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NEPAL

August 2015

REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY— STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR NEPAL

In the context of the request for disbursement under the Rapid Credit Facility, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 31, 2015, following discussions that ended on June 29, 2015, with the officials of Nepal on economic developments and policies underpinning the IMF arrangement under the Rapid Credit Facility. Based on information available at the time of these discussions, the staff report was completed on July 17, 2015.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF.
- A **Statement by the Executive Director** for Nepal.

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

Letter of Intent sent to the IMF by the authorities of Nepal*

*Also included in Staff Report

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

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International Monetary Fund
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Press Release No. 15/365
FOR IMMEDIATE RELEASE
July 31, 2015

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Approves US$ 49.7 million Disbursement Under the Rapid Credit Facility for Nepal

The Executive Board of the International Monetary Fund (IMF) today approved a disbursement of SDR 35.6 million (US$49.7 million) for Nepal under the Rapid Credit Facility (RCF).[1] This financial support will help the country address the urgent balance of payments and fiscal needs associated with the rehabilitation and reconstruction efforts in the aftermath of the powerful earthquake that occurred on April 25 causing widespread damage and devastation.

The Executive Board's approval enables the disbursement of the full amount, which represents 50 percent of Nepal's quota in the IMF. At the request of the authorities, the money will be disbursed as direct budget support to the Ministry of Finance's account at the central bank of Nepal.

Following the Executive Board's discussion of Nepal, Mr. Mitsuhiro Furusawa, Deputy Managing Director and Acting Chair, issued the following statement:

"Many lives were lost as a result of the April and May earthquakes, and the damage to homes, buildings, infrastructure, and agriculture was extensive, with the total cost of the earthquakes estimated at about US$7 billion or about one-third of GDP. The overall economic impact is expected to be far-reaching in both the short and medium terms, and manifested in a slowing of potential growth, rising inflationary pressures, widening fiscal and current account deficits, and increased debt levels.

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[1] The RCF (http://www.imf.org/external/np/exr/facts/rcf.htm) provides immediate financial assistance with limited conditionality to low-income countries with an urgent balance of payments need. In this context, the economic policies of a member receiving RCF financing are expected to address the underlying balance of payments difficulties and support policy objectives including macroeconomic stability and poverty reduction. Financing under the RCF carries a zero interest rate, has a grace period of 5.5 years, and a final maturity of 10 years. The Fund reviews the level of interest rates for all concessional facilities every two years.

“Sizable aid pledges received from multilateral and bilateral donors in the context of the June 25 International Conference on Nepal’s Reconstruction, amounting to about US$4 billion of grants and concessional loans, will be disbursed over the next five years to help finance the reconstruction effort. The Nepali authorities remain committed to maintaining fiscal and debt sustainability, and the high concessionality of the aid will help to ensure that Nepal’s risk of debt distress remains low.

“Strengthening public financial management will be key to the swift and effective implementation of reconstruction efforts, and enhancement of the quality of public investment. To address the persistent under-implementation of the capital budget, the authorities are simplifying administrative procedures for capital spending and have established a National Reconstruction Authority (NRA) to speed up reconstruction in the country’s districts that were affected the most by the earthquakes. Moreover, strong coordination between the NRA and the annual budget process will help to promote effective use of earthquake relief funds. Enhanced donor coordination, additional capacity building support and the Fund’s continued provision of technical assistance in public financial management will help to underpin the authorities’ reconstruction efforts.

“The authorities will continue to strengthen financial regulation and supervision, and carry out reforms designed to mitigate risks that have been amplified by the earthquakes. The development of contingency plans would complement this. The authorities will also continue to implement policies and programs to improve financial inclusion.

“Structural reforms will remain key to overcoming persistent challenges, with a view to accelerating the recovery and fostering a more durable growth. In this regard, greater emphasis is needed on reforms designed to enhance competitiveness and strengthen the business climate in key priority areas—such as transportation and energy, education and training, and SME access to finance—to help set the stage for the next phase of Nepal’s growth and development.”

INTERNATIONAL MONETARY FUND

NEPAL

July 17, 2015

REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY

EXECUTIVE SUMMARY

Context: A powerful earthquake hit Nepal on April 25. Over 8,800 lives were lost and damages and losses are estimated at US$7 billion or nearly one third of GDP. Reconstruction of housing, government buildings and infrastructure will open fiscal and balance of payments gaps in the coming years. Before the earthquake, Nepal's macroeconomic performance was broadly favorable but the government's weak budget implementation capacity held back growth and propped up the external position.

Request for Fund assistance: The Nepalese authorities are requesting financial assistance under the Fund's Rapid Credit Facility (RCF) to address the urgent balance of payments and fiscal needs associated with the rehabilitation and reconstruction efforts. In the attached letter, they request the equivalent of SDR35.65 million (50 percent of quota), with the full amount to become available upon Board approval, to be disbursed as direct budget support. In the context of a June 25 donor conference, multilateral and bilateral donors pledged about US$4 billion worth of grants and concessional loans to be disbursed over five years, to cover the remaining financing needs.

