



NEPAL

April 2020

2020 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR NEPAL

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2020 Article IV consultation with Nepal, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its March 17, 2020 consideration of the staff report that concluded the Article IV consultation with Nepal.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 17, 2020 on a lapse-of-time basis, following discussions that ended on January 17, 2020, with the officials of Nepal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 27, 2020.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association.
- A **Statement by the Executive Director** for Nepal.

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

Selected Issues

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IMF Executive Board Concludes 2020 Article IV Consultation with Nepal

FOR IMMEDIATE RELEASE

- The 2020 Article IV Staff Report was prepared by a staff team of the IMF for the Executive Board's consideration on March 17, 2020 on a lapse-of-time basis. The staff report reflects discussions with the Nepali authorities in Kathmandu during January 5-17, 2020 and is based on the information available as of end-January 2020. It focuses on Nepal's near and medium-term challenges and policy priorities and was prepared before COVID-19 became a global pandemic and resulted in unprecedented strains in global trade, commodity and financial markets. The report, therefore, does not reflect the implications of these developments and related policy priorities. The outbreak has greatly amplified uncertainty and downside risks around the outlook. Staff is closely monitoring the situation and will continue to work on assessing its impact and the related policy response in Nepal and globally.
- During recent years, strong growth in Nepal has been supported by greater political stability, improved electricity supply, and reconstruction activity following the devastating earthquakes in 2015.
- GDP growth is expected to moderate amid slower growth in India, sluggish remittances, and weaker agricultural production. In this context, there has been a welcome narrowing of the current account deficit, stabilization of gross official reserves, and slower credit growth.
- Additional policies are needed to continue to support inclusive growth, while safeguarding macroeconomic and financial stability. Fiscal policy should remain prudent, and the transition to fiscal federalism carefully managed. Macroprudential measures should remain in place to limit the buildup of financial sector risk. Recent reforms to boost foreign investment need a supportive implementation environment.

Washington, DC – April 6, 2020 On March 17, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Nepal and considered and endorsed the staff appraisal without a meeting.²

Recent strong growth in Nepal has been supported by greater political stability, an electricity supply that is more reliable and with broader access, and reconstruction activity following the devastating earthquakes in 2015. Nepal has seen significant poverty reduction, though vulnerabilities remain, exacerbated by climate related shocks.

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.

Growth performed well in FY2018/19. Growth increased to 7.1 percent, reflecting a rebound in agriculture, earthquake reconstruction, and buoyant tourism. Higher food prices prompted a rise in headline inflation to 6.5 percent in December 2019. The current account deficit was 7.7 percent of GDP in FY2018/19, with remittances helping to finance the large trade deficit. The central government deficit narrowed to 4.6 percent of GDP, due to improvements in revenue collection and underspending with respect to the budget. Provinces and local governments also saw spending under-execution.

There are signs of moderation in economic activity in FY2019/20. Remittance inflows have recently decelerated because of a slowdown in major remittance-sending economies, including India. Agricultural sector performance has been weaker this year. During the first months of FY2019/20, the current account deficit narrowed considerably, due to lower imports of fuel and construction material, reflecting both slowing reconstruction activities and greater domestic electricity and cement production. Gross official reserves were at US\$8.7 billion in December 2019, remaining adequate at 6.9 months of prospective imports. Credit growth tapered to 14.8 percent (y/y) in December 2019 compared to 25.4 percent (y/y) a year earlier, reflecting regulatory tightening and slowing deposit growth due to sluggish remittances.

Executive Board Assessment

In concluding the 2020 Article IV Consultation with Nepal, Executive Directors endorsed staff's appraisal as follows:

Growth is expected to moderate, helping to contain macroeconomic stability risks. Nepal's recent strong growth performance has been supported by a stable political environment, a more reliable electricity supply, and post-earthquake reconstruction spending. For FY2019/20, growth is expected to ease to 6 percent including because of slower growth in India, sluggish remittance inflows, and weaker agricultural production. Inflation is expected at 6 percent due to high food inflation. In the context of moderating growth, there has been a welcome narrowing of the current account deficit and stabilization of gross official reserves. Credit growth has moderated from very high levels, though credit as a share of GDP remains elevated relative to peers. Nonetheless, downside risks remain, including renewed balance of payments pressures and increase in financial-sector risks if credit growth were to increase sharply or remittances slowdown abruptly. Nepal's external position in FY2018/19 is assessed as weaker than the level consistent with fundamentals and desirable policy settings.

Efforts to prevent excessive credit growth and contain financial-sector risks should continue. The NRB has appropriately implemented macroprudential measures to limit the buildup of systemic risk in the financial sector. It has also taken actions to further strengthen bank supervision and regulation, including the introduction of a supervisory information system and implementation of selected elements of the Basel III capital framework. The recent regulatory requirement for banks to cross-check corporate borrowers' financial information against the ITS is expected to facilitate more prudent risk assessment by banks. Activation of the countercyclical capital buffer that will require banks to increase their level of capital by July 2020 is appropriate. The NRB should continue to closely monitor asset quality of banks and improve monitoring of concentration risk.

Fiscal policy should be geared towards containing external pressures and protecting fiscal sustainability. In this regard, a fiscal deficit of 4.5 percent of GDP, similar to the outcome in FY2018/19, would be prudent. Recent upgrades to tax administration are commendable. Staff underscores that a top-down budget process and MTF based on conservative revenue and expenditure assumptions would instill greater prioritization and would avoid creating unrealistic revenue expectations among SNGs. While important steps have been taken to improve public

financial management, further efforts are needed to ensure that spending is of high quality and executed in a timely manner.

The transition to fiscal federalism is a monumental challenge and needs to be carefully managed. To protect fiscal sustainability, the overall expenditure envelope of SNGs needs to be aligned with available funding, with tight limits on any subnational borrowing. A robust reporting and monitoring system for SNGs is urgently needed. There also needs to be a clear delineation of roles and responsibilities across levels of government to ensure adequate delivery of services and investments.

Strengthening the implementation of monetary policy requires a well-functioning interest rate framework that reduces volatility in short-term interest rates. Less short-term interest rate volatility would support financial market development and improve policy signaling and transmission. Staff emphasizes the need to introduce a standing deposit facility as a first step towards establishing a reliable implementation track record for the interest rate corridor.

Achieving the central bank's mandated price and financial stability objectives calls for modernizing the NRB governance framework to improve its autonomy and accountability, Reforms are needed to strengthen independent oversight, safeguard institutional and personal autonomy, and enhance internal controls and quality of external audit, all underpinned by supportive human resource management.

To boost growth prospects, structural reforms that encourage high-quality investment projects, in particular FDI, are critical. As post-earthquake reconstruction spending draws to a close in coming years, maintaining the recent growth momentum will require an enabling implementation environment for infrastructure projects and FDI. To ensure that high-quality projects move forward in a clear and timely manner, staff encourages authorities to focus on adequate staffing, better skills matching, and aligning incentives across and within government ministries responsible for project approvals, implementation, and subsequent monitoring.

Table 1. Nepal: Selected Economic Indicators, 2016/17-2024/25 ^{1/}

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
			Est.			Projections			
Output and prices (annual percent change)									
Real GDP	8.2	6.7	7.1	6.0	5.7	5.5	5.4	5.3	5.3
Headline CPI (period average)	4.5	4.1	4.6	6.0	5.9	5.8	5.6	5.3	5.3
Headline CPI (end of period)	2.7	4.6	6.0	5.9	5.8	5.7	5.5	5.3	5.3
Fiscal Indicators: Central Government (in percent of GDP)									
Total revenue and grants	24.1	25.3	26.0	25.8	26.0	25.8	25.5	25.6	25.5
of which: Tax revenue	20.7	21.1	21.9	21.9	21.8	21.6	21.4	21.3	21.4
Expenditure	27.2	31.9	30.6	30.4	30.4	30.0	29.7	29.4	29.3
Expenses	19.4	23.0	23.6	23.1	23.1	22.9	22.7	22.7	22.8
Net acquisition of nonfinancial assets	7.8	8.9	7.0	7.3	7.3	7.1	7.0	6.7	6.5
Operating balance	4.7	2.3	2.4	2.8	2.9	2.9	2.9	2.8	2.8
Net lending/borrowing	-3.1	-6.7	-4.6	-4.5	-4.4	-4.2	-4.1	-3.9	-3.7
Statistical discrepancy	-1.3	-3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	1.8	3.6	4.6	4.5	4.4	4.2	4.1	3.9	3.7
Net acquisition of financial assets	1.4	-0.7	1.7	1.6	0.9	0.9	0.9	0.9	0.9
Net incurrence of liabilities	3.2	2.9	6.3	6.1	5.3	5.0	5.0	4.8	4.6
Foreign	1.3	2.4	2.1	2.4	1.9	1.6	1.6	1.5	1.3
Domestic	1.9	0.4	4.2	3.7	3.4	3.4	3.4	3.3	3.3
Money and credit (annual percent change)									
Broad money	15.5	19.4	15.8	13.2	11.9	11.6	11.1	10.9	10.7
Domestic credit	20.2	26.1	21.7	17.6	15.7	14.3	13.8	13.3	13.1
Private sector credit	18.0	22.3	19.1	15.0	13.8	12.5	12.2	12.0	12.0
Saving and Investment (in percent of nominal GDP)									
Gross investment	45.2	55.2	62.3	54.6	53.4	52.4	51.5	50.6	49.8
Private	23.6	25.8	30.0	25.1	24.4	24.0	23.5	23.3	23.0
Central government	7.8	8.9	7.0	7.3	7.3	7.1	7.0	6.7	6.5
Change in Stock	13.8	20.5	25.3	22.2	21.7	21.3	21.0	20.6	20.2
Gross national saving	44.8	47.1	54.6	49.4	48.5	47.6	46.8	46.0	45.3
Private	41.3	46.1	53.3	47.8	47.0	46.1	45.3	44.6	44.0
Central government	3.5	1.0	1.2	1.6	1.5	1.5	1.4	1.4	1.4
Balance of Payments									
Current account (in millions of U.S. dollars)	-93	-2,350	-2,369	-1,760	-1,832	-1,963	-2,104	-2,215	-2,323
In percent of GDP	-0.4	-8.1	-7.7	-5.2	-4.9	-4.8	-4.7	-4.6	-4.4
Trade balance (in millions of U.S. dollars)	-8,446	-10,849	-11,373	-11,658	-12,379	-13,140	-13,956	-14,770	-15,643
In percent of GDP	-33.5	-37.4	-37.1	-34.2	-33.1	-32.2	-31.4	-30.5	-29.6
Exports of goods (y/y percent change)	9.9	15.5	12.1	1.4	9.9	9.9	9.9	9.9	9.9
Imports of goods (y/y percent change)	30.0	27.4	5.4	2.4	6.5	6.5	6.5	6.2	6.3
Workers' remittances (in millions of U.S. dollars)	6,556	7,224	7,769	8,402	8,825	9,270	9,737	10,227	10,742
In percent of GDP	26.0	24.9	25.3	24.7	23.6	22.7	21.9	21.1	20.3
Gross official reserves (in millions of U.S. dollars)	9,264	9,304	8,545	8,536	8,419	8,233	8,045	7,850	7,673
In months of prospective imports	8.3	7.9	7.0	6.6	6.1	5.5	5.1	4.7	4.3
Memorandum items									
Public debt (in percent of GDP)	26.1	30.2	30.1	33.7	35.7	37.4	39.0	40.3	41.1
Nominal GDP (in billions of U.S. dollars)	25.2	29.0	30.7	34.1	37.4	40.8	44.5	48.4	52.9
Nominal GDP (in billions of Nepalese Rupees)	2,674	3,031	3,464	3,892	4,354	4,860	5,406	5,997	6,687
Private Sector Credit (in percent of GDP)	74.7	80.6	84.0	86.0	87.5	88.2	88.9	89.8	90.2
Exchange rate (NPR/US\$; period average)	106.2	104.4	112.9	...	...	...	...	...	...
Real effective exchange rate (average, y/y percent change)	3.6	0.2	-1.4	...	...	...	...	...	...

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

Note: Data as of January 31, 2020.

1/ Fiscal year ends in mid-July.



NEPAL

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION

February 27, 2020

KEY ISSUES

This Staff Report was prepared by a staff team of the IMF for the Executive Board's consideration on March 17, 2020 on a lapse-of-time basis. The staff report reflects discussions with the Nepali authorities in Kathmandu during January 5-17, 2020 and is based on the information available as of end-January 2020. It focuses on Nepal's near and medium-term challenges and policy priorities and was prepared before COVID-19 became a global pandemic and resulted in unprecedented strains in global trade, commodity and financial markets. The report, therefore, does not reflect the implications of these developments and related policy priorities. The outbreak has greatly amplified uncertainty and downside risks around the outlook. Staff is closely monitoring the situation and will continue to work on assessing its impact and the related policy response in Nepal and globally.

Context. Recent strong growth has been supported by greater political stability, more reliable electricity supply, and earthquake reconstruction. Nepal has seen significant poverty reduction, but vulnerabilities remain, exacerbated by climate related shocks. Fiscal federalism is expected to improve service delivery and accountability, though faces challenges from weak capacity of subnational governments.

Outlook and risks. For FY2019/20, growth is expected to ease to 6 percent, due to slower growth in India, sluggish remittance inflows, and weaker agricultural production. There has been a welcome narrowing of the current account deficit and stabilization of gross official reserves. Nonetheless, downside risks remain, related to a further slowdown in remittances and the financial-sector.

Main policy recommendations. The policy mix should be geared at containing external pressures and protecting financial stability, while preserving fiscal sustainability.

- A neutral fiscal stance—which would entail under-execution of the budget as observed in previous years—would help contain external and domestic pressures. The overall expenditure envelope of subnational governments should be aligned with available funding, with tight limits on any subnational borrowing.

- Credit growth should be kept in check by maintaining macroprudential measures. The central bank should continue to closely monitor asset quality of banks and improve monitoring of concentration risk.
- The interest rate framework should be strengthened to reduce volatility in short-term interest rates.
- The authorities should stand ready to tighten fiscal and macroprudential policies if balance of payments pressures reemerge or if credit growth increases sharply.
- To boost medium-term growth prospects, structural reforms that encourage timely implementation of high-quality investment projects, in particular FDI, are critical.

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

Discussions took place in Kathmandu during January 5-17, 2020. The staff team comprised Ms. L. Jaramillo Mayor (Head), Mr. P. Blagrave, Mr. K. Min, Ms. J. Yoo (all APD), Mr. M. Bazarbash (MCM), and was assisted by Mr. L. Breuer (Senior Resident Representative for Bhutan/India/Nepal) and Ms. Dulal (local office). Ms. Mahasandana and Ms. Pandit (both OED) also participated in the mission. Mr. N. Singh and Mr. K. Rivas (both APD) supported the preparation of this report.

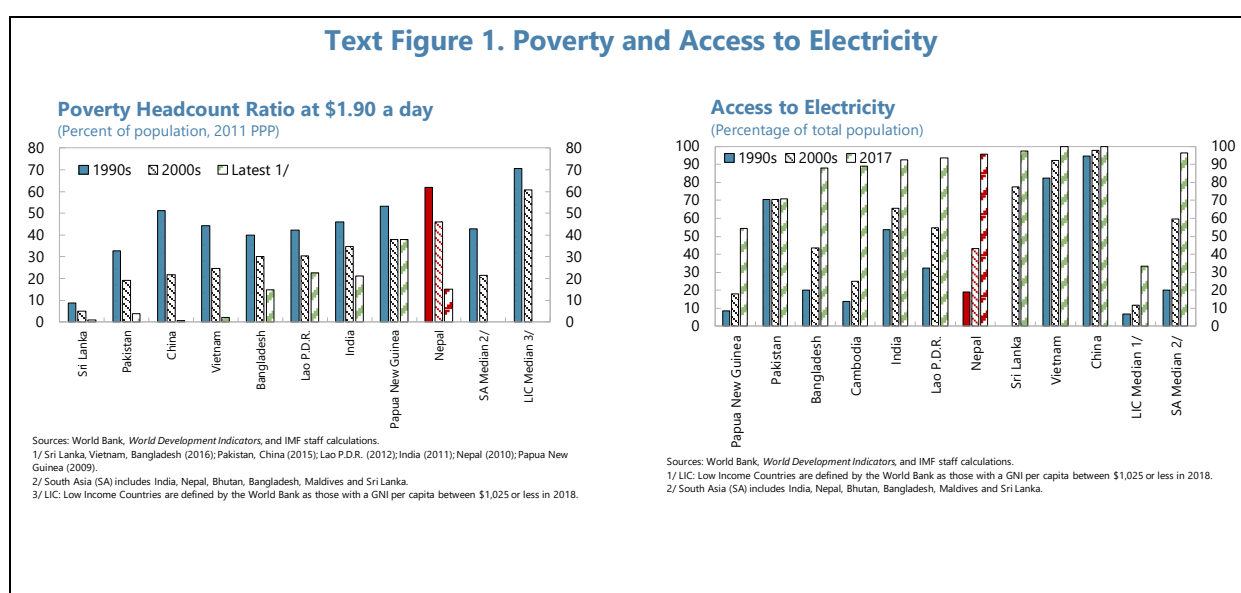
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BACKGROUND

1. Nepal's recent strong growth performance has been supported by greater political stability, more reliable electricity supply, and earthquake reconstruction. The single-party government holds a strong majority in Parliament, providing an opportunity for greater political stability and to push reforms that strengthen inclusive growth, which has helped improve the business environment. Electricity imports from India and greater domestic generation have contributed to stable electricity supply and broader access (Text Figure 1). Currently, over 90 percent of the population has access to electricity, compared to less than 50 percent a decade ago. Following massive earthquakes in 2015, the National Reconstruction Authority reports that 69 percent of the reconstruction of private housing, schools, health institutions, heritage sites, and government buildings has been completed as of December 2019.¹

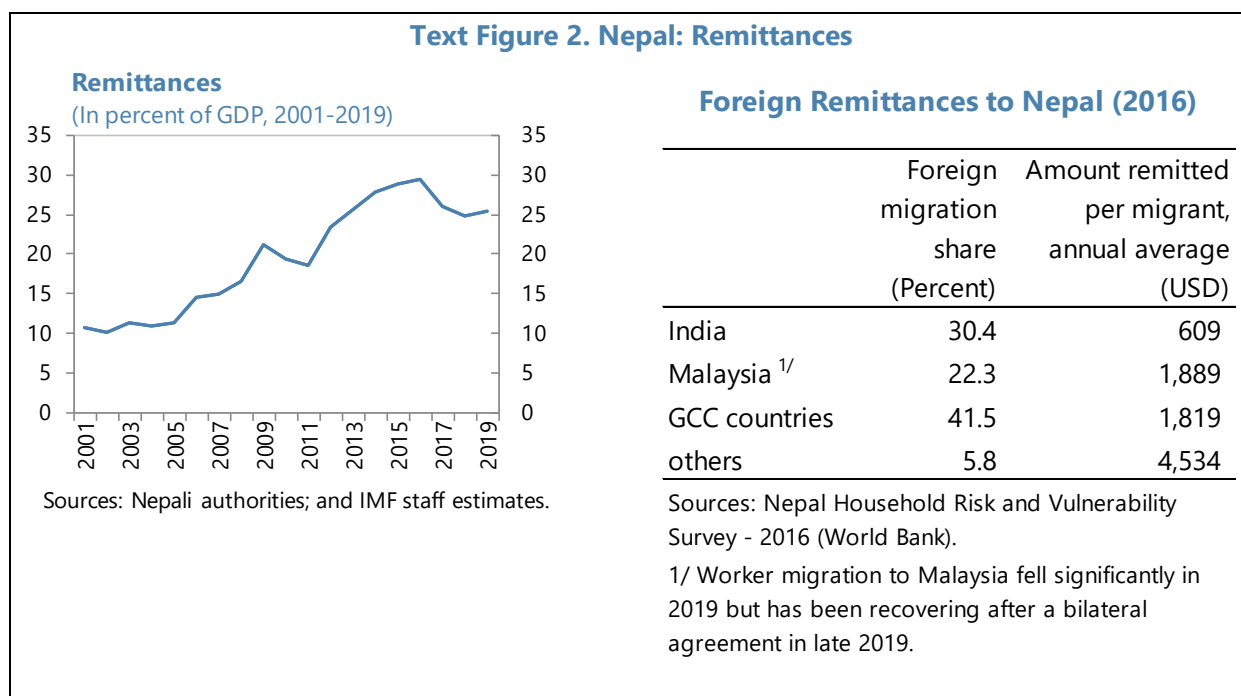


2. Nepal has seen a significant reduction in poverty, but vulnerabilities remain. The estimated poverty headcount ratio (at the US\$1.90 per person per day international poverty line) fell from 15 percent in 2008 to 9.3 percent in 2018 (Text Figure 1). Notwithstanding the declining poverty trend, vulnerability remains high, with 41 percent of the population living on incomes below US\$3.20 a day and several development areas still lagging peers (Figure 6). Vulnerabilities are further exacerbated by climate related shocks, such as floods and landslides, as well as other natural disasters such as earthquakes.

3. The government's vision is to achieve middle-income country status by 2030. Under its development plan 'Prosperous Nepal, Happy Nepal' the authorities are looking to shift the engine of growth from consumption to investment, with plans focused on investments in physical and social infrastructure.

¹ The [National Reconstruction Agency](#) estimates the total cost of reconstruction at NPR\$630 billion.

4. Nepal’s growth model relies heavily on employment overseas. Remittance inflows—mainly from Gulf Cooperation Council (GCC) countries, India, and Malaysia—represented 25 percent of GDP in FY2018/19 (Text Figure 2). Remittances have alleviated poverty and unemployment. Household data shows that remittances have boosted consumption of productive goods (such as durable goods, education and health), without discouraging labor supply of remittance-receiving family members (see Selected Issues, Chapter 1). Nevertheless, remittances have also led to real exchange rate appreciation, which can affect competitiveness. Private investment has been insufficient to support adequate job creation and promote productivity growth, weighing down potential growth.



5. The transition to fiscal federalism is proceeding as mandated by the 2015 constitution, but challenges are monumental. The shift to federalism was a result of the peace agreement after the decade-long armed conflict. Responsibility for the provision of many public services is being devolved to 7 provincial and 753 local governments. Federalism can improve service delivery and strengthen accountability. However, challenges include spending pressures and weak capacity of subnational governments (SNGs).

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

6. Growth performed well in FY2018/19. GDP growth increased to 7.1 percent in FY2018/19 (mid-July 2018 to mid-July 2019) from 6.7 percent in FY2017/18, reflecting a rebound in agriculture, earthquake reconstruction, and buoyant tourism. Higher food prices prompted a rise in headline inflation to 6.5 percent in December 2019, compared to 3.7 percent a year earlier.

7. The current account deficit has been narrowing in recent months, due in part to greater domestic production of electricity and cement. The current account deficit was 7.7 percent of GDP in FY2018/19, with remittances helping to finance the large trade deficit. During the first months of FY2019/20, the current account deficit narrowed considerably to an estimated 4.3 of GDP, thanks to lower imports of fuel and construction material, reflecting both slowing reconstruction activities and greater domestic electricity and cement production. Exports and FDI inflows remain weak as a share of GDP. Remittances have recently been sluggish because of weak economic performances in major remittance-sending economies. Gross official reserves were at US\$8.7 billion in December 2019, remaining adequate at 6.9 months of prospective imports. Nepal's external position in FY2018/19 is assessed as weaker than the level consistent with fundamentals and desirable policy settings (Annex I).²

8. Credit growth to the private sector has moderated but remains elevated as a share of GDP, raising concerns about risks to financial sector asset quality. Credit growth eased to 14.8 percent (y/y) in December 2019 compared to 25.4 percent (y/y) a year earlier, reflecting regulatory tightening and slowing deposit growth due to sluggish remittances. Nevertheless, credit rose rapidly in recent years to 84 percent of GDP in July 2019, among the highest in its peer group. Official data show that the non-performing loans ratio is at 1.4 percent and all banks are exceeding the regulatory capital adequacy ratio of 11 percent. However, there are risks to asset quality arising from evergreening practices and difficulty in evaluating consolidated exposure to borrowers.³

9. Fiscal policy has been less expansionary than implied by recent budgets due to under-execution of spending. For the past three fiscal years, budgets featured overall deficit projections of around 8 percent of GDP, incorporating reconstruction spending and higher transfers and revenue sharing with subnational governments. Nevertheless, capacity constraints at the federal and subnational levels led to considerable under-execution and backloading of spending, especially for capital projects, and therefore lower deficits (Text Figure 4). Data for the first months of this FY also show a similar trend of underspending. In FY2018/19, the central government deficit narrowed to 4.6 percent of GDP (from 6.7 percent of GDP in FY2017/18), resulting in a negative fiscal impulse. Public debt is around 30 percent of GDP, implying a low risk of debt distress.

10. Revenue collection in FY2018/19 was enhanced by upgrades to the tax system. Several recently enacted measures to improve tax administration and strengthen compliance helped support an increase in revenue collection to 24.8 percent of GDP, from 24.0 percent in FY2017/19.⁴ This gain was driven mainly by revenues relating to domestic activity, as import-related revenues remained flat as a share of GDP. Of note, the tax administration expanded its use of digitalization for payments and monitoring, and introduced a Permanent Account Number (PAN) system for tax

² The authorities informed staff about restrictions on exchange facilities for non-life insurance payments to India. Staff is seeking further information to conclude an assessment of these from an Article VIII perspective.

³ Evergreening was highlighted as a major issue in [Nepal Rastra Bank \(2019\)](#), Bank Supervision Report 2018, April 2019.

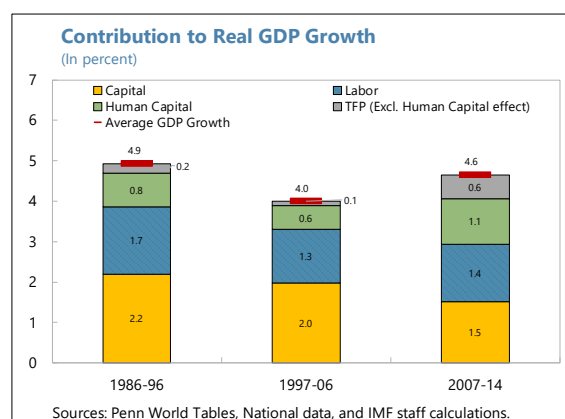
⁴ Recent major reforms to tax administration are outlined in Annex IV.

filings. In addition, reforms to customs valuation and adoption of risk-based clearance and an e-payment system will help control revenue leakages. These administrative measures also reduce the opportunities for corruption.

11. Importantly, the new Integrated Tax System (ITS) will facilitate more prudent risk assessment by banks and strengthen tax compliance. The ITS is a recently launched on-line portal that contains the financial information provided by corporations in their tax returns. Banks have been mandated by the central bank to cross-check borrower financial statements against the ITS when originating and renewing business loans.⁵ Anecdotally, discrepancies between financial information submitted for loan applications and tax purposes have not been uncommon.

12. In FY2019/20, external headwinds and domestic shocks will contribute to a moderation of growth to 6 percent, and a narrower current account deficit. The Nepali economy will be negatively affected by the slowdown in India through its extensive exposures in terms of trade and investment, as well as business sentiment. Sluggish remittances growth is also expected to negatively affect the economy. In addition, agricultural sector performance is projected to be weaker this year. Inflation is expected to average around 6 percent, driven by food prices. The current account deficit is forecast to narrow to 5.2 percent of GDP, with foreign exchange reserves stabilizing at US\$8.5 billion (6.6 months of prospective imports).

