INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/74

NEPAL

March 2017

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT

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 2017 Article IV consultation with Nepal, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis. It is based on information available at the time it was completed on March 13, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.

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

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FOR IMMEDIATE RELEASE
March 27, 2017

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

IMF Executive Board Concludes 2017 Article IV Consultation with Nepal

The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Nepal on March 27, 2017, and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

Nepal's economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions at the southern border. The growth of real GDP at market prices slowed to 0.6 percent in 2015/16 (mid-July 2015 to mid-July 2016). Shortages of fuel and other essential goods due to the trade disruption drove up inflation to 12 percent (y/y) in January 2016, but eased subsequently to 3.2 percent in January 2017, mainly on account of lower food prices.

Budget under-spending worsened in 2015/16. At the same time, revenues exceeded the budget due to one-off telecom sector collections. As a result, the budget was in surplus for the fourth year in a row and net public debt declined further to 22 percent of GDP, down from 34 percent of GDP in 2011/12.

Private sector credit growth surged to a 7-year high of 31 percent (y/y) in January 2017.

The current account surplus reached 6.3 percent of GDP in 2015/16 on account of lower imports from the trade disruption. Exports also suffered. The growth rate of remittances slowed sharply, to 1 percent in 2015/16, from an annual average of 15 percent during the previous 5 years, due to weak growth in oil-producing host countries. Gross reserves of the central bank reached a record US$8.7 billion, covering more than nine months of imports, in January 2017.

Growth is projected to reach 5.5 percent in 2016/17 and inflation is expected to undershoot the central bank's mid-2017 target of 7.5 percent.

Executive Board Assessment

In concluding the 2017 Article IV consultation with Nepal, Executive Directors endorsed the staff's appraisal, as follows:

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

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Nepal’s economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions. The normalization of economic activity is supported by a good monsoon, accommodative monetary policy, and rising government spending. Inflation has been decelerating due to base effects related to last year’s trade disruption but is expected to remain above India’s inflation. More recently, the authorities have also been able to advance reforms in a number of areas.

The medium-term outlook critically depends on efforts to sustain and deepen the nascent reform momentum. Stronger policies are needed to enhance confidence amid ongoing political uncertainty. They are also needed to strengthen key institutions and administrative capacity, which are critical for overcoming poor service delivery and chronic under-implementation of the budget, and for boosting private investment and growth. Accordingly, in the absence of stronger policies, and taking into account the lower projected growth of remittances and the effects of the earthquakes and trade disruption, growth would likely fall below the average of the past decade and fall short of what is needed to substantially improve living standards and social indicators.

Risks to the outlook are broadly balanced. The rebound in economic activity could be more pronounced and persistent than set out in the baseline, particularly if the momentum in policy and structural reforms is sustained and deepened. Key downside risks pertain to domestic political instability, the weak financial sector, slowing remittances impacting financial sector liquidity, and lower growth in India due to the demonetization shock.

To support Nepal’s recovery while maintaining macroeconomic and financial stability, the macroeconomic policy mix should be rebalanced toward a more accommodative fiscal position and a tighter monetary stance. Staff welcomes the authorities’ plans and efforts to scale up government spending to rebuild after the earthquakes and address infrastructure gaps to boost medium-term growth. In view of the limited implementation capacity, it will be essential to have a realistic budget that effectively prioritizes spending to maximize growth dividends, including in social spending areas most important for inclusive growth. The scaling up of government spending should not exceed the economy’s aggregate absorptive capacity and should be anchored in a medium-term expenditure framework to ensure quality and fiscal sustainability.

The monetary policy framework needs further strengthening. Staff welcomes the introduction of an interest rate corridor. Next steps would involve refining the framework by fixing the floor of the interest rate corridor to reduce the volatility of interbank interest rates and adopting a medium-term inflation objective consistent with eliminating the inflation wedge with India on a sustained basis. With remittances set to slow, fiscal policy turning expansionary, and the current account turning to a deficit, a tightening of monetary policy is needed to prevent the exchange rate from becoming somewhat overvalued.

Financial sector reforms should be accelerated in line with FSAP recommendations to mitigate macro-financial risks, including related to the rapid growth of credit. Financial sector supervision should be strengthened, building on the recent amendments to several aspects of the regulatory framework. Macro-prudential measures introduced in the aftermath of the 2010-11 episode of financial sector pressures to contain credit growth have served Nepal well and should be maintained after the temporary relief granted in February lapses in July.

Raising Nepal's potential growth requires sustained efforts to build policy implementation capacity, improve the business climate, and develop the hydropower sector. Structural reforms to deregulate product and factor markets should complement prioritized investment to upgrade transportation infrastructure and improve power supply.

Nepal: Selected Economic Indicators, 2013/14-2017/18 [1/]

	2013/14	2014/15	2015/16	2016/17	2017/18
				Projections	
Output and prices (annual percent change)					
Real GDP	6.0	2.7	0.6	5.5	4.5
CPI (period average)	9.0	7.2	9.9	6.7	7.6
CPI (end of period)	8.1	7.6	10.4	6.5	7.5
Fiscal Indicators (in percent of GDP)					
Total revenue and grants	20.4	20.9	23.3	24.2	24.1
of which: tax revenue	15.9	16.8	18.7	20.0	20.1
Expenditure	18.8	20.2	22.0	25.3	25.3
Expenses	15.5	16.0	16.5	19.3	19.3
Net acquisition of nonfinancial assets	3.4	4.2	5.5	6.0	6.0
Operating balance	4.9	4.8	6.8	4.9	4.8
Net lending/borrowing	1.5	0.7	1.4	-1.1	-1.2
Statistical discrepancy	-0.9	-1.2	-1.1	0.0	0.0
Net financial transactions	-1.5	-0.7	-1.4	1.1	1.2
Net acquisition of financial assets	2.4	2.2	5.2	-1.3	-1.2
Net incurrence of liabilities	0.0	0.3	2.8	-0.2	-0.1
Foreign	0.2	0.6	1.1	0.8	0.7
Domestic	-0.3	-0.2	1.7	-1.0	-0.8
Money and credit (annual percent change)					
Broad money	19.1	19.9	19.5	15.9	13.6
Domestic credit	13.9	16.4	17.4	20.2	17.8
Private sector credit	18.3	19.4	23.2	19.0	16.7
Velocity	1.3	1.1	1.0	1.0	1.0
Saving and Investment (in percent of nominal GDP)					
Gross investment	41.2	38.8	34.0	42.7	42.6
Gross fixed investment	23.5	27.7	25.0	31.4	31.4
Private	20.1	23.6	19.5	25.5	25.4
Central government	3.4	4.2	5.5	6.0	6.0
Change in stock	17.7	11.0	8.9	11.2	11.2
Gross national saving	45.7	43.8	40.3	42.4	41.2
Private	40.5	38.5	33.3	37.2	36.1
Central government	5.2	5.2	7.0	5.1	5.1
Balance of Payments					
Current account (in millions of U.S. dollars)	908	1,067	1,339	-73	-338
In percent of GDP	4.5	5.0	6.3	-0.3	-1.3
Trade balance (in millions of U.S. dollars)	-6,082	-6,670	-6,389	-8,079	-8,856
In percent of GDP	-30.4	-31.3	-30.2	-34.7	-34.7
Exports value growth (y/y percent change)	5.4	-4.0	-28.8	18.8	3.9
Imports value growth (y/y percent change)	14.3	7.7	-7.4	25.7	9.1
Workers' remittances (in millions of U.S. dollars)	5,543	6,192	6,253	6,467	6,787
In percent of GDP	27.7	29.1	29.6	27.7	26.6
Gross official reserves (in millions of U.S. dollars)	6,172	7,162	8,574	8,690	8,494
In months of prospective GNFS imports	8.3	10.4	10.1	9.4	8.6
Memorandum items					
Public debt (in percent of GDP)	28.3	25.2	27.3	25.7	23.2
GDP at market prices (in billions of Nepalese rupees)	1,965	2,120	2,249	2,532	2,848
GDP at market prices (in billions of U.S. dollars)	20.0	21.3	21.2	23.3	25.5
Exchange rate (NRs/US$; period average)	98.3	99.5	106.3	…	…
Real effective exchange rate (average, y/y percent change)	-2.8	7.7	5.9	…	…

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

1/ Fiscal year ends in mid-July.

INTERNATIONAL MONETARY FUND

NEPAL

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

March 13, 2017

KEY ISSUES

Context. Nepal's economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions at the southern border. The upswing has been supported by the new government's efforts to revitalize the reform agenda. The key challenge is to put policies in place that will extend the cyclical recovery into a sustained period of high and inclusive growth.

Outlook and Risks. Staff expects growth to reach 5.5 percent in 2016/17, supported by a good monsoon, accommodative monetary policy, and rising government spending. Inflation is at a multi-year low as prices normalize following last year's disruptions. In the absence of strong policies and sustained reforms, growth would likely revert to the average of the past decade and fall short of substantially improving living standards and social indicators. Risks to the baseline are broadly balanced with the main downside risks pertaining to domestic political stability and the financial sector.

Key policy recommendations. Sustaining and deepening the nascent reform momentum observed in recent months would help boost growth and allow more progress in achieving the sustainable development goals (SDGs). Efforts should focus on strengthening key institutions and administrative capacity to overcome the chronic under-implementation of the budget and boost private investment and growth.

- **Fiscal policy** should focus on facilitating post-earthquake reconstruction and medium-term growth through higher and better-quality public investment.
- **Monetary policy** needs to be tightened to support the exchange rate peg and competitiveness by closing the inflation wedge with India on a sustained basis. Monetary management should be strengthened further building on recent steps to adopt an interest rate corridor.
- The buildup of risks related to the rapid credit growth underscores the importance of accelerating **financial sector reforms,** through stronger supervision, building on the recent amendments to the regulatory framework, and more stringent loan classification and provisioning and upgrading of banks' risk management, in line with FSAP recommendations.
- **Structural reform** will be essential to unlock growth. Key priorities include strengthening policy implementation capacity, upgrading transportation infrastructure, improving the business climate, and developing the hydropower sector.

Approved By
Kenneth Kang (APD) and Zeine Zeidane (SPR)

Discussions took place in Kathmandu during January 11–23, 2017. The staff team comprised Mr. Almekinders (head), Ms. Wong, Ms. Sodsriwiboon (all APD), Mr. O'Mahony (STA) and Mr. Chida (OAP), and was assisted by Mr. Bauer (Senior Resident Representative for Bhutan/India/Nepal). Mr. Marcelo and Mr. Nguyen (both OED) also participated in the mission. Ms. Inoue and Ms. Le (both APD) assisted in the preparation of this report.

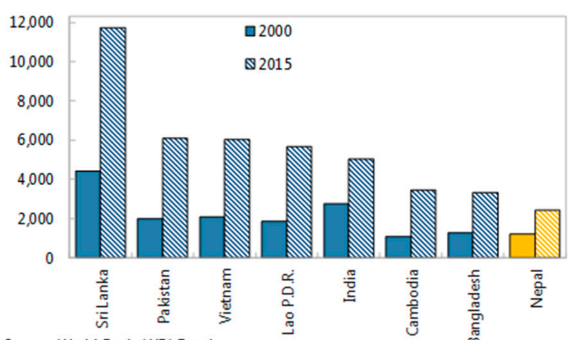
CONTENTS

INTRODUCTION

1. **Macroeconomic performance has been broadly satisfactory, with low public debt and moderate inflation, but growth averaged only 4 percent over the last decade, among the lowest in the region.** The government's vision is to graduate from least-developed country status by 2022 and achieve middle income country status by 2030. The government recently endorsed the 14th Development Plan (2016/17–2018/19) which targets annual average growth of 7.2 percent and a reduction in the share of the population living in poverty by 4.6 percent to 17 percent by 2018/19. However, frequent changes in government have held back progress in addressing infrastructure gaps, weak institutional capacity, and the difficult business climate.

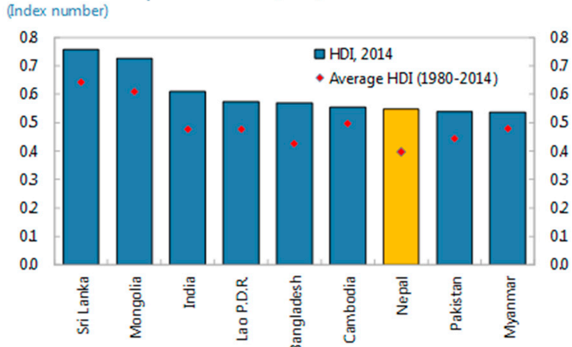
2. **With the country trapped in a low investment, low growth equilibrium, large numbers of Nepalese have sought employment overseas.** Nepal is now one of the largest recipients of remittances in the world. At 30 percent of GDP in FY2015/16, remittances help to reduce poverty, support the balance of payments, and boost the fiscal accounts through higher import-related revenues. But they have also contributed to an appreciation of the real exchange rate, rapid wage growth, stagnant exports and a widening trade deficit.

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



Source: World Bank, *WDI Database*.

Human Development Index (HDI)
(Index number)



Source: UNDP, *Human Development Report 2015*.

3. **Political uncertainty is likely to persist with several elections to be held in the coming months.** Following the 2015 earthquakes, the main political parties reached agreement on a new constitution, which includes the transition to a federal system. However, after a change in government and unrest among ethnic groups in the south of the country, Nepal suffered from a 4½ month blockade of its terrestrial trade routes. In August 2016, a new coalition—the ninth government in nine years—assumed power. Under a power-sharing deal, PM Dahal from the *Communist Party of Nepal Maoist Center* is to oversee the first local elections in almost two decades, set for mid-May, and then hand the reins to a PM of the *Nepali Congress* who will oversee federal and provincial polls. The government has promised to address outstanding grievances related to the new constitution but no agreement has been reached so far.

4. **The authorities' policies are broadly in line with past Fund advice but policy implementation remains weak.** The new government has increased recurrent spending to facilitate post-earthquake reconstruction but inefficiencies in capital budget management and

implementation are holding back a scaling up of public investment to support medium-term growth. The introduction in mid-2016 of an interest rate corridor has been a positive step to strengthen the monetary policy framework and transmission which in turn supports the exchange rate peg by reducing the inflation wedge with India. Recent amendments to the legal and regulatory frameworks governing the central bank and the financial sector should help strengthen supervision and bank governance, and ultimately reduce financial sector vulnerabilities.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

5. Economic activity in 2015/16 suffered from the earthquakes and border blockades, while policy support was stymied by the continued under-execution of the budget.

- *Growth and inflation*. Real GDP growth slowed to 0.6 percent in 2015/16 (mid-July to mid-July). Shortages of fuel and other essential goods drove up inflation to 12 percent (y/y) in January 2016. Inflation subsequently eased on lower food prices (Figure 1).

- *Fiscal*. Budget under-implementation worsened in 2015/16, particularly for capital spending. At the same time, revenues exceeded the budget due to one-off telecom sector collections (1 percent of GDP). As a result, the budget was in surplus for the fourth year in a row and net public debt (gross public debt net of government deposits held at the central bank) fell to 22 percent of GDP, down from 34 percent of GDP in 2012 (Figure 2).

- *External*. The current account surplus reached 6.3 percent of GDP as the trade disruption lowered imports. Exports also fell, led by primary commodities and manufactured products. The growth rate of remittances slowed sharply, to 1 percent in 2015/16, from an annual average of 15 percent during the previous 5 years, due to weak growth in oil-producing host countries. Gross reserves of the central bank reached a record US$8.7 billion (10 months of imports) in December 2016 (Figure 3).

6. More recently, the economy is showing signs of a broad-based recovery.

- *Cyclical rebound*. The normalization of economic activity, a favorable monsoon season, improved power supply, accommodative monetary policy and rising government spending—in part due to the disbursement of housing grants to earthquake-affected households and a hike in government wages and pensions—are spurring a cyclical rebound, as evidenced in recent months by rising imports and tax revenues. Staff expects growth to reach 5.5 percent in 2016/17, somewhat less than the government's aspirations in view of softer remittances and delays in implementing the capital budget.

- *Inflation deceleration.* Base effects related to last year's trade disruption have pushed down inflation in Nepal to 3.2 percent (y/y) in January 2017. Nevertheless, inflation is expected to remain above India's this year and next.

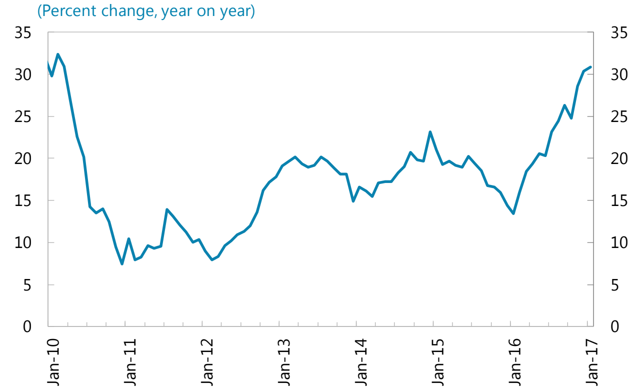
- *India shock*. India's sudden withdrawal of legal tender of high-denomination banknotes is expected to have a limited economic impact overall on Nepal. Banks' holdings of Indian rupee notes are small but some corporates and households—of migrant workers and in the border area—are likely to hold such notes, affecting their purchasing power.

7. Macro-financial risks are on the rise.

- *Rapid credit growth.* Nepal maintains a peg to the Indian rupee and a *de jure* closed capital account. Insufficient sterilization of large BOP inflows loosened monetary conditions in recent years. This, along with the fourfold increase in paid-up capital required by the Nepal Rastra Bank (NRB), pushed private sector credit growth to a 7-year high of 31 percent (y/y) in January 2017. The increase in credit was concentrated in overdrafts, which can be diverted to risky activities such as purchases of land, real estate, and stocks (Figure 4).

Nepal: Private sector credit growth

(Percent change, year on year)



Sources: Nepali authorities.

- *Liquidity tightening.* High credit growth has now pushed banks' loan to deposit ratio close to the regulatory maximum of 80 percent. Temporary regulatory relief granted by the central bank in February (see ¶26) would allow for continued rapid credit growth, raising macro-financial risks. Softening remittances—which have been a key funding source for Nepal's predominantly bank-based financial sector—and rising imports contributed to a tightening of liquidity, pushing up interbank interest rates and leading to a correction in stock prices.

8. The medium-term outlook critically depends on progress in reforms. To illustrate this, staff prepared two scenarios (see text table):

- *Baseline.* The baseline scenario takes into account the experience in other fragile countries where disruptions such as the recent earthquakes and trade blockades had permanent effects on potential growth. Persistent political uncertainty and slow progress in strengthening key institutions and the bureaucracy would make it hard to overcome the chronic under-performance of the budget and improve the business climate to boost private investment which remains at around 25 percent of GDP over the medium term. Thus, growth settles somewhat below the 4 percent average of the past decade, delivering only modest improvements in living standards and social indicators. The current account is projected to swing to a deficit of about 2 percent of GDP in the medium term on higher imports amid slowing remittances.

- *Reform scenario*. The reform scenario illustrates the impact of sustaining and deepening the nascent reform momentum, including by (i) strengthening the government's policymaking and implementation capacity with regard to capital budget implementation and the central bank's monetary policy framework to effect a sustained tightening of monetary policy; (ii) bolstering regulation and supervision of the financial sector to improve the quality of credit; and (iii) creating a conducive environment for domestic and foreign investment, as well as accelerated implementation of donor-supported projects. In this scenario, growth accelerates gradually to close to 6 percent in the medium term, underpinned by public capital spending which is 1½ percent of GDP higher than in the baseline. The additional capital spending is assumed to be financed from concessional loans and grants from multilateral and bilateral development partners, including those pledged in the aftermath of the earthquakes. FDI-financed hydropower projects are an additional driver of growth. Sustained revenue efforts would create fiscal space to raise government current spending by close to 2 percent of GDP (see ¶15), allowing more progress in achieving the SDGs. Remittances growth is expected to be more moderate, in

Nepal: Macroeconomic Framework--Baseline and Reform Scenarios, 2015/16-2020/21 [1/]

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2017/18	2018/19	2019/20	2020/21
	Est.	Proj.	Baseline scenario projections				Reform scenario projections			
Output and prices (annual percent change)										
Real GDP	0.6	5.5	4.5	3.8	3.8	3.8	4.8	5.0	5.5	5.8
CPI (period average)	9.9	6.7	7.6	7.3	6.7	6.5	6.7	6.7	6.0	5.2
CPI (end of period)	10.4	6.5	7.5	7.0	6.5	6.5	7.0	6.5	5.5	5.0
Fiscal Indicators (in percent of GDP)										
Total revenue and grants	23.3	24.2	24.1	24.1	24.1	24.0	24.9	25.1	25.4	25.7
of which: tax revenue	18.7	20.0	20.1	20.0	20.0	20.0	20.8	21.0	21.3	21.7
Expenditure	22.0	25.3	25.3	25.0	24.6	24.5	26.6	26.8	27.2	27.8
Expenses	16.5	19.3	19.3	19.0	19.1	19.0	20.2	20.3	20.2	20.8
Net acquisition of nonfinancial assets	5.5	6.0	6.0	6.0	5.5	5.5	6.5	6.5	7.0	7.0
Statistical discrepancy	-1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing	1.4	-1.1	-1.2	-1.0	-0.5	-0.4	-1.8	-1.7	-1.8	-2.0
Net financial transactions	-2.4	1.1	1.2	1.0	0.5	0.4	1.8	1.7	1.8	2.0
Net acquisition of financial assets	5.2	-1.3	-1.2	1.2	1.2	1.2	-1.3	1.2	1.2	1.2
Net incurrence of liabilities	2.8	-0.2	-0.1	2.1	1.6	1.6	0.5	2.9	3.0	3.2
Foreign	1.1	0.8	0.7	1.2	1.1	1.4	1.4	2.6	3.1	3.1
Domestic	1.7	-1.0	-0.8	0.9	0.6	0.2	-0.9	0.2	-0.1	0.1
Balance of Payments										
Current account (in millions of U.S. dollars)	1,339	-73	-338	-450	-543	-648	-645	-956	-1,238	-1,552
In percent of GDP	6.3	-0.3	-1.3	-1.6	-1.8	-2.0	-2.5	-3.5	-4.1	-4.7
Trade balance (in millions of U.S. dollars)	-6,389	-8,079	-8,856	-9,486	-10,162	-10,892	-8,948	-9,719	-10,521	-11,284
In percent of GDP	-30.2	-34.7	-34.7	-34.3	-33.9	-33.6	-35.3	-35.1	-34.7	-34.2
Exports value growth (y/y percent change)	-28.8	18.8	3.9	4.0	4.1	4.2	4.0	4.1	4.5	5.0
Imports value growth (y/y percent change)	-7.4	25.7	9.1	6.8	6.9	6.9	10.1	8.2	7.9	7.1
Workers' remittances (in millions of U.S. dollars)	6,253	6,467	6,787	7,151	7,564	8,018	6,586	6,881	7,209	7,584
In percent of GDP	29.6	27.7	26.6	25.8	25.2	24.7	26.0	24.9	23.8	23.0
FDI (in millions of U.S. dollars)	55.5	72.8	79.6	86.4	93.6	117.4	279.1	366.4	374.6	399.5
In percent of GDP	0.3	0.3	0.3	0.3	0.3	0.4	1.1	1.3	1.2	1.2
Gross official reserves (in millions of U.S. dollars)	8,574	8,690	8,494	8,381	8,443	8,451	8,304	8,001	8,155	8,062
In months of prospective GNFS imports	10.1	9.4	8.6	7.9	7.5	7.0	8.2	7.3	7.0	6.5
Memorandum items										
Public debt (in percent of GDP)	27.3	25.7	23.2	22.8	22.5	22.3	23.9	24.1	24.8	25.9
GDP at market prices (in billions of U.S. dollars)	21.2	23.3	25.5	27.7	30.0	32.4	25.3	27.7	30.3	33.0

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

part owing to improved employment opportunities in the domestic economy as growth accelerates. Imports increase more rapidly than in the baseline scenario reflecting higher capital spending and FDI-financed hydropower projects.

