthening to facilitate people's access and economic development. Building on its global and regional experiences, IFC remains interested in providing support for the development of PPPs in Nepal. IFC will also seek to leverage the co-location of the IFC and World Bank offices, aiming for greater collaboration and interaction in Nepal, particularly in the areas of financial markets, infrastructure, climate change, and business enabling environment.

ANNEX III. RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Country Program

The Asian Development Bank (ADB) began lending to Nepal in 1969. As of 31 December 2011, Nepal has received 156 loans/grants—123 sovereign ADF loans ($2,731.082 million), 5 non sovereign loans ($58.64 million), and 28 ADF grants ($827.915 million) totaling $3,617.637 million. Sectors covered through ADB loans and grants are agriculture and natural resources; education; energy; finance; law, economic policy and public sector management; multisector; transport and communication; water and other municipal infrastructure services. The portfolio of active sovereign ADF loans and grants as of 31 December 2011 consists of 42 loans and grants with an overall net amount of $1,418.94 million.

The assistance program for 2011 comprised six projects with a total of $116.0 million in ADF grants and $154.0 in concessional loans. The programs and projects include the Electricity Transmission Expansion & Supply Project (loan $56.0 million and grant $19.0 million); High Mountain Agribusiness & Livelihood Improvement Project (grant $20.0 million); Decentralized Rural Infrastructure & Livelihood Project (Additional Financing) (loan $18.0 million and grant $7.0 million); School Sector Reform Program (grant $65.0 million); Capital Market and Infrastructure Capacity Support Project (grant $5.0 million); Kathmandu Valley Water Supply Improvement Project (loan $80.0 million).

Technical Assistance

As of 31 December 2011, ADB has approved technical assistance projects totaling $162.69 million. There are currently 45 ongoing TAs including JFPRs as of 31 December 2011 amounting to $43.65 million. 23 projects and 11 TAs which are about 55% and 27%, respectively, of the Nepal portfolio, are currently being administered by the Nepal Resident Mission.

Private Sector Operations

ADB firmly supports the need for private sector involvement and development of a strong local private sector for the long-term economic growth of Nepal. Prudent investment in the energy sector is felt elemental and is a priority focus for ADB to address the looming power crisis of the country. At the end of 2011, cumulative approvals for 4 private sector projects in Nepal amounted to $58.64 million.

Sovereign Loans and Grants by the Asian Development Bank, 1968–2011

(As of 31 December 2011)

	1968-2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
	(in million of US dollars)											
Loans												
Agriculture and Natural Resources	656.2	0.0	0.0	20.0	70.0	0.0	0.0	0.0	0.0	0.0	0.0	18.0
Education	61.1	19.6	30.0	0.0	20.0	0.0	30.0	0.0	0.0	25.0	0.0	0.0
Energy	364.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	65.0	0.0	56.0
Finance	7.3	0.0	0.0	0.0	0.0	0.0	56.0	0.0	0.0	0.0	60.4	0.0
Industry and trade	127.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public Sector Management		30.0		35.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transport and Communication	236.9	46.0	0.0	0.0	20.0	0.0	0.0	0.0	0.0	70.0	13.5	0.0
Water supply, sanitaiton and other municipal infrastructure and services	224.0	0.0	0.0	39.0	0.0	0.0	0.0	0.0	0.0	0.0	70.0	80.0
Multisector	127.1	0.0	30.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Regional Cooperation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	12.8	11.0	0.0
Total Loans	**1804.2**	**95.6**	**60.0**	**94.0**	**110.0**	**0.0**	**86.0**	**0.0**	**0.0**	**172.8**	**154.9**	**154.0**
Grants												
Agriculture and Natural Resources	0.0	0.0	0.0	0.0	0.0	0.0	18.0	0.0	0.0	0.0	46.5	27.0
Education	0.0	0.0	0.0	0.0	0.0	0.0	2.0	0.0	8.0	70.0	0.0	65.0
Energy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.5	19.0
Finance	0.0	0.0	0.0	0.0	0.0	0.0	8.7	0.0	0.0	0.0	12.1	5.0
Public Sector Management	0.0	0.0	0.0	0.0	0.0	0.0		0.0	106.3	0.0	0.0	0.0
Transport and Communication	0.0	0.0	0.0	0.0	0.0	0.0	55.2	0.0	25.0	10.0	25.5	0.0
Water supply, sanitaiton and other municipal infrastructure and services	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	45.1	10.0	0.0
Multisector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	25.6		0.0
Regional Cooperation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	9.0	0.0	12.8	11.0	0.0
Total Grants	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**83.9**	**109.0**	**139.3**	**163.5**	**107.6**	**116.0**
Total Approved (Loan and Grant)	**1804.2**	**95.6**	**60.0**	**94.0**	**110.0**	**0.0**	**169.9**	**109.0**	**139.3**	**336.3**	**262.5**	**270.0**
Gross disbursement (Loans and grants)	1220.6	57.3	28.2	33.5	22.0	43.7	108.0	102.3	127.1	199.5	111.2	208.8
Technical Assistance												
Total approved	98	4	4	4.2	3.2	2.1	5.8	7.2	4.6	5.7	10.5	13.6
Gross disbursement	54.1	5	3.9	4.2	4.2	3.6	2	4.6	4.6	6.8	14.2	8.8

ANNEX IV. STATISTICAL ISSUES

Economic and financial data are generally adequate for surveillance, with scope for improvement especially in fiscal (external financing) data, more detailed price statistics, and the timeliness and quality of balance of payments data. Nepal provides core data to the Fund and releases data in government and central bank publications. It has been a participant in the General Data Dissemination System (GDDS) since May 2001. Metadata were initially posted on the Dissemination Standards Bulletin Board in May 2001 and last updated in January 2009.

Real Sector Statistics

The Central Bureau of Statistics (CBS) compiles **national accounts** using the methodology of the *1993 SNA*. Key estimates include GDP by industry (in current and constant prices) and by expenditure categories (current prices), and gross national income and savings. A 2011 STA mission revealed that on the expenditure side, no separate estimate of change in inventories is made, and inventories plus statistical discrepancy is treated as a residual, which has risen over time to more than 13 percent of GDP. This raises serious doubts over the reliability of other categories of final expenditure, particularly household final consumption and capita formation. On the activity side, while benchmark estimates are assessed to be robust, weaknesses arise due to low quality of extrapolators and lack of benchmark surveys in key areas such as construction and trade. Previous STA missions in 2005 and 2006 (with AsDB assistance) provided support to the development of quarterly national accounts (QNA) and the rebasing of the annual national accounts to 2000/01 from 1994/95. CBS is now considering rebasing national accounts to 2004/05 or 2010/11, for the reference year 2013/14 or 2014/15. QNA from the activity side have been prepared for 2004/05 to 2010/11, and publication is expected this year, two months after the end of the first quarter of 2012/13. High frequency indicators are generally lacking; a quarterly manufacturing production index exists but updates are not available since Q1 of 2010/11.

The Nepal Rastra Bank (NRB) compiles the **consumer price index** (CPI), with 2005/06 as base year. Survey work to revise the CPI basket is underway, expected to be completed in 2013/14, in order to produce a new CPI series by 2015/16. The new survey will include more commodities and is expected to yield a more representative basket, as the previous survey was carried out during the armed conflict, which may have affected survey responses. A core inflation series is not published, although underlying data necessary to calculate such a series appear to be available. NRB also publishes a **wholesale price index** (WPI), with weights based on 1999/2000 data. Broadly, the index covers agricultural commodities (49.6 percent), domestic manufactured goods (20.4 percent), and imported goods (30 percent). As well, an **index of wages and salaries** is compiled and published, with base year 2004/05.

Government Finance Statistics

Authorities began to compile fiscal data in accordance with IMF's 2001 *Government Finance Statistics* (GFS) in 2011, an important step forward. Meanwhile, treasury single account (TSA) has been rolled out to 60 districts including Kathmandu, which allows for more timely and accurate fiscal data reporting and monitoring. However, a number of fees collected outside the budget and the operations of local governments are not reported in the annual budget, monthly reporting of development spending often excludes amounts directly paid by donors, and there is no compilation of the government's balance sheet in accordance with IMF's GFS 2001. Government finance statistics are regularly reported for publication in the *Government Finance Statistics Yearbook,* but not in the *International Finance Statistics*.

Monetary and Financial Statistics

Following up on the recommendations of a 2009 STA mission that NRB broaden the coverage of monthly monetary statistics to include development banks and finance companies[1], NRB now publishes an expanded broad money survey, which is a significant step forward.