13. Over the medium-term, growth is expected to ease to 5.3 percent. Factors supporting above-average growth in recent years—including earthquake reconstruction, building of administrative infrastructure for subnational governments, and worker remittances from GCC countries linked to major infrastructure projects—are expected to wane. Growth prospects are supported by the expected expansion of hydropower and tourism—that would also support exports—and improved government service delivery in the context of fiscal federalism. Nonetheless, production capacity remains constrained by infrastructure gaps and inadequate levels of private investment, and thus a modest contribution of the capital stock to growth (chart). Staff analysis suggests that timely action to improve infrastructure level and quality would boost medium- to long-term growth (see Selected Issues, Chapter 2).⁶



14. Risks to the outlook are mainly on the downside (Annex II). A sharp increase in credit growth would renew pressure on the balance of payments and exacerbate financial sector risks. An abrupt slowdown in deposit growth, emanating from disruptions in remittances, could affect

⁵ Banks have also been mandated to require that borrowers provide a tax clearance certificate when applying for personal loans.

⁶ Annex VI takes stock of staff policy advice from 2017 and 2018.

liquidity and expose loan portfolio weaknesses. Greater government underspending than expected in the baseline poses a downside risk to growth. External risks pertain to a further economic slowdown in India or GCC countries, and higher international oil prices could increase the import bill. Nepal faces a substantial risk from natural disasters, and over the medium-term those relating to climate change (e.g. flooding and landslides) are expected to become more frequent and severe. On the upside, growth could be boosted if tourism activity accelerates, hydropower projects come on stream earlier, or government infrastructure projects are implemented more expeditiously.

Authorities' Views

15. Authorities have a more optimistic medium-term growth outlook than staff, emphasizing favorable export prospects and the role of fiscal federalism. The authorities underscored that strong growth is critical to their ambition of achieving middle-income-country status by 2030. They recognized external headwinds facing the economy this year. However, they expect growth rates above 8 percent over the medium-term, supported by an expansion of tourism—as international airports in Lumbini and Pokhara are completed and by attracting tourists from different countries—and greater hydropower that will allow for exports to India and Bangladesh. The strategy of bolstering exports would help Nepal maintain strong growth without exerting pressure on the balance of payments. The authorities also anticipate that full implementation of fiscal federalism will stimulate economic activity through better distribution of resources and more efficient delivery of services, supporting more balanced regional development.

POLICY DISCUSSIONS

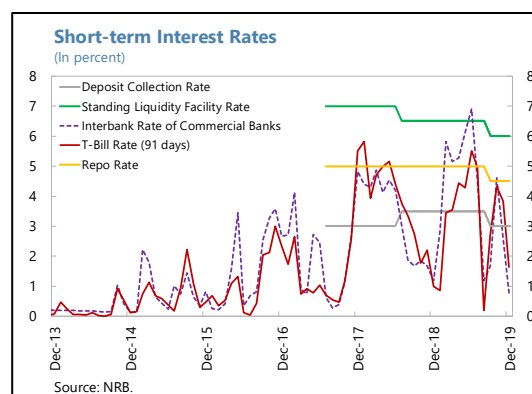
While the economy has been growing above its long-term average in the last few years, there are signs of moderation, underscored by a welcome narrowing of the current account deficit, stabilization of foreign reserves, and slower credit growth. The policy mix should be geared at containing external pressures and protecting financial stability, while preserving fiscal sustainability. This would be supported by a neutral fiscal stance, and careful management of the transition to fiscal federalism. Credit growth should be kept in check by maintaining macroprudential measures, while actions are taken to build the monetary policy framework and strengthen financial sector supervision. The authorities should nevertheless stand ready to tighten fiscal and macroprudential policies if balance of payments pressures reemerge or if credit growth increases sharply. Expanding Nepal's productive capacity calls for more private investment, including by promoting an enabling implementation environment that allows quality investment projects to move forward in a clear and timely manner.

A. Monetary and Exchange Rate Policy

16. Notwithstanding the exchange rate peg, capital controls imply that there is some limited scope for monetary policy to influence price stability. Nepal's exchange rate peg to the Indian rupee (1.6 Nepalese rupees per Indian rupee since 1994) provides a credible nominal anchor. At the same time, capital controls provide some limited room for monetary policy to influence domestic prices. Indeed, staff analysis showed that domestic factors play an important role in driving

non-food inflation.⁷ However, in the context of less developed financial markets and very weak pass-through from the policy rate to markets rates, macroprudential policies have proven to be more effective than the interest rate as a policy tool, by directly affecting the supply of credit.

17. The interest rate corridor (IRC) has not been effective in stabilizing short-term interest rates. Deficiencies in the IRC framework—including lack of a standing deposit facility—have resulted in highly volatile short-term rates that often fall below the IRC floor (Annex III).⁸ This has undermined the credibility of the IRC and there is no transmission of short-term rates to deposit and lending rates.



18. There are shortcomings in the autonomy and accountability of the Nepal Rastra Bank (NRB). Only three out of seven members of the Board are independent. The NRB Act obliges the NRB to follow government directives, and a proposed amendment would allow for dismissal of NRB senior officials if directives are not followed, further weakening the NRB's operational autonomy. Frequent rotation of management and staff undermines capacity building, disincentivizes ownership of key institution-building initiatives, and hampers the implementation of sound internal controls. In addition, the quality of the external audit falls short of international standards and progress on other priority recommendations from the 2018 safeguards monitoring visit has been slow (see Informational Annex).

Policy Recommendations

19. To strengthen the implementation of monetary policy, the NRB needs a well-functioning interest rate framework that reduces volatility in short-term interest rates. This would allow the NRB to improve financial market development as well as policy signaling and transmission. As a necessary first step, the NRB should introduce a standing deposit facility as a solid floor of the IRC, which would imply a tightening. It can then aim to anchor short-term market rates near the policy rate through regular open market operations. Once the IRC track-record has been firmly established, the NRB can adjust the rates as needed to support the peg and macroeconomic stability objectives. In the meantime, macroprudential policies should continue to be used as necessary, as discussed below, and it is crucial to continue to maintain an adequate level of reserves to preserve the credibility of the peg (Annex I).

20. Achieving the central bank's mandated price and financial stability objectives requires that operational autonomy go hand in hand with enhanced accountability. Modernizing the

⁷ See 2019 Selected Issues Paper.

⁸ Under the existing framework, liquidity is provided at the request of financial institutions under the standing liquidity facility. However, liquidity absorption through the deposit collection facility and open market operations are at the discretion of the NRB.

NRB governance framework calls for legal amendments to the NRB Act to strengthen independent oversight and safeguard institutional and personal autonomy. Internal controls and the quality of external audit should be enhanced.⁹ A prerequisite for success is supportive human resource management. The NRB would benefit from reducing the frequency of rotation of staff—particularly between unrelated business areas that require different skillsets and qualifications—to allow sufficient time for on-the-job training and building expertise, as well as ensuring that training better matches staff responsibilities.

Authorities' Views

21. The authorities agreed that there is scope to improve the functioning of the monetary policy operational framework. The authorities noted that the IRC framework has been developing gradually as the NRB gains more experience and financial institutions gain familiarity. The NRB is in the process of making the IRC more effective through more active open market operations. The authorities anticipate that the new human resource development plan, which is being finalized, will better support skills building and specialization.

B. Financial Sector Policies

22. The NRB has appropriately implemented macroprudential measures to limit the buildup of systemic risk in the financial sector. Alternative measures suggest that credit growth in 2018 exceeded prudent levels (Text table).

However, since late 2018, credit has moderated, as the credit-to-core capital and deposit (CCD) ratio became binding for most banks and the limit on personal overdraft loans was reduced.¹⁰ The recent requirement to cross-check borrowers' financial information against the ITS has also contributed to the moderation of credit growth. Furthermore, a 2 percent countercyclical capital buffer by July 2020 has been mandated and a debt service to income ratio for non-business loans was introduced.

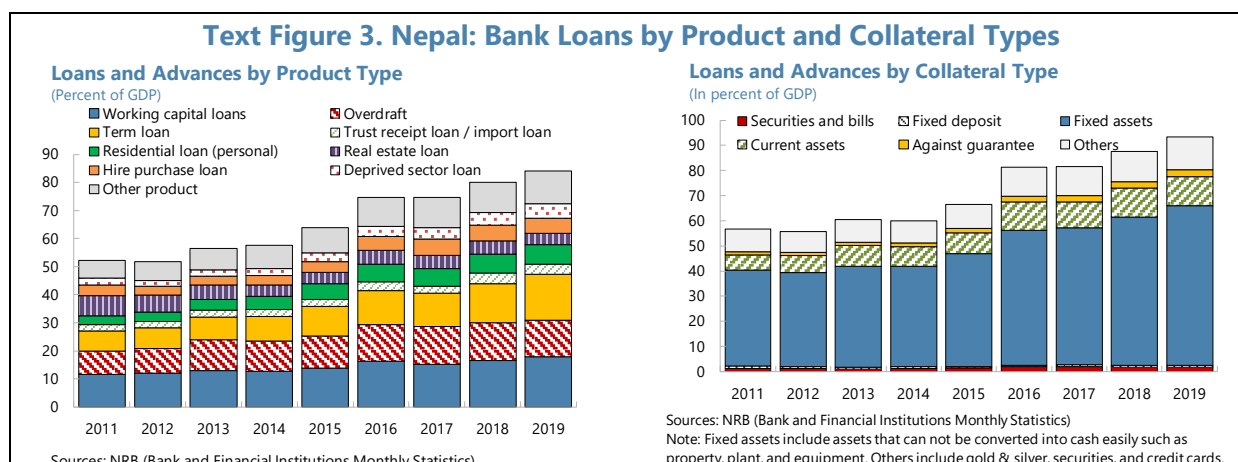
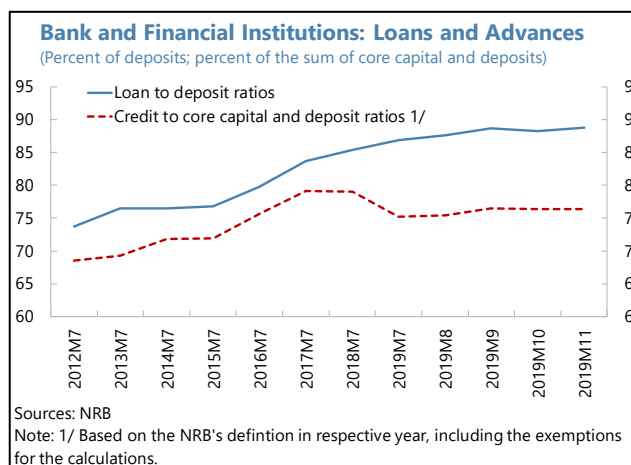
Nepal: Credit Boom Identification	
2018	Credit Boom
Nominal credit and GDP growth	Yes
Credit to GDP ratio increase more than 3 percent (GFSR, 2011)	Yes
BIS credit gap 1/	Yes
Gourinchas et al (2001)	No
Mendoza and Terrones (2008)	Yes
Dell'Ariccia et al (2012)	Yes
Source: Jahan and Sodsriwiboon (Forthcoming).	
1/ Red color presents positive credit gap from BIS credit gap approach, as the BIS credit gap does not have a specific criteria for credit boom.	

23. While official numbers suggest that the non-performing loan ratio is low, there are potentially significant risks to asset quality. A large share of the loan portfolio is revolving in nature, with about 40 percent consisting of overdraft and working capital loans. During on-site inspections, supervisors have uncovered evergreening where firms use revolving loans to make interest

⁹ These recommendations are in line with the IMF safeguards assessment (2011, 2016, 2018).

¹⁰ Under the CCD ratio ceiling, banks can provide loans only up to 80 percent of the sum of core capital and deposits. The NRB recently removed interbank borrowing from the CCD calculation, in line with Fund advice, effectively tightening the measure. In August 2018, NRB reduced the limit on personal overdraft loans to Rs.5 million from 7.5 million.

payments. In addition, lack of harmonized group codes across banks constrains their ability to accurately measure the repayment capacity and collateral adequacy of business groups on a consolidated basis. The lack of group codes also hinders the NRB’s ability to monitor concentration risk in the financial system. Finally, banks have significant real estate exposures, including through commercial loans collateralized by real estate properties (Text Figure 3). These different risks raise concerns that non-performing loans are understated, provisioning for loan losses is inadequate, and capital adequacy is overstated.



24. The authorities have made progress in strengthening regulation and supervision.

Several elements of the Basel III capital adequacy framework 2015 have been implemented for commercial banks.¹¹ The NRB has improved its risk-based on-site supervision, with Fund support. The Supervisory Information System (SIS) was launched in its pilot phase in January 2020, which should facilitate timely and reliable collection and analysis of supervisory data. Nonetheless, off-site supervision remains compliance rather than risk-based and frequent rotation of staff hinders capacity development.¹²

25. Financial inclusion is improving, including through fintech, though challenges remain.

The NRB is actively promoting financial inclusion by mandating an expansion of bank branches to all

¹¹ These include the Capital Conservation Buffer, Common Equity Capital, and Leverage Ratio.

¹² Annex V takes stock of 2014 FSAP recommendations.

753 localities. Improvements in infrastructure—such as access to more reliable electricity, mobile, and internet networks—have been conducive to fintech payments and greater usage of financial services by individuals (see Selected Issues, Chapter 3). The authorities have also taken measures to promote payments service providers. However, business informality continues to affect access to financing and use of digital services.

Policy Recommendations

26. Macprudential measures should continue to be strictly enforced to prevent excessive credit growth. The NRB should resist any relaxation of the CCD ratio and stand ready to tighten it if sharp credit growth resumes. Staff supports the requirement for banks to cross-check corporate borrowers' financial information against the ITS in assessing credit limits, which is expected to foster reliable reporting of financials. The activation of the counter cyclical buffer and introduction of debt-service-to-gross-income limits are welcome.

27. Asset quality of banks should be closely monitored and evergreening practices curtailed. To address risks related to revolving loans, the NRB should enforce the requirement that banks regularly review companies' financial statements and adjust credit limits accordingly. Access to financial information in the ITS should help. To better monitor risks related to real estate exposures, the housing price index being developed by the NRB should be finalized promptly.

28. Measures are needed to enhance monitoring of concentration risk within the financial sector. NRB should urge the bankers' association to develop a task force, possibly in cooperation with Credit Information Bureau, to harmonize the group codes used to identify the largest 50 business groups. Harmonized group codes should then be included in reporting through the SIS, to facilitate the NRB's analysis of top borrowers.

29. Further strengthening of risk-based off-site supervision is needed, supported by effective use of the new information system. This includes improved risk analysis by off-site supervisors of individual banks and the sector, facilitated by the SIS. The NRB should advance in the development of new processes and a new manual of off-site supervision.

30. Financial inclusion, particularly through fintech, can be further enhanced. Fintech payments should be encouraged for areas with geographical barriers where bank branches are not economically justified. Actions to enhance digital financial inclusion of businesses include reducing compliance burdens, increasing benefits of using formal services, and raising financial literacy. Policies and regulations should be tailored to support healthy development of the fintech sector.

Authorities' Views

31. The authorities broadly agreed with the need to maintain macroprudential measures and continue to closely monitor the quality of assets in the financial system. They underscored that the financial sector is sound and credit growth is healthy. The NRB intends to maintain recent regulatory measures, while closely monitoring their impact on credit developments. The authorities

will continue to strengthen financial sector oversight, supported by the SIS. The expanded coverage of the Credit Information Bureau and inclusion of the Permanent Account Number in SIS reporting is expected to facilitate monitoring of credit exposure. Payment and settlement systems have also been upgraded with the launch of Real Time Gross Settlement System in November 2019, addressing systemic settlement risks. On financial inclusion, the authorities plan to expand digital banking in remote areas, supplementing the expansion of bank branches to almost all localities.

C. Fiscal Policy

32. The FY2019/20 budget again targets an ambitious increase in both revenue and spending, but the effective stance will depend on implementation. As in prior years, the budgeted tax revenue increase appears overly optimistic compared to the measures described in the budget. Instead, staff projects that tax revenues will remain broadly flat as a share of GDP, as weaker-import related revenues would be offset with revenues derived from domestic activity, in line with outturns so far this FY. Government expenditure is budgeted to be 8 percentage points of GDP higher than last year's outcome. Full implementation of the budget would result in a central government deficit of 8.3 percent of GDP. Nevertheless, reflecting expenditure-implementation-related capacity constraints and a more modest view of revenue mobilization, staff projects a central government deficit of 4.5 percent of GDP (Text Figure 4).

33. Subnational governments face significant capacity constraints. SNG budget execution rates averaged only about 60 percent in FY2018/19 (Text Figure 4). Spending is likely to increase in FY2019/20, including because the legal framework for staff hiring is now in place. There is insufficient data on SNG operations, with the financial reporting system yet to be implemented.

Policy Recommendations

34. A neutral fiscal stance would help contain external and domestic pressures. The transition to a federal system reflects a national political compromise and entails a permanent shift up of expenditure to GDP. Nonetheless, total costs are uncertain. In this context, it is important for Nepal to limit overall deficits to levels that keep debt on a sustainable path. Moreover, for the near-term, keeping a neutral fiscal stance will avoid stoking domestic demand and balance of payments pressures. Staff's baseline forecast is consistent with this recommendation. Full execution of budgeted expenditure is unlikely due to capacity constraints and the government's intention to offset revenue shortfalls by curtailing expenditures vis-à-vis the budget.

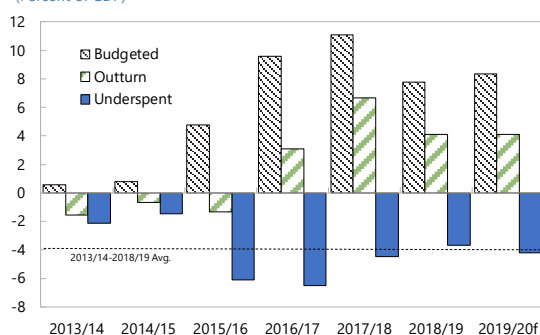
35. Budget formulation—at both central and sub-national government levels—should be anchored in a medium-term fiscal framework (MTFF) that is not overly ambitious. At all levels of government, a top-down budget process and MTFF based on revenue and expenditure assumptions that are not overly optimistic would instill greater prioritization of expenditure plans, prevent dilution of implementation capacity, and avoid creating an unrealistic resource expectations among SNGs (via transfers and revenue sharing). More conservative budgets would also enhance accountability and better support broader macroeconomic management, while helping to shed light on risks and vulnerabilities. In this regard, the central government could consider creating and empowering a macro-fiscal unit to support formulation of the MTFF and budget through macroeconomic and fiscal forecasting, including sensitivity analysis to alternative assumptions and policy scenarios.

36. Further actions are needed to strengthen the fiscal federalism framework. Ongoing technical work, with support from the World Bank, to assess the cost of responsibilities devolved to SNGs along with staffing needs is an important step in this regard. Nonetheless, to protect fiscal

Text Figure 4. Nepal: Implementation of Government Budget

Nepal: Central Government Fiscal Deficits

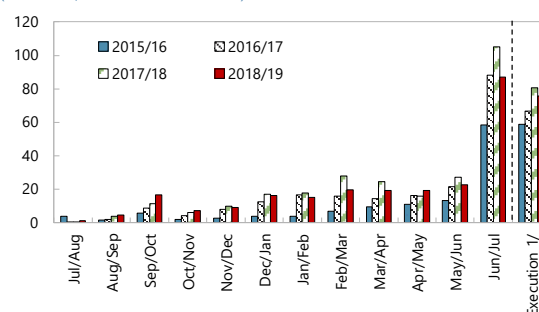
(Percent of GDP)



Sources: National authorities, and IMF staff calculations.

Nepal: Execution of Capital Expenditure, Central Government

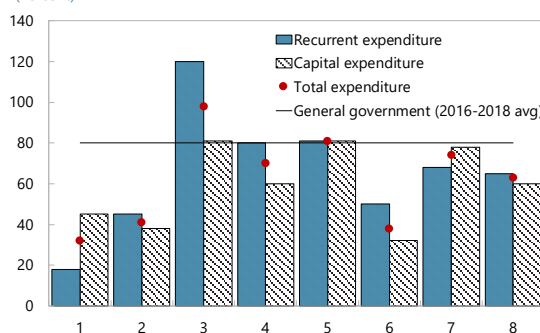
(NPR Billion, or otherwise as indicated)



Sources: National authorities, and IMF staff calculations.
1/ Annual execution rate of capital expenditure in percent.

Nepal: Estimated Budget Execution Rates of Provinces

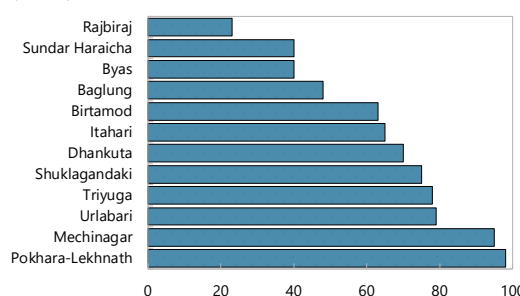
(Percent)



Sources: World Bank, South Asia Economic Focus Fall 2019.

Nepal: Execution of Capital Expenditure of Selected Local Governments

(Percent)



Source: World Bank, South Asia Economic Focus Fall 2019.

sustainability, the overall SNG expenditure envelope should be aligned with available funding and tight limits should be set on any subnational borrowing. A robust reporting and monitoring system

for SNGs is urgently needed. There also needs to be a clear delineation of roles and responsibilities across levels of government in terms of service delivery and investment-project management to ensure adequate implementation while avoiding duplication.

37. There remains a need to improve public financial management (PFM) and budget implementation across levels of government. Adequate government-service provision and sufficient levels of capital spending can only be achieved with a proper PFM architecture in place. In this regard, the recent enactment of the Financial Procedure and Fiscal Responsibility Act to strengthen internal audit practices, alongside recent PFM administration efforts by the Financial Comptroller General's Office, are important steps forward (Annex IV). However, further efforts are needed, including to strengthen the procurement process as discussed below. There is an ongoing need to train staff at the SNG level and ensure that adequate controls and accountability are in place.

Authorities' Views

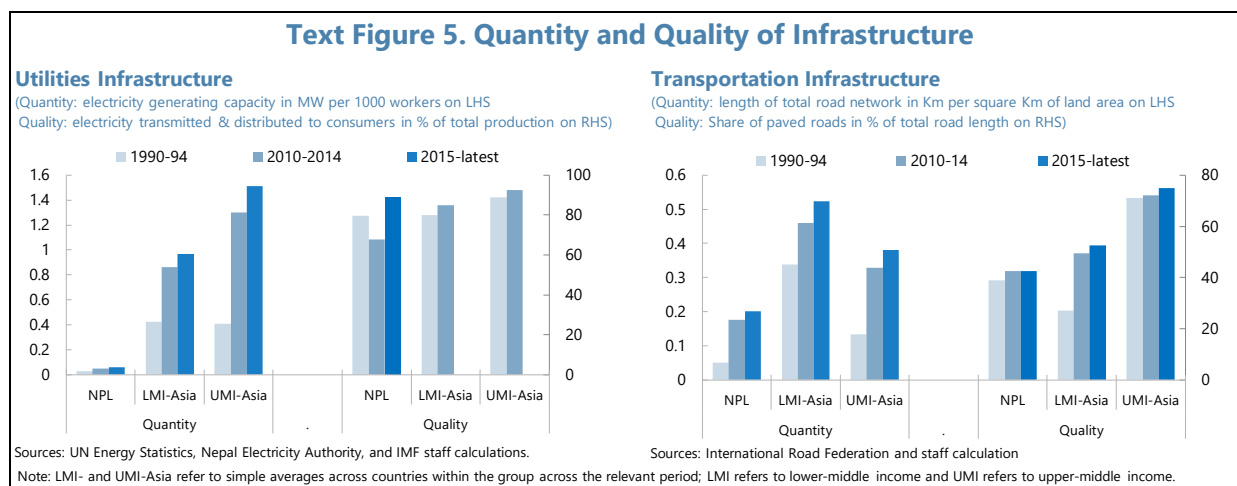
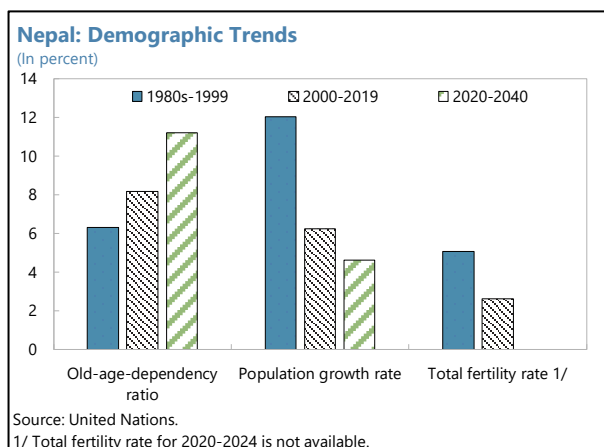
38. The authorities noted that the budget is used to articulate an ambitious policy agenda, while underscoring the importance of maintaining fiscal discipline. They view a central government deficit outcome of around 5 percent of GDP as prudent. The authorities acknowledged that import growth this fiscal year has been lower than expected, implying a likely underperformance of associated revenues, and indicated that expenditure will be closely managed to keep the deficit in check. Important progress has been made in establishing the legal framework for fiscal federalism and efforts are underway to examine any duplication of responsibilities and spending across levels of government. In addition, measures were implemented to strengthen capital-spending execution rates and smooth its annual profile, in particular the adoption of a project bank overseen by the National Planning Commission and an action room in the Prime Minister's office for monitoring progress on major projects.

D. Structural Reforms

39. Reform efforts in recent years have helped improve the investment climate. Greater political stability and electricity supply are key structural changes. In the 2020 World Bank Doing Business Report, Nepal's performance improved, though over a longer horizon the improvement has been more modest (see 2018 Article IV).¹³ The report highlighted improvements in the Integrated Check Post at the Nepal-India border that reduced the time and cost for cross-border trading and expanded coverage of the Credit Information Bureau that supports greater access to credit.

¹³ The Doing Business Report includes scores regarding numerous areas relating to conducting business in a country. Nepal's performance is particularly strong in the areas of obtaining credit and trading across borders, but is weak in the areas of contract enforcement, getting electricity, and ease of obtaining construction permits. Use of these indicators should be considered carefully, as they are derived from perceptions-based data.

40. Nonetheless, growth is constrained by insufficient infrastructure investment and anemic foreign direct investment (FDI). Nepal is in the midst of a demographic dividend, with its working-age population expected to continue growing strongly through about 2025 (chart). To better harness the demographic dividend, the private sector must play a larger role in driving economic activity and creating quality jobs. However, noteworthy impediments remain. There are important gaps in the size and quality of the infrastructure network (Text Figure 5, Selected Issues Chapter 2). The process for obtaining all necessary investment-project permits remains cumbersome, often spanning several ministries and involving long approval times, and in some cases a lack of clarity regarding jurisdiction (including between levels of government). In addition, perceptions-based indicators suggest corruption is a significant problem, and that weaknesses in the public procurement process contribute to project under-execution (see 2018 Article IV).