9. **Risks to the baseline scenario are broadly balanced (Annex 1).** The rebound in economic activity could be more pronounced and persistent, particularly if (i) higher-than-expected capital spending and accelerated payment of housing grants add to the recent surge in government spending; (ii) the momentum in policy and structural reforms created in recent months is sustained and deepened; (iii) a breakthrough is achieved with regard to reaching financial closure for one or more large foreign-financed hydropower projects; and/or (iv) a faster recovery in international oil prices causes oil-exporting countries to increase hiring of Nepali workers. Key downside risks pertain to domestic political instability, the failure to increase implementation capacity, financial sector vulnerabilities, and slowing remittances impacting financial sector liquidity. Hasty implementation of a new framework for federal fiscal relations as mandated under the constitution could strain the government and its finances given prevailing weaknesses in public financial management (PFM) and institutional capacity.

Authorities' Views

10. **The authorities were somewhat more optimistic regarding the near-term growth outlook.** They were hopeful that the pickup in reconstruction activity, notable improvement in power supply, and strong agricultural output would allow the government's 6.5 percent growth target to be achieved. With regard to staff's reform scenario, the authorities concurred that structural reforms and increased policy implementation capacity would be key to sustaining higher growth in the medium term. They expected higher growth dividends from the reforms.

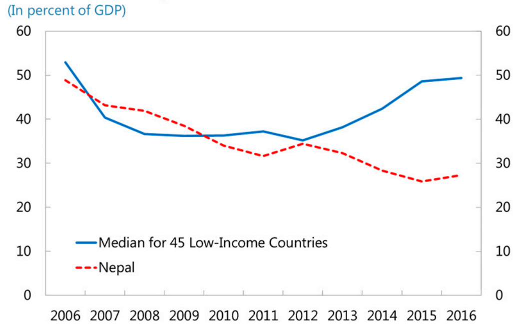
POLICY DISCUSSIONS

Discussions focused on policies to build on the cyclical rebound and create conditions for sustained high and inclusive growth, while safeguarding financial sector stability.

A. Fiscal Policy to Meet Public Spending Needs

11. **Fiscal policy was tighter than envisaged in recent years due to bottlenecks in budget implementation.** As a result, Nepal's public debt-to-GDP ratio continued to decline to 22 percent of GDP in 2015/16 (net of government deposits), unlike in many other low-income countries. The joint IMF/World Bank Debt Sustainability Analysis concludes that Nepal's risk of debt distress remains low.

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



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

12. The 2016/17 budget envelope is very large and unlikely to be implemented in full, given limited budget execution capacity (¶16). Compared to the 2015/16 outturn, it aims for a near doubling of total spending, including a 150 percent increase in capital spending. The budget targets an overall fiscal deficit of 10 percent of GDP, compared to a surplus of 2.4 percent of GDP (based on financing data) in 2015/16. The mid-year budget review, released in February, marked down capital spending by one-sixth thereby reducing the fiscal deficit target to 6.7 percent of GDP.

13. Taking into account likely underspending of the budget, staff projects a fiscal deficit of 1.1 percent of GDP and a fiscal impulse of about 1½ percent of GDP in 2016/17. Spending is projected to increase by 3.2 percent of GDP, consisting of the disbursement of housing grants to earthquake-affected households (1.9 percent of GDP), higher salaries and allowances (0.8 percent of GDP), and capital spending (0.5 percent of GDP). Corrected for one-off receipts, underlying revenue is projected to rise by 1.9 percent of GDP.

Nepal: Expenditure by Economic Classification

	2013/14	2014/15	2015/16		2016/17	
			Budget	Actual	Budget	Actual 1/
	(In percent of GDP)					
Expenditure	18.8	20.2	30.8	22.0	36.7	8.4
Expenses	15.5	16.0	21.5	16.5	24.4	7.4
Compensation of employees	4.3	4.2	4.6	4.0	5.2	1.9
Use of goods and services	1.5	1.5	3.5	2.0	3.9	0.5
Interest and Services	0.6	0.4	1.0	0.4	0.9	0.2
Subsidies	0.1	0.0	0.1	0.0	0.1	0.0
Grants	6.9	7.4	9.2	7.6	10.4	3.4
Social Security	2.1	2.4	3.1	2.5	3.8	1.4
Net acquisition of non-financial assets	3.4	4.2	9.3	5.5	12.3	1.1

Sources: FCGO; and IMF staff estimates.
1/ Up to Janaury 1, 2017.

Policy Recommendations

14. The authorities' plans and efforts to scale up government spending to rebuild after the earthquakes and address infrastructure gaps are welcome. Nonetheless, in scaling up public spending, care should be taken not to exceed the economy's aggregate absorptive capacity and to safeguard expenditure quality. Throughout, close policy coordination and information sharing with the central bank will be important to ensure that the fiscal expansion does not lead to overheating and leaves room for adequate private sector credit growth.

- In the current and next fiscal years, the macroeconomic framework could accommodate the use of the government's accumulated cash balances. Total net domestic financing (NDF: net incurrence of domestic liabilities minus the change in government deposits at the central bank) could amount to about 1½ percent of GDP per annum.

- In subsequent years, Nepal also has some fiscal space. Concessional external financing can finance the bulk of the 1½ percent of GDP increase in government capital spending over the medium term. High-quality capital spending financed by concessional donor inflows can be accommodated since it keeps the debt burden in check while allowing for the needed infrastructure push. Given staff's projections for foreign financing, this will translate to overall fiscal deficits of up to 2 percent of GDP per annum in the medium term. To prevent crowding out credit to the private sector, shortfalls in donor financing should not be replaced by additional domestic financing of the budget and NDF should not exceed 1 percent of GDP per annum.

15. Continued improvements in revenue performance will be important to support adequate levels of development spending. The authorities' ongoing efforts to prepare a unified tax code and draw up a medium-term strategic plan to strengthen customs administration, could be instrumental in this, along with their plans to set up a Revenue Board (Annex II). If fully implemented, they could raise revenue by 1¾ percent of GDP over the medium term.

Nepal: Government Revenue 1/

	2013/14	2014/15	2015/16		2016/17	
			Budget	Actual	Budget	Proj.
(In percent of GDP)						
Total revenue	18.2	19.1	21.1	21.4	22.3	22.3
Total tax revenue	15.9	16.8	19.0	18.7	20.2	20.1
Taxes on income, profits, and capital gains	3.8	4.1	4.7	5.1	4.9	...
Taxes on property	0.3	0.4	0.5	0.6	0.6	...
Taxes on goods and services	8.0	8.5	9.8	9.1	10.6	...
VAT	5.1	5.3	6.3	5.4	6.5	...
Excises	2.3	2.5	2.9	2.9	3.2	...
Taxes on international trade and transactions	3.5	3.5	3.7	3.7	3.8	...
Customs and other import duties	3.3	3.3	3.5	3.5	3.6	...
Non-tax revenue	2.2	2.4	2.1	2.7	2.2	2.2

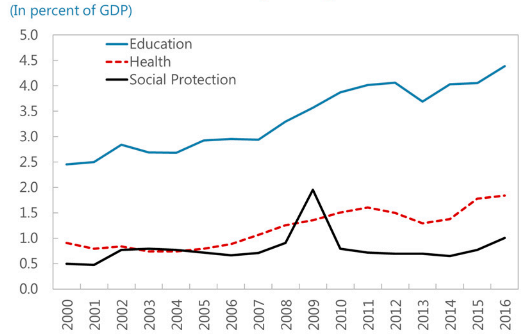
Sources: FCGO; and IMF staff estimates.
1/ Fiscal year is mid-August to mid-July
2/ Mid-year budget review released in late February 2017.

16. Budget preparation and implementation capacity should be strengthened further. This is critically important to break out of Nepal's low-investment-low-growth equilibrium.

- *Budget*. Budgets should be more realistic and capital spending should be spread more evenly over the year. Ambitious budgets and back-loaded implementation increase the risk of low-quality spending.

- *Projects*. Only well-prepared and prioritized projects should be included in the budget and the expansion of government spending should be anchored in a medium-term expenditure framework (MTEF) to ensure fiscal sustainability. In particular, projects should only be included in the budget after completion of a feasibility study, necessary environmental assessments, and land acquisition requirements. In this regard, the authorities' plans to focus on project readiness and preparation of a "bank" of projects that have gone through the various preparatory stages would be welcome. For such projects, government bodies should be able to start the tendering process immediately after the adoption of the budget and should no longer be required to obtain authorizations, including from the National Planning Commission, once the fiscal year has started.

Nepal: Government Social Spending
(In percent of GDP)



Sources: *Government Finance Statistics*; and data from the authorities.

- *PFM*. In addition to immediate steps to increase budget implementation capacity in the short term, there is a broader need to integrate the disparate PFM systems that currently exist across ministries and to strengthen budget coordination under the leadership of the Ministry of Finance.

- *SDGs*. Building on Nepal's early adoption of the SDGs, social spending priorities need to be costed, included in the MTEF, and translated into realistic annual budget allocations (Annex III).

17. To contain fiscal risks, and create additional fiscal space to address social and infrastructure gaps, financial support to state-owned enterprises (SOEs) should be phased out. In recent years, some 1¾ percent of GDP was spent per annum on equity injections and loans to SOEs, including banks:

- *Oil*. The repayment of Nepal Oil Company (NOC)'s debt over the course of the past two fiscal years is welcome. Full application of the automatic oil price adjustment mechanism should continue to prevent a recurrence of NOC losses as international oil prices rise.

- *Electricity*. The reduction in electricity load shedding achieved in recent months is encouraging. This reflects improvements in the management of demand and supply, which should continue. The welcome reform of electricity tariffs at the start of the fiscal year should be the impetus for a further strengthening of the finances of the Nepal Electricity Authority.

18. The impending fiscal decentralization has the potential to improve the quality and delivery of government services, provided that it is based on robust and sustainable inter-governmental fiscal arrangements. Developing these arrangements in the coming months will be a major policy challenge and should be a top priority on the authorities' policy agenda. Ideally, an enabling legal framework for fiscal decentralization should be put in place prior to the first subnational elections under the new constitution. The authorities have requested technical assistance from the IMF to develop such a framework. To make fiscal decentralization work, it would be important to build policy implementation capacity at the sub-national level which will require sustained efforts.

Authorities' Views

19. The authorities generally concurred with the staff's assessment and fiscal policy advice and expressed confidence in their ability to speed up budget execution and advance structural reforms. The implementation rate of the budget in the first half of the current fiscal year was lower than expected even though the budget was introduced earlier than in previous years. The delays were related to the transition to the new government and lack of project preparedness. The authorities highlighted recent measures such as the 10-point directive issued by the Ministry of Finance in November 2016 which emphasizes pro-active steps by line ministries, and intensified monitoring of capital budget implementation. They expected these to show results in the second half of the fiscal year.

B. Strengthening the Monetary Policy Framework

20. The peg to the Indian rupee serves as a transparent anchor for monetary policy. The peg continues to benefit Nepal in view of its close economic relationship with India and need to build policy implementation capacity. However, Nepal's real effective exchange rate (REER) is now about 13 percent more appreciated than the average for 2010-14. Staff assesses that with a continuation of current trends, the exchange rate would become somewhat overvalued (Box 1)

21. Overly accommodative monetary policy has put pressure on the exchange rate peg by keeping credit growth and inflation too high. For most of the last two fiscal years, the NRB's sterilization of remittances has been insufficient to stabilize money market conditions. To curb the risk-taking behavior caused by the low real interest rates—on the basis of the authorities' inflation target of 7.5 percent, real lending rates are about 1 percent—the NRB appropriately tightened loan-to-value ratios for real estate and margin lending in July 2016 and introduced a 50 percent loan-to-value ratio for automobile loans in February 2017.

22. A new operational framework for monetary policy based on an interest rate corridor was announced in July 2016. It was supported by the introduction of new instruments (two-week repos, two-week deposit auctions, as well as the issuance of NRB bonds), needed to stabilize money market rates within the corridor. However, volatility of interbank rates has remained high

Policy Recommendations

23. Monetary policy needs to be tightened. With remittances set to slow, fiscal policy turning expansionary, the current account turning to a deficit, and inflation continuing to run 2–3 percent higher than in India, a tightening of monetary policy is needed to sustain the peg. This should be done by the NRB adopting a medium-term inflation objective consistent with eliminating the inflation wedge with India. As it stands, the 14th Development Plan targets average inflation of 7.5 percent per annum. This is not ambitious enough to maintain the peg considering that India has set itself an inflation target of 4 percent with a tolerance band of plus/minus 2 percent for the next five years. In line with good international practice, the authorities should build a broad-based consensus for a more ambitious inflation target (Annex IV). This would call for providing more monetary policy autonomy to the central bank. However, provisions in the NRB Act Amendment (NRBAA) Bill, approved by Parliament in September 2016, indicate that the government of Nepal may issue directives to the central bank on money, banking and finance and that it shall be the duty of the central bank to abide by such directives.

24. The NRB's adoption of an interest rate corridor is welcome. The operation of the corridor should be enhanced by introducing standing overnight credit and deposit facilities. The existing Standing Liquidity Facility (SLF, currently at 7 percent) could act as the corridor's ceiling. This would need to be complemented by a binding interest rate floor (provided by an overnight deposit standing facility), which could be set at a level close to current market conditions. Moreover, the NRB would periodically review the level of the floor to keep short-term interest rates in line with fundamentals, and could gradually narrow the width of the corridor to contain interbank rate volatility.

25. Consideration should be given to phase out NRB requirements for directed lending by commercial banks. Sectoral lending targets may result in lower credit standards and asset quality, and contribute to financial instability by encouraging mispricing of risk. Phasing them out, while promoting financial inclusion through strengthening the regulation and supervision of microfinance institutions and cooperatives, would help strengthen monetary policy transmission and risk management practices, and allow the central bank to focus on its core functions.

26. Risks related to the rapid growth of credit should be addressed. The regulatory and macro-prudential measures introduced in the aftermath of the 2010–11 episode of financial sector pressures should be maintained to contain the buildup of financial sector risks. In the context of the mid-term review of monetary policy, announced in February, the central bank provided relief to banks with regard to the 80 percent loan-to-deposit (LTD) ratio ceiling. This relief should be withdrawn promptly when it lapses in mid-July, in order to moderate credit growth, normalize interest rates, discourage excessive risk taking, and reduce the impetus to capital outflows.

Authorities' Views

27. The authorities were pleased with the initial experience with the interest rate corridor. They were confident that the interest rate corridor would help improve monetary management. The framework will be gradually upgraded, in line with international practice, as policymakers and market participants gain more experience with it.

28. The authorities reiterated that the peg to the Indian Rupee has served Nepal well. While they broadly concurred with the staff's exchange rate assessment, they did not see the inflation divergence between Nepal and India becoming a threat to the peg and expected India's gains in disinflation to help hold down inflation in Nepal. The authorities noted that the directed lending policy aims to stimulate growth in productive sectors and boost financial inclusion, particularly in the rural area, and felt that risks to financial stability were minor given the limited scope of the policy.

C. Addressing Vulnerabilities to Safeguard Financial Stability

29. The 2014 FSAP highlighted a number of weaknesses in the legal and supervisory framework governing financial institutions. The authorities have begun to address these weaknesses in the context of four World Bank Development Policy Credits (DPCs), in collaboration with the UK's Department for International Development and the IMF. In September 2016, parliament approved the NRB Act Amendment (NRBAA) Bill and the new Deposit and Credit Guarantee Fund Act (DCGF). The former aims to strengthen and clarify the bank resolution powers of the NRB, while the latter enhances the legal framework for the deposit insurance scheme. Amendments to the Bank and Financial Institutions Act (BAFIA), which aim to strengthen the governance of commercial banks were passed in January 2017. The NRBAA shows improvements in some areas, including raising the central bank's capital and aligning the accounting standards with international practice. However, it curtails the autonomy of the central bank (see ¶23) and does not address two key FSAP recommendations (Annex V), regarding granting explicit consolidated supervision powers and clarifying emergency liquidity assistance provisions. Staff is still in the process of clarifying the extent and modalities of the central bank's special resolution regime powers under the amended law, a third FSAP recommendation.

30. Financial soundness indicators (FSIs) reported by the banks have improved (Table 5). All 28 Class A banks now meet the minimum 10 percent capital adequacy ratio (CAR). The three state-owned banks, which represent about a fifth of system assets and were undercapitalized until 2014, have retained earnings and received capital injections. Banks have made progress increasing their paid-up capital with a view to meeting the new requirement for mid-July 2017. Bank profits were at a record high in 2015/16 and non-performing loans (NPLs) and loan-loss provisions at a record low.

31. While these developments are positive, several weaknesses and vulnerabilities remain and the FSIs may therefore not be accurate. Loan classification and bank supervision are still in need of strengthening, and connected lending, ever-greening, and poor risk management practices, compounded by directed lending, suggest that the underlying asset quality in the banking system is weaker than indicated by the financial soundness indicators reported by the banks. Regulatory forbearance measures allowed banks to freeze the loan classification of borrowers impacted by the earthquakes and trade disruptions, while for loans that were rescheduled or restructured by April 2016, no additional loan-loss provisioning was required. However, preliminary data on capitalized interest suggests that only a small amount of loans (about ½ percent of GDP) benefitted from these forbearance measures which are set to run out from April 2017.

Policy Recommendations

32. Financial sector reforms, including recommended by the FSAP (Annex V), need to be accelerated and macro-financial risks need careful monitoring:

- *Supervision*. The NRB should accelerate the strengthening of the bank supervision function. Ongoing efforts to put in place a supervisory information system and to strengthen other credit assessment tools and agencies should be accelerated. To emphasize risk management requirements, the Risk Management Guideline should be converted to a Directive. The NRB's stress testing capabilities need to be upgraded. The NRB should carefully review the quality of the reported increase in banks' capital ahead of the mid-2017 deadline to quadruple paid-up capital from the mid-2015 regulatory minimum.

- *Staffing*. Supervisory capacity should be strengthened by increasing continuity in job assignments. Accordingly, a program to hire, train and retain supervisory staff should be developed, possibly in the context of a dedicated career stream that would be exempted from the existing staff rotation policy.

- *Regulation*. Secondary legislation for the NRBAA, the DCGF, and BAFIA needs to be upgraded. In addition to strengthening banks' risk management practices and disclosure standards, a clean-up period for overdraft loans needs to be introduced. The urgency of this move, which would bring Nepal more into line with the Basel Core Principles, is highlighted by the surge in overdraft loans in recent months. A bank resolution operational framework also needs to be developed urgently.

- *Financial inclusion and financial cooperatives*. The large number of financial cooperatives account for more than 15 percent of financial system assets and have linkages to the banks. However, the absence of meaningful regulation and supervision of the cooperatives sector needs to be remedied, for example through the creation of a designated second-tier institution as well as resolution tools. This would complement and support the government's welcome financial inclusion goals.

- *Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT).* Welcome developments include the completion of the national risk assessment, the recent issuance of rules which operationalize the Asset (Money) Laundering Prevention (Second Amendment) Ordinance 2013 and the start of preparations for the Mutual Evaluation scheduled for 2019/20. The central bank should continue to roll out the application of risk-based offsite and onsite AML/CFT tools, including decisive and prompt enforcement action and sanctions for non-compliance with AML/CFT requirements. Strengthened implementation of the AML/CFT framework is encouraged, notably by cooperatives, insurance companies and securities firms.

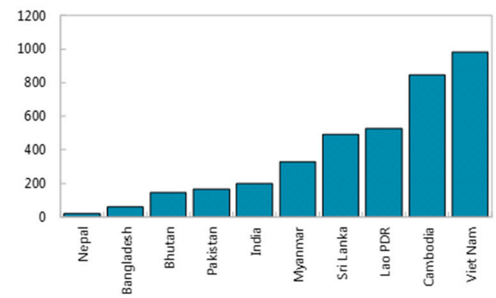
Authorities' Views

33. The authorities underscored their commitment to accelerate and strengthen financial sector reforms. They considered the BAFIA and NRBAA amendments to be instrumental in helping to address key regulatory gaps in line with FSAP recommendations. The NRB planned to convert the guideline for risk management practices into a directive in due course, and concurred that the stress testing capacity needed to be enhanced. To advance reforms and address financial sector vulnerabilities, the authorities emphasized the need for strong coordination among relevant counterparts, including the central bank, the Ministry of Finance, and the regulators of the stock market (SEBON), and the insurance sector (Insurance Board).

D. Structural Reforms to Unlock Nepal's Growth Potential

34. Nepal needs to improve its business environment and address structural bottlenecks to stimulate private sector activity and job creation. More than 500,000 persons enter the labor force each year but employment opportunities are limited. FDI flows to Nepal are lower than in peer countries and policies to stimulate private sector-led growth need urgent strengthening. Nepal's overall ranking in the World Bank's *Doing Business* report fell to 107th in 2017 (from 99th in 2016). Getting credit and construction permits, and enforcing contracts remains difficult (Figure 5). And national priority projects continue to experience extensive delays.

FDI Stock Per Capita in 2014
(US Dollar at current price)



Sources: UNCTAD

35. Efforts are underway to boost investment. Transmission lines have been readied to import more power from India. After long delays, the Melamchi drinking water project is nearing completion. Preparatory work continues for the Upper Karnali and Arun III hydropower projects, even as the two groups of foreign investors, which signed Project Development Agreements in 2014 for US$1 billion each, were recently granted extensions to their deadlines to reach financial closure. Following a Power Summit in December 2016, arrangements are being made for an Infrastructure Summit in February and an Investment Summit in March, all to lure potential investors. Several laws are being drafted to streamline the business environment.

Policy Recommendations

36. Priority structural reforms pertain to the power sector, infrastructure investment and the regulatory framework for the corporate sector:

- Drawing up and agreeing on an ambitious medium-term program of power sector reforms, possibly with assistance from multilateral and bilateral donors, could add to the recent reform momentum in the sector.

- Deregulation of product and factor markets can help reduce operating costs and spur productivity growth through greater contestability of markets and competition (e.g. in goods and passenger transport). Also, a one-stop shop should not only be offered for large investments, but to any investor.

