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NEPAL

July 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR NEPAL

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 2014 Article IV consultation with Nepal, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 3, 2014, following discussions that ended on April 22, 2014, 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 June 17, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- A **Staff Statement** of July 3, 2014 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its July 3, 2014 consideration of the staff report that concluded the Article IV consultation with Nepal.
- A **Statement by the Executive Director** for Nepal.

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

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INTERNATIONAL MONETARY FUND

NEPAL

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

June 17, 2014

KEY ISSUES

Context: Successful elections for a new Constituent Assembly and formation of a new government have stabilized the political situation.

Macroeconomic situation and outlook: Nepal's macroeconomic situation remains broadly favorable. Growth is projected to recover in 2013/14 owing to good monsoons, robust growth in services, and increased public spending. Inflation is moderating, in line with developments in India. High remittance inflows are supporting a strong external position, as well as high reserve money growth. Risks to the outlook are slightly tilted to the downside, involving slower-than-expected growth in countries hosting Nepali workers and domestic financial sector risks.

Medium term prospects: While remittances are expected to continue to support the external position, the outlook for growth depends on improving the environment for private investment. This requires a decisive boost in public capital spending, and structural reforms in key areas.

Financial sector: Despite progress, significant vulnerabilities remain. The recent assessment under the FSAP, Nepal's first, raised concerns about asset quality and interconnectedness, as well as financial sector infrastructure—including the legal framework—and supervision and crisis preparedness. At the same time, a largely unsupervised cooperatives sector is growing rapidly.

Key policy recommendations: Monetary policy should aim at controlling the volatility and level of excess reserves in the financial system, implying a modest tightening of monetary conditions. The exchange rate peg to the Indian rupee provides a useful nominal anchor for the economy, and the real exchange rate is broadly in line with fundamentals. Capital spending needs to be boosted to provide key infrastructure, and reforms implemented to support private investment, which will help generate sustained economic growth and employment opportunities. In the financial sector, further reforms to bolster regulation and supervision, and improve financial infrastructure are needed to reduce risk and increase access to finance.

Approved By
Paul Cashin and Ranil Salgado

Discussions took place in Kathmandu during April 9-22, 2014. The staff team comprised Mr. Pitt (head), Messrs. Ojima and Mohommad (all APD), and Mr. Mathieu (MCM), and was assisted by Mr. Richardson (Senior Resident Representative for India/Nepal). Messrs. Ghaffour and Kharel (both OED) also participated. May Inoue, Michael Dalesio, and Qianqian Zhang (all APD) assisted in the preparation of this report.

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INTRODUCTION

1. Political uncertainty has receded after successful elections for a new Constituent Assembly (CA) in November 2013. The Maoist party—the largest party in the previous CA—lost in a landslide, winning only 14 percent of seats. The two other main parties—Nepali Congress and United Marxist-Leninists (UML)—won 34 percent and 30 percent of the vote, respectively, and are the main partners in the governing coalition. The previous CA, elected in April 2008, had been dissolved in May 2012, following repeated changes of government and failure to draft a new constitution.

2. Remittances have led to improvements in living standards, but may be weakening external competitiveness. Remittances from an estimated 2.2 million workers abroad (8 percent of the population) are projected to rise to almost 30 percent of GDP in 2013/14, considerably larger than the 9 percent of GDP in 2000. At the same time, the poverty headcount fell from 55 percent in 1995 to 25 percent in 2011. However, remittances may also erode competitiveness, as suggested by rising wages and declining shares of exports and industry in GDP, and weaken the impulse for policy reforms.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

A. Recent Developments

3. The macroeconomic situation remains solid, but growth is low. GDP growth slowed to below 4 percent in 2012/13, largely due to a weather-related weakening in agricultural output, but the delay in passing a full budget also resulted in low capital spending and a fiscal surplus.[1] Inflation rose to over 10 percent y/y in December 2013 in the wake of the depreciation of the Indian rupee, but moderated to 8.9 percent y/y in March 2014. Growth of remittances rose to 17½ percent in the first eight months of 2013/14, partly on account of the depreciation. This fueled further build-up of international reserves, which stood at $5.8 billion (8.1 months of prospective imports) in March. High remittance inflows also drove reserve money growth of 30½ percent y/y in March, though private sector credit growth slowed to 15½ percent y/y. Despite efforts to accelerate spending, capital expenditure remained low.

4. The authorities have made efforts to implement IMF policy advice, but have been hampered by political uncertainty. Progress has been made toward consolidating the financial sector, and the Nepal Rastra Bank (NRB) has begun to strengthen supervision, including with technical assistance (TA) from the IMF and donors. A full budget was passed on time for 2013/14, the treasury single account (TSA) has been rolled out to all 75 districts, and reforms in revenue administration are ongoing (with IMF TA). However, monetary policy has remained loose, and

[1] The fiscal year ends in mid-July.

non-transparent implicit subsidies to the Nepal Oil Corporation (NOC) and Nepal Electricity Authority (NEA) continue.

B. Outlook

5. The macroeconomic outlook is broadly stable. Output growth is expected to pick up to around 4¾ percent in 2013/14, driven by a recovery in agriculture, strong services, and higher public spending. Inflation is projected to moderate further (in line with declining Indian inflation) but remain high, at 8 percent (y/y). The current account surplus is forecast to rise to over 4 percent of GDP on account of remittances. Capital spending should accelerate in the last quarter, in line with previous patterns, contributing to net incurrence of financial liabilities projected at 1¼ percent of GDP. Private sector credit growth is expected to accelerate slightly. In 2014/15, growth is projected to increase somewhat as confidence improves, and inflation to moderate with India's inflation. The current account surplus is expected to decline, as remittance growth slows.

6. Medium-term prospects hinge on improving the environment for private investment. While remittances are expected to continue to support the external position, the outlook for growth will remain modest in the absence of a decisive boost in public capital spending to crowd in private investment, and structural reforms in the financial sector, and telecommunications, competition, labor market, and business regulation reforms. Growth is projected to remain at around 4½ percent in the medium term, with gradual improvements in execution of the capital expenditure budget supporting activity as remittance growth moderates. The external position is expected to remain strong, with international reserves high.

7. Risks to the outlook are somewhat tilted to the downside (Annex 1). With limited links to global financial markets, external risks to the outlook stem mainly from a slower-than-projected recovery in India (Box 1), or a slowdown in countries that host Nepali workers. Domestic risks arise from the financial sector, especially from the large number of weak smaller banks and the largely unsupervised cooperatives sector, and from a potential failure to further improve the political climate. On the other hand, a decisive reform push and increase in public investment would likely boost private investment, raising growth beyond baseline projections. A debt sustainability analysis (DSA) indicates that Nepal is at low risk of debt distress, due to reduced estimates of the cost of a potential banking sector crisis, and the increase in the discount rate used to assess LICs' debt burden. This is a significant improvement compared to the previous DSA, which indicated a moderate risk of debt distress (Appendix 1).

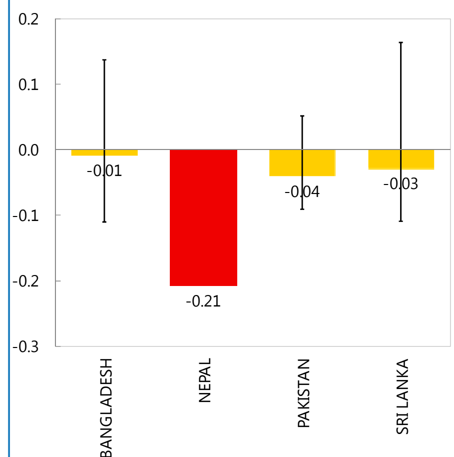
Authorities' Views

8. The authorities broadly concurred with the staff's assessment, but thought that growth could be higher, on account of stronger growth in services. They also pointed to their plans to accelerate capital spending, and spur credit to productive sectors (especially agriculture, hydroelectric power, industry, and tourism). With regard to risks, they emphasized that further improvement of the political climate was a prerequisite for higher private sector investment.

Box 1: Spillovers from India

Nepal has a close economic relationship with India, with the open border facilitating movement of goods and labor. However, trade and remittance flows do not suggest large spillovers from India to Nepal. While India is Nepal's largest trading partner, exports constitute a small share in Nepal's GDP, limiting the potential impact of a slowdown in Indian demand. Remittances from India are estimated to account for only 10 percent of total remittances received by Nepal; 90 percent originate from other destinations, primarily Persian Gulf states and Malaysia. With the closed capital account, international financial linkages are also limited (the open border does not appear to have led to significant cross-border capital movement). While econometric evidence suggests that the impact on Nepal from a shock to India's growth is the highest among South Asian peers, the overall effect is modest (Cashin and Raissi, IMF Country Report No. 14/58).

Responses of Output to a Negative GDP Shock in India



Note: Depicts annual percent change in output of a given country associated with 1% decline in GDP of India, together with the 16th and 84th percentile error bands.

POLICY DISCUSSIONS

The key to Nepal's development and growth is boosting the domestic economy in the presence of continued strong remittance inflows, which are among the highest in the world. This requires well-coordinated financial, fiscal, and structural policies.

A. Exchange Rate Policy

9. The level of the exchange rate appears broadly in line with fundamentals (Box 2). However, remittances skew domestic activity to non-tradables and contribute to reducing the competitiveness of agriculture and industry.

10. International reserves are high, by a range of measures (Text Table). Reserve coverage, after peaking in 2015/16, is projected to stabilize at around 8½ months of prospective imports in the medium term, as remittance growth is expected to moderate and investment increase gradually.

11. The peg to the Indian rupee serves as a transparent anchor. It continues to benefit Nepal in view of its close economic relationship with India. Moreover, the recent Indian rupee depreciation has boosted Nepal's competitiveness vis-à-vis third countries. At the current juncture an "engineered depreciation" or devaluation against the Indian rupee would in the short run likely lead to additional remittance inflows, boosting international reserves and liquidity

Box 2: Exchange Rate Assessment

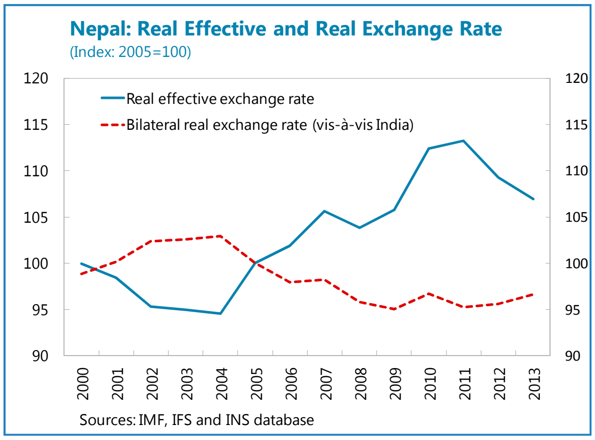
CGER-type analyses that take into account remittances point to an exchange rate broadly in line with fundamentals, despite high current account surpluses and continued accumulation of international reserves. The estimate under the macroeconomic balance approach suggests some undervaluation, while the external sustainability approach indicates slight overvaluation. However, data limitations and rapid structural change in the economy make these estimates unreliable, as indicated by the wide range of the results in the macroeconomic balance approach.

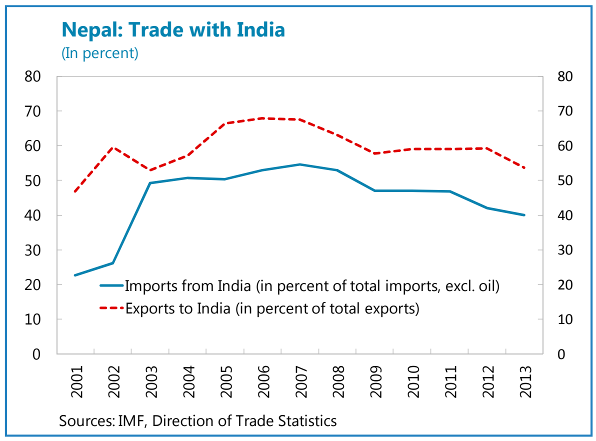
Nepal: Exchange Rate Assessment 1/

	Lower	Mean	Upper
Macroeconomic Balance	-32.3	-8.7	8.3
External Sustainability	---	2.4	---

1/ + (-) is over(under)valuation.

Alternative indicators also suggest that the level of the exchange rate is broadly appropriate. With the appreciation of the Indian rupee against third currencies in the past decade, and relatively high levels of inflation, Nepal's real effective exchange rate (REER) has broadly appreciated. However, the bilateral real exchange rate with India, Nepal's largest trading partner, has depreciated by 6 percent over the past decade. Moreover, the recent depreciation of the Indian rupee has helped to reduce the REER as well.





beyond baseline projections. It would also trigger inflationary pressures, necessitating a sharp tightening of monetary policy to lock in any competitiveness gains. This could cause additional stress in a still-weak financial system.

Table: Reserve Adequacy

	Jul-11	Jul-12	Jul-13	Mar-14
Gross international reserves				
In millions of U.S. dollars	3,085	4,307	4,972	5,846
In months of prospective GNFS imports	5.8	7.2	7.4	8.1
In percent of foreign currency deposts	1,070	2,233	1,780	1,614
In percent of broad money	24	34	36	39
In percent of reserve money	94	120	134	153
Change in gross international reserves				
In millions of U.S. dollars since mid-July of prev. year	253	1,222	665	875
In percent of reserve money at mid-July of prev. year	9	37	19	24

Sources: Data provided by the Nepali authorities, and IMF staff estimates

Authorities' Views

12. The authorities agreed that the peg had provided stability during recent years of political turmoil. However, they pointed out that the parity had not been changed for two decades, even as India's growth had exceeded Nepal's by a wide margin. In this context, they were concerned about the appreciation of the REER in recent years, and Nepal's widening trade deficit.

B. Monetary Policy

Background

13. Excess liquidity has again built up rapidly, and is undermining the conduct of monetary policy. After a tightening of banks' liquidity in late 2012/13, excess liquidity rose again in 2013/14, fueled by remittance inflows and accumulation of government balances in the financial system. This has again pushed interbank and t-bill interest rates to very low levels, and begun to affect retail interest rates.

14. The NRB has attempted to reduce excess liquidity, with limited means and modest success. Over the course of the year, the NRB conducted reverse repo operations, using a total of Nrs 19.5 billion worth of treasury bills, out of its total stock of around Nrs 22 billion. This has succeeded in reducing excess liquidity from a peak of Nrs 70 billion in November 2013 (7 percent of total deposit) to around Nrs 40 billion in March 2014. However, nominal interest rates remain close to zero, as the liquidity overhang persists.

15. The NRB has instituted bank credit policies designed to stimulate lending and economic activity. Regulations mandating minimum shares of lending to deprived and productive sectors aim to encourage banks to explore new investment opportunities, and a cap on the spread between lending and deposit rates is intended to force banks to improve efficiency.

Staff Views

16. Harnessing the financial sector and remittances to support economic development is challenging. While the goal of channeling remittance inflows to productive investment is appropriate, care needs to be taken to avoid unintended consequences, and preserve financial sector soundness. Excess liquidity, and its high volatility, is undermining monetary management, could adversely affect asset quality, and acts to increase lending spreads. More broadly, monetary policy cannot compensate for the lack of infrastructure and other structural impediments to growth (see below).

17. Monetary policy should focus on controlling the volatility and level of excess liquidity in the banking system. This requires stepping up sterilization and/or raising required reserves, with appropriate consideration of cost sharing between the financial system and the budget. The NRB should more actively smooth short-term fluctuations in excess liquidity—partly caused by uneven capital spending over the course of the year—through open market operations (OMOs), and aim to reduce its level (this can also include injections of liquidity). Key steps are:

- *Government debt securities.* Additional issuance of treasury bills and bonds to the NRB is needed to provide room for OMOs. This would also provide the opportunity to build a yield curve. Alternatively, the NRB could issue its own securities, but this may fragment an already shallow market.

- *Strengthening institutional settings.* Enhanced cooperation between the NRB and the Ministry of Finance in forecasting revenue and expenditure flows could improve liquidity forecasts. Separating monetary from debt management considerations in monetary policy and operational decisions would increase the focus and credibility of the NRB's monetary policy. This could be supported by establishing a monetary policy committee at the NRB.

18. An interest rate corridor would further strengthen monetary management, a step under consideration by the authorities. It would limit interest rate volatility, facilitate liquidity management, and improve monetary policy transmission. It could also help reduce the interest rate differential with India and incentives for capital flight, though at present this problem appears small.

19. These measures would help tighten very loose monetary conditions. While the impact on inflation would be modest (Box 3), there is some room for leaning against still-high inflation, thereby supporting competitiveness. Higher interest rates could also curb relatively cheap consumer credit, and with it, imports.

20. Policies to direct lending and cap interest spreads are of limited effectiveness, and can have unintended effects. They may undermine asset quality by pushing lending to weakly supervised micro-finance institutions and largely unsupervised cooperatives, and

Box 3: Inflation Determinants

Indian inflation is the key driver of Nepali inflation. The currency peg and close trade relations with India suggest that Nepal effectively imports India's inflation. However, other factors also play a role in generating inflation, albeit a relatively small one.

Determinants of Nepalese Inflation

Dependent variable: $\Delta\ln(CPI)_t$

	Coeff/(SE)
$\Delta\ln(CPI)_{t-1}$	0.37***
	(0.06)
$\Delta\ln(CPI\_India)_t$	0.45***
	(0.08)
$\Delta\ln(Broad\ Money_{t-1})$	0.12**
	(0.05)
$\Delta\ln(NEER_{t-1})$	-0.06
	(0.019)
Constant	-0.010
	(0.04)
Observations	152
R-squared	0.41

Notes:
Standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1
Sample: March 2001-December 2013

Econometric estimates suggest that Indian inflation has the most significant impact on Nepali inflation, with a 1 percent increase in India's inflation leading to a 0.45 percent increase in Nepali inflation. Inflation expectations also play a significant role. Changes in broad money have a limited impact: a 1 percent increase in broad money growth corresponds to only a 0.1 percent increase in inflation. The effect of the lagged NEER is small and not statistically significant.

reduce quality standards for direct lending. In addition, a cap on spreads impedes longer-term lending and might discourage bank expansion into remote areas with higher operating costs and lower credit volumes than in urban areas. These effects run against the NRB's goals to expand access to financial services, and promote lending to productive sectors.[2] Against this background, these policies should be reviewed and modified, and eventually phased out. Promoting access to finance and investment lending could be achieved by other means (see below).

Authorities' Views

21. The authorities saw a significant role for the NRB in promoting growth. In their view, excess reserves were a result of banks failing to seek out lending opportunities and actively contribute to economic development, and they did not want to reward such inactivity through remunerated reserves or debt issuance to mop up liquidity (the Ministry of Finance also had reservations about the interest cost of sterilization bonds). They also did not regard excess liquidity as a cause for concern, as it had not translated into excessive lending or higher inflation. Nonetheless, they indicated that they were considering introducing an interest rate corridor, as well as issuance of sterilization bonds.

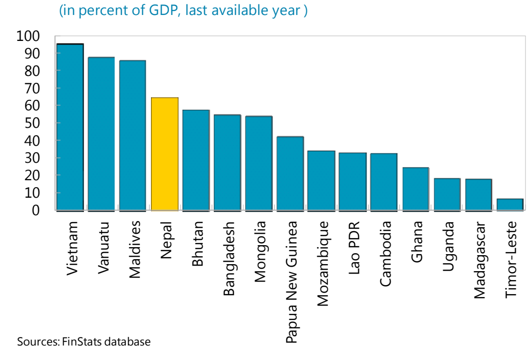
22. The authorities explained that demand for credit was high. Their directed lending and spread caps policies were meant to increase efficiency in financial intermediation by encouraging banks to lend to productive sectors that could contribute to development and job creation, while also encouraging savings. They were also of the view that the agricultural and hydroelectric power sectors had high growth potential but lacked financing, which necessitated NRB intervention. They also considered that enhancing supply by these sectors could reduce inflation. They pointed to prudential regulations on real estate lending and credit-to-deposit ratios that limited financial sector risk and would preclude an asset price bubble. However, they acknowledged that these policies could have unintended effects, such as hindering longer-term lending.

