INTERNATIONAL MONETARY FUND

IMF Country Report No. 15/317

# NEPAL

November 2015

## 2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; 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 2015 Article IV consultation with Nepal, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 16, 2015 consideration of the staff report that concluded the Article IV consultation with Nepal.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 16, 2015, following discussions that ended on October 1, 2015, 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 October 30, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Nepal.

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November 18, 2015

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

**IMF Executive Board Concludes 2015 Article IV Consultation with Nepal**

On November 16, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Nepal.

The earthquakes in April and May and protests and trade disruptions following the promulgation of a new constitution in September have exacerbated the macroeconomic policy challenges facing the Nepalese economy. Real GDP growth is estimated to have decelerated to 3.4 percent in 2014/15 (mid-July 2014 to mid-July 2015) from 5.5 percent in 2013/14. Inflation had been moderating from a high base but the recent acceleration to 6.9 percent in August (y/y) widens the wedge over Indian CPI, thereby undermining Nepal's competitiveness given the exchange rate peg to the Indian rupee. The financing data indicates that the budget was in surplus for the third year in a row, even as revenues fell short of the budget for the first time in several years. As a result, public debt remained on a declining path, falling to 26 percent of GDP in 2014/15, from 32 percent of GDP in 2012/13. The external current account surplus reached 5.0 percent of GDP in 2014/15, aided by a surge in remittances following the earthquake and lower oil import prices. Reserves rose to US$7.2 billion, or 33 percent of GDP, covering almost eight months of prospective imports.

Growth is expected to gradually rebound to around 5.5 percent by 2016/17, as economic activity recovers from the earthquake and reconstruction gains momentum. Inflation is projected to rise to about 8.5 percent over the next 12 months as losses in agricultural production and damage to transport systems represent a large shock to the supply of agricultural products. However, over time, inflation pressures should decline as supply bottlenecks ease. Stepped-up foreign aid and higher inflows of remittances will further boost liquidity pressures in the financial system, necessitating active liquidity management to avoid excess inflation relative to India. The medium-term outlook depends importantly on the authorities' reform efforts. Experiences in other fragile countries show that natural disasters can have permanent effects on potential

[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.

growth, thus highlighting the need for ambitious macroeconomic and structural policies. This underscores the importance of a decisive boost to public capital spending and reforms to strengthen the business climate.

Recent developments have heightened the downside risks to the staff's baseline scenario. Continued political instability and a continuation of the recent disruptions to economic activity and transportation and trade routes to and from the country's southern border and the related fuel crisis could severely affect growth and inflation in this fiscal year. Another important downside risk relates to the government's capacity to boost capital spending owing in part to the delay in setting up the National Reconstruction Authority (NRA).

## Executive Board Assessment[2]

While macroeconomic management has been broadly satisfactory, Executive Directors noted that Nepal's macroeconomic performance has been held back by the earthquakes and the recent unrest and disruptions to transportation and trade routes. While growth is expected to gradually rebound as reconstruction gains momentum, the outlook is subject to downside risks. Directors called for policy action to boost capital spending, maintain macroeconomic stability, and lift potential growth.

Directors emphasized that fiscal policy needs to support post-earthquake reconstruction spending and medium-term growth through higher public investment. Swiftly operationalizing the National Reconstruction Authority and strengthening the government's capital budget implementation capacity by establishing proper and transparent planning, selection, and implementation for major capital projects remain priorities. Directors agreed that continued improvements in revenue performance and anchoring fiscal policy by a ceiling on net domestic financing of the budget would help to maintain a strong fiscal position. They noted that concessional external financing can finance the bulk of a sustained increase in capital spending needed to address infrastructure gaps.

Directors concurred that the peg to the Indian rupee continues to serve as a transparent anchor and that monetary policy should be geared toward supporting the peg. While a temporary increase in inflation as a result of the recent supply shocks should be accommodated, Directors recommended that, as conditions normalize, monetary policy be reoriented to keeping Nepalese inflation close to that in India. Strengthening the central bank's liquidity management capacity will be important in this regard.

Directors called for intensified efforts to safeguard the financial sector's stability and resilience. They looked forward to the implementation of the high-priority FSAP recommendations,

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

including a further strengthening of bank supervision and the development of a bank resolution framework. Noting that financial sector risks may have been amplified by the earthquakes and the recent disruption to economic activity, they welcomed the authorities' intention to conduct a diagnostic of these events' impact on banks and insurance companies. Directors also encouraged the authorities to enhance the quality of the central bank's external audit and legal framework to further support its autonomy and governance.

Directors stressed the importance of unlocking the country's hydropower generation potential and sustained reforms to improve the investment climate to help achieve Nepal's goal of becoming a middle-income country by 2030. They also recommended that state-owned enterprises in the energy sector be put on a sound financial footing to reduce losses and contingent liabilities.

Directors encouraged the authorities to continue to collaborate closely with the Fund, including on capacity development. They welcomed the authorities' interest in discussing a longer-term engagement, possibly through the Extended Credit Facility, which could support macroeconomic and structural reforms to accelerate the post-earthquake recovery and foster sustainable and inclusive growth.

## Nepal: Selected Economic Indicators, 2012/13-2016/17[1]

| | 2012/13 | 2013/14 | 2014/15 | 2015/16 | 2016/17 |
|---|---|---|---|---|---|
| | | | | Projections | |
| **Output and prices** (annual percent change) | | | | | |
| Real GDP | 4.1 | 5.4 | 3.4 | 4.4 | 5.4 |
| CPI (period average) | 9.9 | 9.0 | 7.2 | 8.0 | 8.3 |
| CPI (end of period) | 7.7 | 8.1 | 7.6 | 8.5 | 8.0 |
| **Fiscal indicators** (in percent of GDP) | | | | | |
| Total revenue and grants | 19.3 | 20.6 | 20.8 | 21.9 | 22.0 |
| Expenditure | 17.2 | 19.1 | 19.9 | 24.2 | 24.2 |
| Expenses | 14.2 | 15.6 | 15.8 | 17.7 | 17.8 |
| Net acquisition of nonfinancial assets | 3.0 | 3.4 | 4.1 | 6.5 | 6.4 |
| Statistical discrepancy | 0.2 | 0.9 | 0.7 | 0.0 | 0.0 |
| Net lending/borrowing | 2.2 | 2.4 | 1.6 | -2.3 | -2.2 |
| Net acquisition of financial assets | 1.1 | 1.2 | 1.4 | 1.5 | 1.2 |
| Net incurrence of liabilities | -1.2 | -1.2 | -0.3 | 3.8 | 3.4 |
| Foreign | -0.3 | -0.1 | 0.8 | 2.9 | 1.9 |
| Domestic | -0.8 | -1.1 | -1.0 | 0.9 | 1.5 |
| **Money and credit** (annual percent change) | | | | | |
| Broad money | 16.4 | 19.1 | 19.9 | 12.8 | 15.1 |
| Domestic credit | 12.2 | 13.9 | 15.7 | 15.8 | 18.3 |
| Private sector credit | 11.3 | 18.3 | 19.4 | 16.5 | 18.0 |
| Velocity | 2.0 | 1.2 | 1.1 | 1.1 | 1.1 |
| **Saving and Investment** (in percent of nominal GDP) | | | | | |
| Gross investment | 29.8 | 28.7 | 28.9 | 31.6 | 30.9 |
| Private | 26.7 | 25.2 | 24.9 | 25.2 | 24.5 |
| Central government | 3.0 | 3.4 | 4.1 | 6.5 | 6.4 |
| Gross national saving | 33.1 | 33.3 | 33.9 | 29.2 | 29.2 |
| Private | 27.8 | 28.0 | 28.9 | 25.6 | 25.4 |
| Central government | 5.3 | 5.3 | 5.0 | 3.5 | 3.8 |
| **Balance of payments** | | | | | |
| Current account (in millions of U.S. dollars) | 635 | 908 | 1,067 | -570 | -426 |
| In percent of GDP | 3.3 | 4.6 | 5.0 | -2.5 | -1.7 |
| Trade balance (in millions of U.S. dollars) | -5,247 | -6,082 | -6,670 | -8,453 | -9,106 |
| In percent of GDP | -27.2 | -30.8 | -31.2 | -36.9 | -36.2 |
| Exports value growth (y/y percent change) | -3.1 | 5.4 | -4.0 | 2.0 | 5.4 |
| Imports value growth (y/y percent change) | 10.9 | 14.3 | 7.7 | 23.5 | 7.5 |
| Workers' remittances (in millions of U.S. dollars) | 4,931 | 5,543 | 6,192 | 6,631 | 7,131 |
| In percent of GDP | 25.6 | 28.1 | 29.0 | 28.9 | 28.3 |
| Gross official reserves (in millions of U.S. dollars) | 4,972 | 6,172 | 7,162 | 7,320 | 7,594 |
| In months of imports of goods and services | 7.3 | 8.3 | 7.9 | 7.6 | 7.3 |
| **Memorandum items** | | | | | |
| Public debt (percent of GDP) | 32.3 | 28.3 | 25.7 | 28.9 | 29.4 |
| GDP at market prices (in billions of Nepalese rupees) | 1,695 | 1,942 | 2,125 | 2,396 | 2,733 |
| GDP at market prices (in billions of U.S. dollars) | 19.3 | 19.8 | 21.4 | 22.9 | 25.2 |
| Exchange rate (Nrs/US$; period average) | 88.0 | 98.3 | 99.5 | … | … |
| Real effective exchange rate (eop, y/y percent change) | -0.6 | -4.0 | 8.2 | … | … |

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

[1] Fiscal year ends mid-July.

INTERNATIONAL MONETARY FUND

# NEPAL

## STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

October 30, 2015

## KEY ISSUES

**Context**: Nepal has been trapped in a low-investment, low-growth equilibrium. The authorities' aim is to graduate from least-developed country status within 7 years.

**Macroeconomic situation and outlook**: The earthquakes in April and May have held back growth. Together with the recent unrest and disruptions to trade routes, they also pushed up inflation. Growth is expected to gradually rebound as economic activity recovers and reconstruction gains momentum. High remittance inflows are supporting a strong external position, as well as high broad money growth. The outlook is subject to considerable downside risk, involving continued political and economic instability and slower-than-expected growth of government capital spending.

**Medium-term prospects**: While remittances are expected to continue to support the external position, the outlook for growth depends importantly on the authorities' reform efforts. Experience in other fragile states shows that natural disasters can have permanent effects on potential growth. This underscores the importance of a decisive boost to public capital spending and reforms to strengthen the business climate.

**Key policy recommendations**: Fiscal policy needs to support post-earthquake reconstruction and medium-term growth through higher public investment. Stronger public financial management (PFM) will be key to the swift and efficient implementation of higher capital spending. Along with efforts to improve the business climate, this should support private investment needed to generate sustained higher economic growth and employment opportunities. The exchange rate peg to the Indian rupee provides a useful nominal anchor to the economy, and the real exchange rate is broadly in line with fundamentals. Money growth should be contained to a level consistent with supporting the peg. The monetary operations framework needs to be strengthened to put the central bank in a position to better control the growth of broad money in the face of strong inflows of remittances and aid. Financial sector reforms should continue to focus on bolstering regulation and supervision, and improving financial infrastructure, to reduce risk and increase access to finance.

Approved By
**Kalpana Kochhar and Steven Barnett**

Discussions took place in Kathmandu during Sep. 20–Oct. 1, 2015. The staff team comprised Mr. Almekinders (head), Ms. Wong (APD), Ms. Mendoza (MCM), Ms. Marinkov (FAD), and Mr. Chida (OAP), and was assisted by Mr. Richardson (Senior Resident Representative for Bhutan/India/Nepal) and Ms. Das (APD). Ms. Tangcharoenmonkong and Mr. Marcelo (both OED) also participated. Ms. Inoue and Mr. Dalesio (both APD) assisted in the preparation of this report.

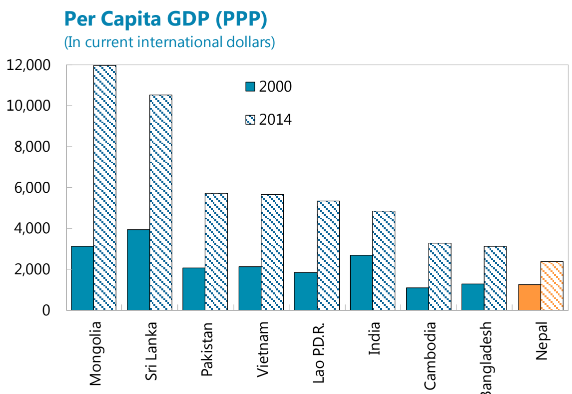
## CONTENTS

**APPENDICES**

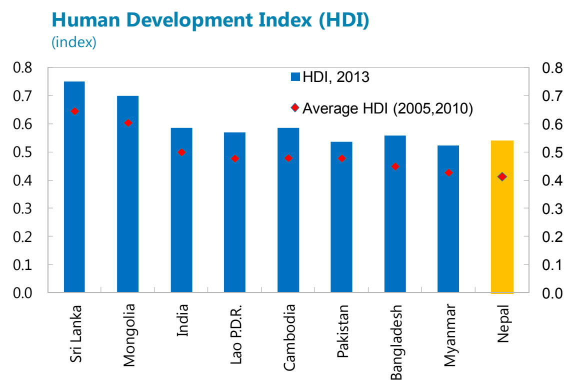
# INTRODUCTION

**1. Nepal has been trapped in a low-investment, low-growth equilibrium and remains Asia's poorest country, despite progress with poverty reduction:**

- After a decade-long civil war and the subsequent abolition of the monarchy in 2008, the country has been undergoing a gradual transition to a federal democratic state. Macroeconomic management has been broadly satisfactory. However, partly because of successive governments' preoccupation with internal power rivalries, infrastructure investment has been inadequate and the business climate unsupportive of growth. Due to lack of opportunities at home, Nepalis have been moving abroad in large numbers, mostly to Persian Gulf countries and Malaysia.
- Poverty has been declining, from over 50 percent of the population in 2003/04 to just under 25 percent in 2010/11, thanks in part to rising remittances, which currently amount to about 29 percent of GDP. Nevertheless, output per capita remains the lowest in the region, and further efforts are needed to improve human development indicators (Table 9).



Source: World Bank, *WDI Database.*



Source: UNDP, *Human Development Report 2014.*

**2. Nepal was hit by two massive earthquakes, in April and May.** Over 8,800 lives were lost and damages and losses are estimated at US$7 billion or nearly one third of GDP. In the context of a June 25 international donor conference, multilateral and bilateral donors pledged more than US$4 billion worth of grants and concessional loans to be disbursed over five years. The Nepalese authorities requested the equivalent of SDR35.65 million (50 percent of quota) under the Fund's Rapid Credit Facility. The funds were disbursed as direct budget support.

**3. The September 20 promulgation of the constitution triggered unrest, a fuel crisis, and a change in government.** After the earthquakes, the main political parties settled on a federal model of parliamentary government with seven provinces. However, fearing that the proposed provincial boundaries will perpetuate their political marginalization, ethnic groups in the south of the country mounted protests. The resulting disruptions to economic activity and transportation and trade routes to and from the southern border caused shortages of fuel and other imported goods. Parliament voted out the Prime Minister. His party moved to the opposition and a new Prime Minister and Cabinet were inaugurated in mid-October.

# RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

**4. The earthquakes exacerbated the macroeconomic policy challenge of boosting growth by raising public capital spending and private investment, while containing inflation**:

- Real GDP growth is estimated to have decelerated to 3.4 percent in 2014/15, compared to a pre-earthquake baseline forecast of 5 percent. Growth had accelerated to 5.5 percent in 2013/14 owing largely to a favorable monsoon. Average growth of 4 percent in the three previous years lagged neighboring countries.
- Inflation had been moderating from a high base, in line with developments in India. However, the recent acceleration, to 6.9 percent in August (y/y), widens the wedge over Indian CPI, thereby undermining Nepal's competitiveness.
- Preliminary data on government spending suggests a 28 percent increase in capital spending in 2014/15. However, the financing data indicates that the budget was in surplus for the third year in a row, even as revenues fell short of the budget for the first time in several years. As a result, public debt remained on a declining path, falling to 26 percent of GDP in 2014/15, from 32 percent of GDP in 2012/13.
- The external position has remained strong. The current account surplus reached 5.0 percent of GDP in 2014/15, aided by a surge in remittances following the earthquake and lower oil import prices. Reserves rose to US$7.2 billion, or 33 percent of GDP, covering almost eight months of prospective imports.
- The effect of the earthquakes on the financial system has yet to become clear. As of July 2015, commercial and development banks had capital adequacy ratios comfortably in excess of the required minima (6 percent) and reported low non-performing loans (Table 8).

**5. Growth is expected to gradually rebound to around 5½ percent by 2016/17, as economic activity recovers from the earthquake and reconstruction gains momentum**. Inflation is projected to rise to about 8½ percent over the next 12 months. Losses in agricultural production and damage to transport systems represent a large shock to the supply of agricultural products, which account for some 40 percent of the CPI basket. However, over time, as agricultural production recovers and transportation infrastructure improves, inflation pressure should ease. Stepped-up foreign aid and higher inflows of remittances will further boost liquidity pressures in the financial system, necessitating active liquidity management to avoid excess inflation relative to India.