- Modernization of labor relations to enhance labor market flexibility and streamlining of the regulatory environment are urgently needed. In light of this, the extensive stakeholder consultations that have informed the ongoing deliberations on the draft Labor Bill and Foreign Investment and Technology Transfer (FITT) Bill should be brought to fruition.

Authorities' Views

37. The authorities were encouraged by the results of recent power sector reforms. They expressed optimism about the impact of the Specialized Economic Zones Act, the draft Labor Bill and FITT Bill, as well as the development of the hydropower sector. In particular, they expected that structural reforms in these areas would enhance the business climate and encourage new investment and job creation.

E. Strengthening Capacity Development and Statistics

38. The Fund's capacity building efforts have had mixed results. Progress is hampered by frequent rotation of staff in the central bank, ministries, and government agencies.

39. The upcoming launch of the South Asia Regional Training and Technical Assistance Center (SARTTAC) in New Delhi allows for more, better-tailored, and better-integrated TA and training. The government of Nepal has pledged an important financial contribution to the operation of the Center and is represented on its Governing Board.

Policy recommendations

40. There are several steps that can be taken to strengthen capacity building:

- It is critically important for the authorities to review existing rotation policies, train specialized officials (e.g. bank supervisors, tax inspectors, statisticians, etc.) early in their tenure, and retain them in their positions for much longer than is the current practice.

- The Nepali authorities should participate actively in drawing up SARTTAC's training and TA program, carefully select officials for the various training courses, and work with the providers of TA to act on their recommendations.

- The central bank should follow up on the 2015 Safeguards Assessment recommendations. The NRB publishes its audited financial statements, but the assessment's key recommendations to enhance the quality of the external audit and to modernize the central bank law remain outstanding. The internal audit function should also be improved, including through technical assistance.

41. Efforts to strengthen statistics should be continued. Work on updating the base year of the national accounts and compiling and disseminating quarterly GDP statistics should be accelerated and data gaps identified in the SDG status report should be addressed. There is also scope to enhance cooperation between the Financial Comptroller General Office and the NRB in the publication of more complete and comprehensive Government Finance Statistics.

Authorities' Views

42. The authorities agreed that capacity building was important but there were no plans to change the rotation policies.

STAFF APPRAISAL

43. Nepal's economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions. The normalization of economic activity is supported by a good monsoon, accommodative monetary policy, and rising government spending. Inflation has been decelerating due to base effects related to last year's trade disruption but is expected to remain above India's inflation. More recently, the authorities have also been able to advance reforms in a number of areas.

44. The medium-term outlook critically depends on efforts to sustain and deepen the nascent reform momentum. Stronger policies are needed to enhance confidence amid ongoing political uncertainty. They are also needed to strengthen key institutions and administrative capacity, which are critical for overcoming poor service delivery and chronic under-implementation of the budget, and for boosting private investment and growth. Accordingly, in the absence of stronger policies, and taking into account the lower projected growth of remittances and the effects of the earthquakes and trade disruption, growth would likely fall below the average of the past decade and fall short of what is needed to substantially improve living standards and social indicators.

45. Risks to the outlook are broadly balanced. The rebound in economic activity could be more pronounced and persistent than set out in the baseline, particularly if the momentum in policy and structural reforms is sustained and deepened. Key downside risks pertain to domestic political instability, the weak financial sector, slowing remittances impacting financial sector liquidity, and lower growth in India due to the demonetization shock.

46. To support Nepal's recovery while maintaining macroeconomic and financial stability, the macroeconomic policy mix should be rebalanced toward a more accommodative fiscal position and a tighter monetary stance. Staff welcomes the authorities' plans and efforts to scale up government spending to rebuild after the earthquakes and address infrastructure gaps to boost medium-term growth. In view of the limited implementation capacity, it will be essential to have a realistic budget that effectively prioritizes spending to maximize growth dividends, including in social spending areas most important for inclusive growth. The scaling up of government spending should not exceed the economy's aggregate absorptive capacity and should be anchored in a medium-term expenditure framework to ensure quality and fiscal sustainability.

47. The monetary policy framework needs further strengthening. Staff welcomes the introduction of an interest rate corridor. Next steps would involve refining the framework by fixing the floor of the interest rate corridor to reduce the volatility of interbank interest rates and adopting a medium-term inflation objective consistent with eliminating the inflation wedge with India on a sustained basis. With remittances set to slow, fiscal policy turning expansionary, and the current account turning to a deficit, a tightening of monetary policy is needed to prevent the exchange rate from becoming somewhat overvalued.

48. Financial sector reforms should be accelerated in line with FSAP recommendations to mitigate macro-financial risks, including related to the rapid growth of credit. Financial sector supervision should be strengthened, building on the recent amendments to several aspects of the regulatory framework. Macro-prudential measures introduced in the aftermath of the 2010-11 episode of financial sector pressures to contain credit growth have served Nepal well and should be maintained after the temporary relief granted in February lapses in July.

49. Raising Nepal's potential growth requires sustained efforts to build policy implementation capacity, improve the business climate, and develop the hydropower sector. Structural reforms to deregulate product and factor markets should complement prioritized investment to upgrade transportation infrastructure and improve power supply.

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

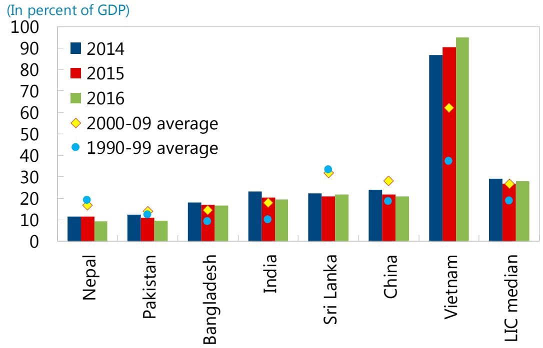
Box 1. Nepal: External Sector Assessment and Reserve Adequacy

Reserves are more than adequate but with a continuation of current trends, the exchange rate would become somewhat overvalued

Nepal's balance of payments has been in surplus in recent years with rising remittances more than offsetting declining exports of goods and services and expanding imports:

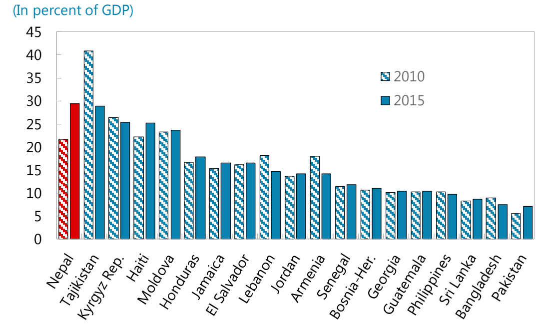
- **Nepal's export performance has been weak, lagging that of peers.** The exports of goods and services to GDP ratio declined from 16 percent in the early 2000s to 11.7 percent in 2014/15. The earthquakes and disruptions to trade pushed the ratio down to 9.3 percent of GDP in 2015/16. Reflecting also the inflation differential with India, Nepal's REER is now about 13 percent more appreciated than the average for 2010-14. However, concerns about the competitiveness of Nepal's exports go beyond the level of the real exchange rate. The infrastructure gap, power shortages, and restrictive labor regulations make for a difficult business environment.
- **Nepal stands out because of the large remittances it receives**. At almost 30 percent of GDP in 2015/16, Nepal's remittances are among the highest in the world. The bulk of remittances comes from migrant workers in Persian Gulf countries and Malaysia.

Exports of Goods and Services
(In percent of GDP)



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

Inflows of Remittances, Selected Countries, 2015
(In percent of GDP)



Sources: World Bank, *Remittances Data*; IMF, *World Economic Outlook*.
Note: Observation for Nepal is for fiscal year 2015/16.

Gross international reserves (of which about a quarter is held in Indian rupees) have risen to US$8.8 billion, equal to more than 9 months of imports. Taking into account the peg to the Indian rupee, the need to be able to absorb external shocks, and the low opportunity cost of holding reserves, 7 months of imports would be adequate (see also Box 2 in EBS/15/83).

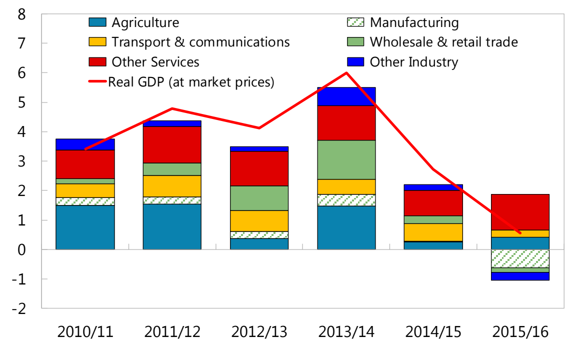
Under current policies and with a continuation of recent trends, the exchange rate would become somewhat overvalued. Slowing remittances and a projected shift in fiscal policy are expected to cause the BOP to swing to a deficit. In conjunction with the ongoing appreciation of the REER, with inflation continuing to run 2-3 percent higher than in India, the exchange rate would become overvalued**.** Various econometric approaches to assess the exchange rate do not give uniform results. However, in view of the REER appreciation and the weak export performance, it seems opportune to assign more weight to the finding of the equilibrium REER approach:

- The current account (CA) panel regression approach takes fundamentals, policy variables, and cyclical factors into account in estimating the current account "norm". The CA norm for Nepal is estimated at -2.8 percent of GDP, while the underlying CA in 2015/16 was 4.1 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 21 percent. However, the CA is projected to converge to the norm over the medium term.
- The equilibrium real 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 17 percent overvalued as of mid-2016.
- Reflecting persistent underinvestment in the domestic economy, Nepal's net international investment position (IIP) is strong for a low-income country: +15 percent of GDP in 2015. Nepal could afford to run a current account deficit of about 2 percent of GDP, as currently projected in the medium term, and still stabilize its IIP at -15 percent of GDP, thus suggesting that the REER is in line with fundamentals.

Figure 1. Nepal: Macroeconomic Developments

The trade disruption compounded the effects of the earth-quakes, reducing growth to 0.6 percent in 2015/16.

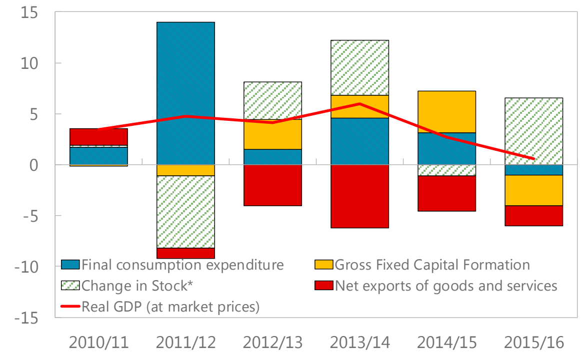
Real GDP Growth by Sector
(In percent)



Source: Nepal Central Bureau of Statistics.

Growth has been underpinned by consumption but the statisical discrepany in the national accounts has been significant.

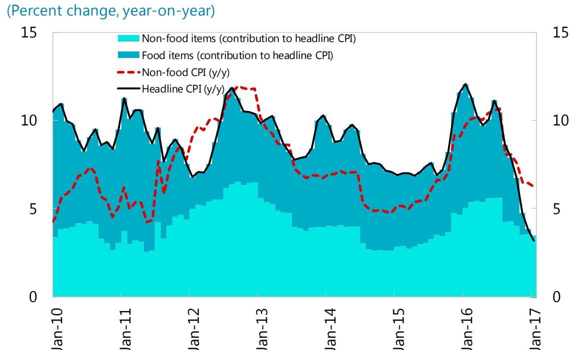
Real GDP Growth by Expenditure
(In percent)



Sources: Nepal Central Bureau of Statistics.
*Includes statistical discrepancy.

Inflation decelerated rapidly, to 3.2 percent (y/y) in January 2017, as food prices normalized…

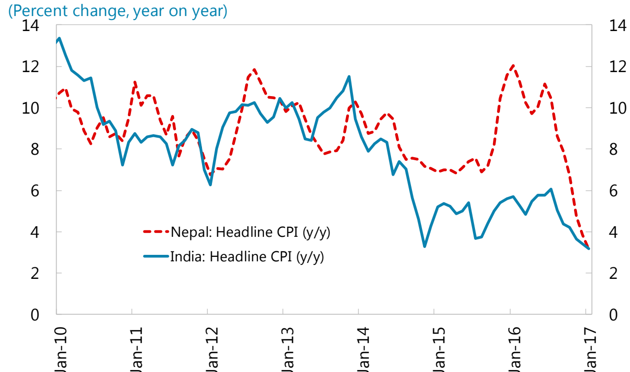
Consumer Price Inflation
(Percent change, year-on-year)



Sources: Nepali authorities; and IMF staff estimates.

…causing the inflation gap with India to narrow.

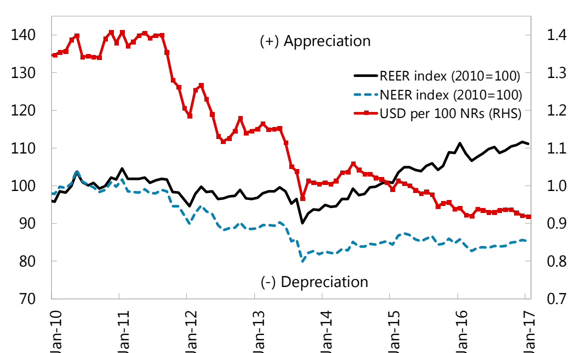
Consumer Prices in Nepal and India
(Percent change, year on year)



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

In combination with the peg to the Indian rupee, this has put the REER 13 percent above the 2010-14 average.

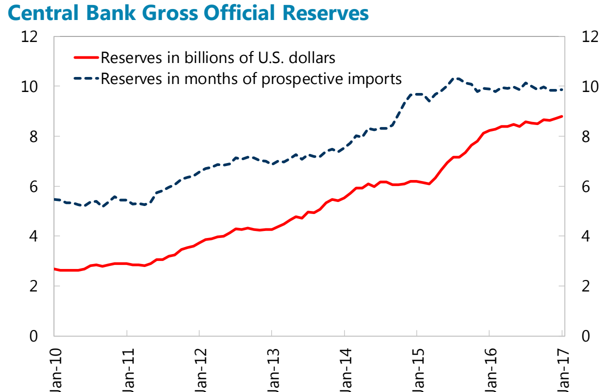
Exchange Rates



Sources: Nepali authorities; and IMF staff estimates.

Reserves increased to US$8.8 billion supported by stong remittance inflows.

Central Bank Gross Official Reserves



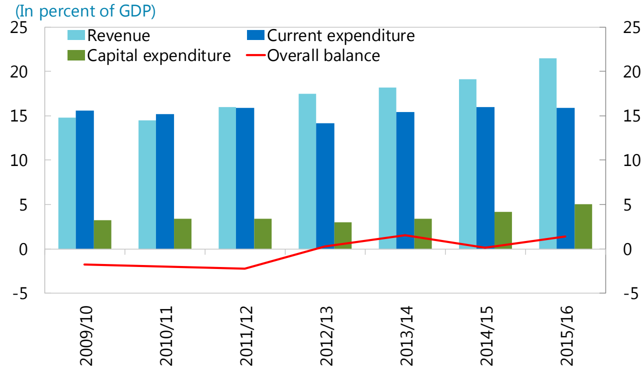
Sources: Nepali authorities; and IMF staff estimates.

Figure 2. Nepal: Fiscal Developments

Strong revenue growth and subdued capital spending kept the budget in surplus for the past four years.

Fiscal Performance

(In percent of GDP)

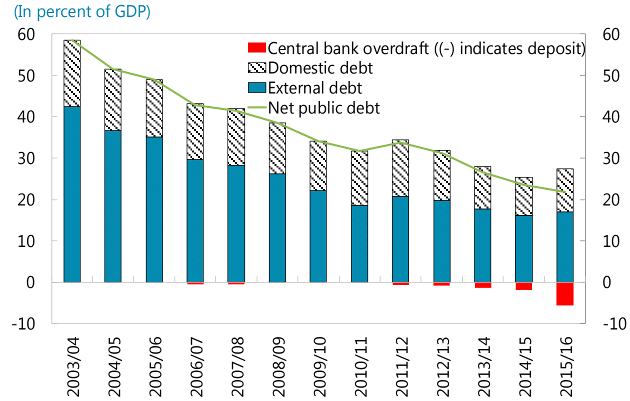


Sources: Nepali authorities; and IMF staff estimates.
Note: Overall balance: incurrence of net liabilities (incl. government deposits at NRB).

As a result, public debt declined steadily and the government accumulated large cash balances at the central bank.

Public Debt

(In percent of GDP)

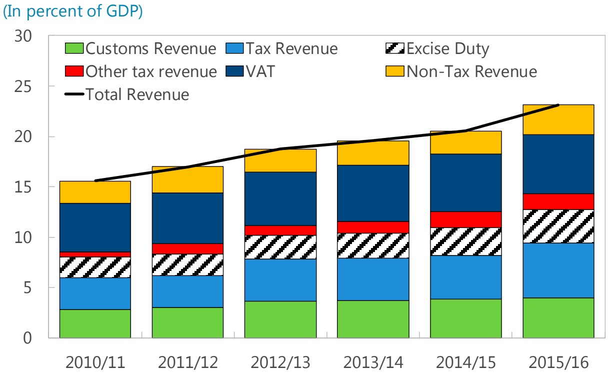


Sources: Nepali authorities; and IMF staff estimates

Revenue mobilization is supported by increases in VAT and customs thanks to higher imports.

Fiscal Revenue

(In percent of GDP)

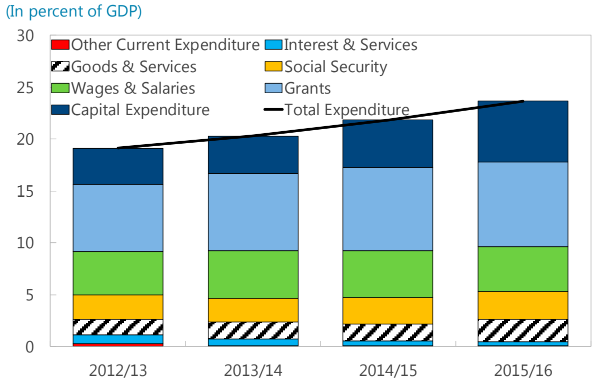


Sources: Nepali Authorities, and IMF staff estimates.

Recurrent expenditure has been edging up.

Fiscal Expenditure

(In percent of GDP)

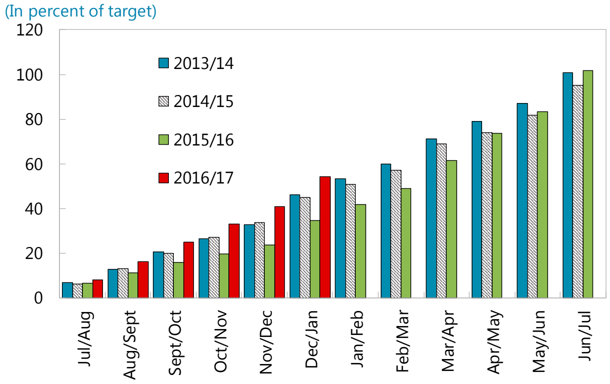


Sources: Nepali Authorities, and IMF staff estimates.

Revenues exceeded the collection target in 2015/16…

Revenue Collection Rate

(In percent of target)

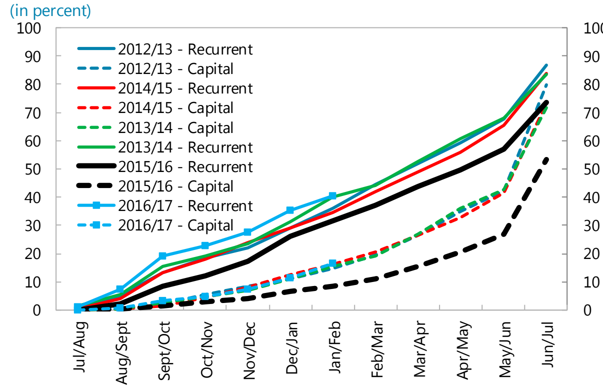


Sources: Nepali Authorities, and IMF staff estimates.

…whereas budget execution rates declined. And capital spending has been bunching toward the end of the fiscal year.

Budget Execution Rate

(in percent)

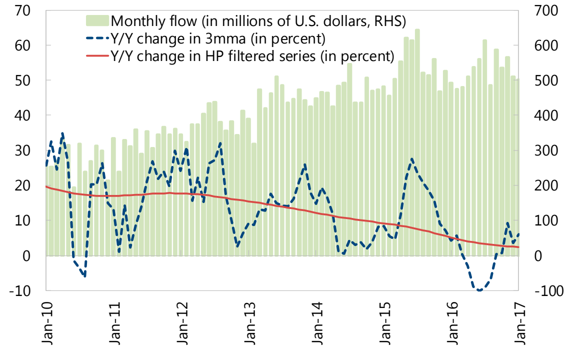


Source: Nepali authorities.

Figure 3. Nepal: External Sector Developments

Remittances remain resilient but their growth is slowing…

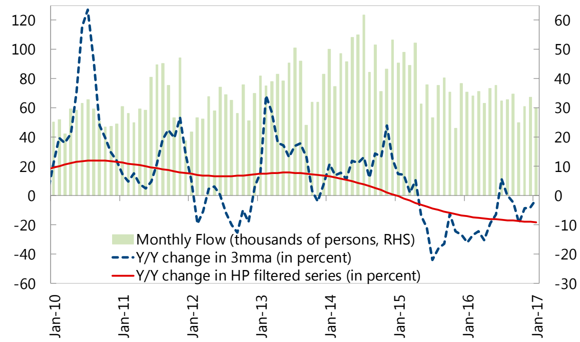
Remittances



Sources: Nepali authorities; and IMF staff estimates.

… due to a slowdown in the outflow of migrant workers.

Foreign Employment

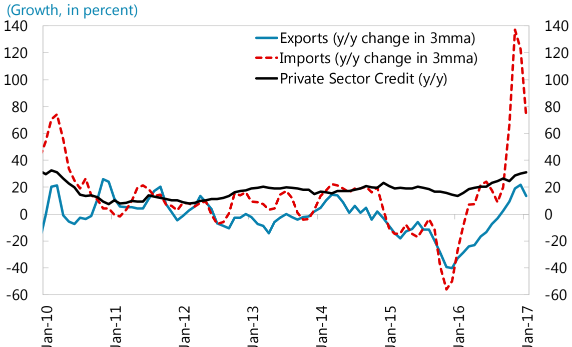


Sources: Nepali authorities; and IMF staff estimates.

Imports have rebounded strongly from the trade disruption.

Trade and Private Sector Credit

(Growth, in percent)

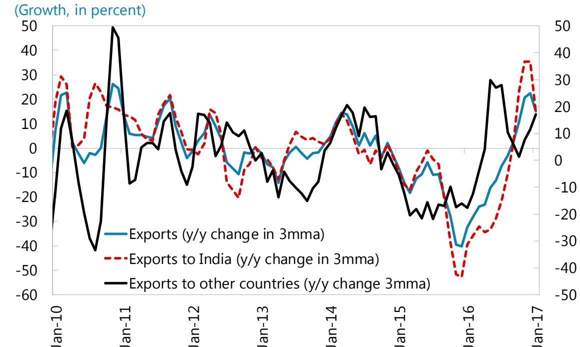


Sources: Nepali authorities; and IMF staff estimates.