There is room for improvement in the reporting of interest rate data. At present, key policy rates including t-bill, interbank, and NRB policy rates are available, but deposit and lending rates of commercial banks are not well reported, while those of development banks and finance companies are not reported at all. It may be useful to report the prime lending rate of top 5 commercial banks, as well as average deposit rates of the same, to provide a sense of the movement over time. At present, maximum and minimum rates are reported, which remain relatively fixed over time and are not very informative.

Following up on recommendations of a 2011 STA mission NRB has resumed reporting monthly monetary data in the format of SRF 1SR for the central bank and SRF 2SR for commercial banks; and resume reporting monthly monetary data in the format of SRF 2SR covering the entire ODC sector**.**

External Sector Statistics

The NRB compiles and disseminates balance of payments statistics in conformity with the fifth edition of the Balance of Payments Statistics Manuel (BPM5), but does not compile statistics on the international investment position. Overall the quality of BOP data is weak and net errors and omissions remain large[2]. Trade data compiled separately by the NRB, the Customs Department, and the Trade Promotion Center (overseas trade only) exhibit discrepancies. Export and import price indices are not published.

A 2010 STA mission identified key shortcomings in BOP statistics, including: (i) underestimation of imports, and to a lesser extent exports; (ii) significant problems in measurement of remittances; (iii) incompleteness of data on foreign grants, making it difficult to classify current vs. capital, and official

[1] Latest data provided by authorities for July 2012 indicated that 16 percent of private sector deposits are accounted for development banks and finance companies.

[2] In 2011/12, errors and omissions were 20 percent of the current account balance. In previous years, this has been as high as nearly 40 percent.

vs. private grants; (iv) absence of direct investment data; and (v) unrecorded financial flows. The report makes specific recommendations to improve the quality of BOP line items. For example, trade data should be reconciled with main trading partners India and China, and coverage of trade should be expanded to include undeclared imports and exports using border surveys. Remittance data, which relies on bank reporting, should be verified in the short run with money transfer operators and counterparts, and in the long run be based on an enumeration of migrants in different destinations.

The STA mission also found that adequate data exists to produce annual and quarterly IIP statistics, subject to improvements in the quality of direct investment data.

MoF does compile data on total grants received by the government and private sector from donor agencies, and a new Aid Management Platform (AMP) has been in use since last year, which should help improve reporting of foreign aid. However, coordination between Foreign Aid Coordination Division (FACD) in Ministry of Finance (MoF) and the Balance of Payments Division (BOPD) in NRB on external grants appears to be weak, complicating estimation of foreign financing.

Nepal—Table of Common Indictaors Required for Surveillance
(As of October 5, 2012)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	Aug. 2012	Sept. 2012	D and M	W and M	W and M
International reserve assets and reserve liabilities of the Monetary Authorities[1]	Aug. 2012	Oct. 2012	M	M	M
Reserve/base money	Aug. 2012	Oct. 2012	M	M	M
Broad money	Aug. 2012	Oct. 2012	M	M	M
Central bank balance sheet	Aug. 2012	Oct. 2012	M	M	M
Consolidated balance sheet of the banking system	Aug. 2012	Oct. 2012	M	M	M
Interest rates[2]	Aug. 2012	Oct. 2012	D and M	W and M	W and M
Consumer price index	Aug. 2012	Oct. 2012	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Jul. 2012	Sept. 2012	M	M	M
Revenue, expenditure, balance and composition of financing[3] – central government	Jul. 2012	Sept. 2012	M	M	M
Stocks of central government and central government-guaranteed debt[5]	Jul. 2012	Aug. 2012	A/M	A/M	A/M
External current account balance	Aug. 2012	Oct. 2012	M	M	M
Exports and imports of goods and services	Aug. 2012	Oct. 2012	M	M	M
GDP/GNP	2011/12	April 2012	A	A	A
Gross external debt	Jul. 2012	Aug. 2012	A	A	A

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds. Interest rates of commercial banks are reported in the monthly monetary update, whereas official interest rates are reported weekly as well as monthly.

[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. Domestic debt is reported monthly and external debt is reported on annual basis.

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

INTERNATIONAL MONETARY FUND

NEPAL

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

November 2, 2012

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Nepal remains at moderate risk of debt distress.[1] *The baseline external public debt indicators show that external debt dynamics are sound and broadly resilient to standard stress tests. Nevertheless, under an alternative scenario reflecting systemic financial sector stress, external debt indicators breach the indicative thresholds, underscoring the pressing need to address financial sector vulnerabilities.*[2] *A prudent fiscal stance remains appropriate, and net domestic financing of deficits should be contained to around 2 percent of GDP in the near term. However, a marginal increase in net domestic financing (by less than ¾ percent of GDP) to finance much-needed capital spending could be warranted in the context of enhanced public financial management. In this vein, stronger efforts to improve the utilization of foreign aid, particularly grants, would mitigate pressures on the domestic debt market, while structural reforms to boost long-run growth and revenue generation would improve overall public debt sustainability.*

[1] The risk rating is determined using the Low-Income Country Debt Sustainability Analysis (LIC-DSA) framework. Nepal's fiscal year starts in mid-July.

[2] The thresholds are determined based on Nepal's policy performance rating, which is "medium" according to the CPIA score.

BACKGROUND

1. **The total stock of public debt in Nepal remained stable at 33¼ percent of GDP by end-2011/12[3], the same level of 2010/11 and down from around 60 percent a decade ago, largely reflecting a prudent fiscal policy.** External public debt stood at 20½ percent of GDP (US$ 3½ billion) by end-2011/12, rising from 18¾ percent of GDP due mainly to exchange rate depreciation against the U.S. dollar. The World Bank and Asian Development Bank (ADB) account for 83 percent of external debt, while Japan is the largest bilateral creditor accounting for 6¼ percent of total external debt. Domestic public debt stood at 12¾ percent of GDP by end-2011/12, compared to 14½ percent a year ago.

MACROECONOMIC ASSUMPTIONS

2. **Macroeconomic assumptions are broadly similar to those of the previous DSA.** Key differences include: (i) a higher path for fiscal revenue over the medium term (taking into account the strong reform momentum in this area); and (ii) a small narrowing of the external current account deficit, which to some extent reflects the correction of exchange rate overvaluation as a result of recent depreciation against the U.S. dollar (Box 1). Other assumptions are as follows:

Box 1. Macro Assumptions Comparison Table

	Previous DSA		Current DSA			Difference (current vs previous)	
	MT	LT	2012	MT	LT	MT	LT
Real growth (%)	3.8	4.0	4.6	4.0	4.0	0.2	0.0
Inflation (GDP deflator, %)	7.5	5.0	8.7	7.7	5.1	0.2	0.1
Revenue and grants(% GDP)	18.8	19.0	18.3	18.1	19.2	-0.7	0.2
Grants (% GDP)	3.0	2.6	2.6	2.1	1.8	-0.9	-0.8
Primary expenditure (% GDP)	20.9	21.0	18.7	19.3	21.3	-1.6	0.3
Primary deficit (% GDP)	2.1	2.0	0.4	1.2	2.1	-0.9	0.1
NDF (% GDP)	2.7	2.5	-0.1	2.3	2.7	-0.4	0.2
Exports of G&S (y/y growth)	7.3	7.0	11.7	7.7	7.1	0.4	0.1
Imports of G&S (y/y growth)	11.3	8.0	0.6	9.3	7.4	-2.0	-0.6
Remittances (y/y growth)	12.5	7.0	24.5	10.9	7.5	-1.6	0.5
Current account balance(% GDP)	-0.8	-2.6	4.7	-0.5	-0.5	0.3	2.1

Note: MT stands for medium term and reflects average over the next 5 years, and LT refers to long term and generally reflects indicators at the end of the projection period.

- **Real GDP growth is projected to slow to 3¾ percent in 2012/13 compared with 4½ percent in 2011/12, and then gradually accelerate to 4 percent in the medium term.** This short-term drop in growth reflects a softening global economic outlook, and particularly much slower activity in India. The medium term outlook would be supported by a gradual global

[3] The fiscal year ends on July 15.

recovery, enhanced political stability, and rising investment. Over the long run, resolution of such structural impediments as infrastructure would set growth on a higher sustainable path. Inflation is expected to decline to 8¼ percent in 2012/13 and further to 5 percent over the long run, assuming moderating external price pressures.