C. Financial Sector Policies

Background

23. Nepal's financial sector is large relative to peer countries. Liberal licensing policies in the past have led to proliferation of financial institutions. As of April 2014, the NRB regulated 30 Class A commercial banks, 86 Class B development banks, 56 Class C finance companies, and 35 Class D microfinance banks.

Domestic Bank Deposits
(in percent of GDP, last available year)



Sources: FinStats database
Note: last available year is 2012 for Nepal ,2010 for Lao PDR, and 2011 for all other countries.

[2] The NRB has also introduced regulations to link the opening of bank branches in the Kathmandu Valley to opening of branches in underbanked areas, and to increase transparency. These have been successful and should be retained.

The distinctions between Class A, B, and C banks have been eroded over time. In addition, a very large number (about 17,000) of credit cooperatives exist outside the NRB's supervisory perimeter. Nonetheless, despite a large increase in bank branches over the last decade, access to finance remains limited, especially in remote areas and for small and medium enterprises.

24. The number of financial institutions is declining, albeit slowly. The NRB is encouraging mergers, and developing banks and finance companies, in which public confidence is generally lower, are seeking to merge with commercial banks. The recently approved by-law on acquisitions should broaden options for further consolidation of the banking sector.

25. The authorities have made progress in addressing financial sector vulnerabilities. The NRB has conducted a special review of risk management practices in 20 banks (which were found to be deficient), and is conducting another special review of 54 banks representing over 50 percent of financial sector assets. The NRB is also gradually developing its crisis management capability, and a Supervision Coordination Committee under its leadership has been established to help monitor the cooperatives sector.

26. The legal framework is being strengthened. Draft amendments to the NRB Act to enhance the NRB's crisis management and supervision powers are being prepared, and the process of amending the Banking and Financial Institutions Act (BAFIA) to harmonize it with the amended NRB Act has begun. A new Deposit Insurance and Credit Guarantee Corporation Bill has been drafted. The newly-elected parliament has also enacted AML/CFT ordinances into law. This may facilitate Nepal's removal from the enhanced scrutiny of the Financial Action Task Force, which will review progress this June.

Staff Views

27. Notwithstanding this progress, Nepal's first-ever assessment under the Financial Sector Assessment Program (FSAP) identified significant financial sector vulnerabilities. Bank supervision remains largely compliance-based, fragmented, and underresourced. Nonperforming loans are likely underreported, evergreening is widespread, and stress tests suggest banking system strains if asset quality deteriorates moderately. Interconnections within the financial system and to other sectors are substantial, adding to concerns about lending practices. The largely unsupervised cooperatives sector is growing rapidly, partly fueled by directed lending policies, and poses a significant risk to the stability of the financial system. To reduce risks and strengthen the resilience of the financial system, and enhance access to finance, the assessment under the FSAP has laid out a number of key recommendations (Box 4).

28. Limited financial infrastructure is an impediment to stability and development. The payments system lacks redundancy and is handicapped by limited use of electronic means. Several laws on debt enforcement and insolvency systems have been enacted, but implementation has been ineffective and inconsistencies among laws give rise to disputes. Credit information is weak and there is limited use of the insolvency regime.

Box 4: Key FSAP Recommendations

Financial Stability

Significant further consolidation of the financial sector is needed. To avoid creating large, weak banks out of small, weak banks, and strengthen the financial system overall, the NRB should:

- Undertake a thorough asset quality review to identify problem loans in banks' balance sheets.
- Actively guide the bank consolidation process to ensure stronger banks emerge.
- Strengthen bank licensing regulations and policy to include adequate fit-and-proper criteria, a requirement for satisfactory risk management systems, and tighter standards for related parties and intra-group exposures.
- Be given special resolution powers to close insolvent banks, and those banks that do not meet tightened licensing standards after an adequate transition period.
- Be granted explicit consolidated supervision powers and amend the legal framework to incorporate a comprehensive definition of related parties and controlling interests.

Financial Sector Oversight and Crisis Management

Supervision, despite some recent improvements, requires significant further strengthening. Key actions are:

- Expedite implementation of a more risk-based approach to supervision and the integration of off- and on-site supervision (though capacity constraints will need to be taken into account).
- Supervisors should not hesitate to exercise judgment, and follow up more thoroughly on implementation of their recommendations.
- Exercise the NRB's corrective and sanctioning powers proactively, and amend the prompt corrective action framework to trigger stronger corrective action at an earlier stage.
- Increase staffing and analytical capacity, limit staff rotation, develop IT and management systems, and streamline the NRB Board's participation in operational decisions.
- Bring the Employment Provident Fund (EPF) and Citizens Investment Trust (CIT), two state-owned insurance providers, under joint supervision of the NRB and the Insurance Board,
- Significantly strengthen supervision of cooperatives by the Department of Cooperatives.
- Develop and coordinate agency-specific contingency plans, and carry out crisis simulations under the umbrella of the Interagency Coordination Committee, which should meet on a regular basis.

Financial Development and Infrastructure

Enhanced financial access and deepening could be promoted by the following steps:

- Clarify the mandate and reduce the number of state-owned banks.
- Accelerate the modernization of the payments system.
- Create a collateral registry, and eliminate the reporting threshold to the Credit Information Bureau.
- Improve and implement the debt enforcement and insolvency systems.

Authorities' Views

29. The authorities broadly agreed with staff recommendations. However, they pointed to resource constraints as well as the difficulty of closing financial institutions, though they indicated that the number of financial institutions has come down due to mergers of a number of development banks and finance companies. They also considered that re-licensing now would be disruptive and should be carried out gradually. With regard to joint supervision of the EPF and CIT, they noted that legal and institutional arrangements needed to be amended, and were being reviewed.

D. Fiscal Policy

Background

30. The fiscal position is solid, with public debt projected to decline to 30½ percent of GDP in 2013/14, but execution of the capital budget is sluggish. Revenue growth remained strong due to high import growth and ongoing administrative reforms in the Inland Revenue and Customs Departments. Grant inflows strengthened, mainly related to election spending. High revenue growth has financed large increases in current spending, including on salaries, wages and pensions. The authorities significantly raised the capital budget in 2013/14, even though execution remains difficult and the overall level remains low. However, capital spending is underrecorded as some transfers to local governments, accounted as expense, are used for capital formation.

Staff Views

31. Fiscal policy needs to support growth through higher public investment. Key areas with a large impact on potential growth are power generation and distribution, and transport. Investments in these areas would also likely crowd in private sector investment, as they would provide essential infrastructure for agriculture and industry. Spending on health and education has increased significantly in recent years, including with donor support. This should be continued. Care needs to be taken to monitor expenditures executed through local bodies.

32. There is ample fiscal space to finance additional investment and social spending. There is room for further growth in revenues, even if at decreasing rates. At the same time, with public debt low, a modest expansion of fiscal deficits is affordable without endangering debt sustainability. Further space should be created by reducing or eliminating implicit subsidies to the NOC. At the same time, the sustainability of current spending will need to be ensured. This applies in particular to civil service remuneration and pensions, which, though still low, could rise substantially over the longer run.

33. NOC losses need to be addressed to avoid the build-up of further liabilities.[3] Prices should be adjusted as needed to avoid recurrent losses and interruptions in supply, ideally through an automatic pricing mechanism, while protecting the poor. If some subsidies are required to this end, these should be transparently recorded.

34. Raising public investment requires reforms, including to the budget planning and execution processes. The planned introduction of a Fiscal Responsibility and Budget Management Act (FRBM) should be used to remove obstacles to an efficient execution of the capital budget (e.g., the requirement for spending authorization from the Planning Commission even after budget approval, and no multi-year spending authorizations). Consideration should also be given to better prioritize spending within sectors, concentrating financial and personnel resources to ensure completion of key projects. Following the rollout of the TSA, further public financial management reforms to enhance cash management, and improve revenue and expenditure forecasts could also help manage capital spending.

Authorities' Views

35. The authorities agreed on the need to boost capital spending. They intend to pass the 2014/15 budget one month ahead of the beginning of the fiscal year, which should facilitate execution of the capital budget, but are also examining other obstacles to public investment, including provisions in the Procurement Act. With regard to fuel pricing, they pointed to political constraints.

E. Boosting Sustainable and Inclusive Growth

36. While poverty has been reduced significantly in recent years, Nepal's human development indicators remain low. Further expenditures on health and education could help reduce the human effects of poverty and improve the productivity of the workforce. The expansion of telecommunications offers an opportunity to extend financial services through mobile telephony, which could transform access to finance and promote inclusion, as demonstrated in many peer countries.

37. To generate sustained economic growth and employment opportunities, which alone can deliver lasting development, key domestic policy reforms are needed. While financial sector policies and higher public investment can contribute to support private sector investment, more comprehensive reforms are also required. Labor market reforms and improvements in the efficiency of markets through competition, e.g. in fuel distribution and goods and passenger transport, would support broader economic development. To this end, creation of a dedicated competition authority should be considered. Lastly, a one-stop shop should not only be offered for large investments, but to any investor.

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[3] The NOC currently has Nrs 34 billion in debt (1¾ percent of GDP).

38. The exploitation of Nepal's large hydroelectric power potential should be accelerated, especially given long lead times for projects. The expansion of power supply through projects currently underway should alleviate power shortages, but demand is expected to increase as well. In addition, power could also be exported to India, diversifying sources of foreign exchange. To this end, large-scale projects involving foreign investment to generate power and build infrastructure for power trade with India should be developed expeditiously.

Authorities' Views

39. The authorities agreed with the need to enhance infrastructure and remove hurdles toward more inclusive growth. They pointed out that cellular phone subscriptions now amount to 85 percent of the population, and are estimated to cover 65-70 percent of individuals. They also indicated that a few hydroelectric power projects, particularly those financed with domestic resources, have shown good execution and may offer lessons for other projects. While large projects have a higher long-term impact on output, shorter gestation projects may be more useful for kick-starting growth.

OTHER ISSUES

40. Some progress in implementing recommendations from the safeguards assessment has been made. New accounting software has been installed, and all government transactions are monitored through the TSA, and controls over reserve management is being strengthened.

41. Efforts to strengthen macroeconomics statistics should continue, including in the context of the National Strategy for Development of Statistics. TA is being provided by the IMF to improve statistics in national accounts, fiscal accounts, balance of payments, and monetary accounts. There is scope to further improve the quality of those statistics, supporting more effective economic monitoring and policy formulation.

STAFF APPRAISAL

42. The macroeconomic situation is broadly stable, and the external position strong. Continued robust remittance inflows are supporting high international reserves; however, they also fuel excess liquidity in the financial system, and skew activity to non-tradables and contribute to reducing the competitiveness of agriculture and industry. The fiscal position is solid, and while public debt and the risk of debt distress are low, public investment remains modest.

43. Poverty reduction has progressed, but economic growth is weak. High remittance inflows are increasing welfare, as does public spending on health and primary education. While the improvement in the political environment following the elections to the CA should help raise confidence, low public investment, a weak business climate, and eroding external competitiveness are holding back growth.

44. Monetary policy should focus on controlling liquidity. While the NRB has stepped up sterilization operations, it should use OMOs more actively to control both the level and volatility of liquidity in the financial system. This would help tighten very loose monetary conditions, reduce financial sector risks and improve the monetary policy transmission mechanism. To this end, the NRB should be equipped with adequate amounts of sterilization bonds, cooperation between the NRB and the Ministry of Finance needs to be stepped up, and the institutional set-up for monetary policy strengthened.

45. Financial sector policies should aim to strengthen supervision, reduce vulnerabilities and make the financial system more efficient. While the NRB has made progress, the financial system remains vulnerable, as the recent assessment under the FSAP underlines. The number of banks should be further substantially reduced, alongside a strengthening of the licensing framework. In this context, the authorities should not hesitate to close insolvent banks. The move to risk-based supervision should be expedited, and the legal framework enhanced. Staffing and IT also need strengthening. Developing financial infrastructure would also help reduce risks and increase access to credit. At the same time, supervision of cooperatives needs to be expanded and significantly strengthened.

46. Fiscal policy has ample room to support growth and poverty reduction. Revenues are projected to rise further, though at decreasing rates, and low public debt would allow for a modest expansion of fiscal deficits without endangering debt sustainability. There is also room to create further fiscal space by reducing or eliminating implicit NOC subsidies. The authorities' intention to pass the 2014/15 budget earlier than usual to help accelerate capital spending is welcome, but comprehensive measures are needed, including passage of the FRBM Act, and other changes to the legal and institutional framework.

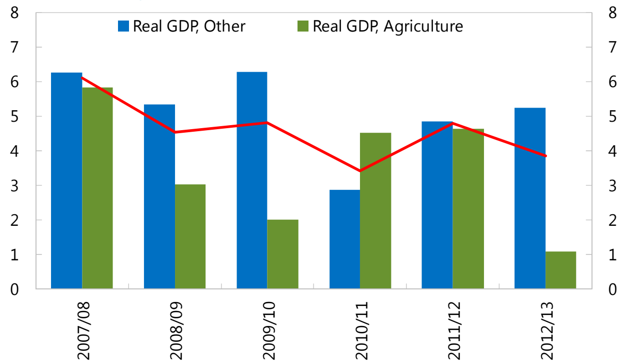
47. Reforms to boost inclusive growth need to be tackled with urgency. There is significant room to boost competitiveness to develop industry and agriculture, which would provide domestic employment opportunities. While better public infrastructure would provide a significant impetus to inclusive growth, reforms to improve labor relations, boost competition, and reducing the regulatory burden are a necessary complement. Accelerating large privately financed infrastructure projects would also provide a boost to investor confidence.

48. It is proposed that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Nepal: Recent Developments

Economic growth slowed in 2012/13, largely due to weak agricultural output …

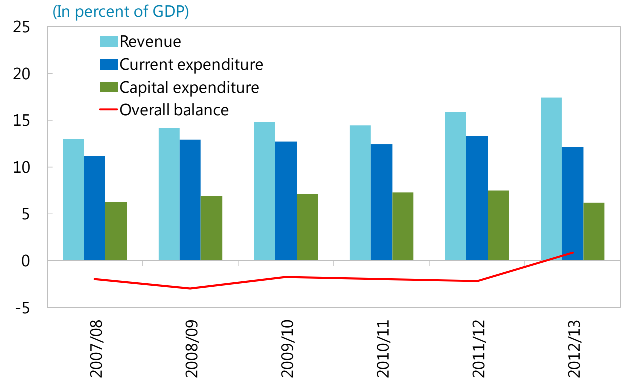
Real GDP Growth
(Percent change)



Sources: Nepali authorities; and IMF staff estimates

… and anemic public investment due to delay of the 2012/13 budget.

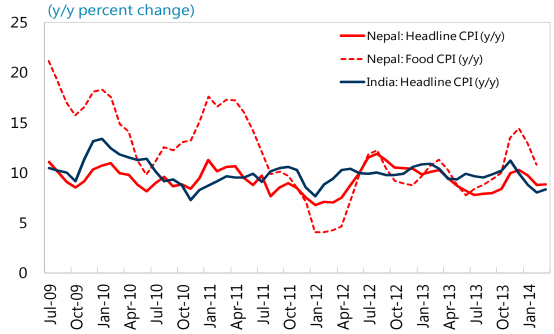
Fiscal Performance
(In percent of GDP)



Sources: Nepali authorities; and IMF staff estimates

Inflation, after spiking in December, is gradually decelerating but remains high.

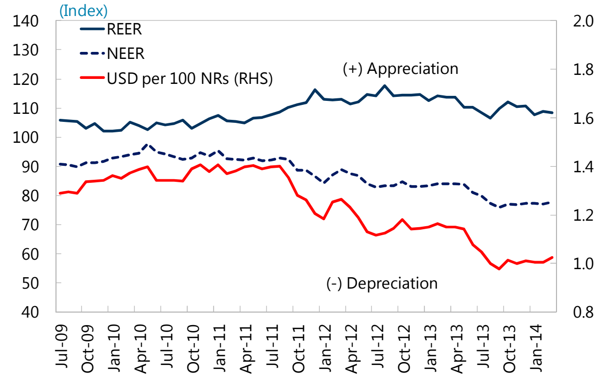
Consumer Price Inflation
(y/y percent change)



Sources: Nepali authorities, Haver analytics; and IMF staff estimates.

The Nepalese rupee has weakened reflecting the peg to the Indian rupee, and the REER has depreciated.

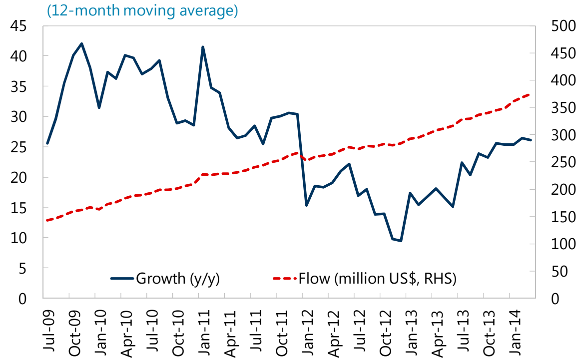
Exchange Rate
(Index)



Sources: Nepali authorities; and IMF staff estimates.

Worker's remittances are still growing, albeit at a reduced pace …

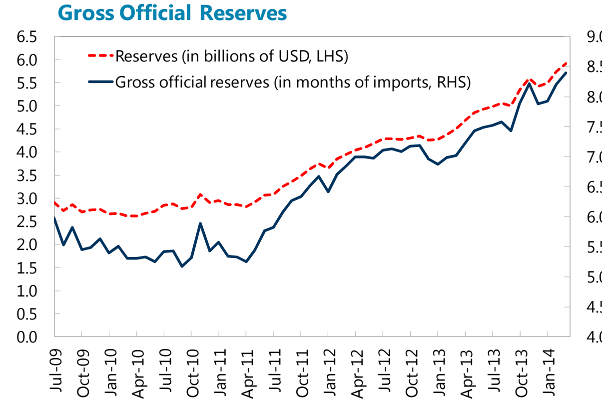
Remittances
(12-month moving average)



Sources: Nepali authorities; and IMF staff estimates

… fueling continued accumulation of international reserves.

Gross Official Reserves



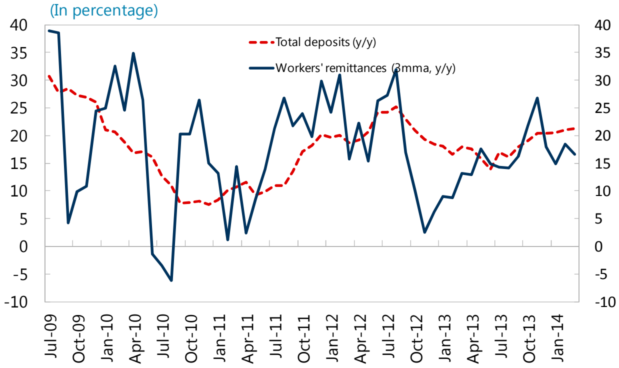
Sources: Nepali authorities; and IMF staff estimates

Figure 2. Nepal: Monetary and Financial Developments

Deposit growth has been supported by workers' remittances …

Nepal: Deposit and Workers' Remittances

(In percentage)



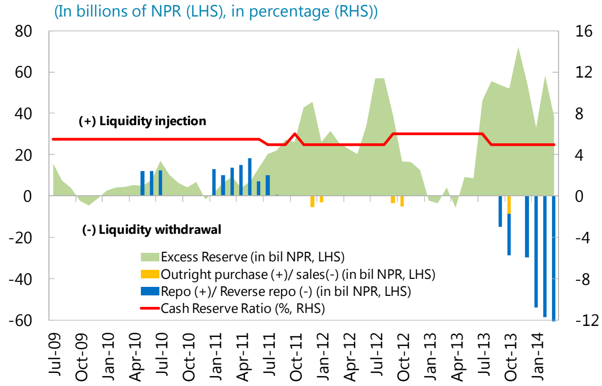
Sources: Nepali authorities; and IMF staff estimates.

Note: total deposits inlude class A, B, and C banks after July 2011, but only cover class A banks prior to then.

Leading to increases in banks' excess reserves.