41. Efforts to increase compliance with global AML/CFT standards are ongoing, ahead of the 2020/21 review to assess compliance with the global AML/CFT standards, though a mutual evaluation (peer review) program by the Asia Pacific Group. Nepal's AML/CFT National Strategy and Action Plan was launched in August 2019, with numerous committees tasked with identifying gaps vis-à-vis the Financial Action Task Force prescribed standards. There has been some recent progress towards addressing the highest priority deficiencies, including regarding legislation to clarify penalties for financing of terrorism, though changes have not yet been passed into law.

42. Although Nepal’s contribution to global carbon emissions is miniscule, it is highly vulnerable to climate change.¹⁴ Owing in part to its heavy dependence on hydropower, Nepal contributed only 0.09 percent of global greenhouse gas emissions (2012). However, rising temperatures, changing weather patterns, and the higher frequency of severe storms brought on by climate change will increase flooding, landslides, and produce greater variation in meltwater flow which feeds hydropower dams. These effects will jeopardize the lives of those living in landslide- and flood-prone areas, as well as the livelihoods of those who rely on agriculture, which is heavily dependent on steady rainfall for irrigation.

Policy Recommendations

43. There has been some progress on legislative reforms to bolster foreign and private sector investment, but further actions are needed. Several provisions in the revised Foreign Investment and Technology Transfer Act (FITTA) and the new Public Private Partnership and Investment Act (PPPIA) go in the right direction. These include the establishment of a one-stop service center and a shortening of the approval timeline for projects. However, a very high investment threshold for foreign investors (500,000 USD) undermines efforts to attract FDI to promising small and medium-sized enterprises and should be reduced. A more streamlined approvals process as well as a clearer demarcation of responsibilities between levels of government under fiscal federalism is needed.

44. To boost foreign investment, new legislation and regulations need to be supported by an enabling implementation environment. Despite some progress on legislation, the investment situation on the ground appears to be little changed. Responsible ministries have not been equipped to adequately move projects forward, contributing to substantial uncertainty for potential private-sector and foreign investors. Improving implementation capacity requires adequate staffing, better skills matching, and aligning incentives across and within Ministries to ensure high-quality projects move forward in a clear and timely manner.

45. Further efforts to improve the public procurement process will also strengthen governance. Recent reforms to public procurement regulations—including a reduction in the up-front project mobilization grant size, more stringent scrutiny of bidding contractors’ capacity to deliver, and the introduction of a project pipeline—go in the right direction. However, the ultimate enforcement of these regulations, and project monitoring more generally, lies with the Public Procurement Monitoring Office (PPMO), which is understaffed. More resources should be devoted to the PPMO for hiring staff with expertise in procurement and contract monitoring. Ministries responsible for public construction contracts also need to be more active in tracking project execution, including by maintaining data on projects underway and past performance of contractors.

¹⁴ According to the Global Climate Risk Index—a widely used source for assessing climate risk—Nepal consistently ranks in the top 20 most vulnerable countries globally. The index ranks the climate risk indices of 181 countries every year, taking into account the number of deaths per 100,000 inhabitants attributable to climate-related shocks and the sum of (USD, PPP) property losses.

46. When formulating its medium-term economic framework, Nepal should factor in policies which support climate-change mitigation and adaptation. Nepal desires to be on a low-carbon development path. Its emphasis on hydropower as well as the e-mobility guidance—which incentivizes the purchase of electric vehicles through tax exemptions—are welcome steps regarding reducing its carbon footprint. As in most countries, there is a need to build fiscal space and reserve buffers to respond to consequences of extreme weather events, including those attributable to climate change. Adhering to disaster-proof building codes is also critical. Given the substantial resource needs associated with building fiscal buffers in a developing-country context, foreign-grant support must play a key role.

Authorities' Views

47. The authorities underscored their commitment to improving the investment climate in Nepal. Authorities underscored that efforts to attract FDI and boost private sector investment are being supported by amendments to FITTA and the new PPPI Act. In this regard, last year's Nepal Investment Summit generated many prospective project agreements and concrete spending commitments. Several transportation infrastructure (road, rail) projects are expected to get underway by the end of FY2019/20. In addition, ongoing efforts to improve tax administration and public financial management enhance transparency and governance.

E. Strengthening Statistics and Building Capacity

48. Statistics are generally adequate for surveillance, but there is room for improvement. The ongoing rebasing of national accounts to the new 2010/11 base year (from 2000/01) is a necessary step for SNA2008 compliance. The exercise is expected to result in changes in the composition of GDP, and less so in the GDP level given the scarcity of new information sources. Another GDP rebasing is advisable once new census and survey information is available. The forthcoming dissemination of BOP data according to the BPM6 framework and other improvements to data quality are expected to help reduce large errors and omissions.

49. Fund capacity development and surveillance have been closely integrated in Nepal, although efforts have had varying degrees of success. The Fund provides technical assistance and training from HQ, SARTTAC, and the Singapore Training Institute, as well as a MCM long-term financial sector expert based in Kathmandu. In support of the policy priorities in Nepal, capacity development priorities to be covered by the Fund continue to be: (i) financial sector supervision and regulation; (ii) monetary policy framework; (iii) fiscal federalism; (iv) public financial management; and (v) statistics issues on national accounts, government finance statistics, and the external sector. To improve capacity building, less frequent rotation of NRB staff is warranted and officials nominated for training should have job responsibilities aligned with the proposed course.

STAFF APPRAISAL

50. Growth is expected to moderate, helping to contain macroeconomic stability risks.

Nepal's recent strong growth performance has been supported by a stable political environment, a more reliable electricity supply, and post-earthquake reconstruction spending. For FY2019/20, growth is expected to ease to 6 percent including because of slower growth in India, sluggish remittance inflows, and weaker agricultural production. Inflation is expected at 6 percent due to high food inflation. In the context of moderating growth, there has been a welcome narrowing of the current account deficit and stabilization of gross official reserves. Credit growth has moderated from very high levels, though credit as a share of GDP remains elevated relative to peers. Nonetheless, downside risks remain, including renewed balance of payments pressures and increase in financial-sector risks if credit growth were to increase sharply or remittances slowdown abruptly. Nepal's external position in FY2018/19 is assessed as weaker than the level consistent with fundamentals and desirable policy settings.

51. Efforts to prevent excessive credit growth and contain financial-sector risks should continue.

The NRB has appropriately implemented macroprudential measures to limit the buildup of systemic risk in the financial sector. It has also taken actions to further strengthen bank supervision and regulation, including the introduction of a supervisory information system and implementation of selected elements of the Basel III capital framework. The recent regulatory requirement for banks to cross-check corporate borrowers' financial information against the ITS is expected to facilitate more prudent risk assessment by banks. Activation of the countercyclical capital buffer that will require banks to increase their level of capital by July 2020 is appropriate. The NRB should continue to closely monitor asset quality of banks and improve monitoring of concentration risk.

52. Fiscal policy should be geared towards containing external pressures and protecting fiscal sustainability.

In this regard, a fiscal deficit of 4.5 percent of GDP, similar to the outcome in FY2018/19, would be prudent. Recent upgrades to tax administration are commendable. Staff underscores that a top-down budget process and MTF based on conservative revenue and expenditure assumptions would instill greater prioritization and would avoid creating unrealistic revenue expectations among SNGs. While important steps have been taken to improve public financial management, further efforts are needed to ensure that spending is of high quality and executed in a timely manner.

53. The transition to fiscal federalism is a monumental challenge and needs to be carefully managed.

To protect fiscal sustainability, the overall expenditure envelope of SNGs needs to be aligned with available funding, with tight limits on any subnational borrowing. A robust reporting and monitoring system for SNGs is urgently needed. There also needs to be a clear delineation of roles and responsibilities across levels of government to ensure adequate delivery of services and investments.

54. Strengthening the implementation of monetary policy requires a well-functioning interest rate framework that reduces volatility in short-term interest rates. Less short-term interest rate volatility would support financial market development and improve policy signaling and transmission. Staff emphasizes the need to introduce a standing deposit facility as a first step towards establishing a reliable implementation track record for the interest rate corridor.

55. Achieving the central bank's mandated price and financial stability objectives calls for modernizing the NRB governance framework to improve its autonomy and accountability, Reforms are needed to strengthen independent oversight, safeguard institutional and personal autonomy, and enhance internal controls and quality of external audit, all underpinned by supportive human resource management.

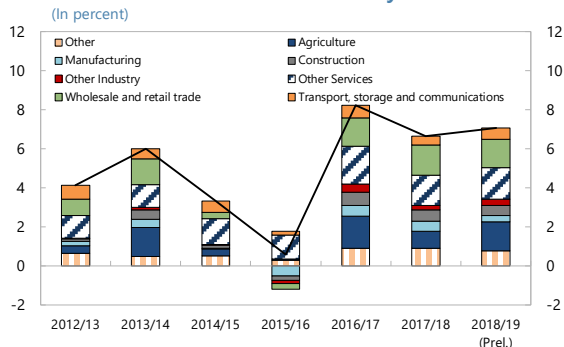
56. To boost growth prospects, structural reforms that encourage high-quality investment projects, in particular FDI, are critical. As post-earthquake reconstruction spending draws to a close in coming years, maintaining the recent growth momentum will require an enabling implementation environment for infrastructure projects and FDI. To ensure that high-quality projects move forward in a clear and timely manner, staff encourages authorities to focus on adequate staffing, better skills matching, and aligning incentives across and within government ministries responsible for project approvals, implementation, and subsequent monitoring.

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

Figure 1: Nepal Recent Macro-Economic Developments

Growth remained strong in FY2018/19 supported by the pick-up in the agriculture sector, while the service sector remains a key driver for growth.

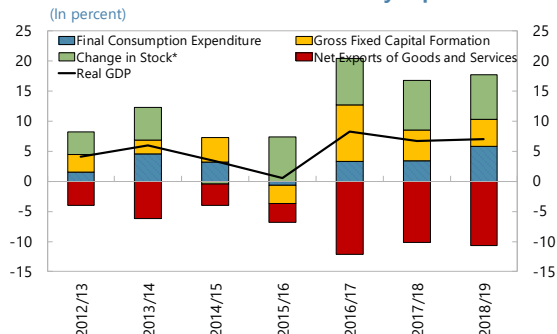
Contribution to Real GDP Growth by Sector



Sources: Nepal Central Bureau of Statistics, and IMF staff calculations.

On the expenditure side, growth was supported by stronger consumption expenditure.

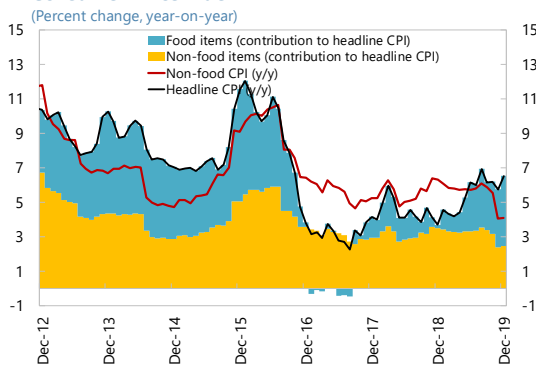
Contribution to Real GDP Growth by Expenditure



Sources: Nepali Authorities, and IMF staff calculations. *Includes Statistical discrepancy

Headline inflation was to 6.5 percent (y/y) in December.

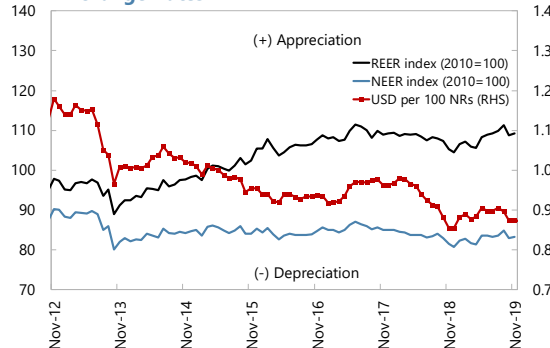
Consumer Price Index



Sources: Nepali authorities; and IMF staff estimates.

The REER appreciated by 3.3 percent in Nov. 2019 (y/y).

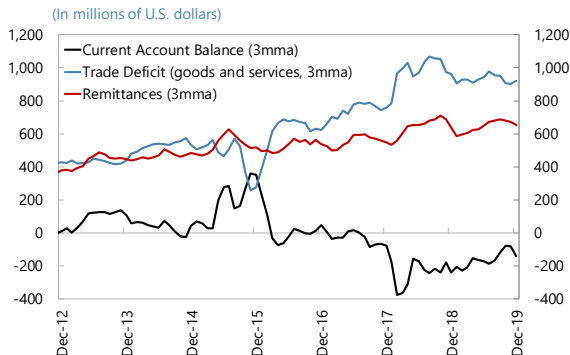
Exchange Rates



Sources: Nepali authorities; and IMF staff estimates.

The current account deficit has narrowed in recent months, due in part to lower imports of fuel and construction material.

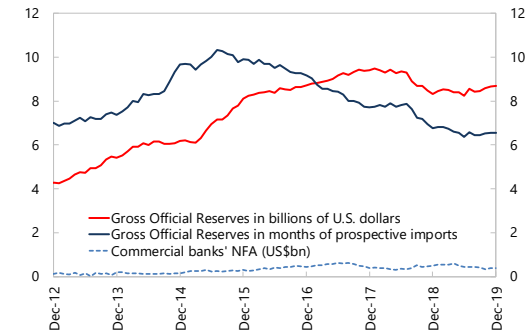
Current Account Balance



Source: Nepali authorities.

Gross official reserves have stabilized at around US\$8.7 billion, covering about 6.9 months of prospective imports of goods and services.

Central Bank Gross Official Reserves & Commercial Banks NFA



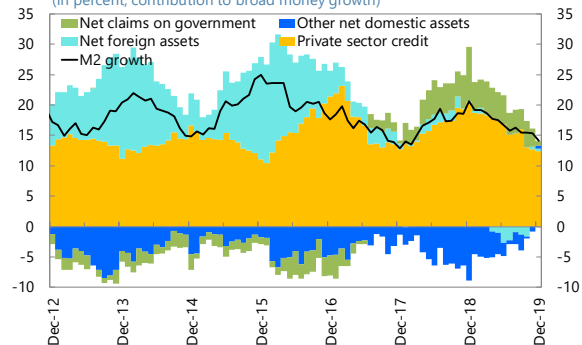
Sources: Nepali authorities; and IMF staff estimates.

Figure 2. Nepal: Monetary Sector Developments

Broad money expanded by 14.1 percent (y/y) in December, driven mostly by private sector credit growth.

Broad Money Growth

(In percent, contribution to broad money growth)

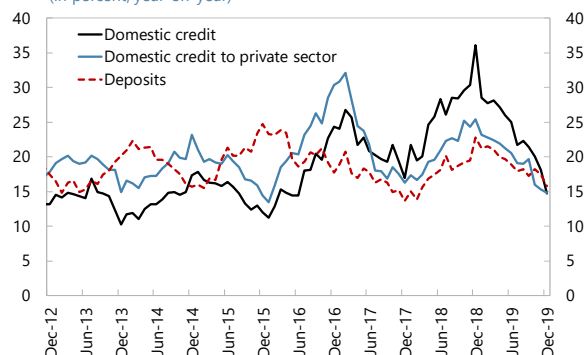


Sources: Nepali authorities; and IMF staff estimates.

Private sector credit growth slowed to 14.8 percent in December (y/y).

Deposits and Credit Growth

(In percent, year-on-year)

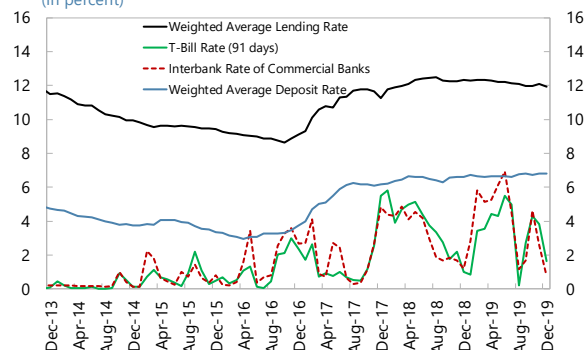


Sources: NRB and IMF staff calculations.

Short-term interest rates showed large volatility in FY2018/19, while deposit and lending rates remained stable.

Interest Rates

(In percent)

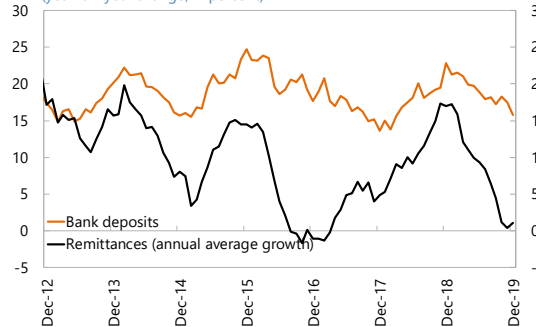


Source: NRB.

Deposit growth was 15.7 percent (y/y) in December.

Bank Deposits and Remittances

(year-on-year change, in percent)

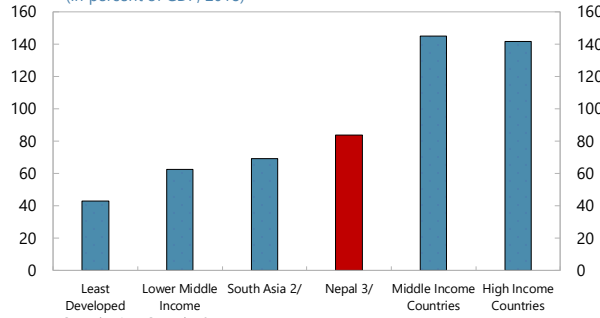


Sources: Nepali Authorities, IMF staff calculations.

The credit-to-GDP ratio in Nepal is among the highest in its peer group.

Domestic Credit Provided by Financial Sector

(In percent of GDP, 2018)



Source: World Bank, World Development Indicators, and Nepal Rastra Bank (NRB).

1/ UN Classification.

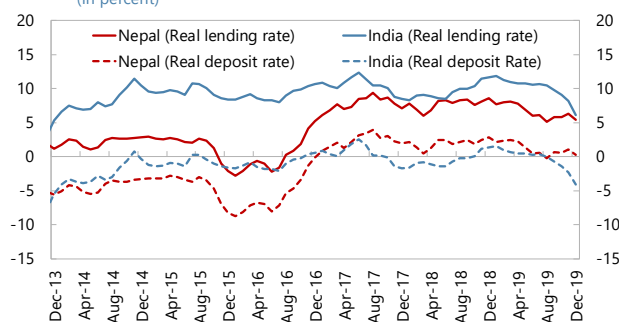
2/ As of 2017

3/ Nepal data as of July-2019, from the NRB.

The deposit interest rate is near zero in real terms.

Real Interest Rates 1/

(In percent)

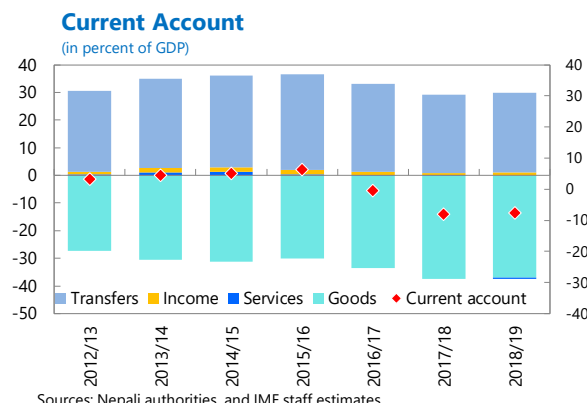


Sources: NRB, CEIC, Haver Analytics, and IMF staff calculations.

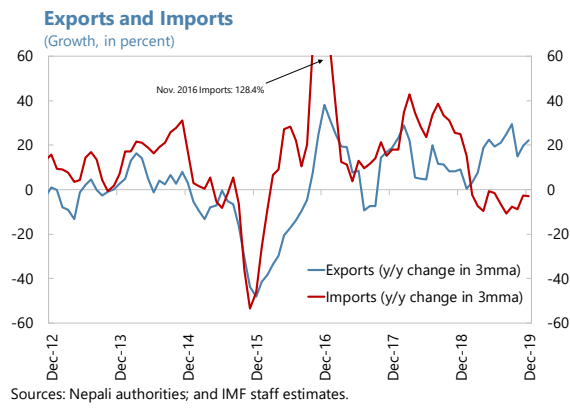
1/ Real rates are calculated by subtracting contemporaneous inflation from the nominal rates.

Figure 3. Nepal: External Sector Developments

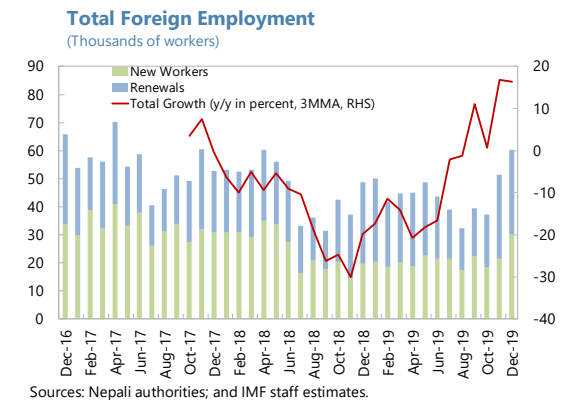
The current account deficit was about 8 percent of GDP for the last two consecutive years...



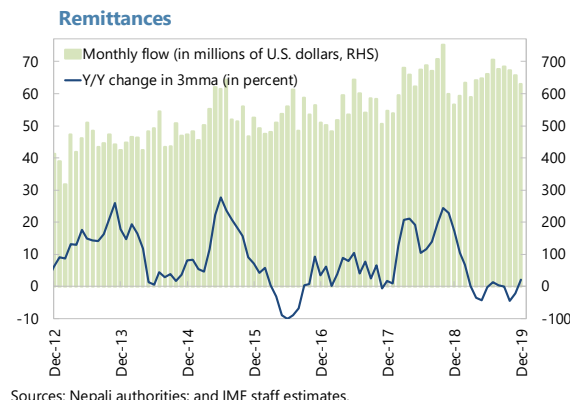
...but the trade balance has been improving recently as import growth has declined.



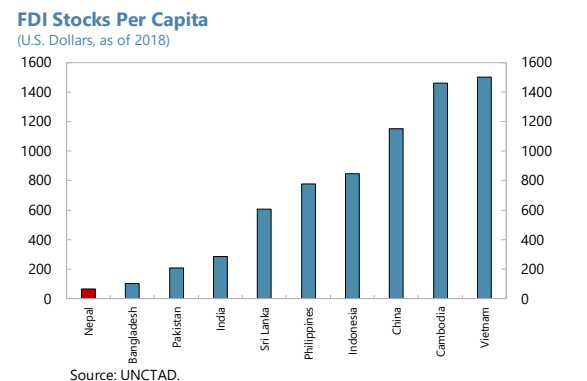
The total number of foreign workers (new and renewals) grew by 16.4 percent in December (y/y, 3mma)...



... while the growth of remittances has slowed in recent months..



Attracting FDI flows has been a struggle.



Exports contribute little to GDP, and their role has been decreasing over time.

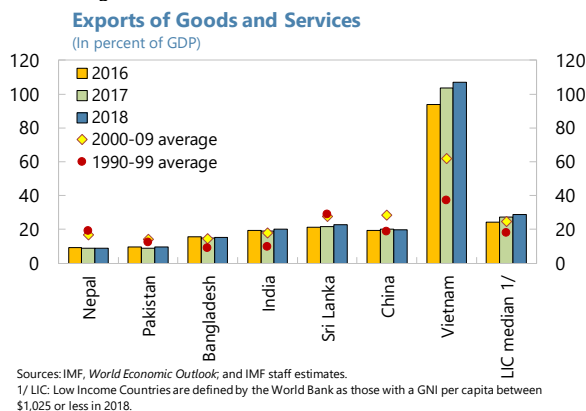
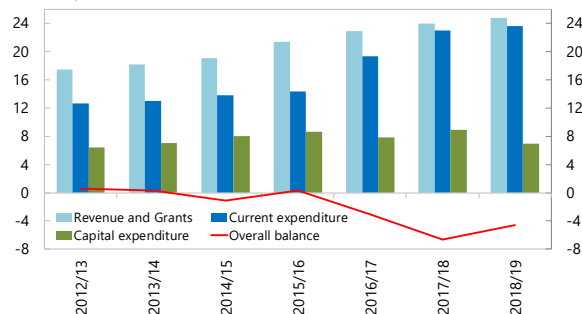


Figure 4. Nepal: Recent Fiscal Developments

In FY2018/19, the fiscal deficit was 4.6 percent of GDP compared to 6.7 percent of GDP in FY2017/18.

Public debt remained flat at 30 percent of GDP in 2018/19.

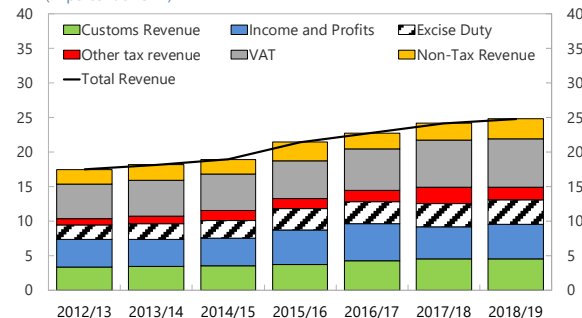
Central Government Fiscal Performance
(In percent of GDP)



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

In FY2018/19, the chief source of revenue was VAT (7.0 percent of GDP), followed by income tax revenue and customs.

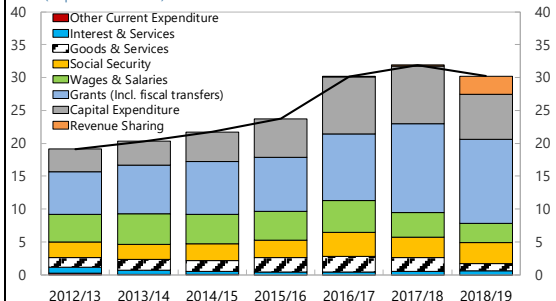
Central Government Fiscal Revenues (Excl. Grants)
(In percent of GDP)



Sources: Nepali Authorities, and IMF staff estimates.

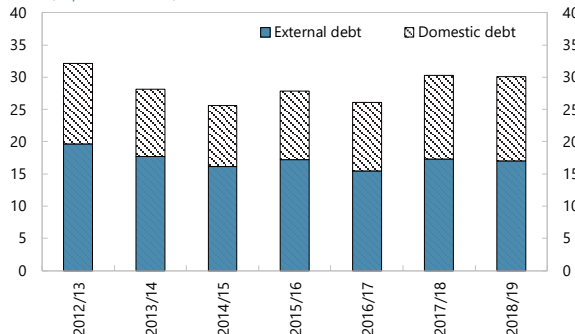
Expenditure grants were the biggest component of spending in FY2018/19, followed by capital expenditure.

Central Government Fiscal Expenditure
(In percent of GDP)



Sources: Nepali Authorities, and IMF staff estimates.

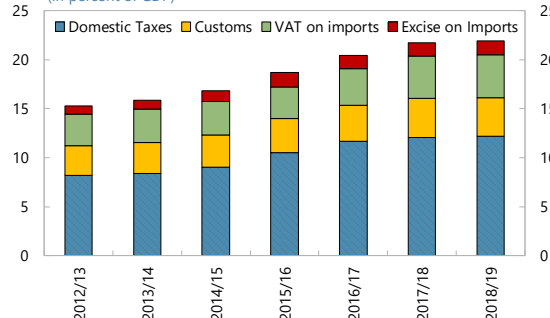
Public Debt
(In percent of GDP)



Sources: Nepali authorities, and IMF staff estimates.