- **The exchange rate peg to the Indian rupee is assumed to remain at the current level over the projection period, and the external current account is projected to move from a small surplus in 2012/13 to moderate deficits over the medium and long term.** Remittance growth is projected to moderate to 7½ percent over the long run, largely reflecting a gradually slowing historical trend and economic prospects of migrant host countries.[4] Exports are hampered by structural bottlenecks as well as exchange rate overvaluation, and the ratio of exports to GDP is expected to further decline through the projection period reflecting weak competitiveness. Imports are largely driven by remittances, and thus would also decline in relation to GDP as remittances moderate. Both exports and imports are projected to grow by an annual average of 7–8 percent.

- **Fiscal policy is assumed to remain prudent, with net domestic financing (NDF) standing at 2¼ percent of GDP over the medium term, and at 2¾ percent of GDP in the long run.** Revenue and grants are projected to reach 17½ percent and 1¾ percent of GDP over the long run, respectively (compared with 15¾ percent and 2½ percent in 2011/12). Higher revenue is mainly attributable to improved tax administration and revenue policy, while lower grants are associated with the end of the peace process and an expected shift in donor financing from grants to concessional loans. On the expenditure side, current spending has been constrained and capital expenditures under-executed in 2011/12, leading to a lower projection of primary expenditures compared to the previous DSA. Assuming improved budget execution and higher capital spending, primary expenditures would stand at 21¼ percent over the long run. As a consequence, the primary deficit would stand at 2 percent of GDP in the long run (same as in the previous DSA) .

- **Concessionality of foreign loans is projected to decline gradually**. With rising per capita income and capital spending, new borrowings on relatively less favorable terms, for example, loans from non-traditional donors to finance hydropower projects, could become increasingly important. As a result, the assumed grant element (the measure of concessionality in this DSA exercise), would fall to 32½ percent by 2032.

[4] For empirical study, see "Remittances in South Asia and the Philippines: Determinants and Outlook", IMF Selected Issues Paper, 2009.

EXTERNAL DEBT SUSTAINABILITY

A. Baseline

3. Under baseline projections, Nepal's debt indicators remain below the indicative sustainability thresholds (Table 3b, Figure 1). As in the previous DSA, remittances are formally included in the analysis because the inflows (accounting for 23 percent of GDP) represent a sizeable and comparatively stable element of the balance of payments. Nevertheless, debt dynamics are also vulnerable to the potential volatility of remittances. The impact of a sharp slowdown in remittances is discussed below. With relatively conservative assumptions on growth and external borrowing, current projections indicate that the baseline debt ratios would remain sustainable over the long term.

B. Stress Tests and Alternative Scenarios

4. Nepal's debt dynamics remain generally sound under standard stress tests. Standard tests include shocks to GDP growth, exports, non-debt creating flows and combinations of these shocks, as well as a one-time 30 percent exchange rate depreciation. Nepal's debt indicators are below the sustainability thresholds under all but the most severe of these stress test scenarios. More specifically, Nepal's debt dynamics remain susceptible to shocks to remittance inflows. A substantial slowdown in remittances—reflected in a one standard deviation below average growth of non-debt creating flows in 2013 and 2014—would cause the "PV of external debt to export + remittance" ratio to exceed the indicative threshold by 10 percentage points in 2014.

5. Non-standard scenarios, based on Nepal-specific risks, highlight the financial sector fragilities as a key risk. Higher remittances have eased banks' liquidity situation in 2011/12, but heightened credit risk following the recent sharp downturn in real estate prices remains a key vulnerability. A hypothetical financial stress scenario mimics the shocks that could be triggered by a loss of confidence or a drop in remittances—leading to self-reinforcing feedback between deposit runs, capital flight, and a systemic financial sector stress. Under this scenario, the ratio of "PV of external debt-to-GDP+remittances" would rise substantially and stay above the threshold in 2015–2018, peaking in 2016 at 40½ percent; the PV of external debt-to-revenue ratio would be above the threshold across the whole projection period, and peak at 337¾ percent in 2013; and the debt service to revenue ratio would also be slightly above the threshold from 2016 onwards. (Figure 1).[5]

[5] Key assumptions include (i) a 50 percent loss of central bank foreign exchange reserves; (ii) a one-time exchange rate depreciation of 33 percent; (iii) an output loss of 30 percent over a 4 year horizon; and (iv) a fiscal cost (for bank resolution and deposit coverage) of 23 percent of GDP—presumably financed through domestic debt, but later replaced by foreign debt given the more favorable terms and the need to supplement depleted foreign exchange reserves.

PUBLIC DEBT SUSTAINABILITY

6. **Under the baseline scenario, the PV of public debt would be moderately higher at the end of the projection period.** As a share of GDP, the PV of public debt increases from 31 percent in 2012 to 37 by the end of the projection period. In percent of revenue and grants, the PV of public debt increases from 171 percent to 190 percent.

7. **Although the total level of public debt remains broadly in the same margin, its composition is projected to shift toward domestic debt due to constraints on the capacity to mobilize external resources.**[6] In the context of the current exchange rate peg, weak competitiveness and financial sector vulnerabilities, sizeable increases in public domestic debt could be increasingly difficult to accommodate. This could lead to higher real interest rates— potentially crowding out private sector credit—or requiring a tighter rein on primary fiscal expenditures which could endanger anti-poverty and development goals.

8. **Stress tests suggest vulnerability to shocks**. The largest adverse impact arises from the heightened financial stress scenario outlined above, which would raise the PV of debt to GDP ratio to over 90 percent. Among the standard stress tests, the largest impact on public debt arises from an increase in other debt-creating flows by 10 percent of GDP, which would increase the PV of debt-to-GDP by more than 9 percentage points and leave it at higher levels for a prolonged period.

9. **Contingent liabilities arising from, inter alia, the SOE sector and pension scheme could pose risks to this assessment.** NOC and NEA are making substantial losses, and hold domestic debt arrears equivalent to 5¾ percent of GDP, with the majority owed to fiscal or quasi-fiscal agencies.[7] Meanwhile, the on-budget pension scheme has no independent source of funding (such as employee contributions), and could over time cause the fiscal stance to deteriorate. Limited information on the pension scheme impedes a reliable estimate of the financing needs in the periods ahead and their potential impact on debt dynamics. The clearance of SOE arrears would presumably be based on first introducing an automatic fuel pricing mechanism supplemented by a social protection scheme, the cost of which depends on the program design.

AUTHORITIES' VIEWS

10. **The authorities concurred with the DSA and its policy messages**. They are aware of the risk to debt dynamics posed by financial sector stress and other contingent liabilities. Meanwhile, they recognize the need to improve utilization of donors' resources to curb the increase in domestic debt and commit to contain net domestic financing to 2 percent of GDP in 2012/13. However, they stress that systemic financial sector stress is not very likely and the chunk of the banking sector is generally sound though weaknesses

[6] Domestic debts include T-bills, development bonds, overdraft from the Nepal Rastra Bank, etc. The maturity of T-bills ranges from 28 days to a year, with T-bills of 91 days most actively traded.