Nepal: Excess Reserves and Open Market Operations

(In billions of NPR (LHS), in percentage (RHS))

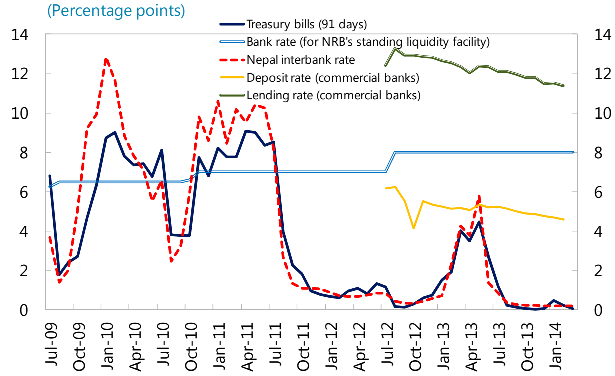


Sources: Nepali authorities; and IMF staff estimates.

Interbank rates spiked on temporary tighter liquidity, but fell back as remittances continued to rise.

Nepal: Interest Rate

(Percentage points)

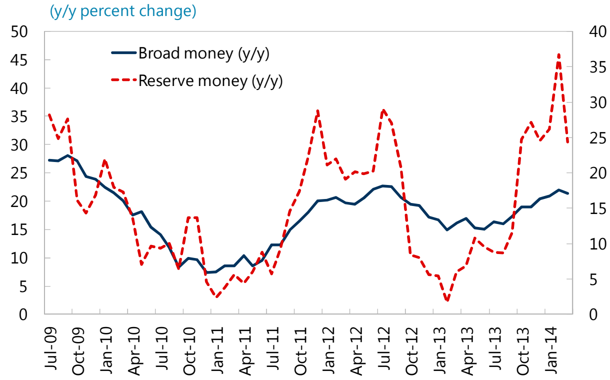


Sources: Nepali authorities; and IMF staff estimates.

Broad money is relatively stable while reserve money is volatile due to seasonality of the public sector balance.

Nepal: Monetary aggregates

(y/y percent change)

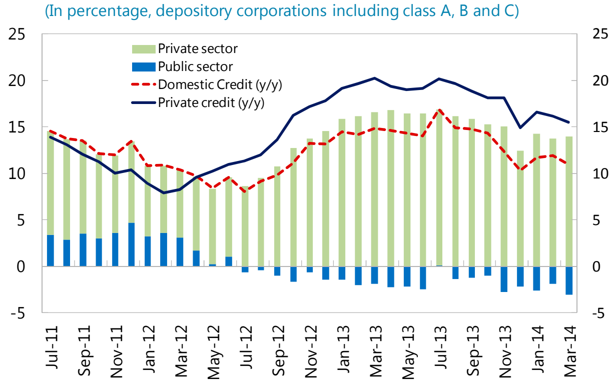


Sources: Nepali authorities; and IMF staff estimates.

Credit to private sector is decelerating but remains robust …

Nepal: Components of Domestic Credit Growth

(In percentage, depository corporations including class A, B and C)

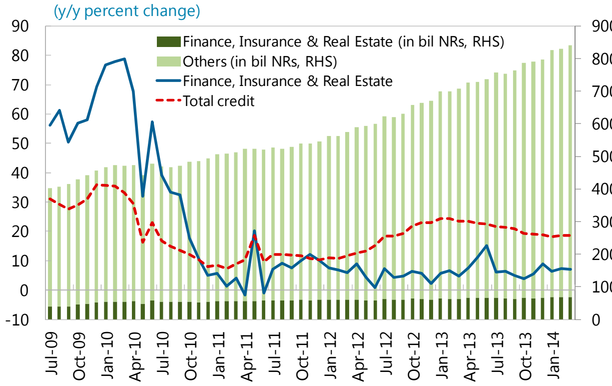


Sources: Nepali authorities; and IMF staff estimates.

… and some is flowing to the real estate sector.

Nepal: Credit Growth (Commercial Banks)

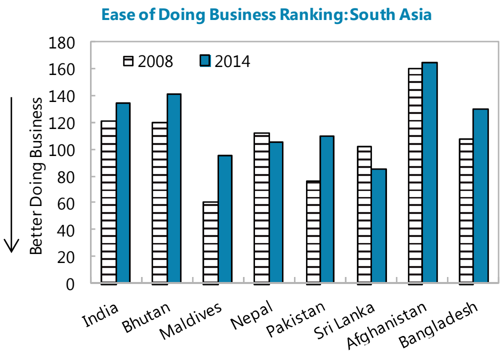
(y/y percent change)



Sources: Nepali authorities; and IMF staff estimates.

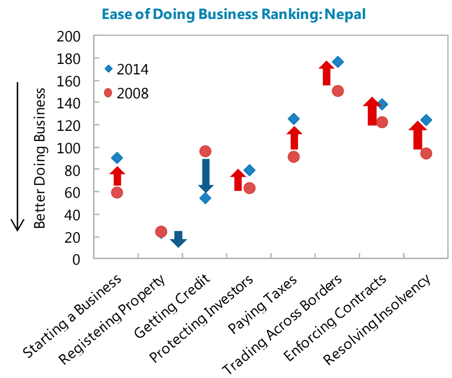
Figure 3. Nepal: Business Environment and Governance

Nepal's overall ranking improved ....



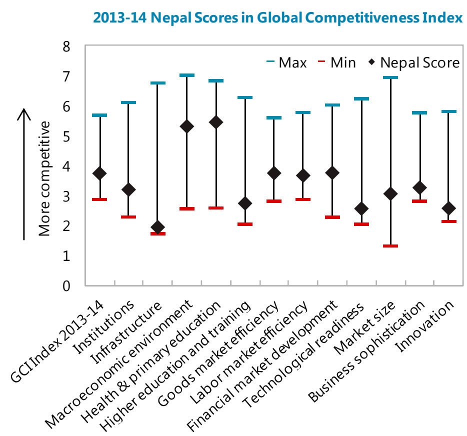
Sources: World Bank, Doing Business Report (2014 and 2008)

... but deteriorated along several dimensions.



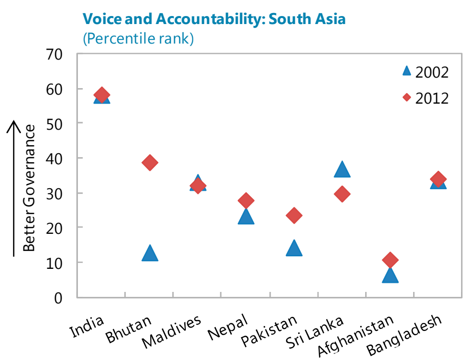
Sources: World Bank, Doing Business Report (2014 and 2008)

In particular, infrastructure and higher education are key impediments.



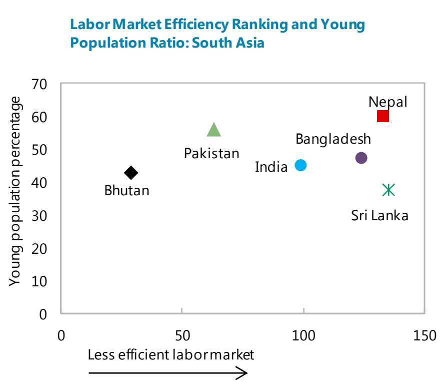
Sources: World Economic Forum Global Competitiveness Report (2013-14)

Voice and accountability have risen but there remains ample room for further improvements.



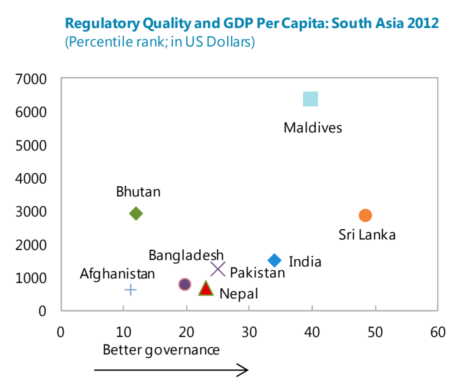
Sources: Worldwide Governance Indicators 2013
Note: Voice and Accountability reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom.

Labor markets seem less efficient than regional peers...



Sources: World Development Indicators (2012) and World Economic Forum Global Competitiveness Report (2013)
Note: Young population ratio: people younger than 15 as percentage of population aged 15-64.

... and regulatory quality also indicates room for further improvement.



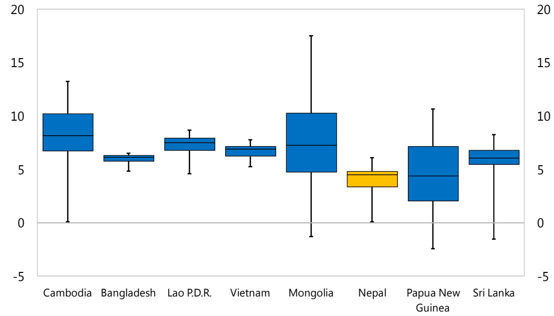
Sources: Worldwide Governance Indicators 2013; IMF
Note: Regulatory quality eflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector.

Note: These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.

Figure 4. Nepal: Inclusive Growth

Economic growth has been stable but low, …

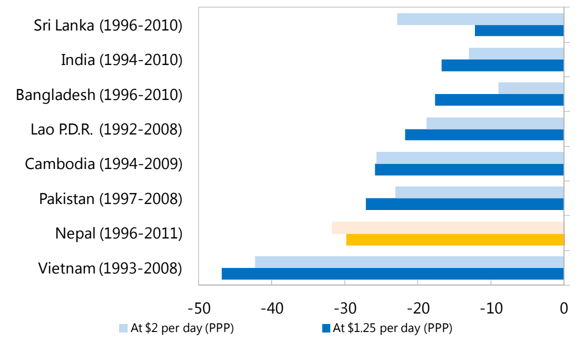
Volatility of GDP Growth, 2000–12 1/
(In percent)



Source: IMF's *World Economic Outlook*
1/ Each candlestick shows maximum, 3rd quartile, median, 1st quartile, and minimum growth rates, respectively, during the sample period.

… while income poverty has declined dramatically, largely due to remittances..

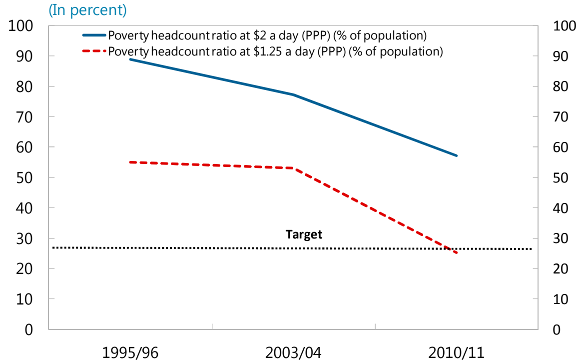
Change in poverty headcount ratios
(In percent points)



Source: World Bank, WDI Database

The MDG poverty reduction target has already been met …

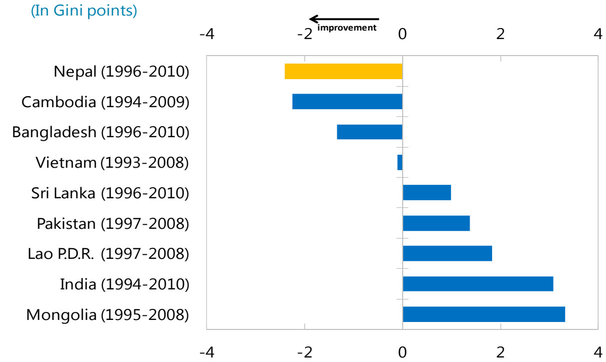
Nepal: Trends in poverty headcount ratios
(In percent)



Sources: Nepali auhtorities; and WDI database

… and income distribution has also improved.

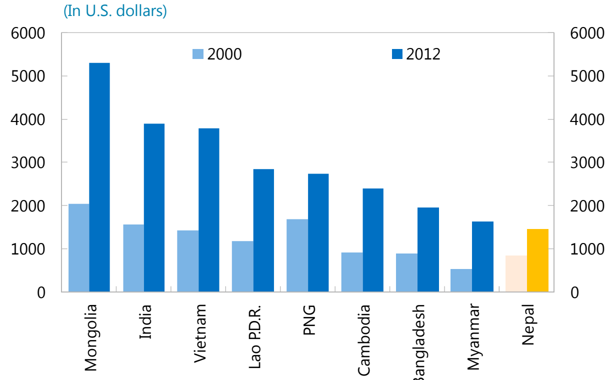
Change in Gini Index
(In Gini points)



Source: World Bank, WDI database

However, output per capita remains among the lowest in the region…

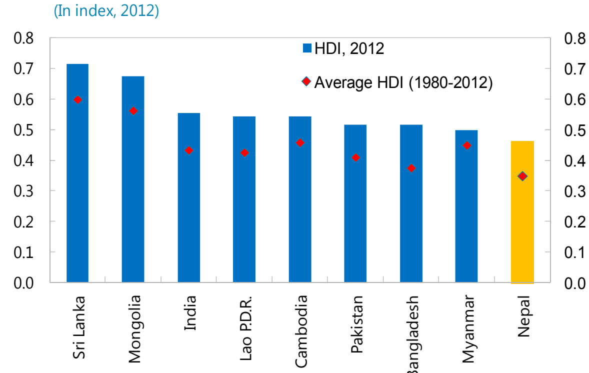
Per Capita GDP (PPP)
(In U.S. dollars)



Source: World Bank, WDI Database

… and further efforts are needed to improve human welfare.

Human Development Index (HDI)
(In index, 2012)



(Source) Human Development Report 2013 (UNDP)

Table 1. Nepal: Selected Economic Indicators, 2010/11–2014/15 1/

	2010/11	2011/12	2012/13	2013/14	2014/15
				Proj.	
Output and prices (annual percent change)					
Real GDP	3.4	4.8	3.9	4.8	5.0
CPI (period average)	9.6	8.3	9.9	8.8	7.8
CPI (end of period)	9.7	11.5	7.7	8.0	7.5
Nonfood CPI (end of period)	7.6	11.2	7.2	…	…
Fiscal Indicators (in percent of GDP)					
Total revenue and grants	17.7	18.7	19.3	21.1	21.3
Expenditure	18.7	19.3	17.9	20.8	21.1
Expenses	15.2	15.9	14.6	17.2	17.2
Net acquisition of nonfinancial assets	3.4	3.4	3.2	3.7	3.9
Net lending/borrowing	-1.0	-0.6	1.4	0.2	0.2
Net acquisition of financial assets	1.0	1.6	0.9	1.5	2.0
Net incurrence of liabilities	2.0	2.2	-0.6	1.3	1.8
Foreign	-0.3	-0.2	-0.3	0.3	0.7
Domestic	2.3	2.4	-0.2	1.0	1.1
Money and credit (annual percent change)					
Broad money	12.3	22.7	16.3	20.5	19.9
Domestic credit	13.7	8.0	16.9	15.5	18.0
Private sector credit	13.1	11.3	20.2	16.4	18.7
Velocity	1.5	1.4	1.3	1.2	1.1
Saving and Investment (in percent of nominal GDP)					
Gross investment	30.0	30.0	29.8	29.4	29.8
Private	26.6	26.7	26.6	25.7	25.9
Central government	3.4	3.4	3.2	3.7	3.9
Gross national saving	29.1	34.9	33.1	33.5	33.1
Private	27.0	32.2	28.2	29.7	29.1
Central government	2.0	2.7	4.9	3.8	4.0
Balance of Payments					
Current account (in millions of U.S. dollars)	-181	909	635	801	676
In percent of GDP	-1.0	4.8	3.3	4.1	3.3
Trade balance (in millions of U.S. dollars)	-4,470	-4,605	-5,247	-5,961	-6,760
In percent of GDP	-23.5	-24.4	-27.3	-30.9	-33.3
Exports value growth (y/y percent change)	13.2	5.0	-3.1	6.5	4.5
Imports value growth (y/y percent change)	10.2	3.4	10.9	12.5	12.1
Workers' remittances (in millions of U.S. dollars)	3,545	4,414	4,931	5,671	6,297
In percent of GDP	18.6	23.4	25.6	29.4	31.0
Gross official reserves (in millions of U.S. dollars)	3,085	4,307	4,972	6,082	7,120
In months of prospective GNFS imports	5.8	7.2	7.4	8.2	8.6
Memorandum items					
Public debt (in percent of GDP)	34.5	36.3	31.5	30.5	29.7
GDP at market prices (in billions of Nepalese rupees)	1,367	1,527	1,693	1,931	2,183
GDP at market prices (in billions of U.S. dollars)	19.0	18.9	19.2	…	…
Exchange rate (NRs/US$; period average)	71.9	81.0	88.0	…	…
Real effective exchange rate (eop, y/y percent change)	1.2	-4.6	-2.3	…	…

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

[1] Fiscal year ends in mid-July.

Table 2. Nepal: Summary of Government Operations, 2010/11–2014/15 1/

	2010/11	2011/12	2012/13	2013/14		2014/15	
				Budget	Proj.	MTEF 2/	Proj.
	(In billions of Nepalese rupees)						
Total revenue and grants	242	285	327	424	407	490	465
Total revenue	197	244	296	354	353	421	409
Tax revenue	172	207	260	315	314	374	366
Non-tax revenue	26	38	36	40	40	47	44
Grants	44	41	31	70	54	69	56
Expenditure	255	295	302	439	402	491	461
Expenses	208	243	248	353	331	394	375
Of which : Interest payments	13	15	14	19	19	21	20
Salaries and allowances	45	53	52	73	73	81	81
Net acquisition of nonfinancial assets	47	51	55	85	71	97	85
Operating balance	34	42	79	71	75	96	90
Net lending/borrowing	-13	-10	24	-14	5	-1	5
Net financial transactions	13	10	-24	14	-5	1	-5
Net acquisition of financial assets	14	24	15	32	29	60	44
Net incurrence of liabilities	27	34	-9	46	24	61	39
Foreign	-4	-2	-5	27	5	28	15
Domestic	32	36	-4	19	19	33	24
	(In percent of GDP, unless otherwise indicated)						
Total revenue and grants	17.7	18.7	19.3	22.0	21.1	22.5	21.3
Total revenue	14.4	16.0	17.5	18.4	18.3	19.3	18.7
Tax revenue	12.6	13.5	15.3	16.3	16.3	17.1	16.7
Non-tax revenue	1.9	2.5	2.2	2.1	2.1	2.2	2.0
Grants	3.3	2.7	1.8	3.6	2.8	3.2	2.6
Expenditure	18.7	19.3	17.9	22.7	20.8	22.5	21.1
Expenses	15.2	15.9	14.6	18.3	17.2	18.0	17.2
Of which : Interest payments	0.9	1.0	0.8	1.0	1.0	0.9	0.9
Salaries and allowances	3.3	3.5	3.1	3.8	3.8	3.7	3.7
Net acquisition of nonfinancial assets	3.4	3.4	3.2	4.4	3.7	4.4	3.9
Operating balance	2.5	2.7	4.7	3.7	3.9	4.4	4.1
Net lending/borrowing	-1.0	-0.6	1.4	-0.8	0.2	0.0	0.2
Net financial transactions	1.0	0.6	-1.4	0.8	-0.2	0.0	-0.2
Net acquisition of financial assets	1.0	1.6	0.9	1.6	1.5	2.8	2.0
Net incurrence of liabilities	2.0	2.2	-0.6	2.4	1.3	2.8	1.8
Foreign	-0.3	-0.2	-0.3	1.4	0.3	1.3	0.7
Domestic	2.3	2.4	-0.2	1.0	1.0	1.5	1.1
Memorandum items							
Change in net credit to central government (in billions of NRs)	26.9	-9.2	0.2	...	19.0	...	24.2
Change in net credit to central government	2.0	-0.6	0.0	...	1.0	...	1.1
Primary balance	0.0	0.4	2.2	0.2	1.2	0.9	1.1
Public debt	34.5	36.3	31.5	30.2	30.5	...	29.7
Domestic	14.6	13.5	11.4	11.0	11.0	...	10.8
External	19.9	22.7	20.1	19.2	19.5	...	18.9
GDP (in billion of Nepalese rupees)	1,367	1,527	1,693	1,931	1,931	2,183	2,183

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.

2/ Based on the authorities' data and Fund staff assumptions.