**6. The medium-term outlook depends importantly on the authorities' reform efforts**. Experience in other fragile countries shows that natural disasters can have permanent effects on potential growth. For instance, the June 2015 IMF policy paper on *IMF Engagement with Countries in Post-Conflict and Fragile Situations—Stocktaking* notes that fragile states tend to experience larger growth downturns in the face of shocks. This highlights the need for ambitious macroeconomic and structural policies. To illustrate this and the importance of ramping up public infrastructure spending and attracting FDI-financed mega-projects to boost medium-term growth, staff prepared two scenarios (see Table 1):

- The baseline scenario is an updated version of the medium-term scenario presented in the context of Nepal's request for a disbursement under the RCF. In this scenario, following the

## Table 1. Nepal: Macroeconomic Framework—Baseline and Reform Scenarios, 2012/13–2019/20 1/

| | 2012/13 | 2013/14 | 2014/15 Est. | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Baseline scenario projections | | | | | Reform scenario projections | | | | |
| **Output and prices** (annual percent change) | | | | | | | | | | | | | |
| Real GDP | 4.1 | 5.4 | 3.4 | 4.4 | 5.4 | 3.9 | 3.8 | 3.8 | 4.4 | 5.6 | 5.3 | 5.5 | 5.8 |
| CPI (period average) | 9.9 | 9.0 | 7.2 | 8.0 | 8.3 | 7.7 | 7.0 | 6.1 | 8.0 | 7.7 | 6.5 | 5.5 | 5.0 |
| CPI (end of period) | 7.7 | 8.1 | 7.6 | 8.5 | 8.0 | 7.5 | 6.5 | 5.7 | 8.5 | 7.0 | 6.0 | 5.0 | 5.0 |
| **Fiscal Indicators** (in percent of GDP) | | | | | | | | | | | | | |
| Total revenue and grants | 19.3 | 20.6 | 20.8 | 21.9 | 22.0 | 22.2 | 22.4 | 22.5 | 22.0 | 22.3 | 23.0 | 23.2 | 23.2 |
| of which: tax revenue | 15.3 | 16.1 | 16.8 | 16.8 | 17.1 | 17.4 | 17.6 | 17.6 | 16.9 | 17.3 | 18.2 | 18.3 | 18.4 |
| Expenditure | 17.2 | 19.1 | 19.9 | 24.2 | 24.2 | 23.7 | 22.3 | 22.6 | 24.0 | 24.4 | 24.4 | 24.2 | 23.9 |
| Expenses | 14.2 | 15.6 | 15.8 | 17.7 | 17.8 | 18.0 | 17.9 | 17.8 | 17.4 | 17.7 | 17.7 | 17.7 | 17.7 |
| Net acquisition of nonfinancial assets | 3.0 | 3.4 | 4.1 | 6.5 | 6.4 | 5.7 | 4.4 | 4.7 | 6.6 | 6.7 | 6.6 | 6.5 | 6.3 |
| Statistical discrepancy | 0.2 | 0.9 | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net lending/borrowing | 2.2 | 2.4 | 1.6 | -2.3 | -2.2 | -1.5 | 0.1 | -0.1 | -2.0 | -2.1 | -1.4 | -1.0 | -0.7 |
| Net financial transactions | -2.2 | -2.4 | -1.6 | 2.3 | 2.2 | 1.5 | -0.1 | 0.1 | 2.0 | 2.1 | 1.4 | 1.0 | 0.7 |
| Net acquisition of financial assets | 1.1 | 1.2 | 1.4 | 1.5 | 1.2 | 1.3 | 1.2 | 1.1 | 1.5 | 0.9 | 0.8 | 0.7 | 0.6 |
| Net incurrence of liabilities | -1.2 | -1.2 | -0.3 | 3.8 | 3.4 | 2.7 | 1.1 | 1.2 | 3.5 | 3.0 | 2.2 | 1.7 | 1.3 |
| Foreign | -0.3 | -0.1 | 0.8 | 2.9 | 1.9 | 1.8 | 1.4 | 1.1 | 3.0 | 2.1 | 2.0 | 1.6 | 1.0 |
| Domestic | -0.8 | -1.1 | -1.0 | 0.9 | 1.5 | 0.9 | -0.4 | 0.1 | 0.5 | 0.9 | 0.2 | 0.1 | 0.3 |
| **Balance of Payments** | | | | | | | | | | | | | |
| Current account (in millions of U.S. dollars) | 635 | 908 | 1,067 | -570 | -426 | -452 | -352 | -234 | -623 | -555 | -1,174 | -1,440 | -1,356 |
| In percent of GDP | 3.3 | 4.6 | 5.0 | -2.5 | -1.7 | -1.7 | -1.2 | -0.8 | -2.7 | -2.2 | -4.3 | -4.9 | -4.3 |
| Trade balance (in millions of U.S. dollars) | -5,247 | -6,082 | -6,670 | -8,453 | -9,106 | -9,867 | -10,450 | -11,080 | -8,503 | -9,227 | -10,565 | -11,372 | -12,207 |
| In percent of GDP | -27.2 | -30.8 | -31.2 | -36.9 | -36.2 | -36.2 | -36.2 | -36.2 | -37.1 | -36.8 | -38.8 | -38.8 | -38.5 |
| Exports value growth (y/y percent change) | -3.1 | 5.4 | -4.0 | 2.0 | 5.4 | 6.0 | 6.0 | 6.0 | 2.0 | 5.4 | 6.0 | 6.0 | 6.0 |
| Imports value growth (y/y percent change) | 10.9 | 14.3 | 7.7 | 23.5 | 7.5 | 8.1 | 5.9 | 6.0 | 24.2 | 8.2 | 13.6 | 7.5 | 7.2 |
| Workers' remittances (in millions of U.S. dollars) | 4,931 | 5,543 | 6,192 | 6,631 | 7,131 | 7,698 | 8,308 | 8,964 | 6,631 | 7,131 | 7,698 | 8,346 | 9,056 |
| In percent of GDP | 25.6 | 28.1 | 29.0 | 28.9 | 28.3 | 28.3 | 28.8 | 29.3 | 28.9 | 28.4 | 28.3 | 28.5 | 28.6 |
| Gross official reserves (in millions of U.S. dollars) | 4,972 | 6,172 | 7,162 | 7,320 | 7,594 | 8,003 | 8,548 | 9,138 | 7,325 | 7,558 | 7,978 | 8,448 | 8,979 |
| In months of prospective GNFS imports | 7.3 | 8.3 | 7.9 | 7.6 | 7.3 | 7.3 | 7.3 | 7.3 | 7.5 | 6.9 | 6.7 | 6.7 | 6.6 |
| Excl. reconstruction- and FDI-related imports | | | 9.0 | 8.3 | 7.8 | 7.5 | 7.3 | 7.3 | 8.3 | 7.4 | 7.4 | 7.4 | 7.4 |
| **Memorandum items** | | | | | | | | | | | | | |
| Public debt (in percent of GDP) | 32.3 | 28.3 | 25.7 | 28.9 | 29.4 | 29.6 | 28.7 | 28.0 | 28.6 | 28.8 | 28.5 | 28.0 | 27.0 |
| GDP at market prices (in billions of U.S. dollars) | 19.3 | 19.8 | 21.4 | 22.9 | 25.2 | 27.2 | 28.9 | 30.6 | 22.9 | 25.1 | 27.2 | 29.3 | 31.7 |

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

[1] Fiscal year ends in mid-July.

initial reconstruction-related, partially donor-funded rebound in activity, growth decelerates to around 4 percent over the medium term (Tables 3–7). Continued under-implementation of the budget and under-investment hold back imports thereby supporting reserves. A debt sustainability analysis conducted on the basis of this scenario in the RCF staff report (IMF Country Report 15/224) concluded that Nepal's risk of debt distress would remain low.

- The reform scenario illustrates the implications of adopting staff's policy advice. These reforms would aim to sustain the growth momentum, with an acceleration to about 6 percent by 2019/20, on sustained efforts to strengthen the government's capital budget implementation capacity, while bringing inflation down to the neighborhood of that in India. A persistent push to develop large FDI-financed hydropower projects would lay the basis for stronger, sustained, private-sector led growth in the next decade. Construction on the large hydropower projects is projected to start in 2017/18. Insofar as these projects are highly import intensive, and FDI and donor financing do not completely cover higher import spending, the current account balance would turn to modest deficits in the medium term due to higher imports and reserves would be lower than in the baseline. External debt would remain manageable and continue to be contracted largely on highly concessional terms.

**7. Recent developments have heightened the downside risks to the baseline scenario** (Table 2). Continued political instability and a continuation of the recent disruptions to economic activity and transportation and trade routes to and from the country's southern border and the related fuel crisis could severely affect growth and inflation in this fiscal year. Another important downside risk relates to the government's capacity to boost capital spending**.** The baseline scenario assumes a considerable degree of under-execution of the ambitious 2015/16 budget. Nevertheless, owing also to delays in setting up the National Reconstruction Authority (NRA) which remain to be resolved, the 40 percent increase in expenditure relative to the 2014/15 budget outturn that is projected in the baseline scenario, and expected to persist through 2015/16, may not be achieved. Other downside risks pertain to remittances, and the financial sector.

### Authorities' Views

**8. The authorities were more optimistic on the outlook for growth.** The unrest and disturbances to trade routes were deemed to be temporary phenomena. Once stability would return, there would be confidence effects from the new constitution. The authorities were also hopeful that the measures taken to streamline procedures for government spending would pay off. Together with progress in operationalizing the NRA this was expected to underlie an important pick up in government capital and reconstruction spending following the October/November festival season. In conjunction with base effects from low growth in 2014/15, this was expected to raise growth above 5 percent in 2015/16.

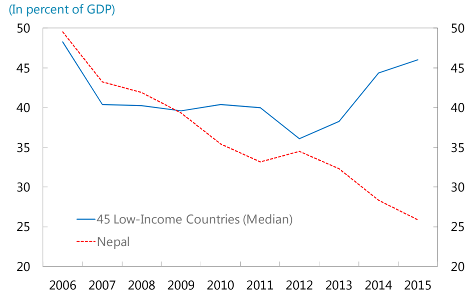
# POLICY DISCUSSIONS

*Nepal's long-term vision is to graduate from least-developed country status by 2022 and to achieve middle income country status by 2030. Accordingly, key objectives of Nepal's 13th Development Plan (2013-16) are to achieve an annual growth rate of 6 percent and bring down the percentage of the population living below the poverty line to 18 percent by 2016. These objectives are echoed in the Budget for 2015/16 (mid-July 2015/mid-July 2016) and Monetary Policy for 2015/16. Experience in other low-income countries has shown that the recovery and reconstruction after a natural disaster such as the recent earthquakes takes considerable time. In light of this, discussions focused on the macroeconomic policy mix needed to support Nepal's recovery while maintaining macroeconomic and financial stability.*

## A. Fiscal Policy

**9. Fiscal policy was tighter than planned in recent years due to budget implementation bottlenecks**. Spending under-implementation left the large infrastructure gap mostly unaddressed. In conjunction with relatively strong revenue collection, it kept the public debt to GDP ratio on a declining path, unlike in other low-income countries.

Public Debt in Nepal and other LICs
(In percent of GDP)




Sources: IMF, LIC DSF database, and IMF staff estimates.

**10. Going forward, fiscal policy needs to support post-earthquake reconstruction and medium-term growth through higher public investment.** This should be financed through a combination of higher tax revenues (see ¶14), external grants and loans, and domestic financing.

**11. The 2015/16 budget targets a large increase in spending.** Compared to the estimated outturns for 2014/15, it aims for a 44 percent increase in current spending and a 168 percent increase in capital spending. In the IMF's presentation of the fiscal data, the 2015/16 budget targets an overall fiscal deficit—measured by the net incurrence of liabilities—of 4.9 percent of GDP, compared to a surplus of 0.3 percent of GDP in 2014/15. If implemented, this fiscal impulse would have important implications for the conduct of monetary policy.

**12. It is unlikely that the budget can be implemented in full.** The Budget Speech labeled 2015/16 as the "Year of Implementation". While this is welcome, persistent implementation challenges and delays in operationalizing the NRA will make full budget implementation highly unlikely. For the next fiscal year, staff recommends that the budget targets a substantial but realistic spending increase. Reforms recommended to strengthen budget implementation are discussed in ¶16.

**13. Fiscal policy should be anchored by a ceiling on net domestic financing of the budget (NDF).** Concessional external financing can finance the bulk of the projected increase in infrastructure spending. On this basis, and taking into account the exchange rate peg and the need to protect international reserves as well as the need to ensure adequate space for continued growth in private sector credit, NDF should not exceed 1 percent of GDP per annum. High-quality capital spending financed by concessional donor inflows should be accommodated since it keeps debt in check while allowing for the needed infrastructure push. Given staff's projections for concessional foreign financing, this will translate to an overall fiscal deficit of 3¾ percent of GDP per annum in the short term, and 2½ percent of GDP per annum in the medium term (reform scenario in the text table). In case of capital spending shortfalls, the deficit should be reduced one for one with shortfalls in donor-financed spending (with a corresponding reduction in NDF and a rise in NFA for any donor financing received but not spent). As discussed below, this fiscal performance would need to be underpinned by decisive structural fiscal reforms.

**14. Continued improvements in revenue performance will be important to maintain a strong fiscal position and meet the increasing need for capital expenditure.** Revenue has been growing in recent years, albeit at a decreasing rate, on the back of rising consumption and imports. However, revenue fell short of the FY2014/15 budget and the ambitious target set for this year implies a strong possibility of another shortfall in the current fiscal year. To ensure that the tax revenue to GDP ratio remains on a rising trend, staff recommended the following:

- The Inland Revenue Department (IRD) needs to ensure that taxpayer compliance is not adversely affected by the earthquake and the current unrest in the country.
- Staff welcomed the recently completed review of the tax policy framework and the intent to commence with the implementation of various policy reforms from FY2015/16. Staff encouraged the authorities to work closely with FAD in the drafting of a unified tax code.
- The findings and recommendations of a VAT-GAP analysis, conducted by a recent FAD mission, should be used for an action plan to improve tax administration and compliance.

**15. Stronger public financial management (PFM) will be key to the swift and efficient implementation of post-earthquake reconstruction as well as the "regular" capital budget.** Budget execution in Nepal suffers from persistent problems related to structural weaknesses such as poor project management and bureaucratic hindrances. The earthquake has added urgency to the need to improve capital budget execution and the authorities recently announced steps to expedite expenditure and simplify approval processes. [1]

**16. Capital budget implementation remained slow in the first two months of the fiscal year**. A coordinated effort by the Ministry of Finance (MOF), the National Planning Commission (NPC), and key line ministries to address bottlenecks is needed. Staff welcomed the MOF's ongoing efforts to draft a Fiscal Responsibility and Budget Management Act (FRBM). This could provide important guidance to the budget implementation process and should be put in place in time for

[1] For spending items included in the approved budget, government bodies are no longer required to obtain authorization from the District Development Committee, the line ministry and the NPC, a process that could take up to six months. Similarly, multi-year projects included in the approved budget in one year no longer need to be re-authorized at the start of each fiscal year. Projects with minimal implementation will henceforth need to surrender budget resources. And a revised employee performance evaluation system will incentivize project completion.

the start of the next fiscal year. Staff welcomed the preparation of the PFM Reform Action Plan (following the publication of the Public Expenditure and Financial Accountability (PEFA) Assessment in May) and encouraged the authorities to focus the Plan on key priorities for each agency and implement it as soon as possible. Finally, staff reiterated past FAD PFM technical assistance advice to enhance upstream project preparation, appraisal and selection, including: (i) establishing proper and transparent planning, selection and implementation for major capital projects; and (ii) developing better targeted selection and prioritization criteria based on cost-benefit analyses, project life cycle and future recurrent costs, project implementation readiness, as well as associated risks (see also Box 3 in the staff report for Nepal's request for disbursement under the RCF).

**17. Debt management needs to be strengthened in view of the increasingly complex debt instruments and larger borrowing envisaged in the future, particularly related to the development of Nepal's hydropower potential**. The joint IMF/World Bank Debt Sustainability Analysis conducted in the context of Nepal's request for disbursement under the RCF concluded that Nepal's risk of debt distress remains low. However, a Debt Management Performance Assessment (DeMPA) conducted by the World Bank in August 2014 called for improving the effectiveness of managerial oversight on the debt management functions. It also recommended to task one entity with the preparation of a comprehensive debt management strategy, analyze the costs and risks of the debt portfolio, and make debt service forecasts more robust.

**18. Protecting priority social spending and improving the effectiveness of safety nets are important**. The growth of spending on health and education has stagnated in the last few years. Staff encouraged the authorities to reverse this trend and noted that the macro framework in the reform scenario can accommodate an increase in current spending by almost 2 percent of GDP per annum. Once earthquake-related spending is phased out, a rising share of this increase should be allocated to social spending.

**19. Large state-owned enterprises (SOEs) in the energy sector need to be put on a sound financial footing.** This is needed to reduce contingent liabilities and encourage private and foreign energy sector investment. In recent years, the combined losses of the Nepal Electricity Authority (NEA) and Nepal Oil Corporation (NOC) averaged about 1½ percent of GDP per year. To prevent future accumulation of losses, the automatic bi-weekly oil price adjustment mechanism introduced in 2014 should be adhered to and electricity tariffs should be reviewed more regularly. The NEA's operations should be scrutinized more closely and remaining losses should be covered by transparent budget transfers.

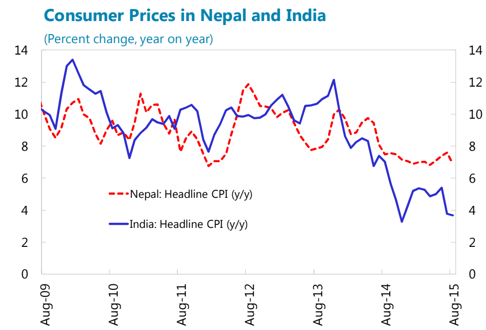
### Authorities' Views

**20. The authorities were confident that capital budget implementation would pick up from mid-November**, after the festival season, and would end higher relative to the last fiscal year in part due to the simplification of administrative procedures. Nevertheless, they acknowledged scope to improve implementation capacity and that while there had been improvements in procurement, more needed to be done, including to strengthen capacity of the public and private construction sectors. The authorities viewed the 1 percent of GDP ceiling on NDF as too restrictive in view also of the abundance of liquidity in the financial system.

**21. The authorities pointed out that social spending had been rising steadily in absolute terms** and that much of the reconstruction spending would be on schools and health facilities. Moreover, local governments also carry out social spending but tracking this is difficult. On retail fuel prices, the authorities noted the importance of broadly maintaining parity with prices across the border to prevent distortions.

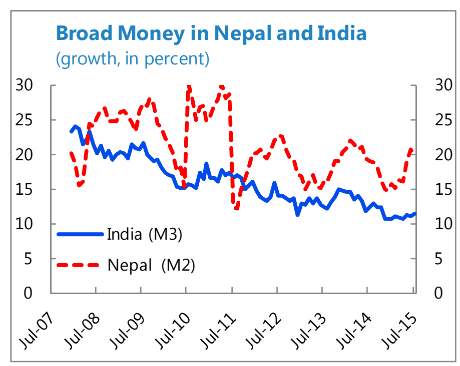
## B. Monetary and Exchange Rate Policy

**22. 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. The level of the exchange rate remains broadly in line with fundamentals (Box 1). However, remittances skew domestic activity to non-tradables and contribute to reducing the competitiveness of agriculture and industry. Accordingly, in the staff's view, the authorities' focus should be on competitiveness-enhancing structural reforms to support the peg. Stepped-up efforts to install enough hydropower capacity to eliminate load shedding could give a big boost to the investment climate.

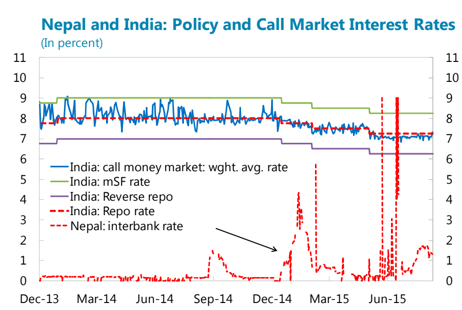


Sources: Nepali authorities, Haver analytics; and IMF staff estimates.

**23. Money growth should be contained to a level consistent with supporting the peg.** By mid-2014, Nepal's inflation began to decouple from that in India, reflecting the Reserve Bank of India's increased emphasis on bringing consumer price inflation down in the context of their planned transition to flexible inflation targeting. The earthquake has exacerbated the decoupling of inflation in the two countries. Given the economic disruption caused by the earthquake and the recent unrest, some temporary increase in inflation in Nepal is inevitable and should be accommodated. However, as the economy recovers, the Nepal Rastra Bank (NRB) should aim to keep Nepalese inflation close to that in India to maintain competitiveness. Accordingly, efforts should be made to contain the growth of broad money in 2015/16 (Table 5).




