Nepal—Assessment Letter for the Asian Development Bank

August 17, 2009

Despite the recent political fragility and the global financial crisis, the macroeconomic situation in Nepal remains broadly stable. Real GDP growth in 2009/10 is expected to be resilient at 4 percent, slightly down from 4.7 percent in 2008/09 due to power shortages, difficult labor relations, and adverse weather conditions. Due to the continued growth of remittances, the current account and balance of payments remain in surplus and foreign exchange reserves have increased to a level sufficient to cover 8 months of imports. The 2008/09 budget deficit (after grants) was contained to 1.5 percent of GDP owing to strong revenue growth and underspending. Up to May 2009, M2 continued to grow by more than 20 percent on a year-on-year basis and credit growth, which in recent years has been particularly rapid to the real estate sector, rebounded compared to the first quarter of 2009. Inflation has remained high at about 13 percent for 2008/09, driven mostly by food prices increases as has been the case for India's CPI, and has yet to decline.

Going forward, Nepal's economic prospects depend on creating an economic environment conducive to growth. The exchange rate peg with the Indian Rupee remains appropriate in the near term and keeps Nepal's inflation rate close to Indian CPI, with fiscal discipline remaining essential to underpin the peg and maintain macroeconomic stability. Structural reforms and infrastructure investments continue to be key to maintaining competitiveness over the medium term. The main risks to the near-term outlook stem from lower remittances and financial sector weaknesses related to the exposure to the real estate sector.

Fiscal policy has been prudent over the past several years,[1] but risks are rising. Although the authorities remain committed to containing domestic borrowing to about 2 percent of GDP in line with previous IMF staff recommendations, the 2009/10 budget envisages revenue growth of 24 percent compared to the 2008/09 outturn, which will be difficult to achieve. Moreover, current outlays are budgeted to increase by 32 percent from the 2008/09 outturn and new expenditure pressures are emerging. The deficit is thus likely to exceed the budget by a considerable amount (about 1 percent of GDP, entailing domestic borrowing of 3¼ percent of GDP) and, over time, such fiscal slippage could undermine macroeconomic stability. Furthermore, while at current oil prices the Nepal Oil Corporation

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[1] The last IMF/World Bank Debt Sustainability Analysis (May 2008) concluded that Nepal's external debt was subject to a moderate risk of debt distress, a change from the previous DSA that had classified Nepal at high risk of debt distress reflecting improved debt indicators.

(NOC) is still covering its costs, the absence of an automatic fuel pricing mechanism implies that its financial position will be threatened should international fuel prices rise.

A modest tightening of monetary policy is advisable. Real interest rates on bank deposits remain negative. As inflationary pressures have not yet eased and loose monetary conditions are likely to have contributed to the rapid rise in real estate prices, a modest tightening of monetary policy would be appropriate: given stringent capital controls and lower deposit rates compared to those of India, there remains room to raise interest rates.

Progress on structural reform continues to be held back by the fragile political situation. Efforts are needed on a number of fronts:

- *Banking sector.* The recent attempts to liquidate the Nepal Development Bank and stop registration of new banks are welcome steps. Enforcement of prudential regulation, however, remains weak and given the proliferation of financial institutions and rapid credit expansion in recent years, the authorities face significant challenges.

- *Price adjustment mechanism for oil products*. Introducing an automatic fuel pricing mechanism remains an important measure to contain quasi-fiscal costs. Such a mechanism would serve to depoliticize the setting of fuel prices and prevent a recurrence of the fuel shortages and subsidies of last year.

- *Public sector.* The accounting, auditing, and reporting of public sector operations are inadequate. The budget coverage is confined to the central budget with very limited information on quasi-fiscal activities. Internal control procedures are not fully effective and expenditure management weak.

Status of IMF relations. The 2008 Article IV consultation was discussed by the Executive Board in May 2008. A staff visit is planned for late August and the next Article IV consultation is preliminarily scheduled for the Spring of 2010.