Table 3. Nepal: Monetary Indicators, 2010/11–2014/15 1/

	2010/11	2011/12	2012/13	Mar 2014	2013/14	2014/15
					Proj.	
	(In billions of Nepalese rupees, end-period)					
Nepal Rastra Bank						
Reserve money	234	319	354	375	494	623
Net domestic assets	23	-54	-111	-189	-130	-150
Claims on public sector	55	17	2	-58	17	15
Claims on private sector	4	5	5	4	4	5
Claims on banks & financial institutions	8	0	3	1	0	2
Other items (net)	-45	-77	-121	-137	-151	-172
Net foreign assets	212	374	465	564	624	773
Monetary Survey						
Broad money	922	1,131	1,315	1,458	1,585	1,900
Narrow money	223	264	302	334	481	579
Quasi-money	699	867	1,014	1,123	1,104	1,321
Net domestic assets	706	756	847	877	951	1,115
Domestic credit	913	986	1,153	1,202	1,331	1,571
Credit to public sector	185	176	179	121	199	227
of which : Credit to central government	163	154	154	89	173	198
Credit to private sector	727	810	973	1,081	1,132	1,344
Other items(net)	-207	-230	-305	-325	-380	-456
Net foreign assets	216	375	468	580	634	785
	(Twelve-month percent change)					
Reserve money	7.2	36.4	10.9	30.4	39.4	26.2
Broad money	12.3	22.7	16.3	21.4	20.5	19.9
Net domestic assets	16.2	7.1	12.0	8.4	12.2	17.3
Domestic credit	14.6	8.0	16.9	11.0	15.5	18.0
Credit to public sector	17.2	-4.9	1.9	30.3	10.8	14.0
Credit to private sector	13.9	11.3	20.2	15.5	16.4	18.7
Net foreign assets	1.3	73.4	25.0	48.1	35.5	23.8
Memorandum items						
Velocity	1.5	1.4	1.3	…	1.2	1.1
Multiplier	3.9	3.5	3.7	3.9	3.2	3.0
Private credit (in percent of GDP)	53.2	53.0	57.5	…	58.6	61.6
GDP at market prices (in billions of Nepalese rupees)	1,367	1,527	1,693	…	1,931	2,183

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, 2010/11–2018/19

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
						Proj.			
					(in million US dollars)				
Current account	-181	909	635	801	676	475	202	-115	-429
Current account (excluding official transfers)	-501	515	378	432	301	85	-194	-524	-848
Trade balance	-4,470	-4,605	-5,247	-5,961	-6,760	-7,606	-8,464	-9,311	-10,178
Exports, f.o.b.	961	1,008	977	1,041	1,088	1,142	1,205	1,277	1,354
Imports, f.o.b.	-5,430	-5,613	-6,224	-7,002	-7,848	-8,748	-9,668	-10,588	-11,532
Services (net)	-121	175	87	97	106	128	151	182	213
Receipts	741	893	1,083	1,104	1,181	1,298	1,417	1,548	1,679
Of which : tourism	344	380	390	434	467	516	565	620	675
Payments	-863	-718	-995	-1,007	-1,075	-1,170	-1,265	-1,367	-1,466
Income	106	147	146	164	172	175	178	182	183
Credit	245	274	263	264	278	289	301	314	324
Debit	-139	-127	-117	-101	-106	-115	-123	-132	-141
Current transfers	4,304	5,192	5,648	6,502	7,158	7,779	8,336	8,833	9,353
Credit, of which:	4,351	5,254	5,732	6,586	7,247	7,875	8,439	8,944	9,471
General government	320	394	257	369	375	390	396	409	419
Workers' remittances	3,545	4,414	4,931	5,671	6,297	6,863	7,376	7,817	8,287
Debit	-46	-62	-84	-85	-89	-96	-103	-111	-118
Capital account	222	221	117	193	195	203	206	213	217
Financial account	108	303	-50	43	173	264	349	407	455
Direct investment	90	112	102	112	128	149	172	185	197
Portfolio investment	0	0	0	0	0	0	0	0	0
Other investment (net)	18	191	-152	-69	45	115	177	223	258
MT debt (net)	37	11	-13	68	137	212	299	311	376
Other (net)	-19	180	-139	-138	-92	-97	-122	-88	-118
Errors and omissions	105	-208	-32	80	0	0	0	0	0
Overall balance	255	1,225	670	1,116	1,044	942	757	505	243
Financing	-255	-1,225	-670	-1,116	-1,044	-942	-757	-505	-243
Change in reserve assets (- =increase)	-96	-1,222	-665	-1,110	-1,039	-934	-750	-500	-240
Use of IMF resources (net)	-2	-3	-5	-6	-5	-8	-7	-5	-4
IMF Disbursements	0	0	0	0	0	0	0	0	0
IMF Repayment	2	3	5	6	5	8	7	5	4
Memorandum items									
Current account (in percent of GDP)	-1.0	4.8	3.3	4.1	3.3	2.2	0.9	-0.5	-1.6
Current account, excl. grants (in percent of GDP)	-2.6	2.7	2.0	2.2	1.5	0.4	-0.8	-2.1	-3.1
Trade balance (in percent of GDP)	-23.5	-24.4	-27.3	-30.9	-33.3	-34.7	-35.9	-36.8	-37.7
Exports (in percent of GDP)	5.1	5.3	5.1	5.4	5.4	5.2	5.1	5.0	5.0
Imports (in percent of GDP)	28.6	29.8	32.3	36.3	38.6	39.9	41.1	41.8	42.7
Exports (y/y percent change)	13.2	5.0	-3.1	6.5	4.5	5.0	5.5	6.0	6.0
Imports (y/y percent change)	10.2	3.4	10.9	12.5	12.1	11.5	10.5	9.5	8.9
Remittances (in percent of GDP)	18.6	23.4	25.6	29.4	31.0	31.3	31.3	30.9	30.7
Remittances (y/y percent change)	13.9	24.5	11.7	15.0	11.0	9.0	7.5	6.0	6.0
Total external debt (in percent of GDP)	19.9	22.7	20.1	19.5	18.9	18.4	18.4	18.4	18.6
Debt service (in percent of current account receipts)	5.2	6.0	5.1	5.1	5.3	5.4	5.4	5.5	5.6
Gross official reserves (in millions of U.S. dollars)	3,085	4,307	4,972	6,082	7,120	8,054	8,804	9,304	9,544
In months of prospective GNFS imports	5.8	7.2	7.4	8.2	8.6	8.8	8.8	8.6	8.6
As a share of broad money (in percent)	23.8	33.9	36.0	…	…	…	…	…	…
Nominal GDP (in millions of U.S. dollars)	19,011	18,852	19,243	…	…	…	…	…	…

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

Table 5. Nepal: Macroeconomic Framework, 2010/11–2018/19 1/

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
						Proj.			
Output and prices (annual percent change)									
Real GDP	3.4	4.8	3.9	4.8	5.0	4.7	4.5	4.5	4.5
CPI (period average)	9.6	8.3	9.9	8.8	7.8	7.0	6.3	5.9	5.9
CPI (end of period)	9.7	11.5	7.7	8.0	7.5	6.5	6.0	5.9	5.8
Nonfood CPI (end of period)	7.6	11.2	7.2	…	…	…	…	…	…
Fiscal Indicators (in percent of GDP)									
Total revenue and grants	17.7	18.7	19.3	21.1	21.3	21.6	21.7	21.9	22.1
Expenditure	18.7	19.3	17.9	20.8	21.1	21.6	21.8	22.0	22.3
Expenses	15.2	15.9	14.6	17.2	17.2	17.3	17.4	17.4	17.5
Net acquisition of nonfinancial assets	3.4	3.4	3.2	3.7	3.9	4.3	4.4	4.6	4.8
Net lending/borrowing	-1.0	-0.6	1.4	0.2	0.2	0.0	-0.1	-0.1	-0.2
Net acquisition of financial assets	1.0	1.6	0.9	1.5	2.0	2.0	2.0	2.0	2.0
Net incurrence of liabilities	2.0	2.2	-0.6	1.3	1.8	2.0	2.1	2.1	2.2
Foreign	-0.3	-0.2	-0.3	0.3	0.7	1.0	1.3	1.2	1.4
Domestic	2.3	2.4	-0.2	1.0	1.1	1.0	0.8	0.9	0.8
Money and credit (annual percent change)									
Broad money	12.3	22.7	16.3	20.5	19.9	…	…	…	…
Domestic credit	13.7	8.0	16.9	15.5	18.0	…	…	…	…
Private sector credit	13.1	11.3	20.2	16.4	18.7	…	…	…	…
Velocity	1.5	1.4	1.3	1.2	1.1	…	…	…	…
Saving and Investment (in percent of nominal GDP)									
Gross investment	30.0	30.0	29.8	29.4	29.8	31.1	30.3	31.1	31.9
Private	26.6	26.7	26.6	25.7	25.9	26.8	25.9	26.4	27.1
Central government	3.4	3.4	3.2	3.7	3.9	4.3	4.4	4.6	4.8
Gross national saving	29.1	34.9	33.1	33.5	33.1	33.3	31.1	30.6	30.3
Private	27.0	32.2	28.2	29.7	29.1	29.0	26.7	26.0	25.5
Central government	2.0	2.7	4.9	3.8	4.0	4.2	4.5	4.6	4.8
Balance of Payments									
Current account (in millions of U.S. dollars)	-181	909	635	801	676	475	202	-115	-429
In percent of GDP	-1.0	4.8	3.3	4.1	3.3	2.2	0.9	-0.5	-1.6
Trade balance (in millions of U.S. dollars)	-4,470	-4,605	-5,247	-5,961	-6,760	-7,606	-8,464	-9,311	-10,178
In percent of GDP	-23.5	-24.4	-27.3	-30.9	-33.3	-34.7	-35.9	-36.8	-37.7
Exports value growth (y/y percent change)	13.2	5.0	-3.1	6.5	4.5	5.0	5.5	6.0	6.0
Imports value growth (y/y percent change)	10.2	3.4	10.9	12.5	12.1	11.5	10.5	9.5	8.9
Workers' remittances (in millions of U.S. dollars)	3,545	4,414	4,931	5,671	6,297	6,863	7,376	7,817	8,287
In percent of GDP	18.6	23.4	25.6	29.4	31.0	31.3	31.3	30.9	30.7
Gross official reserves (in millions of U.S. dollars)	3,085	4,307	4,972	6,082	7,120	8,054	8,804	9,304	9,544
In months of prospective GNFS imports	5.8	7.2	7.4	8.2	8.6	8.8	8.8	8.6	8.6
Memorandum items									
Public debt (in percent of GDP)	34.5	36.3	31.5	30.5	29.7	29.1	28.8	28.7	28.8
GDP at market prices (in billions of Nepalese rupees)	1,367	1,527	1,693	1,931	2,183	2,446	2,717	3,009	3,316
GDP at market prices (in billions of U.S. dollars)	19.0	18.9	19.2	…	…	…	…	…	…
Exchange rate (NRs/US$; period average)	71.9	81.0	88.0	…	…	…	…	…	…
Real effective exchange rate (eop, y/y percent change)	1.2	-4.6	-2.3	…	…	…	…	…	…

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

[1] Fiscal year ends in mid-July.

Table 6. Nepal: Commercial Banks' FSIs, 2006–2013

	2006	2007	2008	2009	2010	2011	2012	2013
				(in percent)				
Capital adequacy								
Capital fund to risk weighted assets	-5.3	-1.7	4.0	7.2	9.6	10.6	11.5	12.3
Tier 1 capital to risk weighted assets	…	…	1.8	5.2	7.9	9.1	10.0	10.7
Asset quality								
NPLs to total loans	13.2	10.6	6.1	3.6	2.5	3.2	2.6	2.7
Loan loss provision to total loans	15.1	12.4	8.2	5.9	4.6	4.0	3.5	3.4
Earnings and profitability								
Return on equity (ROE) 1/		31.4	35.2	34.7	33.9	25.3	22.5	28.2
Return on assets (ROA) 1/	4.3	1.4	2.0	4.9	1.9	1.7	1.5	1.7
Interest income to gross income	69.5	70.4	68.3	73.9	77.9	81.4	82.4	81.6
Non-interest expenditures to gross income	70.9	70.3	70.4	60.1	60.2	53.2	48.0	58.3
Employees expenses to non-interest expenditures	16.6	19.0	18.7	25.1	23.7	22.2	21.5	20.4
Liquidity								
Liquid assets to total assets	9.1	9.0	11.8	26.0	13.1	11.2	15.2	14.7
Liquid assets to demand and savings deposits	20.5	20.1	25.0	31.1	31.7	31.6	40.6	39.8
Liquid assets to total deposits	13.5	13.2	15.9	18.3	16.0	14.3	18.6	18.2
Exposure to real estate								
Share of real estate and housing loans	…	…	…	19.4	20.7	18.5	16.9	14.6
Share of loans collateralized by land and buildings	…	…	…	71.7	58.4	68.4	55.9	55.2

1/ Excluding state-owned banks.

Table 7. Nepal: Millennium Development Goals

Targets	Indicators	1990/ Earliest	Most recent	2015 Target	Status of Progress
Goal 1: Eradicate extreme poverty and hunger					
Target: Halve between 1990 and 2015, the proportion of people living below the poverty line	Proportion of population below the national poverty line (percent) 1/	55(95)	25.2(11)	27.5	Achieved
Target: Halve by 2015, the proportion of people who suffer from hunger	Proportion of population below minimum level of dietary energy consumption (percent)	49(90)	22.5(10)	25	Achieved
Goal 2: Achieve universal primary education					
Target: Ensuring that by 2015, children everywhere will be able to complete a full course of primary schooling	Net primary enrollment ratio (percent)	64(90)	93.7(10)	100	Likely
	Reaching last grade	38(90)	77.9(10)	100	Possible
	Literacy rate of 14-24 age	49.6(90)	86.5(10)	100	Possible
Goal 3: Promote gender equality and empower women					
Target: Eliminate gender disparity in primary and secondary education preferably by 2005, and to all levels of education by 2015	Ratio of girls to boys in primary education (percent)	56(90)	99(11)	100	Achieved
	Ratio of girls to boys in secondary education (percent)	43(90)	99(10)	100	Achieved
	Ratio of females to males in tertiary institutes (percent)	32(90)	63(10)	100	Unlikely
Goal 4: Reduce child morality					
Target: Reduce by two-thirds between 1990 and 2015, the under-five mortality rate	Under-five mortality rate (per 1,000 births)	162(90)	54(11)	38	Unlikely
	Infant mortality rate (per 1,000 live births)	108(90)	46(11)	32	Unlikely
	Immunization, measles (percent of children under 12 months)	108(90)	46(11)	90	Likely
Goal 5: Improve maternal health					
Target: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio	Maternal mortality ratio (per 100,000 live births)	850(90)	229(08)	213	Likely
	Births attended by skilled health personnel (percent)	7(90)	36(11)	60	Unlikely
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Target: Halt and begin to reverse the spread of HIV/AIDS	HIV prevalence among population aged 15-24 years (percent)	0.29(90)	0.3(11)	0.35	Achieved
Target: Halt and begin to reverse the spread of malaria and other major diseases	Annual parasite incidence of malaria per 100,000 people	119(90)	16(10)	Halt and reverse	Achieved
	Prevalence rate of tuberculosis cases per 100,000 people	460(90)	238(11)	210	Likely
Goal 7: Ensure environmental sustainability					
Target: Halve between 1990 and 2015, sustainable access to safe drinking water and sanitation	Proportion of population with access to an improved drinking water source (percent)	46(90)	80(08)	73	Achieved
	Proportion of population with access to improved sanitation (percent)	6(90)	43(08)	53	Unlikely

Source: World Bank, Nepal Development Update (April, 2013)

Annex I. Risk Assessment Matrix [1]

Source	Likelihood	Impact	Policy Response to Minimize Impact
DOMESTC RISKS			
Financial sector distress A credit and asset price bubble could re-emerge if excess liquidity is translated into higher credit growth. Alternatively, conditions in the real estate market could deteriorate.	Medium	Medium/High	Move to pro-active and risk-based supervision and exercise corrective and sanctioning powers more forcefully, and earlier. Increase resources for supervision.
Political instability Political stalemate and infighting, even in the aftermath of the Constituent Assembly election, could undermine confidence and delay economic reforms.	Medium	Low/Medium	Preserve fiscal and external policy space.
Decisive reform push and increase in public investment (upside) Economic reforms and a boost in public investment in critical infrastructure bolster confidence and accelerate private investment and growth.	Low	High	
EXTERNAL RISKS			
Slower-than-projected recovery in India Prolonged slow growth in India could reduce FDI and, to some extent, exports and remittances.	Medium	Low	Accelerate structural reforms to improve the investment climate and boost public investment.
Protracted period of slower growth in emerging economies. An economic slowdown in countries (Persian Gulf countries, Malaysia) hosting Nepali overseas workers could weaken remittance inflows. This would reduce demand and growth; tighten liquidity and expose weaknesses in the financial system; and reduce government revenues due to slower import growth.	High	Medium/High	Preserve fiscal and external policy space to cope with adverse shock in the short term. In the longer term, boost public investment, and pursue structural reforms to improve the investment climate to reduce dependency on remittances.

[1]The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

INTERNATIONAL MONETARY FUND

NEPAL

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 17, 2014

Prepared By Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of April 30, 2014)

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	41.17	60.45

IV. Outstanding Purchases and Loans:

	SDR Million	Percent Allocation
RCF Loans	28.52	40.00
ECF arrangements	26.02	36.49

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		
	2014	2015	2016	2017	2018
Principal	8.55	9.98	12.83	8.91	5.70
Charges/interest	0.03	0.14	0.11	0.09	0.07
Total	8.58	10.12	12.95	9.00	5.77

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 March, 2014, the exchange rate for the Nepalese rupee (Nr) was US$1=Nrs. 97.88.

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.

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. Also, the NRB's financial reporting would be strengthened by resolving the many qualifications raised by the external auditors each year.

2012 Article IV Consultation

The Executive Board discussed the staff report for the 2012 Article IV consultation (IMF Country Report No. 12/ 326) on November 16, 2012. Consultations with Nepal are held on the standard 12 month Article IV consultation cycle.

Technical Assistance Since 2010

	Purpose	**Year**
MCM	Monetary Policy/Operations	Continuous
	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
	Exchange Rate and Capital Account Liberalization	2013
FAD	Tax and Customs Administration Reforms/Modernization	2006–12
	Follow up on the LTO and Customs Administration Reform	2010
	PFM Stocktake	2010
	Capacity Building Workshop	2009–10
	Revenue Administration	2011–13
	Extension of LT Treasury Advisor	2011
	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
	Implementation of a Large Tax Payer Unit	2013
	Review of Tax Policy and VAT Administration	2013
	Public Financial Management	2014
	Pension reform	2014
LEG	AML/CFT National Strategy	2010, 2011, 2014
	Work-at-Home Assignment	2011
	Bank Resolution	2012
	AML/CFT Legal Drafting Mission	2012, 2013, 2014
	AML/CFT Structures and Tools	2012, 2013, 2014
STA	Balance of Payments Statistics	2010, 2012, 2014
	Monetary Statistics	2011, 2014
	National Accounts	2012, 2014

Resident Representative

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

RELATIONS WITH THE WORLD BANK GROUP

(As of April 10, 2014)

A. Partnership in Nepal's Development Strategy

Nepal has achieved remarkable progress over the last years. The country managed to halve the percentage of people living on less than $1.25 a day in only seven years, from 53 percent in 2003/2004 to 25 percent in 2010/2011. Several social indicators in education, health and gender have also improved. In addition, since the end of the civil war in 2006, Nepal has successfully transitioned away from being a post-conflict country and former combatants have been integrated into the country's armed forces. While the country's political transition – notably the drafting of a new constitution – is taking longer than expected, the November 2013 elections, which resulted in a peaceful transfer in power, were an important step toward the formation of an inclusive and democratic state.

To build on this progress, Nepal needs to take advantage of its economic potential and put in place the prerequisites that will provide faster, sustained and inclusive growth. While the political process remains intricate (understandably so given Nepal's relatively short experience with democratic governance), the country urgently needs to pay greater attention to the economy. Remarkably, Nepal's economy grew steadily even during the height of conflict and economic management remained prudent, resulting in a budget surplus in 2013. Yet growth levels are too low to allow Nepal to continue its past progress and relegate poverty to history. Current growth relies heavily on remittances supporting consumption and growth in basic services with low growth potential.