**24. The monetary operations framework needs to be strengthened to put the NRB in a position to better control the growth of broad money**. A positive first step in this respect is the creation, since the FSAP, of separate open market committees for public debt management and



Sources: Reserve Bank of India; Nepal Rastra Bank; and IMF staff calculations.

monetary management. Staff also welcomed the introduction of deposit auctions in August 2014. Over the past year, deposit auctions have at times contributed to the mopping up of excess liquidity. The next step would be to hold regular pre-announced deposit auctions with a view to effectively mop up excess liquidity and systematically raising short-term interest rates from current low levels, closing the gap with interbank interest rates in India. This should be supported by the NRB refining its liquidity forecasting framework building on suggestions made in the context of the FSAP and earlier MCM technical assistance missions. A key recommendation has been for the NRB to adopt an interest rate corridor to provide more systematic guidance to short-term interest rates with a view to strengthening the monetary transmission mechanism. In addition, treasury sterilization bonds could be introduced for the purpose of addressing structural excess liquidity with NRB instruments (repo/reverse repo) used for fine-tuning. The introduction of treasury sterilization bonds would also foster capital market development and make the cost of monetary tightening transparent in the budget. Consideration should also be given to phase out the NRB's directed lending facilities as they complicate the conduct of monetary policy and are not core central bank functions; they should be gradually transferred to the budget.

**Authorities' Views**

**25. The authorities favored a looser monetary policy stance to promote growth.** They broadly concurred with the staff's exchange rate assessment. By virtue of the peg to the Indian rupee, India's gains in disinflation were expected to spill over to lower inflation in Nepal. Broad money should expand by at least 15 percent to support growth. In view of market imperfections, the NRB's directed lending facilities are needed to achieve the government's inclusive growth objectives. They expected interest rates to rise once government spending would pick up. To regulate liquidity, the authorities were also looking at monetary operations frameworks other than the interest rate corridor. They questioned the relevance of treasury sterilization bonds in the context of a separation of public debt management and monetary management.

## C. Financial Sector Reforms

**26. Steps have been taken to begin to address weaknesses in the legal and supervisory framework governing financial institutions highlighted by the 2014 FSAP.** The 2014 FSAP stress tests suggest banking system strains if asset quality deteriorates moderately. The attached matrix (Appendix I) summarizes the limited progress made so far in implementing high-priority FSAP recommendations. Staff recommended follow through on existing policy initiatives along with additional reforms to support the stability and resilience of the financial sector:

- **Strengthen the taskforces set up to follow up on the FSAP recommendations.** Staff welcomed the various taskforces in the NRB and the GON established to follow up on FSAP recommendations. Given the large number of recommendations as well as the need for collaboration across institutions, an apex committee may be useful. That committee should be provided a mandate, technical support, suitable resources and a firm timetable.

- **Continue to strengthen the bank supervision function.** The NRB is working to complete the first cycle of risk-based supervision (RBS) on-site inspections. Off-site supervision needs significant strengthening to complement the on-site component. As the supervisory information system (SIS) is put in place, plans to integrate the off-site and on-site functions should be developed. A program to hire, train and retain supervisory staff should be developed to provide for continuity in supervisory activities. In this regard, staff urges the NRB to revisit the staff rotation policy, which has undermined its ability to effectively supervise the financial system.

- **Limit further forbearance.** Staff welcomed the NRB's statement that post-earthquake forbearance on asset classification and loan loss provisioning would remain limited in scope and time-bound.

- **Extend legal upgrades to secondary legislation.** While the primary legislation (BAFIA, NRB Act Amendments, Deposit and Credit Guarantee Fund Act) has benefitted from considerable TA and is pending enactment, the secondary legislation and regulations require attention. The NRB is encouraged to identify the priorities in the prudential regulations that need upgrading and begin the upgrade process.

- **The NRB Risk Management guideline should be converted to a directive, officially introducing risk management requirements to the banking industry**. The directive's issuance will help level the playing field by officially informing the industry of the shift to risk-based supervision. Additionally, guidance should be provided as the industry transitions to IFRS.

- **Use the results of the Special Inspections Program to prepare a diagnostic of the impact of the earthquakes on the banks.** This diagnostic could be based on the results of the ongoing special inspection of 54 BFIs (representing 64 percent of the banking system) by DFID, in coordination with the World Bank and the Fund, and by performing additional diagnostics of financial institutions to determine their resilience. On this basis, a strategy should be developed to resolve unviable BFIs and address possible capital shortfalls in others.

- **Develop an operational framework for bank resolution.** Building on the relevant laws that have been submitted to Parliament, the next step in the development of an operational framework for bank resolution is to draw up implementing regulations.

- **Formalize a system to monitor banks' capital-raising plans.** The two-year phase in period to increase the paid up capital demands diligent NRB oversight. A formal review process should be established to ensure that each BFI has internalized the obligation to increase the capital and adheres to the capital plan. Also included in this process should be a robust review of the accounting techniques used by BFIs, to minimize the potential for overstated earnings. And the NRB should establish a contingency plan that would include corrective action and administrative sanctions in the event of failure to meet required capital levels.

**27. Efforts to strengthen the Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) framework should continue.** Staff welcomed the enactment of the

AML/CFT ordinances and Nepal's exit from FATF's enhanced scrutiny in June 2014. The implementation of the AML/CFT regime should be further strengthened, including through the issuance of implementing rules and the application of risk-based supervisory tools, supported by ongoing IMF TA.

**28. The ongoing safeguards assessment of the NRB will call for a strengthening of the quality of the NRB's external audit and legal framework.** A safeguards assessment mission in September 2015 found that limited progress has been made in following up on recommendations made in the context of a similar evaluation in 2011. Notable positive developments include the successful implementation of a new accounting system and improved financial reporting practices. However, several key functions lag behind and strong commitment from the NRB Board and senior management will be needed to modernize them; in particular internal audit and currency and vault operations. Priority should be given to the following:

- The quality of the external audit should be brought in compliance with international standards. The NRB should engage an auditor with requisite global experience and expertise in the audit of large financial institutions.

- The NRB's legal framework should be enhanced to further support central bank autonomy and governance.

**Authorities' Views**

**29. The authorities broadly agreed with the recommendations and requested technical assistance and training to support implementation.** The Special Inspections Program would be completed by October and the NRB had asked DFID to go ahead with the preparation of the "fast diagnostic" of the impact of the earthquake on banks and insurance companies. The NRB would consider the modalities for monitoring banks' implementation of their capital plans. It would aim to issue the Risk Management directive by February 2016.

## D. Enabling Sustainable and Inclusive Growth

**30. Efforts to improve the business climate should be intensified**. There is considerable scope to simplify trading across borders, enforcing contracts, paying taxes and getting credit. Staff welcomed the steps taken to extend the one-stop-shop to facilitate registration of new companies beyond large investors, to any investor. As a next step, the one-stop-shop should be further improved for instance by strengthening the investment facilitation coordination committee. In addition, labor market reforms including streamlining the complex labor code, streamlining procedures (e.g. environmental impact assessments) and strengthening policy frameworks to boost private-sector-led investment are critical.

**31. Unlocking Nepal's hydropower generation potential would relieve power shortages and enable the exports of power to help diversify foreign exchange earnings** (Box 2). In this regard, staff welcomed the Power Trade Agreement signed with India and the Project Development Agreements signed for the development of two large hydropower projects with foreign investors. Large hydropower projects are complex and take long to develop. In view also of earlier failed attempts to develop Nepal's hydropower potential, staff encouraged the authorities to consider setting up a special high-qualified project committee that could help to establish realistic project timetables to spearhead progress in developing the large hydroelectric power projects in the pipeline.

# KEY OBJECTIVES OF A POSSIBLE ECF ARRANGEMENT

32. **A possible ECF arrangement would focus on supporting the government's efforts to recover from the earthquakes.** The authorities first expressed interest in longer-term Fund engagement in the context of the discussions on their request for a disbursement under the RCF. Program discussions could take place later this year, depending on the new government's interest. The arrangement's aim would be to boost public and private investment, social spending and financial inclusion, and address financial system weaknesses, with a view to improving growth prospects and poverty reduction efforts, and all while preserving overall macroeconomic stability. Accordingly, the program would focus on strengthening policies in four key areas: (i) public capital budget management; (ii) monetary policy operations; (iii) financial sector reforms; and (iv) the business climate. In transition to a higher growth trajectory, the government's medium-term reform efforts will create additional external financing needs, over and above those created by the earthquake-related reconstruction effort. Access to IMF financial resources—which like in the RCF would be disbursed to the MOF's account at the NRB—would depend on program strength, as a more robust reform agenda over the near- to medium term would come with a greater BOP and fiscal financing need—currently suppressed by budget under-execution and under-investment.

# STAFF APPRAISAL

33. **Macroeconomic performance has been held back by the earthquakes and the ongoing political instability.** Growth has been dampened by the disruption caused by the natural disaster and the recent unrest and the under implementation of the budget**.** The supply shocks related to the earthquake and trade disruption have caused Nepal's inflation to rise, exacerbating its decoupling from the declining path of inflation in India. Meanwhile, remittances have continued to support consumption, poverty reduction, and high international reserves.

34. **Growth is expected to gradually rebound as reconstruction gains momentum but inflation is projected to rise over the next 12 months**. Losses in agricultural production and damage to transport systems along with the recent disruption to trade routes represent a large shock to the supply of agricultural products and other goods. However, over time, as agricultural production recovers and transportation infrastructure improves, inflation pressure should ease.

**35. The medium-term outlook depends importantly on the authorities' reform efforts**. Experience in other fragile countries shows that natural disasters can have permanent effects on potential growth, thus highlighting the need for ambitious macroeconomic and structural policies. In a "reform scenario," the growth momentum from post-earthquake reconstruction would be sustained through determined efforts to strengthen the government's capital budget implementation capacity and a persistent push to develop large FDI-financed hydropower projects. Given that hydropower projects are highly import intensive, the current account balance would turn to modest deficits in the medium term due to higher imports and reserves would be lower than in the baseline. External debt would remain manageable and continue to be contracted largely on highly concessional terms.

**36. Recent developments have heightened the downside risks to the baseline scenario**. Continued political instability and disruptions to trade to and from the southern border could severely affect growth and inflation in this fiscal year. Another important downside risk relates to the government's capacity to boost capital spending**.** Owing also to the delay in setting up the National Reconstruction Authority (NRA), the increase in expenditure may be more limited than expected.

**37. Fiscal policy needs to support post-earthquake reconstruction spending and medium-term growth through higher public investment**. Establishing proper and transparent planning, selection, and implementation for major capital projects remains a priority. Continued improvements in revenue performance will be important to maintain a strong fiscal position. Concessional external financing can finance the bulk of the sustained increase in government capital spending needed to address infrastructure gaps. On this basis, and taking into account the exchange rate peg and the need to protect international reserves as well as the need to ensure adequate space for continued growth in private sector credit, fiscal policy should be anchored by a ceiling on net domestic financing of the budget (NDF).

**38. Monetary policy should be geared toward supporting the exchange rate peg, containing inflation, and safeguarding reserves**. As the economy recovers, the central bank would need to closely monitor price developments. In light of the exchange rate peg, monetary policy would need to be oriented to keep Nepalese inflation close to that in India. Higher inflows of foreign aid and remittances will further boost liquidity pressures in the financial system, necessitating active liquidity management.

**39. Efforts to enhance the stability and resilience of the financial sector should be intensified**. In particular, implementation of the high-priority FSAP recommendations should be accelerated. Financial sector risks may have been amplified by the earthquakes, thus underscoring the importance of conducting a diagnostic of their impact on the banks, continuing to strengthen the bank supervision function, and developing an operational framework for bank resolution. The two-year phase in period to increase banks' paid up capital requires diligent NRB oversight. The quality of the NRB's external audit should be brought in compliance with international standards and its legal framework should be enhanced to further support central bank autonomy and governance.

**40. The peg to the Indian rupee continues to serve as a transparent anchor and the level of the exchange rate remains broadly in line with fundamentals**. To the extent that remittances skew domestic activity to non-tradables and contribute to reducing the competitiveness of agriculture and industry, the authorities' focus should be on competitiveness-enhancing structural reforms. Stepped-up efforts to install enough hydropower capacity to eliminate load shedding could give a big boost to the investment climate and inclusive growth.

**41. It is proposed that the next Article IV consultation takes place on the standard 12-month cycle.**

## Table 2. Nepal: Risk Assessment Matrix 1/

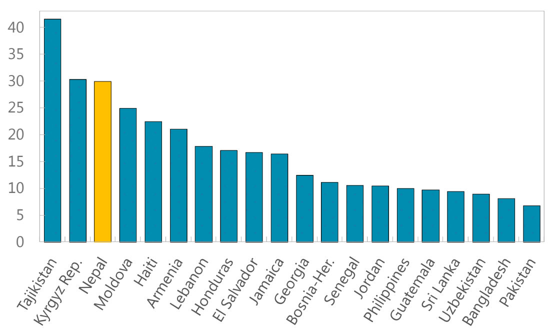
| Source | Likelihood | Impact | Policy Response to Minimize Impact |
|---|---|---|---|
| **DOMESTC RISKS** | | | |
| **Post-earthquake reconstruction is slow**<br>Under-execution of the ambitious 2015/16 budget and delays in reconstruction work in the aftermath of the earthquake, could depress confidence and hold back private investment and growth. | High | High | Boost the government's ability to manage capital expenditure as well as complex reconstruction projects, underpinned by effective coordination mechanisms that will enhance the ability of line ministries to execute their capital and reconstruction budgets. |
| **Political instability**<br>Political instability, even in the aftermath of the promulgation of the constitution, could undermine confidence and delay economic reforms. | High | Medium/High | Preserve fiscal and external policy space. |
| **Financial sector distress**<br>The damages and economic disruption caused by the earthquake could exacerbate existing weaknesses in the loan portfolio of banks and financial institutions. | 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. |
| **Natural disaster**<br>Natural disasters similar to the recent earthquake could take a significant toll on Nepal, including by damaging infrastructure, housing and the production base. | Low | Medium/High | Prepare for future disasters by: (i) adhering to disaster-proof building codes, (ii) accelerating structural reforms to diversify the economy; (iii) building fiscal space and reserves buffers; and (iv) enhancing financial safety nets. |
| **EXTERNAL RISKS** | | | |
| **Persistently low energy prices**<br>A slowdown in countries hosting Nepali migrant workers (Persian Gulf countries, Malaysia) 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. | Medium | Medium/High | Strengthen the financial sector and preserve fiscal and external policy space to cope with adverse shocks 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. |
| **Slower-than-projected growth in India**<br>Prolonged slow growth in India could reduce FDI and, to some extent, exports and remittances. | Medium | Medium | Accelerate structural reforms to improve the investment climate and boost public investment. |

[1]The Risk Assessment Matrix (RAM) shwos events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood 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 between 30 and 50 percent). 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.

## Box 1. Nepal – Exchange Rate Assessment

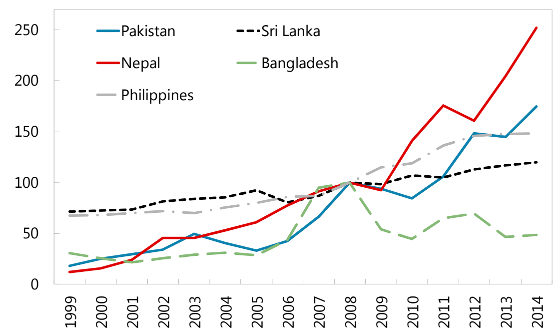
**Nepal stands out through the large remittances it receives and their effect on the economy**. At almost 30 percent of GDP in 2014, Nepal's remittances are its most important source of foreign exchange, amounting to 2½ times exports of goods and services and over ⅔ of imports. The bulk of remittances come from migrant workers in Persian Gulf countries and Malaysia. In recent years, the outflow of workers from Nepal has outpaced that of Pakistan, Bangladesh, Sri Lanka and the Philippines—larger countries with migrant workers heading to similar destinations as Nepal. The number of registered migrant workers leaving Nepal hit a record high of almost 600,000 in 2014—very large relative to its population of about 28 million. Correspondingly, the growth of remittances has averaged 15 percent since 2009/10.

**Inflows of Remittances, Selected Countries, 2014**
(In percent of GDP)



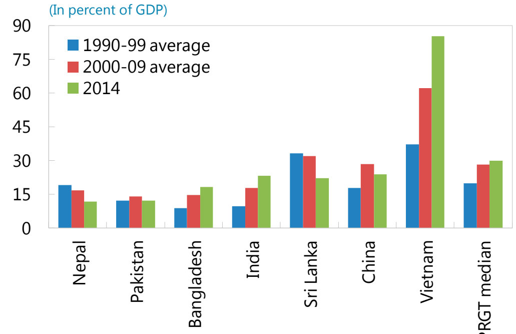

Sources: World Bank, Remittances Data; IMF, *World Economic Outlook*.

**Gross Outflow of Migrant Workers**
(Index, 2008=100)



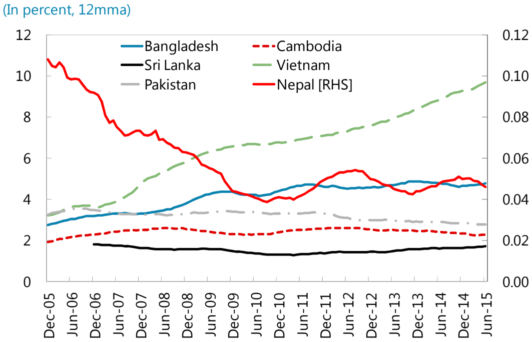

**Nepal's export performance has been weak, lagging that of peers.** The exports of goods and services to GDP ratio declined from 16 percent in the early 2000s to 11½ percent in 2014/15. In the garment's sector, for example, Nepal's market share in exports to the US has halved since 2005, and its share in the EU market has also declined. Weak exports along with the remittances-fueled increase in imports have caused the trade deficit as a share of output to increase steadily over the years, reaching 31 percent of GDP in 2013/14.

**Exports of Goods and Services**
(In percent of GDP)



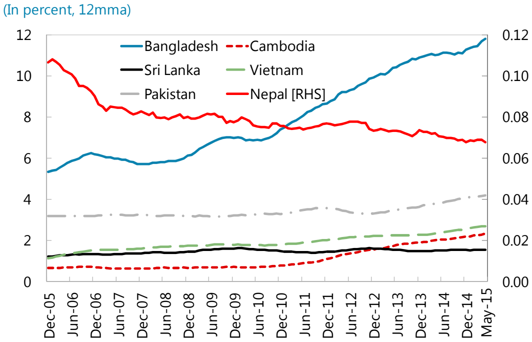

Sources: *World Economic Outlook*, and IMF staff estimates.

**Shares in U.S. Garments Market**
(In percent, 12mma)




Source: U.S. Department of Commerce.

**Shares in E.U. Garments Market**
(In percent, 12mma)



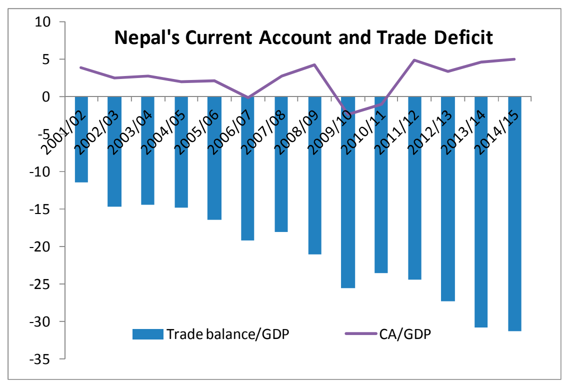

Source: Eurostat.

## Box 1. Nepal – Exchange Rate Assessment (Concluded)

**Gross international reserves (including the central bank's holdings of Indian rupees) reached US$7.2 billion at the end of 2014/15, equal to 7.9 months of prospective imports**. Reserves have risen on the strength of remittances and notwithstanding lackluster export performance. As laid out in the recent RCF staff report, Nepal's reserves should be maintained at about 7 months of imports of goods and services not related to FDI-financed projects, in view of the peg to the Indian rupee, the need to be able to absorb external shocks and the low opportunity cost of holding reserves.

