Nepal—Assessment Letter for the Asian Development Bank
November 16, 2007

Economic outcomes were broadly satisfactory during 2006/07, and macroeconomic policies have remained sound. Real GDP rose by 2½ percent, notwithstanding poor weather conditions which affected paddy production, and political uncertainties which continued to dampen nonagricultural activity. With monetary management by Nepal Rastra Bank (NRB) geared to maintaining the exchange rate peg to the Indian rupee, headline inflation remains broadly in line with price developments in India. The 2006/07 budget exceeded its revenue target, with a strong tax administration effort. Current spending was lower than budgeted, reflecting savings from the postponement of elections to the next fiscal year, and capital spending picked up. While external aid fell short of the budgeted amount, domestic financing was limited. International reserves were around US$2 billion (6½ months of goods and services imports), supported by robust remittances.

Going forward, Nepal's economic prospects can improve with normalization of the political situation and reform implementation. On balance, real GDP growth could rise to 4 percent in 2007/08, subject to favorable agricultural performance, and continued strength in tourist arrivals with a knock on effect on the service sector more generally. The unsettled political environment poses the most immediate risk to growth. Meanwhile, macroeconomic policies remain well-anchored. The 2007/08 budget is appropriately focused on social sectors and infrastructure spending in rural areas, a higher targeted revenue-to-GDP ratio, and limited domestic financing. The exchange rate peg to the India rupee should help continue to contain inflation to levels close to those in India, while structural reforms and infrastructure investments are key to maintaining competitiveness over the medium term.

Structural reforms have progressed, but much remains to be accomplished. As part of the PRGF-supported program in 2006/07–2007/08, progress has been made in tax administration, and financial and public sector reforms. Continued reforms in these areas are key for sustained growth and poverty reduction.

- Fiscal reforms should be geared to further improving tax administration to reduce leakages and broaden the tax base. Improvements in public expenditure management and increased fiscal transparency are also required.

- Financial sector reforms can help improve intermediation and financial stability. While the revised Bank and Financial Institutions Act would provide a strengthened framework for financial sector integrity, the NRB needs to further address gaps in its supervisory framework, and progress is required in loan recovery from large, willful defaulters to improve the financial condition of the two largest commercial banks.

- The October price adjustments for petroleum products are welcome, but further increases and the introduction of an automatic pricing mechanism are required to place the loss-making Nepal Oil Corporation's finances on a sustainable footing.

Status of IMF relations. The fifth (and final) review under the Poverty Reduction and Growth Facility was completed on November 9, 2007. The 2008 Article IV consultation is slated for spring 2008.