To move to a higher growth trajectory, Nepal will have to remove bottlenecks to private and public investment in key growth sectors. The most vivid example of Nepal's economic potential is hydropower. While the estimated potential for hydroelectricity generation in Nepal is 84,000 MW, of which at least half is economically viable, only 746 MW (less than 2 percent of the viable potential) is currently developed. Hydropower development could be a game changer for Nepal. Development of the sector would reduce load-shedding and provide major revenues through exporting electricity to India or even China.

The World Bank Group (WBG) stands ready to support Nepal's aspirations for increasing economic growth through increased investments in key sectors while providing support to make growth more inclusive and to help equalize opportunities across groups and communities. This constitutes a major shift in World Bank Group (WBG) support away from short-term post-conflict assistance towards establishing the foundations for increased and inclusive growth. After three consecutive interim strategies in Fiscal Years (FY) 2007, 2009 and 2011, the WBG will provide more long-term support. A new Country Partnership Strategy (CPS) is being finalized and will cover four years from FY2014-2018.

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. Under its new CPS, the WBG will shift its ongoing engagement in the education sector toward a stronger focus on equalizing access, improving quality and providing skills for jobs.

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 of reproductive 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. The 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 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. The upcoming joint IDA-IFC Kabeli-A Hydroelectric Project will add on grid generation capacity through public private investment in a peaking run-of-river hydropower project with an installed capacity of 37.6 MW. It will also assist the Investment Board of Nepal (IBN) in improving its ability to carry out its responsibilities of facilitating the development of large hydropower projects across the country in line with applicable international performance, technical, environmental and social standards.

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, the project supports 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.

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. 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.

The Bank and the IMF also work closely together on providing support to financial sector strengthening, most recently through carrying out a joint Financial Sector Assessment Program (FSAP). WBG support to the financial sector aims to address economic risks stemming from the sector's rapid expansion and associated distress in the banking sector. To address financial-sector vulnerabilities, the Bank has been providing technical assistance in the areas of crisis management, bank resolution and deposit insurance. A FY13 Development Policy Operation (DPO), developed closely with DFID and the IMF, helped to address some of the root causes of the sector's difficulties. A follow-up DPO – building on the FSAP as well as a DFID-supported banking sector diagnostic – will aim to consolidate banking sector stability and pave the way for developing a more robust and inclusive financial sector.

C. World Bank Group Strategy and Lending Operations

World Bank Group support to Nepal is aligned to its twin global goals—eliminating extreme poverty and boosting shared prosperity. A poverty "lens", developed for the news CPS, concludes that while Nepal's progress on poverty reduction was commendable, a significant share of the population remains clustered around the poverty line. It confirms the need for WBG support to focus on removing Nepal's binding growth constraints to allow for higher income levels. In this context the International Development Association (IDA), the International Finance Corporation (IFC) and the Multi-lateral Investment Guarantee Agency (MIGA) will continue to foster its ongoing collaboration to make maximum use of its joint comparative advantage. WBG efforts will be organized within two pillars. Under pillar 1, it will support increasing economic growth and competitiveness, and will focus on hydroelectric power generation, enhancing transport connectivity, and improving the business environment. Under pillar 2, the WBG will provide support to increasing inclusive growth and opportunities for shared prosperity, by enhancing the productivity of agriculture, equalizing access to health care, skills development and social protection. Cutting across these pillars, WBG activities will contribute to improving the effectiveness, efficiency and accountability of public expenditure.

WBG support will be guided by the principles of balancing risks and rewards, selectivity and flexibility. In a shift from more cautious approaches taken in past strategies, the WBG will engage in larger programs that strive for nation-wide impact. Regarding selectivity, this strategy consolidates the WBG's engagement into fewer sectors, where the Group has a comparative advantage and can leverage its financing and analytical resources for greater development impact. In addition, the WBG will maintain programming flexibility, given the politically-fragile country environment.

Within each of the CPS pillars, the strategy identifies specific areas where the Bank Group can make a difference. For IDA, these include transport, energy, education/skills, health, and public expenditure management. For IFC, these include supporting hydropower, improving access to finance, facilitate new private investments and reduce the barriers of investment in priority sectors, promote tourism and support agribusiness. IDA and IFC expect to work together on hydropower development, agriculture, and improving access to finance.

FY14 Lending Program: In FY14, IDA is committing US$222 million in new commitments, including the Strengthening National Rural Transport Project (U$100 million), Irrigation and Water Management Additional Financing (US$50 million) and the Third Rural Water Supply and Sanitation Project (US$72 million).

Bank Assistance Program in Nepal: The current portfolio consists of 17 projects with net commitments of $1.5 billion, and three regional projects with net commitments of about $240 million. The average project size is $86 million, near the Bank-wide IDA average of about $87 million. Cumulative disbursements as of January 31, 2014, were $633 million (about 46 percent of net commitments) for the national and about $15million (about 6 percent of net commitments) for the regional projects.

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.

Activities of the International Finance Corporation (IFC) in Nepal

IFC's committed investment portfolio in Nepal stood at $40 million as of March 4, 2014, consisting of power, transport, banking, microfinance, tourism, and trade finance lines. IFC invested in 14 projects (for $57 million in total) over the last ISN period (FY12 and FY13) and 6 projects (for around $4 million in total) in FY14 as of March 4, 2014. Most recently, IFC's investments include hydropower investments, an airline expansion, and credit for trade financing.

On the advisory services side, IFC is engaged in a range of areas including investment climate, access to finance and sustainable business advisory. Besides, there is also a pipeline of advisory projects in the PPP transaction space. IFC's advisory services has strengthened multifold, from an active portfolio of $1.3 million in FY09 (three projects) to $12.8 million as of February 2014 (10 percent of South Asia Portfolio), across 12 projects in Nepal. Some high impact ongoing programs in the country include: Investment Climate Reform Project; enhancing access to finance through strengthening the payments system and credit bureau, and improving sustainable energy finance practices; and promoting climate resilient agriculture. A strong pipeline of projects has been developed to continue the transformative work. Some of the upcoming projects include work in the Nepal hydro sector which is a IFC/World Bank joint initiative and includes support for impact investments and sector wide adoption of E&S standards; scaling up renewable energy and SME banking programs; and development of PPP transactions in critical sectors.

Going forward, IFC will seek to continue the programs aligned with the three strategic pillars of IFC's South Asia Strategy which includes: (a) inclusive growth; (b) climate change; and (c) regional and global integration. IFC will continue to prioritize on the hydropower sector, financial sector and agribusiness. IFC's additionality in Nepal comes through providing longer tenor financing than is available in the market, patient equity capital, crisis response products such as liquidity facilities, global and regional expertise and experience, and technical assistance to enhance areas such as corporate governance and management of environmental and social risks. IFC aims to continue to respond to client needs through facilities such as SME Venture Fund, Infraventures, transaction advice for PPPs, and risk-sharing facilities. As local currency financing is essential for companies and sectors that generate local currency revenues, including large scale infrastructure hydropower-projects, IFC plans to continue its effort in partnership with IDA, with the GON to create such instruments.

IFC is supporting the Nepal Business Forum (NBF), a public private dialogue platform established by the GoN in 2010, which brings together over 40 government and private sector agencies to dialogue and review government policy and regulation towards the private sector, with the aim of improving the effectiveness, and accountability of private sector policy making, and regulatory enforcement. Given the political uncertainty and civil unrest, the NBF has been an important tool in helping the country refocus on economic growth by facilitating constructive dialogue on constraints to investment, trade and export, and finance and credit.

In addition, IFC's advisory service continues to facilitate new private investments and reduce the barriers of investment in key priority sectors including tourism, agriculture, finance, and infrastructure (especially hydropower). IFC is supporting the GoN with PPP transaction advisory to assist in evaluating its priority projects through a Memorandum of Understanding with the Investment Board of Nepal. Under this MoU, IFC will provide support to the development of feasibility studies, strategic options for particular projects, development of contract documents, as well as support and capacity building to take these projects to market.

Other ongoing IDA/IFC work is laying the foundation to help Nepal transform to a climate resilient development path—consistent with poverty reduction and sustainable development goals—with financial support from the Pilot Program for Climate Resilience and other climate investment funds. IFC is working with leading agribusiness firms to improve agricultural and water management practices, introduce new technologies among smallholder farmers producing rice, maize and sugarcane to help them adapt to climate change. The objective is to expand the agriculture sector in Nepal using sustainable and replicable climate smart models in order to improve farmer resilience.

Table II.1. IDA Projects

(Amounts in US$million)

IBRD/IDA *

Total Disbursed (Active)	675.32
of w hich has been repaid	0.00
Total Disbursed (Closed)	762.54
of w hich has been repaid	419.19
Total Disbursed (Active + Closed)	1,437.86
of w hich has been repaid	419.19
Total Undisbursed (Active)	711.52
Total Undisbursed (Closed)	16.04
Total Undisbursed (Active + Closed)	727.55

Active Projects

Project ID	Project Name	IDA	Cancel.	Undisb.
P132289	Kali Gandaki Rehab	27.3		27.8
P125495	NP: Bridges Program Support	60.0		43.3
P120265	NP: Emerging Towns Project	25.0	6.4	10.9
P104015	NP: Enhanced Vocational Educ & Trng	50.0	10.4	26.2
P099296	NP: Irrig & Water Res Mgmt Proj	114.3		59.8
P112893	NP: Kabeli Transmission Project	38.0		28.3
P105860	NP: PAF II	245.0	0.0	82.0
P110762	NP: Peace Support Project	50.0	13.1	1.9
P118179	NP: Rani Jamara Kulariya Irrigation Proj	43.0		31.1
P095977	NP: Road Sector Development Project	117.6		28.5
P113441	NP: School Sector Reform Program	230.0		103.4
P090967	NP: Second Higher Education Project	60.0		14.6
P117417	NP: Second HNP and HIV/AIDS Project	129.2		57.2
P113002	NP: Social Safety Nets Project	64.5	5.2	7.8
P087140	NP:Agriculture Commercialization & Trade	60.0		50.7
P125359	NP:Community Actionfor Nutrition Project	40.0		37.7
P132750	SNRTP	100.0		100.2
Overall Result		**1453.8**	**35.1**	**711.5**

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Country Program

The Asian Development Bank (ADB) began lending to Nepal in 1969. As of 31 December 2013, Nepal has received 167 loans/grants—128 sovereign ADF loans ($3,103.38 million), 5 non-sovereign loans ($58.64 million), and 34 ADF grants ($823.75 million) totaling $3,985.77 million. Nepal Country Partnership Strategy (CPS) 2013–2017, approved in October 2013 is more selective, with a bulk of the CPS resource envelope allocated to operations in energy, transport, and urban infrastructure and services, followed by agriculture and education. Five thematic priorities—gender equality and social inclusion, environmental sustainability, good governance, regional cooperation and integration, and private sector development will be mainstreamed in ADB operations. The portfolio of active sovereign ADF loans and grants as of 31 December 2013 consists of 47 loans and grants with an overall net amount of $1,553.75 million.

The assistance program for 2013 comprised seven projects with a total of $330.5 million in ADF loans and $45.5 million in ADF grants. The projects include the Tanahu Hydropower Project (loan $150.0 million); Skills Development Project (grant $20.0 million); Kathmandu Valley Waste Water Management Project (loan $80.0 million); SASEC Road Connectivity Project (loan $75.0 million); Project Preparatory Facility for Energy (grant $21.0 million); and Bagmati River Basin Improvement Project (loan $25.5 million and grant $4.5 million).

Technical Assistance

As of 31 December 2013, ADB has approved technical assistance (TA) projects totaling $180.30 million. There are currently 24 ongoing TAs amounting to $32.8 million. 19 projects (22 loans and grants) and 6 TAs which are about 51% and 25%, respectively, of the Nepal portfolio, are currently being administered by the Nepal Resident Mission.

Private Sector Operations

ADB’s private sector operations in Nepal began in 1989. As of 31 December 2013, cumulative approvals in four projects amounted to $58.6 million. One of the major private sector projects is the 60-MW Khimti Hydropower project, which was approved in 1996. ADB's private sector operations will focus mainly on hydropower development, both for domestic sale and for export to India although many constraints to investment remain and further policy dialogue is required. Moving forward in the energy sector, ADB’s private sector arm will look into private sector-led investments on a case-by-case basis.

ADB's Trade Finance Program (TFP) fills market gaps by providing guarantees and loans through partner banks in support of trade. TFP has done over 8,000 transactions supporting over $16 billion in trade and over 4,000 small and medium-sized enterprises since 2004. In 2013, TFP supported $4 billion in trade through over 2,000 transactions. In Nepal, the TFP works with three banks and has supported over $69 million in trade.

Sovereign Loans and Grants by the Asian Development Bank, 1968 - 2013

(as of 31 December 2013)

	1968-2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Loans										
Agriculture and Natural Resources	746.2	0.0	0.0	0.0	0.0	0.0	0.0	18.0	0.0	25.5
Education	130.7	0.0	30.0	0.0	0.0	25.0	0.0	0.0	0.0	0.0
Energy	364.4	0.0	0.0	0.0	0.0	65.0	0.0	56.0	0.0	150.0
Finance	7.3	0.0	56.0	0.0	0.0	0.0	60.4	0.0	0.0	0.0
Industry and trade	127.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.5	0.0
Public Sector Management	65.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transport and Communication	302.9	0.0	0.0	0.0	0.0	70.0	13.5	0.0	0.0	75.0
Water supply, sanitation and other municipal infrastructure and services	263.0	0.0	0.0	0.0	0.0	0.0	70.0	80.0	44.8	80.0
Multisector	157.1	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	12.8	11.0	0.0	0.0	0.0
Total Loans	**2163.8**	**0.0**	**86.0**	**0.0**	**0.0**	**172.8**	**154.9**	**154.0**	**52.3**	**330.5**
	0.0									
Grants	0.0									
Agriculture and Natural Resources	0.0	0.0	18.0	0.0	0.0	0.0	46.5	27.0	11.0	4.5
Education	0.0	0.0	2.0	0.0	8.0	70.0	0.0	65.0	0.0	20.0
Energy	0.0	0.0	0.0	0.0	0.0	0.0	2.5	19.0	0.0	21.0
Finance	0.0	0.0	8.7	0.0	0.0	0.0	12.1	5.0	0.0	0.0
Industry and trade	127.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.5	0.0
Public Sector Management	0.0	0.0		0.0	106.3	0.0	0.0	0.0	21.0	0.0
Transport and Communication	0.0	0.0	55.2	0.0	25.0	10.0	25.5	0.0	0.0	0.0
Water supply, sanitation and other municipal infrastructure and services	0.0	0.0	0.0	0.0	0.0	45.1	10.0	0.0	12.0	0.0
Multisector	0.0	0.0	0.0	100.0	0.0	25.6		0.0	0.0	0.0
Regional Cooperation	0.0	0.0	0.0	9.0	0.0	12.8	11.0	0.0	0.0	0.0
Total Grants	**127.2**	**0.0**	**83.9**	**109.0**	**139.3**	**163.5**	**107.6**	**116.0**	**51.5**	**45.5**
Total Approved (Loan and Grant)	**2291.0**	**0.0**	**169.9**	**109.0**	**139.3**	**336.3**	**262.5**	**270.0**	**103.8**	**376.0**
Gross disbursements (Loans and Grants)	**1361.6**	**43.7**	**108.0**	**102.3**	**127.1**	**199.5**	**111.2**	**208.8**	**89.7**	**159.4**
	0.0									
Technical Assistance	0.0									
Total approved	113.4	2.1	5.8	7.2	4.6	5.7	10.5	13.6	6.5	11.9
Gross disbursement	71.4	3.6	2	4.6	4.6	6.8	14.2	8.8	6.8	5.4

STATISTICAL ISSUES

Economic and financial data are broadly 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 capital 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. Significant progress has been made compiling quarterly national accounts estimates for the period 2004/05 to 2012/13; however, these data still require extensive review and editing before publishing. It had been planned that the quarterly data would be published in March or April 2014. The lack of data which can be used to assess estimates for annual household consumption expenditure remains a major shortcoming. The CBS has launched an annual household survey that will collect data on household expenditure that could be used to improve the household expenditure estimates. 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). The CBS has received TA to update and expand the producer price index (PPI) to include other economic sectors. Current PPI coverage is restricted to manufacturing. 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 Government Finance Statistics Manual 2001 (GFSM 2001) in 2011, an important step forward. Still the budget classification needs further improvement to exclude financing transactions from the functional classification of expenditure, make a more clear distinction between revenue and transactions in nonfinancial assets, subsidies and capital payments to enterprises, and other improvements to ensure full consistency with the GFSM 2001. Meanwhile, treasury single account (TSA) has been rolled out to all 75 districts including Kathmandu, which allows for more timely and accurate fiscal data reporting and monitoring. However, a number of fees collected outside the budget, foreign aid directly paid by donors, the operations of extrabudgetary entities and local governments are not reported in the annual budget, and there is no compilation of the government's balance sheet in accordance with the GFSM 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, the NRB now compiles and publishes an expanded broad money survey, which is a significant step forward.

There is room for improvement in the reporting of data on the interest rates. 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.

Data on the NRB's claims on other depository corporations (ODCs) are not consistent with the data on the ODCs' liabilities to the NRB because ODCs' liabilities include only refinance and repo credit from the NRB; separate data on the NRB's deposits at the ODCs are currently not available and therefore are excluded from the ODCs' liabilities to the NRB.

External Sector Statistics

The NRB compiles and disseminates balance of payments (BOP) statistics in conformity with the fifth edition of the *Balance of Payments Statistics Manual* (*BPM5*). Balance of Payments statistics present several shortcomings in terms of coverage, classification, and data sources. Key shortcomings in BOP statistics are: (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 vs. private grants; (iv) absence of direct investment data; and (v) unrecorded financial flows.

Nepal is a participant of the Japan Administered Account for Selected IMF Activities (JSA) project on the Improvement of External Sector Statistics-ESS (BOP, IIP, and External Debt Statistics) in the Asia and Pacific Region. Since 2012, NRB has been receiving technical assistance in the area of ESS. The 2013 STA mission has observed important progress in the implementation of recommendations of previous TA missions. Thus, for first time, the NRB has compiled a preliminary draft of the International Investment Position (IIP), resumed the compilation of external sector debt statistics, and improved the compilation of direct investment. The drafts of the IIP, EDS, and DI have been submitted to the NRB management for approval before national dissemination and submission to IMF STA. In the area of data source, the mission has continued redesigning the International Reporting System (ITRS), the main collection source for compiling BOP and IIP, and assisted the authorities in improving the surveys for collecting direct investment and trade credit data.

Overall the quality of BOP data has improved with the support of IMF STA technical assistance (TA) and training of the NRB staff through ESS IMF HQ and regional courses.

Nepal—Table of Common Indicators Required for Surveillance
(As of April 30, 2014)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	Mar. 2014	Apr. 2014	D and M	W and M	W and M
International reserve assets and reserve liabilities of the Monetary Authorities[1]	Mar. 2014	Apr. 2014	M	M	M
Reserve/base money	Mar. 2014	Apr. 2014	M	M	M
Broad money	Mar. 2014	Apr. 2014	M	M	M
Central bank balance sheet	Mar. 2014	Apr. 2014	M	M	M
Consolidated balance sheet of the banking system	Mar. 2014	Apr. 2014	M	M	M
Interest rates[2]	Mar. 2014	Apr. 2014	D and M	W and M	W and M
Consumer price index	Mar. 2014	Apr. 2014	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Mar. 2014	Apr. 2014	M	M	M
Revenue, expenditure, balance and composition of financing[3] – central government	Mar. 2014	Apr. 2014	M	M	M
Stocks of central government and central government-guaranteed debt[5]	Mar. 2014	Apr. 2014	A/M	A/M	A/M
External current account balance	Mar. 2014	Apr. 2014	M	M	M
Exports and imports of goods and services	Mar. 2014	Apr. 2014	M	M	M
GDP/GNP	2012/13	Sep. 2013	A	A	A
Gross external debt	Jul. 2013	Sep.2013	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).