Tax collections relating to imports comprise nearly half of total tax revenues.

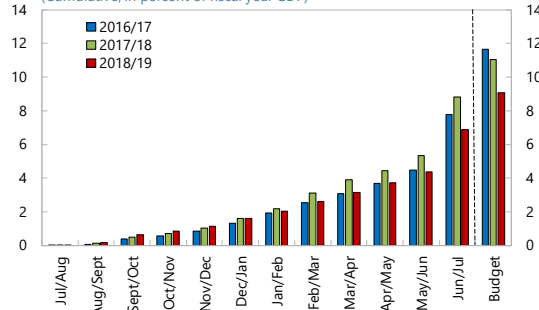
Central Government Tax Revenue by Source
(In percent of GDP)



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

Capital expenditure was 7 percent of GDP in 2018/19

Central Government Capital Expenditure
(Cumulative, in percent of fiscal year GDP)



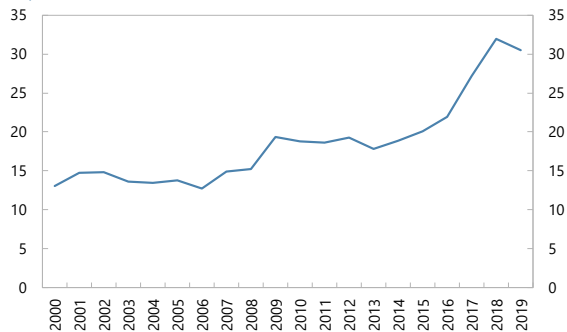
Sources: Nepali Authorities and IMF staff calculations

Figure 5. Nepal: Cross Country Fiscal Performance

Government expenditure has risen, in the context of the transition to fiscal federalism.

Nepal: General Government Total Expenditure

(In percent of GDP)

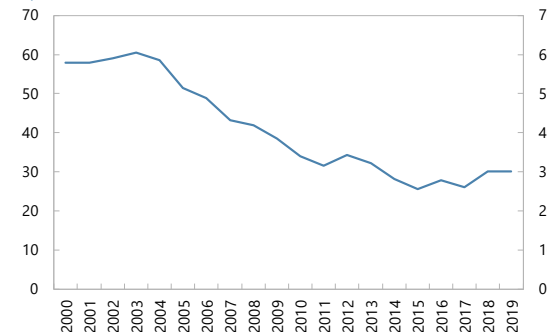


Source: IMF, World Economic Outlook.

Nepal's stock of public debt remains modest, at 30 percent of GDP.

Nepal: General Government Gross Debt

(In percent of GDP)

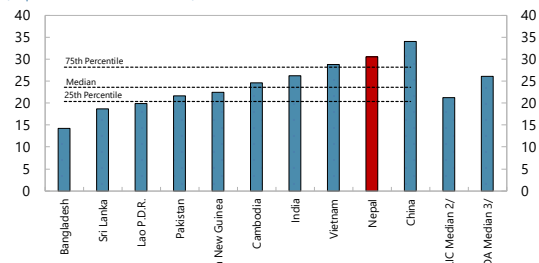


Source: IMF, World Economic Outlook.

Relative to peer countries, Nepal's public expenditure is high.

General Government Total Expenditure 1/

(In percent of GDP, as of 2018)



Sources: IMF, World Economic Outlook, and staff calculations.

1/ For Nepal, data is as of FY 2018/19.

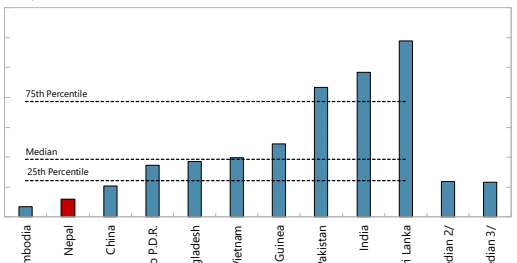
2/ LIC: Low Income Countries are defined by the World Bank as those with a GNI per capita between \$1,025 or less in 2018.

3/ IDA: 76 low income countries that are eligible to borrow from the International Development Association (IDA).

Thanks to its low stock of debt and relatively low interest rates, Nepal's interest expense is modest.

General Government Interest Expense 1/

(In percent of GDP, as of 2018)



Sources: IMF, World Economic Outlook, and staff calculations.

1/ For Nepal, data is as of FY 2018/19.

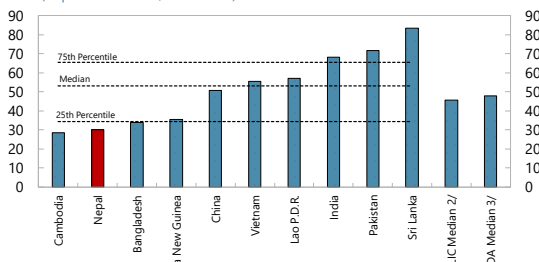
2/ LIC: Low Income Countries are defined by the World Bank as those with a GNI per capita between \$1,025 or less in 2018.

3/ IDA: 76 low income countries that are eligible to borrow from the International Development Association (IDA).

Gross debt is considerably lower than in peer countries, and Nepal remains at low risk of debt distress (see also Debt Sustainability Analysis).

General Government Gross Debt 1/

(In percent of GDP, as of 2018)



Sources: IMF, World Economic Outlook, and staff calculations.

1/ For Nepal, data is as of FY 2018/19.

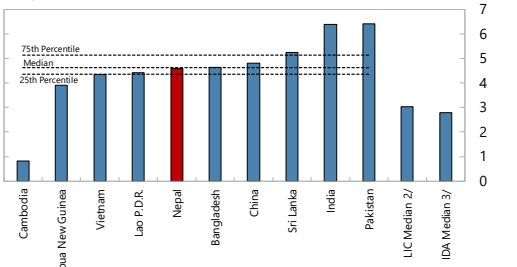
2/ LIC: Low Income Countries are defined by the World Bank as those with a GNI per capita between \$1,025 or less in 2018.

3/ IDA: 76 low income countries that are eligible to borrow from the International Development Association (IDA).

Nepal's fiscal deficit is comparable to that in peer countries.

General Government Fiscal Deficit 1/

(In percent of GDP)



Sources: IMF, World Economic Outlook, and staff calculations.

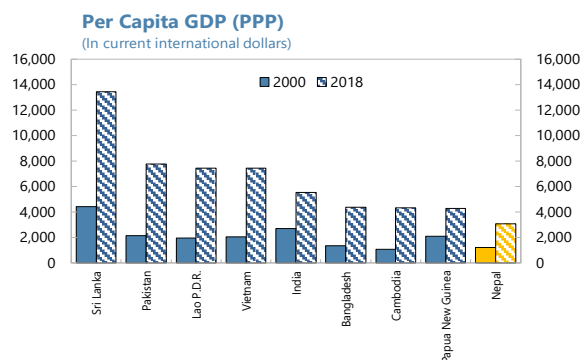
1/ For Nepal, data is as of FY 2018/19.

2/ LIC: Low Income Countries are defined by the World Bank as those with a GNI per capita between \$1,025 or less in 2018.

3/ IDA: 76 low income countries that are eligible to borrow from the International Development Association (IDA).

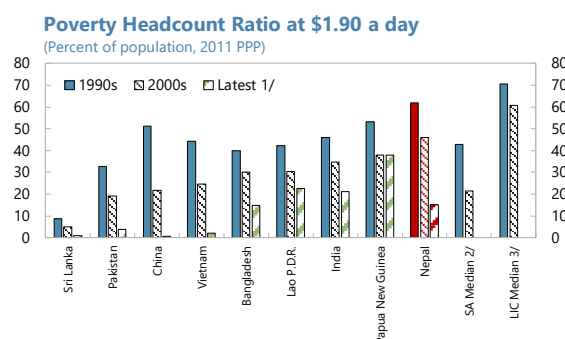
Figure 6. Nepal: Socio-Economic Indicators

Nepal is among the lowest income countries in South Asia.



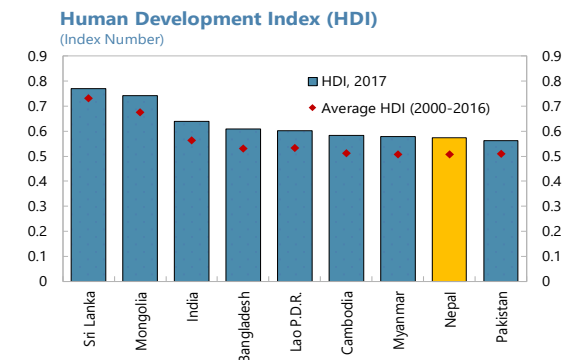
Source: World Bank, World Development Indicators.

Poverty has fallen significantly in the last decade.



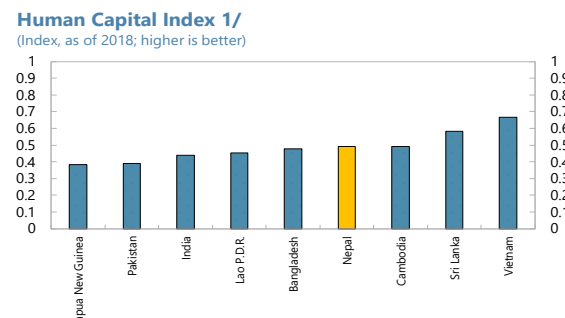
Sources: World Bank, World Development Indicators, and IMF staff calculations.
 1/ Sri Lanka, Vietnam, Bangladesh (2016); Pakistan, China (2015); Lao P.D.R. (2012); Nepal (2010); Papua New Guinea (2009).
 2/ South Asia (SA) includes India, Nepal, Bhutan, Bangladesh, Maldives and Sri Lanka.
 3/ LIC: Low Income Countries are defined by the World Bank as those with a GNI per capita between \$1,025 or less in 2018.

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



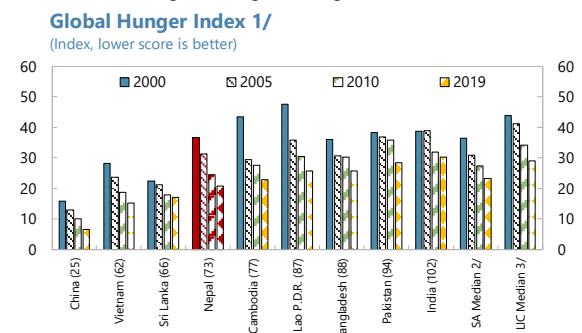
Sources: UNDP, and IMF staff calculations.

Expected human capital development is somewhat hampered by incomplete education and health factors.



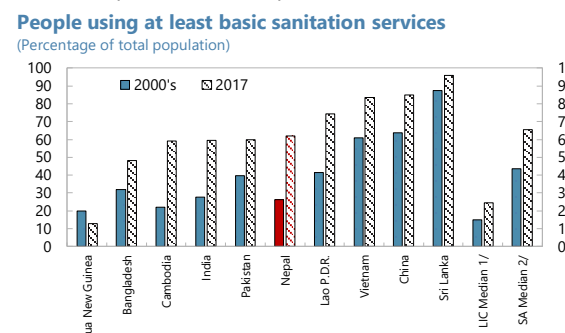
Source: The World Bank, Human Capital Project.
 1/ Measures the human capital that a child born today can expect to attain by her 18th birthday, given the risks of poor health and poor education in the country where she lives. Units represent productivity relative to a benchmark of complete education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

There is substantial scope and need to improve poverty metrics, including relating to hunger



Sources: Global Hunger Index, and IMF staff calculations.
 1/ The Global Hunger Index is a multidimensional indicator that captures undernourishment, child wasting, child stunting, and child mortality. Number in parenthesis represents the country's 2019 rank out of 117 countries.
 2/ South Asia (SA) includes only India, Nepal, Bangladesh and Sri Lanka.
 3/ LIC: Low Income Countries are defined by the World Bank as those with a GNI per capita between \$1,025 or less in 2018.

Substantial gains have been made in sanitation, though there is scope for further improvement



Sources: World Bank, World Development Indicators, and IMF staff calculations.
 1/ LIC: Low Income Countries are defined by the World Bank as those with a GNI per capita between \$1,025 or less in 2018.
 2/ South Asia (SA) includes India, Nepal, Bhutan, Bangladesh, Maldives and Sri Lanka.

Table 1. Nepal: Selected Social and Economic Indicators, 2016/17–2024/25¹

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
				Est.	Projections				
Output and prices (annual percent change)									
Real GDP	8.2	6.7	7.1	6.0	5.7	5.5	5.4	5.3	5.3
Headline CPI (period average)	4.5	4.1	4.6	6.0	5.9	5.8	5.6	5.3	5.3
Headline CPI (end of period)	2.7	4.6	6.0	5.9	5.8	5.7	5.5	5.3	5.3
Fiscal Indicators: Central Government (in percent of GDP)									
Total revenue and grants	24.1	25.3	26.0	25.8	26.0	25.8	25.5	25.6	25.5
of which: Tax revenue	20.7	21.1	21.9	21.9	21.8	21.6	21.4	21.3	21.4
Expenditure	27.2	31.9	30.6	30.4	30.4	30.0	29.7	29.4	29.3
Expenses	19.4	23.0	23.6	23.1	23.1	22.9	22.7	22.7	22.8
Net acquisition of nonfinancial assets	7.8	8.9	7.0	7.3	7.3	7.1	7.0	6.7	6.5
Operating balance	4.7	2.3	2.4	2.8	2.9	2.9	2.9	2.8	2.8
Net lending/borrowing	-3.1	-6.7	-4.6	-4.5	-4.4	-4.2	-4.1	-3.9	-3.7
Statistical discrepancy	-1.3	-3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	1.8	3.6	4.6	4.5	4.4	4.2	4.1	3.9	3.7
Net acquisition of financial assets	1.4	-0.7	1.7	1.6	0.9	0.9	0.9	0.9	0.9
Net incurrence of liabilities	3.2	2.9	6.3	6.1	5.3	5.0	5.0	4.8	4.6
Foreign	1.3	2.4	2.1	2.4	1.9	1.6	1.6	1.5	1.3
Domestic	1.9	0.4	4.2	3.7	3.4	3.4	3.4	3.3	3.3
Money and credit (annual percent change)									
Broad money	15.5	19.4	15.8	13.2	11.9	11.6	11.1	10.9	10.7
Domestic credit	20.2	26.1	21.7	17.6	15.7	14.3	13.8	13.3	13.1
Private sector credit	18.0	22.3	19.1	15.0	13.8	12.5	12.2	12.0	12.0
Saving and Investment (in percent of nominal GDP)									
Gross investment	45.2	55.2	62.3	54.6	53.4	52.4	51.5	50.6	49.8
Private	23.6	25.8	30.0	25.1	24.4	24.0	23.5	23.3	23.0
Central government	7.8	8.9	7.0	7.3	7.3	7.1	7.0	6.7	6.5
Change in Stock	13.8	20.5	25.3	22.2	21.7	21.3	21.0	20.6	20.2
Gross national saving	44.8	47.1	54.6	49.4	48.5	47.6	46.8	46.0	45.3
Private	41.3	46.1	53.3	47.8	47.0	46.1	45.3	44.6	44.0
Central government	3.5	1.0	1.2	1.6	1.5	1.5	1.4	1.4	1.4
Balance of Payments									
Current account (in millions of U.S. dollars)	-93	-2,350	-2,369	-1,760	-1,832	-1,963	-2,104	-2,215	-2,323
In percent of GDP	-0.4	-8.1	-7.7	-5.2	-4.9	-4.8	-4.7	-4.6	-4.4
Trade balance (in millions of U.S. dollars)	-8,446	-10,849	-11,373	-11,658	-12,379	-13,140	-13,956	-14,770	-15,643
In percent of GDP	-33.5	-37.4	-37.1	-34.2	-33.1	-32.2	-31.4	-30.5	-29.6
Exports of goods (y/y percent change)	9.9	15.5	12.1	1.4	9.9	9.9	9.9	9.9	9.9
Imports of goods (y/y percent change)	30.0	27.4	5.4	2.4	6.5	6.5	6.5	6.2	6.3
Workers' remittances (in millions of U.S. dollars)	6,556	7,224	7,769	8,402	8,825	9,270	9,737	10,227	10,742
In percent of GDP	26.0	24.9	25.3	24.7	23.6	22.7	21.9	21.1	20.3
Gross official reserves (in millions of U.S. dollars)	9,264	9,304	8,545	8,536	8,419	8,233	8,045	7,850	7,673
In months of prospective imports	8.3	7.9	7.0	6.6	6.1	5.5	5.1	4.7	4.3
Memorandum items									
Public debt (in percent of GDP)	26.1	30.2	30.1	33.7	35.7	37.4	39.0	40.3	41.1
Nominal GDP (in billions of U.S. dollars)	25.2	29.0	30.7	34.1	37.4	40.8	44.5	48.4	52.9
Nominal GDP (in billions of Nepalese Rupees)	2,674	3,031	3,464	3,892	4,354	4,860	5,406	5,997	6,687
Private Sector Credit (in percent of GDP)	74.7	80.6	84.0	86.0	87.5	88.2	88.9	89.8	90.2
Exchange rate (NPR/US\$; period average)	106.2	104.4	112.9	...	...	...	...	...	...
Real effective exchange rate (average, y/y percent change)	3.6	0.2	-1.4	...	...	...	...	...	...

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

¹/Fiscal year ends mid-July.

Table 2. Nepal: Balance of Payments, 2016/17–2024/25¹

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	
			Est.			Projections				
	(in millions of US dollars)									
Current account	-93	-2,350	-2,369	-1,760	-1,832	-1,963	-2,104	-2,215	-2,323	
Current account (excluding official transfers)	-935	-2,633	-2,667	-2,119	-2,281	-2,453	-2,638	-2,795	-2,957	
Trade balance	-8,446	-10,849	-11,373	-11,658	-12,379	-13,140	-13,956	-14,770	-15,643	
Exports, f.o.b.	774	894	1,002	1,016	1,117	1,228	1,350	1,484	1,632	
Imports, f.o.b.	-9,219	-11,743	-12,375	-12,675	-13,496	-14,368	-15,306	-16,254	-17,274	
Services (net)	26	18	-147	-118	-104	-88	-59	-35	-5	
Receipts	1,492	1,697	1,654	1,844	2,034	2,234	2,459	2,688	2,954	
Of which: tourism	552	643	651	729	811	899	992	1,093	1,211	
Payments	-1,466	-1,680	-1,801	-1,962	-2,138	-2,322	-2,518	-2,723	-2,959	
Income	294	210	358	398	436	476	519	564	617	
Credit	490	660	708	786	862	942	1,026	1,116	1,219	
Debit	-196	-450	-350	-389	-426	-466	-507	-552	-603	
Current transfers	8,032	8,271	8,793	9,619	10,215	10,789	11,392	12,026	12,709	
Credit, of which:	8,069	8,327	8,889	9,669	10,270	10,849	11,457	12,097	12,786	
General government	841	283	298	359	449	490	534	580	634	
Workers' remittances	6,556	7,224	7,769	8,402	8,825	9,270	9,737	10,227	10,742	
Debit	-37	-56	-96	-50	-55	-60	-65	-71	-78	
Financial account	255	1,344	689	1,584	1,533	1,580	1,705	1,791	1,899	
Direct investment	127	169	115	163	179	195	213	255	306	
Portfolio investment	0	0	0	0	0	0	0	0	0	
Other investment (net)	128	1,175	573	1,421	1,354	1,385	1,492	1,536	1,594	
Of which: Trade credit	144	556	427	445	478	514	553	593	637	
Official loans	426	764	546	802	684	662	711	695	686	
Errors and omissions	316	1,086	839	0	0	0	0	0	0	
Overall balance	603	249	-704	-5	-107	-176	-177	-186	-166	
	(in percent of GDP)									
Current account	-0.4	-8.1	-7.7	-5.2	-4.9	-4.8	-4.7	-4.6	-4.4	
Current account (excluding official transfers)	-3.7	-9.1	-8.7	-6.2	-6.1	-6.0	-5.9	-5.8	-5.6	
Trade balance	-33.5	-37.4	-37.1	-34.2	-33.1	-32.2	-31.4	-30.5	-29.6	
Exports, f.o.b.	3.1	3.1	3.3	3.0	3.0	3.0	3.0	3.1	3.1	
Imports, f.o.b.	-36.6	-40.4	-40.3	-37.2	-36.1	-35.2	-34.4	-33.6	-32.7	
Services (net)	0.1	0.1	-0.5	-0.3	-0.3	-0.2	-0.1	-0.1	0.0	
Receipts	5.9	5.8	5.4	5.4	5.4	5.5	5.5	5.6	5.6	
Of which: tourism	2.2	2.2	2.1	2.1	2.2	2.2	2.2	2.3	2.3	
Payments	-5.8	-5.8	-5.9	-5.8	-5.7	-5.7	-5.7	-5.6	-5.6	
Income	1.2	0.7	1.2	1.2	1.2	1.2	1.2	1.2	1.2	
Credit	1.9	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	
Debit	-0.8	-1.5	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	
Current transfers										
Credit, of which:	32.0	28.7	29.0	28.4	27.5	26.6	25.7	25.0	24.2	
General government	3.3	1.0	1.0	1.1	1.2	1.2	1.2	1.2	1.2	
Workers' remittances	26.0	24.9	25.3	24.7	23.6	22.7	21.9	21.1	20.3	
Debit	-0.1	-0.2	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	
Financial account	1.0	4.6	2.2	4.6	4.1	3.9	3.8	3.7	3.6	
Direct investment	0.5	0.6	0.4	0.5	0.5	0.5	0.5	0.5	0.6	
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other investment (net)	0.5	4.0	1.9	4.2	3.6	3.4	3.4	3.2	3.0	
Of which: Trade credit	0.6	1.9	1.4	1.3	1.3	1.3	1.2	1.2	1.2	
Official loans	1.7	2.6	1.8	2.4	1.8	1.6	1.6	1.4	1.3	
Errors and omissions	1.3	3.7	2.7	0.0	0.0	0.0	0.0	0.0	0.0	
Overall balance	2.4	0.9	-2.3	0.0	-0.3	-0.4	-0.4	-0.4	-0.3	
Memorandum items										
Imports (y/y percent change)	30.0	27.4	5.4	2.4	6.5	6.5	6.5	6.2	6.3	
of which Oil imports (y/y percent change)	9.0	8.9	8.7	8.4	8.4	8.5	8.6	8.6	8.7	
Exports of G&S (in percent of GDP)	42.4	46.2	46.2	42.9	41.8	40.9	40.1	39.2	38.3	
Imports of G&S (in percent of GDP)										
Remittances (y/y percent change)	4.8	10.2	7.6	8.1	5.0	5.0	5.0	5.0	5.0	
Total external debt (in percent of GDP)	15.5	17.3	17.0	18.3	18.6	18.7	18.7	18.7	18.4	
Gross official reserves (in mil U.S. dollars)	9,264	9,304	8,545	8,536	8,419	8,233	8,045	7,850	7,673	
In months of prospective imports	8.3	7.9	7.0	6.6	6.1	5.5	5.1	4.7	4.3	
As a share of broad money (in percent)	36.9	33.0	26.2	...	...	...	...	...	...
Gross foreign exchange reserves (in mil U.S. dollars) 2/	10,465	10,056	9,474	...	...	...	...	...	...
In months of prospective imports	9.4	8.5	7.8	...	...	...	...	...	...
In months of current imports	11.8	9.0	8.0	...	...	...	...	...	...
Nominal GDP (in mil U.S. dollars)	25,181	29,040	30,690	34,081	37,382	40,847	44,498	48,374	52,868	

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

1/ Fiscal year ends in mid-July.

2/ The authorities define gross foreign exchange reserves as follows: Gross official reserves -Gold/SDR/IMF reserve position + Bank/financial institutions' reserves

Table 3. Nepal: Reserve Money and Monetary Survey, 2016/17–2024/25¹

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
				Projections					
(In billions of Nepalese rupees, end-period)									
Nepal Rastra Bank									
Reserve money	657	710	699	703	710	709	714	717	722
Net domestic assets	-296	-308	-237	-284	-284	-283	-276	-268	-261
Claims on public sector	-82	-49	-29	-25	-24	-24	-24	-24	-24
Claims on private sector	4	5	4	6	7	7	8	8	9
Claims on banks & financial institutions	7	12	23	26	27	27	27	27	27
Other items (net)	-225	-277	-234	-290	-293	-293	-287	-280	-273
Net foreign assets	953	1,018	936	987	994	992	990	986	983
Monetary Survey									
Broad money	2,592	3,094	3,582	4,054	4,536	5,062	5,626	6,240	6,908
Narrow money	569	669	727	807	903	1,008	1,120	1,248	1,382
Quasi-money	2,022	2,425	2,855	3,247	3,633	4,054	4,506	4,992	5,527
Net domestic assets	1,577	2,040	2,597	3,022	3,497	4,024	4,590	5,209	5,881
Domestic credit	2,156	2,719	3,309	3,891	4,504	5,148	5,856	6,632	7,504
Credit to public sector	159	276	399	545	695	862	1,048	1,248	1,471
of which : Credit to central government	128	236	346	484	624	781	956	1,144	1,353
Credit to private sector	1,997	2,443	2,910	3,346	3,809	4,286	4,808	5,384	6,033
Other items (net)	-579	-679	-712	-870	-1,007	-1,124	-1,266	-1,423	-1,623
Net foreign assets	1,015	1,054	985	1,032	1,039	1,038	1,035	1,031	1,028
(Twelve-month percent change)									
Reserve money	20.1	8.1	-1.5	0.6	0.9	-0.1	0.7	0.5	0.6
Broad money	15.5	19.4	15.8	13.2	11.9	11.6	11.1	10.9	10.7
Net domestic assets	22.4	29.4	27.3	16.3	15.7	15.1	14.1	13.5	12.9
Domestic credit	20.2	26.1	21.7	17.6	15.7	14.3	13.8	13.3	13.1
Credit to public sector	57.5	73.7	44.2	36.7	27.5	24.1	21.6	19.1	17.9
Credit to private sector	18.0	22.3	19.1	15.0	13.8	12.5	12.2	12.0	12.0
Net foreign assets	6.1	3.9	-6.6	4.8	0.7	-0.1	-0.2	-0.5	-0.3
Memorandum items									
Private credit (in percent of GDP)	74.7	80.6	84.0	86.0	87.5	88.2	88.9	89.8	90.2
Net Foreign Assets, NRB (in percent of GDP)	35.6	33.6	27.0	24.6	21.4	18.6	16.3	14.2	12.6
Nominal GDP (in billions of Nepalese Rupees)	2,674	3,031	3,464	3,892	4,354	4,860	5,406	5,997	6,687

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

^{1/} Fiscal year ends in mid-July.