**The application of several econometric approaches[1] suggests that the exchange rate is broadly in line with macro-economic fundamentals. Last year's Article IV consultation concluded that the exchange rate was broadly in line with fundamentals.** Reflecting also the inflation differential with India, Nepal's REER appreciated by about 8 percent over the past year. Nevertheless, and in part because Nepal's large trade deficits are sustained by even larger remittances, various econometric approaches to assess the exchange rate produce a relatively wide range of estimates:

i) The current account panel regression approach takes fundamentals, policy variables, and cyclical factors into account in estimating the current account "norm".[2] The current account norm for Nepal is estimated at 1.8 percent of GDP, while the underlying current account in 2014/15 is 5.0 percent of GDP. Assuming an elasticity of the trade balance with respect to the REER of -0.33, the difference between the two suggests an undervaluation of the REER 9.7 percent.




ii) The index equilibrium exchange rate approach compares the current value of the REER with an estimate of its medium-term equilibrium value. The gap between the two indicates that the REER is approximately 23 percent overvalued as of end-June 2015.

iii) The external sustainability approach determines that the current account that is consistent with stabilizing Nepal's net international investment position (IIP) at the 2013 level of 9.8 percent of GDP is estimated at -0.4 of GDP. Taken together with the current account projected in the medium term (-1.1 percent of GDP), this suggests the REER is overvalued by 2.1 percent.

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[1] These are based on the EBA methodology. See "The External Balance Assessment (EBA) Methodology, IMF 2013, IMF WP/13/272.

[2]The current account norm is based on a reduced form panel regression of the current account on policy variables, non-policy fundamentals, and cyclical factors. The difference between the current account norm and the actual underlying current account is then combined with an elasticity of the trade balance to the REER to arrive at an estimate of the REER that is consistent with fundamentals and desirable policies.

## Box 2. Nepal—Developing the Hydropower Potential

*Nepal's per capita use of electricity is among the lowest in the world. The inadequate electricity supply results in persistent load shedding, representing a major constraint to growth. Developing the country's vast hydropower potential should be a top priority to boost growth and diversify foreign exchange earnings.*

**At present, less than one percent of Nepal's vast hydropower potential is being exploited.** Nepal's commercially viable hydropower generation potential is estimated at 43,000 MW. Earlier attempts to develop this vast potential on a large scale have failed.

**Over the past year some promising steps were made**, notwithstanding the earthquake-related damage to the Upper Tamakoshi project which pushed back its date of completion to late-2017:

- Nepal signed a power trade agreement with India in September 2014.
- Project development agreements were signed for two large projects (Upper Karnali (900MW) and Arun-3 (900MW)).
- Nepal's Investment Board cleared a proposal by a Chinese investor to develop the West Seti (750MW) project.
- The capacity of government agencies involved in the regulation and development of the hydropower sector is being strengthened through technical assistance from various development partners (e.g. the World Bank, Japan, and the United States).

Table 1. Nepal: Planned Large Hydropower Projects

| Project | Capacity (MW) | Cost (US$m) | Expected completion | Developer | Status |
|---|---|---|---|---|---|
| Upper Tamakoshi | 456 | 441 | 2017 | Upper Tamakoshi Hydro Power Ltd, Subsidiary of NEA (Nepal) | Slated for completion by late-2017. |
| West Seti | 750 | 1,000 | 2022 | Three Gorges, China | Cleared by Investment Board in April 2015. Special Purpose Vehicle is being formed and on-site investigation is underway. |
| Upper Karnali | 900 | 1,050 | 2021 | GMR, India | Project development agreement signed in Sept. 2014. Financial closure expected in Sept. 2016. |
| Arun-3 | 900 | 1,009 | 2020 | SJVNL, India | Project development agreement signed in November 2014. |
| **Total** | **3,006** | **3,500** | | | |
| Memorandum items: | | | | | |
| Current power production (MW) | | | 800 | | |
| Current power demand (MW) | | | 1,400 | | |

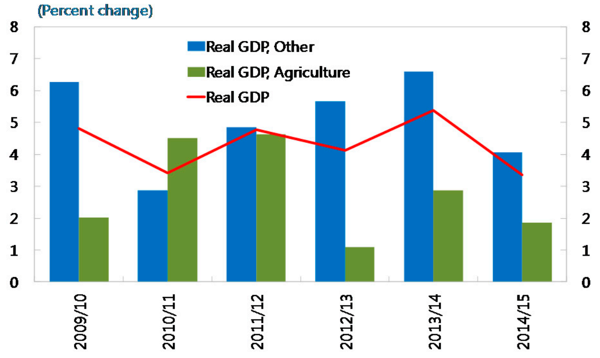
Sources: Nepalese authorities, World Bank and news reports.

## Figure 1. Nepal: Recent Macroeconomic Developments

*Growth averaged 4.5 percent in recent years but it slowed to 3.4 percent in 2014/15 due to the earthquake.*

**Real GDP Growth**

(Percent change)

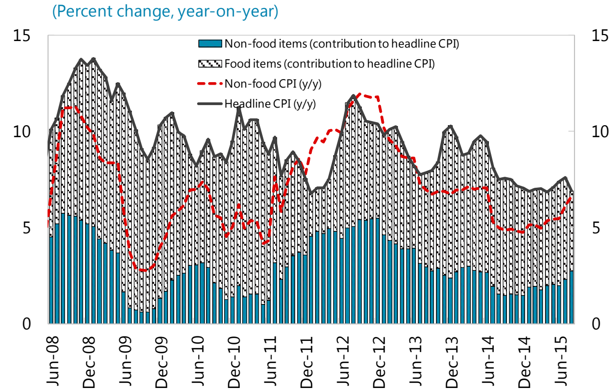



Sources: Nepali authorities; and IMF staff estimates.

*Inflation stood at 6.9 percent (y/y) in August…*

**Consumer Price Inflation**

(Percent change, year-on-year)

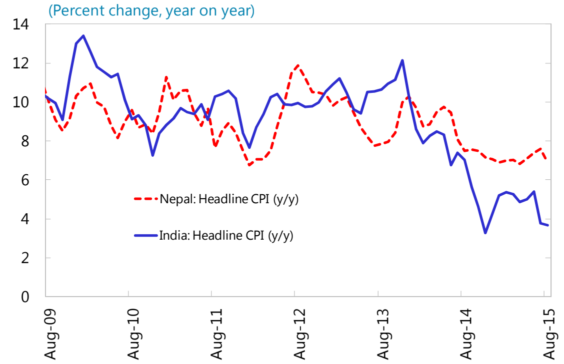



Sources: Nepali authorities; and IMF staff estimates.

*…substantially higher than in India.*

**Consumer Prices in Nepal and India**

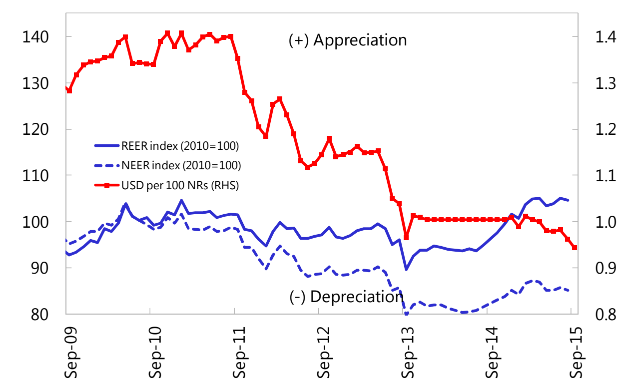
(Percent change, year on year)




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

*In combination with the stable nominal exchange rate, this has put the REER 12 percent above the 2013/14 average.*

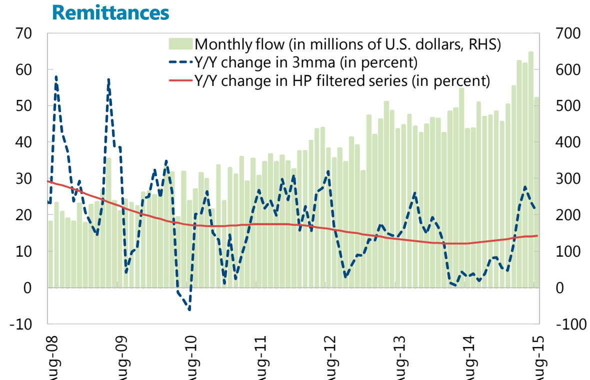
**Exchange Rates**




Sources: Nepali authorities; and IMF staff estimates.

*Remittances have picked up after the earthquake…*

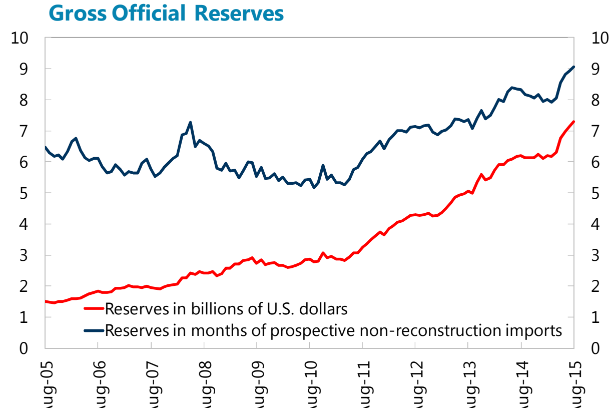
**Remittances**




Sources: Nepali authorities; and IMF staff estimates.

*…pushing reserves to a record of US$7.3 billion*

**Gross Official Reserves**

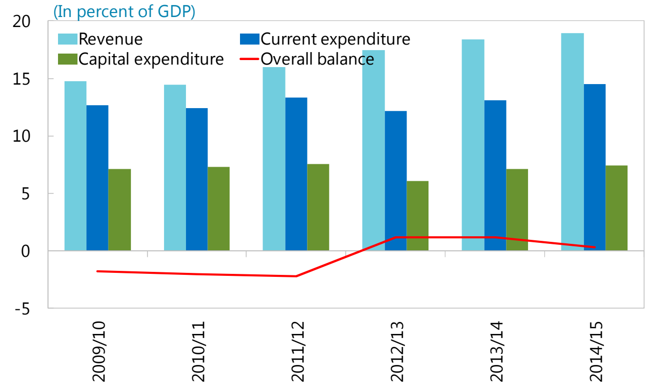



Sources: Nepali authorities; and IMF staff estimates.

## Figure 2. Nepal: Recent Fiscal and Monetary Developments

*Strong revenue growth combined with subdued capital spending kept the budget in surplus for the third year in a row.*

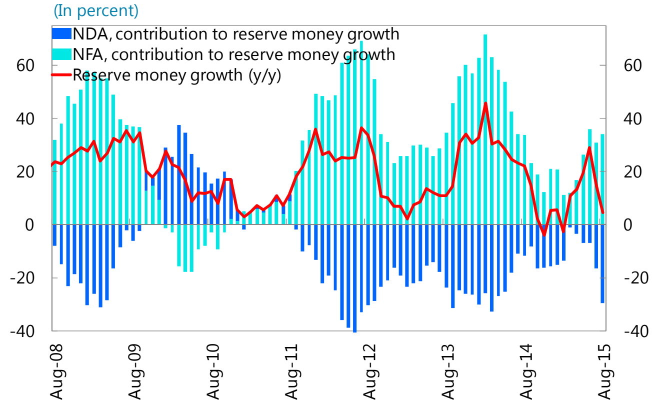
### Fiscal Performance
(In percent of GDP)




Sources: Nepali authorities; and IMF staff estimates.

*Rising government deposits at the central bank and more activist central bank operations are keeping reserve money in check*

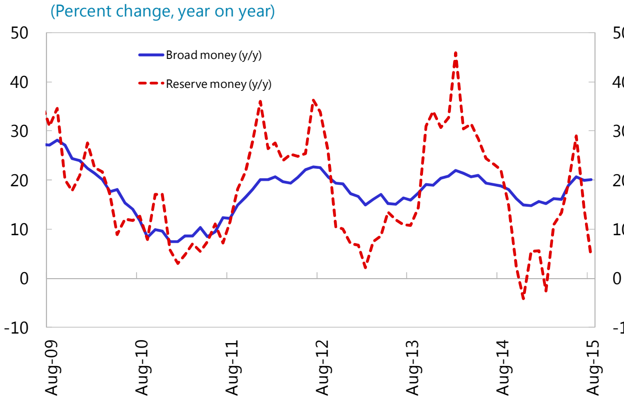
### Central Bank Balance Sheet
(In percent)




Sources: Nepali authorities; and IMF staff estimates.

*Broad money growth rose to 20 percent in August (y/y)...*

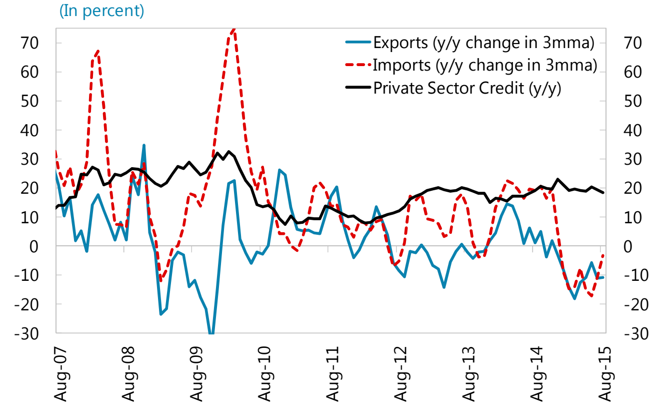
### Nepal: Monetary aggregates
(Percent change, year on year)




Sources: Nepali authorities; and IMF staff estimates.

*...about equal to the rate of private credit growth.*

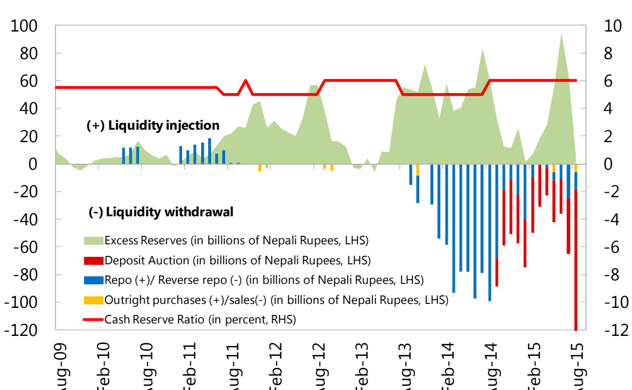
### Private Sector Credit and Trade
(In percent)




Sources: Nepali authorities; and IMF staff estimates.

*Banks' excess reserves increased in recent months until the NRB mopped up NR107 billion through a deposit auction in August*

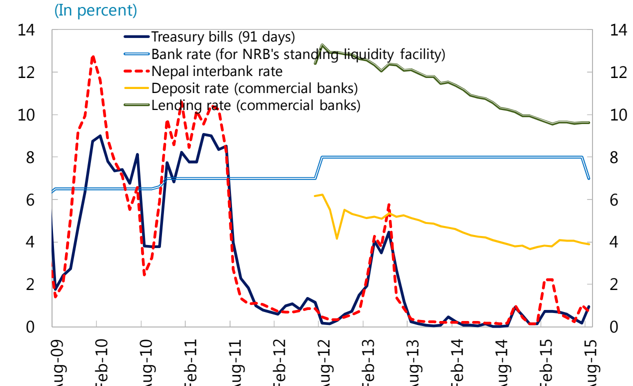
### Excess Reserves and Open Market Operations




Sources: Nepali authorities; and IMF staff estimates.

*As a result, the interbank interest rate has ticked up and deposit and lending rates have bottomed out.*

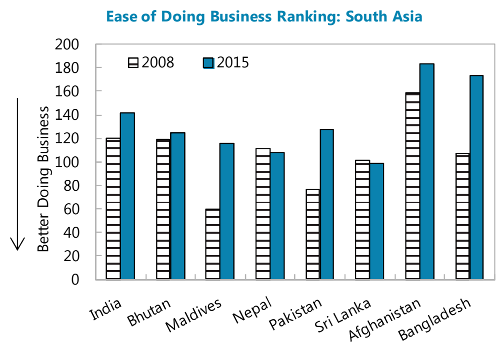
### Interest Rates
(In percent)




Sources: Nepali authorities; and IMF staff estimates.

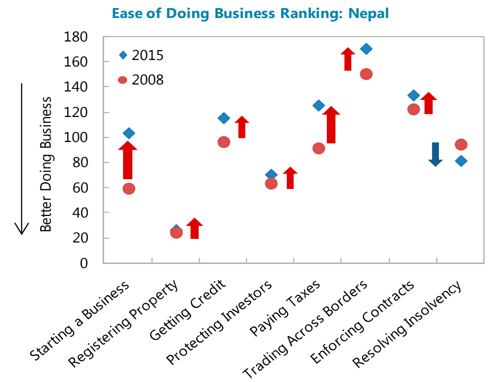
## Figure 3. Nepal: Business Environment and Governance

*Nepal's overall ranking improved marginally…*



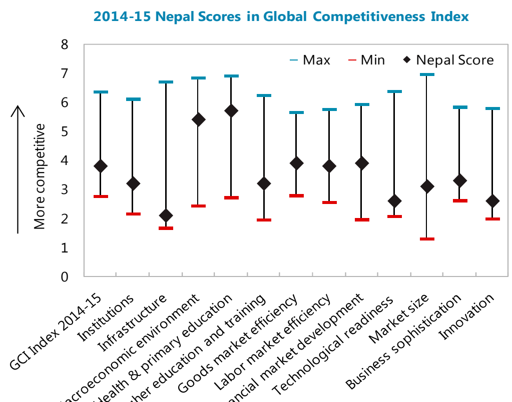

Sources: World Bank, Doing Business Report (2015 and 2008)

*…but deteriorated in most areas important to business.*



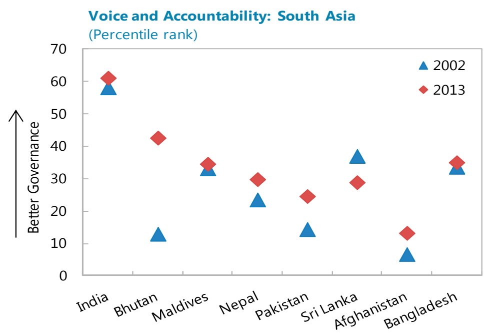

Sources: World Bank, Doing Business Report (2015 and 2008)

*Competitiveness is hampered by inadequate infrastructure.*



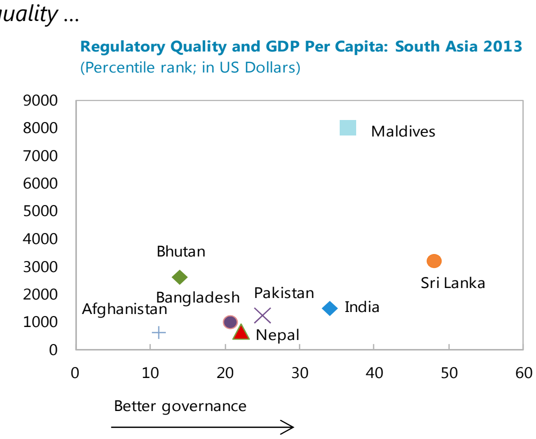

Sources: World Economic Forum Global Competitiveness Report (2014-15)

*Voice and accountability have improved but lagged behind peers.*



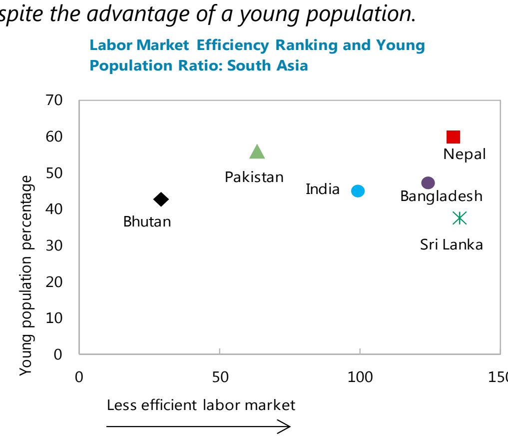

Sources: Worldwide Governance Indicators 2014
Note: Voice and Accountability reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom.