NEPAL

June 17, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

Approved By
Paul Cashin and Ranil Salgado (IMF) and Jeffrey Lewis and Ernesto May (IDA)

Prepared by the staffs of the International Monetary Fund and the World Bank

Nepal is assessed to be at low risk of debt distress compared to the previous assessment of moderate risk, mainly due to reduced estimates of the cost of a potential financial sector shock and the increase in the discount rate used.[1] *Generally prudent fiscal policy and low execution of capital spending budgets have underpinned declining levels of public debt. The baseline external public debt indicators show that external debt dynamics are broadly sound and remain resilient to standard stress tests.*[2] *Efforts to raise capital investment would enhance long term growth; in this context, raising net incurrence of liabilities to around 2½ percent of GDP over the medium term would help boost domestic capacity while maintaining a stable debt profile.*

BACKGROUND

1. The total stock of public debt in Nepal declined in 2013 to 31¼ percent of GDP from 36 percent in 2012, and from around 60 percent a decade ago, largely reflecting prudent fiscal policy. External debt stood at 20 percent of GDP by end-2013 ($3½ billion), of which 85 percent is concessional borrowing from World Bank and Asian Development Bank (ADB). Japan is the largest bilateral creditor, followed by Korea, India and China. Domestic debt declined from 13½ percent of GDP in 2012 to 11½ percent by end-2013, on account of low budget execution resulting in a budget surplus in 2012/13.

[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.

MACROECONOMIC ASSUMPTIONS

2. Macroeconomic assumptions remain broadly in line with the previous DSA (Box 1). Key differences, reflecting developments since the previous DSA, include (i) moderately improved growth prospects, (ii) higher revenue gains over the long term, based on better-than-anticipated performance to date and in line with continued emphasis on revenue administration reforms, and (iii) a slightly stronger current account in the near and medium term, driven by higher-than-anticipated remittance growth, which is only partially offset by stronger imports. In the long term, however, the current account is expected to be slightly weaker.

- Real GDP growth is expected to recover from 3½ percent in 2012/13 to 4¾ percent in 2013/14, mainly driven by a recovery in agricultural output, a buoyant services sector supported by remittances, and higher public spending. The election of a new Constituent Assembly and government has reduced the degree of political uncertainty. The baseline assumes improved budget execution of capital spending compared to the previous DSA in line with authorities' efforts in this area, as growth of remittance inflows moderates. Overall, growth in the medium and long run is projected at 4½ percent, slightly higher than 4 percent assumed previously.

- The external current account is projected to move from a sizeable surplus in 2013/14 to moderate deficits over the medium to long term. The exchange rate peg with the Indian rupee is assumed to remain at the current level over the projection period. Import growth is expected to moderate in line with remittances. Export growth is projected to increase only

Box 1. Macroeconomic Assumptions Table

	Previous DSA				Current DSA			Current versus previous	
	2012	**2014**	**MT**	**LT**	**2014**	**MT**	**LT**	**MT**	**LT**
Real growth (%)	4.6	3.9	4.0	4.0	4.8	4.7	4.5	0.7	0.5
Inflation (GDP deflator, %)	8.7	8.1	7.7	5.1	8.8	7.1	5.0	-0.6	-0.1
Revenues and grants (% GDP)	18.3	17.9	18.1	19.2	21.1	21.7	22.5	3.6	3.3
Grants (% GDP)	2.6	2.0	2.1	1.8	2.8	2.5	2.3	0.4	0.5
Primary expenditure (% GDP)	18.7	19.2	19.3	21.3	21.4	22.9	24.0	3.6	2.7
Net acquisition of non-financial assets (% GDP)	3.1	3.3	3.3	4.2	3.7	4.4	5.2	1.1	1.0
Primary deficit (% GDP)	0.4	-0.6	1.2	2.1	0.3	1.1	1.5	-0.1	-0.6
Net incurrence of liabilities	1.4	2.3	2.5	3.6	1.3	2.1	2.5	-0.4	-1.1
Net domestic financing (% GDP)	1.4	2.3	2.4	2.7	1.0	1.0	1.5	-1.4	-1.2
Exports of G&S (y/y growth)	11.7	8.2	7.7	7.1	4.1	7.2	6.0	-0.5	-1.1
Imports of G&S (y/y growth)	0.6	9.4	9.3	7.4	10.9	10.2	6.1	0.9	-1.3
Remittances (y/y growth)	24.5	8.3	10.9	7.5	15.0	7.9	6.0	-3.0	-1.5
Current account balance (% GDP)	4.7	-0.3	-0.5	-0.5	4.2	0.9	-0.8	1.4	-0.3

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

moderately, reflecting weak competitiveness due to significant infrastructure bottlenecks. As a consequence, the ratio of exports to GDP is expected to gradually decline over the medium term.

- Fiscal policy is expected to remain prudent. Enhanced revenue generation backed by tax administration reforms, augmented external grants (which, though, decline over time as a share of GDP), and moderately higher fiscal deficits would allow for higher public investment, which would increase from 3.7 percent of GDP in 2014 to 5.2 percent in 2034. Net incurrence of liabilities is projected to rise from 1¼ percent of GDP in 2013/14 to 2¼ percent over the next five years, rising gradually to 2½ percent towards the end of the DSA horizon. This path is consistent with a stable debt profile. Financing of the deficit is expected to tilt increasingly towards domestic sources (rising to 1½ percent of GDP in the long term), as public financial management improves and external loans decline relative to GDP.

- The grant element of foreign borrowing has increased relative to the previous DSA, mainly on account of the upward revision of the discount rate to 5 percent. The change in the discount rate, unified at 5 percent for all LIC DSAs, was made to prevent a narrowing of borrowing space for LICs due to historically low advanced economy interest rates and inflated debt burden estimates. As a result of the higher discount rate, the grant element remains in the range of 53–55 percent throughout the DSA horizon compared to 32–36 percent in the previous DSA, and one breach observed in the previous DSA (PV of external debt to exports + remittances in response to the most extreme shock) is no longer observed. Future debt disbursements are assumed to be mostly concessional IDA and ADB loans, with enhancement of total IDA assistance by at least 10 percent, triggered by the low-risk assessment.[3]

EXTERNAL DEBT SUSTAINABILITY

A. Baseline

3. Under the baseline scenario, Nepal's external debt indicators remain well below indicative sustainability thresholds (Figure 1 and, Table 3b). As in the previous DSA, remittances are formally included in the analysis as inflows remain robust, and are poised to touch nearly 30 percent of GDP in 2013/14. However, debt dynamics may be susceptible to volatility in remittance flows, as captured under standard shocks, discussed below. Over the medium term, the present value (PV) of external debt stabilizes at 8 percent of GDP + remittances, 25 percent of exports + remittances,

[3] The change in risk rating from "moderate" to "low" would lead to a switch from a 45–55 percent mix of grants and loans, respectively, from IDA to 100 percent financing on standard IDA credit terms, with a roughly 10 percent increase in the level of total assistance. This has been incorporated into the projections. The ADB already provides 100 percent loan assistance.

and 50 percent of revenues. Debt service-to-exports + remittances stabilizes at 1½ percent, while the ratio of debt service to revenues stabilizes at 3¼ percent.

B. Stress Tests and Alternative Scenarios

4. **Debt dynamics remain resilient to standard shocks.** These stress tests include shocks to GDP growth, exports, non-debt creating flows, and a combination of these shocks, as well as a one-time 30 percent nominal depreciation shock. Under the most severe shock (to non-debt creating flows, capturing a remittance shock), the PV of debt to exports + remittances rises rapidly over the next 2 years but stays below the threshold, and thereafter declines again, while all other indicators remain well below the thresholds.

PUBLIC DEBT SUSTAINABILITY

5. **Under the baseline, the ratio of public debt to GDP rises modestly by the end of the projection period.** The public debt-to-GDP ratio increases slightly from 31¼ percent in 2013 to 32½ percent in 2034. In PV terms, public debt to GDP declines somewhat from 25½ percent in 2013 to 23¾ percent by 2034. As a ratio of revenues and grants, the PV of public debt declines from 132 percent in 2013 to 103 percent. The composition of public debt is projected to tilt somewhat towards higher domestic debt, from 36 percent in 2013 to 40 percent of total public debt in 2034.

6. **Debt dynamics remain resilient under standard stress tests.** In the context of the PV of public debt-to-GDP ratio, the most extreme shock is a 30 percent one-time depreciation in 2015, which does not lead to a breach of the threshold. Among the other stress tests, the 10 percent of GDP increase in debt creating flows shock mimics a financial sector shock leading to domestic debt-financed bank recapitalization needs.[4] Under this shock, the PV of public debt-to-GDP ratio rises to a peak of 29 percent in 2015, again staying well below the 56 percent threshold. The financial sector shock assumed in the previous DSA, which led to sustained breaches on multiple debt indicators, is considered unlikely in view of the stress test findings in the recent assessment under the Financial Sector Assessment Program, and some progress on financial sector reforms.[5]

7. **Contingent liabilities arise mainly from the operations of state owned enterprises (SOEs), and rising pension costs need to be addressed to head off future risks.** Nepal Oil Corporation (NOC) and Nepal Electricity Authority (NEA) are the two biggest loss-making SOEs, on average making combined losses of 1½ percent of GDP a year, and needing frequent government bail-outs despite periodic (though not automatic) price adjustments to recover costs. In addition,

[4] A stress test conducted during the recent FSAP suggests that the recapitalization needs for the entire banking sector (public and private) from a financial sector shock in which nonperforming assets increase by 2 percentage points (implying a 50 percent increase) could amount to 4¾ percent of GDP. This test, based on updated calibration, supersedes the one conducted in the previous DSA.

[5] Key assumptions included (i) 50 percent loss of central bank foreign exchange reserves; (ii) a one-time 33 percent depreciation of the currency; (iii) an output loss of 30 percent over 4 years; and (iv) fiscal costs of bank resolution and deposit coverage of 23 percent of GDP financed through domestic and foreign debt.

NOC's outstanding loans (arising from accumulated past losses) alone stand at nearly NR 34 billion, or 1¾ percent of GDP. NEA's outstanding loans from the Government stood at nearly NR 69 billion (3½ percent of GDP). Other contingent liabilities of the SOE sector, including debt arrears, accumulated losses, government guaranteed debt, and unfunded liabilities to employees, amount to another 2 percent of GDP. Government guaranteed debt, mainly loans from the pension fund to NOC, is estimated at ¾ percent of GDP, and does not appear to pose a risk to debt sustainability. Civil service pension liabilities, are currently modest at 1¼ percent of GDP, rising to 1½ percent by 2025, and can be addressed through adequate parametric reforms in the medium term according to a recent IMF TA mission on pension reforms.

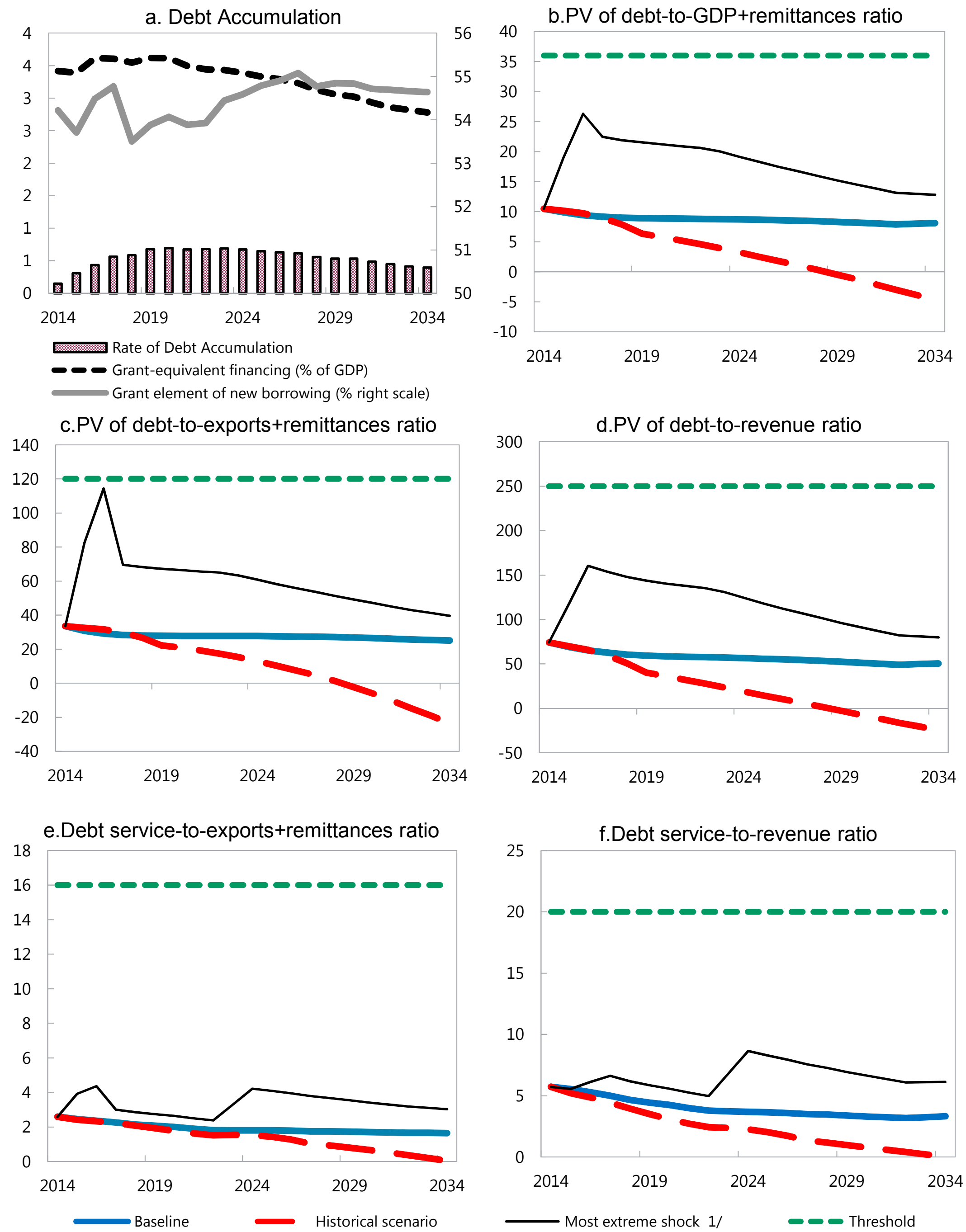
AUTHORITIES' VIEWS

8. The authorities broadly concurred with the findings and policy messages of the DSA. They expressed some concern over the change in IDA assistance from a mix of loans and grants to loans only triggered by the assessment of a low risk of debt distress, and pointed out that they were being penalized for their success. With respect to improving execution of capital spending, they highlighted various measures that they intend to implement to improve the situation. These include introducing the budget a month earlier in FY2015 to speed up the release of budget appropriations for investment projects, as well as amendments to the Procurement Act, and the drafting of a Fiscal Responsibility and Budget Management Law to enhance the budgeting and expenditure process.

CONCLUSION

9. The DSA suggests Nepal's risk of debt distress is low. This changes the assessment of moderate risk of debt distress in the previous DSA. The moderately improved medium term growth path and the higher discount factor underlying the current DSA imply a lower PV of public debt path than the previous assessment, even with a moderate increase in the size of fiscal deficits to enable higher capital spending in the medium term. The change implies that the mix of IDA assistance to Nepal will change to 100 percent IDA loans, but the level of IDA assistance will also increase by about 10 percent since the 20 percent discount applied to grants will not apply to a fully loan-based allocation. In order to maximize the growth benefits of somewhat enhanced allocation and the space afforded by the low debt trajectory, Nepal should make efforts to improve public financial management to boost public investment, by enhancing project appraisal, streamlining the budget release process, and strengthening monitoring of capital budget execution.

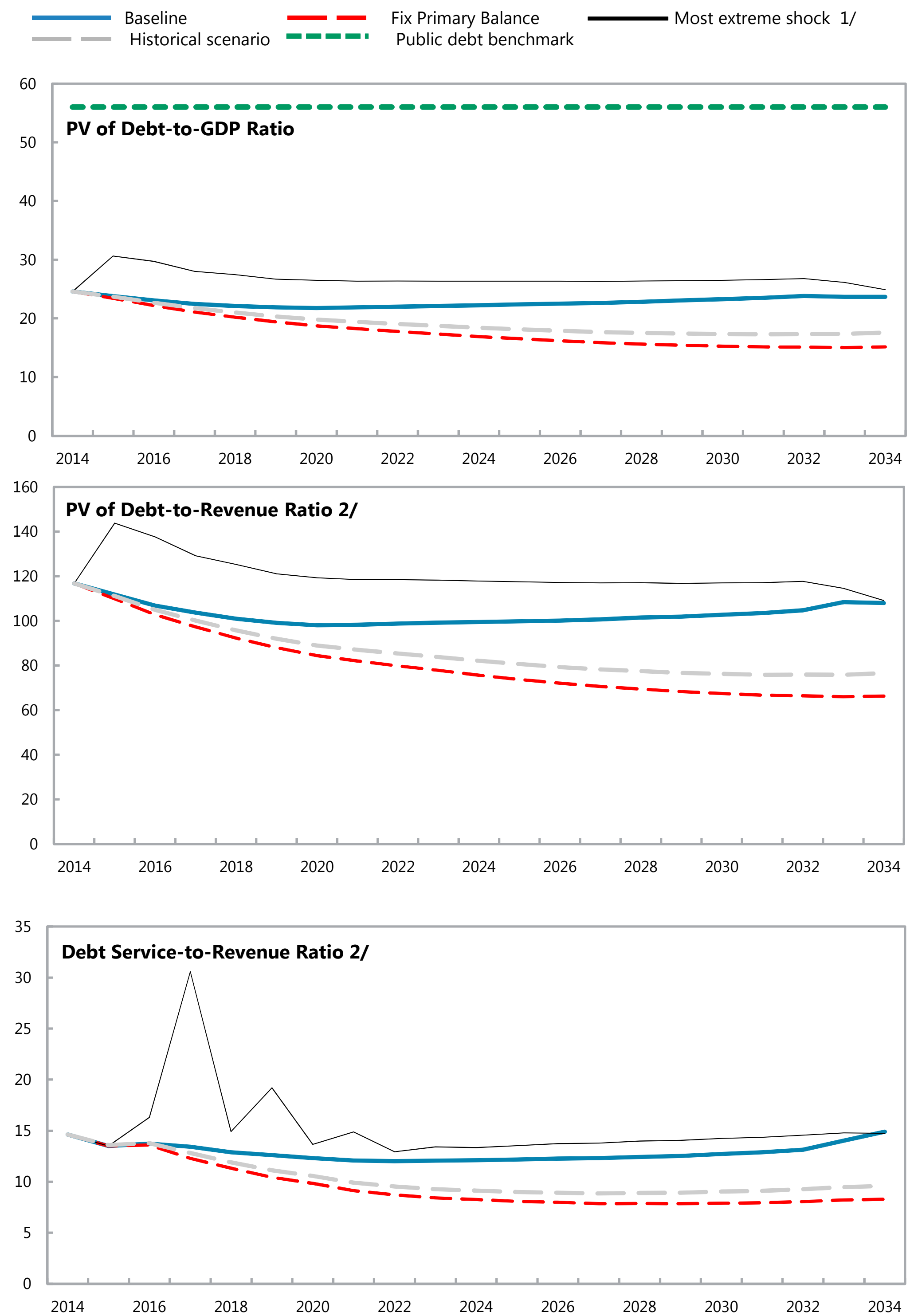
Figure 1. Nepal: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2014–2034 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2024. In figure b. it corresponds to a Non-debt flows shock; in c. to a Non-debt flows shock; in d. to a Non-debt flows shock; in e. to a Non-debt flows shock and in figure f. to a Non-debt flows shock

Figure 2. Nepal: Indicators of Public Debt Under Alternative Scenarios, 2014–2034 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio on or before 2024.
2/ Revenues are defined inclusive of grants.

