Nepal—Assessment Letter for the World Bank
May 29, 2015

1. **Before the earthquakes of April 25 and May 12, Nepal's macroeconomic performance was relatively strong**:

- Growth accelerated to 5.5 percent in 2013/14, thanks largely to a favorable monsoon.

- Inflation had been moderating, broadly in line with developments in India, but remained high at 7 percent (y/y) in March 2015.

- The fiscal position in 2013/14 (mid-July 2013 to mid-July 2014) was again in surplus, on account of under-execution of spending amid solid revenue growth. As a result, public debt eased further, to 25 percent of GDP. The trend of budget under-execution continued through April 2015, indicating that a small fiscal surplus looked again likely in 2014/15. Public debt remained on a declining path.

- The external position remained strong. The current account surplus reached 4.6 percent of GDP in 2013/14, as remittances continued to grow rapidly, reaching a record-high 28 percent of GDP. Net of remittances, however, Nepal ran a current account deficit of 23.6 percent of GDP in 2013/14. International reserves rose to US$6.2 billion by March 2015, equal to 29 percent of GDP and covering almost eight months of prospective imports.

2. **The earthquakes are expected to cause an initial slowdown in economic activity and to strain Nepal's external position**. Pending the completion of the Post-Disaster Needs Assessment it is too early to provide estimates of the damage. However, Nepal's Cabinet has established a US$2 billion (about 10 percent of GDP) *Earthquake Relief Fund for Reconstruction and Rehabilitation*. The damage to property has adversely affected productive capacity. The tourism sector which generated about 2½ percent of GDP in foreign currency earnings in 2013/14 has also been hit. The growth recovery will largely be determined by the vigor of the reconstruction effort. There are two components to the expected increase in reconstruction activity:

- The large-scale import needs related to public sector reconstruction will strain Nepal's external position and the pace of public sector reconstruction will importantly depend on the amount of external finance Nepal receives to rebuild. Alternatively, without the mobilization of substantial additional aid, foreign reserves would be expected to fall significantly over the medium term

- Private sector reconstruction will largely be driven and financed by remittances.

It should be noted that the speed of Nepal's recovery will not only depend on the amount of external financing received. Other key factors include the extent to which Nepal's absorptive capacity is increased by addressing implementation bottlenecks, as well as effective coordination among donors.

3. **Risks to the outlook other than those related to the earthquake pertain to external demand, financial sector, and political risks**. With limited links to global financial markets, the main external risks to the outlook stem from a slowdown in host countries for Nepali workers (especially in oil-exporting countries, e.g., the GCC countries and Malaysia), and a potential slower-than-anticipated recovery in India, which is Nepal's largest trading partner. Domestic risks are related to long-standing vulnerabilities in the financial sector, as identified in the 2014 FSAP, and political instability which could undermine confidence and delay economic reforms.

4. **There is ample scope to strengthen monetary, fiscal and financial sector policies, but the earthquakes have made reinforcing fiscal policy and financial sector policy top priorities:**

- Before the earthquakes staff argued that there was fiscal space to significantly boost investment in public infrastructure (power and transport) without endangering debt sustainability. The joint World Bank-IMF DSA conducted in the 2014 Article IV cycle rated Nepal at "low" risk of debt distress, and staff believes this rating continues to be warranted, as little new debt has been incurred. At the same time, the large post-earthquake reconstruction needs have added urgency to addressing institutional constraints—including in the budget planning and execution processes—which impede an efficient execution of the capital budget. Recent technical assistance by the IMF's Fiscal Affairs Department provided detailed recommendations to address implementation bottlenecks.

- The widespread earthquake-related damage to property could expose financial sector vulnerabilities. The 2014 FSAP—Nepal's first—identified a number of financial sector weaknesses, including asset quality issues, interconnections in the financial system, as well as financial sector infrastructure—including the legal framework—and supervision and crisis preparedness. At the same time, a largely unsupervised credit cooperatives sector has been growing rapidly. The Nepal Rastra Bank has in recent years taken a number of macro-prudential measures to curb risks, and improved its supervision. However, it will be important for the NRB to strengthen its capacity further, use its corrective and sanctioning powers more fully, and respond decisively to possible instances of financial distress caused by the earthquakes.

- The exchange rate peg with the Indian rupee serves as a transparent anchor for monetary policy, and continues to benefit Nepal in view of its close economic relationship with India. Against this background, monetary policy should aim at controlling the level and volatility of excess liquidity to keep Nepalese inflation in the neighborhood of that in India. Liquidity management may now be complicated by increased aid and remittances flows.

IMF Relations

The joint IMF-World Bank FSAP was completed in mid-2014 and the 2014 Article IV consultation was concluded by the IMF's Executive Board on July 3, 2014. An IMF mission visited Nepal during May 10-15, 2015 to help assess the macroeconomic impact of the earthquakes. Staff is planning a follow-up mission to discuss the provision of financial support through the Rapid Credit Facility. In recent years, the Fund has been providing ample technical assistance in the areas of tax administration, tax policy, public expenditure management, monetary policy operations, banking supervision, and macroeconomic statistics.