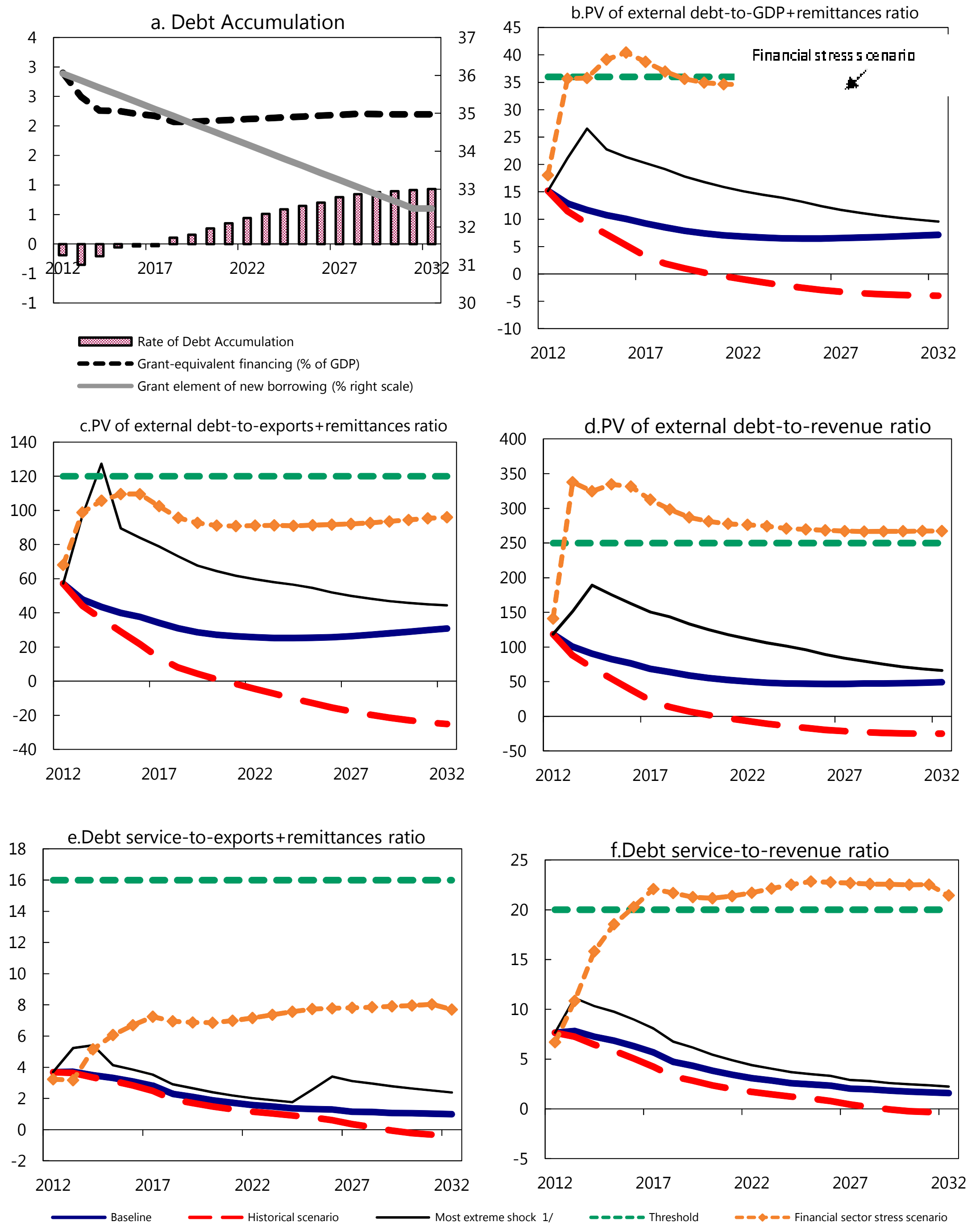
[7] NOC is Nepal Oil Corporation; NEA is Nepal Electricity Authority.

concentrate in a few smaller banks and financial companies. They also argue that foreign grants would be stronger than staff projection given the sizable commitments.

CONCLUSION

11. Nepal faces a moderate risk of external public debt distress but risks could arise from financial sector vulnerabilities, a shock to remittances, or quasi-fiscal liabilities. Although external debt burden indicators generally do not breach the thresholds in both baseline scenario and stress tests, under a heightened financial stress scenario, the debt burden rises notably, with external debt breaching thresholds for prolonged periods. This test stresses the need to urgently address financial sector weaknesses via in-depth reforms. The analysis also suggests that contingent liabilities from SOEs and the pension scheme could pose additional risks to debt dynamics. This highlights the importance of containing net domestic financing of deficits to around 2 percent of GDP in the near term that would create space for contingent liabilities, though there is marginal room to accommodate additional capital spending in case it is strengthened via enhanced public financial management.

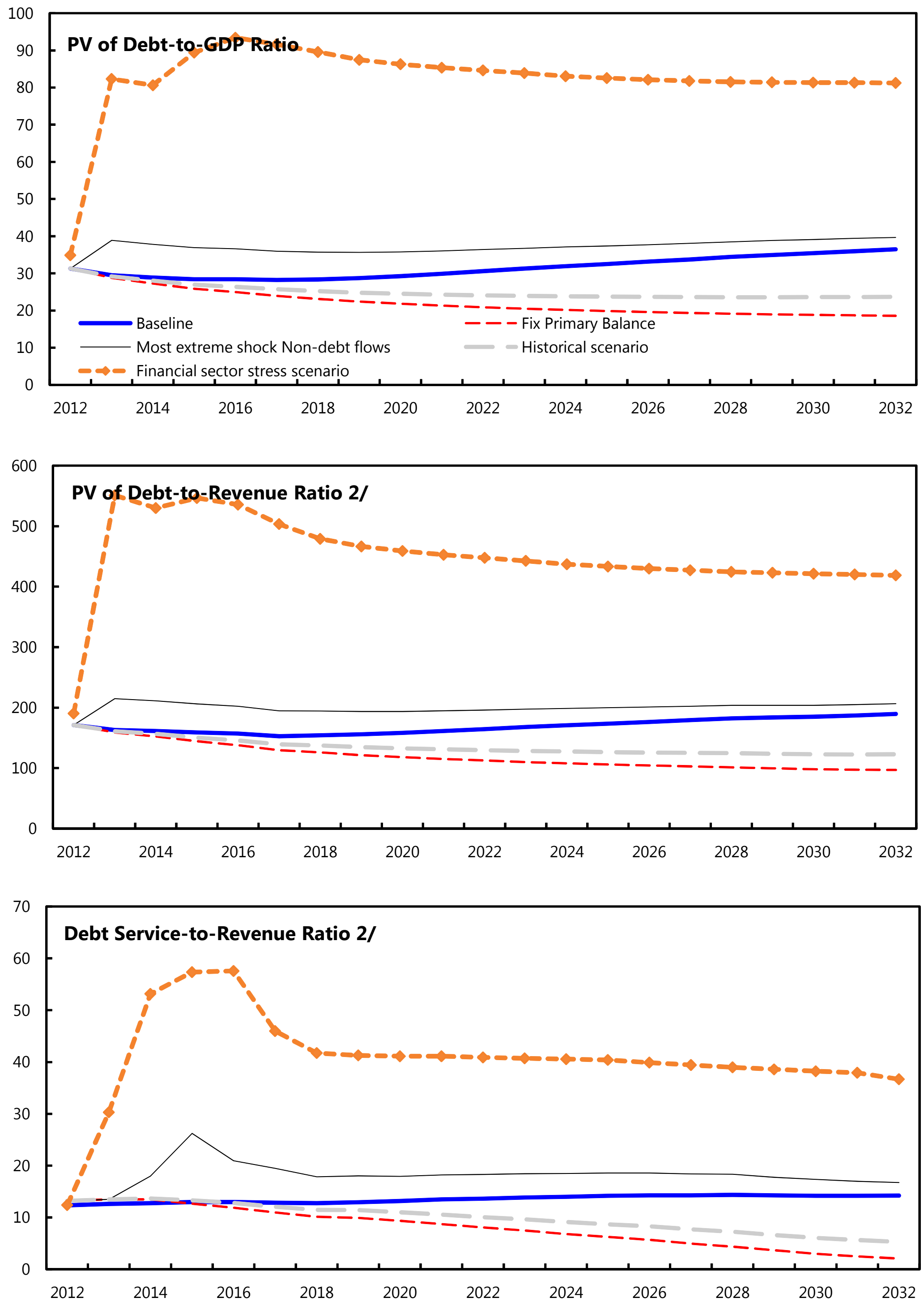
Figure 1. Nepal: Indictors of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2012–2032 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2022. In figure b. it corresponds to a Non-debt flows shock; in c. to a Combination shock; in d. to a Non-debt flows shock; in e. to a Combination shock and in figure f. to a Financial sector stress scenario shock

Figure 2. Nepal: Indicators of Public Debt Under Alternative Scenarios, 2012–2032 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2022.

2/ Revenues are defined inclusive of grants.