Table 4. Nepal: Central Government Operations, 2016/17–2024/25¹

	2016/17	2017/18	2018/19		2019/20		2020/21	2021/22	2022/23	2023/24	2024/25	
			Budget	Rev. Budget	Proj.	Budget						Proj.
(In billions of Nepalese rupees)												
Total revenue and grants	645	766	1,004	907	901	1,170	1,006	1,132	1,254	1,381	1,533	1,707
Total revenue	613	727	946	860	860	1,112	959	1,068	1,183	1,304	1,449	1,614
Tax revenue	554	640	838	777	759	1,009	851	951	1,052	1,157	1,280	1,432
Non-tax revenue	59	87	107	83	101	103	108	118	132	147	169	182
Grants	32	39	59	47	42	58	47	64	70	77	84	93
Expenditure	727	968	1,274	1,158	1,059	1,496	1,182	1,322	1,456	1,604	1,765	1,956
Recurrent expenditure	519	697	960	885	818	1,088	898	1,004	1,111	1,226	1,363	1,522
<i>Of which:</i> Interest payments	10	16	26	26	21	27	23	30	36	44	53	62
Salaries and allowances	119	112	117	117	100	145	116	130	145	156	173	193
Grants & subsidies	244	198	171	168	121	178	132	144	148	160	177	197
Fiscal transfer	...	212	328	270	322	334	327	366	408	454	504	562
Revenue sharing 2/	...	...	114	102	97	131	124	139	154	169	187	207
Capital expenditure	209	271	314	273	242	408	284	318	345	378	402	435
Operating balance	126	69	45	21	84	82	108	128	143	155	170	185
Net lending/borrowing	-83	-202	-269	-251	-158	-326	-176	-190	-202	-223	-232	-249
Statistical discrepancy	-35	-92	0	-22	0	0	0	0	0	0	0	0
Net financial transactions	48	109	269	230	158	326	176	190	202	223	232	249
Net acquisition of financial assets	37	-22	97	94	59	99	62	39	43	48	53	59
Foreign	3	4	0	0	0	0	0	0	0	0	0	0
Domestic (net)	34	-26	97	94	58	99	62	39	43	48	53	59
Sale of equity	17	45	58	56	42	63	43	26	29	32	36	40
Lending minus repayment	26	19	39	37	17	36	19	12	14	15	17	19
Change in cash/deposit	-9	-89	0	0	0	0	0	0	0	0	0	0
Net incurrence of liabilities	85	87	366	324	217	425	238	229	245	271	285	309
Foreign	35	74	229	187	71	271	93	81	80	88	87	88
Domestic	50	13	137	137	146	155	145	148	165	184	198	221
(In percent of GDP, unless otherwise indicated)												
Total revenue and grants	24.1	25.3	29.0	26.2	26.0	30.1	25.8	26.0	25.8	25.5	25.6	25.5
Total revenue	22.9	24.0	27.3	24.8	24.8	28.6	24.6	24.5	24.4	24.1	24.2	24.1
Tax revenue	20.7	21.1	24.2	22.4	21.9	25.9	21.9	21.8	21.6	21.4	21.3	21.4
Non-tax revenue	2.2	2.9	3.1	2.4	2.9	2.6	2.8	2.7	2.7	2.7	2.8	2.7
Grants	1.2	1.3	1.7	1.3	1.2	1.5	1.2	1.5	1.4	1.4	1.4	1.4
Expenditure	27.2	31.9	36.8	33.4	30.6	38.4	30.4	30.4	30.0	29.7	29.4	29.3
Recurrent expenditure	19.4	23.0	27.7	25.6	23.6	28.0	23.1	23.1	22.9	22.7	22.7	22.8
<i>Of which:</i> Interest payments	0.4	0.5	0.8	0.8	0.6	0.7	0.6	0.7	0.7	0.8	0.9	0.9
Salaries and allowances	4.4	3.7	3.4	3.4	2.9	3.7	3.0	3.0	3.0	2.9	2.9	2.9
Grants & subsidies	9.1	6.5	4.9	4.8	3.5	4.6	3.4	3.3	3.1	3.0	3.0	3.0
Fiscal transfer	...	7.0	9.5	7.8	9.3	8.6	8.4	8.4	8.4	8.4	8.4	8.4
Revenue sharing	...	...	3.3	3.0	2.8	3.4	3.2	3.2	3.2	3.1	3.1	3.1
Capital expenditure	7.8	8.9	9.1	7.9	7.0	10.5	7.3	7.3	7.1	7.0	6.7	6.5
Operating balance	4.7	2.3	1.3	0.6	2.4	2.1	2.8	2.9	2.9	2.9	2.8	2.8
Net lending/borrowing	-3.1	-6.7	-7.8	-7.3	-4.6	-8.4	-4.5	-4.4	-4.2	-4.1	-3.9	-3.7
Statistical discrepancy	-1.3	-3.0	0.0	-0.6	0	0	0	0	0	0	0	0
Net financial transactions	1.8	3.6	7.8	6.6	4.6	8.4	4.5	4.4	4.2	4.1	3.9	3.7
Net acquisition of financial assets	1.4	-0.7	2.8	2.7	1.7	2.6	1.6	0.9	0.9	0.9	0.9	0.9
Foreign	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic (net)	1.3	-0.8	2.8	2.7	1.7	2.5	1.6	0.9	0.9	0.9	0.9	0.9
Sale of equity	0.6	1.5	1.7	1.6	1.2	1.6	1.1	0.6	0.6	0.6	0.6	0.6
Lending minus repayment	1.0	0.6	1.1	1.1	0.5	0.9	0.5	0.3	0.3	0.3	0.3	0.3
Change in cash/deposit	-0.3	-3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	3.2	2.9	10.6	9.3	6.3	10.9	6.1	5.3	5.0	5.0	4.8	4.6
Foreign	1.3	2.4	6.6	5.4	2.1	7.0	2.4	1.9	1.6	1.6	1.5	1.3
Domestic	1.9	0.4	4.0	4.0	4.2	4.0	3.7	3.4	3.4	3.4	3.3	3.3
Memorandum items												
Primary balance	-2.7	-6.1	-7.0	-6.5	-4.0	-7.7	-3.9	-3.7	-3.4	-3.3	-3.0	-2.8
Public debt	26.1	30.2	...	...	30.1	...	33.7	35.7	37.4	39.0	40.3	41.1
External	15.5	17.3	...	...	17.0	...	18.3	18.6	18.7	18.7	18.7	18.4
Domestic	10.6	12.9	...	...	13.1	...	15.4	17.1	18.8	20.3	21.6	22.6
Resources for sub-national governments (billions of Nepalese Rupees)	...	...	442	372	420	465	451	505	562	623	691	768
(in percent of GDP)	...	...	12.8	10.7	12.1	11.9	11.6	11.6	11.6	11.5	11.5	11.5
Nominal GDP (billions of Nepalese Rupees)	2,674	3,031	3,464	3,464	3,464	3,892	3,892	4,354	4,860	5,406	5,997	6,687

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

1/ Fiscal year ends in mid-July.

2/ 30 percent of VAT and domestic excise revenues are shared with sub-national governments.

Table 5. Nepal: Financial Soundness Indicators, 2013/14–2018/19¹

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
	(in percent)					
Capital adequacy						
Capital to risk weighted assets	13.4	12.6	12.2	12.9	14.7	14.1
Tier 1 capital to risk weighted assets	11.8	11.0	10.4	11.4	13.4	12.8
Asset quality						
NPLs to total loans	1.9	2.5	2.1	1.5	1.4	1.3
Loan loss provision to total loans	2.4	2.9	2.7	2.2	2.1	1.9
Earnings and profitability						
Return on equity (ROE)	28.2	26.9	28.0	17.8	18.8	15.0
Return on assets (ROA)	1.7	1.5	1.5	1.8	1.8	1.6
Interest income to gross income	83.4	82.6	78.9	78.7	79.7	84.5
Non-interest expenditures to gross income	18.3	18.9	21.1	19.4	17.9	15.2
Employees expenses to non-interest expenditures	43.1	44.6	45.0	46.4	48.4	50.8
Liquidity						
Liquid assets to total assets	25.3	24.4	24.7	23.0	19.3	18.4
Liquid assets to total deposits	30.4	29.2	29.4	26.9	23.5	22.8
Exposure to real estate						
Share of real estate and housing loans	16.1	15.1	14.9	14.9	14.2	13.4
Share of loans collateralized by land and buildings	50.9	51.7	52.5	59.9	59.1	59.7

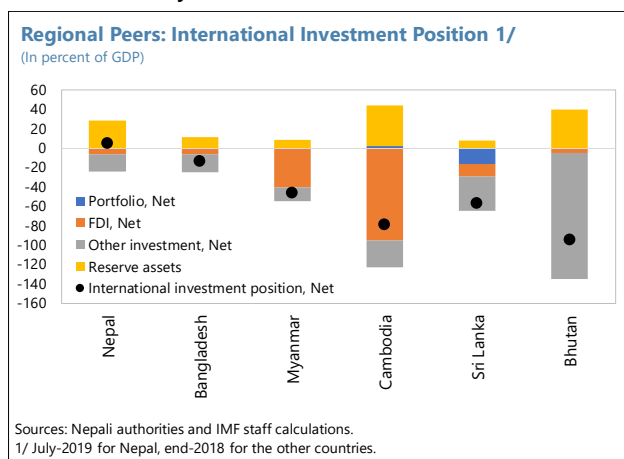
Source: Nepalese authorities.

1/ Data for "A" class commercial banks, excluding state owned banks. Data presented as at the end of the fiscal year (i.e. in mid-July for the year indicated).

Annex I. External Sector Assessment

Nepal's external position in 2018/19 is assessed to be weaker than the level consistent with medium-term fundamentals and desirable policy settings. Nepal's large current account deficit reflects high imports due to earthquake reconstruction and strong domestic demand. Nonetheless, the current level of foreign reserves is assessed to be adequate and the net international investment position is stronger than in regional peers, supporting the peg to the Indian rupee. Prudent macroeconomic policies are advised to safeguard medium-term external sustainability.

1. Nepal's international investment position (IIP) is stronger than regional peers. Nepal's net IIP stood at US\$1.4 billion (4.8 percent of GDP) as at mid-July 2019. Central bank reserve assets exceed public external debt. External liabilities related to foreign direct investment (FDI) are rather small owing to Nepal's weak business climate which has held back private investment. However, there has been a sharp decline in Nepal's IIP over the last two fiscal years (a 65 percent decrease). A continuation of this trend, combined with higher FDI as the business climate improves, could bring Nepal's net IIP to negative territory. Nonetheless, Nepal is at present a net creditor, therefore there are no immediate sustainability concerns.



2. Nepal's external position is assessed to be weaker than the level consistent with medium-term fundamentals and desirable policy settings:

- The EBA-lite current account model^{1 2} indicates that Nepal's current account is weaker than the current account norm. The current account deficit continued at 7.7 percent of GDP in FY2018/19, reflecting high imports due to earthquake reconstruction and strong domestic demand. Remittances—a quarter of GDP—helped to finance the large trade deficit. This compares with a current account norm of a deficit of 3.8 percent of GDP in FY2018/19. The model indicates a CA-gap of between -2.8 to -4.8 percent of GDP. Assuming an elasticity of the trade balance with respect to changes in the REER of -0.18, this indicates that the REER would need to depreciate between 15 to 27 percent to close the current account gap.

¹ <https://www.imf.org/en/Publications/WP/Issues/2019/03/19/The-External-Balance-Assessment-Methodology-2018-Update-46643>

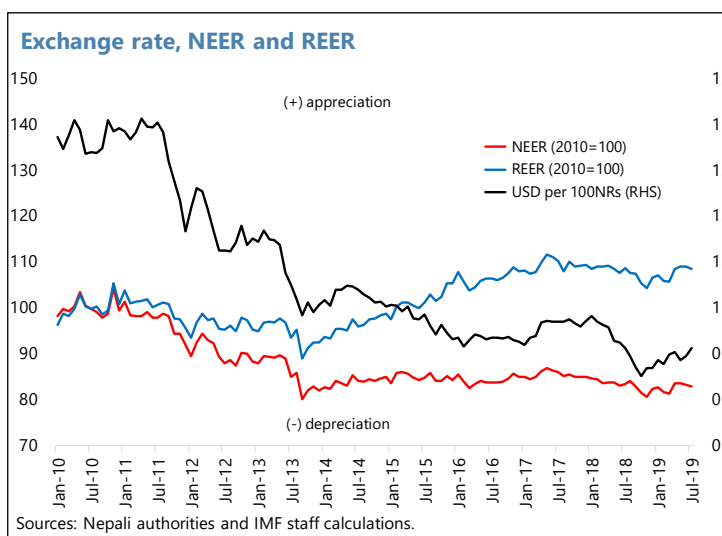
² These models were applied using mid-2019 data for Nepal and end-2018 data for other countries.

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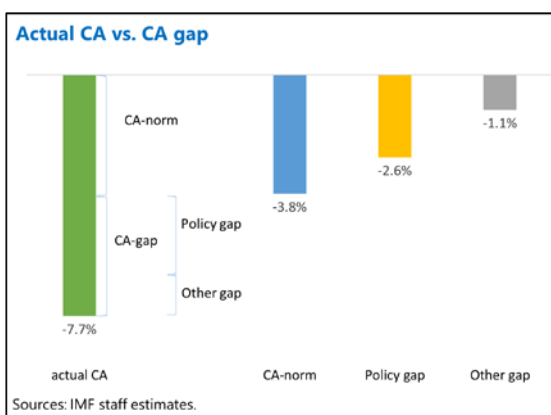
- The EBA-lite IREER model indicates that Nepal's real effective exchange rate (REER) is overvalued compared to the equilibrium REER: By mid-July 2019, Nepal's REER is estimated to be 21 percent more appreciated than the equilibrium REER derived from a panel regression for 126 countries.
- However, large positive net errors and omissions suggest that the current account deficit and the REER gaps are likely overestimated. Positive net errors and omissions in the balance of payments have been persistent and amounted to 2.7 percent of GDP in FY 2018/19.

The results of EBA-lite models	
EBA-lite-CA	
CA actual	-7.7%
CA norm 1/	-3.8%
CA gap	-3.8%
of which Policy ga	-2.6%
REER gap	21.8%
EBA-lite-IREER	
ln(REER) actual	4.67
ln(REER) norm	4.46
REER gap	20.9%
of which Policy ga	3.8%

Source: IMF staff estimates.
1/ Multilaterally consistent cyclically adjusted CA norm.



3. The EBA-lite models illustrate that Nepal's weak external position is closely associated with expansionary monetary/financial policies. The current account gap (-3.8 percent of GDP) can be attributed to (1) an estimated policy gap (-2.6 percent of GDP, 70 percent of CA-gap) and (2) other gap (residual, -1.1 percent of GDP, 30 percent of CA-gap). This suggests that prudent monetary and financial policies would help safeguard Nepal's medium-term external sustainability.

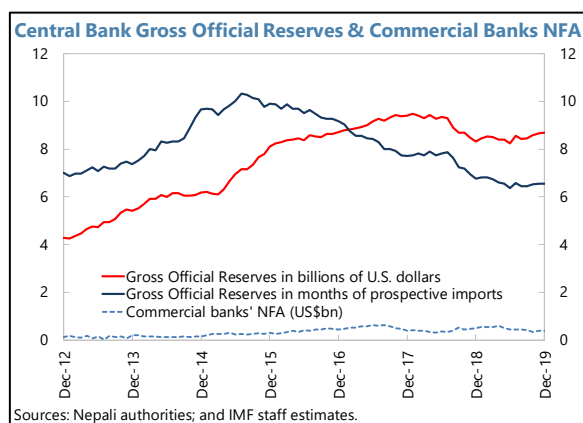


4. Nepal's competitiveness is affected by structural impediments, in addition to real exchange rate appreciation. Nepal is a landlocked country and relies heavily on India for ground transportation with the rest of the world. Two-thirds of trade is with India and all oil imports are from India. According to the trade treaty with India, Nepal can settle trade with India in Indian rupees and foreign direct investment from India can be made in Indian rupees. In this context, the peg to the Indian rupee reduces exchange rate uncertainty for trade and investment with its major trading partner. Nevertheless, the real appreciation of the Nepali rupee against the Indian rupee can

impact Nepal's competitiveness. Moreover, private investment and exports are held back by the infrastructure gap, red tape, and product and labor market frictions.

5. Capital flows consist mostly of concessional loans and trade credit. FDI comprised only 0.4 percent of GDP in FY2018/19, as a result of restrictions and complexity of the current approval system. Nepal's capital account remains mostly closed, therefore portfolio flows are negligible. In FY2018/19, official loans declined reflecting delays in project implementation. Trade credits fell slightly.

6. Despite their decline, the level of gross official reserves remains adequate. Nepal's central bank reserves fell to US\$8.5 billion at mid-July 2019 from a peak of US\$9.5 billion in mid-January 2018. The IMF's tool for assessing reserve adequacy in credit-constrained economies (ARA-CC)³ suggests that the current level of Nepal's foreign exchange reserves—equivalent to about 7 months of prospective imports of goods and services and 28 percent of broad money—is adequate.⁴ Reserves have been stabilizing in recent months, thanks in part to greater domestic electricity and cement production. Although current account deficits would narrow somewhat over the medium term, gross official reserve coverage is expected to decline to 4.3 months of prospective imports by FY2024/25.



Regional comparison of Reserve indicators, 2018				
	Months of imports of G&S 1/	Percent of Exports of G&S	Percent of M2	Percent of GDP
Indonesia	7	58	30	12
Malaysia	6	41	23	28
Philippines	7	86	31	24
Singapore	6	46	43	78
Thailand	9	62	33	41
Sri Lanka	3	35	16	8
Myanmar	3	34	13	8
Mongolia	5	43	44	27
Lao P.D.R.	1	12	8	4
Cambodia	5	48	46	41
Vietnam	2	19	14	23
Median	5	43	30	24
Nepal (Sep 2019)	6.4	281	27	25

Sources: IMF, WEO; and staff estimates.
1/ In months of prospective imports of goods and services.

³ See "Guidance Note: Assessing Reserve Adequacy in Credit-Constrained Economies" November 2015

⁴ Nepal is assessed to be "credit constrained" for the purpose of this exercise given that it does not regularly borrow from international capital markets and is not rated to be "investment grade." According to this methodology, Nepal's economic classification is non-resource rich, and the exchange rate regime is fixed. This methodology calculates the benefits of reserves and balances them against the assumed cost of holding reserves (6.2 percent), which provides an estimate of the adequate level of reserves of 3.6 months of prospective imports of goods and services. In this calculation, most recent ones or 5-year projections were used for Nepal's economic indicators including potential real GDP growth rate of 5 percent. Modifying the ARA metric to include a buffer given Nepal's high vulnerability to natural disasters (lowering the growth rate by 2 percentage points to 3 percent, based on estimates in Nepal's 2015 Staff Report on the request for disbursement under the Rapid Credit Facility), increases the adequate level of reserves to 4.2 months of prospective imports of goods and services.

Source of Risk	Location of Source	Relative Likelihood	Time Horizon	Expected Impact	Main Impacts → Recommended Policy Actions
Large swings in energy prices	External	H	ST, MT	M	<i>Mixed effects: higher international oil prices could put pressure on the current account through higher oil import bills and rising inflation, but may improve external employment prospects for Nepali migrants, strengthening remittance inflows</i> → Continue developing hydroelectric capacity to lessen dependence on oil imports; tighten stance of fiscal policy
Rising protectionism and retreat from multilateralism	External	H	ST, MT	L	<i>While a slowdown of global economic activity and more volatile global financial conditions may affect Nepal's major trading partners and Nepal's oversea employment host countries, Nepal's low export base and closed capital account will likely limit the spillovers.</i> → Maintain sound policy frameworks, including improving the investment climate to reduce dependence on remittance inflows.
Cyber-attacks	External	L	ST, MT	M – H	<i>Safeguards monitoring report (2018) identified significant vulnerability to cyber risks at the NRB, due to weak IT infrastructure and practices. This risk also exists within commercial banks.</i> → In the broader context of overall strengthening of NRB capacity, such as efforts to improve governance and organizational setup, focus also on enhancing capacity in the NRB's IT department.
Excessively expansionary monetary policy	Domestic	M	ST, MT	H	<i>A sharp increase in credit growth would add to demand growth and BOP pressures and increase the buildup of financial sector risks.</i> → Tighten macroprudential policies to contain credit growth.
Financial sector vulnerabilities, exposed by waning remittances	Domestic	M	ST, MT	H	<i>A slowdown in deposit growth, emanating from waning remittance inflows and associated softening of real estate prices, could affect liquidity and expose existing loan-portfolio weaknesses.</i> → Exercise supervisory, corrective, and sanctioning powers more forcefully, including through more pro-active risk-based supervision.
Weaker-than-expected growth in India and GCC countries	External	H	ST, MT	H	<i>Slower growth in India and GCC countries could reduce remittances, FDI and exports.</i> → Accelerate structural reforms to improve the investment climate and boost public investment.
Higher frequency and severity of natural disaster and climate change	Domestic	L – M	ST, MT	H	<i>Nepal is highly vulnerable to natural disasters, such as earthquakes and floods.</i> → Adhere to disaster-proof building codes; build fiscal space and reserve buffers; enhance financial safety nets.

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

2/ Risks to prices are broadly balanced, reflecting offsetting—but large and uncertain—supply and demand shocks.

Annex III. Improving the Effectiveness of the Interest Rate Corridor

1. A well-functioning interest rate corridor (IRC) would allow the NRB to move toward an interest rate framework that improves financial market development as well as policy signaling and transmission.¹⁹ In particular, it would²⁰:

- Enhance the signaling of the monetary policy stance, hence facilitating achievement of the NRB's price stability mandate;
- Help stabilize the short-end of the yield curve, in turn supporting financial market development, notably the government securities market;
- Facilitate commercial banks' liquidity management, dampening the liquidity risk premium;
- For the longer term, provide the Nepalese authorities a greater degree of freedom on the choice of an alternative nominal anchor.

2. The IRC is not yet functioning as an effective policy tool.²¹ Short-term rates are highly volatile and often fall below the corridor (Figure 1). Under the existing framework, liquidity is provided at the request of financial institutions under the standing liquidity facility. However, liquidity absorption through the deposit collection facility and open market operations are at the discretion of the NRB. So far, the NRB has been intervening asymmetrically (Figure 2). When liquidity²² falls low in the system, the NRB has been able to broadly anchor the interbank market rate within the corridor by providing liquidity (under the standing facility and also through repos, both with collateral requirements). However, when liquidity increases, liquidity absorption has been insufficient, and the interbank market rate has plummeted. The current asymmetric approach and high volatility of short-term interest rates undermine the credibility of the IRC among financial market agents and does not enable the transmission of short-term rates to deposit and lending rates.

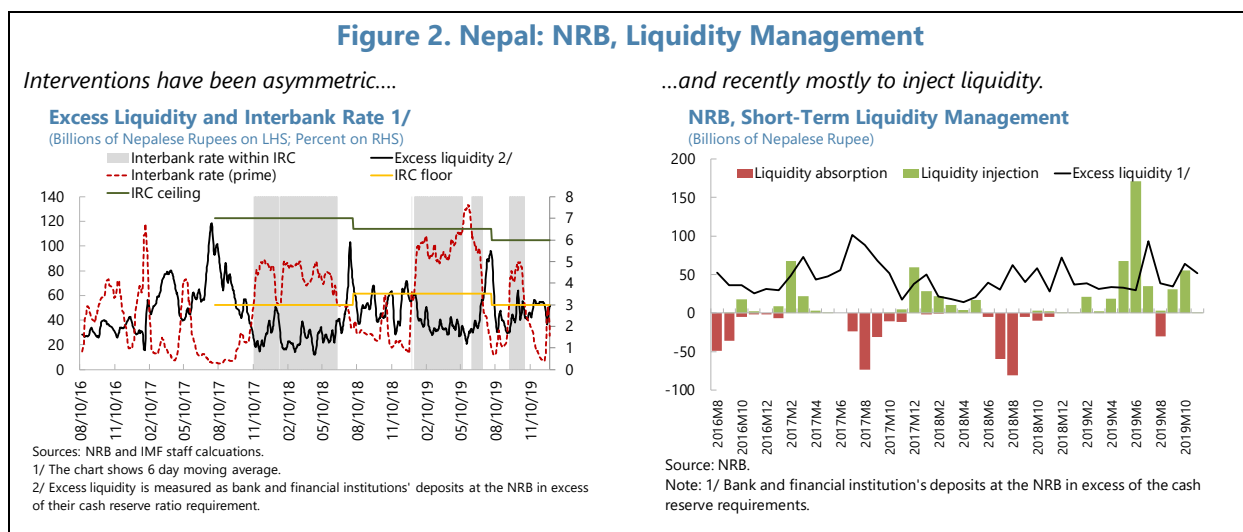
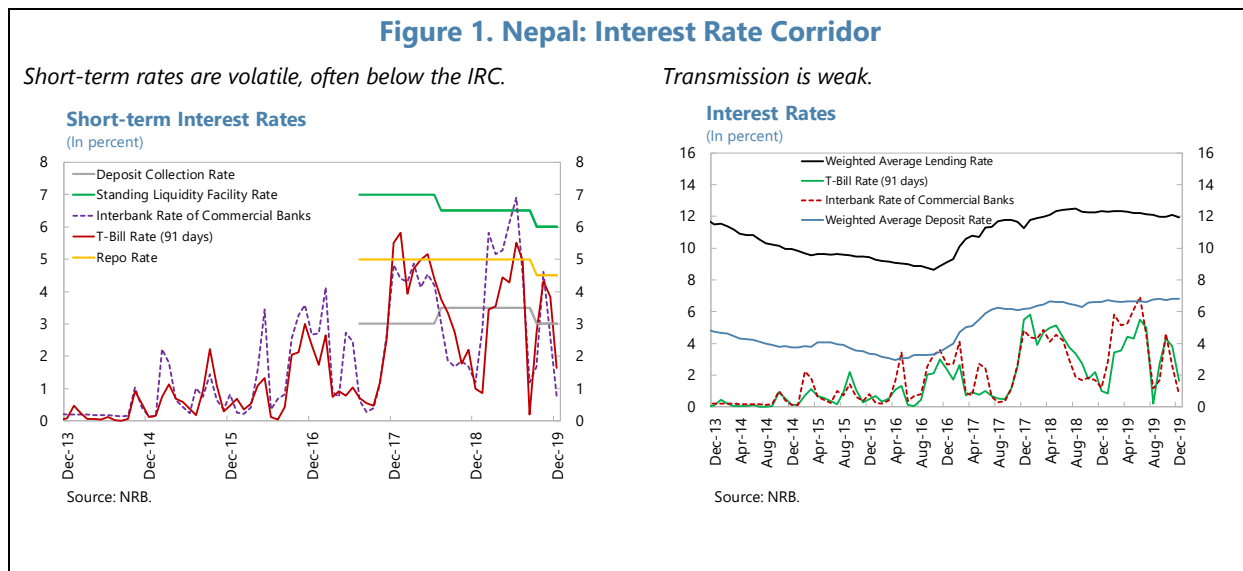
¹⁹ See IMF (2015), "Evolving Monetary Policy Frameworks in Low-Income and Other Developing Countries", October 2015.

²⁰ The IRC cannot be expected to lift all the obstacles (often of a structural nature) that may exist in the monetary policy transmission mechanism (i.e., transmission of short-term interbank market rates to the yield curve, to banks' lending and deposits rates, and the economy at large).

²¹ In the context of less developed financial markets and very weak pass-through from the policy rate to market rates, macroprudential policies have proven more effective than the interest rate as a policy tool, by directly affecting the supply of credit. Until a full-fledged interest rate-based framework is in place, keeping the CCD ratio in place will be necessary.