Table 1a. Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2011–2034

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections								
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-19 Average	2024	2034	2020-34 Average
Public sector debt 1/	34.5	36.3	31.5			30.5	29.7	29.1	28.8	28.7	28.8		30.4	32.5	
of which: foreign-currency denominated	19.9	22.7	20.1			19.5	18.9	18.4	18.4	18.4	18.6		19.4	19.4	
Change in public sector debt	-2.8	1.7	-4.8			-1.0	-0.8	-0.6	-0.3	-0.1	0.1		0.3	0.3	
Identified debt-creating flows	-3.7	3.0	-2.6			-1.0	-0.8	-0.6	-0.3	-0.1	0.1		0.3	0.1	
Primary deficit	1.1	1.2	-1.4	0.5	1.0	0.3	0.9	1.1	1.2	1.2	1.3	1.0	1.6	1.3	1.5
Revenue and grants	17.7	18.7	19.3			21.1	21.3	21.6	21.7	21.9	22.1		22.4	23.0	
of which: grants	3.3	2.7	1.8			2.8	2.6	2.6	2.5	2.5	2.5		2.4	2.1	
Primary (noninterest) expenditure	18.8	19.9	17.9			21.4	22.2	22.7	22.9	23.2	23.4		23.9	24.3	
Automatic debt dynamics	-4.8	1.8	-1.2			-1.4	-1.7	-1.7	-1.5	-1.4	-1.3		-1.3	-1.2	
Contribution from interest rate/growth differential	-2.0	-1.8	-1.6			-1.7	-1.7	-1.5	-1.3	-1.3	-0.9		-1.3	-1.2	
of which: contribution from average real interest rate	-0.7	-0.2	-0.2			-0.3	-0.3	-0.1	-0.1	0.0	0.4		0.0	0.2	
of which: contribution from real GDP growth	-1.2	-1.6	-1.3			-1.5	-1.4	-1.3	-1.3	-1.3	-1.2		-1.3	-1.4	
Contribution from real exchange rate depreciation	-2.8	3.6	0.4			0.4	0.0	-0.2	-0.1	-0.1	-0.4		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	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	1.0	-1.3	-2.2			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.2	
Other Sustainability Indicators															
PV of public sector debt	...	...	25.5			24.6	23.8	23.1	22.5	22.1	21.9		22.2	23.7	
of which: foreign-currency denominated	...	...	14.1			13.6	13.0	12.4	12.1	11.8	11.7		11.3	10.6	
of which: external	...	...	14.1			13.6	13.0	12.4	12.1	11.8	11.7		11.3	10.6	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	6.4	6.2	4.5			4.4	4.8	5.0	5.1	5.0	5.1		5.2	6.1	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	132.2			116.7	111.7	106.8	103.7	100.9	99.0		99.5	102.8	
PV of public sector debt-to-revenue ratio (in percent)	...	...	145.8			134.4	127.0	121.7	117.2	114.0	111.7		111.3	113.0	
of which: external 3/	...	...	80.5			74.3	69.2	65.4	62.8	60.7	59.5		56.7	50.7	
Debt service-to-revenue and grants ratio (in percent) 4/	14.5	12.4	15.0			14.6	13.5	13.7	13.4	12.9	12.6		12.1	14.9	
Debt service-to-revenue ratio (in percent) 4/	17.8	14.5	16.5			16.9	15.4	15.7	15.2	14.6	14.2		13.6	16.4	
Primary deficit that stabilizes the debt-to-GDP ratio	3.8	-0.5	3.4			1.3	1.7	1.7	1.4	1.4	1.2		1.2	1.0	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	3.4	4.8	3.9	4.2	0.9	4.8	5.0	4.7	4.5	4.5	4.5	4.7	4.5	4.5	4.5
Average nominal interest rate on forex debt (in percent)	0.9	1.0	1.9	1.1	0.3	1.0	1.0	1.1	1.2	1.2	1.2	1.1	1.0	1.0	1.0
Average real interest rate on domestic debt (in percent)	-3.9	-0.4	-2.8	-3.1	3.2	-1.3	-0.6	0.3	1.0	1.3	1.7	0.4	2.2	3.0	2.3
Real exchange rate depreciation (in percent, + indicates depreciation)	-12.3	19.1	1.8	-3.2	10.6	1.9	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	10.8	6.6	6.7	8.6	4.0	8.8	7.8	7.0	6.3	6.0	5.5	6.9	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	0.0	0.1	-0.1	0.1	0.1	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	...	...	54.2	53.7	54.5	54.8	53.5	53.9	54.1	54.6	54.6	...

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 1b. Nepal: Sensitivity Analysis for Key Indicators of Public Debt, 2014–2034

	Projections							
	2014	2015	2016	2017	2018	2019	2024	2034
PV of Debt-to-GDP Ratio								
Baseline	25	24	23	22	22	22	22	24
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	25	24	23	22	21	20	18	18
A2. Primary balance is unchanged from 2014	25	23	22	21	20	19	17	15
A3. Permanently lower GDP growth 1/	25	24	23	23	23	22	24	27
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	25	24	24	24	24	24	26	28
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	25	24	24	23	23	22	23	23
B3. Combination of B1-B2 using one half standard deviation shocks	25	24	24	23	23	23	24	26
B4. One-time 30 percent real depreciation in 2015	25	30	28	27	26	25	24	23
B5. 10 percent of GDP increase in other debt-creating flows in 2015	25	31	30	28	27	27	26	25
PV of Debt-to-Revenue Ratio 2/								
Baseline	117	112	107	104	101	99	99	108
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	117	111	105	100	96	92	82	77
A2. Primary balance is unchanged from 2014	117	110	103	97	92	88	76	66
A3. Permanently lower GDP growth 1/	117	112	107	105	103	101	106	118
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	117	114	112	110	109	108	115	121
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	117	114	110	107	104	102	102	99
B3. Combination of B1-B2 using one half standard deviation shocks	117	113	109	107	105	104	109	113
B4. One-time 30 percent real depreciation in 2015	117	139	130	123	118	113	105	99
B5. 10 percent of GDP increase in other debt-creating flows in 2015	117	144	138	129	125	121	118	109
Debt Service-to-Revenue Ratio 2/								
Baseline	15	14	14	13	13	13	12	15
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	15	14	14	13	12	11	9	10
A2. Primary balance is unchanged from 2014	15	14	14	12	11	10	8	8
A3. Permanently lower GDP growth 1/	15	14	14	14	13	13	13	16
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2015-2016	15	14	14	14	14	14	14	17
B2. Primary balance is at historical average minus one standard deviations in 2015-2016	15	14	14	15	14	13	12	14
B3. Combination of B1-B2 using one half standard deviation shocks	15	14	14	14	13	14	14	16
B4. One-time 30 percent real depreciation in 2015	15	15	16	16	16	16	15	16
B5. 10 percent of GDP increase in other debt-creating flows in 2015	15	14	16	31	15	19	13	15

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 2a. Nepal: External Debt Sustainability Framework, Baseline Scenario, 2011–2034 1/

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2011	2012	2013			2014	2015	2016	2017	2018	2019	2014-2019 Average	2024	2034	2020-2034 Average
External debt (nominal) 1/	**20.1**	**22.9**	**20.2**			**19.5**	**18.9**	**18.4**	**18.4**	**18.4**	**18.6**		**19.4**	**19.4**	
of which: public and publicly guaranteed (PPG)	19.9	22.7	20.1			19.5	18.9	18.4	18.4	18.4	18.6		19.4	19.4	
Change in external debt	-3.9	2.8	-2.6			-0.7	-0.6	-0.4	0.0	0.0	0.2		0.1	0.5	
Identified net debt-creating flows	-3.3	-5.2	-4.3			-5.7	-4.9	-3.7	-2.4	-1.1	0.1		-1.3	0.0	
Non-interest current account deficit	**0.8**	**-5.0**	**-3.5**	**-2.1**	**2.3**	**-4.3**	**-3.5**	**-2.4**	**-1.1**	**0.3**	**1.4**		**0.1**	**1.4**	0.5
Deficit in balance of goods and services	24.1	23.5	26.8			30.4	32.8	34.1	35.3	36.1	36.9		34.8	37.7	
Exports	9.0	10.1	10.7			11.1	11.2	11.1	11.1	11.2	11.2		11.1	11.3	
Imports	33.1	33.6	37.5			41.5	43.9	45.2	46.4	47.2	48.1		45.9	49.0	
Net current transfers (negative = inflow)	-22.6	-27.5	-29.4	-22.0	4.5	-33.7	-35.2	-35.5	-35.4	-34.9	-34.6		-34.1	-35.8	-34.0
of which: official	-1.7	-2.1	-1.3			-1.9	-1.8	-1.8	-1.7	-1.6	-1.6		-1.9	-2.4	
Other current account flows (negative = net inflow)	-0.7	-1.0	-0.9			-1.0	-1.0	-1.0	-1.0	-0.9	-0.9		-0.7	-0.5	
Net FDI (negative = inflow)	**-0.5**	**-0.6**	**-0.5**	**-0.2**	**0.2**	**-0.6**	**-0.6**	**-0.7**	**-0.7**	**-0.7**	**-0.7**		**-0.7**	**-0.7**	-0.7
Endogenous debt dynamics 2/	**-3.6**	**0.4**	**-0.3**			**-0.8**	**-0.7**	**-0.6**	**-0.6**	**-0.6**	**-0.6**		**-0.6**	**-0.7**	
Contribution from nominal interest rate	0.2	0.2	0.2			0.2	0.2	0.2	0.2	0.2	0.2		0.2	0.2	
Contribution from real GDP growth	-0.7	-1.0	-0.9			-1.0	-0.9	-0.8	-0.8	-0.8	-0.8		-0.8	-0.8	
Contribution from price and exchange rate changes	-3.1	1.1	0.4			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**-0.6**	**8.0**	**1.6**			**5.0**	**4.2**	**3.2**	**2.3**	**1.0**	**0.1**		**1.4**	**0.5**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	14.2			13.6	13.0	12.4	12.1	11.8	11.7		11.3	10.6	
In percent of exports	...	...	132.7			122.5	116.1	111.4	108.3	105.5	103.8		102.1	94.2	
PV of PPG external debt	**...**	**...**	**14.1**			**13.6**	**13.0**	**12.4**	**12.1**	**11.8**	**11.7**		**11.3**	**10.6**	
In percent of exports	**...**	**...**	**131.4**			**122.5**	**116.1**	**111.4**	**108.3**	**105.5**	**103.8**		**102.1**	**94.2**	
In percent of government revenues	**...**	**...**	**80.5**			**74.3**	**69.2**	**65.4**	**62.8**	**60.7**	**59.5**		**56.7**	**50.7**	
Debt service-to-exports ratio (in percent)	**11.1**	**10.6**	**9.5**			**9.4**	**9.3**	**9.0**	**8.6**	**8.1**	**7.7**		**6.7**	**6.2**	
PPG debt service-to-exports ratio (in percent)	**11.1**	**10.6**	**9.5**			**9.4**	**9.3**	**9.0**	**8.6**	**8.1**	**7.7**		**6.7**	**6.2**	
PPG debt service-to-revenue ratio (in percent)	**6.9**	**6.7**	**5.8**			**5.7**	**5.6**	**5.3**	**5.0**	**4.7**	**4.4**		**3.7**	**3.3**	
Total gross financing need (Billions of U.S. dollars)	0.6	-0.6	-0.2			-0.7	-0.6	-0.4	-0.2	0.1	0.4		0.0	0.9	
Non-interest current account deficit that stabilizes debt ratio	4.7	-7.8	-0.8			-3.6	-2.9	-1.9	-1.0	0.3	1.2		0.0	0.9	
Key macroeconomic assumptions															
Real GDP growth (in percent)	3.4	4.8	3.9	4.2	0.9	4.8	5.0	4.7	4.5	4.5	4.5	4.7	4.5	4.5	4.5
GDP deflator in US dollar terms (change in percent)	14.9	-5.4	-1.7	7.5	8.1	-4.3	0.2	3.2	2.7	2.8	2.1	1.1	2.0	-2.8	1.4
Effective interest rate (percent) 5/	0.8	0.9	0.9	0.9	0.0	1.0	1.0	1.1	1.2	1.2	1.2	1.1	1.0	1.0	1.0
Growth of exports of G&S (US dollar terms, in percent)	10.8	11.7	8.4	7.5	8.0	4.1	5.8	7.6	7.4	7.8	7.3	6.7	6.3	3.5	6.0
Growth of imports of G&S (US dollar terms, in percent)	7.9	0.6	14.0	14.9	9.0	10.9	11.4	11.2	10.2	9.3	8.7	10.3	6.5	5.5	6.1
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	54.2	53.7	54.5	54.8	53.5	53.9	54.1	54.6	54.6	54.6
Government revenues (excluding grants, in percent of GDP)	14.4	16.0	17.5			18.3	18.7	18.9	19.2	19.4	19.6		20.0	21.0	20.2
Aid flows (in Billions of US dollars) 7/	1.0	0.7	0.5			0.6	0.7	0.8	0.8	0.8	0.9		1.2	2.1	
of which: Grants	0.6	0.5	0.3			0.5	0.5	0.6	0.6	0.6	0.7		0.9	1.3	
of which: Concessional loans	0.3	0.2	0.1			0.1	0.1	0.2	0.2	0.2	0.2		0.3	0.8	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			3.4	3.4	3.6	3.6	3.5	3.6		3.4	2.8	3.2
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			86.4	82.7	81.7	79.8	79.9	79.1		80.1	82.7	81.1
Memorandum items:															
Nominal GDP (Billions of US dollars)	19.0	18.9	19.2			19.3	20.3	21.9	23.6	25.3	27.0		37.2	64.0	
Nominal dollar GDP growth	18.8	-0.8	2.1			0.3	5.2	8.0	7.4	7.5	6.7	5.8	6.6	1.5	5.9
PV of PPG external debt (in Billions of US dollars)			2.5			2.5	2.6	2.7	2.8	2.9	3.1		4.2	6.7	
(PVt-PVt-1)/GDPt-1 (in percent)						0.1	0.3	0.4	0.6	0.6	0.7	0.4	0.7	0.4	0.6
Gross workers' remittances (Billions of US dollars)	3.5	4.4	4.9			5.7	6.3	6.9	7.4	7.8	8.3		11.1	19.9	
PV of PPG external debt (in percent of GDP + remittances)	...	...	11.2			10.5	9.9	9.4	9.2	9.0	8.9		8.7	8.1	
PV of PPG external debt (in percent of exports + remittances)	...	...	38.7			33.6	30.7	29.2	28.4	28.0	27.8		27.7	25.1	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	2.8			2.6	2.5	2.4	2.3	2.2	2.1		1.8	1.6	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

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

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

Table 2b. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–2034

	Projections							
	2014	2015	2016	2017	2018	2019	**2024**	2034
PV of debt-to-GDP+remittances ratio								
Baseline	11	10	9	9	9	9	**9**	8
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	11	10	10	9	8	6	**3**	-5
A2. New public sector loans on less favorable terms in 2014-2034 2/	11	10	10	10	10	11	**12**	14
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	11	10	9	9	9	9	**9**	8
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	11	10	10	10	10	10	**9**	8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	11	10	10	9	9	9	**9**	8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	11	19	26	22	22	22	**19**	13
B5. Combination of B1-B4 using one-half standard deviation shocks	11	17	24	21	20	20	**18**	12
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	11	13	12	12	11	11	**11**	10
PV of debt-to-exports+remittances ratio								
Baseline	34	31	29	28	28	28	**28**	25
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	34	33	32	30	27	22	**13**	-24
A2. New public sector loans on less favorable terms in 2014-2034 2/	34	31	31	32	32	34	**39**	44
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	34	30	29	28	28	27	**27**	25
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	34	31	32	31	31	31	**30**	26
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	34	30	29	28	28	27	**27**	25
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	34	83	114	70	68	67	**61**	40
B5. Combination of B1-B4 using one-half standard deviation shocks	34	73	101	66	65	64	**58**	39
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	34	30	29	28	28	27	**27**	25
PV of debt-to-revenue ratio								
Baseline	74	69	65	63	61	60	**57**	51
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	74	70	66	60	51	40	**19**	-25
A2. New public sector loans on less favorable terms in 2014-2034 2/	74	70	69	70	70	72	**80**	89
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	74	69	66	64	61	60	**57**	51
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	74	70	70	67	65	64	**60**	52
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	74	68	67	65	62	61	**58**	52
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	74	117	160	154	148	144	**124**	80
B5. Combination of B1-B4 using one-half standard deviation shocks	74	108	146	140	135	131	**114**	75
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	74	97	92	88	85	84	**80**	71

Table 2b. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–2034 (Continued)

(In percent)

Debt service-to-exports+remittances ratio								
Baseline	3	2	2	2	2	2	**2**	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	3	2	2	2	2	2	**2**	0
A2. New public sector loans on less favorable terms in 2014-2034 2/	3	2	2	2	2	2	**3**	3
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	3	2	2	2	2	2	**2**	2
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	3	3	2	2	2	2	**2**	2
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	3	2	2	2	2	2	**2**	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	3	4	4	3	3	3	**4**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	3	4	4	3	3	3	**4**	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	3	2	2	2	2	2	**2**	2
Debt service-to-revenue ratio								
Baseline	6	6	5	5	5	4	**4**	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2014-2034 1/	6	5	5	4	4	4	**2**	0
A2. New public sector loans on less favorable terms in 2014-2034 2/	6	6	5	5	5	5	**5**	6
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2015-2016	6	6	5	5	5	5	**4**	3
B2. Export value growth at historical average minus one standard deviation in 2015-2016 3/	6	6	5	5	5	5	**4**	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2015-2016	6	6	6	5	5	5	**4**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2015-2016 4/	6	6	6	7	6	6	**9**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	6	5	6	6	6	6	**8**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2015 5/	6	8	8	7	7	6	**5**	5
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	50	50	50	50	50	50	**50**	50

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.

INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with Nepal

On July 3, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Nepal.

Nepal's economy has stabilized, though growth remains low, following elections for a new Constituent Assembly which has reduced political uncertainty. Growth is projected to recover to 4¾ percent in 2013/14, from below 4 percent the year before, supported by agriculture, increased fiscal spending, and continued strong remittance inflows. Inflation moderated to 8.9 percent year on year in March 2014 after increasing by double-digits following the depreciation of the Indian rupee (to which the Nepali rupee is pegged). Remittances grew by 17.5 percent in the first eight months of 2013/14 and are set to reach nearly 30 percent of GDP in 2013/14. This has led to a sizeable current account surplus and further build-up of international reserves, which stood at $5.8 billion in March. With limited sterilization of remittance inflows, nominal interbank and treasury bill rates remain close to zero and excess reserves in the financial system persist. A debt sustainability analysis indicates that Nepal is now at a low risk of debt distress.

[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.

Medium-term prospects hinge on improving the investment environment. Growth is projected to remain at around 4.5 percent, with gradual improvements in implementation of the capital expenditure and budget supporting activity as remittance growth moderates. Inflation is expected to decline in line with developments in India. Downside risks to the outlook stem from a possible weaker than expected recovery in India, and/or a slowdown in countries hosting Nepali migrant workers.

Progress has been made in addressing financial sector weaknesses, with efforts to enhance supervision, consolidate the sector, and strengthen the legal framework for crisis management and bank resolution. Nonetheless, Nepal's first-ever assessment under the Financial Sector Assessment Program (FSAP) identified significant financial sector vulnerabilities. Bank supervision remains largely compliance-based, fragmented, and under-resourced. Concerns about the reliability of financial soundness indicators remain, and stress tests suggest banking system strains if asset quality deteriorates moderately. Interconnections within the financial system and to other sectors are substantial, adding to concerns about lending practices. A largely unsupervised cooperatives sector is growing rapidly, partly fueled by directed lending policies, and poses a significant risk to the stability of the financial system.

Executive Board Assessment[2]

Executive Directors welcomed Nepal's strong fiscal and external positions and progress in raising living standards, supported by large remittance inflows. Directors noted nevertheless that economic growth remains subdued, with downside risks from a weaker-than-expected recovery in India or a slowdown in countries hosting Nepali migrant workers. In this context, Directors emphasized the need for continued sound macroeconomic management and deeper structural reforms to boost competitiveness and longer-term prospects.