*There is room for further improvement in regulatory quality …*




Sources: Worldwide Governance Indicators 2014; IMF
Note: Regulatory quality effects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector.

*…labor markets are less efficient than regional peers despite the advantage of a young population.*




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.

## Table 3. Nepal: Selected Economic Indicators, 2012/13–2019/20 1/

| | 2012/13 | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|---|---|---|---|---|---|---|---|---|
| | | | Est. | | | Projections | | |
| **Output and prices** (annual percent change) | | | | | | | | |
| Real GDP | 4.1 | 5.4 | 3.4 | 4.4 | 5.4 | 3.9 | 3.8 | 3.8 |
| CPI (period average) | 9.9 | 9.0 | 7.2 | 8.0 | 8.3 | 7.7 | 7.0 | 6.1 |
| CPI (end of period) | 7.7 | 8.1 | 7.6 | 8.5 | 8.0 | 7.5 | 6.5 | 5.7 |
| **Fiscal Indicators** (in percent of GDP) | | | | | | | | |
| Total revenue and grants | 19.3 | 20.6 | 20.8 | 21.9 | 22.0 | 22.2 | 22.4 | 22.5 |
| of which: tax revenue | 15.3 | 16.1 | 16.8 | 16.8 | 17.1 | 17.4 | 17.6 | 17.6 |
| Expenditure | 17.2 | 19.1 | 19.9 | 24.2 | 24.2 | 23.7 | 22.3 | 22.6 |
| Expenses | 14.2 | 15.6 | 15.8 | 17.7 | 17.8 | 18.0 | 17.9 | 17.8 |
| Net acquisition of nonfinancial assets | 3.0 | 3.4 | 4.1 | 6.5 | 6.4 | 5.7 | 4.4 | 4.7 |
| Statistical discrepancy | 0.2 | 0.9 | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net lending/borrowing | 2.2 | 2.4 | 1.6 | -2.3 | -2.2 | -1.5 | 0.1 | -0.1 |
| Net financial transactions | -2.2 | -2.4 | -1.6 | 2.3 | 2.2 | 1.5 | -0.1 | 0.1 |
| Net acquisition of financial assets | 1.1 | 1.2 | 1.4 | 1.5 | 1.2 | 1.3 | 1.2 | 1.1 |
| Net incurrence of liabilities | -1.2 | -1.2 | -0.3 | 3.8 | 3.4 | 2.7 | 1.1 | 1.2 |
| Foreign | -0.3 | -0.1 | 0.8 | 2.9 | 1.9 | 1.8 | 1.4 | 1.1 |
| Domestic | -0.8 | -1.1 | -1.0 | 0.9 | 1.5 | 0.9 | -0.4 | 0.1 |
| **Money and credit** (annual percent change) | | | | | | | | |
| Broad money | 16.3 | 19.1 | 19.9 | 12.8 | 15.1 | … | … | … |
| Domestic credit | 16.9 | 13.9 | 15.7 | 15.8 | 18.3 | … | … | … |
| Private sector credit | 20.2 | 18.3 | 19.4 | 16.5 | 18.0 | … | … | … |
| Velocity | 1.3 | 1.2 | 1.1 | 1.1 | 1.1 | … | … | … |
| **Balance of Payments** | | | | | | | | |
| Current account (in millions of U.S. dollars) | 635 | 908 | 1,067 | -570 | -426 | -452 | -352 | -234 |
| In percent of GDP | 3.3 | 4.6 | 5.0 | -2.5 | -1.7 | -1.7 | -1.2 | -0.8 |
| Trade balance (in millions of U.S. dollars) | -5,247 | -6,082 | -6,670 | -8,453 | -9,106 | -9,867 | -10,450 | -11,080 |
| In percent of GDP | -27.2 | -30.8 | -31.2 | -36.9 | -36.2 | -36.2 | -36.2 | -36.2 |
| Exports value growth (y/y percent change) | -3.1 | 5.4 | -4.0 | 2.0 | 5.4 | 6.0 | 6.0 | 6.0 |
| Imports value growth (y/y percent change) | 10.9 | 14.3 | 7.7 | 23.5 | 7.5 | 8.1 | 5.9 | 6.0 |
| Workers' remittances (in millions of U.S. dollars) | 4,931 | 5,543 | 6,192 | 6,631 | 7,131 | 7,698 | 8,308 | 8,964 |
| In percent of GDP | 25.6 | 28.1 | 29.0 | 28.9 | 28.3 | 28.3 | 28.8 | 29.3 |
| Gross official reserves (in millions of U.S. dollars) | 4,972 | 6,172 | 7,162 | 7,320 | 7,594 | 8,003 | 8,548 | 9,138 |
| In months of prospective GNFS imports | 7.3 | 8.3 | 7.9 | 7.6 | 7.3 | 7.3 | 7.3 | 7.3 |
| Excl. reconstruction- and FDI-related imports | … | … | 9.0 | 8.3 | 7.8 | 7.5 | 7.3 | 7.3 |
| **Memorandum items** | | | | | | | | |
| Public debt (in percent of GDP) | 32.3 | 28.3 | 25.7 | 28.9 | 29.4 | 29.6 | 28.7 | 28.0 |
| GDP at market prices (in billions of Nepalese rupees) | 1,695 | 1,942 | 2,125 | 2,396 | 2,733 | 3,060 | 3,351 | 3,651 |
| GDP at market prices (in billions of U.S. dollars) | 19.3 | 19.8 | 21.4 | 22.9 | 25.2 | 27.2 | 28.9 | 30.6 |
| Exchange rate (NRs/US$; period average) | 88.0 | 98.3 | 99.5 | … | … | … | … | … |
| Real effective exchange rate (average, y/y percent change) | -0.6 | -4.0 | 8.2 | … | … | … | … | … |

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

[1] Fiscal year ends in mid-July.

## Table 4. Nepal: Summary of Government Operations, 2012/13–2019/20 1/

| | 2012/13 | 2013/14 | 2014/15 | | 2015/16 | | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Budget 2/ | Est. | Budget 2/ | Proj. | Projections | | | |
| | | | | | (In billions of Nepalese rupees) | | | | | |
| **Total revenue and grants** | 327 | 399 | 496 | 443 | 586 | 525 | 601 | 681 | 751 | 820 |
| Total revenue | 296 | 357 | 423 | 403 | 475 | 458 | 529 | 604 | 667 | 729 |
| Tax revenue | 260 | 312 | 375 | 358 | 427 | 403 | 466 | 534 | 589 | 644 |
| Non-tax revenue | 36 | 45 | 48 | 45 | 48 | 55 | 63 | 70 | 77 | 85 |
| Grants | 31 | 42 | 73 | 40 | 111 | 67 | 72 | 77 | 84 | 91 |
| **Expenditure** | 292 | 370 | 511 | 422 | 693 | 579 | 661 | 725 | 747 | 823 |
| Expenses | 240 | 303 | 394 | 336 | 484 | 425 | 486 | 550 | 601 | 651 |
| *Of which* : Interest payments | 14 | 12 | 23 | 9 | 21 | 14 | 16 | 19 | 23 | 23 |
| Salaries and allowances | 51 | 68 | 90 | 74 | 104 | 96 | 119 | 140 | 157 | 173 |
| Net acquisition of nonfinancial assets | 52 | 67 | 117 | 86 | 209 | 155 | 175 | 175 | 146 | 172 |
| Operating balance | 86 | 96 | 102 | 107 | 102 | 100 | 115 | 130 | 150 | 168 |
| Statistical discrepancy | 3 | 17 | 0 | 14 | 0 | 0 | 0 | 0 | 0 | 0 |
| Net lending/borrowing | 38 | 46 | -14 | 34 | -59 | -54 | -60 | -45 | 3 | -4 |
| Net financial transactions | -38 | -46 | 14 | -34 | 59 | 54 | 60 | 45 | -3 | 4 |
| Net acquisition of financial assets | 18 | 23 | 50 | 29 | -61 | 36 | 33 | 38 | 39 | 40 |
| Net incurrence of liabilities | -20 | -23 | 64 | -6 | 119 | 91 | 93 | 83 | 35 | 44 |
| Foreign | -5 | -1 | 29 | 17 | 73 | 69 | 52 | 55 | 48 | 38 |
| Domestic | -14 | -22 | 35 | -22 | 47 | 21 | 41 | 28 | -13 | 5 |
| | | | | | (In percent of GDP, unless otherwise indicated) | | | | | |
| **Total revenue and grants** | 19.3 | 20.6 | 23.4 | 20.8 | 24.0 | 21.9 | 22.0 | 22.2 | 22.4 | 22.5 |
| Total revenue | 17.5 | 18.4 | 19.9 | 19.0 | 19.5 | 19.1 | 19.4 | 19.7 | 19.9 | 20.0 |
| Tax revenue | 15.3 | 16.1 | 17.6 | 16.8 | 17.5 | 16.8 | 17.1 | 17.4 | 17.6 | 17.6 |
| Non-tax revenue | 2.1 | 2.3 | 2.3 | 2.1 | 2.0 | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 |
| Grants | 1.8 | 2.2 | 3.5 | 1.9 | 4.5 | 2.8 | 2.6 | 2.5 | 2.5 | 2.5 |
| **Expenditure** | 17.2 | 19.1 | 24.0 | 19.9 | 28.4 | 24.2 | 24.2 | 23.7 | 22.3 | 22.6 |
| Expenses | 14.2 | 15.6 | 18.5 | 15.8 | 19.9 | 17.7 | 17.8 | 18.0 | 17.9 | 17.8 |
| *Of which* : Interest payments | 0.8 | 0.6 | 1.1 | 0.4 | 0.9 | 0.6 | 0.6 | 0.6 | 0.7 | 0.6 |
| Salaries and allowances | 3.0 | 3.5 | 4.2 | 3.5 | 4.3 | 4.0 | 4.3 | 4.6 | 4.7 | 4.7 |
| Net acquisition of nonfinancial assets | 3.0 | 3.4 | 5.5 | 4.1 | 8.6 | 6.5 | 6.4 | 5.7 | 4.4 | 4.7 |
| Operating balance | 5.1 | 4.9 | 4.8 | 5.0 | 4.2 | 4.2 | 4.2 | 4.3 | 4.5 | 4.6 |
| Statistical discrepancy | 0.2 | 0.9 | 0.0 | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net lending/borrowing | 2.2 | 2.4 | -0.7 | 1.6 | -2.4 | -2.3 | -2.2 | -1.5 | 0.1 | -0.1 |
| Net financial transactions | -2.2 | -2.4 | 0.7 | -1.6 | 2.4 | 2.3 | 2.2 | 1.5 | -0.1 | 0.1 |
| Net acquisition of financial assets | 1.1 | 1.2 | 2.3 | 1.4 | -2.5 | 1.5 | 1.2 | 1.3 | 1.2 | 1.1 |
| Net incurrence of liabilities | -1.2 | -1.2 | 3.0 | -0.3 | 4.9 | 3.8 | 3.4 | 2.7 | 1.1 | 1.2 |
| Foreign | -0.3 | -0.1 | 1.4 | 0.8 | 3.0 | 2.9 | 1.9 | 1.8 | 1.4 | 1.1 |
| Domestic | -0.8 | -1.1 | 1.6 | -1.0 | 1.9 | 0.9 | 1.5 | 0.9 | -0.4 | 0.1 |
| **Memorandum items** | | | | | | | | | | |
| Primary balance | 3.0 | 3.0 | 0.4 | 2.1 | -3.5 | -1.7 | -1.6 | -0.8 | 0.8 | 0.5 |
| Public debt | 32.3 | 28.3 | ... | 25.7 | ... | 28.9 | 29.4 | 29.6 | 28.7 | 28.0 |
| Domestic | 12.2 | 10.4 | ... | 9.3 | ... | 9.1 | 9.5 | 9.4 | 8.2 | 7.7 |
| External | 20.0 | 17.9 | ... | 16.5 | ... | 19.8 | 19.9 | 20.2 | 20.5 | 20.3 |
| GDP (in billion of Nepalese rupees) | 1,695 | 1,942 | 2,125 | 2,125 | 2,439 | 2,396 | 2,733 | 3,060 | 3,351 | 3,651 |

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 5. Nepal: Monetary Indicators, 2012/13–2016/17

| | 2012/13 | 2013/14 | 2014/15 | 2015/16 | 2016/17 |
|---|---|---|---|---|---|
| | | | | Projections | |
| | (In billions of Nepalese rupees, end-period) | | | | |
| **Nepal Rastra Bank** | | | | | |
| Reserve money | 354 | 437 | 499 | 563 | 646 |
| Net domestic assets | -111 | -150 | -221 | -203 | -181 |
| Claims on public sector | 2 | -1 | -21 | 15 | 15 |
| Claims on private sector | 5 | 4 | 5 | 5 | 6 |
| Claims on banks & financial institutions | 3 | 2 | 3 | -19 | -32 |
| Other items (net) | -121 | -154 | -208 | -204 | -170 |
| Net foreign assets | 465 | 586 | 721 | 766 | 827 |
| **Monetary Survey** | | | | | |
| Broad money | 1,315 | 1,566 | 1,878 | 2,118 | 2,437 |
| Narrow money | 302 | 355 | 425 | 645 | 741 |
| Quasi-money | 1,014 | 1,211 | 1,453 | 1,473 | 1,696 |
| Net domestic assets | 847 | 967 | 1,131 | 1,322 | 1,578 |
| Domestic credit | 1,153 | 1,313 | 1,519 | 1,760 | 2,082 |
| Credit to public sector | 179 | 162 | 145 | 159 | 193 |
| *of which* : Credit to central government | 154 | 140 | 120 | 132 | 162 |
| Credit to private sector | 973 | 1,151 | 1,374 | 1,601 | 1,889 |
| Other items(net) | -305 | -346 | -388 | -438 | -504 |
| Net foreign assets | 468 | 599 | 747 | 796 | 859 |
| | (Twelve-month percent change) | | | | |
| Reserve money | 10.9 | 23.3 | 14.3 | 12.8 | 14.8 |
| Broad money | 16.3 | 19.1 | 19.9 | 12.8 | 15.1 |
| Net domestic assets | 12.0 | 14.1 | 17.0 | 16.9 | 19.4 |
| Domestic credit | 16.9 | 13.9 | 15.7 | 15.8 | 18.3 |
| Credit to public sector | 1.9 | -9.9 | -10.3 | 9.3 | 21.4 |
| Credit to private sector | 20.2 | 18.3 | 19.4 | 16.5 | 18.0 |
| Net foreign assets | 25.0 | 28.0 | 24.7 | 6.6 | 7.9 |
| **Memorandum items** | | | | | |
| Velocity | 1.3 | 1.2 | 1.1 | 1.1 | 1.1 |
| Multiplier | 3.7 | 3.6 | 3.8 | 3.8 | 3.8 |
| Private credit (in percent of GDP) | 57.4 | 59.3 | 64.7 | 66.8 | 69.1 |
| GDP at market prices (in billions of NR) | 1,695 | 1,942 | 2,125 | 2,396 | 2,733 |

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

## Table 6. Nepal: Balance of Payments, 2012/13–2019/20

| | 2012/13 | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|---|---|---|---|---|---|---|---|---|
| | | | | | | Projections | | |
| | | | | (in million US dollars) | | | | |
| **Current account** | 635 | 908 | 1,067 | -570 | -426 | -452 | -352 | -234 |
| Current account (excluding official transfers) | 378 | 547 | 774 | -1,081 | -893 | -941 | -841 | -737 |
| Trade balance | -5,247 | -6,082 | -6,670 | -8,453 | -9,106 | -9,867 | -10,450 | -11,080 |
| Exports, f.o.b. | 977 | 1,030 | 988 | 1,008 | 1,062 | 1,125 | 1,193 | 1,264 |
| Imports, f.o.b. | -6,224 | -7,112 | -7,658 | -9,461 | -10,168 | -10,992 | -11,642 | -12,344 |
| Services (net) | 87 | 214 | 275 | -177 | 77 | 138 | 147 | 156 |
| Receipts | 1,083 | 1,277 | 1,499 | 1,272 | 1,459 | 1,634 | 1,732 | 1,836 |
| *Of which* : tourism | 390 | 473 | 537 | 344 | 428 | 517 | 548 | 582 |
| Payments | -995 | -1,063 | -1,224 | -1,449 | -1,382 | -1,496 | -1,585 | -1,681 |
| Income | 146 | 334 | 342 | 355 | 390 | 422 | 447 | 474 |
| Credit | 263 | 403 | 428 | 447 | 491 | 531 | 563 | 597 |
| Debit | -117 | -69 | -86 | -92 | -101 | -109 | -115 | -122 |
| Current transfers | 5,648 | 6,442 | 7,120 | 7,703 | 8,213 | 8,855 | 9,503 | 10,216 |
| Credit, of which: | 5,732 | 6,477 | 7,146 | 7,804 | 8,323 | 8,974 | 9,629 | 10,350 |
| General government | 257 | 362 | 293 | 524 | 481 | 505 | 505 | 521 |
| Workers' remittances | 4,931 | 5,543 | 6,192 | 6,631 | 7,131 | 7,698 | 8,308 | 8,964 |
| Debit | -84 | -34 | -26 | -100 | -110 | -119 | -126 | -134 |
| **Capital account** | 117 | 173 | 148 | 290 | 194 | 192 | 207 | 202 |
| **Financial account** | -50 | -19 | 83 | 397 | 514 | 675 | 695 | 625 |
| Direct investment | 102 | 33 | 44 | 59 | 74 | 89 | 104 | 223 |
| Portfolio investment | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other investment (net) | -152 | -51 | 39 | 339 | 440 | 586 | 591 | 402 |
| MT debt (net) | -13 | 45 | 460 | 662 | 550 | 599 | 524 | 425 |
| Other (net) | -139 | -96 | -421 | -323 | -109 | -13 | 67 | -23 |
| **Errors and omissions** | 37 | 121 | 185 | 0 | 0 | 0 | 0 | 0 |
| **Overall balance** | 739 | 1,184 | 1,483 | 117 | 282 | 415 | 549 | 594 |
| **Financing** | -739 | -1,184 | -1,483 | -117 | -282 | -415 | -549 | -594 |
| Change in reserve assets (- =increase) | -665 | -1,200 | -1,477 | -158 | -274 | -409 | -545 | -590 |
| Use of IMF resources (net) | -5 | -6 | -5 | 41 | -8 | -6 | -4 | -4 |
| IMF Disbursements | 0 | 0 | 0 | 50 | 0 | 0 | 0 | 0 |
| IMF Repayment | 5 | 6 | 5 | 9 | 8 | 6 | 4 | 4 |
| **Memorandum items** | | | | | | | | |
| Current account (in percent of GDP) | 3.3 | 4.6 | 5.0 | -2.5 | -1.7 | -1.7 | -1.2 | -0.8 |
| Current account, excl. grants (in percent of GDP) | 2.0 | 2.8 | 3.6 | -4.7 | -3.5 | -3.5 | -2.9 | -2.4 |
| Trade balance (in percent of GDP) | -27.2 | -30.8 | -31.2 | -36.9 | -36.2 | -36.2 | -36.2 | -36.2 |
| Exports (in percent of GDP) | 5.1 | 5.2 | 4.6 | 4.4 | 4.2 | 4.1 | 4.1 | 4.1 |
| Imports (in percent of GDP) | 32.3 | 36.0 | 35.9 | 41.3 | 40.4 | 40.4 | 40.3 | 40.3 |
| Exports (y/y percent change) | -3.1 | 5.4 | -4.0 | 2.0 | 5.4 | 6.0 | 6.0 | 6.0 |
| Imports (y/y percent change) | 10.9 | 14.3 | 7.7 | 23.5 | 7.5 | 8.1 | 5.9 | 6.0 |
| Remittances (in percent of GDP) | 25.6 | 28.1 | 29.0 | 28.9 | 28.3 | 28.3 | 28.8 | 29.3 |
| Remittances (y/y percent change) | 11.7 | 12.4 | 11.7 | 7.1 | 7.5 | 8.0 | 7.9 | 7.9 |
| Total external debt (in percent of GDP) | 20.0 | 17.9 | 16.5 | 19.8 | 19.9 | 20.2 | 20.5 | 20.3 |
| Debt service (in percent of current account receip | 2.4 | 2.2 | 1.6 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 |
| Gross official reserves (in millions of U.S. dollars) | 4,972 | 6,172 | 7,162 | 7,320 | 7,594 | 8,003 | 8,548 | 9,138 |
| In months of prospective GNFS imports | 7.3 | 8.3 | 7.9 | 7.6 | 7.3 | 7.3 | 7.3 | 7.3 |
| Excl. reconstruction- and FDI-related imports | … | … | 9.0 | 8.3 | 7.8 | 7.5 | 7.3 | 7.3 |
| As a share of broad money (in percent) | 36.0 | 37.9 | 38.7 | 36.8 | 34.4 | … | … | … |
| Nominal GDP (in millions of U.S. dollars) | 19,270 | 19,761 | 21,356 | 22,927 | 25,160 | 27,233 | 28,868 | 30,607 |