²² Excess liquidity in this context refers to bank and financial institutions' deposits at the NRB in excess of the required amount under the Cash Reserve Ration regulation.

3. Credibility of the IRC hinges on a sustained track-record of keeping the interbank rate within the corridor. This could be achieved by introducing a standing deposit facility (SDF) as a solid floor of the IRC. The SDF would enable banks to park excess liquidity with the NRB at their discretion, without the NRB providing collateral to banks. Once the IRC track-record has been firmly established, the NRB can refine the width of the corridor if needed to further lower interest rate volatility without discouraging interbank trading and adjust the rates as needed to support the peg and macroeconomic stability objectives. Further, when short-term interest rates are stable within the corridor, discrete changes in the policy rate will have greater impact on banks' behavior including the setting of deposit and lending rates.



Annex IV. Tax Administration and Public Financial Management Reforms (2019)

Building on past reforms to the tax structure and tax base, as well as efforts to improve tax administration and enforcement (see Annex III of the 2018 Article Consultation staff report), several new measures have been introduced over the last year which are expected to improve tax-revenue collection and public financial administration.

1. Reforms to Tax Administration

- Key steps to reduce under-invoicing of imports, and thereby raise customs revenues include reforms to the custom valuation process such as greater automation, the adoption of risk-based customs clearance, and an e-payment system.
- A Permanent Account Number (PAN) system has been introduced for tax filings and claiming tax allowances and expenses. The system applies to individuals and businesses, and is expected to reduce revenue leakages and increase formal sector activity. The system will be supported by a biometric registration system, which is under development.
- A new provision of the VAT tax code will provide final consumers with a rebate of 10 percent of the tax paid if they make payments through an electronic channel. The objective is to increase formalization by bringing more transactions into the tax net.
- The Integrated Tax System (ITS) was created, which facilitates the cross-checking of financial information.

2. Reforms to Public Financial Management Systems and Processes

- The passage of the Financial Procedure and Fiscal Responsibility Act (2019) serves as a framework to guide the process of reforming PFM systems and practices. One key facet is that it clearly separates accounting personnel from internal auditors to ensure independence of the internal audit practice.
- At the federal level, the integration of the Line Ministry Budget Information System (LMBIS), Treasure Single Account (TSA), and Computer-based Government Accounting System (CGAS) will improve information sharing across ministries.
- At the sub-national level, the Provincial LMBIS system (PLMBIS) has been rolled out, and at the local government level the Sub-national Treasury Regulatory Application (SuTRA) has been implemented to capture all facets of budget planning. Substantial training efforts on the operation of both systems for subnational government staff have been conducted by the Financial Comptroller General's Office and will continue.
- The monitoring of major capital projects has been enhanced by the installation of an action room within the office of the Prime Minister, which tracks progress in major projects, identifies problems, and is positioned to respond rapidly to remove obstacles.

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

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	Short term (ST)	Not done The interest rate corridor (IRC) is not serving as an effective policy tool. Deficiencies in the IRC framework—including lack of a standing deposit collection facility—have resulted in highly volatile short-term rates that often fall below the IRC floor.
Undertake a thorough Asset Quality Review (AQR) to identify the extent of problem loans in banks' balance sheets (with TA support).	NRB	ST	Fully Implemented
Conduct an in-depth review and financial analysis of loan portfolios during bank examinations.	NRB	ST/Medium term (MT)	In process Loan portfolio reviews are performed on a regular basis during on-site inspections by the Supervision department of the NRB. The quality of reviews should be enhanced by the launching of Supervisory Information System (SIS)
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 <ul style="list-style-type: none"> • A Payment and Settlement System Department was established in 2015. Directives for Payment Institutions and Licensing Policy for Payment-Related Institutions were issued in 2016. Nepal Payment System Development Strategy was issued, and Payment System Oversight Framework of 2018 was published. A real-time gross settlement system (RTGS) is in full operation since November 22, 2019 in commercial banks. • The Payment and Settlement Act is before parliament. Payment System Oversight Bylaws are under discussion. • Nepal Financial Reporting Standards (NFRS) were adopted by Class A banks in FY2016/17. • The Credit Information Bureau has expanded its coverage. • Limited progress has been made regarding the strengthening of the collateral registry and debt recovery areas.
Financial Sector Oversight			
A. Banking Sector			
Redefine supervisory approach by: integrating risk-based off-site and on-site supervision; <ul style="list-style-type: none"> • 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 Risk-based on-site supervision is being implemented for Class A banks. SARTTAC TA has been received to help extend it to off-site supervision. The pilot Supervisory Information System (SIS) was launched on January 8, 2020. Regular training is being provided for on-site and off-site supervisors, and unit-wise rotation policy is being implemented. No action taken on streamlining the NRB Board's participation in operational decisions.
Ensure effective compliance with supervisory directives and guidelines by:	NRB	MT	In process The onsite inspection and enforcement unit in the Banking Supervision Department continue to follow up on the

Recommendations	Responsible Authority	Time Line*	Progress to date
<ul style="list-style-type: none"> performing a thorough follow up of the implementation of supervisory recommendations; proactive, earlier, and stronger corrective actions. 			implementation of supervisory recommendations. Risk Management Directive was issued in November 2017, in order to strengthen the effective enforcement of major components of Risk Management Guidelines.
Review licensing regulations and policy to strengthen the licensing process and support a consolidation of the sector. Once completed, re-license all Classes A, B, and C banks that meet the new reinforced requirements, with an appropriate phase-in period, into a single-license category.	NRB	MT	Not done
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 progress The Bank and Financial Institutions Act (BAFIA), 2016 has defined the term "Related Party" and "Controlling Interest". However, neither the BAFIA nor the NRB Act has assigned explicit powers to NRB for consolidated supervision of bank and financial institutions including their related parties and entities with controlling interest.
B. Non-banking Sector			
Divide the CIT into two separate legal entities, segregating the capital market business, to be placed under the supervision of the Securities Board of Nepal (SEBON), from the pension fund business.	MOF/SEBON	ST	Not done
Place the EPF and CIT pension fund business under the joint supervision of the Insurance Board (IB) and NRB.	IB/NRB/MOF	MT	Not done
Strengthen the operational independence of the IB and SEBON.	SEBON/IB/MOF	ST	Not done
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	Fully implemented
Develop and implement a banking financial institution (BFI) Supervision Enforcement policy that presumes certain enforcement action based on CAMELS ratings.	NRB	MT	In process The supervisory adjustments in risk weighted assets are currently tied up with CAMELS ratings.
Revise NRB Act to clarify emergency liquidity assistance (ELA) provisions.	NRB/MOF	ST	Done NRB Act has been amended with the revision in provision related to refinancing and lender of last resort in section 49. Previously, refinancing and lender of last resort facilities had been available for 6 months and could be renewed for another 6 months only, however, with the amendment, the tenure has been extended to 1 year for both the facilities.
Revise NRB Act to grant it special resolution regime powers.	NRB/MOF	ST	Fully implemented
Establish a national financial crisis coordinating committee comprised of all financial sector, regulatory, and supervisory agencies. Develop each individual agency's crisis contingency plans and roll up individual agency plans into a national crisis contingency plan.	MOF/NRB/IB/SEBON	ST/MT	Done Crisis Management Co-ordination Committee has been formed with the conveyorship of the Deputy Governor, including representative from the Ministry of Finance, the Securities Exchange Board of Nepal, and the Insurance Board.
Crisis simulations should be conducted periodically.	MOF/NRB/IB/SEBON	MT	Not done

Annex VI. Staff Policy Advice from the 2017 and 2018 Article IV

Staff Advice	Policy Actions
Fiscal Policy	
Care should be taken not to exceed the economy's aggregate absorptive capacity and to safeguard expenditure quality (2017). Accordingly, staff recommended more front-loaded fiscal consolidation and an improved composition of expenditure in the medium-term (2018).	In FY2018/19, the central government deficit is estimated to have narrowed to 4.5 percent of GDP (from 6.7 percent of GDP in FY2017/18).
Continued improvements in revenue performance will be important, including efforts to strengthen customs administration (2017/18).	Authorities have undertaken substantial measures to strengthen customs administration, including reforms to customs valuation and adoption of risk-based customs clearance and an e-payment system. The Department of Customs is implementing ASYCUDA World and risk-based custom clearance to incentivize traders with good track record with faster compliance.
Budget preparation and implementation capacity should be strengthened further, with a more realistic initial assessment and capital spending spread more evenly throughout the fiscal year (2017/18).	Budget remains ambitious, and capital spending is typically backloaded in the fiscal year. Authorities are working on measures aimed at strengthening capital-spending execution rates, and smoothing its annual profile—most noteworthy are the adoption of a project pipeline, overseen by the National Planning Commission, and an action room in the Prime Minister's office for monitoring progress on major projects.
Expansion of government spending should be anchored in a medium-term expenditure framework (2017). A comprehensive assessment of the resources needed by subnational governments to deliver on their expenditure mandates set out in the Constitution should be conducted expediently (2018).	There has been progress assessing the spending needs of sub-national governments, with a workstream led by the World Bank. The Federalism Capacity Needs Assessment provides a broad framework for the devolution of resources and responsibilities under fiscal federalism. Work is ongoing to assess the fiscal gap between expenditure needs and revenue capacity at the SNG level. Authorities are also embarking on an assessment of the duplication of responsibilities and spending across different levels of government.
Monetary, Exchange Rate, and Financial Policies	
The interest rate corridor should be complemented by a binding interest rate floor, 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 (2017). The NRB should resume using its IRC, by actively mopping up excess liquidity when needed, bringing interbank rates back towards the mid-point of the target range. The corridor itself should also be adjusted to better align short-term nominal interest rates in Nepal with those in India (2018).	The NRB narrowed the width of the corridor by 1 percentage point in July 2018. However, it continues to lack a binding floor and liquidity absorption remains fully at the NRB's discretion.
Consideration should be given to phase out NRB requirements for directed lending by commercial banks (2017).	The provision for banks to extend at least 25 percent of their total lending to priority sectors remains in effect, with the intention to ensure channeling of resources into priority sectors (e.g., agriculture, energy, tourism and small and medium enterprises) to support the economic growth target.
Regulatory and macro-prudential measures should be maintained to contain the buildup of financial sector risks, and the relief to banks with regard to the 80 percent loan-to-deposit ratio ceiling should be withdrawn (2017).	The NRB maintains a range of macroprudential measures such as the credit-to-core capital and deposit ratio, loan-to-value ratio, and sectoral limits on banks' exposure. The NRB has also recently introduced debt service-to-income ratio as well as a countercyclical capital buffer (2 percent) to be met by July 2020. In August 2019, the NRB removed interbank borrowing from the CCD ratio calculation.
The monetary policy stance needs to be tightened to rein in imbalances and support the exchange rate peg. The NRB should adopt a medium-term inflation objective consistent with eliminating the inflation wedge with India (2017).	In the context of less developed financial markets and very weak pass-through from the policy rate to markets rates, macroprudential policies have proven to be more effective than the interest rate as a policy tool, by directly affecting the supply of credit. Macroprudential measures have been playing a critical role in containing credit growth.

Staff Advice	Policy Actions
Communication regarding the quarterly reviews conducted by the NRB—which are now in their third year—should be enhanced and used to assess and explain the appropriateness of the policy stance (2018).	Monetary policy statements continue to be a channel for the NRB to announce policy changes including its monetary policy operating targets. However, they lack a clear evaluation of the appropriateness of the announced policy stance that is grounded by a sound assessment of current macroeconomic and market developments.
In the context of the recently initiated review of the NRB Act, staff recommends amendments to strengthen the central bank’s operational autonomy (2018).	A recently proposed amendment, currently tabled in the Parliament, maintains the provision that allows the government to issue directives to the central bank related to currency, banking and finance, and allow dismissal of the governor, deputy governor, and the board of directors if instructions are not followed. Further, it introduced an additional ground for dismissal: causing unnecessary delay in work performance of the Bank.
To ensure that credit growth slows to a sustainable pace, macro-prudential measures should be tightened (2017/18).	Since late 2018, the credit-to-core capital and deposit (CCD) ratio became binding for most banks and the NRB reduced the limit on personal overdraft loans. In recent months, the NRB removed interbank borrowing from the CCD calculation and introduced the requirement to cross-check borrower financial information against the Integrated Tax System. The NRB is also requiring a 2 percent countercyclical capital buffer by July 2020 and introduced a debt service to income ratio for non-business loans.
Given data and supervisory weaknesses, as well as the cyclical position of the economy, banks should build additional capital and provisioning buffers against potential losses (2018).	SIS has been launched and is expected to enhance NRB’s off-site supervision. Banks have not built additional buffers against losses. There are lingering gaps in measuring asset quality.
Staff recommends introduction of a directive to govern practices related to revolving lending, including working capital loans. The requirement for a clean-up period for revolving loans needs to be introduced to help curb ever-greening practices (2018).	A new circular by the NRB requires banks to cross-check reported net tradable assets with tax reports with the likely outcome of controlling the size of working capital loans. The authorities do not have an intention to introduce a clean-up period for working capital loans.
On the regulatory front, the central bank’s lender of last resort policy, last updated in 2011, needs to be further clarified and aligned with standard central bank practices with respect to emergency liquidity assistance (2018).	A consultant has been hired to draft LOLR policy and the draft is in the progress of being finalized.
Staff welcomes the plan to establish a supervisory mechanism for financial cooperatives given the vast number of cooperatives and their linkages to banks as well as the importance of cooperatives to provide financial services particularly in remote areas and to underserved groups.	Depending on the territory of cooperatives’ activity, corresponding government authority—municipal, province and federal—monitors and supervises the cooperatives. Authorities are encouraging merging of cooperatives to facilitate more effective supervision of cooperatives.
Structural Policies	
Nepal needs to improve its business environment and address structural bottlenecks to stimulate private sector activity, encourage foreign direct investment, and boost job creation. A single window should be offered to all investors, the investment board of Nepal Act should be strengthened, and public-private partnership policy should be amended. Amendments to the Labor Bill and Foreign Investment and Technology Transfer Act (FITTA) are needed which enhance labor and product-market flexibility (2017/18).	The new FITTA (2019), which supersedes the Investment Board of Nepal Act, includes several improvements vis-à-vis the previous act, including: a broader definition of what constitutes foreign investment, and a foreign investor; Investment Board of Nepal to approve projects above 6 billion rupees; a shortened approval timeline (from 30 to 7 days); a one-stop service center to facilitate foreign investors obtaining necessary visas and some other documentation; and scope for some assistance with land procurement. The Public-Private-Partnership Act is in the process of being revised, but legislation has not yet been passed into law.
Efforts are needed to strengthen institutions and reduce corruption. The public procurement act should be strengthened, extending the scope of misconduct which can be pursued as corruption by the Commission for the Investigation of the Abuse of Authority (CIAA). (2018)	Several public-procurement regulations have been issued, including a reduction in the ‘mobilization’ payment paid to contractors (from 20 to 10 percent), and improvements to the evaluation of bidding contractors’ capacity to deliver. Changes to the Public Procurement Act are in progress, but have not yet been passed into legislation by parliament. The CIAA has played an active role in bringing cases against parties accused of misconduct.



NEPAL

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 27, 2020

Prepared By

Asia and Pacific Department

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FUND RELATIONS

(As of December 31, 2019)

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	1.36	2.00

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
RCF Loans	38.50	24.54

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			
	2020	2021	2022	2023	2024
Principal	2.85	7.13	7.13	7.13	7.13
Charges/interest	0.50	0.49	0.49	0.49	0.50
Total	3.35	7.62	7.62	7.62	7.63

Exchange Rate Arrangement

The exchange rate arrangement of Nepal is a conventional peg to a single currency unit. The Nepalese rupee is pegged to the Indian rupee at a rate of NRs 1.6 per Indian rupee. As of January 30, 2020, the exchange rate of the Nepalese rupee (Nr) was US\$1=Nrs. 114.2

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.¹

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.

A safeguards monitoring mission in May 2018 found implementation of safeguards recommendations from the 2016 assessment to be limited. Similarly, progress on implementing recommendations from the 2018 monitoring visit continues to be slow, as several priority recommendations remain outstanding. Key areas that need to be strengthened include the NRB's autonomy and governance by way of amending the central bank legal framework, external audit, and internal controls. Staff is providing technical assistance to strengthen the internal audit function, and the NRB is in the process of establishing an information security unit and updating its lender of last resort regulation. Greater progress in strengthening safeguards continues to be hampered by human resources policy, which the NRB is currently reviewing.

2018 Article IV Consultation

Consultations with Nepal are held on the standard 12-month Article IV consultation cycle. The 2018 Article IV Consultation discussions were held during December 2-13, 2018 in Kathmandu and the Executive Board concluded the consultation on February 8, 2019 (IMF Country Report No. 19/60).

¹ The authorities informed staff about restrictions on exchange facilities for non-life insurance payments to India. Staff is seeking further information to conclude an assessment of these from an Article VIII perspective.

Technical Assistance (since 2018 Article IV Consultation)

	Purpose	Year
MCM	Strengthening Internal Audit	2018
	Cyber Security	2018
SARTTAC	Financial Supervision and Regulation	2018/2019
	Strengthening Fiscal Reporting	2018
	Government Finance Statistics and Public Sector Debt Statistics Training	2018/2019
	Price Statistics Training	2018
	National Accounts Training	2019
	Liquidity Monitoring and Forecast Tool	2019
	External Sector Statistics	2019
STA	Fiscal federalism workshop	2020
	Monetary and Financial Statistics	2019
	External Sector Statistics	2019

Resident Representative

Mr. Luis Breuer has been the Senior Resident Representative since July 26, 2019. He is based in New Delhi.

INFORMATION ON THE ACTIVITIES OF OTHER IFIS

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

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

STATISTICAL ISSUES

As of January 2020

I. Assessment of Data Adequacy for Surveillance
<p>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.</p>
<p>National Accounts: The Central Bureau of Statistics (CBS) compiles national accounts using the 1993 SNA standard. Key estimates include annual GDP by production and by expenditure categories (in current and constant prices), and gross national income and savings. Some expenditure categories continue to be affected by limited source data, particularly for household final consumption and the current and constant price discrepancies with GDP by production have become very large in recent years. During 2020, the CBS has plans to release a major revision of the national accounts that are SNA2008 compliant and will update the base year for the constant price measures from 2000/01 to 2010/11. The compilation of the new benchmark year for the national accounts and its rebasing, based on the supply and use table framework, is being supported by the World Bank. Quarterly GDP estimates are compiled and are to be updated with the revised base year.</p>
<p>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.</p>
<p>Government Finance Statistics: The authorities began to compile fiscal data for the budgetary central government in accordance with IMF's Government Finance Statistics Manual 2001 (GFSM 2001) in 2011 and is now – with the support of SARTTAC – adopting GFSM 2014. Annual data on government operations are reported to STA. However, further improvement is needed in a number of areas in order for the evolving time series to support surveillance. For example, financing transactions should be excluded from the functional classification of expenditure; a clearer distinction needs to be made in the COA between revenue and expense transactions and transactions in nonfinancial assets; clarifications are needed as to whether transfers are correctly classified: as social benefits, as subsidies, or as capital payments to enterprises. There may also be cases where the latter represent acquisitions of financial assets (equity stakes). Compilation of below-the-line financing transactions needs improvement and the government's financial balance sheet needs further development. Efforts are underway that will allow for more timely and</p>

accurate reporting and monitoring of consolidated general government operations (operations of extra- budgetary entities and local governments)

Monetary and Financial Statistics: The Nepal Rastra Bank (NRB) reports the Standardized Report Forms (SRFs) 1SR for central bank, 2SR for other depository corporations (ODCs), and 5SR for monetary aggregates for publication in the IMF's *International Financial Statistics* on a monthly basis with a lag of about one month. The coverage of monthly monetary statistics has been expanded to include development banks and finance companies, and the NRB now compiles and publishes an expanded broad money survey, which is a significant step forward. However, there are some inconsistencies in the reporting of positions between the NRB and the ODCs. Minimizing these will further improve data quality. A monetary and financial statistics mission took place in November 2019 to assist the NRB in improving the compilation of SRFs 1SR and 2SR and advancing work to expand the SRF 2SR coverage to include microfinance institutions and savings and credit cooperatives.

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

Financial Soundness Indicators: the NRB reports the 12 core financial soundness indicators (FSIs) and 8 of the 13 encouraged FSIs for deposit takers, 2 FSIs for the other financial corporations (OFCs), one FSI for households, and 2 FSIs for real estate markets—on a quarterly basis—on posting on the IMF's FSI website. FSIs are reported with a lag of about one quarter.

External Sector Statistics: The NRB compiles and disseminates balance of payments (BOP) statistics in conformity with the fifth edition of the *Balance of Payments Manual (BPM5)*. In 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)*. Key shortcomings in external sector statistics (ESS) are: (i) overestimation of imports of goods; (ii) underestimation of exports of travel services (iii) inclusion of commercial banks' assets in reserve assets; (iv) incompleteness of data on foreign grants, making it difficult to classify current vs. capital, and official vs. private grants; and (v) potential under-coverage of external debt statistics (EDS).

Since 2012, NRB has been receiving technical assistance (TA) in the ESS that include the areas of BOP, IIP and EDS. The 2019 STA mission reviewed NRB's preliminary BOP data according to the BPM6 framework, and assisted the authorities in improving the measurement of trade in goods and services, remittances, direct investment, trade credit, external debt statistics, and reserve assets.

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

II. Data Standards and Quality	
Nepal has implemented the recommendations of enhanced General Data Dissemination System (e-GDDS). Its National Summary Data Page was launched in June 2017 and is available at https://www.nrb.org.np/red/nsdp/ .	Data ROSC on fiscal transparency was published in October 2007.

Nepal—Table of Common Indicators Required for Surveillance
(As of January 31, 2020)

	Date of latest observation	Date received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
Exchange Rates	12/19	01/20	D and M	W and M	W and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	12/19	01/20	M	M	M
Reserve/Base Money	12/19	01/20	M	M	M
Broad Money	12/19	01/20	M	M	M
Central Bank Balance Sheet	12/19	01/20	M	M	M
Consolidated Balance Sheet of the Banking System	12/19	01/20	M	M	M
Interest Rates ²	12/19	01/20	D and M	W and M	W and M
Consumer Price Index	12/19	01/20	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	12/19	01/20	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	12/19	01/20	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	12/19	01/20	M/A	M/A	M/A
External Current Account Balance	12/19	01/20	M	M	M
Exports and Imports of Goods and Services	12/19	01/20	M	M	M
GDP/GNP	2018/19	08/19	A	A	A
Gross External Debt	2018/19	08/19	A	A	A
International Investment Position ⁶	Q2/19	08/19	Q	Q	Q

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

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

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

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



NEPAL

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

February 27, 2020

Approved By
Anne-Marie Gulde Wolfe
and **Maria Gonzalez (IMF)**
and **Marcello Estevão (IDA)**

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

Nepal	
Joint Bank-Fund Debt Sustainability Analysis	
Risk of external debt distress	Low
Overall risk of debt distress	Low
Granularity in the risk rating	Not Applicable
Application of judgment	No

The Debt Sustainability Analysis using the joint IMF/WB Debt Sustainability Framework for Low Income Countries (LIC-DSF) shows that Nepal remains at low risk of debt distress for both the external and overall public debt. All debt and debt service indicators are projected to be well below their indicative threshold values under the baseline scenario as well as the stress tests. However, the analysis indicates that Nepal's public debt is projected to gradually increase over the medium-term owing to continuing fiscal and current account deficits, and that debt sustainability is vulnerable to export and economic growth shocks. These findings stress the importance of implementing reforms to increase the economy's resilience to external shocks and to encourage diversification. Further efforts to improve the domestic productivity and competitiveness and to enhance monitoring of risks related to contingent liabilities are necessary to ensure medium- to long-term debt sustainability.

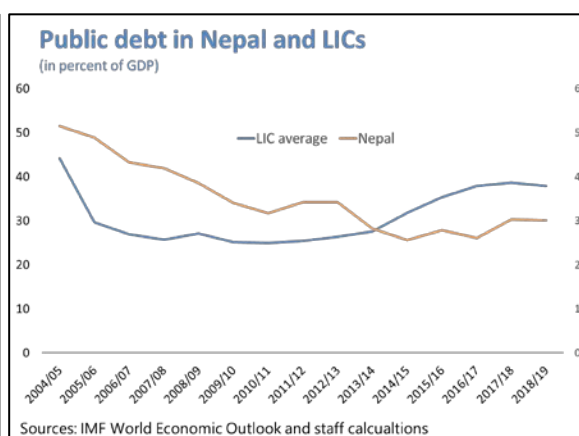
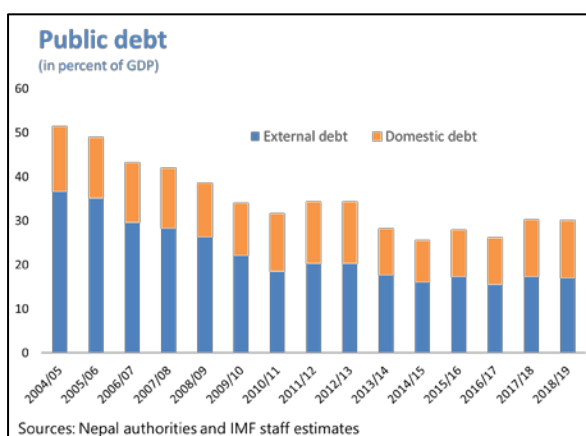
PUBLIC DEBT COVERAGE

1. **The coverage of public debt in this analysis includes central and local governments' debts, government guarantees, and central bank borrowing.** Nepal's provincial and local governments had no debt. Their borrowing framework is under consideration and should be monitored carefully. The Nepal Rastra Bank (NRB, Nepal's central bank) borrowed from the IMF through the Rapid Credit Facility and on-lent the funds (about US\$50 million) to the government. Bond issuances by the central bank were only for the purpose of the monetary policy. Nepal's state-owned enterprises (SOEs) borrow abroad through the central government, therefore included in the coverage of central government debt. The government has recently started providing guarantees for debts of SOEs.

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

BACKGROUND ON DEBT

2. **Nepal's total public debt is estimated at 30.1 percent of GDP at mid-2019.** Following a prolonged decline, to 25 percent of GDP in mid-2015, Nepal's public debt rose to 30.2 percent of GDP at mid-2018. The public debt stock for July 2019 stayed at almost the same level as the previous fiscal year. Nepal's public debt remains low compared to other low-income countries.



3. External public debt stood at 17 percent of GDP at mid-July 2019. The external debt-to-GDP ratio declined slightly by 0.4 percentage point since mid-2018. The net present value (PV) of the external debt is estimated at about 12.2 percent of GDP due to the high degree of concessionality. Nepal's external debt was owed mainly to multilateral creditors (89 percent of all external debt), such as the World Bank's International Development Association (IDA) and the Asian Development Bank. Their loans had low interest rates (1 percent on average) and long maturities (26 years on average). For the bilateral loans, Japan was the largest bilateral creditor, followed by China, India, and Korea.

Nepal: External Public Debt, at end FY2018/19 1/			
	In millions of US\$	In percent of GDP	In percent of external debt
Total external	5,366	17.0%	100%
Multilateral	4,760	15.1%	89%
AsDB	1,826	5.8%	34%
IDA	2,781	8.8%	52%
Bilateral	606	1.9%	11%
Paris Club	319	1.0%	6%
Non-Paris Club	287	0.9%	5%

Source: Nepalese authorities; and IMF staff estimates.
1/ Nepal's fiscal year starts in mid-July. For example, FY2018/19 covers mid-July 2018 to mid-July 2019.