Exports have recovered, driven by exports to India.

Exports

(Growth, in percent)

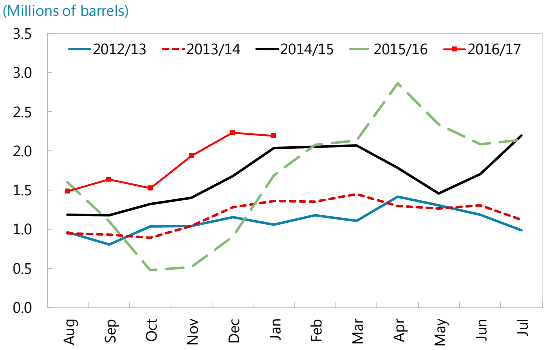


Sources: Nepali authorities; and IMF staff calculations.

Oil import volumes are also on the rise.

Oil Import Volume

(Millions of barrels)



Sources: Nepali authorities; and IMF staff estimates.

But strong remittances kept the current account in surplus

Current Account

(in percent of GDP)

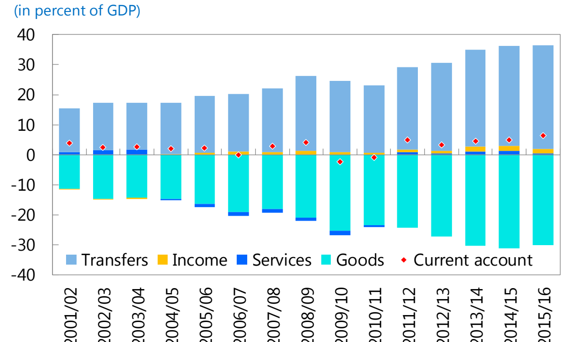
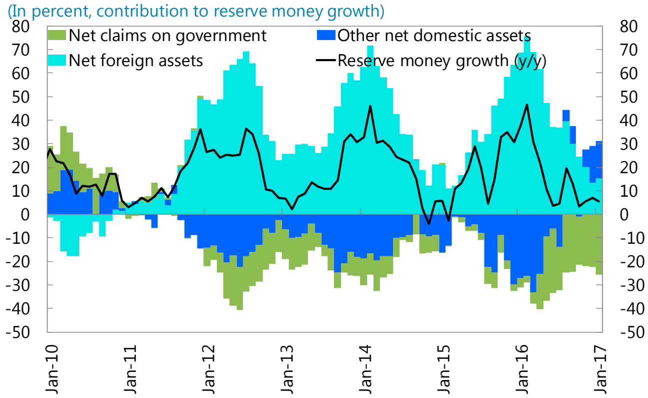


Figure 4. Nepal: Monetary Developments

Reserve money has slowed on moderating growth of central bank NFA.

Central Bank Balance Sheet

(In percent, contribution to reserve money growth)

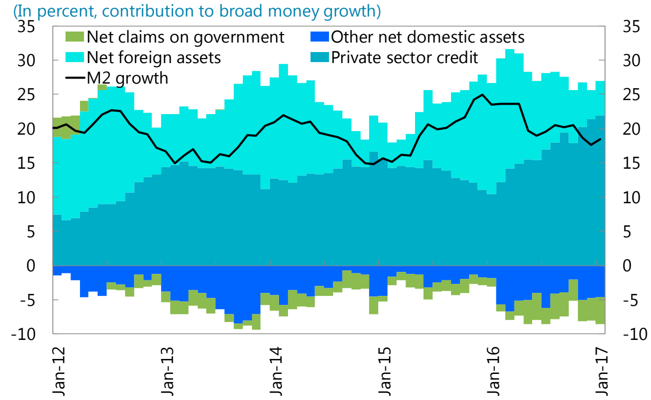


Sources: Nepali authorities; and IMF staff estimates.

Credit to the private sector is the key driver of the 19 percent (y/y) increase in broad money (M2) in January 2017.

Broad Money Growth

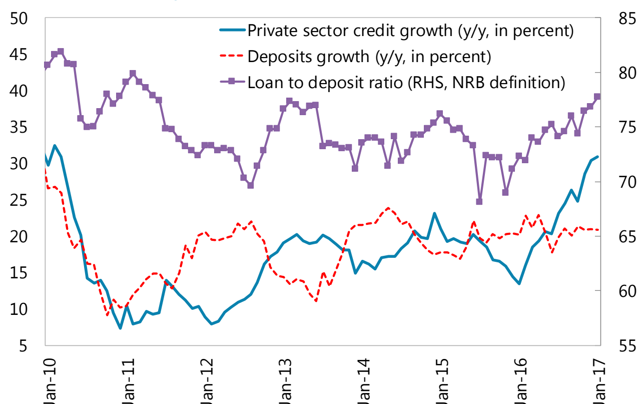
(In percent, contribution to broad money growth)



Sources: Nepali authorities; and IMF staff estimates.

Credit growth hit a 7-year high in January 2017, surpassing the growth of bank deposits and pushing up the loan to deposit ratio.

Nepal: Monetary Developments

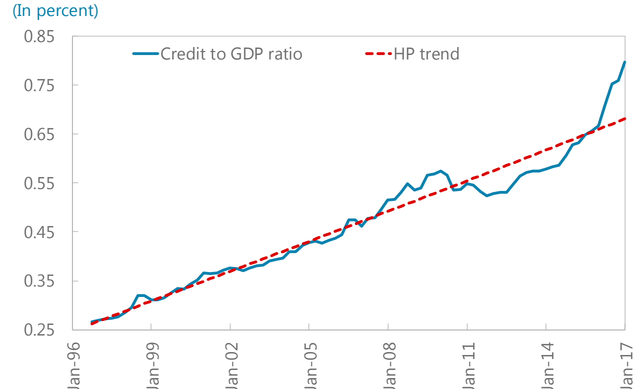


Sources: Nepali authorities.

Credit has been expanding above trend.

Credit Gap Analysis, 1996-2016

(In percent)

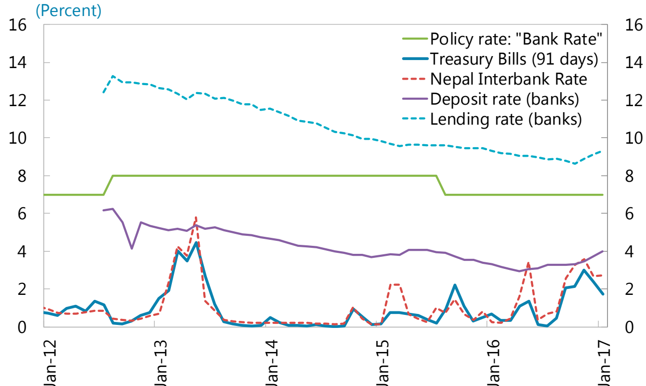


Sources: Nepali authorities and IMF staff calculations.

Loose monetary conditions pushed interest rates down. But rates have been edging up in recent months.

Nepal: Interest Rates

(Percent)

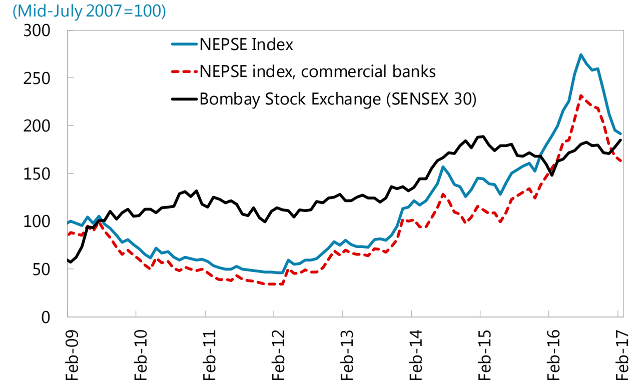


Sources: Nepali authorities.

Tightening liquidity conditions have turned the momentum in Nepal's stock market.

Stock Market Performance in Nepal and India

(Mid-July 2007=100)



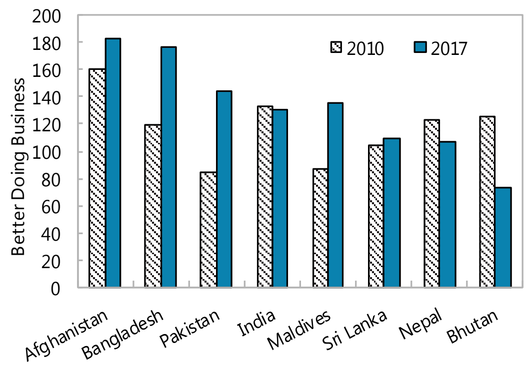
Sources: Nepali authorities; and IMF staff estimates

Figure 5. Nepal: Business Environment and Governance

Nepal's overall ranking has improved somewhat compared to 2010. But it slipped compared to 2016...

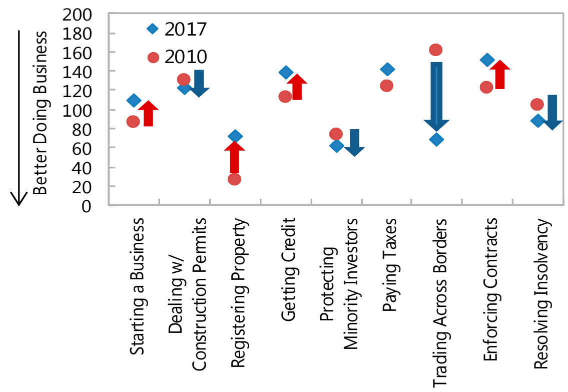
...and deteriorated in some areas important to business.

Ease of Doing Business Ranking: South Asia



Sources: World Bank, Doing Business Report (2017 and 2010)

Ease of Doing Business Ranking: Nepal

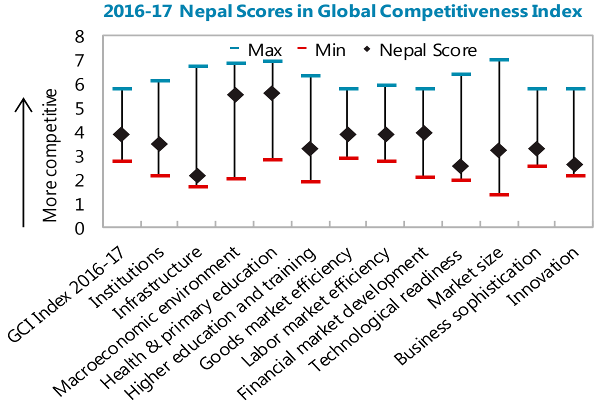


Source: World Bank, Doing Business Report (2017 and 2010).

Competitiveness is hampered by inadequate infrastructure.

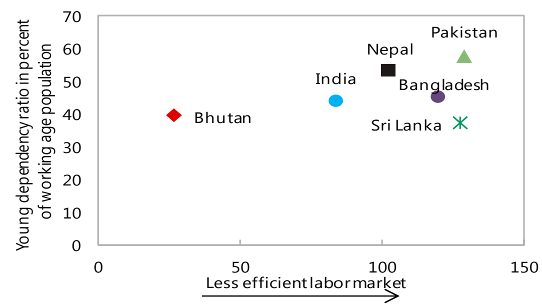
...labor markets are less efficient than in regional peers despite the advantage of a young population.

2016-17 Nepal Scores in Global Competitiveness Index



Source: World Economic Forum Global Competitiveness Report (16/17)

Labor Market Efficiency Ranking and Young Population Ratio: South Asia



Sources: World Development Indicators (2015) and World Economic Forum Global Competitiveness Report (2016)

Note: Young, defined as people younger than 15; working-age population as 15-64.

Table 1. Nepal: Macroeconomic Framework, 2013/14-2021/22 1/

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
				Projections					
Output and prices (annual percent change)									
Real GDP	6.0	2.7	0.6	5.5	4.5	3.8	3.8	3.8	3.8
CPI (period average)	9.0	7.2	9.9	6.7	7.6	7.3	6.7	6.5	6.5
CPI (end of period)	8.1	7.6	10.4	6.5	7.5	7.0	6.5	6.5	6.5
Fiscal Indicators (in percent of GDP)									
Total revenue and grants	20.4	20.9	23.3	24.2	24.1	24.1	24.1	24.0	24.0
of which: tax revenue	15.9	16.8	18.7	20.0	20.1	20.0	20.0	20.0	20.0
Expenditure	18.8	20.2	22.0	25.3	25.3	25.0	24.6	24.5	24.4
Expenses	15.5	16.0	16.5	19.3	19.3	19.0	19.1	19.0	18.9
Net acquisition of nonfinancial assets	3.4	4.2	5.5	6.0	6.0	6.0	5.5	5.5	5.5
Operating balance	4.9	4.8	6.8	4.9	4.8	5.0	5.0	5.0	5.1
Net lending/borrowing	1.5	0.7	1.4	-1.1	-1.2	-1.0	-0.5	-0.4	-0.4
Statistical discrepancy	-0.9	-1.2	-1.1	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	-1.5	-0.7	-1.4	1.1	1.2	1.0	0.5	0.4	0.4
Net acquisition of financial assets	2.4	2.2	5.2	-1.3	-1.2	1.0	1.2	1.2	1.2
Net incurrence of liabilities	0.0	0.3	2.8	-0.2	-0.1	2.1	1.6	1.6	1.5
Foreign	0.2	0.6	1.1	0.8	0.7	1.2	1.1	1.4	1.3
Domestic	-0.3	-0.2	1.7	-1.0	-0.8	0.9	0.6	0.2	0.2
Money and credit (annual percent change)									
Broad money	19.1	19.9	19.5	15.9	13.6	12.5	10.8	10.6	10.6
Domestic credit	13.9	16.4	17.4	20.2	17.8	14.3	11.0	10.7	11.8
Private sector credit	18.3	19.4	23.2	19.0	16.7	14.3	11.1	11.2	12.3
Velocity	1.3	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Saving and Investment (in percent of nominal GDP)									
Gross investment	41.2	38.8	34.0	42.7	42.6	42.1	41.7	41.4	41.1
Gross fixed investment	23.5	27.7	25.0	31.4	31.4	31.0	30.7	30.5	30.3
Private	20.1	23.6	19.5	25.5	25.4	25.0	25.2	25.0	24.8
Central government	3.4	4.2	5.5	6.0	6.0	6.0	5.5	5.5	5.5
Change in stock	17.7	11.0	8.9	11.2	11.2	11.1	11.0	10.9	10.8
Gross national saving	45.7	43.8	40.3	42.4	41.2	40.5	39.9	39.4	38.9
Private	40.5	38.5	33.3	37.2	36.1	35.1	34.6	34.1	33.5
Central government	5.2	5.2	7.0	5.1	5.1	5.3	5.3	5.3	5.5
Balance of Payments									
Current account (in millions of U.S. dollars)	908	1,067	1,339	-73	-338	-450	-543	-648	-745
In percent of GDP	4.5	5.0	6.3	-0.3	-1.3	-1.6	-1.8	-2.0	-2.1
Trade balance (in millions of U.S. dollars)	-6,082	-6,670	-6,389	-8,079	-8,856	-9,486	-10,162	-10,892	-11,658
In percent of GDP	-30.4	-31.3	-30.2	-34.7	-34.7	-34.3	-33.9	-33.6	-33.3
Exports value growth (y/y percent change)	5.4	-4.0	-28.8	18.8	3.9	4.0	4.1	4.2	4.2
Imports value growth (y/y percent change)	14.3	7.7	-7.4	25.7	9.1	6.8	6.9	6.9	6.8
Workers' remittances (in millions of U.S. dollars)	5,543	6,192	6,253	6,467	6,787	7,151	7,564	8,018	8,500
In percent of GDP	27.7	29.1	29.6	27.7	26.6	25.8	25.2	24.7	24.3
Gross official reserves (in millions of U.S. dollars)	6,172	7,162	8,574	8,690	8,494	8,381	8,443	8,451	8,452
In months of prospective GNFS imports	8.3	10.4	10.1	9.4	8.6	7.9	7.5	7.0	6.7
Memorandum items									
Public debt (in percent of GDP)	28.3	25.2	27.3	25.7	23.2	22.8	22.5	22.3	22.0
GDP at market prices (in billions of Nepalese rupees)	1,965	2,120	2,249	2,532	2,848	3,171	3,513	3,885	4,297
GDP at market prices (in billions of U.S. dollars)	20.0	21.3	21.2	23.3	25.5	27.7	30.0	32.4	35.0
Exchange rate (NRs/US$; period average)	98.3	99.5	106.3	...	...	...	...	...	...
Real effective exchange rate (average, y/y percent ch	-2.8	7.7	5.9	...	...	...	...	...	...
India's CPI (period average) 2/	9.4	5.9	4.9	5.1	4.7	5.2	5.2	5.0	4.9

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

1/ Fiscal year ends in mid-July.

2/ Fiscal year ends end-March.

Table 2. Nepal: Summary of Government Operations, 2013/14–2021/22 1/

	2013/14	2014/15	2015/16		2016/17			2017/18	2018/19	2019/20	2020/21	2021/22
			Budget 2/	Est.	Budget 2/	Revised Budget	Proj.	Projections				
					(In billions of Nepalese rupees)							
Total revenue and grants	400	442	586	525	673	654	612	687	763	846	934	1,033
Total revenue	357	406	475	482	566	579	565	635	706	782	864	957
Tax revenue	312	356	427	421	511	506	506	572	635	704	778	861
Non-tax revenue	44	50	48	61	55	74	60	63	70	78	87	96
Grants	44	36	111	43	107	75	47	51	57	63	70	76
Expenditure	370	428	693	495	929	824	639	720	793	863	951	1,048
Expenses	304	339	484	371	617	562	488	551	604	671	739	813
Net acquisition of nonfinancial assets	67	89	209	123	312	262	151	170	189	192	212	235
Operating balance	97	103	102	154	56	93	124	136	159	174	196	220
Net lending/borrowing	30	14	-107	30	-256	-170	-27	-34	-30	-18	-17	-15
Statistical discrepancy	-17	-26	-49	-24	0	44	0	0	0	0	0	0
Net financial transactions	-47	-40	59	-55	256	214	27	34	30	18	17	15
Net acquisition of financial assets	46	47	61	117	7	0	-33	-35	36	40	45	49
Foreign	0	0	0	0	0	0	0	0	0	0	0	0
Domestic (net)	46	47	61	117	7	0	-33	-35	36	40	45	49
Sale of equity	9	11	12	13	23	20	14	17	19	22	24	26
Lending minus repayment	13	26	49	11	44	39	13	15	17	19	21	23
Change in cash/deposit	23	10		94	-59	-59	-59	-68	0	0	0	0
Net incurrence of liabilities	-1	7	119	63	263	214	-5	-2	67	58	61	64
Foreign	4	12	73	25	170	121	21	21	39	37	53	54
Domestic	-5	-5	47	37	93	93	-26	-22	28	21	9	10
					(In percent of GDP, unless otherwise indicated)							
Total revenue and grants	20.4	20.9	26.1	23.3	26.6	25.8	24.2	24.1	24.1	24.1	24.0	24.0
Total revenue	18.2	19.1	21.1	21.4	22.3	22.9	22.3	22.3	22.3	22.3	22.2	22.3
Tax revenue	15.9	16.8	19.0	18.7	20.2	20.0	20.0	20.1	20.0	20.0	20.0	20.0
Non-tax revenue	2.2	2.4	2.1	2.7	2.2	2.9	2.4	2.2	2.2	2.2	2.2	2.2
Grants	2.2	1.7	4.9	1.9	4.2	3.0	1.8	1.8	1.8	1.8	1.8	1.8
Expenditure	18.8	20.2	30.8	22.0	36.7	32.5	25.3	25.3	25.0	24.6	24.5	24.4
Expenses	15.5	16.0	21.5	16.5	24.4	22.2	19.3	19.3	19.0	19.1	19.0	18.9
Net acquisition of nonfinancial assets	3.4	4.2	9.3	5.5	12.3	10.3	6.0	6.0	6.0	5.5	5.5	5.5
Operating balance	4.9	4.8	4.5	6.8	2.2	3.7	4.9	4.8	5.0	5.0	5.0	5.1
Net lending/borrowing	1.5	0.7	-4.8	1.4	-10.1	-6.7	-1.1	-1.2	-1.0	-0.5	-0.4	-0.4
Statistical discrepancy	-0.9	-1.2	-2.2	-1.1	0.0	1.8	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	-2.4	-1.9	2.6	-2.4	10.1	8.5	1.1	1.2	1.0	0.5	0.4	0.4
Net acquisition of financial assets	2.4	2.2	2.7	5.2	0.3	0.0	-1.3	-1.2	1.2	1.2	1.2	1.2
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic (net)	2.4	2.2	2.7	5.2	0.3	0.0	-1.3	-1.2	1.2	1.2	1.2	1.2
Sale of equity	0.5	0.5	0.5	0.6	0.9	0.8	0.6	0.6	0.6	0.6	0.6	0.6
Lending minus repayment	0.7	1.2	2.2	0.5	1.7	1.6	0.5	0.5	0.5	0.5	0.5	0.5
Change in cash/deposit	1.2	0.5	0.0	4.2	-2.3	-2.3	-2.3	-2.4	0.0	0.0	0.0	0.0
Net incurrence of liabilities	0.0	0.3	5.3	2.8	10.4	8.5	-0.2	-0.1	2.1	1.6	1.6	1.5
Foreign	0.2	0.6	3.2	1.1	6.7	4.8	0.8	0.7	1.2	1.1	1.4	1.3
Domestic	-0.3	-0.2	2.1	1.7	3.7	3.7	-1.0	-0.8	0.9	0.6	0.2	0.2
Memorandum items												
Primary balance	2.1	1.1	-3.8	1.7	-9.2	...	-0.5	-0.7	-0.5	-0.1	0.0	0.1
Public debt	28.3	25.2	...	27.3	...	...	25.7	23.2	22.8	22.5	22.3	22.0
External	18.0	15.9	...	16.9	...	...	17.5	16.7	16.0	15.8	16.0	16.0
Domestic	10.3	9.3	...	10.4	...	...	8.2	6.5	6.8	6.7	6.3	5.9
GDP (in billion of Nepalese rupees)	1,965	2,120	2,249	2,249	2,532	2,532	2,532	2,848	3,171	3,513	3,885	4,297

Sources: Nepalese authorities; and IMF 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