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

**Table 7. Nepal: Macroeconomic Framework, 2012/13–2019/20 1/**

| | 2012/13 | 2013/14 | 2014/15 | Baseline Scenario 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|---|---|---|---|---|---|---|---|---|
| **Output and prices** (annual percent change) | | | | | | | | |
| Real GDP | 4.1 | 5.4 | 3.4 | 4.4 | 5.4 | 3.9 | 3.8 | 3.8 |
| CPI (period average) | 9.9 | 9.0 | 7.2 | 8.0 | 8.3 | 7.7 | 7.0 | 6.1 |
| CPI (end of period) | 7.7 | 8.1 | 7.6 | 8.5 | 8.0 | 7.5 | 6.5 | 5.7 |
| **Fiscal Indicators** (in percent of GDP) | | | | | | | | |
| Total revenue and grants | 19.3 | 20.6 | 20.8 | 21.9 | 22.0 | 22.2 | 22.4 | 22.5 |
| of which: tax revenue | 15.3 | 16.1 | 16.8 | 16.8 | 17.1 | 17.4 | 17.6 | 17.6 |
| Expenditure | 17.2 | 19.1 | 19.9 | 24.2 | 24.2 | 23.7 | 22.3 | 22.6 |
| Expenses | 14.2 | 15.6 | 15.8 | 17.7 | 17.8 | 18.0 | 17.9 | 17.8 |
| Net acquisition of nonfinancial assets | 3.0 | 3.4 | 4.1 | 6.5 | 6.4 | 5.7 | 4.4 | 4.7 |
| Statistical discrepancy | 0.2 | 0.9 | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net lending/borrowing | 2.2 | 2.4 | 1.6 | -2.3 | -2.2 | -1.5 | 0.1 | -0.1 |
| Net financial transactions | -2.2 | -2.4 | -1.6 | 2.3 | 2.2 | 1.5 | -0.1 | 0.1 |
| Net acquisition of financial assets | 1.1 | 1.2 | 1.4 | 1.5 | 1.2 | 1.3 | 1.2 | 1.1 |
| Net incurrence of liabilities | -1.2 | -1.2 | -0.3 | 3.8 | 3.4 | 2.7 | 1.1 | 1.2 |
| Foreign | -0.3 | -0.1 | 0.8 | 2.9 | 1.9 | 1.8 | 1.4 | 1.1 |
| Domestic | -0.8 | -1.1 | -1.0 | 0.9 | 1.5 | 0.9 | -0.4 | 0.1 |
| **Money and credit** (annual percent change) | | | | | | | | |
| Broad money | 16.3 | 19.1 | 19.9 | … | … | … | … | … |
| Domestic credit | 16.9 | 13.9 | 15.7 | … | … | … | … | … |
| Private sector credit | 20.2 | 18.3 | 19.4 | … | … | … | … | … |
| Velocity | 1.3 | 1.2 | 1.1 | … | … | … | … | … |
| **Saving and Investment** (in percent of nominal GDP) | | | | | | | | |
| Gross investment | 29.8 | 28.7 | 28.9 | 31.6 | 30.9 | 30.7 | 30.7 | 29.7 |
| Private | 26.7 | 25.2 | 24.9 | 25.2 | 24.5 | 25.0 | 26.3 | 25.0 |
| Central government | 3.0 | 3.4 | 4.1 | 6.5 | 6.4 | 5.7 | 4.4 | 4.7 |
| Gross national saving | 33.1 | 33.3 | 33.9 | 29.2 | 29.2 | 29.1 | 29.5 | 28.9 |
| Private | 27.8 | 28.0 | 28.9 | 25.6 | 25.4 | 25.0 | 25.1 | 24.4 |
| Central government | 5.3 | 5.3 | 5.0 | 3.5 | 3.8 | 4.1 | 4.4 | 4.6 |
| **Balance of Payments** | | | | | | | | |
| Current account (in millions of U.S. dollars) | 635 | 908 | 1,067 | -570 | -426 | -452 | -352 | -234 |
| In percent of GDP | 3.3 | 4.6 | 5.0 | -2.5 | -1.7 | -1.7 | -1.2 | -0.8 |
| Trade balance (in millions of U.S. dollars) | -5,247 | -6,082 | -6,670 | -8,453 | -9,106 | -9,867 | -10,450 | -11,080 |
| In percent of GDP | -27.2 | -30.8 | -31.2 | -36.9 | -36.2 | -36.2 | -36.2 | -36.2 |
| Exports value growth (y/y percent change) | -3.1 | 5.4 | -4.0 | 2.0 | 5.4 | 6.0 | 6.0 | 6.0 |
| Imports value growth (y/y percent change) | 10.9 | 14.3 | 7.7 | 23.5 | 7.5 | 8.1 | 5.9 | 6.0 |
| Workers' remittances (in millions of U.S. dollars) | 4,931 | 5,543 | 6,192 | 6,631 | 7,131 | 7,698 | 8,308 | 8,964 |
| In percent of GDP | 25.6 | 28.1 | 29.0 | 28.9 | 28.3 | 28.3 | 28.8 | 29.3 |
| Gross official reserves (in millions of U.S. dollars) | 4,972 | 6,172 | 7,162 | 7,320 | 7,594 | 8,003 | 8,548 | 9,138 |
| In months of prospective GNFS imports | 7.3 | 8.3 | 7.9 | 7.6 | 7.3 | 7.3 | 7.3 | 7.3 |
| Excl. reconstruction- and FDI-related imports | | | 9.0 | 8.3 | 7.8 | 7.5 | 7.3 | 7.3 |
| **Memorandum items** | | | | | | | | |
| Reconstruction-related expenditure (in percent of GDP) | … | … | … | 3.0 | 2.7 | 1.8 | … | … |
| Public debt (in percent of GDP) | 32.3 | 28.3 | 25.7 | 28.9 | 29.4 | 29.6 | 28.7 | 28.0 |
| GDP at market prices (in billions of U.S. dollars) | 19.3 | 19.8 | 21.4 | 22.9 | 25.2 | 27.2 | 28.9 | 30.6 |

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

[1] Fiscal year ends in mid-July.

## Table 8. Nepal: Commercial Banks' Financial Soundness Indicators, 2008–2015 1/

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| | | | | (in percent) | | | | |
| **Capital adequacy** | | | | | | | | |
| Capital fund to risk weighted assets | 4.0 | 7.2 | 9.6 | 10.6 | 11.5 | 12.3 | 12.0 | 11.9 |
| Tier 1 capital to risk weighted assets | 1.8 | 5.2 | 7.9 | 9.1 | 10.0 | 10.7 | 10.4 | 10.3 |
| **Asset quality** | | | | | | | | |
| NPLs to total loans | 6.1 | 3.6 | 2.5 | 3.2 | 2.6 | 2.6 | 2.9 | 2.6 |
| Loan loss provision to total loans | 8.2 | 5.9 | 4.6 | 4.0 | 3.5 | 3.4 | 3.5 | 3.2 |
| **Earnings and profitability** | | | | | | | | |
| Return on equity (ROE) 2/ | 35.2 | 34.7 | 33.9 | 25.3 | 22.5 | 28.2 | 24.5 | 28.0 |
| Return on assets (ROA) 2/ | 2.0 | 4.9 | 1.9 | 1.7 | 1.5 | 1.7 | 1.5 | 1.5 |
| Interest income to gross income | 68.3 | 73.9 | 77.9 | 81.4 | 82.4 | 81.6 | 81.7 | 76.3 |
| Non-interest expenditures to gross income | 70.4 | 60.1 | 60.2 | 53.2 | 48.0 | 58.3 | 24.6 | 24.1 |
| Employees expenses to non-interest expenditures | 18.7 | 25.1 | 23.7 | 22.2 | 21.5 | 20.4 | 57.2 | 55.6 |
| **Liquidity** | | | | | | | | |
| Liquid assets to total assets | 11.8 | 26.0 | 13.1 | 11.2 | 15.2 | 14.7 | 26.2 | 25.5 |
| Liquid assets to demand and savings deposits | 25.0 | 31.1 | 31.7 | 31.6 | 40.6 | 39.8 | 43.6 | n.a. |
| Liquid assets to total deposits | 15.9 | 18.3 | 16.0 | 14.3 | 18.6 | 32.4 | 31.7 | 29.2 |
| **Exposure to real estate** | | | | | | | | |
| Share of real estate and housing loans | … | 19.4 | 20.7 | 18.5 | 16.9 | 14.6 | 13.9 | 13.8 |
| Share of loans collateralized by land and buildings | … | 71.7 | 58.4 | 68.4 | 55.9 | 55.2 | 54.9 | 55.8 |

Source: Nepalese authorities.
1/ End of fiscal year (mid-July). All 30 commercial banks unless noted otherwise.
2/ Excluding state-owned banks.

## Table 9. 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/ | 42(90) | 23.8(13) | 21 | Likely |
| ***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) | 15.7 (13) | 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) | 95.3 (13) | 100 | Likely |
| | Reaching last grade | 38(90) | 84.2 (13) | 100 | Possible |
| | Literacy rate of 14-24 age | 49.6(90) | 88.6 (13) | 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) | 102(13) | 100 | Achieved |
| | Ratio of girls to boys in secondary education (percent) | 43(90) | 99(13) | 100 | Achieved |
| | Ratio of females to males in tertiary institutes (percent) | 32(90) | 73(13) | 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) | 54 | Achieved |
| | Infant mortality rate (per 1,000 live births) | 108(90) | 46(11) | 36 | Achieved |
| | Immunization, measles (percent of children under 12 months) | 108(90) | 88 (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) | 170 (13) | 213 | Achieved |
| | Births attended by skilled health personnel (percent) | 7(90) | 50 (13) | 60 | Likely |
| **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) | 0.12 (13) | Halt and reverse | 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) | 0.08 (13) | 0.06 | Likely |
| | Prevalence rate of tuberculosis cases per 100,000 people | 460(90) | 238 (13) | Halt and reverse | Achieved |
| **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) | 85 (13) | 73 | Achieved |
| | Proportion of population with access to improved sanitation (percent) | 6(90) | 62 (13) | 80 | Unlikely |

Source: UNDP, Nepal Millennium Development Goals--Progress Report (September 2013).

# Appendix I. Progress in Implementing High-Priority FSAP Recommendations

| | Recommendations | Responsible Authority | Time Line* | Progress to date |
|---|---|---|---|---|
| | | ***Financial Stability*** | | |
| 1. | Refocus monetary policy operations on domestic liquidity management to reduce excess reserves, and especially their volatility, with appropriate burden sharing of costs between the financial system and the budget. Introduce Treasury sterilization bonds. | NRB | ST | **In process**<br>The NRB has been holding deposit auctions intermittently since August 2014 to reduce banks' excess liquidity. The introduction of Treasury sterilization bonds is under discussion |
| 2. | Undertake a thorough Asset Quality Review (AQR) to identify the extent of problem loans in banks' balance sheets (with TA support). | NRB | ST | **Not done**<br>Lack of AQR is largely offset by the special investigations conducted by KPMG (Portugal) in conjunction with NRB supervisors. Reviews conducted in BFIs holding about 64% of total assets. |
| 3. | Conduct an in-depth review and financial analysis of loan portfolios during bank examinations. | NRB | ST/MT | **In process**<br>Loan portfolio reviews are performed on-site; the reviews are guided by the outmoded asset classification and loss provisioning guidance. As the supervisors gain experience, it is expected the reviews will be more in-depth. |
| 4. | Reinforce efforts to address financial infrastructure shortcomings in the Payments System, clearing, credit information, collateral registry, and debt recovery areas. | NRB/MOF | ST/MT | **In process**<br>NRB established a payment and settlement system department, which will also oversee some of the new products such as mobile banking and branchless banking.<br>Reforms have been identified to strengthen the credit information bureau, the collateral registry and debt recovery areas but action has not yet been taken. |
| | | ***Financial Sector Oversight*** | | |
| | | ***A. Banking Sector*** | | |
| 5. | Redefine supervisory approach by:<br>• integrating risk-based off-site and on-site supervision;<br>• increasing analytical capacity through training;<br>• introducing supervisory management information systems (MIS);<br>• developing a dedicated human resources (HR) rotation policy; and<br>• streamlining the NRB board participation in operational decisions. | NRB | ST/MT | **In process / not done**<br>Supported by FIRST-funded TA (FIRST) risk-based supervision (RBS) is being implemented for Class A institutions; and is in preliminary stage for on-site supervision. A complementary off-site RBS component is yet to be developed. A donor is assisting in procurement of MIS, and FIRST aims to support off-site RBS practices. A critical need remains for a dedicated HR policy to hire, train and retain qualified supervisors. No action taken on streamlining the NRB Board's participation in operational decisions. |
| 6. | Ensure effective compliance with supervisory directives and guidelines by:<br>• performing a thorough follow up of the implementation of supervisory recommendations;<br>• proactive, earlier, and stronger corrective actions. | NRB | MT | **Not done**<br>Corrective and supervisory actions remain largely informal; with PCA having a formal framework. The FIRST project supports the development of programs to ensure compliance. |

| | | | | |
|---|---|---|---|---|
| 7. | Review licensing regulations and policy to strengthen the licensing process and support a consolidation of the sector. Once completed, re-license all Classes A, B, and C banks that meet the new reinforced requirements, with an appropriate phase-in period, into a single-license category. | NRB | MT | **Under review**<br>NRB has indicated its intent to review the licensing framework; this is supported by the FIRST project. The consolidation of the sector may – in the long run have an impact on the various classes of FI. |
| 8. | Granting the NRB explicit consolidated supervision powers, amending the legal framework to incorporate a comprehensive definition of related parties and controlling interests. | NRB | MT | **Not done**<br>Although amended BAFIA and NRB Acts have been submitted to Parliament, it is uncertain if the listed items were addressed.* Introduction of consolidated supervision will be sequenced as appropriate. |
| | ***B. Non-banking Sector*** | | | |
| 9. | Divide the CIT into two separate legal entities, segregating the capital market business, to be placed under the supervision of the Securities Board of Nepal (SEBON), from the pension fund business. | MOF/SEBON | ST | **In preparation**<br>MOF is preparing a concept report (based on a study trip to India) |
| 10. | Place the EPF and CIT pension fund business under the joint supervision of the Insurance Board (IB) and NRB. | IB/NRB/MOF | MT | **Not done**<br>Regulatory and supervisory options are being explored. |
| 11. | Strengthen the operational independence of the IB and SEBON. | SEBON/IB/ MOF | ST | **Not done**<br>The government is first looking to strengthen the capacity of the IB and the SEBON. |
| | ***Crisis Management*** | | | |
| 12. | Revise Prompt Corrective Action (PCA) policy to require stronger supervisory action, including designation of problematic status at an earlier stage of capital depletion. | NRB | ST | **Under consideration**<br>NRB considering including liquidity as a trigger for PCA program. No changes made regarding the designation of problematic status. |
| 13. | Develop and implement a banking financial institution (BFI) Supervision Enforcement policy that presumes certain enforcement action based on CAMELS ratings. | NRB | MT | **Not done**<br>As the supervisory reforms are implemented, such an enforcement policy may emerge. |
| 14. | Revise NRB Act to clarify ELA provisions. | NRB/MOF | ST | **In preparation**<br>NRB Act Amendments tabled in Parliament.* |
| 15. | Revise NRB Act to grant it special resolution regime powers. | NRB/MOF | ST | **In preparation**<br>NRB Act Amendments tabled in Parliament.* |
| 16. | Establish a national financial crisis coordinating committee comprised of all financial sector, regulatory, and supervisory agencies. Develop each individual agency's crisis contingency plans and roll up individual agency plans into a national crisis contingency plan. | MOF/NRB/IB /SEBON | ST/M T | **Not done**<br>A high-level interagency coordination committee meets on an *ad hoc* basis. It would be important to formalize the mandate of this committee to include the development of a national crisis contingency plan. |
| 17. | Crisis simulations should be conducted periodically. | MOF/NRB/IB /SEBON | MT | **Not done**<br>A simulation has not yet been conducted; the authorities are encouraged to conduct crisis simulations after passage of the relevant Acts. |

* English versions of the BAFIA and the NRB Acts that have been tabled in Parliament are not available; therefore there is no clarity regarding the efficacy of the proposed text.