Table 1a.Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2009-2032
(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections								
	2009	2010	2011			2012	2013	2014	2015	2016	2017	2012-17 Average	2022	2032	2018-32 Average
Public sector debt 1/	39.3	35.4	33.3			33.3	31.3	30.7	30.4	30.5	30.4		32.9	39.5	
o/w foreign-currency denominated	26.3	22.1	18.7			20.5	17.7	16.3	15.2	14.5	13.6		10.7	11.6	
Change in public sector debt	-1.9	-3.9	-2.1			0.0	-2.0	-0.6	-0.3	0.1	-0.2		0.7	0.5	
Identified debt-creating flows	-0.7	-5.9	-3.5			1.7	-1.9	-0.6	-0.4	0.0	-0.3		0.5	0.3	
Primary deficit	2.2	0.9	1.1	0.8	1.0	0.4	1.1	1.3	1.5	1.5	1.4	1.2	2.1	2.1	2.0
Revenue and grants	16.8	18.0	17.7			18.3	18.1	17.9	17.9	18.1	18.5		18.6	19.2	
of which: grants	2.7	3.2	3.3			2.6	2.3	2.0	1.9	1.9	1.9		1.8	1.8	
Primary (noninterest) expenditure	19.0	19.0	18.7			18.7	19.2	19.2	19.4	19.6	19.9		20.7	21.3	
Automatic debt dynamics	-3.1	-6.9	-4.5			1.3	-2.9	-1.8	-1.7	-1.2	-1.5		-1.3	-1.6	
Contribution from interest rate/growth differential	-2.9	-2.8	-1.9			-1.7	-1.2	-1.2	-1.3	-1.2	-1.1		-1.0	-1.2	
of which: contribution from average real interest rate	-1.1	-1.0	-0.6			-0.2	0.0	-0.1	-0.1	0.0	0.1		0.3	0.3	
of which: contribution from real GDP growth	-1.8	-1.8	-1.3			-1.5	-1.2	-1.2	-1.1	-1.2	-1.2		-1.2	-1.5	
Contribution from real exchange rate depreciation	-0.2	-4.1	-2.6			3.0	-1.7	-0.6	-0.5	0.0	-0.4		...	...	
Other identified debt-creating flows	0.2	0.1	0.0			-0.1	-0.1	-0.2	-0.2	-0.2	-0.2		-0.3	-0.2	
Privatization receipts (negative)	0.2	0.1	0.0			-0.1	-0.1	-0.2	-0.2	-0.2	-0.2		-0.3	-0.2	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-1.2	2.0	1.3			-1.7	0.0	0.0	0.1	0.1	0.1		0.2	0.2	
Other Sustainability Indicators															
PV of public sector debt	...	...	31.7			31.3	29.5	28.9	28.4	28.4	28.2		30.6	36.5	
o/w foreign-currency denominated	...	...	17.0			18.6	15.9	14.4	13.2	12.4	11.4		8.4	8.6	
o/w external	...	...	17.0			18.6	15.9	14.4	13.2	12.4	11.4		8.4	8.6	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	6.0	4.4	4.8			3.9	4.5	4.8	5.2	5.2	5.2		6.6	7.3	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	179.1			171.1	163.0	161.2	158.9	157.1	152.7		164.5	189.7	
PV of public sector debt-to-revenue ratio (in percent)	...	...	219.5			199.6	186.2	181.1	177.7	175.1	169.8		181.8	208.8	
o/w external 3/	...	...	118.1			118.5	100.3	90.5	82.6	76.6	68.7		50.2	49.3	
Debt service-to-revenue and grants ratio (in percent) 4/	16.2	13.2	14.5			12.3	12.6	12.8	13.0	13.0	12.8		13.6	14.2	
Debt service-to-revenue ratio (in percent) 4/	19.3	16.1	17.8			14.4	14.4	14.3	14.5	14.5	14.3		15.1	15.6	
Primary deficit that stabilizes the debt-to-GDP ratio	4.1	4.8	3.2			0.4	3.1	1.9	1.8	1.4	1.6		1.3	1.5	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	4.5	4.8	3.9	3.8	1.6	4.6	3.8	3.9	3.9	4.0	4.0	4.0	4.0	4.0	4.0
Average nominal interest rate on forex debt (in percent)	0.9	1.0	0.9	1.0	0.0	1.9	2.0	2.0	1.9	1.9	1.9	1.9	1.4	0.8	1.2
Average real interest rate on domestic debt (in percent)	-9.0	-8.1	-3.5	-2.3	3.9	-2.4	-1.7	-1.5	-1.3	-0.4	0.4	-1.1	1.4	1.4	1.3
Real exchange rate depreciation (in percent, + indicates depreciation)	-0.8	-16.4	-12.5	-5.3	7.5	16.9	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	15.9	15.1	10.4	7.9	4.5	8.7	8.3	8.1	7.9	6.9	6.1	7.7	5.0	5.0	5.1
Growth of real primary spending (deflated by GDP deflator, in percent)	19.3	4.6	2.6	2.7	6.0	4.4	6.7	4.1	4.9	4.8	5.5	5.1	4.7	4.0	4.5
Grant element of new external borrowing (in percent)	...	...	...	...	...	36.0	35.9	35.7	35.5	35.3	35.1	35.6	34.2	32.5	...

Sources: Country authorities; and staff estimates and projections.
1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues excluding grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2a.Nepal: Sensitivity Analysis for Key Indicators of Public Debt 2012-2032

		Projections						
	2012	2013	2014	2015	2016	2017	2022	2032
PV of Debt-to-GDP Ratio								
Baseline	31	30	29	28	28	28	31	36
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	31	29	28	27	26	26	24	24
A2. Primary balance is unchanged from 2012	31	29	27	26	25	24	21	19
A3. Permanently lower GDP growth 1/	31	30	29	29	29	29	34	47
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2013-2014	31	30	30	30	31	31	35	43
B2. Primary balance is at historical average minus one standard deviations in 2013-2014	31	30	30	29	29	29	31	37
B3. Combination of B1-B2 using one half standard deviation shocks	31	30	29	29	29	29	33	40
B4. One-time 30 percent real depreciation in 2013	31	36	35	34	34	33	34	38
B5. 10 percent of GDP increase in other debt-creating flows in 2013	31	39	38	37	37	36	36	40
PV of Debt-to-Revenue Ratio 2/								
Baseline	171	163	161	159	157	153	165	190
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	171	161	157	150	146	139	130	123
A2. Primary balance is unchanged from 2012	171	159	152	145	138	130	112	97
A3. Permanently lower GDP growth 1/	171	164	163	162	162	159	183	245
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2013-2014	171	166	169	169	170	167	189	226
B2. Primary balance is at historical average minus one standard deviations in 2013-2014	171	166	166	164	162	157	168	192
B3. Combination of B1-B2 using one half standard deviation shocks	171	165	163	162	162	159	176	207
B4. One-time 30 percent real depreciation in 2013	171	201	197	192	188	181	184	197
B5. 10 percent of GDP increase in other debt-creating flows in 2013	171	215	211	206	202	195	196	206
Debt Service-to-Revenue Ratio 2/								
Baseline	12	13	13	13	13	13	14	14
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	13	13	14	13	13	12	10	5
A2. Primary balance is unchanged from 2012	13	13	13	13	12	11	8	2
A3. Permanently lower GDP growth 1/	13	14	14	14	14	14	16	20
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2013-2014	13	14	14	15	15	15	17	19
B2. Primary balance is at historical average minus one standard deviations in 2013-2014	13	13	14	15	15	14	15	15
B3. Combination of B1-B2 using one half standard deviation shocks	13	14	14	14	14	14	15	16
B4. One-time 30 percent real depreciation in 2013	13	15	17	17	17	17	17	17
B5. 10 percent of GDP increase in other debt-creating flows in 2013	13	13	18	26	21	19	18	17