Table 3. Nepal: Monetary Indicators, 2013/14–2021/22 1/

	2013/14	2014/15	2015/16	Jan-17	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
					Projections					
	(In billions of Nepalese rupees, end-period)									
Nepal Rastra Bank										
Reserve money	437	523	547	555	633	719	809	896	991	1,096
Net domestic assets	-150	-198	-366	-399	-321	-238	-162	-104	-34	47
Claims on public sector	-1	-13	-109	-198	-42	20	20	20	20	20
Claims on private sector	4	5	4	4	5	5	6	7	7	8
Claims on banks & financial institutions	2	3	7	10	6	6	6	6	6	6
Other items (net)	-154	-193	-269	-216	-290	-270	-194	-137	-67	13
Net foreign assets	586	721	913	954	954	957	971	1,001	1,025	1,049
Monetary Survey										
Broad money	1,566	1,878	2,245	2,426	2,602	2,957	3,327	3,687	4,077	4,509
Narrow money	355	425	503	529	791	897	1,009	1,119	1,239	1,370
Quasi-money	1,211	1,453	1,741	1,896	1,811	2,060	2,318	2,567	2,838	3,138
Net domestic assets	967	1,131	1,289	1,419	1,596	1,947	2,303	2,631	2,996	3,402
Domestic credit	1,313	1,527	1,793	1,915	2,156	2,539	2,902	3,221	3,566	3,988
Credit to public sector	162	153	101	10	142	188	215	235	245	257
of which : Credit to central government	140	127	75	-21	109	155	177	194	201	209
Credit to private sector	1,151	1,374	1,692	1,905	2,014	2,351	2,687	2,986	3,321	3,731
Other items(net)	-346	-397	-505	-496	-560	-591	-599	-590	-571	-586
Net foreign assets	599	747	956	1,006	1,006	1,010	1,024	1,056	1,081	1,107
	(Twelve-month percent change)									
Reserve money	23.3	19.8	4.6	5.4	15.7	13.6	12.5	10.8	10.6	10.6
Broad money	19.1	19.9	19.5	18.5	15.9	13.6	12.5	10.8	10.6	10.6
Net domestic assets	14.1	17.0	14.0	24.0	23.9	22.0	18.3	14.2	13.9	13.6
Domestic credit	13.9	16.4	17.4	24.0	20.2	17.8	14.3	11.0	10.7	11.8
Credit to public sector	-9.9	-5.2	-34.1	-88.7	40.1	32.9	14.1	9.5	4.3	4.8
Credit to private sector	18.3	19.4	23.2	30.9	19.0	16.7	14.3	11.1	11.2	12.3
Net foreign assets	28.0	24.7	28.0	11.5	5.2	0.4	1.4	3.1	2.4	2.4
Memorandum items										
Velocity	1.3	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Multiplier	3.6	3.6	4.1	4.4	4.1	4.1	4.1	4.1	4.1	4.1
Private credit (in percent of GDP)	58.6	64.8	75.3	82.1	79.6	82.5	84.7	85.0	85.5	86.8
GDP at market prices (in billions of NR)	1,965	2,120	2,249	2,320	2,532	2,848	3,171	3,513	3,885	4,297

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

Table 4. Nepal: Balance of Payments, 2013/14–2021/22 1/

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
				Projections					
				(in million US dollars)					
Current account	908	1,067	1,339	-73	-338	-450	-543	-648	-745
Current account (excluding official transfers)	547	774	947	-338	-628	-765	-894	-1,028	-1,160
Trade balance	-6,082	-6,670	-6,389	-8,079	-8,856	-9,486	-10,162	-10,892	-11,658
Exports, f.o.b.	1,030	988	704	836	869	903	940	980	1,020
Imports, f.o.b.	-7,112	-7,658	-7,092	-8,915	-9,725	-10,389	-11,103	-11,872	-12,678
Services (net)	214	275	92	228	297	328	360	393	428
Receipts	1,277	1,499	1,302	1,466	1,650	1,791	1,939	2,095	2,262
Of which : tourism	473	537	393	503	563	611	660	714	769
Payments	-1,063	-1,224	-1,210	-1,238	-1,353	-1,463	-1,579	-1,702	-1,835
Income	334	342	320	356	389	422	458	495	534
Credit	403	428	405	446	488	530	574	620	670
Debit	-69	-86	-85	-90	-99	-107	-116	-125	-136
Current transfers	6,442	7,120	7,316	7,423	7,831	8,285	8,802	9,356	9,950
Credit, of which:	6,477	7,146	7,351	7,525	7,943	8,406	8,933	9,498	10,103
General government	362	293	392	279	305	331	368	398	434
Workers' remittances	5,543	6,192	6,253	6,467	6,787	7,151	7,564	8,018	8,500
Debit	-34	-26	-36	-102	-112	-121	-131	-142	-153
Capital account	173	148	159	143	156	170	189	204	223
Financial account	-19	-102	-91	55	-8	172	420	462	534
Direct investment	33	44	55	73	80	86	94	117	144
Portfolio investment	0	0	0	0	0	0	0	0	0
Other investment (net)	-51	-145	-146	-18	-88	85	326	345	390
MT debt (net)	45	118	505	357	188	449	447	440	457
Other (net)	-96	-264	-651	-376	-275	-364	-121	-96	-68
Errors and omissions	121	185	175	0	0	0	0	0	0
Overall balance	1,184	1,298	1,583	125	-190	-108	66	18	12
Financing	-1,184	-1,298	-1,583	-125	190	108	-66	-18	-12
Change in reserve assets (- =increase)	-1,200	-1,293	-1,624	-116	196	113	-62	-8	-2
Use of IMF resources (net)	-6	-5	41	-8	-6	-4	-4	-10	-10
IMF Disbursements	0	0	50	0	0	0	0	0	0
IMF Repayment	6	5	9	8	6	4	4	10	10
Memorandum items									
Current account (in percent of GDP)	4.5	5.0	6.3	-0.3	-1.3	-1.6	-1.8	-2.0	-2.1
Current account, excl. grants (in percent of GDP)	2.7	3.6	4.5	-1.4	-2.5	-2.8	-3.0	-3.2	-3.3
Trade balance (in percent of GDP)	-30.4	-31.3	-30.2	-34.7	-34.7	-34.3	-33.9	-33.6	-33.3
Exports (in percent of GDP)	5.2	4.6	3.3	3.6	3.4	3.3	3.1	3.0	2.9
Imports (in percent of GDP)	35.6	35.9	33.5	38.2	38.1	37.5	37.0	36.6	36.2
Exports (y/y percent change)	5.4	-4.0	-28.8	18.8	3.9	4.0	4.1	4.2	4.2
Imports (y/y percent change)	14.3	7.7	-7.4	25.7	9.1	6.8	6.9	6.9	6.8
of which Oil imports (y/y percent change)	11.4	-17.0	-42.8	62.6	13.7	4.2	12.5	4.5	4.1
Remittances (in percent of GDP)	27.7	29.1	29.6	27.7	26.6	25.8	25.2	24.7	24.3
Remittances (y/y percent change)	12.4	11.7	1.0	3.4	4.9	5.4	5.8	6.0	6.0
FDI (in percent of GDP)	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.4	0.4
Total external debt (in percent of GDP)	18.0	15.9	16.9	17.5	16.7	16.0	15.8	16.0	16.0
Gross official reserves (in millions of U.S. dollars)	6,172	7,162	8,574	8,690	8,494	8,381	8,443	8,451	8,452
In months of prospective GNFS imports	8.3	10.4	10.1	9.4	8.6	7.9	7.5	7.0	6.7
As a share of broad money (in percent)	37.9	38.7	41.0	36.8	…	…	…	…	…
Nominal GDP (in millions of U.S. dollars)	19,995	21,314	21,154	23,316	25,501	27,678	29,986	32,403	35,013

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

1/ Fiscal year ends in mid-July.

Table 5. Nepal: Commercial Banks' Financial Soundness Indicators, 2013–2016 1/

	2013	2014	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
	(in percent)								
Capital adequacy									
Capital fund to risk weighted assets	13.4	12.6	11.7	11.9	11.9	12.2	12.5	12.6	11.9
Tier 1 capital to risk weighted assets	11.8	11.0	10.1	10.2	10.2	10.4	10.9	11.1	10.4
Asset quality									
NPLs to total loans	1.9	2.5	2.7	2.3	2.3	2.1	1.8	1.4	1.3
Loan loss provision to total loans	2.4	2.9	2.9	2.7	2.7	2.7	1.2	2.2	2.1
Earnings and profitability									
Return on equity (ROE)	28.2	26.9	23.7	29.2	21.6	28.0	20.8	21.7	...
Return on assets (ROA)	1.7	1.5	1.3	1.7	1.6	1.5	1.7	1.8	...
Interest income to gross income	83.4	82.6	81.5	79.5	79.8	78.9	79.4	78.2	...
Non-interest expenditures to gross income	18.3	18.9	20.4	19.8	20.2	21.1	20.0	20.6	...
Employees expenses to non-interest expenditures	43.1	44.6	47.0	45.9	45.1	45.0	47.5	47.3	...
Liquidity									
Liquid assets to total assets	25.3	24.4	22.2	21.4	20.6	24.7	22.8	21.7	...
Liquid assets to total deposits	30.4	29.2	26.7	25.8	24.8	29.4	27.6	26.3	...
Exposure to real estate									
Share of real estate and housing loans	16.1	15.1	14.6	14.5	14.5	14.9	14.6	14.9	...
Share of loans collateralized by land and buildings	50.9	51.7	51.8	52.0	53.1	52.5	55.5	54.6	...

Source: Nepalese authorities.

1/ Data presented on a calendar year basis. "A" class banks excluding state owned banks.

Annex I. Risk Assessment Matrix[1]

Source	Likelihood	Time Horizon	Impact	Policy Response to Minimize Impact
DOMESTC RISKS				
Slow progress in post-earthquake reconstruction Under-execution of the ambitious 2016/17 budget and further delays in reconstruction work could depress confidence and hold back private investment and growth.	High	Short to Medium Term	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 Political instability under the power-sharing arrangement of the coalition government could undermine confidence and delay economic reforms.	High	Short to Medium Term	Medium/High	Preserve fiscal and external policy space. Ensure policy continuity.
Financial sector vulnerabilities Vulnerabilites arising from the earthquakes and trade disruption, and uncertainties associated with deposit growth could affect liquidity and exacerbate existing weaknesses in the loan portfolio of banks and financial institutions.	Medium	Medium Term	Medium/High	Regulatory forbearance to help deal with the aftermath of the earthquake and trade disruption should be completely phased out. Exercise corrective and sanctioning powers more forcefully. Move to pro-active and risk-based supervision. Increase resources and raise capacity for supervision.
Natural disaster Nepal with weak crisis prepareness and capacity is highly vulnerable to natural disasters similar to the recent earthquake, which could take a significant toll, including by damaging infrastructure, housing and the production base.	Low	Short to Medium Term	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				
Lower energy prices Production cuts by OPEC and other major producers may not materialize as agreed, keeping prices lower than the WEO baseline. A prolonged slowdown in countries hosting Nepali migrant workers (Persian Gulf countries, Malaysia) could further weaken remittance inflows. This would further reduce demand and growth; lower growth in private deposits would tighten liquidity and expose weaknesses in the financial system; and reduce government revenues due	Low	Short to Medium	Medium/High	Strengthen the financial sector and preserve fiscal and external policy space to cope with adverse shocks. In the longer term, boost public investment, and pursue structural reforms to improve the investment climate to attract higher private investment to reduce dependency on remittances.
Weaker-than expected global growth Retreat from cross-border intergration and policy uncertainty and divergence would weigh on global growth and exacerbate global financial market volatility.	High	Short to Medium	Low	Maintain sound policy frameworks and enhance financial stability.
Slower-than-projected growth in India Slower growth in India could reduce remittances and, to some extent, FDI and exports.	Medium	Short to Medium	High	Accelerate structural reforms to improve the investment climate and boost public investment.
Reduced financial services by global/regional banks ("derisking") Loss of corresponding banking services could affect the cost and inward transfer of remittances. However, as money tranfer operators are preferred option to banks in receving remittance in Nepal, together with the prevalence of informal remittance channel such as the *hawala* system, derisking has limited impact on remittance transfers to Nepal.	High	Short to Medium Term	Low	Enhance coordinated efforts by the public and private secors to mitigate risk and promote formal remittance tranfers. Continue strengthening regulatory and supervisory frameworks to meet relevant international standards, including on AML/CFT measures, and regulate informal remittance channels that are susceptible to illegal activities.

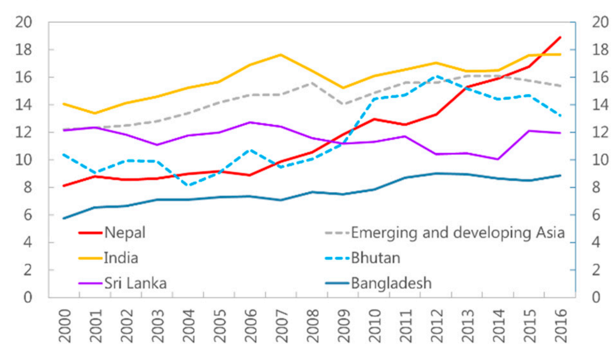
[1]The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability 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. "Short Term" and "Medium Term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex II. Domestic Revenue Mobilization[1]

Nepal has achieved strong growth in domestic revenue in recent years. This was facilitated by rapid growth of the tax base—with rising remittances propelling consumption and imports—alongside sustained efforts to strengthen tax administration, including at customs. There is considerable scope to raise revenue further.[2] This would be important to finance the current and capital spending needed to achieve the Sustainable Development Goals (SDGs) and address infrastructure bottlenecks to boost medium-term growth and raise living standards throughout Nepal. The authorities' ongoing efforts to modernize the tax system and strengthen core tax and customs administration have the potential to substantially raise collections. The recent establishment of the IMF's South Asia Regional Training and Technical Assistance Center (SARTTAC) in India, provides additional opportunities for relevant training and technical assistance (TA), to augment IMF assistance that has been provided in the past.

Following a review of the tax system, the government is currently drafting a new single tax code to implement tax policy improvements and to consolidate and harmonize the main domestic taxes under one piece of legislation. A High-Level Tax System Review Commission (HLTSRC) formed in 2014 conducted extensive consultation with a wide range of stakeholders. The Commission's recommendations, delivered in July 2015, envisage broadening the base for the value-added tax (VAT) base, simplification of the major taxes, and introduction of tax expenditures as supplementary information in the annual budget. The recommendations are mostly in line with those made by FAD tax policy missions in 2013 and 2015. A February 2017 mission advised the authorities on the preparation of the new single tax code. The new legislation, which the authorities aim to implement from 2018, would help reduce compliance costs and create a business-friendly environment.

General Government Tax Revenue
(In percent of GDP)



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

The Inland Revenue Department (IRD) has strengthened tax administration as it implemented the Strategic Plan (2012/13-2016/17) and the supporting Reform Plan (2012/13-2014/15). Administrative improvements included: (i) establishment of a segment-based organization in Kathmandu with Medium Taxpayer Offices focused on improving compliance of medium taxpayers and Taxpayer Service Offices bringing services and support closer to small taxpayers; (ii) reducing taxpayers' compliance costs through better use of information technology and expansion of e-services for registration and filing; (iii) enhancing taxpayer education offerings; (iv) expansion of payment options for taxpayers; and (v) establishment of an Internal Monitoring System to set annual targets for core functions.

[1] Prepared with input from Ms. Adams, and Messrs. Nagy and Nakayama.

[2] It should be noted that Nepal's current relatively high revenue to GDP ratio compared to regional peers may reflect underestimation of Nepal's GDP due to the outdated national accounts base year (2000/01).

There is room to bring core tax compliance performance indicators more in line with modern tax administration standards building on the IRD's earlier gains.[3,4] Gains can be made with regard to making the register of taxpayers more accurate, increasing on-time filing, managing VAT refunds, using enforcement powers to prevent tax arrears and nonpayment, and strengthening the audit program, including by employing a range of audit types to bring more taxpayers under the audit program.

The Department of Customs (DOC) has a long history of formalized planning, which has enabled it to make significant strides in modernizing customs administration. FAD has provided detailed guidance to assist the DOC to develop its strategic, reform and operational planning processes. Under the first four Customs Reform and Modernization Action Plans (CRMAP), commencing in 2003, and with extensive TA from a wide range of donors,[5] the DOC has taken important steps in reforming its operations. These include the implementation of ASYCUDA++, and ongoing migration to ASYCUDA World; ongoing implementation of the Nepal National Single Window and Trade Portal and updated organization structure.

The DOC is continuing to work in areas which it needs to focus its reform efforts with donor assistance. These areas, drawn from the CRMAP 2013–2017, include simplifying and harmonizing customs procedures, strengthening customs valuation processes, strengthening Post Clearance Audit (PCA), controlling revenue leakage, and balancing trade facilitation and regulatory intervention.

FAD TA supported the completion of a VAT gap study in 2015 that highlighted VAT policy and compliance gaps. The findings of the study could be used to inform the development of the Ministry of Finance or IRD's VAT policy and administration future work programs.

The authorities' plans to establish a Revenue Board could provide for more continuity in staffing and reform policies. As it stands, the Nepal civil service policies on staff rotation inhibit the sustained buildup of expertise through experience and training. They may also result in institutional focus on short term results, rather than longer term reform planning.

[3] FAD has provided advice on strengthening the IRD's headquarters operations to better design, deliver and monitor national compliance strategies and programs.

[4] The Tax Administration Diagnostic Assessment Tool (TADAT) is a structured means by which tax administrations are assessing their performance outcomes. See www.TADAT.org for information on the tool.

[5] Agencies that have been working with DOC include ADB, JICA, KOICA, UNCTAD, UNESCAP, UNODC, USAID, and the World Bank.

Annex III. Sustainable Development Goals (SDGs)—Progress and Challenges

- **Nepal has made a strong start on the adoption of the SDGs.** Nepal was one of the first countries to publish a preliminary national report on *Sustainable Development Growth 2016-2030* in 2015. The early adoption of the SDGs follows on good progress made on most Millennium Development Goals (MDGs) by 2015 (Table), despite a decade-long armed conflict that ended only in 2006.

- **The next steps are to localize SDGs by setting national priorities.** This includes establishing institutional arrangements, enhancing capacity at the regional and local levels, arranging financial resources to achieve the SDGs, and developing indicators to measure and monitor progress. The government acknowledges the need for goal-specific and cross-cutting interventions in implementing and monitoring the SDGs. In particular, work has begun to mainstream and track the MDGs in the Nepali context to ensure that national goals are synchronized with international goals for sustainable development. The SDGs have also been incorporated into the 14th National 3-year Plan (2016/17-2018/19) that was recently endorsed by the government. To adequately track SDG indicators, there is a need to conduct additional surveys to fill data gaps, improve data collection, strengthen the Central Bureau of Statistics, and implement the National Strategy for the Development of Statistics.

- **The SDGs need to be costed and financial resources need to be mobilized**. It would be important to know how much it will cost Nepal to meet the SDGs. The government has noted that more grants and concessional loans need to be mobilized from development partners. However, this should be complemented by domestic revenue mobilization for which there is ample scope. In the context of the IMF's commitment to support the SDGs, Nepal is a "domestic revenue mobilization pilot". Accordingly, Annex II of this report highlights policy options to efficiently raise more revenue.

- **Development partners' support is crucial**. The government needs to work closely with development partners, the private sector and community organizations. The authorities have noted that development partners will play an important role in developing SDG-based periodic plans, as well as supporting and monitoring implementation.

- **Achieving the ambitious SDGs will pose key challenges**. Frequent government changes and rotation of officials have impeded policy planning, implementation, and reforms. Policy implementation capacity need to be strengthened to achieve 'economic diversification and transformation' (SDG 1,2,8, and 9) and 'economic, gender, and financial inclusion' (SDG 3,4,5, and 10). The latter will also require social change and important structural reforms. Nepal made impressive progress in achieving the MDG on halving absolute poverty. However, the government has recognized that ending absolute poverty by 2030 (SDG1) will be very challenging as this requires reducing the share of the population living below the poverty line from 23.8 percent (estimate for 2011) to 5 percent. Achieving resilient infrastructure (SDG 9) will require an important upgrade to capital budget implementation capacity.

Table 1. 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)	96.2 (14)	100	Likely
	Reaching last grade	38(90)	98.9 (14)	100	Likely
	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)	103 14)	100	Achieved
	Ratio of girls to boys in secondary education (percent)	43(90)	103 (14)	100	Achieved
	Ratio of females to males in tertiary institutes (percent)	32(90)	105 (14)	100	Achieved
Goal 4: Reduce child mortality					
Target: Reduce by two-thirds between 1990 and 2015, the under-five mortality rate	Under-five mortality rate (per 1,000 births)	162(90)	38 (14)	54	Achieved
	Infant mortality rate (per 1,000 live births)	108(90)	33 (14)	36	Achieved
	Immunization, measles (percent of children under 12 months)	108(90)	92.6 (14)	>90	Achieved
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)	258 (14)	213	Likely
	Births attended by skilled health personnel (percent)	7(90)	55.6 (14)	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)	0.03 (14)	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)	0.11 (14)	0.06	Likely
	Prevalence rate of tuberculosis cases per 100,000 people	460(90)	211 (14)	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

Sources: UNDP, Nepal Millennium Development Goals--Progress Report (September 2013); NPC Sustainable Development Goals 2016-30--National (Preliminary) Report.

Annex IV. Strengthening the Monetary Policy Framework and its Implementation

1. A broad consensus has emerged on key features of effective policy frameworks in countries with scope for independent monetary policy, such as Nepal with its pegged exchange rate and *de jure* closed capital account. An October 2015 IMF staff study on *Evolving Monetary Policy Frameworks in Low-Income and Other Developing Countries* draws on cross-country experiences to derive "principles" that encapsulate the key characteristics of sound forward-looking monetary policy frameworks (Annex Table 1).

Annex Table 1. Principles and Key Stakeholders	
Principles for Monetary Policy	**Stakeholders**
I. The CB has a clear mandate in terms of its goals, and operational independence to pursue its goals	Requires consensus in society. Government/Ministry of Finance
II. Price stability is the primary overriding objective of monetary policy	Government. Requires consensus in society.
III. CB has a medium-term inflation objective	Central bank and government
IV. Policy actions take into account implications for macroeconomic activity and financial stability	Central bank, statistics office
V. The CB has a clear and effective operational framework	Central bank, financial regulator
VI. The CB has a transparent forward-looking strategy	Central bank, statistics office
VII. CB communication is transparent and timely	Central bank

2. Nepal's relatively low conformity with the principles appears to be driven by the multiple objectives assigned to the NRB and monetary policy, leading to the deployment of instruments and operational objectives not always geared at achieving the price stability mandate, and to the following:

- *Greater susceptibility of monetary policy to short-term considerations and pressures*, e.g., boosting the money supply and/or driving interest down (including below a level aligned with fundamentals), which can in turn result in inflationary pressures that can place a strain on the peg regime (Principles I and II).

- *Greater difficulties in anchoring the private sector's inflation expectations*, which can make it difficult for the NRB to use a medium-term numerical inflation objective for its internal deliberations, and even more to use it in its communication (Principle III).

- A *complex operational framework,* characterized by a multiplicity of instruments aimed at supporting structural policies, which can make it more difficult for the NRB to align market conditions with its announced policy stance (Principle V).

- *Difficulties for adopting a transparent forward-looking strategy,* as short-term considerations may take priority (Principle VI).

- *Communication becomes even more challenging,* as the multiplicity of objectives and instruments makes it difficult for the NRB to communicate consistently and in a clear and transparent fashion (Principle VII).

3. Addressing the gaps with the Principles requires building a broad-based consensus with stakeholders so that they all share a common view on the NRB's mandate and its monetary policy. While the NRB should play a catalytic role, the process should build on long-term commitment from all relevant authorities. That will facilitate understanding and acceptance of the Principles, and their impact on the country's economic structures.