# Appendix II. Key Policy Recommendations from the 2014 Article IV Consultation

| Policy advice | Implementation status |
|---|---|
| **Fiscal policy** | |
| *Objective: To increase capital spending to provide infrastructure that supports private investment, which will help generate sustained economic growth and employment opportunities.* | |
| Support growth through higher public expenditure | Capital spending increased by 0.7 percent of GDP in 2014/15 but the budget remains under-executed |
| Continue spending increase on health and education | In progress |
| Monitor expenditures executed through local bodies | In progress. A Line Ministry Budget Information System (LIMBS) has been rolled out |
| Ensure sustainability of current spending | Revenue has been growing but fell short of the 2014/15 budget |
| Reduce or eliminate implicit subsidies to the NOC | Implemented. An automatic bi-weekly oil price adjustment mechanism was introduced in 2014. Since the NOC did not fully pass through the decline in international oil prices to its customers, it made a profit in 2014/15 and was able to repay part of its debts |
| Reforms on budget planning and execution process | In progress. MOF has drafted a Fiscal Responsibility and Budget Management Act |
| Enhance cash management, and improve revenue and expenditure forecasts | In progress |
| **Monetary and exchange rate policies** | |
| *Objective: To control the volatility and level of excess reserves in the financial system.* | |
| Step up sterilization and/or raising reserve requirement | Progress made through the introduction of deposit auctions; more effective liquidity management needed |
| Additional issuance of government debt securities for OMOs | Under consideration but challenges remain |
| Enhance cooperation between the NRB and the MOF to improve liquidity forecasts | Problem recognized but challenges remain |
| Separate monetary policy from debt management considerations | Implemented via the creation of separate OMO committees for public debt management and monetary management |
| Introduce interest rate corridor to strengthen monetary framework | Under consideration for implementation over the longer-term |
| Phase out direct lending and cap on interest rate spreads | Will consider if banks begin to lend sufficiently to specific sectors/regions |
| The peg to the Indian rupee provides a useful nominal anchor | Closing the inflation differential with India remains a challenge. |
| **Financial sector** | |
| *Objective: Bolster regulation and supervision and improve financial infrastructure to reduce risk and increase access to finance.* | |
| *See Appendix I for progress in implementing high-priority FSAP recommendations.* | |

Source: IMF Country Report No. 14/214.

INTERNATIONAL MONETARY FUND

# NEPAL

## STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

October 30, 2015

| Prepared By | Asia and Pacific Department |
|---|---|

## CONTENTS

# FUND RELATIONS

(As of September 30, 2015)

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

**General Resources Account:**

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

**SDR Department:**

| | SDR Million | Percent Allocation |
|---|---|---|
| Net cumulative allocation | 68.10 | 100.00 |
| Holdings | 29.01 | 42.61 |

**Outstanding Purchases and Loans:**

| | SDR Million | Percent Quota |
|---|---|---|
| RCF Loans | 64.17 | 90.00 |
| ECF arrangements | 13.90 | 19.49 |

**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 |

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

| | | | Forthcoming | | |
|---|---|---|---|---|---|
| | 2015 | 2016 | 2017 | 2018 | 2019 |
| Principal | 6.42 | 12.83 | 8.91 | 5.70 | 5.70 |
| Charges/interest | 0.00 | 0.02 | 0.02 | 0.02 | 0.02 |
| Total | 6.42 | 12.85 | 8.93 | 5.72 | 5.72 |

### Exchange Rate Arrangement

Nepal unified its exchange rate in February 1993. Since October 1997, the exchange arrangement of Nepal has been reclassified as pegged to a single currency unit. The Nepalese rupee is pegged to the Indian rupee at a rate of 1.6. Currently, all merchandise imports (except for a few goods restricted for security or related reasons) are freely available through an open general license system, with foreign exchange provided through the banking system at the market exchange rate.

As of October 16, 2015, the exchange rate of the Nepalese rupee (Nr) was US$1=Nrs. 103.79. The restriction on quantitative limits on foreign exchange for leisure travel was removed in early 2011. The Industrial Enterprises Act places a 75 percent limit on the conversion and transfer to foreign currency of salaries of non-residents from countries where convertible currency is in circulation. Since the limit applies to amounts that may be less than net salaries, it gives rise to an exchange restriction under Article VIII.

### Safeguards Assessments

A safeguards assessment mission took place in September 2015 in the context of the RCF approved by the Executive Board in July 2015. The mission found that limited progress has been made in following up on recommendations made in the context of a similar evaluation in 2011. Notable positive developments include the successful implementation of a new accounting system and improved financial reporting practices. However, several functions lag behind and strong commitment from the NRB Board and senior management will be needed to modernize them; in particular internal audit and currency and vault operations. Two key priority areas were identified. First, the quality of the external audit should be brought in compliance with international standards. The NRB should engage an auditor with requisite global experience and expertise in the audit of large financial institutions. Second, the NRB's legal framework should be enhanced to further support central bank autonomy and governance.

### 2014 Article IV Consultation

The Executive Board discussed the staff report for the 2014 Article IV consultation (IMF Country Report No. 12/ 326) on July 3, 2014. 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 |

| | | |
|---|---|---|
| | Consultation to support a three-year banking supervision project | 2015 |
| 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 |
| | Customs Administration - Customs Reform and Modernization Strategies | 2015 |
| | Strengthening LTO compliance management activities | 2015 |
| | Strengthening capital budget management | 2015 |
| | Designing a comprehensive tax reform plan | 2015 |
| | Inland Revenue Department (IRD) Reforms—strengthening audit management | 2015 |
| | IRD Reforms—moving from design to implementation phase | 2015 |
| | Tax administration: Post-disaster review and work planning | 2015 |
| | Tax administration: Post-earthquake compliance and risk support | 2015 |
| | Tax Administration: Post-earthquake Large Taxpayer Office -Compliance risk management support | 2015 |
| LEG | AML/CFT National Strategy | 2010, 2011, 2014 |
| | Work-at-Home Assignment | 2011 |
| | Bank Resolution | 2012 |
| | AML/CFT Legal Drafting Mission | 2012, 2013, 2014, 2015 |
| | AML/CFT Structures and Tools | 2012, 2013, 2014, 2015 |
| 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 July, 2015)

## A. Partnership in Nepal's Development Strategy

Nepal has achieved remarkable progress. 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 improved. In addition, growth averaged 4.5 percent per annum during 2006-2015; a percentage point higher than achieved during the conflict period. With the September 2015 promulgation of the constitution, Nepal is posed to attain higher growth with focus returning to development. The country's vision of middle income status by 2030 is a possibility, if available resources are put to productive use.

However, on April 25, a 7.8 magnitude earthquake struck central Nepal. That earthquake and its sequence of aftershocks caused 8,700 deaths and some 25,000 injuries. Estimates suggest that the earthquakes could end up pushing an *additional* 2.5-3.5 percent Nepalese into poverty in 2015/16. This translates to 700,000-982,000 additional poor, directly as a result of the earthquake. A Post-Disaster Needs Assessment (PDNA), completed on June 15, placed total damages and losses to about US $7 billion and reconstruction needs to about US $6.7 billion. While development partners pledged $4.4 billion in aid during the June 2015 International Conference on Nepal's Reconstruction, the actual implementation of the reconstruction remains a challenge. The Government of Nepal through its budget speech in July 2015 announced a reconstruction budget of NPR 91 billion (USD 900 million). However, the modalities of the fungibility, usability and expenditure of the funds towards reconstruction in the 14 worst-affected districts remain unclear. Further clarity awaits the functioning of the National Reconstruction Authority.

To start rebuilding, Nepal needs to take advantage of its economic potential and put in place the prerequisites that will provide faster, sustained and inclusive growth. It has to use available resources to productive use andto quickly make good losses from the earthquakes. Remarkably, Nepal's economy grew steadily even during the height of conflict and economic management remained prudent. This hallmark of prudent economic management is at test more today with low capital investment that resulted in consecutive years of budget surplus.

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) of WBG covers 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 been supporting GON across the entire terrain of the education sector including school education—which also includes early childhood education and non-formal education, higher education, and technical and vocational education and training (TVET). In the school sector, it has supported Nepal's efforts to enhance equitable access to and the quality of school education through a series of projects and programs during the past two decades, including through the ongoing School Sector Reform Program (SSRP). Using a Sector Wide Approach (SWAp), SSRP brings together GON and 13 development partners, of which 10 partners pool their resources with those of GON (Three development partners support the program directly through parallel financing and two pooling partners provide both pooled and non-pooled support). The Second Higher Reform Project, which follows the recently closed Second Higher Education Project, supports reforms in selected institutions for improving quality, relevance and efficiency of higher education, and also assists underprivileged students for equitable access. 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 TVET system in Nepal. Under its new CPS, the WBG will continue its ongoing engagement in the education sector through a stronger focus on improving quality, enhancing equitable access, 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 education 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 practices that contribute to reduced under-nutrition of women of reproductive age and children under the age of two and to provide emergency nutrition and sanitation response to vulnerable populations in Earthquake affected areas.

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. Similarly Strengthening the National Rural Transport Project builds on from the

Bank's earlier work on rural connectivity to enhance the availability and reliability of transport connectivity for rural communities. Connectivity features prominently in the World Bank's current CPS.

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. Similarly Nepal-India Electricity Transmission and Trade Project will support construction of 400 kV high voltage backbone transmission network including receiving substation to evacuated electricity imported from India. The IDA-IFC financed 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. IDA is also funding installation of 25 MW grid connected solar farm and planning and investment in loss reduction activities under the Grid Solar and Energy Efficiency Project.

To support rural development, the Nepal Irrigation and Water Resources Management Project (IWRMP) aims to improve irrigated agriculture productivity and management of selected irrigation schemes, and enhance institutional capacity for integrated water resources management. IWRMP has enabled farmers to increase crop production and cropping intensity through improvement in cropping pattern and demand based extension services. The Modernization of Rani Jamara Kulariya Irrigation Scheme aims to improve irrigation water delivery to, and management in, the command area.

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 in more than 25 districts supported by the project. Similarly, the Agriculture Food Security Project (AFSP) in West Nepal aims to improve food and nutrition security in the 19 remote and food deficit districts in West and far-West Nepal.

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.

Following the devastating earthquakes in April and May 2015, the Bank responded with the $200 million housing reconstruction project which will support rural housing reconstruction of about 20 percent of the houses destroyed in the earthquakes. The project is highly relevant and timely as there is a clear need for housing reconstruction, which was the largest single need identified in the Post-Disaster Needs Assessment (PDNA) – roughly half of the total recovery needs of all sectors. Following the June donor conference, there has been good progress to establish the technical foundation of the program. The Bank is supporting the completion of the Government's Program Operational Manual that will define the implementation arrangements for the housing reconstruction program. Much progress has been made and most technical details have been finalized. The program has been developed through close collaboration with various government agencies, and other stakeholders.

The Bank has recently approved the Development Policy Credit (DPC) which is the second budget support program in a series of three DPCs. DPC1 was for US$ 30 million signed in June 2013 while DPC3 is expected to be implemented in FY16 with major preparatory actions being completed with support from DPC2. The overall objective is of the DPCs for the financial sector is to support the reform program initiated by the Nepalese authorities to reduce the vulnerability of the banking sector and increase its transparency. It is noteworthy that the preparatory work for DPC2 was completed against the backdrop of the devastating earthquake last April. The earthquake disaster has heightened a number of vulnerabilities and presented new challenges. With this in mind, the original planned amount of DPC2 has been increased by US$ 50 million to a total of US$ 100 million. This was done under the IDA's Crisis Response Window to ensure the ongoing financial sector reforms are not derailed due to earthquake and to provide additional post-earthquake financing support to the Government of Nepal.

**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). Under the ownership and leadership of government, the Public Expenditure and Financial Accountability (PEFA) Assessment II was recently completed. This has ushered in joint government and donor partnership collaboration in penning the next PFM reform action plan, which is expected to ensure efficient budget allocations for priority projects.

The Bank and IMF have been jointly advising the Central Bank of Nepal in regulating the financial sector through a Development Policy Program that is working on its second phase.

**Areas of shared responsibility**

The Bank and IMF continues to provide assistance in the overall management of the country's macroeconomic aggregates. They 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, they continue to provide policy advice and technical assistance.

The Bank and 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 new 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 Multilateral 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 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.

**FY15 Lending Program:** FY15, eight projects were delivered with a total value of IDA US$541 million and TF US$16 million, with a total delivery of US$557 million.

**Bank Assistance Program in Nepal:**

As of end of FY15, the Nepal portfolio consisted of 23 Active Investment Projects (which include four TF Projects above US$ 5 million – Nepal Agriculture Food Security Project, PPCR Climate Hazards, SREP Supported Extended Biogas Project and Road Safety Activity under RSDP) with net commitments of US$ 1,861.58 million (of which IDA net commitments are US$ 1,768.71 million and TF net commitments are US$ 92.87 million) and undisbursed balance of about US$962.87 million (of which IDA portion is US$887.43 million and TF portion US$75.44 million). This indicates about 52 percent undisbursed balance from net commitments. In addition, the Nepal portfolio consists of one DPC Project for Financial Sector Stability with net IDA commitments of US$100 million.

**Economic and Sector Work**: The World Bank Group is also engaged in analytical and knowledge dissemination exercises. It provides regular economic updates and advises the Nepalese authorities on key economic policies. It also works with partners and the government on analyzing poverty trends in Nepal. For example, with support from the UK'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.

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

**Activities of the International Finance Corporation (IFC) in Nepal**

Since it resumed operations in 2009, 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 $4 million in total) in FY14 as of March 4, 2014. Most recently, IFC's investments include hydropower investments, an airline expansion, and credit for trade financing. For FY15, IFC has mobilized and invested directly US$ 54 Million with investments in Hydropower, Tourism, Agribusiness and Trade finance. FY 15 is the first fiscal year where IFC was able to mobilize other funders (Canadian Climate change fund, FMO and GAFSP) for its private sector investments in Hydropower, Agribusiness and tourism.

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.

refocuses 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 1. IDA Projects**

(Amounts in US$ million)

**Nepal: Active Portfolio**

**( As of June 30, 2015)**

| Project Name | Net Comm Amt ($m) | Undisbursed Amt ($m) |
|---|---|---|
| NP:Community Actionfor Nutrition Project | 40.00 | 31.63 |
| NP: PPCR: Climate Hazards (TF>USD 5m) | 31.00 | 24.30 |
| Kali Gandaki Rehab | 27.26 | 24.68 |
| NP: Irrig & Water Res Mgmt Proj | 114.30 | 39.11 |
| NP: PAF II | 244.97 | 50.50 |
| NP: School Sector Reform Program | 230.00 | 26.34 |
| NP: Second HNP and HIV/AIDS Project | 129.13 | 6.12 |
| NP: Emerging Towns Project | 18.57 | 7.82 |
| NP: Kabeli "A" Hydroelectric Project | 46.00 | 42.33 |
| NP:Agriculture Commercialization & Trade | 60.00 | 23.47 |
| NP: Road Sector Development Project | 110.85 | 10.78 |
| NP: Enhanced Vocational Educ & Trng | 39.63 | 13.78 |
| NP: Kabeli Transmission Project | 38.00 | 20.00 |
| NP: Rani Jamara Kulariya Irrigation Proj | 43.00 | 21.15 |
| NP: Bridges Program Support | 60.00 | 26.10 |
| Nepal Agriculture and Food Security Project (TF>USD 5m) | 46.50 | 35.78 |
| SREP-Supported Extended Biogas Project (TF>USD 5m) | 7.90 | 7.90 |
| NP: Strengthening National Rural Transport Project | 100.00 | 83.62 |
| NP Rural Water Supply & Sanitation Impr | 72.00 | 58.45 |
| Nepal: Grid Solar & Energy Efficiency | 130.00 | 123.76 |
| Higher Education Reforms Project | 65.00 | 63.15 |
| Road Safety Activity under on RSDP roads(TF>USD 5m) | 7.47 | 7.47 |
| Earthquake Housing Reconstruction Project | 200.00 | 202.38 |
| **Total (23)** | **1,861.58** | **950.62** |
| NP: Financial sector stability DPC2 | 100.00 | |

# RELATIONS WITH THE ASIAN DEVELOPMENT BANK

## Country Program

The Asian Development Bank (ADB) began lending to Nepal in 1969. As of 31 December 2014, Nepal has received 167 loans/grants—133 sovereign ADF loans ($3,433.8 million), 5 non-sovereign loans ($52.8 million), and 34 ADF grants ($823.75 million) totaling $4,310.3 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 integration, and private sector development will be mainstreamed in ADB operations. The portfolio of active sovereign ADF loans and grants as of 31 December 2014 consists of 39 ADF projects and programs (24 loans amounting to $1,253.7 million and 26 grants amounting to $502.3 million) with an overall net amount of $1,756.0 million.

The assistance approved in 2014 comprised five projects with a total of $325 million in ADF loans. The projects include the SASEC Power System Expansion Project ($180 million); Additional financing to Community Managed Irrigated Agriculture Sector Project ($30 million); Additional Financing to Melamchi Water Supply Project ($25 million); Additional financing to South Asia Tourism Infrastructure Development Project ($30 million); and Third Small Towns Water Supply and Sanitation Sector Project ($30 million).

## Technical Assistance

As of 31 December 2014, ADB has approved technical assistance (TA) projects totaling $184.4 million. As of 31 December 2014, there were 26 ongoing TAs amounting to $35.4 million. Twenty one investment projects and 6 TAs, which are about 54% and 23%, respectively, of the ADB's Nepal portfolio, are currently being administered by Nepal Resident Mission.

## Private Sector Operations

ADB's private sector operations in Nepal began in 1989. As of December 2014, 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 9,000 transactions supporting over $19 billion in trade and over 4,000 SMEs across the region since 2004. In 2013 alone, TFP supported $4 billion in trade through over 2,000 transactions. In Nepal, the TFP works with two banks and has supported over $69.7 million in trade between 204 transactions. In addition to filling market gaps, the TFP's objective is to mobilize private sector capital/involvement in developing Asia. In Nepal, 51% of the $69.7 million in trade supported through the TFP was co-financed by the private sector. There are currently no outstanding guarantees for the Nepalese banks. In 2014, it supported one transaction amounting to $17,187.50.