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

Table 3a.: External Debt Sustainability Framework, Baseline Scenario, 2009-2032 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2009	2010	2011			2012	2013	2014	2015	2016	2017	2012-2017 Average	2022	2032	2018-2032 Average
External debt (nominal) 1/	26.3	22.1	18.7			20.5	17.7	16.3	15.2	14.5	13.6		10.7	11.6	
o/w public and publicly guaranteed (PPG)	26.3	22.1	18.7			20.5	17.7	16.3	15.2	14.5	13.6		10.7	11.6	
Change in external debt	-2.0	-4.2	-3.4			1.9	-2.9	-1.4	-1.1	-0.7	-1.0		-0.3	0.2	
Identified net debt-creating flows	-5.0	-3.0	-3.0			-6.1	-1.8	-0.9	-0.6	-0.4	0.0		-0.9	-0.6	
Non-interest current account deficit	-4.4	2.2	0.8	-2.0	2.2	-5.0	-1.0	0.0	0.3	0.6	0.9		0.0	0.5	0.3
Deficit in balance of goods and services	22.1	26.9	24.2			22.8	27.8	28.1	28.3	28.6	28.9		27.9	24.3	
Exports	12.3	9.6	9.0			9.8	9.6	9.6	9.6	9.6	9.6		8.9	7.4	
Imports	34.5	36.6	33.2			32.6	37.5	37.7	37.9	38.1	38.5		36.9	31.7	
Net current transfers (negative = inflow)	-25.1	-23.8	-22.7	-19.4	3.7	-26.7	-27.6	-27.0	-26.9	-26.9	-27.0		-27.2	-23.2	-25.9
o/w official	-2.5	-1.9	-1.7			-2.0	-1.7	-1.1	-1.1	-1.0	-1.0		-1.0	-1.1	
Other current account flows (negative = net inflow)	-1.4	-1.0	-0.7			-1.1	-1.1	-1.1	-1.1	-1.1	-0.9		-0.7	-0.6	
Net FDI (negative = inflow)	-0.2	-0.2	-0.5	-0.1	0.2	-0.6	-0.5	-0.6	-0.6	-0.7	-0.7		-0.7	-0.7	-0.7
Endogenous debt dynamics 2/	-0.4	-4.9	-3.3			-0.5	-0.4	-0.3	-0.3	-0.3	-0.3		-0.3	-0.3	
Contribution from nominal interest rate	0.3	0.2	0.2			0.3	0.4	0.3	0.3	0.3	0.3		0.1	0.1	
Contribution from real GDP growth	-1.3	-1.0	-0.7			-0.8	-0.7	-0.6	-0.6	-0.6	-0.5		-0.4	-0.4	
Contribution from price and exchange rate changes	0.6	-4.1	-2.8			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	3.0	-1.3	-0.4			8.0	-1.0	-0.5	-0.5	-0.3	-0.9		0.6	0.8	
o/w exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	17.0			18.6	15.9	14.4	13.2	12.4	11.4		8.4	8.6	
In percent of exports	...	...	190.0			189.9	164.8	150.2	138.3	130.0	118.3		94.6	116.5	
PV of PPG external debt	...	...	17.0			18.6	15.9	14.4	13.2	12.4	11.4		8.4	8.6	
In percent of exports	...	...	190.0			189.9	164.8	150.2	138.3	130.0	118.3		94.6	116.5	
In percent of government revenues	...	...	118.1			118.5	100.3	90.5	82.6	76.6	68.7		50.2	49.3	
Debt service-to-exports ratio (in percent)	10.2	11.5	11.0			12.3	12.8	12.0	11.5	10.7	9.8		5.8	3.8	
PPG debt service-to-exports ratio (in percent)	10.2	11.5	11.0			12.3	12.8	12.0	11.5	10.7	9.8		5.8	3.8	
PPG debt service-to-revenue ratio (in percent)	8.9	7.5	6.9			7.6	7.8	7.3	6.9	6.3	5.7		3.1	1.6	
Total gross financing need (Billions of U.S. dollars)	-0.4	0.5	0.2			-0.9	0.0	0.1	0.2	0.3	0.3		-0.1	0.0	
Non-interest current account deficit that stabilizes debt ratio	-2.4	6.4	4.2			-6.9	1.9	1.4	1.4	1.3	1.9		0.3	0.3	
Key macroeconomic assumptions															
Real GDP growth (in percent)	4.5	4.8	3.9	3.8	1.6	4.6	3.8	3.9	3.9	4.0	4.0	4.0	4.0	4.0	4.0
GDP deflator in US dollar terms (change in percent)	-2.0	18.4	14.5	8.4	6.5	-2.2	0.6	4.5	4.5	3.6	2.8	2.3	5.0	5.0	4.9
Effective interest rate (percent) 5/	0.9	1.0	0.9	1.0	0.0	1.9	2.0	2.0	1.9	1.9	1.9	1.9	1.4	0.8	1.2
Growth of exports of G&S (US dollar terms, in percent)	4.9	-3.3	10.8	2.9	20.6	11.7	2.8	8.2	8.1	7.9	7.7	7.7	7.2	7.1	7.2
Growth of imports of G&S (US dollar terms, in percent)	12.5	31.7	7.9	16.2	7.6	0.6	19.9	9.4	9.0	8.5	8.0	9.3	7.8	7.4	7.7
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	36.0	35.9	35.7	35.5	35.3	35.1	35.6	34.2	32.5	33.6
Government revenues (excluding grants, in percent of GDP)	14.2	14.8	14.4			15.7	15.8	15.9	16.0	16.2	16.6		16.8	17.5	17.0
Aid flows (in Billions of US dollars) 7/	0.4	0.9	0.8			0.6	0.6	0.6	0.6	0.7	0.7		1.0	2.5	
o/w Grants	0.3	0.5	0.6			0.5	0.5	0.4	0.5	0.5	0.5		0.7	1.8	
o/w Concessional loans	0.1	0.3	0.2			0.1	0.1	0.1	0.2	0.2	0.2		0.3	0.8	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			2.9	2.5	2.3	2.3	2.2	2.2		2.1	2.2	2.1
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			85.2	85.5	81.0	77.5	77.9	79.2		75.7	70.9	73.9
Memorandum items:															
Nominal GDP (Billions of US dollars)	12.9	16.0	19.0			19.4	20.3	22.0	23.9	25.8	27.6		42.0	101.4	
Nominal dollar GDP growth	2.5	24.1	18.9			2.3	4.4	8.6	8.6	7.8	7.0	6.4	9.2	9.2	9.1
PV of PPG external debt (in Billions of US dollars)			3.3			3.2	3.2	3.1	3.1	3.1	3.1		3.5	8.7	
(PVt-PVt-1)/GDPt-1 (in percent)						-0.2	-0.4	-0.2	-0.1	0.0	0.0	-0.1	0.4	0.9	0.6
Gross workers' remittances (Billions of US dollars)	2.7	3.1	3.5			4.4	4.8	5.2	5.6	6.1	6.5		10.1	20.8	
PV of PPG external debt (in percent of GDP + remittances)	...	...	14.4			15.2	12.9	11.7	10.7	10.1	9.2		6.8	7.1	
PV of PPG external debt (in percent of exports + remittances)	...	...	61.6			57.2	47.8	43.5	40.0	37.6	34.2		25.6	30.9	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	3.6			3.7	3.7	3.5	3.3	3.1	2.8		1.6	1.0	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

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

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

Table 3b.Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2012-2032
(In percent)

	Projections							
	2012	2013	2014	2015	2016	2017	**2022**	2032
PV of external debt-to-GDP+remittances ratio								
Baseline	15	13	12	11	10	9	**7**	7
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2012-2032 1/	15	11	9	7	5	3	**-1**	-4
A2. New public sector loans on less favorable terms in 2012-2032 2	15	13	12	11	11	10	**9**	11
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	15	13	12	11	10	9	**7**	7
B2. Export value growth at historical average minus one standard deviation in 2013-2014 3/	15	14	14	13	12	12	**9**	8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	15	12	12	11	10	9	**7**	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 4/	15	21	27	23	21	20	**15**	10
B5. Combination of B1-B4 using one-half standard deviation shocks	15	19	24	21	20	19	**14**	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	15	17	15	14	13	12	**9**	9
PV of external debt-to-exports+remittances ratio								
Baseline	57	48	43	40	38	34	**26**	31
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2012-2032 1/	57	44	36	29	22	14	**-5**	-25
A2. New public sector loans on less favorable terms in 2012-2032 2	57	48	44	42	39	37	**32**	46
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	57	47	43	39	36	34	**26**	31
B2. Export value growth at historical average minus one standard deviation in 2013-2014 3/	57	54	61	56	52	49	**37**	37
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	57	47	43	39	36	34	**26**	31
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 4/	57	104	130	85	80	75	**57**	41
B5. Combination of B1-B4 using one-half standard deviation shocks	57	97	127	90	84	79	**60**	44
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	57	47	43	39	36	34	**26**	31
PV of external debt-to-revenue ratio								
Baseline	119	100	90	83	77	69	**50**	49
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2012-2032 1/	119	88	70	54	39	23	**-7**	-25
A2. New public sector loans on less favorable terms in 2012-2032 2	119	100	92	86	80	75	**63**	73
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	119	100	92	84	76	69	**52**	51
B2. Export value growth at historical average minus one standard deviation in 2013-2014 3/	119	107	112	103	95	87	**64**	53
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	119	97	90	82	75	68	**51**	50
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 4/	119	151	189	176	163	151	**112**	66
B5. Combination of B1-B4 using one-half standard deviation shocks	119	139	175	162	150	139	**103**	63
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	119	140	127	116	105	96	**71**	70

Table 3b.Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2012-2032 (continued)

(In percent)