4. There is ample scope for enhancing conformity with the Principles immediately, in particular in areas under the direct control of the NRB. They include: short-term liquidity forecasting and management (and related actions to support market development, including financial market infrastructures); effective internal organizational structures; analytical capacity to support the monetary policy decision making process (including inflation forecasts, analysis of the transmission channels); and communication strategy. The current benign fiscal and balance of payments position provides a favorable window of opportunity to commit to the modernization of the monetary policy framework, building on the recent adoption of an interest rate corridor.

Annex V. Progress in Implementing High-Priority FSAP Recommendations

Recommendations	Responsible Authority	Time Line*	Progress to date
Financial Stability			
Refocus monetary policy operations on domestic liquidity management to reduce excess reserves, and especially their volatility, with appropriate burden sharing of costs between the financial system and the budget. Introduce Treasury sterilization bonds.	NRB	ST	**In process** An interest rate corridor was introduced in mid-2016. There is scope to strengthen the new framework further in line with IMF TA recommendations. NRB bonds were issued.
Undertake a thorough Asset Quality Review (AQR) to identify the extent of problem loans in banks' balance sheets (with TA support).	NRB	ST	**In process** NRB supervisors are following-up on the special inspections that were done to review asset quality. Prompt corrective action was taken in some cases.
Conduct an in-depth review and financial analysis of loan portfolios during bank examinations.	NRB	ST/MT	**In process** 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 that the review will increasingly focus on asset quality and borrowers' financials.
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** • NRB established a payment and settlement system department in July 2015, which will also oversee some of the new products such as mobile banking and branchless banking. The NRB has requested Fund TA to strengthen its payment systems oversight function. • Setting up of Real-time gross settlement (RTGS) is being initiated. • Nepal Financial Reporting Standard (NFRS) was drafted. Class A banks are required to adopt NFRS-compliant financial statements by [2016/17]. Other financial institutions are required to adopt NFRS by [2017/18]. • 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			
Redefine supervisory approach by: integrating risk-based off-site and on-site supervision; • increasing analytical capacity through training; • introducing supervisory management information systems (MIS); • developing a dedicated human resources (HR) rotation policy; and • streamlining the NRB board participation in operational decisions.	NRB	ST/MT	**In process / not done** Supported by FIRST-funded TA (FIRST) risk-based supervision (RBS) is being implemented for Class A institutions; and is in the 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.
Ensure effective compliance with supervisory directives and guidelines by: • performing a thorough follow up of the implementation of supervisory recommendations; • proactive, earlier, and stronger corrective actions.	NRB	MT	**In process/not done** Corrective and supervisory actions remain largely informal; with PCA having a formal framework. Some existing provisions are being revised. The FIRST project supports the development of programs to ensure compliance.
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** The NRB has indicated its intent to review the licensing framework in due course. The consolidation of the sector may in the long run have an impact on the various classes of FI.
Granting the NRB explicit consolidated supervision powers, amending the legal framework to incorporate a comprehensive definition of related parties and controlling interests.	NRB	MT	**In process/Not done** The amendments of the NRB Act and the BAFIA Act have been endorsed by the Parliament. However, the NRB's consolidated supervision powers were not specified in the NRB Act. Staff has not yet been able to review the BAFIA Act.
B. Non-banking Sector			
Divide the CIT into two separate legal entities, segregating the capital market business, to be placed under the supervision of the Securities Board of Nepal (SEBON), from the pension fund business.	MOF/SEBON	ST	**In preparation** MOF is preparing a concept report.
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** Regulatory and supervisory options are being explored.

Strengthen the operational independence of the IB and SEBON.	SEBON/IB/MOF	ST	**Not done** The government is first looking to strengthen the capacity of the IB and the SEBON.
			Crisis Management
Revise Prompt Corrective Action (PCA) policy to require stronger supervisory action, including designation of problematic status at an earlier stage of capital depletion.	NRB	ST	**Under consideration** NRB is considering including liquidity as a PCA trigger. No changes have been made on the designation of problematic status.
Develop and implement a banking financial institution (BFI) Supervision Enforcement policy that presumes certain enforcement action based on CAMELS ratings.	NRB	MT	**Not done** As the supervisory reforms are implemented, such an enforcement policy may emerge.
Revise NRB Act to clarify emergency liquidity assistance (ELA) provisions.	NRB/MOF	ST	**Not done** NRB Amendment Act passed by the Parliament does not clarify ELA provisions.
Revise NRB Act to grant it special resolution regime powers.	NRB/MOF	ST	**Mostly done** Special resolution regime powers have been granted but need further clarification, strengthening, and operationalization (Pending further assessment by Fund staff).
Establish a national financial crisis coordinating committee comprised of all financial sector, regulatory, and supervisory agencies. Develop each individual agency's crisis contingency plans and roll up individual agency plans into a national crisis contingency plan.	MOF/NRB/IB/SEBON	ST/MT	**Not done** 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.
Crisis simulations should be conducted periodically.	MOF/NRB/IB/SEBON	MT	**Not done** A simulation has not yet been conducted; the authorities are encouraged to conduct crisis simulations after passage of the relevant Acts.

INTERNATIONAL MONETARY FUND

NEPAL

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

March 13, 2017

Prepared By: Asia and Pacific Department

CONTENTS

FUND RELATIONS

(As of January 31, 2017)

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

General Resources Account:

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

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	68.10	100.00
Holdings	0.07	0.1

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
RCF Loans	55.61	35.45
ECF arrangements	3.21	2.04

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		
	2017	2018	2019	2020	2021
Principal	8.91	5.70	5.70	2.85	7.13
Charges/interest	0.21	0.22	0.22	0.22	0.22
Total	9.12	5.92	5.92	3.07	7.35

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 February 14, 2017, the exchange rate of the Nepalese rupee (Nr) was US$1=Nrs. 107.13. 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

An update safeguards assessment of the Nepal Rastra Bank (NRB) was completed in February 2016 with respect to the Rapid Credit Facility approved on July 31, 2015. The assessment found that the NRB had made limited progress in improving its safeguards framework and addressing recommendations from the previous assessment (2011). In particular, the quality of the external audit continued to fall short of international standards and priority should be given to engaging an auditor with requisite experience. The legal framework should also be enhanced to strengthen the central bank's autonomy and governance arrangements. The assessment concluded that strong commitment from the NRB Board and management is essential to improve the internal audit function and reinforce controls in key areas, including foreign reserves management and currency operations.

2015 Article IV Consultation

The Executive Board discussed the staff report for the 2015 Article IV consultation (IMF Country Report No. 15/ 317) on November 16, 2015. Consultations with Nepal are held on the standard 12-month Article IV consultation cycle.

Technical Assistance (since 2012)

	Purpose	**Year**
FAD	Tax and Customs Administration Reforms/Modernization	2006–12
	Revenue Administration	2011–13
	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
	Capacity development on budget management	2016
	Strengthening customs administration (visit)	2016
	Capacity development to manage fiscal risks via improved budget management	2017
	Tax policy reform and the Single Tax Code	2017
LEG	AML/CFT National Strategy	2014
	Bank Resolution	2012
	AML/CFT Legal Drafting Mission	2012, 2013, 2014, 2015
	AML/CFT Structures and Tools	2012, 2013, 2014, 2015
	Strengthening the AML/CFT Legal, Supervisory and FIU Framework	2016
MCM	Monetary Policy/Operations	Continuous
	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
	Upgrade of Procedures for Licensing and Mergers Authorization	2016
	Upgrading Off-Site Supervision to Risk-Based Supervision	2016
	Strengthening monetary policy framework and its implementation	2016
STA	Balance of Payments Statistics	2012, 2014, 2016
	Monetary Statistics	2014
	National Accounts	2012, 2014
	Government Financial Statistics	2014, 2017

Resident Representative

Mr. Andreas Bauer has been the Senior Resident Representative since June 15, 2016. He is based in New Delhi.

RELATIONS WITH THE WORLD BANK GROUP

(As of February 2017)

A. Partnership in Nepal's Development Strategy

Nepal has achieved remarkable development progress since 2006. Poverty has declined with poverty headcount ratio at US$1.90 per day (2011 PPP) decreasing from 46.1 percent in 2003 to 15 percent in 2010.[1] Several social indicators in education, health and gender have improved. Economic growth averaged at 4.5 percent (2006-2015), one percentage point higher than level achieved during the conflict period. Yet, Nepal is constrained in taking advantage of its economic potential and the country is vulnerable on the political and economic fronts and to exogenous shocks, in particular natural disasters such as the devastating earthquakes in 2015 and the trade disruptions from late 2015 to early 2016.

The country is recovering from the earthquakes and the trade disruptions, which had a huge impact on Nepal's economy and its people. A large portion of the 45 percent of total population that are considered vulnerable[2] may have fallen back into poverty in the aftermaths of the two exogenous shocks. The next round of National Living Standard Survey expected in 2017/2018 will provide data to substantiate the poverty trends.

Under the Fourteenth Periodic Plan (2017-2019), Nepal aims to achieve higher equitable and sustainable growth. To move to a higher growth trajectory, Nepal will need to boost its efforts to remove bottlenecks to long term growth and development. The World Bank Group supports these efforts through its Country Partnership Strategy (FY14-18). The Country Partnership Strategy discussed by the World Bank Group Board of Executive Directors in 2014 constitutes a major shift in support away from short-term post-conflict assistance to establishing the foundations for increased and inclusive growth after three consecutive interim strategies in Fiscal Years (FY) 2007, 2009 and 2011. The World Bank Group continues to be responsive to the evolving country situation and emerging development challenges. Nepal is expected to receive an increase in allocation of IDA resources under IDA18 (FY18-20), including from its Exceptional Risk Mitigation Regime aimed at strengthening the country's resilience.

B. IMF-World Bank Collaboration in Specific Areas

Areas of World Bank leadership

The World Bank has been leading the policy dialogue and engagement in infrastructure, social sectors, agriculture and rural development, which are constraining factors to sustained and inclusive growth in Nepal. In addition, the World Bank has been leading the coordination efforts for disaster management, and has been supporting efforts towards sustainable environment management.

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[1] According to Nepal's national poverty line, 25.2 percent of the population live in poverty. The national poverty line established in 2010/2011 represents the expenditure required to meet the minimum food and non-food needs, and has historically been measured using the Nepal Living Standards Survey. It is the primary benchmark for poverty monitoring as well as identifying and targeting the poor tin Nepal.

[2] Households with more than 10 percent probability of falling back into poverty are considered "vulnerable" households in *Moving up the Ladder,* World Bank 2016.

The World Bank Group has been expanding its support in the energy sector, particularly in hydropower development. Progress in this sector has been uneven due to governance and government capacity issues. The World Bank (International Development Association), International Financial Corporation (IFC), and Multilateral Investment Guarantee Agency (MIGA) are jointly carrying out a Joint Implementation Plan in hydropower development with the goal of supporting transformational hydropower projects. The World Bank and IFC teams have jointly been supporting the development of the Kabeli-A hydropower project and Upper Trishuli 1 hydropower project for which MIGA is considering extending a guarantee. In addition, the World Bank is preparing the Energy Sector Development Policy Credit to support policy, legislation and institutional reforms in the power sector to promote sustainable development, improved investment climate for private participation and improved services, governance and financial performance.

In the transport sector, the World Bank is providing investment project financing for a number of operations to improve all season road access and connectivity. It is also supporting the government program to provide safe, reliable and cost effective bridges as part of Nepal's Strategic Roads Network. This initiative utilizes the program-for-results (PforR) financing instrument that links disbursements of funds directly to the achievement of verifiable results.

In the social sectors, the World Bank has been actively supporting the government across the education sector including school sector[3], higher education, and technical and vocational education and training. Key reforms include to strengthening the quality, efficiency, market relevance and equity; and improving the governance and management of the education system. Recent initiatives include the School Sector Development Program (FY17 approval) using the PforR financing instrument and supporting the government's School Sector Development plan. It builds on the School Sector Reform Program, which used a Sector Wide Approach (SWAp) involving the government and 13 development partners, of which 10 partners pool their resources with those of government[4]. The World Bank has also been supporting reforms to improve quality, relevance, and efficiency of higher education and of vocational training.

In the health sector, the World Bank has been working closely with the government and development partners to support the government's sector program since 2004 through a SWAp, similar to its engagement in the education sector. Building on this support, the World Bank has recently approved the Health Sector Management Program, a PforR operation that addresses the governance and efficient management of public resources.

To support an increase in agriculture productivity and rural development, the World Bank is financing operations to improve agricultural productivity and irrigation and water resource management. It is supporting efforts to promote social inclusion, including through the Poverty Alleviation Fund (PAF) that channels resources to the poorest groups in rural communities for small infrastructure development, employment and income-generating opportunities.

[3] Also includes early childhood education and non-formal education.

[4] Three development partners supported the program directly through parallel financing and two pooling partners provided both pooled and non-pooled support.

Following the devastating earthquakes in 2015, the World Bank responded with the $200 million housing reconstruction project; the Post-Disaster Needs Assessment identified housing reconstruction as the largest single need after the earthquakes.

World Bank Contributions to the IMF Work Program

The World Bank is collaborating and complementing the IMF work program in a few key areas. The World Bank and IMF have been working closely to provide support to strengthen the financial sector, such as implementing the joint Financial Sector Assessment Program. There has also been close collaboration in developing a series of Development Policy Credits (DPCs) financed by the World Bank that aims to address economic risks by reducing vulnerabilities of the banking sector. The World Bank has also been providing technical assistance in the areas of crisis management, bank resolution and deposit insurance.

The World Bank and IMF continue to provide policy advice and technical assistance in macroeconomic management. This includes support in debt management through technical assistance, joint Debt Sustainability Analysis and policy dialogue to ensure fiscal and debt sustainability.

In the area of public expenditure, the World Bank has carried out public expenditure analysis, and provided technical assistance, such as for Medium Term Expenditure Framework. Under the ownership and leadership of the government, the World Bank supported the Public Expenditure and Financial Accountability Assessment (second assessment) in 2015. This ushered in joint government and donor collaboration for public financial management reform action plan, which is expected to ensure effective use of resources for priority projects.

C. World Bank Group Strategy and Lending Operations

Under the World Bank Group (WBG) Nepal Country Partnership Strategy (FY14-18), the WBG is focusing on two pillars: (a) increasing economic growth and competitiveness by expanding hydroelectric power generation, enhancing transport connectivity, and improving the financial sector and the investment climate and (b) promoting inclusive growth and opportunities for shared prosperity through enhancing agriculture sector productivity and improving access to and quality of education, healthcare, skills development, and social protection. As a cross-cutting priority, the WBG engages in strengthening institutional governance and capacities, mainstreaming gender and citizen engagement, and helping Nepal to address vulnerabilities to climate change impacts and mitigate the effects of natural disasters. WBG support is guided by the principles of balancing risks and rewards, selectivity and flexibility.

Given the evolving country context, and the emerging development challenges, there are a number of areas where the WBG is considering scaling up its engagement in the near term including:

- supporting the government in its transition to a federal state,
- helping create jobs domestically given the potential further decline in overseas employment opportunities and youth bulge,
- providing assistance to strengthen resilience against natural disasters including earthquakes, and
- intensifying engagement on policy reforms to improve institutional governance.

Under IDA17 (FY15-17), Nepal is expected to receive approximately US$1.2 billion (US$901 million from core IDA and US$300 million from Crisis Response Window for emergency needs following the 2015 earthquakes). Financing has been on a credit-only basis as Nepal's risk of debt distress was assessed to be low. As of mid-February 2017, the portfolio consisted of 18 IDA projects with a combined net commitment of US$1.72 billion. In the aftermath of the earthquakes and trade disruptions, only one energy technical assistance project was approved, but four operations were granted closing date extensions in FY16. Under IDA18 (FY18-20), Nepal is expected to receive a substantial increase in IDA resources. The WBG is expected to finance projects in high priority areas such as the Upper Trishuli 1 hydropower project, the Fiscal DPC, the Financial Sector DPC4, the Energy Sector DPC, and the Fast Track Highway, an ambitious initiative to improve internal transport connectivity. The increase in resources will also finance efforts to address the emerging development challenges noted above.

The World Bank Group is starting to prepare the Systematic Country Diagnostic in the second-half of FY17 and is expected to prepare a new Country Partnership Framework in FY18.

Box 1. Activities of the International Finance Corporation (IFC) in Nepal

IFC has been working on private sector opportunities and constraints through investments and advisory services to address the key development gaps in Nepal. IFC is focusing on sustainable infrastructure, inclusion, and competitiveness/jobs. In infrastructure, IFC is currently supporting breakthrough hydro power projects that have the potential to turn Nepal into a power surplus country and attract significant FDI. To enhance inclusion, IFC is working on increasing access to financial services for individuals and MSMEs. In the competitiveness/jobs space, IFC is focusing on agribusiness, tourism, manufacturing and services.

IFC's cumulative committed portfolio stood at $52 million as of the end of FY2016 and its advisory services portfolio totaled to $13.3 million. Infrastructure accounted for 68 percent of the total investment portfolio while Telecom, Media, Technology, Venture Capital and Funds accounted for 13 percent. Financial Institutions Group (FIG) and Manufacturing, Agribusiness, and Services (MAS) each had a 9 percent share of the portfolio. Advisory services are in the areas of financial sector, hydro energy, agribusiness, SMEs, tourism, airport PPP, and investment climate.

In the energy sector, IFC has been helping unlock barriers for new infrastructure projects, particularly in hydropower. IFC is working closely with IDA on the joint Kabeli-A Hydroelectric Development Project. In addition, IFC is achieving significant progress on its work on the ground-breaking 216MW Upper Trishuli 1 hydropower project. In the financial sector, IFC is supporting banks and venture funds that finance SMEs and providing trade finance products. Through advisory engagements, IFC is helping enhance financial infrastructure, support financial product development, improve risk management in financial institutions, and strengthen payment regulations. In agribusiness, IFC, through a lead firm, is supporting farmers with climate smart agricultural practices, and in tourism, IFC is helping the government of Nepal in developing new tourism destinations. To support an environment for increased private sector engagement, IFC through the joint Global Practice on Trade and Competitiveness, has been working with the government on broad investment climate and sector specific regulatory reforms.

IFC will continue to work closely with the World Bank to help address institutional capacity constraints to accelerate progress in existing private sector projects and attract more private sector engagements

Table 1. Nepal Portfolio

(as of February 15, 2017)

Project ID	Project Name	Board Approval	Expected Closing	Total Net Comm. Amt. ($M)
P087140	NP:Agriculture Commercialization & Trade	Jun 2009	Jun2018	60.00
P095977	NP: Road Sector Development Project	Dec 2007	Jul 2019	165.62
P099296	NP: Irrig & Water Res Mgmt Proj	Dec 2007	Jun 2018	113.58
P104015	NP: Enhanced Vocational Educ & Trng	Apr 2011	Jun 2017	39.63
P105860	NP: PAF II	Dec 2007	Dec 2018	244.97
P115767	NP-IN Electricity Transmission & Trade Project	Jun 2011	Jun 2018	138.00
P118179	NP: Rani Jamara Kulariya Irrigation Project	Jul 2011	Sep 2017	43.00
P122406	Kabeli-A Hydro Electric Project	Jul 2014	Dec 2019	46.00
P125359	NP:Community Action for Nutrition Project	Jun-2012	Jun 2017	40.00
P125495	NP: Bridges Program Support	Jun 2012	Jul 2017	60.00
P127508	NP: PPCR: Climate Hazards	Jan 2013	Nov 2018	31.00
P128905	Nepal Agriculture and Food Security Proj	Feb2013	Mar 2018	46.50
P131592	SREP-Supported Extended Biogas Project	Aug 2014	Dec 2019	7.90
P132289	Kali Gandaki Rehab	May 2013	Jun 2017	19.71
P132750	SNRTP	Dec 2013	Jul 2019	100.00
P143036	NP Rural Water Supply & Sanitation Improvement Project	May 2014	Jun 2020	72.00
P146344	Nepal: Grid Solar & Energy Efficiency	Dec 2014	Dec 2020	130.00
P147010	Higher Education Reforms Project	Feb 2015	Jun 2020	65.00
P149606	Road Safety Activity under on RSDP roads	Apr 2015	Jul 2017	7.47
P150066	Power Sector Ref.& Sus. Hydropower Dev.	Sep 2015	Jun 2020	20.00
P154548	Strengthening Systems for SP and CR	Dec 2016	Nov 2021	150.00
P155969	Earthquake Housing Reconst Project	Jun 2015	Jul 2020	200.00
P160207	Nepal Health Sector Mgmt Reform PforR	Jan 2017	Jul 2021	150.00

RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Country Program

The Asian Development Bank (ADB) began lending to Nepal in 1969. As of 31 December 2016, Nepal has received 178 loans/grants—136 sovereign ADF loans ($4,028.2 million), 5 non-sovereign loans ($52.8 million), and 34 ADF grants ($823.8 million), 1 OCR loan ($2.0 million), and 2 ADF special grants ($3.3 million) totaling $4,910.0 million. Nepal Country Partnership Strategy (CPS) 2013–2017, approved in October 2013, allocates most of the CPS resource envelope 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 34 ADF projects and programs (25 loans amounting to $1,654.7million and 21 grants amounting to $328.3million) with an overall net amount of $1,983.0million.

The assistance approved in 2016 comprised two projects with a total of $306.8 million in ADF loans. The projects include the Supporting School Sector Development Plan (results-based lending, $120 million); and SASEC Roads Improvement Project ($186.8 million). In addition, a $20 million co-financing grant from Strategic Climate Fund was also approved as an additional financing to South Asia Subregional Economic Cooperation Power System Expansion Project to promote solar power.

Technical Assistance

As of 31 December 2016, ADB has approved technical assistance (TA) projects totaling $193.7 million, there were 22 ongoing TAs amounting to $34.9 million. Currently, 23 investment projects and 6 TAs, which are about 68% and 27%, respectively, of the ADB’s Nepal portfolio, are being administered by Nepal Resident Mission.

Private Sector Operations

ADB’s private sector operations in Nepal began in 1989. As of 31 July 2016, cumulative approvals in four projects amounted to $58.6 million. The most successful of these was the 60-MW Khimti Hydropower (approved in 1996), which paved the way for private sector investment in the hydropower sector. The project was built under a 50-year build-own-operate-and-transfer license to Himal Power Limited. ADB’s loan has been fully repaid.

ADB's Trade Finance Program (TFP) in Nepal works with two banks and has supported over $71 million in trade with 209 transactions as of 30 June 2016. About 51% of the trade supported by the TFP was cofinanced by the private sector. It fills market gaps by providing guarantees and loans through partner banks in support of trade.

Looking ahead, 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.