## Table 2. Sovereign Loans and Grants by the Asian Development Bank, 1968–2014

(as of 31 December 2014)

| | 1968-2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|
| Loans | | | | | | | | | | |
| Agriculture and Natural Resources | 746.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 18.0 | 0.0 | 25.5 | 30.0 |
| Education | 130.7 | 30.0 | 0.0 | 0.0 | 25.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Energy | 364.4 | 0.0 | 0.0 | 0.0 | 65.0 | 0.0 | 56.0 | 0.0 | 150.0 | 180.0 |
| Finance | 7.3 | 56.0 | 0.0 | 0.0 | 0.0 | 60.4 | 0.0 | 0.0 | 0.0 | 0.0 |
| Industry and trade | 127.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 7.5 | 0.0 | 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 | 70.0 | 13.5 | 0.0 | 0.0 | 75.0 | 30.0 |
| Water supply, sanitation and other municipal infrastructure and services | 263.0 | 0.0 | 0.0 | 0.0 | 0.0 | 70.0 | 80.0 | 44.8 | 80.0 | 85.0 |
| 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 | 12.8 | 11.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Total Loans** | **2163.8** | **86.0** | **0.0** | **0.0** | **172.8** | **154.9** | **154.0** | **52.3** | **330.5** | **325.0** |
| Grants | | | | | | | | | | |
| Agriculture and Natural Resources | 0.0 | 18.0 | 0.0 | 0.0 | 0.0 | 46.5 | 27.0 | 11.0 | 4.5 | 0.0 |
| Education | 0.0 | 2.0 | 0.0 | 8.0 | 70.0 | 0.0 | 65.0 | 0.0 | 20.0 | 0.0 |
| Energy | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 2.5 | 19.0 | 0.0 | 21.0 | 0.0 |
| Finance | 0.0 | 8.7 | 0.0 | 0.0 | 0.0 | 12.1 | 5.0 | 0.0 | 0.0 | 0.0 |
| Industry and trade | 127.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 7.5 | 0.0 | 0.0 |
| Public Sector Management | 0.0 | 0.0 | 0.0 | 106.3 | 0.0 | 0.0 | 0.0 | 21.0 | 0.0 | 0.0 |
| Transport and Communication | 0.0 | 55.2 | 0.0 | 25.0 | 10.0 | 25.5 | 0.0 | 0.0 | 0.0 | 0.0 |
| Water supply, sanitation and other municipal infrastructure and services | 0.0 | 0.0 | 0.0 | 0.0 | 45.1 | 10.0 | 0.0 | 12.0 | 0.0 | 0.0 |
| Multisector | 0.0 | 0.0 | 100.0 | 0.0 | 25.6 | | 0.0 | 0.0 | 0.0 | 0.0 |
| Regional Cooperation | 0.0 | 0.0 | 9.0 | 0.0 | 12.8 | 11.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Total Grants** | **127.2** | **83.9** | **109.0** | **139.3** | **163.5** | **107.6** | **116.0** | **51.5** | **45.5** | **0.0** |
| **Total Approved (Loan and Grant)** | **2291.0** | **169.9** | **109.0** | **139.3** | **336.3** | **262.5** | **270.0** | **103.8** | **376.0** | **325.0** |
| **Gross disbursements (Loans and Grants)** | **1405.3** | **108.0** | **102.3** | **127.1** | **199.5** | **111.2** | **208.8** | **89.7** | **159.4** | **151.3** |
| Technical Assistance | | | | | | | | | | |
| Total approved | 115.5 | 5.8 | 7.2 | 4.6 | 5.7 | 10.5 | 13.6 | 6.5 | 11.9 | 4.1 |
| Gross disbursement | 75.0 | 2 | 4.6 | 4.6 | 6.8 | 14.2 | 8.8 | 6.8 | 5.4 | 3.9 |

# STATISTICAL ISSUES

As of October 15, 2015

| I. Assessment of Data Adequacy for Surveillance |
| --- |
| **General:** Economic and financial data are broadly adequate for surveillance, with scope for improvement especially in fiscal data (external financing), more detailed price statistics, and the timeliness and quality of balance of payments data. |
| **National Accounts:** 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. Some expenditure categories continue to be affected by limited source data, particularly for household final consumption, although with the commencement of continuing annual household surveys will eventually lead to improved estimates. The CBS has plans for a major revision of the national accounts, to incorporate improved source data and methodology where possible, and to update the base year for the constant price measures from 2000/01 to 2010/11, but the timing is uncertain. Previous STA missions (latest in January 2014) assisted the CBS to develop quarterly GDP estimates, but progress has been hampered by staff turnover and limitations with source data in terms of range of data and timeliness. |
| **Price Statistics:** The Nepal Rastra Bank (NRB) compiles the **consumer price index** (CPI). A new CPI series with 2014/15 as base year (from previous base year of 2005/06) has been released in October based on a new household expenditure survey. Initial plans had been made to transfer the responsibility of compiling the CPI from the NRB to the Central Bureau of Statistics (CBS). 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 IFS. |

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|---|---|
| **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.<br><br>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.<br><br>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. In February 2015, the NRB started reporting international investment position (IIP) data following the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*).<br><br>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-EDS) 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 IIP, resumed the compilation of EDS, and improved the compilation of direct investment. 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.<br><br>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. | |
| **II. Data Standards and Quality** | |
| The country is a General Data Dissemination System (GDDS) participant since May 2001. Metadata were initially posted on the Dissemination Standards Bulletin Board in May 2001 and last updated in January 2009. | Data ROSC on fiscal transparency was published in October, 2007. |

## Nepal—Table of Common Indicators Required for Surveillance

(As of October 15, 2015)

| | Date of latest observation | Date received | Frequency of Data[7] | Frequency of Reporting[7] | Frequency of Publication[7] |
|---|---|---|---|---|---|
| Exchange Rates | 08/15 | 10/15 | D and M | W and M | W and M |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1] | 08/15 | 10/15 | M | M | M |
| Reserve/Base Money | 08/15 | 10/15 | M | M | M |
| Broad Money | 08/15 | 10/15 | M | M | M |
| Central Bank Balance Sheet | 08/15 | 10/15 | M | M | M |
| Consolidated Balance Sheet of the Banking System | 08/15 | 10/15 | M | M | M |
| Interest Rates[2] | 08/15 | 10/15 | D and M | W and M | W and M |
| Consumer Price Index | 08/15 | 10/15 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4] | 08/15 | 10/15 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government | 08/15 | 10/15 | M | M | M |
| Stocks of Central Government and Central Government-Guaranteed Debt[5] | 08/15 | 10/15 | M/A | M/A | M/A |
| External Current Account Balance | 08/15 | 10/15 | M | M | M |
| Exports and Imports of Goods and Services | 08/15 | 10/15 | M | M | M |
| GDP/GNP | 2014/15 | 08/15 | A | A | A |
| Gross External Debt | 2013/14 | 06/15 | A | A | A |
| International Investment Position[6] | 2014/15 | 08/15 | A | A | A |

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

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

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

**Statement by the IMF Staff Representative**
**November 16, 2015**

1. **This statement provides an update regarding the disruption to transportation and trade in the south of Nepal and its implications for economic activity.** This information does not alter the thrust of recommendations contained in the staff report but it does alter the staff's assessment of the downside risks to the near-term macroeconomic outlook.

2. **The disruption to transportation and trade routes to and from the southern border started two days after the September 20 promulgation of the new constitution**. All petroleum products consumed in Nepal are imported from India by truck. During the last fiscal year, oil imports represented 15 percent of Nepal's total goods imports, amounting to US$1.1 billion or 5.3 percent of GDP. The Nepal Oil Corporation (NOC) is the sole supplier of petroleum products in Nepal and the India Oil Corporation (IOC) is the NOC's sole supplier. With fuel transports into Nepal coming to a virtual halt, the NOC announced in late September that only limited amounts of fuel would be supplied for private vehicles, to slow the drawdown of Nepal's limited petroleum reserves.

3. **The prolonged disruption to trade has resulted in a fuel crisis with an increasingly adverse macroeconomic impact**:

- In recent weeks, in the absence of viable alternative ways for Nepal to secure adequate fuel in the short term, economic activity has been slowing markedly. The NOC announced on November 9 that it would no longer sell fuel for use in private vehicles and instead prioritize the remaining stock for sales to the security forces.

- With winter approaching and shortages of essential supplies worsening, the near-term outlook for Nepal's population is becoming bleak, particularly for those who became homeless as a result of the earthquakes in April and May. Delays in starting with post-earthquake reconstruction are compounded by the trade disruption. Fuel shortages are affecting the delivery of emergency supplies to remote regions affected by the earthquakes.[1] On November 10, in response to acute shortages of cooking gas, petrol,

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[1] In the context of a November 10 press briefing by a United Nations spokesperson, the Secretary-General reiterated his concern over the obstruction of essential supplies on the Nepal-India border. Acute shortages in fuel supplies continue to impede planned deliveries to earthquake-affected villages in Nepal. Humanitarian organizations urgently require fuel to maintain operations and deliver food, warm clothing and shelter materials to high altitude areas that will soon be cut off by harsh winter weather. The Secretary-General underlined Nepal's right of free transit, as a landlocked nation as well as for humanitarian reasons, and called on all sides to lift the obstructions without further delay.

diesel and kerosene, Nepal's Forest Ministry announced that it would start to provide firewood as an alternative means of fuel.

4. **Downside risks to the near-term outlook have become more pronounced.** The media in Nepal report that, following a Cabinet decision on November 9, a written request has been sent to the government of India to help end the ongoing problems at the border and ease the supply of essential goods, including cooking gas, petroleum products and medicine to Nepal. To the extent that the trade disruption is not resolved soon and comprehensively, it will be increasingly difficult for overall economic activity to catch up and register positive growth in this fiscal year. Industrial production and tourism are badly affected by the unavailability of fuel and other essential inputs. Government revenue, particularly customs revenue, is down considerably. And so is government spending. The rebound of growth, to 4.4 percent in 2015/16 (mid-July 2015-mid-July 2016), projected in the staff report is predicated on a marked increase in government capital spending as well as reconstruction activity by the private sector. Over the past three years, government capital spending through mid-November averaged only about 6 percent of the total for the fiscal year. As noted in the staff report, during the Article IV consultation mission the authorities were confident that capital budget implementation would again pick up after the end of the festival season in mid-November.

**Statement by Marzunisham Omar, Executive Director for Nepal**
**Pornvipa Tangcharoenmonkong, Alternate Executive Director**
**and Thomas Benjamin Marcelo, Senior Advisor**
**November 16, 2015**

1. The Nepalese authorities express their appreciation to staff for the constructive engagement and policy dialogue during the 2015 Article IV Consultation. The authorities found that the discussions were appropriately focused on macroeconomic and financial sector policies, as well as structural reforms that struck the right balance between supporting Nepal's post-earthquake reconstruction efforts while maintaining macroeconomic and financial stability. They are broadly in agreement with the thrust of the staff appraisal and would take staff's policy recommendations into consideration in the implementation of their macroeconomic policies and post-earthquake development agenda.

**Recent Economic Developments and Outlook**

2. The earthquakes in April and May 2015 resulted in significant loss of lives and property. The total damages and losses in production are estimated at about US$7 billion, equivalent to nearly one-third of GDP. Real GDP, which has grown by an average of 4.5 percent in the last five years, grew by only 3.0 percent in 2014/2015 as a result of the devastation caused by the earthquakes, with the tourism, infrastructure, real estate, agriculture and finance sectors adversely affected. Inflation moderated to 7.2 percent in 2014/2015, on account of lower oil prices, lower inflation in neighboring countries, and effective liquidity management by the Nepal Rastra Bank (NRB). The headline inflation for the first two months of 2015/2016 (mid-July to mid-September 2015) averaged 7.05 percent.

3. Despite the growing import requirements of post-earthquake reconstruction, Nepal's external sector situation further strengthened in 2014/2015 with the balance of payment surplus reaching US$1.43 billion, from US$1.29 billion in the previous fiscal year, due mainly to the current account surplus, supported by sustained overseas remittances. This has enabled Nepal to maintain adequate gross foreign exchange reserves of US$8.28 billion as of mid-September 2015, which is more than 11 months of imports of goods and services.

4. The authorities earlier projected a GDP growth of 6.0 percent for 2015/2016 on account of the expected significant public and private sector investments in reconstruction and expansion in economic activities. However, the prolonged drought, the trade blockade-like situation in the southern part of the country and the ensuing fuel crisis have delayed the start of recovery and reconstruction-related projects, posing risks to the growth and inflation outlook. Nonetheless, the authorities are optimistic that the effective and inclusive implementation of the new constitution and the measures to accelerate government spending would reap significant growth dividends from the restored political stability and facilitation of economic growth.

**Fiscal Policy**

5. The authorities agree with staff's recommendation that fiscal policy needs to support post-earthquake reconstruction and medium-term growth through higher public investment.

As announced in the 2015/2016 budget in July 2015, the authorities will establish a National Reconstruction Authority (NRA) to coordinate the implementation of rehabilitation and reconstruction activities over the next five years. The authorities remain committed to ensuring the passage of a new bill in parliament that will allow the establishment of the NRA and put recovery efforts back on track.

6. On improving revenue performance, the authorities agree with staff on the need to enhance enforcement of tax compliance and further strengthen tax administration to strengthen the fiscal position. However, given the substantial development requirements and available fiscal space, the authorities can increase domestic borrowing while putting in place measures to avoid crowding out private investment.

7. While the fiscal position remains strong, the budget surplus reflects modest revenue growth and continued underspending. The authorities therefore recognizes that there is an urgent need to accelerate post-earthquake reconstruction, provide assistance to earthquake-affected households and businesses, increase priority social spending and improve the effectiveness of safety nets. In the annual budget for 2015/2016, more than US$8 billion was allocated for reconstruction and development, with US$740 million for the National Reconstruction Fund. The authorities have also prioritized budget allocation to agriculture, education, health, tourism, infrastructure development, connectivity and the construction of hydroelectric power plants.

8. To accelerate capital expenditure, the authorities announced steps to expedite the approvals process and simplify administrative procedures. A Public Financial Management (PFM) reform action plan was also developed, in line with past Fund PFM technical assistance. Budget allocation for unimplemented and slow-moving projects will be redirected to ongoing and better performing projects. Likewise, projects that have detailed feasibility studies and whose environmental assessment and land acquisition requirements have been completed will be prioritized for implementation.

**Monetary and Exchange Rate Policy**

9. The authorities are in favor of an accommodative monetary policy stance to support economic recovery. In 2015/2016, monetary policy is aimed at supporting the attainment of a GDP growth of 6.0 percent, containing inflation within 8.5 percent, and maintaining foreign exchange reserves equivalent to at least 8 months of imports of goods and services. Once economic conditions normalize, the authorities will aim to keep inflation close to that of India. The exchange rate peg to the Indian rupee will help to ensure that India's disinflation gains would lead to lower inflation in Nepal.

10. On liquidity management, the NRB will continue to conduct deposit auctions, introduced in August 2014, to effectively mop up excess liquidity. The authorities agree with staff's recommendation to refine the liquidity monitoring and forecasting framework, building on suggestions made in the context of past technical assistance from the Fund. The NRB is currently studying various approaches, including the interest rate corridor framework, to refine the monetary operations framework in implementing monetary policy to strengthen the monetary transmission mechanism. They expressed interest in receiving IMF

technical assistance on systemic liquidity management, which would involve developing an appropriate liquidity forecasting framework, defining monetary operations consistent with monetary policy objectives, identifying instruments, and laying out the operational modalities.

11. The authorities welcome staff's assessment that the exchange rate remains in line with macroeconomic fundamentals. Staff's assessment have taken into account country-specific factors that are relevant to Nepal, such as the significant role of remittances, notwithstanding the conflicting results and wide range of estimates of the External Balance Assessment. The authorities will continue to maintain a pegged exchange rate to the Indian rupee, which has served Nepal well by providing a transparent and stable anchor for the conduct of monetary policy.

**Financial Sector Policy**

12. To help ease the impact of the devastating earthquakes, the NRB has put in place temporary regulatory relief for banks in the affected areas to enable them to continue to extend credit to borrowers. Among others, the limited and time-bound relief measures cover loan-loss provisioning, loan rescheduling and restructuring, and provision of grace periods for loan repayment. As announced in the 2015/2016 budget in July 2015, the NRB helped to establish an Economic Rehabilitation Fund to provide a refinancing facility and interest subsidy on loans extended to earthquake-affected areas covering residential construction, agriculture, and tourism.

13. The authorities broadly agree with staff's recommendations on further improving the stability and resilience of the financial sector and will continue to implement reforms to further enhance the legal and supervisory framework governing banks and financial institutions (BFIs), in line with the 2014 FSAP recommendations. As announced in the 2015/2016 monetary policy statement in July 2015, the NRB seeks to consolidate the banking industry by encouraging the merger of BFIs through an increase in paid-up capital requirements. Further, NRB directives were issued on the buying and selling of branches of problem banks and on the migration to chip-based card from magnetic strip card for debit and credit cards, as part of security and risk mitigation measures for card protection and electronic payment transactions.

14. The authorities are cognizant of the importance of financial inclusion and have pursued various policies and programs to improve access to financial services. These include: (a) branching policy outside of Kathmandu; (b) provision of interest-free loans to facilitate the establishment of branches in underserved areas; (c) reinstatement of bank branches closed during the conflict period; (d) licensing of new microfinance institutions; (e) introduction of branchless banking and mobile banking; and (f) implementation of financial literacy and financial consumer protection initiatives. The NRB will likewise continue its directed lending facilities to achieve the government's inclusive growth objectives.

15. The NRB also expressed interest in receiving technical assistance in developing a strategic plan to implement the 2014 FSAP recommendations on various areas of BFI

supervision such as bank licensing and regulation, implementation of the Nepal Financial Reporting Standard, further enhancements to prudential regulations and development of a reformulated corrective and enforcement actions framework.

16. The NRB welcomes the preliminary findings of the ongoing Safeguards Assessment in connection with the 2015 Rapid Credit Facility (RCF) disbursement, which gives due recognition to the authorities' significant progress in adopting a new accounting system and improving financial reporting practices. The authorities will continue to pursue further reforms in strengthening the NRB's governance and control frameworks as recommended by the safeguards assessment mission in September 2015, particularly on the internal and external audit mechanisms, currency and vault operations, and the NRB's legal framework.

**Structural Reforms**

17. Notwithstanding the setback to growth from the devastating earthquakes, the authorities remain committed to implementing its ambitious structural reform agenda under Nepal's $13^{th}$ Development Plan (2013-2016), which aims to transition Nepal from least developed country status by 2022. The authorities remain steadfast in accelerating economic reforms to promote higher and more inclusive growth and achieve faster poverty reduction.

18. The authorities are undertaking the necessary structural reforms to remove major bottlenecks to public and private investment and improve competitiveness and the business environment. This necessitates substantial investments in transport infrastructure to expand connectivity within Nepal and with neighboring countries, and in energy infrastructure to increase energy supply through hydroelectric power generation. The authorities recently announced the policy framework for public-private partnership in order to facilitate private sector participation in the development of much needed infrastructure, such as roads, bridges, hydroelectric power plants and transmission lines.

19. As announced in the 2015/2016 budget and monetary policy statement, the authorities are prioritizing the submission and/or passage of key legislations in order to deliver on its structural reform agenda: (a) law on foreign investment and technology transfer to improve the investment climate; (b) laws on a unified tax code, revenue leakage control, and central revenue board to strengthen revenue administration; (c) laws on foreign exchange regulation, restriction on investments abroad, regulation and supervision of savings and credit cooperatives and microcredit institutions, and social security to enhance the efficiency and regulation of the financial sector; and (d) law on land use as part of efforts to strengthen risk and disaster management.

**Concluding Remarks**

20. The authorities would like to extend their gratitude for the continuing provision of humanitarian aid and allocation of grants and concessional loans by the international community for the rehabilitation and reconstruction efforts. The authorities would also like to thank the Fund for its ongoing support through policy advice, technical assistance and the swift RCF disbursement of SDR 35.65 million. This has greatly assisted the authorities in

addressing Nepal's growing balance of payments need and catalyzes further resources for post-earthquake reconstruction and development.

21. Nepal has achieved important progress over the past years in implementing sound macroeconomic policies and critical structural reforms to facilitate economic growth, improve economic conditions and reduce poverty. The country is recovering from the impact of the earthquakes in April and May. The new government is forging a stronger consensus among key stakeholders to implement the new constitution and lay the foundations for supporting Nepal's post-earthquake reconstruction and drive towards high, sustained and inclusive growth. The authorities recognize the challenges ahead and are determined to pursue the structural transformation of their economy and boost economic growth and competitiveness by removing bottlenecks to public and private investment in key sectors.

22. The authorities look forward to continued discussions with the Fund on a comprehensive package of macroeconomic and financial sector policies and structural reforms that could be supported by an Extended Credit Facility. Therefore, the Fund's appointment of a full-time IMF Resident Representative in Nepal would be timely and critical to reinforce the effectiveness of the Fund's engagement with Nepal.