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

Directors agreed that, given a low risk of debt distress, Nepal has fiscal room to support growth, particularly by improving the execution of capital expenditure budgets and social programs. Building on the gains made in revenue administration, they recommended that additional fiscal space be created by reducing implicit subsidies to the state oil and electricity companies. More broadly, Directors encouraged further improvements to the legal and institutional framework, including the passage of a Fiscal Responsibility and Budget Management Act.

Directors noted that the elevated level and volatility of liquidity in the financial system, generated by remittance inflows, call for active management by the central bank, with a view to reducing financial sector risks and improving monetary policy transmission. In this regard, Directors considered it important that the central bank be adequately equipped with government securities to mop up excess liquidity, and that cooperation with the Ministry of Finance be strengthened. They also supported the planned introduction of an interest rate corridor to improve monetary management. Directors encouraged the authorities to phase out directed lending and caps on interest spreads.

Directors welcomed progress in strengthening the financial sector and stressed the need to address remaining vulnerabilities by fully implementing the recommendations from the Financial Sector Assessment Program. Key policy priorities include: further consolidating the banking sector through closure of insolvent banks and tightened licensing standards; expediting the adoption of risk-based supervision; enhancing the oversight of credit cooperatives; and improving the legal framework, particularly for bank resolution. Directors noted that further development of Nepal's financial infrastructure would help harness the sector's potential to support growth and reduce risks.

Directors underscored that structural reforms to boost competitiveness and inclusive growth would help increase employment and reduce dependence on workers' remittances. They encouraged the authorities to step up efforts to address infrastructure bottlenecks, improve labor relations, increase competition, and reduce the regulatory burden.

Nepal: Selected Economic Indicators, 2010/11–2014/15 [1/]

	2010/11	2011/12	2012/13	2013/14	2014/15
				Proj.	
Output and prices (annual percent change)					
Real GDP	3.4	4.8	3.9	4.8	5.0
CPI (period average)	9.6	8.3	9.9	8.8	7.8
CPI (end of period)	9.7	11.5	7.7	8.0	7.5
Nonfood CPI (end of period)	7.6	11.2	7.2	…	…
Fiscal Indicators (in percent of GDP)					
Total revenue and grants	17.7	18.7	19.3	21.1	21.3
Expenditure	18.7	19.3	17.9	20.8	21.1
Expenses	15.2	15.9	14.6	17.2	17.2
Net acquisition of nonfinancial assets	3.4	3.4	3.2	3.7	3.9
Net lending/borrowing	-1.0	-0.6	1.4	0.2	0.2
Net acquisition of financial assets	1.0	1.6	0.9	1.5	2.0
Net incurrence of liabilities	2.0	2.2	-0.6	1.3	1.8
Foreign	-0.3	-0.2	-0.3	0.3	0.7
Domestic	2.3	2.4	-0.2	1.0	1.1
Money and credit (annual percent change)					
Broad money	12.3	22.7	16.3	20.5	19.9
Domestic credit	13.7	8.0	16.9	15.5	18.0
Private sector credit	13.1	11.3	20.2	16.4	18.7
Velocity	1.5	1.4	1.3	1.2	1.1
Saving and Investment (in percent of nominal GDP)					
Gross investment	30.0	30.0	29.8	29.4	29.8
Private	26.6	26.7	26.6	25.7	25.9
Central government	3.4	3.4	3.2	3.7	3.9
Gross national saving	29.1	34.9	33.1	33.5	33.1
Private	27.0	32.2	28.2	29.7	29.1
Central government	2.0	2.7	4.9	3.8	4.0
Balance of Payments					
Current account (in millions of U.S. dollars)	-181	909	635	801	676
In percent of GDP	-1.0	4.8	3.3	4.1	3.3
Trade balance (in millions of U.S. dollars)	-4,470	-4,605	-5,247	-5,961	-6,760
In percent of GDP	-23.5	-24.4	-27.3	-30.9	-33.3
Exports value growth (y/y percent change)	13.2	5.0	-3.1	6.5	4.5
Imports value growth (y/y percent change)	10.2	3.4	10.9	12.5	12.1
Workers' remittances (in millions of U.S. dollars)	3,545	4,414	4,931	5,671	6,297
In percent of GDP	18.6	23.4	25.6	29.4	31.0
Gross official reserves (in millions of U.S. dollars)	3,085	4,307	4,972	6,082	7,120
In months of prospective GNFS imports	5.8	7.2	7.4	8.2	8.6
Memorandum items					
Public debt (in percent of GDP)	34.5	36.3	31.5	30.5	29.7
GDP at market prices (in billions of Nepalese rupees)	1,367	1,527	1,693	1,931	2,183
GDP at market prices (in billions of U.S. dollars)	19.0	18.9	19.2	…	…
Exchange rate (NRs/US$; period average)	71.9	81.0	88.0	…	…
Real effective exchange rate (eop, y/y percent change)	1.2	-4.6	-2.3	…	…

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

[1] Fiscal year ends in mid-July.

Statement by the IMF Staff Representative on Nepal
July 3, 2014

1. **This statement summarizes the main developments since the staff report was issued on June 18, 2014.** This information does not alter the staff's assessment of policy issues and the thrust of recommendations contained in the staff report.

- The latest available data suggest that CPI inflation in Nepal rose to 9.7 percent (year on year) in May, in large part due to weather-related food price hikes. This development broadly resonates with CPI inflation in India, consistent with the findings of staff analysis that inflation in Nepal is closely related to Indian inflation (see Box 3 in the Nepal staff report). The latest CPI inflation rate in India was 8.3 percent (year on year) in May.

- External sector developments are broadly in line with projections in the staff report. Growth of remittances has slowed to 14.5 percent in May (year on year, year to date). International reserves reached $6.1 billion at end-May, with reserve cover at 8.2 months of prospective imports.

- Reserve money growth remained broadly stable, reaching 28.4 percent in May (year on year). Excess reserves in the banking system, after declining earlier in the year, rose again to NRs 54 billion, despite efforts by Nepal Rastra Bank to mop up liquidity (mainly through reverse repo operations).

- Fiscal revenue continues to be buoyant, while expenditure, especially capital spending, has been slow. Revenue grew by 19.4 percent in May (year on year, year to date). Regarding expenditure, as of June 26, with less than one month left until the end of the fiscal year, capital budget execution reached 51 percent of planned spending, while recurrent spending reached 75 percent of budgeted amounts.

Statement by Abdul Ghaffour, Alternate Executive Director for Nepal and Ram Sharan Kharel, Advisor to Executive Director
July 3, 2014

Context Setting

1. The 2014 Article IV Consultation and the first Financial Sector Assessment Program (FSAP) for Nepal were undertaken at a time when political uncertainty has started to normalize with successful election for a new Constitutional Assembly (CA) in November 2013 and the formation of a new coalition government thereafter. The government and the CA are committed to promulgate constitution, complete the ongoing peace process and undertake local election within a year while making political consensus. These developments have created positive enabling environment for the authorities to advance its reform agenda and boost investment towards fostering a high, broad-based and inclusive growth while, at the same time, maintaining socio-economic stability.

2. On behalf of our Nepali authorities, we would like to thank the International Monetary Fund and World Bank team for the focused and constructive discussions on macroeconomic developments and policy issues in Nepal. The authorities acknowledge Staff's comprehensive reports, which shed light on economic challenges and risks facing Nepal's economy and financial sector and the appropriate policy measures to be considered. For the most part, there is broad agreement on major policy thrusts, albeit some reservations on some areas of the FSAP assessment. This statement will provide an update on recent economic development in Nepal and elaborate on selected issues mainly for emphasis and clarifications.

Recent Economic Development and Outlook

3. Despite challenging political situation, Nepal has been able to maintain a strong macroeconomic performance with significant progress in achieving the Millennium Development Goals (MDGs), underpinned by prudent macroeconomic policy, strong donor support, and high inflow of worker's remittance over the years. The economy is estimated to grow by 5.2 percent in 2013/14, slightly higher than the staff's projection, compared to 3.9 percent in the previous year, on the account of improved agriculture sector performance and stronger growth in services.

4. Given the prospect of improving output and easing supply bottlenecks together with downward revision of inflation in India, the consumer price inflation in Nepal is expected to improve from 9.9 percent in 2012/13 to 8.8 percent in 2013/14, which is in line with staff's projection.

5. In the external sector, despite widening trade deficit due to slower growth of exports than imports, current account surplus has strengthened further with improvements in the service incomes, grants and remittance inflows. As a result, the accumulated foreign exchange reserves at mid-May 2014 remain sufficient to cover merchandise goods and service imports for 9.9 months.

6. Notwithstanding the prospects of continued growth and some moderation in inflation, the authorities remain cautious of the external and internal risks. They recognize that global economic slowdown is a major external risk to growth with potentially sizeable impact on remittances, exports, as well as foreign investment. In the financial sector, the rapid growth of remittance inflows has created excess liquidity to a certain extent, and sudden fluctuation in the remittance inflows may affect banking sector stability. On the inflation front, they recognize that monsoon effect on agriculture products, higher global fuel prices, and some supply-side bottlenecks could affect inflation forecast.

Fiscal Policy

7. Our authorities welcome the debt sustainability analysis, which highlights that debt distress remains low in Nepal, underpinned by prudent debt management and fiscal policies over the years. While the fiscal position remains strong, and is characterized by budget surplus, reflecting a strong revenue growth and slow execution of capital expenditure, the authorities are fully aware of the importance to accelerate public investment to support growth. Given the improved political situation, they are now accelerating capital investment on key infrastructure projects with high impact on growth and appropriate social spending. In this regard, our authorities are in the process of amending public spending legislation to remove existing impediments to public sector spending and making “fast-track” route for the implementation of key “national-pride” projects.

8. Our authorities have also undertaken several measures to strengthen public finance management system. They are currently in the process of preparing Fiscal Responsibility and Budget Management Act (FRBM), not only to strengthen public finance management system but also to make fiscal operations more transparent and accountable. They are in the process of reducing budget preparation and implementation lag time, to ensure timely disbursement of resources and minimize fiscal pressure towards the end of fiscal years.

9. The authorities recognize that creating additional fiscal space is equally critical. Hence they will continue strengthening revenue mobilization. In this regard, they are adopting various measures to broaden the tax base, reduce tax exemption and improve grant mobilization.

Budget preparation for FY 2014/15

10. We are pleased to inform the Board that our authorities are in the final stage of preparing the annual budget for FY 2014/15 that commences from mid-July, 2014. The new budget will focus on transitioning Nepal to become “Developing Country” by 2022 by optimizing available investment and improving socioeconomic situation, and at the same time reducing poverty. The government is planning to unveil the annual budget as soon as the parliament approves the proposed guiding principles, objectives and programs for the budget.

Monetary and Exchange Rate Policy

11. The main objective of monetary policy in Nepal is to stabilize price and external sector while facilitating high and sustainable economic growth. It also focuses financial sector stability together with enhancing access to financial services in the rural and remote areas. Monetary targets for FY 2013/14 were set to maintain CPI inflation below 8 percent and secure foreign exchange reserves sufficient to cover the imports of goods and services at least for 8 months. The monetary performance remains close to targets up to mid-May, 2014.

12. Despite achieving monetary targets, our authorities broadly agree with the staff's assessment that excess liquidity prevails in the banking system, albeit, not as alarming as stated in the report. It is important to note that inflation pressure has not been created by the excess liquidity in the economy as private sector credit growth remained sluggish and fiscal stance remained tight over the years. However, our authorities remain vigilant on the level and impact of the seasonal as well as structural liquidity so as to utilize available monetary instruments as in the past and also to introduce long term bonds when appropriate.

13. Our authorities are in broad agreement with staff that monetary policy operation should focus on controlling interest rate and liquidity volatilities so as to minimize market uncertainties and strengthen monetary policy transmission mechanism. In this context, they have introduced Base Rate system since the last fiscal year together with other several progressive measures with the aim of making interest rate structure more transparent and predictable. They are also developing legal, technical and operational framework to adopt interest rate corridor policy in the near future, with the objective to stabilize short-term interest rates and improve interest rate dynamics as highlighted in the staff's report.

14. On the issue of monetary policy governance, our authorities agree with the staff's recommendation to separate the public debt management and monetary policy operation in order to enhance the effectiveness of both operations. In this regard, they have recently established two separate committees for monetary policy operations and public debt management.

15. They also welcome staff's assessment that the level of real exchange rate remains in line with fundamentals, thus supporting the external sector stability. Going forward, the authorities continue to believe that the peg to the Indian rupee is an appropriate anchor that will continue to benefit Nepal in the context of its close economic and social tie-up with India.

Financial Sector

16. Our authorities welcome the FSAP's assessment that Nepal has made significant progress in enhancing access to finance and promoting financial sector dynamism, especially in recent years. The banking sector remains adequately capitalized, liquid and profitable with low level of NPLs, underpinned by credible monetary and financial sector policies over the years.

17. The authorities generally agree with the main thrust of staff's appraisal that financial sector oversight needs to be improved further by strengthening risk management practice for banks. In non-bank financial sector, enhancing credit information system and improving asset portfolios as well as regulatory and supervisory framework including for EPF, CIT and Saving and Credit Cooperatives are critical.

18. Despite large financial sector relative to South Asian peers, our authorities also share staff's assessment that access to financial services remains low and uneven and the overall banking sector remains less competitive. In this context, our authorities are committed to strengthen the financial sector and its banking supervisory framework, in line with the pace of development of its financial sector. They are currently pursuing various measures including financial sector consolidation by encouraging merger and acquisition in the banking sector, and at the same time strengthening regulation and supervision frameworks to improve accountability, transparency and good governance. Banking institutions are also encouraged to expand their operations in rural and remote areas together with mobile banking services to enhance outreach of banking services.

19. The authorities broadly agree with the staff's assessment that there is not much difference among category A (commercial bank), category B (development banks) and category C (finance companies) banking institutions. The authorities are considering undertaking appropriate policy measures to strengthen bank licensing policy and regulation. This will be carefully undertaken and implemented without destabilizing the stability of the overall financial sector and avoid any possible disruption in financial intermediation. In this regard, the authorities are in the process of amending necessary legislations and regulations to consolidate the financial sector thereby reducing number of banking institutions in urban areas through encouraging merger and acquisition and enhancing access to finance in remote and rural areas. Work to enhance banking regulatory and supervisory frameworks will continue to enhance efficiency, transparency and governance in the banking sector. Process to amend the Nepal Rastra Bank Act, 2002 and Banking and Financial Institution Act, 2006 (BAFIA), to strengthen the supervisory framework and empower the central bank to deal with problem-banks and crisis management has already started. In regard to supervision of Employee's Provident Fund (EPF) and Citizen Investment Trust (CIB), the authorities are reviewing legal and institutional arrangements, and have created a temporary supervisory team for the time being.

20. On the assessment of the FSAP with regard to asset quality and loan ever-greening, our authorities wish to highlight that asset quality is one of the key focus area in both their onsite and off-site supervisions. They classify bank's assets into various categories and monitor loan recovery and provisions for outstanding loans regularly. The regulatory provision has also made the banking institutions more transparent and accountable for assessing their asset portfolio through internal and external audit mechanism. More importantly, the public sector banks, which used to accumulate huge amount of NPLs in the past, have gone through restructuring process since a decade ago focusing on asset quality. As a result, the overall non-performing loans have been improved remarkably over the years and hence they disagree with the prospect of loan ever-greening as highlighted in the staff's report.

21. It is observed that some of the recommendations in the FSAP are based on implicit assumption of perfect market mechanism. Given the stage of development of Nepal's financial sector and market imperfections, this has prompted authorities to take certain policy interventions to appropriately guide the market with the end objective of ensuring effective intermediation of funds in the economy and maintaining the overall stability of the financial sector. For example, cap on interest rate spread between the deposit and lending was introduced to correct market imperfection and enhance efficiency in financial intermediation. Our authorities believe that this has helped depositors to get reasonable return on their deposits while borrowers are able to get financing at reasonable prices. It is imperative to consider that while the prolonged low saving rates are detrimental to the saving culture of the public, especially in a country where huge savings is required to finance the investment, the high lending rates in several sectors have left banks in excess liquidity.

22. Similarly, the provision for deprived sector lending requirement are relevant in the Nepalese context not only to guide the market to innovate and refine skills of risk assessment and monitoring but also to fulfills the huge credit gap in the rural and remote areas. This will foster further financial access and inclusion in Nepal. The provision of productive sector lending requirement is also critically important considering the developmental needs of the country and the positive externalities associated with such lending. It will stimulate real economy which in turn will generate the demand for financial services, and thus, helps in long run sustainability of the financial sector.

23. While appreciative of the FSAP exercise, our authorities observe that the scope of the FSAP could have been strengthened further by including assessment of some critically important issues such as remittance and other capital flow related risks and their implication on the domestic financial system. Similarly, assessment on the risks and challenges originating from the exchange rate and capital account liberalization are also excluded in the report while Nepal envisages for further liberalization towards this end with gradually opening of stock and insurance markets for foreign investment. They also believe that including the authorities view more adequately on some of the critical issues where they have positional differences would have made the report more balanced.

Structural Reform and Capacity Enhancement

24. Given the context of improving political situation, our authorities remain steadfast in accelerating economic reforms to promote high and inclusive growth with reducing poverty and unemployment thereby enhancing business environment for investment. While they believe that removing structural bottlenecks especially in electricity generation will help raise potential growth, they are encouraging private investment in hydropower with an objective to overcome problem of power-shortage within three years. In this regard, the Investment Board under the chairmanship of the Prime Minister has been playing a supportive role to increase investment in infrastructure with focusing to hydropower projects.

25. The authorities broadly share the staff's view that addressing the losses of Nepal Oil Corporation (NOC) remains critical, not only to avoid further liabilities but also to make the NOC more sustainable going forward. In this context, they have already started oil price

deregulation by introducing automatic price adjustment mechanism while the NOC is directed to make petroleum transport and distribution system more transparent following the recent report of high-level Parliamentary Studies and Recommendation Committee. They are also reconsidering electricity pricing policy in order to reduce loses of Nepal Electricity Authority.

26. Considering the positive outcome of the previous economic restructuring program underpinned by donor support, discussions are underway to adopt a second generation of reform to remove remaining structural barriers so as to create enabling business environment. Our authorities have recently organized a donor meeting to share the country's economic agenda with donor. They have also organized an international investment symposium recently inviting foreign investors across the globe to explore investment opportunities in Nepal.

27. In the financial sector, a high level Financial Sector Coordination Committee has been established to monitor progress and recommend policy actions to promote financial sector development and stability. The committee frequently meets to assess the issues of the financial sector including those in the saving and credit cooperatives and non-bank financial institutions. Further, the authorities have constituted a high level committee under the chairmanship of Finance Minister to formulate Financial Sector Development Strategy (FSDS). The drafting of the FSDS is underway.

28. Our authorities are appreciative to the Fund for the continued support to enhance their technical capacity in various areas including fiscal, monetary, legal and statistics. They look forward to continue support from the Fund to expedite the reform process thereby strengthening institutional, legal, policy and statistical frameworks.

29. Further, given the commitment, initiation and speed of economic and financial sector reform programs, they continue to believe that the presence of a full-time IMF Resident Representative in Nepal will help reinforce the effectiveness of Fund's engagement with Nepal, and therefore view to consider reinstating the position in Nepal which was abolished in October 2010.

AML/CFT Framework

30. Nepal has made significant progress towards improving the AML/CFT framework in recent years, underpinned mainly by the Fund's assistance. They have recently enacted the AML/CFT ordinances into law. As a result, at a recent meeting of the Financial Action Task Force Committee, Nepal has been removed from the Committee's list of enhanced scrutiny.

Final Remarks

31. Our authorities concur with the staff's assessment that the macroeconomic situation remains solid and the outlook remains favorable. They agree with the major thrust of the staff appraisal and remain committed to remove bottlenecks for enhancing private and public investment in key sectors so as to move towards a higher growth trajectory while maintaining

stability. They also remain steadfast for strengthening financial sector stability and enhancing access to financial service.

32. Finally, our authorities would like to thank the Fund and World Bank for the successful conclusion of the Article IV consultation and the first FSAP in Nepal. The authorities also wish to thank the Fund for the continued support in terms of policy advice and technical assistance as well as donor community for their continued assistance and support to Nepal.