Table 2. Sovereign Loans and Grants by the Asian Development Bank, 1968–2016

	1968-2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Loans ($ million)												
Agriculture and Natural Resources	746.2	0.0	0.0	0.0	0.0	0.0	18.0	0.0	25.5	30.0	0.0	0.0
Education	130.6	30.0	0.0	0.0	25.0	0.0	0.0	0.0	0.0	0.0	200.0	120.0
Energy	364.3	0.0	0.0	0.0	65.0	0.0	56.0	0.0	150.0	180.0	0.0	0.0
Finance	7.3	56.0	0.0	0.0	0.0	60.4	0.0	0.0	0.0	0.0	0.0	0.0
Industry and Trade	127.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public Sector Management	65.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transport and Communication	302.8	0.0	0.0	0.0	70.0	13.5	0.0	0.0	75.0	30.0	0.0	126.8
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	90.0	0.0
Multisector	157.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Regional Cooperation	0.0	0.0	0.0	0.0	12.8	11.0	0.0	0.0	0.0	0.0	0.0	60.0
Total Loans	**2163.4**	**86.0**	**0.0**	**0.0**	**172.8**	**154.9**	**154.0**	**44.8**	**330.5**	**325.0**	**290.0**	**306.8**
Grants ($ million)												
Agriculture and Natural Resources	0.0	18.0	0.0	0.0	0.0	46.5	27.0	11.0	4.5	0.0	0.0	0.0
Education	0.0	2.0	0.0	8.0	70.0	0.0	65.0	0.0	20.0	0.0	0.0	0.0
Energy	0.0	0.0	0.0	0.0	0.0	2.5	19.0	0.0	21.0	0.0	0.0	0.0
Finance	0.0	8.7	0.0	0.0	0.0	12.1	5.0	0.0	0.0	0.0	0.0	0.0
Industry and Trade	0.0	0.0	0.0	0.0	0.0	0.0	0.0	15.0	0.0	0.0	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	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	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	0.0	0.0
Multisector	0.0	0.0	100.0	0.0	25.6	0.0	0.0	0.0	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	0.0	0.0
Total Grants	**0.0**	**83.9**	**109.0**	**139.3**	**163.5**	**107.6**	**116.0**	**59.0**	**45.5**	**0.0**	**0.0**	**0.0**
Total Approved (Loan and Grant)	**2163.4**	**169.9**	**109.0**	**139.3**	**336.3**	**262.5**	**270.0**	**103.8**	**376.0**	**325.0**	**290.0**	**306.8**
Gross disbursement (Loans and Grants)	**1405.3**	**108.0**	**102.3**	**127.1**	**199.5**	**111.2**	**208.8**	**87.7**	**159.4**	**151.3**	**158.6**	**201.0**
Technical Assitance ($ million)												
Total Approved	114.4	5.8	7.2	4.6	5.7	10.5	13.6	6.5	11.9	4.1	3.9	5.5
Gross Disbursement	75.0	2.0	4.6	4.6	6.8	14.0	8.8	6.8	5.4	3.9	5.3	7.3

STATISTICAL ISSUES

As of February 14, 2017

I. Assessment of Data Adequacy for Surveillance
General: Economic and financial data are broadly adequate for surveillance, with scope for improvement especially in updating the base year of the national account, 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 2015 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. Nevertheless, the priority for the authorities should be to address the significant discrepancy between the financial and non-financial accounts, which averages at 1 per cent of GDP for the last three years. Given that the discrepancy appears to be on the financial side (net financial transactions is larger than net lending/borrowing from the non-financial side), immediate focus should be to clarify the flows and stock of currency and deposits. Also, the budget classification in the GFSY return needs further improvement in a number of areas; for example, to exclude financing transactions from the functional classification of expenditure; make a clearer distinction between revenue and transactions in nonfinancial assets (and also ensuring the type of non-financial assets are correctly recorded); clarify whether transactions are correctly classified as financial assets or subsidies and capital payments to enterprises; and other improvements to ensure full consistency with the GFSM 2001. Meanwhile, the treasury single account system (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 extra-budgetary 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. It is expected that after the 2017 Article IV mission, some data on assets and liabilities will be become available and that the authorities will re-start their submission to the WB/IMF Public Sector Debt Database. Government finance statistics are regularly reported for publication in the *Government Finance Statistics Yearbook*, but not in the IFS.
Monetary and Financial Statistics: Following up on the recommendations of a 2009 STA mission that NRB broaden the coverage of monthly monetary statistics to include development banks and finance companies, the NRB now compiles and publishes an expanded broad money survey, which is a significant step forward. There is room for improvement in the reporting of data on the interest rates. At present, key policy rates including T-bill, interbank, and NRB policy rates are available, key deposit and lending rates of commercial banks are reported, but those of development banks and finance companies are not reported at all. It may be useful to report the prime lending rate and deposit rates of top 5 commercial banks to provide a sense of the movement over time. At present, maximum and minimum rates are reported, which remain relatively fixed over time and are not very informative. Data on the NRB's claims on other depository corporations (ODCs) are not consistent with the data on the ODCs' liabilities to the NRB because ODCs' liabilities include only refinance and repo credit from the NRB; separate data on the NRB's deposits at the ODCs are currently not available and therefore are excluded from the ODCs' liabilities to the NRB.
External sector statistics: The NRB compiles and disseminates balance of payments (BOP) statistics in conformity with the fifth edition of the *Balance of Payments Statistics Manual* (*BPM5*). Balance of Payments statistics present several shortcomings in terms of coverage, classification, and data sources. Key shortcomings in BOP statistics are: (i) underestimation of imports, and to a lesser extent exports; (ii) significant problems in measurement of remittances; (iii) incompleteness of data on foreign grants, making it difficult to classify current vs. capital, and official vs. private grants; (iv) absence of direct investment data; and (v) unrecorded financial flows. In February 2015, the NRB started reporting international investment position (IIP) data following the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*). Nepal 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. For the 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. 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 participant on the enhanced General Data Dissemination System (e-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 February 10, 2017)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	12/16	2/17	D and M	W and M	W and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	12/16	2/17	M	M	M
Reserve/Base Money	12/16	2/17	M	M	M
Broad Money	12/16	2/17	M	M	M
Central Bank Balance Sheet	12/16	2/17	M	M	M
Consolidated Balance Sheet of the Banking System	12/16	2/17	M	M	M
Interest Rates[2]	12/16	2/17	D and M	W and M	W and M
Consumer Price Index	12/16	2/17	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	12/16	2/17	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	12/16	2/17	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	12/16	2/17	M/A	M/A	M/A
External Current Account Balance	12/16	2/17	M	M	M
Exports and Imports of Goods and Services	12/16	2/17	M	M	M
GDP/GNP	2015/16	08/16	A	A	A
Gross External Debt	2015/16	1/17	A	A	A
International Investment Position[6]	2015/16	1/17	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).

INTERNATIONAL MONETARY FUND

NEPAL

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

March 13, 2017

Approved By
Kenneth Kang and Zeine Zeidane (IMF) and John Panzer (IDA)

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

Nepal's risk of debt distress[1] remains low, taking into account the important role of remittances. Strong revenue growth and subdued capital spending have kept the budget in surplus for the past four years. As a result, public debt has been on a declining path. The indicators of the public external debt stock and public debt service ratios continue to stay comfortably within the policy-dependent indicative thresholds, even when applying standard stress tests, due to the projected continued high level of concessionality of official borrowing.[2]

BACKGROUND

1. **The 2015 earthquakes and the disruption to trade at Nepal's southern border in FY2015/16 resulted in a sharp slowdown of the Nepali economy but the risk of debt distress is expected to remain low.** The growth of real GDP at market prices is estimated to have slowed to 0.6 percent in FY2015/16, as key sectors of the economy were affected by the trade disruption. Under the baseline macroeconomic scenario which underlies this debt sustainability analysis (DSA), higher financing requirements driven by post-earthquake reconstruction and higher public investment expenditures are assumed to be met primarily by external loans and grants. Nonetheless, the risk of debt distress remains low, thanks to the low starting level of external debt and the high concessionality of new debt.

2. **The present value of external debt in 2016 exceeded the projection in the previous DSA, but a decline is projected over the medium term.** The previous DSA (see IMF Country Report No. 15/317) projected the present value (PV) of public and publicly-guaranteed (PPG)

[1] The risk rating is determined using the low-income debt sustainability analysis (LIC DSA) framework. Nepal's fiscal year starts in mid-July. For example, fiscal year 2016 extends from mid-July 2015 until mid-July 2016.

[2] The thresholds are determined based on Nepal's policy performance rating, which is "medium" according to the CPIA score which averaged 3.39 in 2013–15. Nepal continues to receive large amounts of remittances, averaging 27.5 percent of GDP and 242.9 percent of exports of goods and services per annum during 2013–15. As remittances exceed relevant thresholds (10 percent of GDP and 20 percent of exports of goods and services), they are incorporated into the analysis.

external debt to reach 11½ percent of GDP in 2016 and to gradually rise to 12 percent of GDP over the next five projection years. This DSA compares as follows:

- Despite continued low execution of foreign-financed capital spending, the PV of PPG external debt rose to 12.6 percent of GDP in 2016, 1 percent of GDP higher than projected in the previous DSA. The rising debt ratio reflected lower-than-expected economic growth and depreciation of the Nepali rupee. This provides the new base to project the path of external public debt in the current DSA.

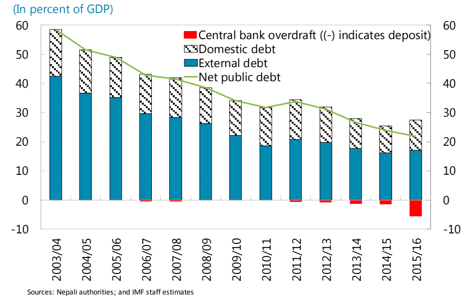
- The PV of PPG external debt is projected to decline slightly over the medium term to about 10¾ percent of GDP by 2022. This takes into account the expected drawdown of government deposits accumulated in recent years (NRs 127 billion by mid-2016 (equivalent to 5.7 percent of GDP), see text table below). The drawdown of deposits will reduce the borrowing requirement and slow the pace of debt accumulation (Box 1 and Table 1a).

3. Nepal's public debt has been on a declining path but it increased to 27.3 percent of GDP in FY2015/16, from 25.2 percent of GDP in FY2014/15, despite a fiscal surplus.

- Strong revenue growth and subdued capital spending have kept the budget in surplus for the past four years. As a result, public debt declined steadily and the government accumulated large cash balances at the central bank.

Public Debt

(In percent of GDP)



- External debt stood at US$3.6 billion or 16.9 percent of GDP at the end of FY2015/16, of which 87 percent was concessional borrowing mainly from the World Bank and the Asian Development Bank (ADB). Japan was the largest bilateral creditor, followed by South Korea, India and China.

- Domestic debt rose from 9.3 percent of GDP at the end of FY2014/15 to 10.4 percent of GDP at the end of FY2015/16, as government bonds were issued as planned even though the under-execution of the budget resulted in the further accumulation of government cash deposits, to NRs 127 billion.

Nepal: Structure of External Public Debt, at end FY2015/2016

	Nominal Value (in million USD)	In percent of GDP	NPV (in million USD)
Public debt	3,566	17.0	2,661
Multilateral	3,225	15.4	2,399
Asian Development Bank	1,417	6.8	1,115
World Bank	1,679	8.0	1,096
IMF	91	0.4	154
Other	37	0.2	34
Official Bilateral	346	1.6	263
Paris Club	193	0.9	157
Non-Paris Club	152	0.7	106
Commerical	-	-	-

Source: Nepali authorities; Fund staff estimates.

Nepal: Domestic Public Debt 1/

(In billions of Nepalese rupees unless otherwise stated)

	2012	2013	2014	2015	2016
Government bonds	209	207	202	197	234
(In percent of GDP)	13.7	12.2	10.3	9.3	10.4
Of which:					
Treasury Bills	132	136	136	120	116
Development Bonds	58	52	47	57	109
National Savings Bonds	16	16	17	17	1
Citizen Savings Bonds	4	3	2	3	8
Memorandum items:					
NRB overdrafts (+) / deposits (-)	-2	-14	-25	-34	-127
Net domestic debt outstanding	207	193	177	163	107
(In percent of GDP)	13.5	11.4	9.0	7.7	4.7

Source: Nepali authorities; Fund staff estimates

[1] Fiscal years ending in mid-July

4. **Debt management capacity could be further enhanced.** The World Bank's 2014 Debt Management Performance Assessment (DeMPA) found that several areas of debt management have been gradually improved, including cash flow forecasting and cash balance management, the better alignment of public debt management with macro policy, as well as the creation of separate open market committees for public debt management and monetary management at the NRB. Nevertheless, the managerial oversight on the debt management functions could be more effective. One entity should be made responsible for the preparation of a comprehensive debt management strategy, analyze the cost and risks of the debt portfolio—including analysis of sensitivity to variability in the exchange rate, and make debt service forecasts more robust. Over the course of 2016, the World Bank has been engaged with the Nepali authorities to undertake training programs geared toward building capacity to formulate and update a consistent debt management strategy.

MACROECONOMIC ASSUMPTIONS

5. **Macroeconomic assumptions for this DSA are consistent with the baseline macroeconomic projections underlying the 2017 Article IV consultation.** The differences from the assumptions underlying the previous DSA include (Box 1): (i) a deterioration in medium-term growth prospects owing to political uncertainty and frequent changes of government; (ii) somewhat lower grants due to delays in project implementation; (iii) somewhat higher government capital spending ("net acquisition of non-financial assets") reflecting sustained efforts on the part of the government; and (iv) slower growth of remittances, in line with the reduced outflows of migrant workers observed .

- Real GDP growth is expected to recover from the earthquakes and the 4½ month trade disruption to reach 5½ percent in FY2016/17 and 4½ percent in FY2017/18, both above the 4 percent historical average (Table 1a). Nevertheless, growth is forecast to moderate to 3.8 percent per annum in the medium term, slightly below that of the previous DSA. This takes into account past patterns in the under-execution of capital budgets, more moderate growth of remittances than in recent years, as well as the experience in other fragile countries where events such as the earthquakes and trade disruption have had permanent effects on potential growth.

- Fiscal policy is expected to remain prudent. Expenditure is projected to rise over the medium term, largely driven by the delivery of household reconstruction grants and to some extent higher capital expenditure. Revenue and grants are projected to stabilize at about 24 percent of GDP. As a result, primary fiscal deficits in the medium term are almost 1 percent of GDP smaller than in the previous DSA. And the net incurrence of liabilities in the medium term is projected to be smaller by 1¾ percent of GDP per annum than in the previous DSA reflecting the drawdown of government cash balances (5.7 percent of GDP in mid-2016). This path is consistent with public debt stabilizing at about 22 percent of GDP in the medium term.

- The large current account surpluses of the last few years are expected to unwind and turn to modest deficits over the medium term. In fact, the current account was broadly in balance during the first 5 months of the current fiscal year, compared to a surplus of more than US$1.4 billion in the same period last year. The exchange rate peg to the Indian rupee is assumed to remain at the current level over the projection period. Import growth is expected to moderate in line with a slowdown in remittances. The growth of the US$-value of exports of goods and services is projected at around 7 percent per annum in the medium term, but export as a share of GDP would decline to below 3 percent in the medium term, reflecting continued weak competitiveness due to the persistent inflation wedge with India and significant infrastructure bottlenecks.

Box 1. Macroeconomic Assumptions Table

	Previous				Current				Current vs. Previous	
	2013/14	**2014/15**	**MT**	**LT**	**2015/16**	**2016/17**	**MT**	**LT**	**MT**	**LT**
Real growth (%)	5.4	3.4	4.2	4.0	5.5	4.5	3.8	3.8	-0.3	-0.2
Inflation (GDP deflator, %)	8.7	5.9	7.2	5.0	6.7	7.6	6.6	5.9	-0.6	0.9
Revenues and grants (% GDP)	20.8	20.3	22.1	22.8	24.2	24.2	24.1	24.4	1.9	1.6
Grants (% GDP)	2.4	1.9	2.6	2.3	1.9	1.9	1.8	1.5	-0.8	-0.7
Primary expenditure (% GDP)	18.9	20.9	24.5	24.2	25.8	25.8	25.5	25.4	1.0	1.2
Net acquisition of non-financial assets (% GDP)	3.3	3.9	5.7	5.0	5.5	6.0	5.7	5.5	0.0	0.5
Primary deficit (% GDP)	-1.9	-0.6	2.3	1.4	1.6	1.6	1.4	1.0	-0.9	-0.4
Net incurrence of liabilities	-1.3	0.6	3.0	1.0	2.8	-0.3	1.3	1.7	-1.7	0.7
Net domestic financing (% GDP)	0.9	1.0	1.7	1.7	5.2	-1.3	0.7	1.2	-1.0	-0.5
Exports of G&S (y/y growth)	12.0	-11.9	7.2	6.5	-19.3	14.8	7.5	6.0	0.3	-0.5
Imports of G&S (y/y growth)	13.2	7.0	10.1	7.6	-6.5	22.3	7.5	6.1	-2.6	-1.5
Remittances (y/y growth)	12.4	11.2	8.5	8.5	1.0	3.4	5.6	6.0	-2.9	-2.5
Current account balance (% GDP)	4.6	2.8	-2.0	1.3	6.3	-0.3	-1.8	-1.4	0.2	-2.7

Note: MT (medium term) is the average over the next 5 years, and LT (long term) is the average over the following 7-20 years.

- In the context of the International Conference on Nepal's Reconstruction (ICNR) held in Kathmandu in June 2015, Nepal’s development partners announced new pledges of financial assistance. About forty percent of this additional financing would come in the form of grants and the remainder in the form of loans. However, reflecting the weak budget implementation capacity which underlies the fiscal surpluses of the last four years and persistent downward trend in Nepal’s public debt to GDP ratio, the baseline assumes only part of the additional external financing—approximately US$2.7 billion for the next 5-year period in order to meet post-earthquake reconstruction-related financing needs—would be drawn.[3]

[3] The ADB has recently noted that its operations in Nepal are challenged by weak capacity of public institutions in project planning and implementation (see page 70 in https://www.adb.org/sites/default/files/publication/211636/mapping-fcas-asia-pacific.pdf). Notwithstanding large development needs, ADB and World Bank disbursement rates to Nepal remain low. In 2015, before the new aid commitments triggered by the earthquakes, US$2.3 billion (11 percent of GDP) remained to be disbursed on the ADB and World Bank’s combined US$3.7 billion portfolio of active projects and programs.

EXTERNAL DEBT SUSTAINABILITY

A. Baseline

6. **Under the baseline scenario, Nepal's external debt indicators continue to stay well below indicative sustainability thresholds** (Figure 1 and Table 1b). As in the previous DSA, remittances are formally included in the analysis as the inflows reached close to 30 percent of GDP in FY2015/16. Nonetheless, debt dynamics may be susceptible to volatility in remittance flows, as captured under standard shocks, discussed below. Over the medium term, the present value (PV) of external debt stabilizes at a level equal to: 8 percent of GDP and remittances, 32 percent of exports and remittances, and 45 percent of revenues. The ratio of debt service to export and remittances stabilizes at 2 percent, while the ratio of debt service to revenues stabilizes at 3 percent over the medium term.

B. Stress Tests and Alternative Scenarios

7. **Debt dynamics remain resilient to standard shocks.** These stress tests include shocks to real GDP growth, exports, non-debt creating flows, and a combination of these shocks, as well as a one-time 30 percent nominal depreciation shock. Under the most severe shock (to non-debt creating flows, capturing a shock to remittances), the PV of debt to exports and remittances rises sharply over the next three years but stays well below the threshold, and declines thereafter, while all other indicators remain well below the thresholds. The relative sensitivity to a shock to remittances illustrates Nepal's exposure to potential adverse developments in the external environment.

PUBLIC DEBT SUSTAINABILITY

8. **Under the baseline, the ratio of public debt to GDP gradually declines from 27.3 percent in 2015/16 to 22 percent of GDP in the medium term and 20½ percent of GDP in the long term** (Table 2a). In PV terms, public debt to GDP also decreases over time, from 23 percent in 2015/16 to 15.7 percent of GDP in 2036/37. As a ratio of revenues and grants, the PV of public debt declines from 98.5 percent in 2015/16 to 62 percent in 2036/37. Unlike in the 2015 DSA, the composition of public debt is projected to tilt toward a higher share of external debt, from 62 percent in 2015/16 to 73 percent in the medium term, before reverting back to 62 percent of total public debt in the long term.

9. **Debt dynamics remain resilient under standard stress tests.** In the context of the PV of public debt to GDP ratio, as in the 2015 DSA, the most extreme shocks are the real GDP growth at historical average minus one standard deviation and the 10 percent of GDP increase in other debt-creating flows in 2017/18. Overall, the PV of public debt to GDP ratio remains well below the 56 percent threshold, for all the standard stress tests.

10. Contingent liabilities arise mainly from the operations of state owned enterprises (SOEs), and civil service pension liabilities:

- The Nepal Oil Corporation (NOC) and the Nepal Electricity Authority (NEA) have been the two largest loss-making SOEs. However, the NOC was able to repay 1½ percent of GDP in loans over the past 2 fiscal years by delaying the pass through of declining oil import prices. The NEA made a loss of ½ percent of GDP in 2015/16 and has long-term debts of close to 5 percent of GDP. But the NEA's cash flow has improved in recent months thanks to a July 2016 hike in electricity tariffs and improvements in demand side management.

- Civil service pension liabilities remain modest. Moreover, according to a 2014 IMF TA mission on pension reforms, these liabilities can be addressed through adequate parametric reforms in the medium term.