	Debt service-to-exports+remittances ratio							
Baseline	4	4	3	3	3	3	**2**	1
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2012-2032 1/	4	4	3	3	3	2	**1**	0
A2. New public sector loans on less favorable terms in 2012-2032 2	4	4	3	3	3	3	**2**	2
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	4	4	3	3	3	3	**2**	1
B2. Export value growth at historical average minus one standard deviation in 2013-2014 3/	4	4	4	4	4	3	**2**	1
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	4	4	3	3	3	3	**2**	1
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 4/	4	5	5	4	4	3	**2**	2
B5. Combination of B1-B4 using one-half standard deviation shocks	4	5	5	4	4	4	**2**	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	4	4	3	3	3	3	**2**	1
	Debt service-to-revenue ratio							
Baseline	8	8	7	7	6	6	**3**	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2012-2032 1/	8	7	6	6	5	4	**2**	0
A2. New public sector loans on less favorable terms in 2012-2032 2	8	8	7	7	7	6	**4**	3
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2013-2014	8	8	7	7	6	6	**3**	2
B2. Export value growth at historical average minus one standard deviation in 2013-2014 3/	8	8	7	7	7	6	**3**	2
B3. US dollar GDP deflator at historical average minus one standard deviation in 2013-2014	8	8	7	7	6	6	**3**	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2013-2014 4/	8	8	8	8	7	7	**4**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	8	8	7	7	7	6	**3**	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2013 5/	8	11	10	10	9	8	**4**	2
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	33	33	33	33	33	33	**33**	33

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

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IMF Executive Board Concludes 2012 Article IV Consultation with Nepal

On November 16, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Nepal.[1]

Background

Nepal remains in an important political transition, but the lack of political consensus complicates macroeconomic management. The dissolution of the constituent assembly in May has delayed significantly the passage of a full-year government budget for 2012/13 and other key pieces of legislation. Higher growth and progress in poverty reduction could be enabled by political consensus, policy stability, an easier labor environment, and more effective use of external support.

Macroeconomic performance improved in 2011/12 despite lingering financial sector vulnerabilities and an uncertain political environment. Real GDP growth accelerated to 4.6 percent, reflecting a strong agricultural harvest, and a vibrant services sector—driven partly by a resurgence of inward remittances. Average headline inflation declined to 8.3 percent on the back of subdued food prices, but nonfood inflation was over 9 percent. The balance of payments registered a record surplus, and the Nepal Rastra Bank's (NRB) foreign exchange reserves increased to $4.3 billion (6.8 months of imports). The government fiscal deficit was smaller than expected. Revenue targets were largely achieved, but capital expenditures were lower than budgeted. Public debt remained constant as a share of GDP. However, quasi-fiscal

[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. 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.

liabilities continued to rise through financial losses at the Nepal Electricity Authority and Nepal Oil Corporation.

Stress on the financial sector receded with strong remittances, but serious balance sheet and other risks remain. The influx of remittances eased liquidity conditions, allowing banks to unwind support provided by the NRB. Financial soundness indicators show some improvement, but concerns remain about the reliability of reported data. Profitability remains low and extension of new private sector credit was tepid. The authorities rendered support to bank balance sheets through accommodative monetary policy and extended forbearance, but have also strengthened supervision and regulation. Revision of the legal framework for bank resolution is under way, and recapitalization plans have been announced and partially implemented for two insolvent state banks. However, significant restructuring of the financial system has yet to emerge, and balance sheet risks from concentrated exposure to a moribund real estate market are high.

The outlook for 2012/13 is challenging. Real GDP growth is projected to decline to 3.8 percent, reflecting a weaker monsoon, and slower services activity as remittance growth may slow. Spillover effects from declining growth in India (through lower export demand, weaker inward investment, and possibly less remittances), and the dampening effect of continued political uncertainty will also present further challenges to growth in Nepal. Inflation is also on the rise, and upward pressure on prices may increase in line with projected developments in India over the next few months.

Against this background, the 2012 Article IV consultation focused on managing downside macroeconomic risks and addressing financial sector vulnerabilities.

Executive Board Assessment

Executive Directors welcomed Nepal’s improved macroeconomic performance and progress on structural reforms despite the difficult political environment. However, Directors noted that downside risks are increasing because of spillover effects from the slowing Indian economy, a protracted political transition, and stresses in the financial sector. To secure macroeconomic stability and to foster sustainable and inclusive growth, Directors emphasized continued commitment to sound policies and structural reforms, particularly in the financial sector.

Directors advised continued fiscal prudence, consistent with the objective of keeping public debt roughly constant over the medium term. They called on the authorities to act expeditiously to pass a full-year budget for 2012/13 and to strengthen public financial management to ensure full execution of the capital budget. Directors stressed the need to address the quasi-fiscal liabilities arising from financial losses at the Nepal Oil Corporation and the Nepal Electricity Authority. Recognizing the difficult political situation, they encouraged the authorities to build consensus to gradually adopt an automatic price adjustment mechanism, while putting in place well-targeted subsidies to protect the vulnerable. Reform of the pension system should also be considered. Directors commended the enhanced revenue mobilization efforts but saw scope for further tax and customs administration reforms.

Directors welcomed the steps taken by the authorities to stabilize the financial sector. To address the underlying vulnerabilities and to strengthen the system, they emphasized the need for a targeted and well sequenced acceleration of financial sector reforms, including the amendment of NRB Act to improve the governance of the financial sector and the broadened prompt corrective action framework. Enhancing supervision and improving the quality of data will also be necessary for increasing financial sector stability. Directors also called for further progress on the AML/CFT framework. They welcomed the authorities’ interest in an FSAP.

Directors considered that a tightening of monetary policy appears warranted to signal commitment to price stability and support the exchange rate peg, which has served the country well. They agreed that open market operations and regular auction of T-bills should be used to mop up excess liquidity.

Directors concurred that accelerating the pace of structural reforms will be important to address competitiveness challenges, and achieve higher and more inclusive growth. Efforts should focus on enhancing the business environment, removing infrastructure bottlenecks, increasing transparency, and improving governance.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Nepal: Selected Economic Indicators [1]

	2009/10	2010/11	2011/12	2012/13
			Est.	Proj.
Output and prices (annual percent change)				
Real GDP	4.8	3.9	4.6	3.8
Non-agricultural GDP	5.4	3.4	4.3	3.7
CPI (period average)	9.5	9.6	8.3	8.3
CPI (end of period)	9.0	9.7	11.5	8.2
Fiscal Indicators (in percent of GDP)				
Total revenue and grants	18.0	17.7	18.3	18.1
Expenditure	18.8	18.6	18.2	18.6
Expenses	15.6	15.2	15.1	15.7
Net acquisition of Nonfinancial Assets	3.2	3.4	3.1	2.9
Net lending/borrowing	-0.8	-1.0	0.1	-0.5
Net acquisition of Financial Assets	1.0	1.0	1.5	1.6
Net Domestic Financing (above the line)	1.7	2.3	1.4	2.3
Money and credit (annual percent change)				
Broad money	14.1	12.3	22.7	12.5
Domestic credit	16.8	14.6	8.0	14.4
Private sector credit	14.2	13.9	11.3	13.0
Velocity	1.5	1.5	1.4	1.4
Investment and saving (in percent of nominal GDP)				
Gross investment	37.1	32.5	32.8	32.9
Private	30.0	25.3	25.7	26.0
Central government	7.1	7.3	7.1	6.9
Gross national saving	34.7	31.6	37.5	33.5
Balance of payments				
Current account (in millions of U.S. dollars)	-378	-181	909	128
In percent of GDP	-2.4	-1.0	4.7	0.6
Trade Balance (in millions of U.S. dollars)	-4,078	-4,470	-4,605	-5,540
In percent of GDP	-25.6	-23.6	-23.7	-27.3
Exports value growth (percent change)	-6.1	13.2	5.0	6.9
Imports value growth (percent change)	36.4	10.2	3.4	17.9
Gross official reserves (in millions of U.S. dollars)	2,844	3,085	4,307	4,595
In months of imports of goods and services	5.4	5.8	6.8	6.6
Memorandum items				
Public debt (percent of GDP)	35.4	33.3	33.3	31.3
GDP at market prices (in billions of Nepalese rupees)	1,193	1,368	1,557	1,750
GDP at market prices (in billions of U.S. dollars)	16.0	19.0	19.4	20.3
Exchange rate (Nrs/US$; period average)	74.8	72.1	80.2	…
Real effective exchange rate (eop, y/y percent change)	7.0	1.4	-4.6	…

Sources: Nepalese authorities; and IMF staff estimates and projections.
[1] Fiscal year ends mid-July.