4. Domestic public debt was 13.1 percent of GDP at mid-July 2019. About 32 percent of domestic public debt is treasury bills with a maturity of up to 1 year (28-days, 91-days, 182-days, and 364-day treasury bills), of which about a half is 364-day bills. Medium- to long-term debt comprises mostly development bonds with maturities of 3-15 years and interest rates of 3-6.5 percent per annum. All the domestic public debt was held by residents, so the analysis is currency-based.

Nepal: Public Domestic Debt, at end FY2018/19			
	In billions of Nepalese rupees	In percent of GDP	In percent of domestic debt
Total domestic	453	13.1%	100%
Treasury bills	147	4.2%	32%
Treasury bonds	306	8.8%	68%
Development bonds	297	8.6%	66%
Others	9	0.3%	2%

Sources: Nepalese authorities; and IMF staff estimates.

5. The stock of private external debt in Nepal has not been published by the authorities, but it is estimated to be very small. While the government and the NRB are encouraging commercial banks to access external loans to alleviate BOP pressures, bank external borrowing has been constrained by limited access and high relative cost. Regulations by the authorities—such as imposing a maximum spread limit (6-month Libor + 4%) on banks' foreign loans—hamper banks' ability to borrow overseas. So far, there has been very small foreign borrowing (about 0.1 percent of GDP at mid-July 2019) by the non-public sector. Reflecting recent government efforts to encourage foreign loans, private external debt is assumed to increase to 1 percent of GDP in the long term.

1 The country's coverage of public debt	The central, state, and local governments plus extra budgetary funds, central bank, government-guaranteed debt, non-guaranteed SOE debt		
	Default	Used for the analysis	Reasons for deviations from the default settings
2 Other elements of the general government not captured in 1.	0 percent of GDP	0	
3 SoE's debt (guaranteed and not guaranteed by the government) 1/	2 percent of GDP	2.0	
4 PPP	35 percent of PPP stock	2.1 2/	
5 Financial market (the default value of 5 percent of GDP is the minimum value)	5 percent of GDP	5	
Total (2+3+4+5) (in percent of GDP)		7.0	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1).
The Nepali government provided guarantee to the purchase of airline by SOE in FY 2018/19, which is 1% of GDP.
2/ 2.1 percent of GDP = 6.01 percent of GDP (PPP contracts as of 2017) * 35 percent of shock (default setting).

6. The contingent liability stress test includes contingent liabilities stemming from SOE debt (2 percent of GDP), PPP projects (2.1 percent of GDP) and financial market (5 percent of GDP). PPP projects have not been formally compiled by the government. According to the PPI database of the World Bank, Nepal's PPP contracts are estimated to account for about 6 percent of GDP as of 2017. The Nepal Oil Corporation (NOC) and the Nepal Electricity Authority (NEA) are major SOEs in Nepal. As of July-2019, the NOC and NEA's debt amounted to 3.3 percent of GDP. Their debts are all owed to the government, so are already included in the government's debt. The government provided a guarantee to the Nepal Airlines Corporations for the purchase of an airplane in FY2018/19, which is 1.0 percent of GDP.

BACKGROUND ON MACRO FORECASTS

7. Growth and inflation: Growth continued to perform well for the past a couple of years. Due to strong performances in agriculture, reconstruction activities, and tourism, real GDP growth picked up to 7.1 percent in FY2018/19 from 6.7 percent in the previous fiscal year. In the mid- to long-term, it is expected to converge to potential growth of 5.3 percent. The inflation rate was 4.6 percent annually in FY2018/19 and rose to 6.0 percent at mid-July 2019 owing to a surge in food prices, but it is expected to stabilize at 5.3 percent over the medium-term.

Text Table 1. Macroeconomic assumptions underlying the current and previous DSA ^{1/}

	Previous DSA			Current DSA					Current vs. Previous	
	2017/18	MT	LT	17/18	18/19	19/20	MT	LT	MT	LT
Real growth (%)	6.3	5.1	4.5	6.7	7.1	5.8	5.4	5.3	0.4	0.8
CPI (period average, %)	4.2	5.3	5.0	4.1	4.6	6.1	5.3	5.0	0.0	0.0
Revenues and grants (% GDP)	25.5	30.2	30.4	25.3	26.0	25.9	25.7	26.1	-4.6	-4.3
Grants (% GDP)	1.1	1.4	1.2	1.3	1.2	1.2	1.4	1.2	0.0	0.0
Primary expenditure (% GDP)	31.5	31.6	32.3	31.4	29.9	29.8	28.9	28.9	-2.7	-3.4
Net acquisition of non-financial assets (% GDP)	8.9	6.6	6.6	8.9	7.0	7.3	6.9	6.2	0.3	-0.4
Primary deficit (% GDP)	-6.0	-1.4	-1.9	-6.1	-3.9	-3.9	-3.2	-2.8	-1.8	-0.9
Net incurrence of liabilities (% GDP)	6.0	2.8	3.4	2.9	6.2	6.1	5.0	5.0	2.2	1.5
Net domestic financing (% GDP)	3.6	0.4	0.5	0.4	4.2	3.7	3.4	4.0	2.9	3.5
Exports of G&S (y/y growth)	14.4	9.1	7.9	14.4	2.5	7.6	9.6	9.6	0.5	1.7
Imports of G&S (y/y growth)	25.6	5.0	5.2	25.6	5.6	4.7	6.4	7.2	1.4	2.0
Remittances (y/y growth)	10.2	5.6	3.9	10.2	7.6	10.5	4.6	5.6	-1.0	1.6
Current account balance (% GDP)	-8.2	-7.2	-2.3	-8.1	-7.7	-5.2	-4.9	-4.0	2.2	-1.7

Note: MT (medium term) is the average over the next 5 years (2020/21-2024/25), and LT (long term) is the average over the following 7-20 years.

Sources: Nepalese authorities; and IMF staff estimates

^{1/} Nepal's fiscal year starts in mid-July. For example, FY2019/20 runs from mid-July 2019 to mid-July 2020.

8. External sector: The current account deficit was still high at 7.7 percent of GDP in FY2018/19 owing to continued strong import growth. Export and foreign direct investment were still weak, with remittances (a quarter of GDP) helping to finance the large trade deficit. Gross official reserves have fallen to US\$8.5 billion in July 2019, from US\$ 9.3 billion at the end of previous fiscal year. However, the large current account deficit in FY2018/19 did not lead to a commensurate increase in external debt or decline in reserves, due to large positive net errors and omissions in the balance of payments (2.7 percent of GDP in FY2018/19). The current account deficit is projected to narrow over the medium-term with slowing import demand. External debt is expected to decrease gradually over the projection period, to 18.5 percent of GDP at mid-2020 and 12 percent of GDP by mid-2040.

9. Fiscal: The primary fiscal deficit outturn of the central government in FY2018/19 decreased to 4.0 percent of GDP from 6.1 percent of GDP in the previous year. Even though the FY2019/20 budget again targets an ambitious increase in spending, the primary fiscal deficit is projected at 3.9 percent of GDP in FY2019/20, taking into account spending capacity constraints. Over the medium-term, it is projected to decrease to 3.2 percent of GDP.

10. Domestic debt: The Nepalese government is expected to gradually increase domestic borrowing to meet its fiscal deficit. Domestic borrowing is expected to reach 4 percent of GDP annually, and the domestic debt stock is projected to increase from 13 percent to 35½ percent of GDP over the long-term, while external debt stock is projected to decrease to 11 percent of GDP over the projection period.

11. Realism of baseline (figure 4): Cross country experience suggests that the baseline fiscal adjustment of Nepal (0.5 percentage point in 3 years) is feasible. Using alternative fiscal multipliers, growth would be higher than in the baseline scenario. Finally, contribution of public capital to GDP growth in the baseline projection is in line with historical experiences.

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TESTS

12. Country classification: In the revised debt sustainability framework (LIC-DSF), a composite indicator (CI) is used to capture the different factors affecting a country's debt carrying capacity. The CI captures the impacts of the different factors through a weighted average of the World Bank's Country Policy and Institutional Assessment (CPIA) score, the country's real GDP growth, remittances, foreign exchange reserves, and world growth¹. The calculation of the CI is based on 10-year averages of the variables, across 5 years of historical data and 5 years of projection. Nepal's CI score is calculated at 3.28, calculated based on the October 2019 World Economic Outlook and 2018 CPIA index, which lies in a range of *strong* rating, the same as last year.

Nepal: Debt Carrying Capacity and Thresholds		
Debt Carrying Capacity		
Final	based on the current vintage	based on the previous
Strong	Strong 3.28	Strong 3.26
Application thresholds		
External debt burden thresholds		
PV of debt in % of		
Exports		240
GDP		55
Debt service in % of		
Exports		21
Revenue		23
Total public debt benchmark		
PV of total public debt in % of GDP		70

13. Tailored stress tests: The revised LIC-DSF includes stress tests to assess the sensitivity of projected debt burden indicators to changes in assumptions. In this analysis, all stress tests were kept at their default settings (historical average minus one standard deviation, or the baseline projection minus one standard deviation, whichever is lower) with additionally including tailored scenario stress test for Nepal. In order to reflect Nepal's vulnerability to natural disasters, such as the 2015 earthquakes, the natural disaster shock

¹ The details on the methodology can be found in the new LIC-DSF guidance note: <https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf>

was applied as one of the stress tests. A one-off shock of 10 percentage points of GDP to the debt-to-GDP ratio in the second year of the projection period (FY2020/21) is assumed, and real GDP growth and exports were lowered by 1.5 and 3.5 percent, respectively, in the year of the shock for the stress test.

EXTERNAL AND PUBLIC SUSTAINABILITY

14. The external DSA shows that Nepal is at low risk of debt distress. Under the baseline scenario, the PV of external debt and debt service ratios are projected not to breach their respective thresholds and to remain stable over the projection period, even with the assumption of growing private external debt to 1 percent of GDP over the projection years. In the stress tests, the debt and debt service ratios also remain below the thresholds throughout the projection period.

15. Stress tests suggest vulnerability to export shock. The export shock is identified as the most extreme one, leading to a rise of the ratios larger than for other shocks, such as real GDP growth, fiscal primary balance, current transfers/FDI flows, national currency depreciation, and natural disaster. Under the export shock scenario, the PV of public external debt-to-export ratio would increase to 213 percent at mid-2022, which is not far below the threshold value (240 percent), but stabilize onwards.

16. The risk of public debt (external + domestic) distress is also low. Public debt is projected to gradually increase from 30 percent of GDP at July 2018/19 to around 46 percent of GDP in FY2039/40 under the baseline scenario. The PV of the debt-to-GDP ratio is analyzed to remain stable at 38 percent of GDP over the projection period, which is well below the 70 percent benchmark. Debt service-to-revenue ratio is projected to rise over the projection period to 36 percent, owing to increasing domestic borrowing, but to remain below 40 percent in 2029/30.

17. Public debt is most vulnerable to a growth shock. A growth shock (one standard deviation in 2020/21 from the baseline) would lead to a rise of the PV of debt-to-GDP ratio to 55 percent in 2029/30. Debt service-to-revenue ratio is also affected most by a growth shock, which is calculated at around 53 percent in 2029/30.

VIEWS OF THE AUTHORITIES

18. The authorities broadly agreed with the assessment of the DSA. They stressed that Nepal's public debt risk has been reduced over the past decade thanks to the government's effective management of public finances. In addition, in the context of fiscal federalism, the authorities have been taking steps to enhance public debt management. The new Public Debt Management bill was submitted to the Parliament and the Public Debt Management Office (PDMO) was established in FY 2018/19 to manage Nepal's public debt in an integrated manner. The PDMO will prepare guidelines to support subnational governments in their appropriate management of borrowings and debts. While the authorities concurred with the team's projection that the share of domestic financing out of total government financing would increase over time, they stressed that the size of domestic financing could be further increased with the continued growth of Nepal's economy.

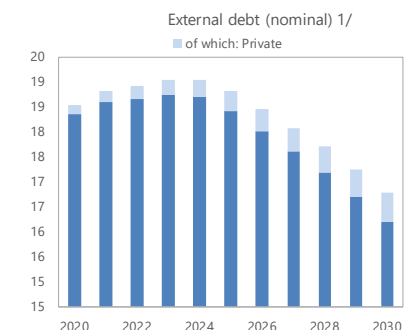
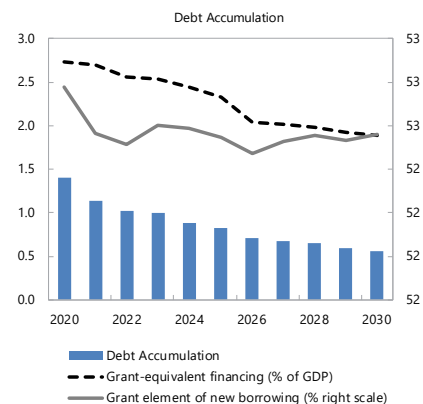
CONCLUSION

19. Nepal remains at low risk of external and overall debt distress. Both in the baseline scenario and in the stress tests, none of debt burden indicators breach the indicative threshold values. However, baseline projections and the standard stress tests show increasing risks for the projection period. Nepal's public debt is projected to gradually increase over the medium-term owing to continuing fiscal and current account deficits. Stress tests indicate that Nepal's debt sustainability remains vulnerable to shocks to exports and economic growth. To build up Nepal's resilience to these shocks, the Nepalese authorities should continue to make efforts to improve the domestic productivity and competitiveness through stepping up quality investment in infrastructure, as well as streamlining regulations and bureaucratic processes. It is also important to pursue rigorous analysis of the risks related to contingent liabilities. Closing the data gap by compiling PPP projects and private sector external debt would help future debt sustainability analysis. The authorities will also need to make significant progress in implementing a medium-term debt strategy and developing the government bond market to facilitate greater domestic financing. Finally, improvements are needed in subnational governments' public financial management and reporting, along with the implementation of a prudent framework for subnational borrowing.

Table 1. Nepal: External Debt Sustainability Framework, Baseline Scenario, 2017-2040

	Actual 2019	Projections (In percent of GDP, unless otherwise indicated)								Average 8/ Historical Projections	
		2020	2021	2022	2023	2024	2025	2030	2040	Historical	Projections
External debt (nominal) 1/	17.1	18.5	18.8	18.9	19.0	19.0	18.8	16.8	11.8	18.7	18.3
of which: public and publicly guaranteed (PPG)	17.0	18.3	18.6	18.7	18.7	18.7	18.4	16.2	10.8	18.7	17.9
Change in external debt	-0.2	1.4	0.3	0.1	0.1	0.0	-0.2	-0.5	-0.6		
Identified net debt-creating flows	6.4	3.8	3.5	3.4	3.3	3.1	2.9	1.9	1.6	-2.6	2.9
Non-interest current account deficit	7.6	5.0	4.8	4.7	4.6	4.4	4.2	3.4	2.8	-0.6	4.2
Deficit in balance of goods and services	37.5	34.6	33.4	32.4	31.5	30.6	29.6	25.2	14.2	29.8	29.7
Exports	8.7	8.4	8.4	8.5	8.6	8.6	8.7	8.8	9.1		
Imports	46.2	42.9	41.8	40.9	40.1	39.2	38.3	34.0	23.3		
Net current transfers (negative = inflow)	-28.7	-28.2	-27.3	-26.4	-25.6	-24.9	-24.0	-20.5	-15.3	-29.2	-24.1
of which: official	-1.0	-1.1	-1.2	-1.2	-1.2	-1.2	-1.2	-1.1	-1.1		
Other current account flows (negative = net inflow)	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3	4.0	-1.2	-1.3
Net FDI (negative = inflow)	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5	-0.6	-0.7	-0.7	-0.4	-0.6
Endogenous debt dynamics 2/	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.5		
Contribution from nominal interest rate	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.1		
Contribution from real GDP growth	-1.2	-0.9	-1.0	-0.9	-0.9	-0.9	-0.9	-0.8	-0.6		
Contribution from price and exchange rate changes	0.2	...	...	...	...	...	...	...	...
Residual 3/	-6.6	-2.4	-3.2	-3.3	-3.2	-3.1	-3.1	-2.4	-2.3	1.4	-2.9
of which: exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators											
PV of PPG external debt-to-GDP ratio	12.2	12.2	12.2	12.1	12.0	11.9	11.6	10.0	6.7		
PV of PPG external debt-to-exports ratio	140.6	145.6	144.5	142.5	140.2	137.4	133.8	113.6	73.4		
PPG debt service-to-exports ratio	8.0	7.9	7.5	7.4	7.5	7.8	7.4	6.5	4.4		
PPG debt service-to-revenue ratio	2.8	2.7	2.6	2.6	2.7	2.8	2.6	2.4	1.7		
Gross external financing need (Million of U.S. dollars)	2427.8	1829.9	1908.9	2058.8	2228.8	2354.2	2449.2	3038.8	6619.7		
Key macroeconomic assumptions											
Real GDP growth (in percent)	7.1	6.0	5.7	5.5	5.4	5.3	5.3	5.3	5.3	4.9	5.4
GDP deflator in US dollar terms (change in percent)	-1.3	4.8	3.8	3.6	3.4	3.2	3.8	3.5	3.5	4.3	3.6
Effective interest rate (percent) 4/	0.8	0.8	0.8	0.8	0.8	0.9	0.9	1.0	1.3	0.9	0.9
Growth of exports of G&S (US dollar terms, in percent)	2.5	7.7	10.2	9.9	10.0	9.5	9.9	9.3	9.4	5.8	9.4
Growth of imports of G&S (US dollar terms, in percent)	5.6	3.3	6.8	6.8	6.8	6.5	6.6	6.4	6.6	12.9	6.3
Grant element of new public sector borrowing (in percent)	...	52.6	52.5	52.5	52.6	52.5	52.5	52.4	52.4	...	52.5
Government revenues (excluding grants, in percent of GDP)	24.8	24.6	24.5	24.4	24.1	24.2	24.1	24.0	24.1	19.3	24.2
Aid flows (in Million of US dollars) 5/	368.3	933.8	1012.9	1050.0	1131.6	1185.1	1237.3	1537.4	2898.6		
Grant-equivalent financing (in percent of GDP) 6/	...	2.7	2.7	2.6	2.5	2.4	2.3	1.9	1.5	...	2.3
Grant-equivalent financing (in percent of external financing) 6/	...	66.5	70.8	71.7	71.7	72.3	73.2	75.3	84.6	...	72.4
Nominal GDP (Million of US dollars)	30690.3	34080.9	37381.9	40846.7	44498.5	48374.3	52868.1	81362.5	192701.7		
Nominal dollar GDP growth	5.7	11.0	9.7	9.3	8.9	8.7	9.3	9.0	9.0	9.4	9.3
Memorandum items:											
PV of external debt 7/	12.3	12.4	12.4	12.3	12.3	12.2	12.0	10.6	7.7		
In percent of exports	142.3	147.8	147.2	145.7	143.8	141.5	138.3	120.3	84.4		
Total external debt service-to-exports ratio	8.0	9.6	9.6	10.0	10.6	11.3	11.3	12.6	14.6		
PV of PPG external debt (in Million of US dollars)	3734.3	4163.6	4551.6	4934.0	5339.7	5734.3	6133.9	8136.4	12851.1		
(PVT-PV1)/GDPT-1 (in percent)	1.4	1.1	1.0	1.0	0.9	0.8	0.8	0.6	0.2		
Non-interest current account deficit that stabilizes debt ratio	7.8	3.6	4.5	4.6	4.5	4.4	4.5	3.8	3.5		

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



Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

3/ Includes exceptional financing (ie. 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.

The residuals in this table are mainly related to reserve drawdown and net errors and omissions. For example, there were reserve drawdown of 4.2% of GDP and positive net E&Os of 2.7% of GDP in FY2018/19.

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

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

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

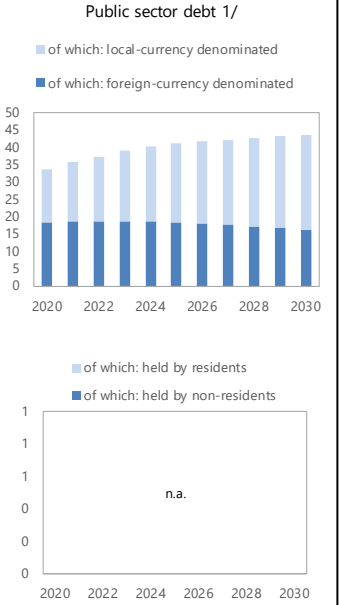
7/ Assumes that PV of private sector debt is equivalent to its face value.

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

Table 2. Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2017-2040
(In percent of GDP, unless otherwise indicated)

	Actual		Projections								Average 6/	
	2019	2020	2021	2022	2023	2024	2025	2030	2040	Historical	Projections	
Public sector debt 1/	30.1	33.7	35.7	37.4	39.0	40.3	41.1	43.6	46.3	30.6	40.1	
of which: external debt	17.0	18.3	18.6	18.7	18.7	18.7	18.4	16.2	10.8	18.7	17.9	
Change in public sector debt	13.1	15.4	17.1	18.8	20.3	21.6	22.6	27.4	35.5			
Identified debt-creating flows	-0.2	3.6	2.0	1.7	1.6	1.3	0.8	0.4	0.0			
Primary deficit	0.8	1.8	1.4	1.1	0.9	0.6	0.2	-0.1	-0.5	-2.0	0.5	
Revenue and grants	26.0	25.8	26.0	25.8	25.5	25.6	25.5	25.2	25.3	21.3	25.5	
of which: grants	1.2	1.2	1.5	1.4	1.4	1.4	1.4	1.2	1.2			
Primary (noninterest) expenditure	30.0	29.8	29.7	29.2	28.9	28.6	28.3	27.8	27.7	21.9	28.5	
Automatic debt dynamics	-3.2	-2.1	-2.3	-2.4	-2.4	-2.4	-2.6	-2.7	-3.0			
Contribution from interest rate/growth differential	-2.5	-2.1	-2.3	-2.4	-2.4	-2.4	-2.6	-2.7	-3.0			
of which: contribution from average real interest rate	-0.5	-0.4	-0.5	-0.5	-0.5	-0.4	-0.6	-0.6	-0.6			
of which: contribution from real GDP growth	-2.0	-1.7	-1.8	-1.9	-1.9	-2.0	-2.0	-2.2	-2.3			
Contribution from real exchange rate depreciation	-0.7	...	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			
Recognition of contingent liabilities (e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			
Residual 7/	-0.9	1.8	0.6	0.6	0.6	0.7	0.6	0.5	0.5	0.9	0.7	
Sustainability indicators												
PV of public debt-to-GDP ratio 2/	24.9	27.8	29.5	31.0	32.4	33.6	34.4	37.6	42.3			
PV of public debt-to-revenue and grants ratio	95.7	107.4	113.4	120.2	126.9	131.3	134.8	149.1	167.4			
Debt service-to-revenue and grants ratio 3/	24.4	26.3	21.6	22.4	25.0	27.9	30.4	35.8	45.4			
Gross financing need 4/	10.3	10.7	9.3	9.2	9.7	10.1	10.6	11.6	13.9			
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	7.1	6.0	5.7	5.5	5.4	5.3	5.3	5.3	5.3	4.9	5.4	
Average nominal interest rate on external debt (in percent)	0.8	0.7	0.7	0.7	0.8	0.8	0.8	0.9	0.9	0.9	0.8	
Average real interest rate on domestic debt (in percent)	-2.6	-1.9	-1.8	-1.7	-1.5	-1.2	-1.8	-1.5	-1.5	-3.2	-1.6	
Real exchange rate depreciation (in percent, + indicates depreciation)	-4.7	...	...	...	...	...	...	...	...	-2.2	...
Inflation rate (GDP deflator, in percent)	6.8	6.0	5.9	5.8	5.6	5.3	5.9	5.6	5.6	8.1	5.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	2.2	5.2	5.4	3.8	4.1	4.2	4.5	5.3	5.3	10.6	4.7	
Primary deficit that stabilizes the debt-to-GDP ratio 5/	4.1	0.3	1.7	1.7	1.7	1.7	2.0	2.2	2.5	3.5	1.8	
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			

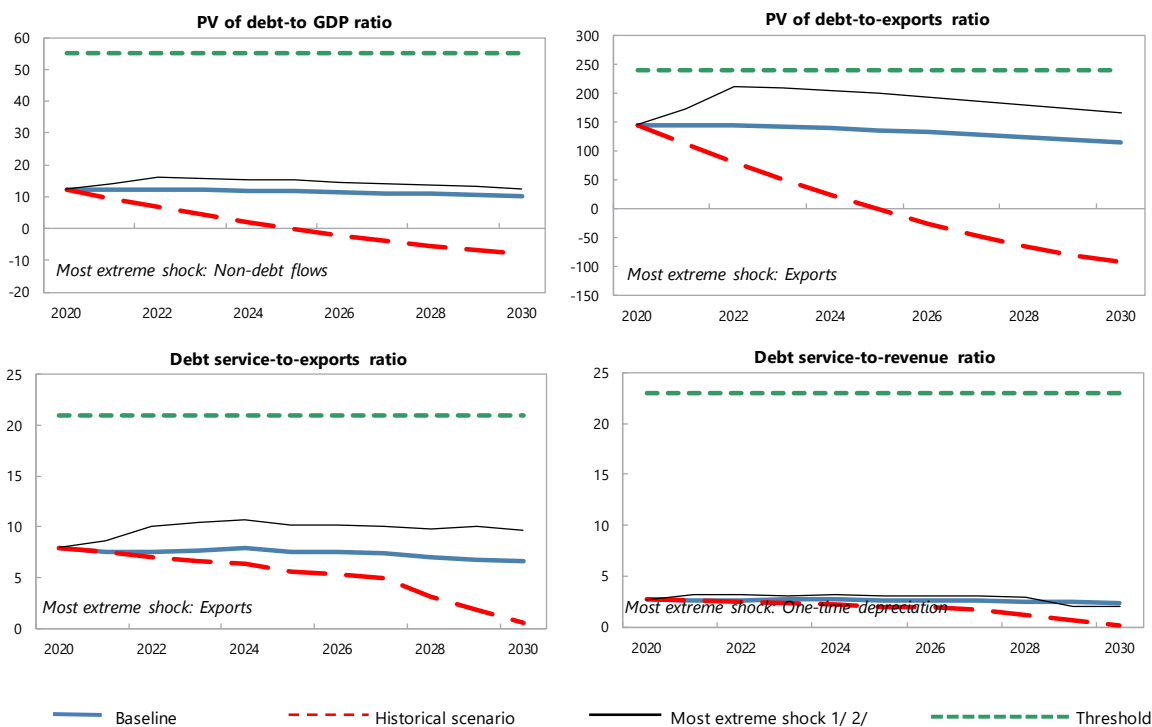
Definition of external/domestic debt	Currency-based
Is there a material difference between the two criteria?	No



Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The central, state, and local governments plus extra budgetary funds, central Bank, government-guaranteed debt, non-guaranteed SOE debt. Definition of external debt is Currency-based.
 2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.
 3/ Debt service is defined as the sum of interest and amortization of medium and long-term, and short-term debt.
 4/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period and other debt creating/reducing flows.
 5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio ((-): a primary surplus), which would stabilize the debt ratio only in the year in question.
 6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.
 7/ The residuals in this table are mainly related to net acquisition of financial assets. For example, the projection of net acquisition of financial assets in FY2019/20 is 1.6% of GDP.