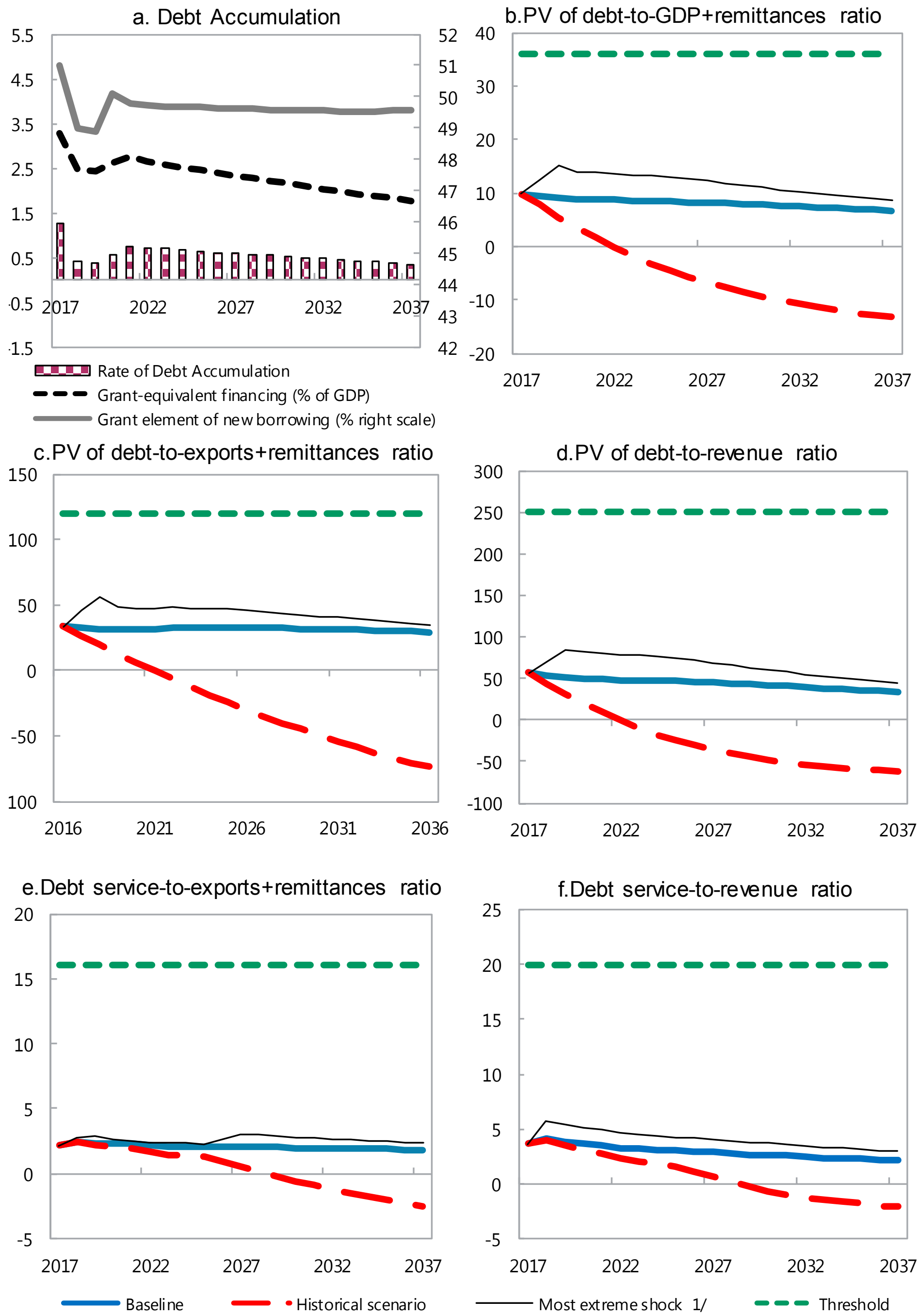
AUTHORITIES' VIEWS

11. The authorities broadly agreed with the findings of the DSA. They noted that their efforts were geared toward strengthening capital budget implementation and mobilizing additional foreign financing with a view to speed up the recovery from the earthquakes and trade disruption and raise medium-term growth. The authorities expressed confidence that the risk of debt distress would remain low even with scaled up public investment.

CONCLUSION

12. The DSA suggests Nepal's risk of debt distress is low. Weak budget execution has contributed to fiscal surpluses in each of the past four years. In recent months there has been a pickup in government spending and a large number of households affected by the 2015 earthquakes have received the first installment of housing grants provided to assist in rebuilding structures that were destroyed by the earthquakes. The government also intends to raise capital spending to address infrastructure bottlenecks and boost growth. On this basis, the baseline macroeconomic projections underlying this DSA assume a pickup in government spending and the fiscal balance turning to a small deficit. However, Nepal's risk of debt distress is expected to remain low in view of the assumed continued high level of concessionality of official borrowing and limited scaling up of capital spending due to weak implementation capacity over the medium term. Under the baseline macroeconomic scenario, the indicators of the public external debt stock and public debt service ratios remain well below the policy-dependent indicative thresholds, even under stress tests, due to the assumed continued high level of concessionality of official borrowing.

Figure 1. Nepal: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2016/17-2036/37 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2026. In figure b. it corresponds to a Combination shock; in c. to a Combination shock; in d. to a Combination shock; in e. to a Combination shock and in figure f. to a One-time depreciation shock

Table 1a. Nepal: External Debt Sustainability Framework, Baseline Scenario, 2013/14-2036/37 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2013/14	2014/15	2015/16			2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2016/17-2021/22 Average	2026/27	2036/37	2022/23-2036/37 Average
External debt (nominal) 1/	18.2	15.9	16.9			17.5	16.7	16.0	15.8	16.0	16.0		15.7	12.9	
of which: public and publicly guaranteed (PPG)	18.0	15.9	16.9			17.5	16.7	16.0	15.8	16.0	16.0		15.7	12.9	
Change in external debt	-1.1	-2.3	1.0			0.6	-0.8	-0.7	-0.2	0.2	0.1		-0.2	-0.3	
Identified net debt-creating flows	-5.8	-6.3	-6.5			-0.8	0.3	0.7	0.9	1.1	1.1		0.2	-0.2	
Non-interest current account deficit	-4.7	-5.2	-6.5	-3.0	3.0	0.1	1.1	1.4	1.6	1.8	1.9		1.3	0.8	1.2
Deficit in balance of goods and services	29.3	30.0	29.8			33.7	33.6	33.1	32.7	32.4	32.1		29.7	26.6	
Exports	11.5	11.7	9.5			9.9	9.9	9.7	9.6	9.5	9.4		8.4	7.7	
Imports	40.9	41.7	39.2			43.5	43.4	42.8	42.3	41.9	41.4		38.1	34.3	
Net current transfers (negative = inflow)	-32.2	-33.4	-34.6	-28.7	4.0	-31.8	-30.7	-29.9	-29.4	-28.9	-28.4		-26.8	-24.1	-25.9
of which: official	-1.8	-1.4	-1.9			-1.2	-1.2	-1.2	-1.2	-1.2	-1.2		-1.3	-1.3	
Other current account flows (negative = net inflow)	-1.8	-1.7	-1.7			-1.7	-1.7	-1.7	-1.7	-1.7	-1.7		-1.7	-1.6	
Net FDI (negative = inflow)	-0.2	-0.2	-0.3	-0.3	0.2	-0.3	-0.3	-0.3	-0.3	-0.4	-0.4		-0.7	-0.7	-0.7
Endogenous debt dynamics 2/	-0.9	-1.0	0.3			-0.7	-0.5	-0.4	-0.4	-0.4	-0.4		-0.4	-0.3	
Contribution from nominal interest rate	0.2	0.1	0.1			0.2	0.2	0.2	0.2	0.2	0.2		0.2	0.1	
Contribution from real GDP growth	-1.1	-0.5	-0.1			-0.8	-0.7	-0.6	-0.6	-0.6	-0.6		-0.6	-0.5	
Contribution from price and exchange rate changes	0.0	-0.7	0.2			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	4.7	4.1	7.5			1.5	-1.1	-1.4	-1.1	-0.9	-1.1		-0.4	-0.1	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	12.6			12.6	11.9	11.3	11.0	10.8	10.7		10.0	8.1	
In percent of exports	...	...	132.7			127.3	120.2	116.1	114.2	114.2	114.1		119.2	105.3	
PV of PPG external debt	...	...	12.6			12.6	11.9	11.3	11.0	10.8	10.7		10.0	8.1	
In percent of exports	...	...	132.7			127.3	120.2	116.1	114.2	114.2	114.1		119.2	105.3	
In percent of government revenues	...	...	58.7			56.3	53.2	50.8	49.2	48.7	48.1		44.7	33.7	
Debt service-to-exports ratio (in percent)	8.9	8.1	10.3			8.2	9.2	8.7	8.4	8.2	7.8		7.7	19.3	
PPG debt service-to-exports ratio (in percent)	8.9	8.1	10.3			8.2	9.2	8.7	8.4	8.2	7.8		7.7	6.6	
PPG debt service-to-revenue ratio (in percent)	5.6	4.9	4.5			3.6	4.1	3.8	3.6	3.5	3.3		2.9	2.1	
Total gross financing need (Billions of U.S. dollars)	-0.7	-0.9	-1.2			0.1	0.4	0.5	0.6	0.7	0.8		0.6	1.6	
Non-interest current account deficit that stabilizes debt ratio	-3.6	-2.9	-7.5			-0.5	1.9	2.1	1.8	1.6	1.9		1.5	1.2	
Key macroeconomic assumptions															
Real GDP growth (in percent)	6.0	2.7	0.6	4.0	1.6	5.5	4.5	3.8	3.8	3.8	3.8	4.2	3.8	3.8	3.8
GDP deflator in US dollar terms (change in percent)	0.1	3.8	-1.3	6.0	8.5	4.4	4.6	4.5	4.4	4.1	4.1	4.4	3.6	3.1	3.5
Effective interest rate (percent) 5/	1.0	0.8	0.9	0.9	0.1	1.1	1.3	1.4	1.4	1.4	1.3	1.3	1.1	1.0	1.1
Growth of exports of G&S (US dollar terms, in percent)	12.0	7.8	-19.3	5.9	10.8	14.8	9.4	7.0	6.9	6.8	6.8	8.6	6.4	6.3	6.0
Growth of imports of G&S (US dollar terms, in percent)	13.2	8.6	-6.5	12.1	11.3	22.3	9.1	7.0	7.0	7.0	6.9	9.9	6.6	5.9	6.1
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	51.0	49.0	48.9	50.1	49.8	49.7	49.7	49.6	49.5	49.6
Government revenues (excluding grants, in percent of GDP)	18.2	19.1	21.4			22.3	22.3	22.3	22.3	22.2	22.3		22.4	24.0	22.9
Aid flows (in Billions of US dollars) 7/	0.6	0.5	0.5			0.6	0.6	0.7	0.7	0.8	0.8		1.2	1.9	
of which: Grants	0.4	0.4	0.4			0.4	0.5	0.5	0.5	0.6	0.6		0.8	1.4	
of which: Concessional loans	0.1	0.1	0.1			0.2	0.2	0.2	0.2	0.2	0.2		0.4	0.6	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			3.3	2.5	2.4	2.6	2.8	2.7		2.3	1.8	2.2
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			70.4	77.7	78.6	76.2	74.1	74.8		76.3	79.4	77.2
Memorandum items:															
Nominal GDP (Billions of US dollars)	20.0	21.3	21.2			23.3	25.5	27.7	30.0	32.4	35.0		50.4	102.4	
Nominal dollar GDP growth	6.1	6.6	-0.7			10.2	9.4	8.5	8.3	8.1	8.1	8.8	7.6	7.0	7.4
PV of PPG external debt (in Billions of US dollars)			2.7			2.9	3.0	3.1	3.3	3.5	3.7		5.1	8.3	
(PVt-PVt-1)/GDPt-1 (in percent)						1.3	0.4	0.4	0.6	0.7	0.7	0.7	0.6	0.4	0.5
Gross workers' remittances (Billions of US dollars)	5.5	6.2	6.3			6.5	6.8	7.2	7.6	8.0	8.5		11.4	20.4	
PV of PPG external debt (in percent of GDP + remittances)	...	...	9.7			9.8	9.4	9.0	8.8	8.7	8.6		8.2	6.8	
PV of PPG external debt (in percent of exports + remittances)	...	...	32.2			33.4	32.5	31.8	31.5	31.7	31.8		32.4	29.4	
Debt service of PPG external debt (in percent of exports + remittanc	...	...	2.5			2.2	2.5	2.4	2.3	2.3	2.2		2.1	1.8	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

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

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

Table 1b. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016/17-2036/37

	Projections							
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	**2026/27**	2036/37
PV of debt-to-GDP+remittances ratio								
Baseline	10	9	9	9	9	9	**8**	7
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	10	8	5	3	2	0	**-7**	-13
A2. New public sector loans on less favorable terms in 2016-2036 2	10	10	10	10	10	10	**11**	11
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	10	10	9	9	9	9	**8**	7
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	10	10	10	10	10	10	**9**	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	10	10	10	10	10	10	**9**	8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	10	12	14	13	13	13	**11**	8
B5. Combination of B1-B4 using one-half standard deviation shocks	10	12	15	14	14	14	**12**	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	10	12	12	11	11	11	**11**	9
PV of debt-to-exports+remittances ratio								
Baseline	33	33	32	31	32	32	**32**	29
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	33	27	20	13	6	-1	**-30**	-74
A2. New public sector loans on less favorable terms in 2016-2036 2	33	34	34	35	36	38	**44**	47
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	33	33	32	31	32	32	**32**	29
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	33	36	39	39	39	39	**39**	33
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	33	33	32	31	32	32	**32**	29
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	33	48	55	47	47	47	**45**	35
B5. Combination of B1-B4 using one-half standard deviation shocks	33	46	55	48	48	47	**46**	35
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	33	33	32	31	32	32	**32**	29
PV of debt-to-revenue ratio								
Baseline	56	53	51	49	49	48	**45**	34
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	56	44	31	19	9	-1	**-36**	-62
A2. New public sector loans on less favorable terms in 2016-2036 2	56	55	54	54	56	57	**60**	54
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	56	54	53	51	50	50	**46**	35
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	56	56	59	57	56	55	**50**	36
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	56	57	58	56	56	55	**51**	38
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	56	67	77	74	73	71	**63**	40
B5. Combination of B1-B4 using one-half standard deviation shocks	56	69	84	81	80	78	**68**	44
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	56	75	71	69	69	68	**63**	47

Table 1b. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2016/17-2036/37 (continued)

	Projections							
	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	**2026/27**	2036/37
Debt service-to-exports+remittances ratio								
Baseline	2	2	2	2	2	2	**2**	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	2	2	2	2	2	2	**1**	-3
A2. New public sector loans on less favorable terms in 2016-2036 2	2	2	2	2	2	2	**3**	3
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	2	2	2	2	2	2	**2**	2
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	2	3	3	3	3	2	**3**	2
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	2	2	2	2	2	2	**2**	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	2	3	3	3	3	2	**3**	2
B5. Combination of B1-B4 using one-half standard deviation shocks	2	3	3	3	3	2	**3**	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	2	2	2	2	2	2	**2**	2
Debt service-to-revenue ratio								
Baseline	4	4	4	4	4	3	**3**	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2016-2036 1/	4	4	4	3	3	2	**1**	-2
A2. New public sector loans on less favorable terms in 2016-2036 2	4	4	4	4	4	4	**4**	3
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2017-2018	4	4	4	4	4	3	**3**	2
B2. Export value growth at historical average minus one standard deviation in 2017-2018 3/	4	4	4	4	4	3	**3**	2
B3. US dollar GDP deflator at historical average minus one standard deviation in 2017-2018	4	4	4	4	4	4	**3**	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2017-2018 4/	4	4	4	4	4	4	**4**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	4	4	4	4	4	4	**5**	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2017 5/	4	6	5	5	5	5	**4**	3
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	49	49	49	49	49	49	**49**	49

Sources: Country authorities; and staff estimates and projections.

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

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

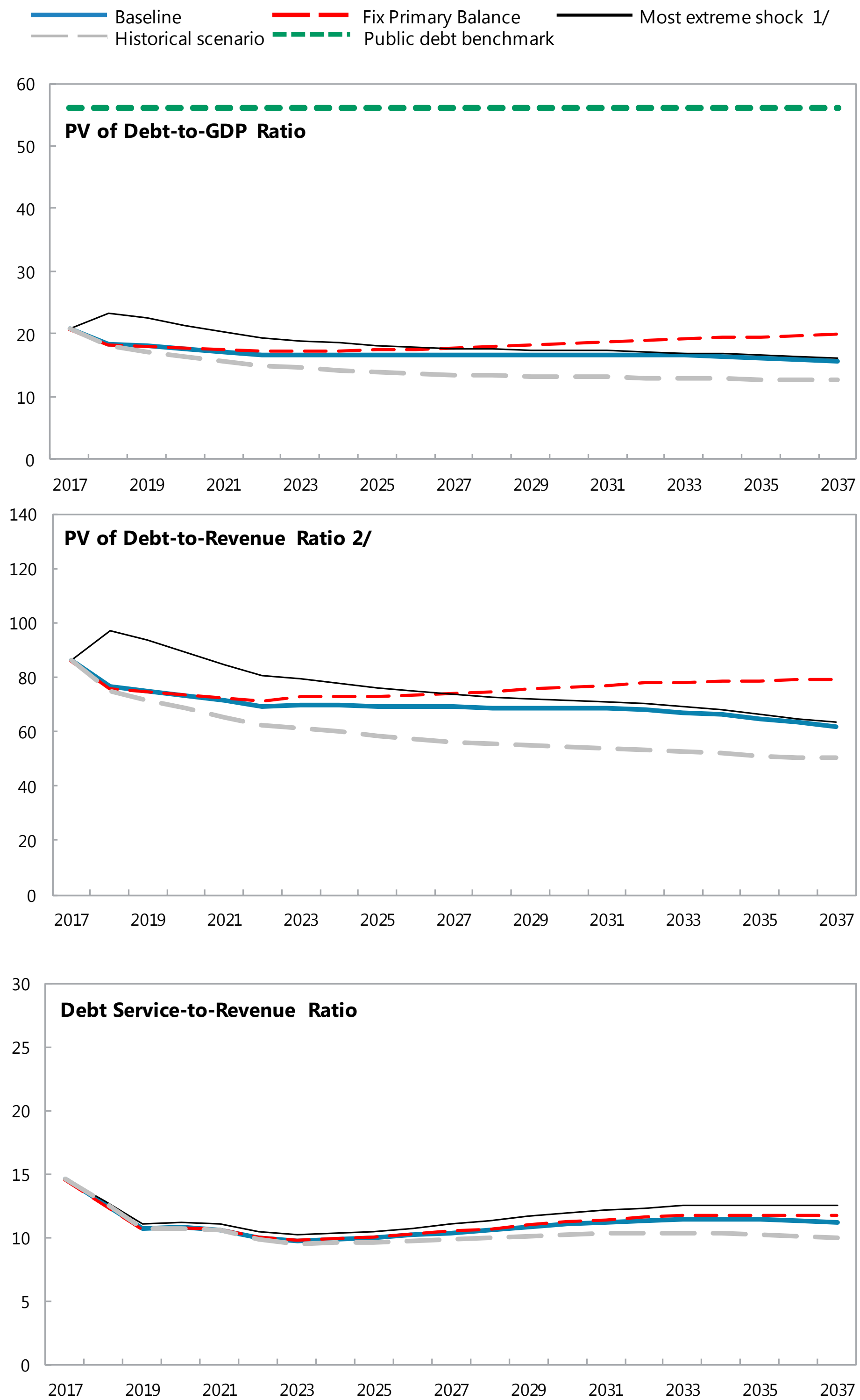
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assum an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

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

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

Figure 2. Nepal: Indicators of Public Debt Under Alternative Scenarios, 2016/17-2036/37 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio on or before 2026.
2/ Revenues are defined inclusive of grants.

Table 2a. Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2013/14-2036/37

(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate						Projections			
	2013/14	2014/15	2015/16			2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2016/17-2021/22 Average	2026/27	2036/37	2022/23-2036/37 Average
Public sector debt 1/	28.3	25.2	27.3			25.7	23.2	22.8	22.5	22.3	22.0		22.3	20.5	
of which: foreign-currency denominated	18.0	15.9	16.9			17.5	16.7	16.0	15.8	16.0	16.0		15.7	12.9	
Change in public sector debt	-3.3	-3.1	2.1			-1.6	-2.5	-0.4	-0.3	-0.3	-0.3		0.0	-0.4	
Identified debt-creating flows	-3.7	-0.8	-0.7			-0.6	-0.1	0.1	-0.2	-0.2	-0.3		0.0	-0.6	
Primary deficit	-1.0	0.7	-0.7	0.7	1.3	1.6	1.8	1.7	1.2	1.2	1.1	1.4	1.2	0.3	1.0
Revenue and grants	20.4	20.9	23.3			24.2	24.1	24.1	24.1	24.0	24.0		24.1	25.3	
of which: grants	2.2	1.7	1.9			1.9	1.8	1.8	1.8	1.8	1.8		1.6	1.3	
Primary (noninterest) expenditure	19.4	21.5	22.7			25.8	26.0	25.7	25.3	25.2	25.1		25.2	25.7	
Automatic debt dynamics	-2.6	-1.4	0.0			-2.2	-1.9	-1.5	-1.5	-1.4	-1.4		-1.2	-0.9	
Contribution from interest rate/growth differential	-2.7	-1.1	-0.6			-1.9	-1.5	-0.8	-1.1	-1.1	-1.1		-0.9	-0.8	
of which: contribution from average real interest rate	-0.9	-0.4	-0.4			-0.4	-0.4	0.0	-0.3	-0.3	-0.3		-0.1	0.0	
of which: contribution from real GDP growth	-1.8	-0.8	-0.1			-1.4	-1.1	-0.9	-0.8	-0.8	-0.8		-0.8	-0.8	
Contribution from real exchange rate depreciation	0.1	-0.3	0.5			-0.4	-0.4	-0.7	-0.3	-0.3	-0.3		...	...	
Other identified debt-creating flows	-0.1	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	-0.1	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	0.4	-2.3	2.8			-1.0	-2.4	-0.6	0.0	0.0	0.0		0.0	0.2	
Other Sustainability Indicators															
PV of public sector debt	...	...	23.0			20.8	18.4	18.1	17.7	17.1	16.6		16.6	15.7	
of which: foreign-currency denominated	...	...	12.6			12.6	11.9	11.3	11.0	10.8	10.7		10.0	8.1	
of which: external	...	...	12.6			12.6	11.9	11.3	11.0	10.8	10.7		10.0	8.1	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	2.8	5.1	3.6			6.1	5.6	4.8	4.4	4.3	4.1		4.3	3.9	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	98.5			86.0	76.3	75.1	73.4	71.2	69.1		68.9	62.0	
PV of public sector debt-to-revenue ratio (in percent)	...	...	107.3			93.1	82.5	81.1	79.3	76.9	74.6		73.9	65.4	
of which: external 3/	...	...	58.7			56.3	53.2	50.8	49.2	48.7	48.1		44.7	33.7	
Debt service-to-revenue and grants ratio (in percent) 4/	13.5	16.7	14.8			14.6	12.6	10.7	10.8	10.6	9.9		10.4	11.2	
Debt service-to-revenue ratio (in percent) 4/	15.1	18.2	16.1			15.8	13.7	11.5	11.6	11.5	10.7		11.1	11.8	
Primary deficit that stabilizes the debt-to-GDP ratio	2.3	3.8	-2.8			3.2	4.3	2.1	1.5	1.4	1.4		1.2	0.7	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	6.0	2.7	0.6	4.0	1.6	5.5	4.5	3.8	3.8	3.8	3.8	4.2	3.8	3.8	3.8
Average nominal interest rate on forex debt (in percent)	1.0	0.8	0.9	1.0	0.1	1.1	1.3	1.4	1.4	1.4	1.3	1.3	1.1	1.0	1.1
Average real interest rate on domestic debt (in percent)	-6.8	-1.9	-2.6	-3.6	10.2	-2.8	-3.6	-3.3	-2.8	-2.6	-2.6	-3.0	0.2	1.8	0.6
Real exchange rate depreciation (in percent, + indicates depreciation	0.5	-1.7	3.4	-2.3	16.3	-2.3	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	11.8	5.1	5.5	10.5	13.2	6.7	7.6	7.3	6.7	6.5	6.5	6.9	6.0	5.5	5.9
Growth of real primary spending (deflated by GDP deflator, in percer	10.3	13.8	6.0	3.1	5.1	20.1	5.2	2.9	2.0	3.5	3.6	6.2	3.9	4.1	4.0
Grant element of new external borrowing (in percent)	...	...	...	...	...	51.0	49.0	48.9	50.1	49.8	49.7	49.7	49.6	49.5	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

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