Statement by Der Jiun Chia, Executive Director for Nepal and Chaipat Poonpatpibul, Senior Advisor November 16, 2012

1. Our Nepalese authorities would like to thank the IMF mission team for the comprehensive assessment of the economy as well as the constructive policy dialogue during the 2012 Article IV consultation. Risks in the financial sector have abated, and macroeconomic conditions have improved since the last assessment. Notwithstanding these positive developments, our authorities are cognizant of the remaining challenges on both the economic and political fronts and continue to be committed to pursue policies to achieve sustained and inclusive growth and foster economic and financial stability.

Recent Developments and Macroeconomic Outlook

2. Despite the adverse prospects and sharply rising risks in 2010/11 particularly from the intensified stress in the banking sector and the prolonged political transition, the efforts by our authorities to restore confidence in the banking sector through liquidity provision, accommodative monetary policy, and strengthened supervisory framework together with favorable remittance proceeds helped prevent the problems that were concentrated in small financial institutions from spreading to the other parts of the system. The banking sector has since started to stabilize and the economy has begun to move back to its normal trajectory.

3. In addition to receding stress in the banking sector and strong remittances, robust growth in the services sector and favorable weather for agricultural production contributed to the 4.6 percent economic expansion in 2011/12 after a dip to 3.9 percent in 2010/11. For 2012/13, although staff's growth projection is 3.8 percent, our authorities expect that it would not be lower than 4 percent as the services sector has continued to perform well, significant progress has been made in resolving the banking sector problems, and remittances have continued to be at high levels albeit with relatively softer growth.

4. On the economic stability side, average inflation declined to 8.3 percent in 2011/12 and is expected to remain within the NRB's target of 7.5 percent in 2012/13, assuming the likely economic slowdown in India, stable exchange rate, and slower money growth. The primary fiscal balance recorded a lower deficit in 2011/12 than in 2010/11, owing to slower capital spending relative to rising revenue mobilization as a result of reform efforts. However, the recent data show that both government revenue and spending in the first month of 2012/13 grew significantly from the same period in the previous year. With the strong outturn of remittances, the current account shifted to a notable surplus and the import coverage of Nepal Rastra Bank (NRB)'s foreign exchange reserves at mid-July, 2012 rose to as high as 8.8 months of imports of goods and services.[1]

[1] This number differs from the number in the Staff Report of 6.8 months of imports as the NRB used the current year's imports of goods and services as a denominator while the staff used the projected imports of goods and services of next year.

5. Notwithstanding the prospects of continued growth and some moderation of inflation, the authorities remain cautious about the risks on both the external and internal fronts. They recognize that India's as well as global slowdown is a major external risk to growth with potentially sizeable impact on remittances, exports, as well as foreign investment. It is also still not clear if the real estate sector is out of the woods. In addition, they are aware that the prolonged political uncertainty can affect fiscal budget implementation and investment decisions of the private sector. Fragility in the financial sector also continues to be an important risk. On the inflation front, they see that higher global fuel prices and some supply-side bottlenecks could emerge as significant drivers of inflation in the future.

Fiscal policy

6. Our authorities are fully committed to maintaining fiscal discipline even during the ongoing political transition period. They recognize that an immediate priority is to pass a full-year budget to ensure timely execution of the envisaged spending in the remaining period of the fiscal year 2012/13. The ruling political parties are exerting full efforts to gather support to pass this budget and, in the case further delay, the current administration will consider to authorize spending through executive orders. Against the shortfall in 2011/12, capital spending is expected to increase in 2012/13 with its declaration as "Nepal Investment Year" to attract foreign investment and the establishment of the new Investment Board in charge of promoting large investment projects.

7. On the revenue side, with the enhanced efforts on revenue mobilization assisted by the Fund experts, the ratio of tax to GDP has reached 15.7 percent in 2011/12. Further efforts will focus on expanding the tax base, executing tax law compliance, controlling revenue leakage, and strengthening human resource development. Our authorities recognize that there is scope to further enhance revenue and view that the main challenge is to increase domestic taxation and reduce reliance on import taxes. The Fund's further technical support in this area is highly appreciated and it will continue to be crucial for further progress.

8. With significant quasi-fiscal implications, continued deficits at the National Oil Corporation (NOC) and the National Electricity Authorities (NEA) need to be addressed. Tackling this problem through implementing an "automatic price mechanism" together with providing well-targeted subsidies to the vulnerable groups is an option; however, this is not an ideal choice under the current political transition period. Likewise, our authorities are open to discuss pension reform and the desirable modalities but this area of reform also needs to await decisions of the new government.

Monetary and exchange rate policy

9. Monetary policy in Nepal has been formulated with the objectives of maintaining price, external sector, and financial sector stability, as well as promoting financial access to the general public and facilitating sustainable economic growth. In 2012/13, the targets include limiting inflation at 7.5 percent, maintaining foreign reserves equivalent to at least 8 months to imports, and attaining credit growth of 15 percent to support economic growth.

Monetary management would be carried out cautiously by closely taking into account the risks to inflation from volatile oil prices in the international market and increasing domestic demand on one hand and possible adverse impact on economic growth and financial sector stability from inadequate liquidity and credit growth on the other hand.

10. Our authorities view that maintaining the pegged exchange rate with the Indian Rupee is still appropriate as a means to maintain economic stability as it provides a transparent and stable anchor for the conduct of monetary policy. They would closely monitor interest rate differentials between India and Nepal and cross-border flows. They view that deposit rate differentials are the main factor behind cross-border capital flows rather than interbank rate differentials. As the former is significantly less than the latter, they assess that an occurrence of capital flight is less likely than in the staff's assessment. In this regard, they regard the peg as appropriate, but are open to review this if conditions change and no longer support it.

Financial Sector

11. Our authorities view that the actions to resolve the problems in 2011/12 in effect have helped stabilize the banking sector. Nonetheless, they still see the need to push forward with further financial sector reforms to address the remaining challenges and strengthen the system as a whole, while taking into account impact on the real sector during the course of the reforms. They view that the reform pace needs to be appropriate to the circumstances and the financial landscape in Nepal. Further initiatives will focus on ensuring timely amendment of the relevant acts, bylaws and licensing policies, strengthening the capital base of financial institutions, implementing risk-based supervision system, enhancing regulatory and supervisory capacity, and promoting financial access to the general public especially in the rural areas.

12. For the key legal reforms, both the amended draft of Nepal Rastra Bank Act, 2002 to increase effectiveness of NRB as a financial institution regulator and the revised draft Bill of the Bank and Financial Institutions Act (BAFIA), 2006 that addresses major issues related to liquidation procedures of financial institutions have been submitted to the parliament. However, due to an absence of parliament, the authorities are trying to legalize these laws through issuing ordinance. Being cognizant that the proliferation of banks has continued to overstretch supervisory capacity of the NRB, moratorium of licensing to commercial banks, development banks and finance companies has been extended except to "D" class financial institutions (micro finance). Meanwhile, the threshold of deposit insurance has been increased to NPR 300,000 from 200,000 to protect the small depositors and enhance depositor's confidence towards financial institutions whereas a modified Deposit Guarantee Act that would incorporate the explicit procedure of deposit payments would be drafted and presented to the future parliament.

Structural Policies

13. Structural reforms on various fronts will continue to be further strengthened. Removing structural bottlenecks especially in electricity generation will help raise potential output of the country. In this regard, a total of 70 megawatt of electricity would be increased

in 2012/13 from the completion of six different hydropower projects. In addition, the authorities have decided to form a steering committee across the government and with the private sector and development partners to further accelerate hydropower development. The formation of the new Investment Board under the chairmanship of the Prime Minister and the recent Bilateral Investment Promotion and Protection Agreement (BIPPA) with India are the major new steps to increase investment in infrastructure and improve the business climate.

Final Remark

14. Although tail risks have abated, and the overall macroeconomic prospects have improved, our Nepalese authorities recognize that the period ahead will continue to be challenging with significant risks on both the internal and external fronts. Hence, the focus of policies will be on ensuring economic and financial sector stability and simultaneously pursuing inclusive growth through enhanced efforts on structural reforms. Our authorities view that continued engagement with the Fund has been very helpful in keeping policies in Nepal on a sound footing and therefore are open to discuss a potential IMF program if the need arises.