Figure 1. Nepal: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2020-2030



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

Borrowing assumptions on additional financing needs resulting from the stress tests*		
	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	0.9%	0.9%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	37	37
Avg. grace period	6	6

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

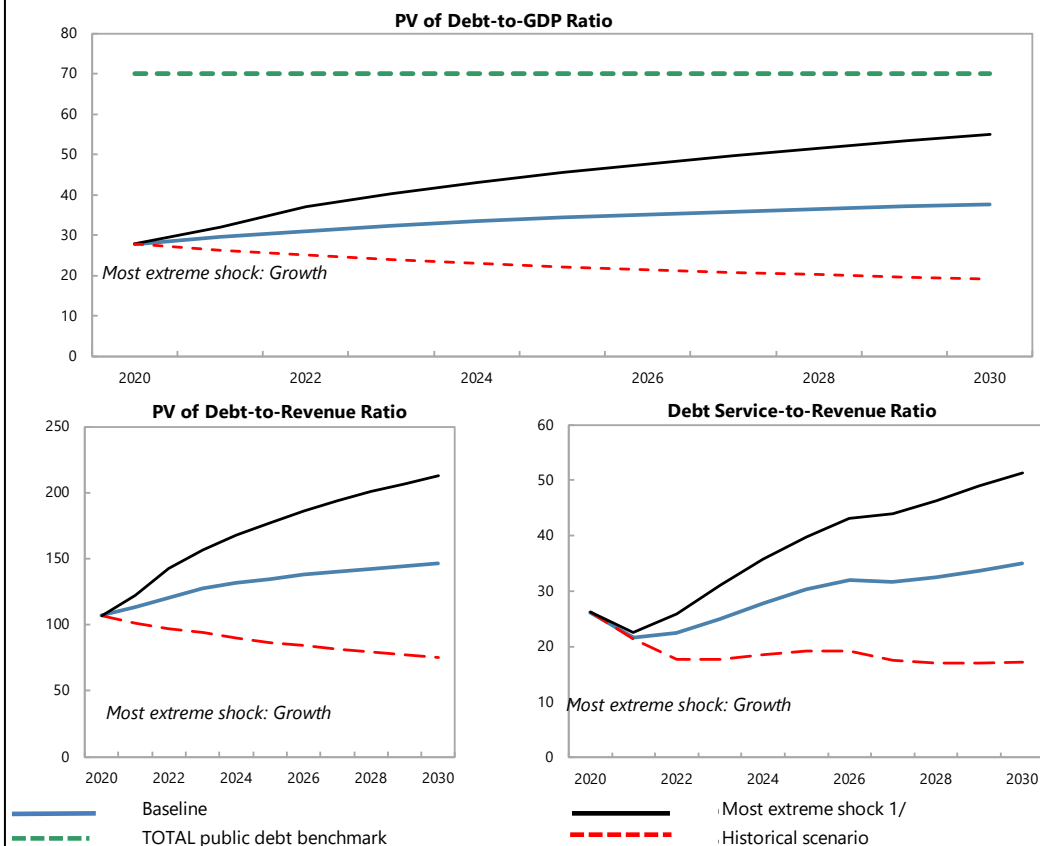
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2030. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most extreme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Nepal: Indicators of Public Debt Under Alternative Scenarios, 2020-2030



Borrowing assumptions on additional financing needs resulting from the stress tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	17%	17%
Domestic medium and long-term	56%	56%
Domestic short-term	27%	27%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	0.9%	0.9%
Avg. maturity (incl. grace period)	37	37
Avg. grace period	6	6
Domestic MLT debt		
Avg. real interest rate on new borrowing	-1.7%	-1.7%
Avg. maturity (incl. grace period)	7	7
Avg. grace period	0	0
Domestic short-term debt		
Avg. real interest rate	-1.7%	-1.7%

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

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2030. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most extreme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

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

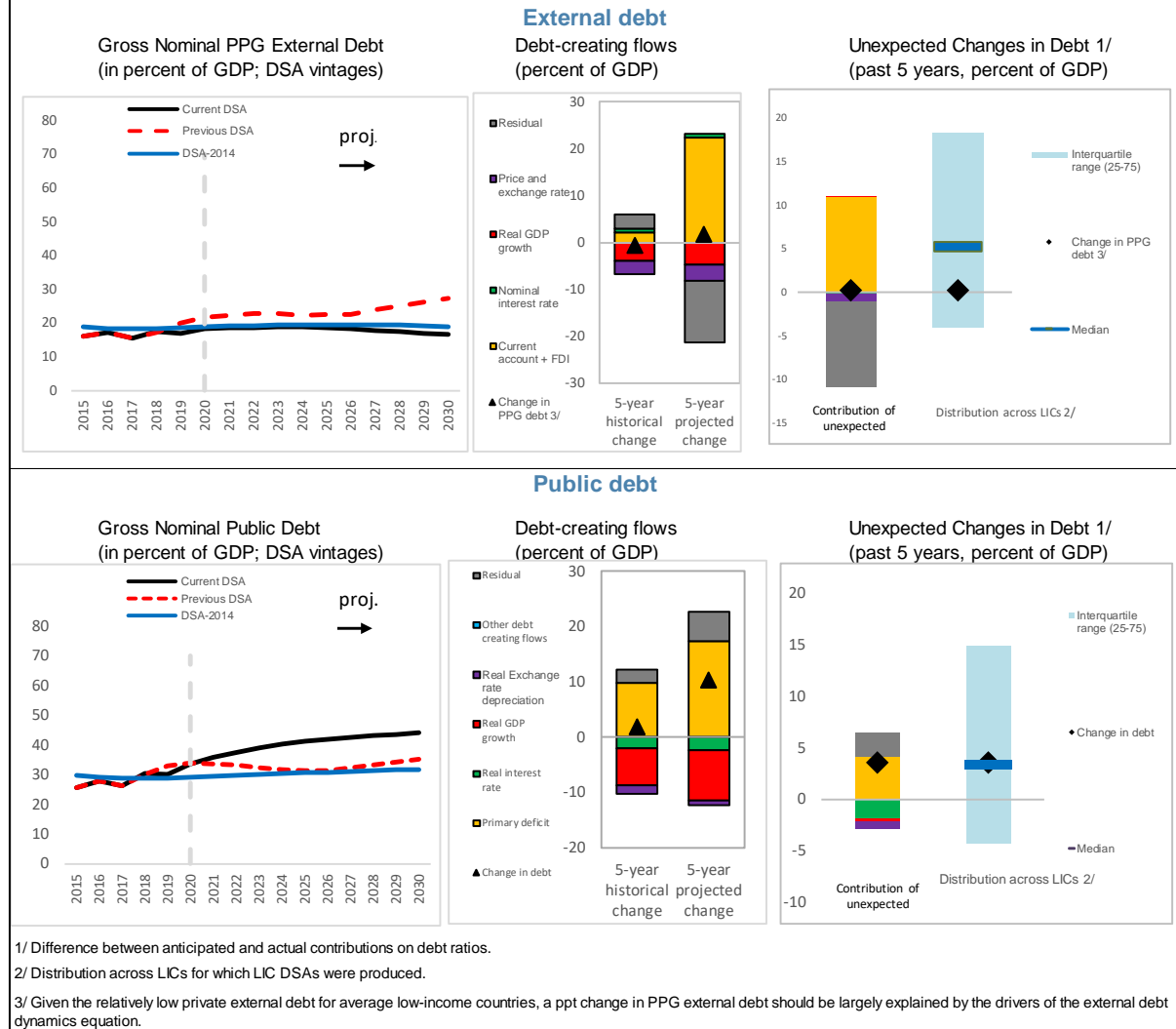


Figure 4. Nepal: Realism tools

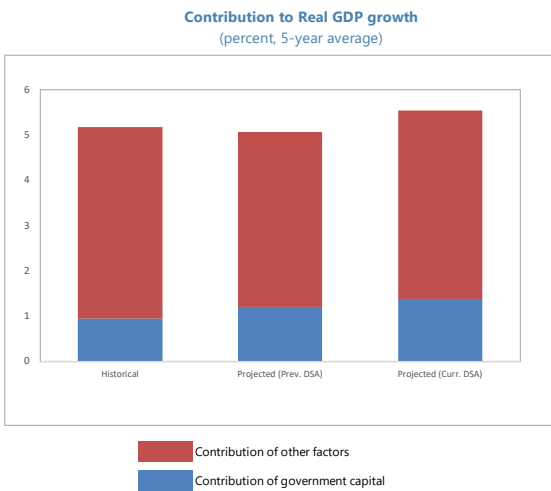
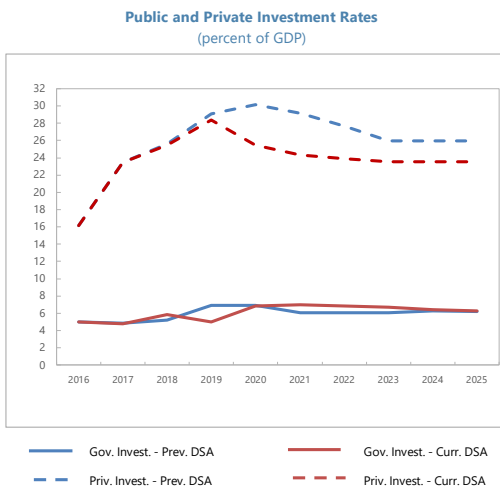
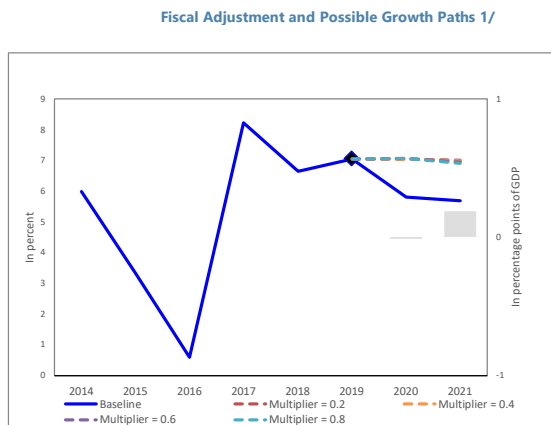
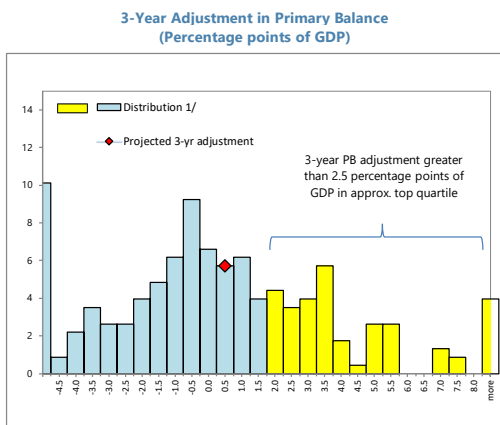


Table 3. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2020-2030
(In percent)

	Projections 1/										
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
PV of debt-to GDP ratio											
Baseline	12	12	12	12	12	12	11	11	11	10	10
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	12	10	7	5	3	0	-2	-3	-5	-6	-7
B. Bound Tests											
B1. Real GDP growth	12	13	13	13	13	13	12	12	12	11	11
B2. Primary balance	12	12	13	13	13	12	12	12	11	11	11
B3. Exports	12	13	14	14	13	13	12	12	11	11	11
B4. Other flows 3/	12	14	16	16	15	15	14	14	13	12	12
B5. Depreciation	12	15	10	10	10	10	10	10	9	9	9
B6. Combination of B1-B5	12	15	16	16	15	15	14	14	13	12	12
C. Tailored Tests											
C1. Combined contingent liabilities	12	13	13	13	13	13	12	12	12	11	11
C2. Natural disaster	12	13	13	13	13	13	13	13	12	12	12
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	55	55	55	55	55	55	55	55	55	55	55
PV of debt-to-exports ratio											
Baseline	146	144	143	140	137	134	130	126	122	118	114
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	146	114	84	56	30	6	-18	-38	-56	-71	-83
B. Bound Tests											
B1. Real GDP growth	146	144	143	140	137	134	130	126	122	118	114
B2. Primary balance	146	147	149	147	145	142	138	135	131	127	123
B3. Exports	146	174	213	209	204	198	192	186	179	172	165
B4. Other flows 3/	146	168	189	184	179	173	167	162	155	148	141
B5. Depreciation	146	144	95	95	94	93	91	89	87	86	85
B6. Combination of B1-B5	146	187	170	198	193	188	181	175	169	161	154
C. Tailored Tests											
C1. Combined contingent liabilities	146	153	154	152	150	147	144	140	137	133	129
C2. Natural disaster	146	159	160	160	158	155	153	150	147	143	139
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	240	240	240	240	240	240	240	240	240	240	240
Debt service-to-exports ratio											
Baseline	8	7	7	8	8	7	7	7	7	7	7
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	8	8	7	7	6	6	5	5	3	2	1
B. Bound Tests											
B1. Real GDP growth	8	7	7	8	8	7	7	7	7	7	7
B2. Primary balance	8	7	7	8	8	7	8	7	7	7	7
B3. Exports	8	9	10	10	11	10	10	10	10	10	10
B4. Other flows 3/	8	7	8	8	8	8	8	8	8	9	8
B5. Depreciation	8	7	7	7	7	7	7	7	6	5	5
B6. Combination of B1-B5	8	8	9	10	10	9	9	9	10	9	9
C. Tailored Tests											
C1. Combined contingent liabilities	8	7	8	8	8	8	8	8	7	7	7
C2. Natural disaster	8	8	8	8	8	8	8	8	7	7	7
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	21	21	21	21	21	21	21	21	21	21	21
Debt service-to-revenue ratio											
Baseline	3	3	3	3	3	3	3	3	3	2	2
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	3	3	2	2	2	2	2	2	1	1	0
B. Bound Tests											
B1. Real GDP growth	3	3	3	3	3	3	3	3	3	3	3
B2. Primary balance	3	3	3	3	3	3	3	3	3	3	3
B3. Exports	3	3	3	3	3	3	3	3	3	3	3
B4. Other flows 3/	3	3	3	3	3	3	3	3	3	3	3
B5. Depreciation	3	3	3	3	3	3	3	3	3	2	2
B6. Combination of B1-B5	3	3	3	3	3	3	3	3	3	3	3
C. Tailored Tests											
C1. Combined contingent liabilities	3	3	3	3	3	3	3	3	3	3	2
C2. Natural disaster	3	3	3	3	3	3	3	3	3	3	3
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Threshold	23	23	23	23	23	23	23	23	23	23	23

Sources: Country authorities; and staff estimates and projections.

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

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

3/ Includes official and private transfers and FDI.

Table 4. Nepal: Sensitivity Analysis for Key Indicators of Public Debt , 2020-2030

	Projections 1/										
	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
PV of Debt-to-GDP Ratio											
Baseline	28	29	31	32	34	34	35	36	36	37	38
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	28	26	25	24	23	22	22	21	20	20	19
B. Bound Tests											
B1. Real GDP growth	28	32	37	40	43	46	48	50	51	53	55
B2. Primary balance	28	32	36	37	38	38	39	39	39	40	40
B3. Exports	28	30	33	34	35	36	36	37	38	38	39
B4. Other flows 3/	28	32	35	36	37	38	38	39	39	40	40
B5. Depreciation	28	31	30	30	31	30	30	30	30	30	30
B6. Combination of B1-B5	28	30	32	33	34	34	35	36	36	37	37
C. Tailored Tests											
C1. Combined contingent liabilities	28	38	39	39	40	40	40	41	41	41	41
C2. Natural disaster	28	39	40	41	42	43	43	43	44	44	45
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
TOTAL public debt benchmark	70	70	70	70	70	70	70	70	70	70	70
PV of Debt-to-Revenue Ratio											
Baseline	107	113	120	127	131	135	139	141	144	147	149
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	107	101	97	94	90	88	86	83	81	80	78
B. Bound Tests											
B1. Real GDP growth	107	122	142	157	168	177	187	195	203	210	216
B2. Primary balance	107	123	139	145	148	150	153	154	156	158	159
B3. Exports	107	116	126	133	137	140	144	146	149	151	153
B4. Other flows 3/	107	121	136	142	146	148	152	154	156	157	159
B5. Depreciation	107	118	116	119	120	120	120	120	119	119	119
B6. Combination of B1-B5	107	117	125	129	132	135	138	141	143	145	147
C. Tailored Tests											
C1. Combined contingent liabilities	107	145	149	154	156	158	160	161	162	163	164
C2. Natural disaster	107	151	156	162	165	167	170	172	173	175	177
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt Service-to-Revenue Ratio											
Baseline	26	22	22	25	28	30	32	32	33	34	36
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2020-2030 2/	26	21	18	18	19	19	20	18	18	18	18
B. Bound Tests											
B1. Real GDP growth	26	23	26	31	36	40	44	45	47	50	52
B2. Primary balance	26	22	26	31	32	34	36	36	37	38	38
B3. Exports	26	22	22	25	28	31	32	32	33	35	36
B4. Other flows 3/	26	22	22	25	28	31	33	32	33	35	37
B5. Depreciation	26	20	22	22	26	28	30	30	30	32	33
B6. Combination of B1-B5	26	21	22	26	28	31	32	32	33	34	36
C. Tailored Tests											
C1. Combined contingent liabilities	26	22	34	32	34	36	38	38	39	39	39
C2. Natural disaster	26	22	36	34	36	38	40	40	41	42	42
C3. Commodity price	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
C4. Market Financing	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Country authorities; and staff estimates and projections.

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

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

3/ Includes official and private transfers and FDI.

**Statement by Alisara Mahasandana, Executive Director for Nepal,
Ranjana Pandit, Advisor to the Executive Director
March 17, 2020**

On behalf of the Nepali authorities, we would like to express our appreciation to the IMF mission chief Ms. Laura and her team for the candid discussion and policy dialogue during the 2020 Article IV Consultation. The authorities welcome the comprehensive staff's report and broadly concur with the policy recommendations. They would take staff's policy recommendations into consideration in the implementation of the macroeconomic policies and the reform agenda. They are grateful for the Fund's partnership and support, including the technical assistance.

Recent Economic Developments and Outlook

Nepal has adopted a federal governance system with three levels of government – federal, province and local. With greater political stability, the present government is able to create a conducive investment environment and foster high, sustainable and inclusive growth, while maintaining socio-economic stability through the social safety net.

Nepalese economy has achieved high growth trajectory over the past three years. Economic growth rate stood at 7.1 percent in FY2018/19 and the authorities are optimistic on the projected growth for FY2019/20, which will be supported mainly by private investment and government investment in mega projects. Meanwhile, inflation was moderate at 4.6 percent in 2018/19 but has edged up at 6.4 percent as of mid-January in 2020 arising partly from food prices and imported prices inflation from India.

On the external front, current account deficit narrowed further in the first half of this fiscal year compared to the same period last year, due mainly to lower import. Import is being substituted by domestic electricity generation and also through the initiatives taken for increase in domestic production and export promotion. Adequate measures are in place to control the informal trade on gold and other goods. Meanwhile, remittance is gradually picking up after the reopening of foreign worker employment in Malaysia. The level of foreign exchange reserves remains adequate to cover imports of merchandise goods and services for 8.4 months as of mid-January 2020.

Despite the favorable economic outlook, near-term growth is subjected to various external headwinds, including further economic slowdown in India and GCC countries, as well as prolonged impact of Covid-19 virus to the tourism activity. Domestic challenges especially the potential delay in structural reform and risks from climate change could also limit medium-term growth prospect.

The authorities commit to pursue prudent macroeconomic policies and steadfast structural reform. They are optimistic in achieving strong growth in the medium term and view that the high growth, along with structural reform measures will support their plan to upgrade the country to a developing economy status by 2022 and reach middle-income country status by 2030. The 15th periodic plan that is formulated to meet the 25-year long-term vision of “Prosperous Nepal, Happy Nepali” also focuses on enhancing social, economic and physical infrastructures. The authorities’ efforts to push forward a high and inclusive growth is critical to alleviate poverty and bring down the absolute poverty level to less than 5 percent by 2030 that are in line with the sustainable development goals (SDGs).

Fiscal Policy and Management

With the fiscal federalism being established in the country, government service delivery was set up in all seven provinces and 753 local governments. Capacity constraints in the subnational government remain a key challenge in ensuring smooth budget execution at the subnational level. Further capacity strengthening to enhance the performance of the subnational government will take time and this underscores the importance of technical assistance from the IMF and other development partners.

The authorities underscore their commitment to fiscal discipline and fiscal reform to enhance revenue mobilization and improve efficacy of public spending and management. They have made important efforts to reform the revenue performance through strengthening of domestic revenue collection and proper revenue sharing mechanism at subnational level. Several measures have been introduced to broaden the tax base and strengthen the tax administration, such as digitalization of tax clearing system, custom automation and risk-based clearing and revenue leakage control mechanism. The use of Permanent Accounting Number (PAN), which allows the authorities to track the income level and tax status of individuals and the biometric system for the corporate income tax are key reform measures that have supported higher tax collection. Meanwhile, the online tax portal for integrated tax system (ITS), that was recently established, enable a good tracking system and improve tax collection performance. As a result, revenue collection from domestic income tax has increased by 30 percent in the first half of FY2019/20, although the trade related revenue declined due to the subdued import performance.

The government expenditure will focus on achieving quality capital spending. Recent key measures undertaken by the government includes reviewing the capital expenditure and reprioritizing the investment projects, developing monitoring system and coordination with line ministries, and strengthening the quality control system of government contractors. The government is also committed to expedite the backloaded expenditure. The authorities will continue to maintain the spending on social safety net in order to support the poor segment of the society. They view that their large social safety net spending, which is higher than the South Asian region average is manageable as the debt position remains low at 30 percent of GDP.

In light of staff's view on the ambitious budget target, the authorities would like to assure that there is a rule-based and transparent fiscal transfer and revenue sharing mechanism in place. The overall resource envelopes provided by the National Planning Commission, including budget programs and modalities are guided by the Medium-Term Expenditure Framework. This framework monitors the budget allocation and budget discipline of subnational governments as well. Budget allocation was set to meet the target of line ministries, and performance-based allocation mechanism has recently been established to correct any overly ambitious target through a performance evaluation.

Monetary and Exchange Rate

The authorities are of the view that the monetary policy stance is appropriate, with the objective of maintaining price and external sector stability. The exchange rate peg to the Indian rupee serve the economy well in providing a nominal anchor for containing imported inflation from India.

The authorities concur with staff that a well-established monetary policy framework remains a concern, particularly in an absence of an effective interest rate corridor. That said, underdeveloped financial market and high prevalence of shadow banking in the financial sector also contribute to the short-term interest rate volatilities. The authorities commit to improve the interest rate corridor effectiveness as suggested by staff.

While the Nepal Rastra Bank (NRB) will continue to ensure adequate supply of credit to support the growth target, a special provision in the NRB Act will limit government borrowing from the central bank.

Financial Sector

The financial sector remains sound, with adequate capital and low level of non-performing loans. As highlighted by staff, various macroprudential measures such as CCD ratio and others, remain appropriate to maintain financial sector soundness. Moreover, reduction of limit for personal overdraft loan, directives for counter cyclical capital buffer and introduction of debt service to income ratio for non-business loans were recently introduced to strengthen the financial sector's resilience. In addition, the Supervisory Information System was newly established to closely monitor and analyze the financial supervisory data and risk-based supervision implemented in all financial institution classes.

The authorities take note of staff's concern with regard to pockets of vulnerabilities that are not fully captured in the consolidated asset exposure. To this end, the central bank is acting promptly by issuing new directives and others moral suasion measures to address this issue. For example, a misused business loan will be categorized as bad loan and subject to 100 percent provision. An integrated tax system which includes borrowers' tax document has been established, and if any

discrepancy is found, the loan will be categorized as bad and subject to 100 percent provision. In this scenario, the authorities will seek assistance from the IMF to further improve the data tracking system.

Bills to amend Nepal Rastra Bank Act, Bank and Financial Institution Act and Securities Act are already in parliamentary committee. The authorities are also in the process to launch the plan to develop insurance and capital market, commodities exchange, mutual fund and corporate bond market.

The authorities are also committed to promote financial inclusion by expanding banking services and ensure access to bank account for every Nepali. The fast-growing usage of FinTech, mobile banking and internet services reflected the improvement in financial access in Nepal.

Structural Reform and Sustainable Growth

The authorities are more optimistic than staff on the growth potential. They underscore the need to improve GDP compilation to enhance data coverage that would adequately capture economic activities of SMEs and self-employed individuals and thus better estimate the potential growth going forward. In addition, the authorities view that investments in infrastructure and other large projects will create new sources of growth. They are also shifting the structure of the economy from agriculture based to industrial and service sectors through large infrastructure investment in energy, transportation and communication sector. At the same time, the authorities also place greater emphasis in localizing the SDGs and people at the grass root level.

The authorities are pleased by the improvement in the Ease of Doing Business indicators and will continue to undertake more reform measures to boost the investment climate and facilitate business operations. Key reform initiatives that have been completed, including the amended Foreign Direct Investment Act, Foreign Assistance Act and the standardization of PPP strategy. The authorities are also in the process of developing FX hedging instruments for investors to better manage their exchange rate risks. The authorities' initiatives to facilitate foreign and domestic investment along with political stability and the World Bank and IFC's fund mobilization activities have resulted in the continued increase in private investments over the past few years. The authorities also view that the recent increase in the threshold for minimum foreign direct investment will continue to attract quality foreign investors for much needed investment projects while protecting local SMEs and small investors. The authorities agree with staff that enhancing the supply of skilled manpower is also critical to attract more private investments.

The authorities amended the Procurement Regulation to ensure more efficient project implementation through the incorporation of critical revision of contractor capacity and progress-based incentives. Project bank concept has also been introduced for projects that involved large and long-term gestation period.

As Nepal is highly vulnerable to climate change and natural disasters, the authorities are planning to develop a disaster resiliency strategy, especially in infrastructure projects by giving high budget priorities to the climate change related projects.

AML/CFT

The authorities commit to implement the AML/CFT measures by internalizing it as part of good governance and bringing them in line with international standards. Along with AML/CFT National Strategy and Action Plan, the authorities have made it mandatory for all commercial banks to report suspicious financial transactions and transaction above the set threshold through the digital report via the go AML software that was built by the UN Office of Drugs and Crime. The transition from manual reporting will facilitate the Financial Information Unit, an independent body headed by a central bank official, to better manage and analyze the essential information.

Capacity Development

The authorities express their appreciation to the Fund for the continued support to enhance their technical capacity in various areas including fiscal, monetary, legal and financial statistics. The authorities would also welcome further technical support to strengthen the fiscal and financial information system at the sub-national level. They also highlight the need for enhancing technical assistance to revisit and rebase the national GDP and disaggregate it up to the sub national level.

Final Remarks

Finally, the authorities would like to thank the Fund for the successful conclusion of the Article IV consultation in Nepal. The authorities express their gratitude to the Fund for the continued support in terms of policy advice and technical assistance as well as to the donor community for their continued cooperation and support to Nepal. The authorities look forward to continuing discussions with the Fund on macroeconomic and financial sector policies including structural reforms and other emerging issues.