Discussions: Given the large reconstruction needs, discussions focused on (i) the economic and fiscal impact of the earthquake; (ii) the government's efforts to strengthen its capacity to plan, prioritize, and implement capital spending; (iii) steps to address risks to the financial system from widespread damage to property; and (iv) debt sustainability.

Next steps after the RCF: The authorities expressed interest in discussing longer-term Fund engagement, possibly through the Extended Credit Facility (ECF). By addressing Nepal's weak implementation capacity, financial system weaknesses, and entrenched structural challenges and improving governance and public financial management, a package of macroeconomic and structural reforms could help speed up the recovery from the earthquake and set the stage for the next phase of Nepal's growth and development.

Approved By
Kalpana Kochhar (APD) and Ranil Salgado (SPR)

Discussions were held in Kathmandu during May 10–15 and June 23–29, 2015. The staff team comprised Mr. Almekinders (head), Mr. Ojima, Ms. Das (all APD), and Ms. Marinkov (FAD, June mission) and was supported by Mr. Richardson (Senior Resident Representative for Nepal based in New Delhi). Ms. Kochhar (APD) joined the June mission and participated in the June 25 donor conference in Kathmandu.

May Inoue and Qianqian Zhang assisted in preparing this report.

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BACKGROUND AND RECENT DEVELOPMENTS

1. **Around midday on April 25, a magnitude 7.8 earthquake struck Nepal, causing widespread damage and devastation.** A second earthquake on May 12 (magnitude 7.3) claimed additional lives and caused more damage to already weakened structures. According to the latest official estimates, over 8,800 lives were lost and 8 million people—nearly a third of Nepal's population—have been affected by the earthquake. Half a million homes were destroyed and another 250,000 were damaged (Box 1). Many cultural and architectural heritage sites have been reduced to rubble.

2. **The authorities acted quickly to minimize disruptions to government and central bank operations**, despite the serious physical damage to the central bank's main cash distribution facilities and to its headquarters and the absence of a disaster recovery site. This was key to maintaining public confidence in the financial sector. Effective collaboration and cooperation, both within the government and among the government and its development partners, was instrumental in completing the Post-Disaster Needs Assessment (PDNA) and presenting it at an international donor conference within two months of the disaster.

3. **The total cost of the earthquake is estimated at about US$7 billion, or ⅓ of GDP**. The damage to buildings and infrastructure is estimated at about 24 percent of GDP. In addition, economic losses (e.g. foregone revenue in agriculture and tourism) are estimated at 9 percent of GDP.[1] The necessary spending on recovery and reconstruction will require a significant increase in government expenditure, push the current account to a deficit, and open fiscal and balance of payments gaps in the coming years.

4. **The authorities are requesting financial assistance from the Fund under the shocks window of the Rapid Credit Facility (RCF) to ease the pressure on official foreign reserves once reconstruction starts in earnest.** In the attached letter, they request a disbursement in the equivalent of SDR35.65 million (50 percent of quota) (Appendix 1). Staff supports the authorities' request. The funds will be used for budget support. Because the Central Bank Law does not permit central bank lending to the government (beyond short-term overdrafts to bridge cash-flow fluctuations), they have asked the funds to be transferred to the Ministry of Finance's account at the central bank. Staff assesses that the authorities have sufficient capacity and commitment to implement policies adequate to address the shock caused by the disaster. In the context of a June 25 donor conference, multilateral and bilateral donors pledged about US$4 billion worth of grants and concessional loans to be disbursed over five years, to cover the remaining financing needs.

Aid Pledged by Key Donors for next 5 years

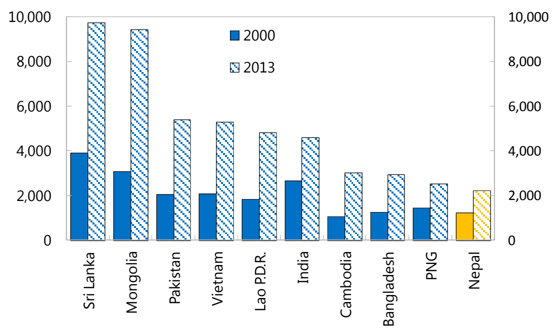
(in millions of U.S. dollars)	Loans (A)	Grants (B)	Total (A)+(B)	Of which: New Pledges
1. Bilateral	958	1,972	2,929	2,143
China	...	767	767	490
EU	...	117	117	117
India	750	650	1,400	1,000
Japan	208	52	260	260
UK	...	110	110	63
US	...	130	130	68
Others	...	145	145	145
2. Multilateral	1,130	20	1,150	600
ADB	580	20	600	250
WB	500	...	500	300
IMF	50	...	50	50
Total	**2,088**	**1,992**	**4,079**	**2,743**

Sources: Nepali authorities; and IMF staff projections.

[1] The Post-Disaster Needs Assessment's estimates for total damage (25 percent of GDP) and economic losses (9 percent of GDP) are considerably less that the relevant thresholds (100 percent of GDP and 25 percent of GDP, respectively) to qualify for IMF debt relief from the Catastrophe Containment and Relief (CCR) Trust.

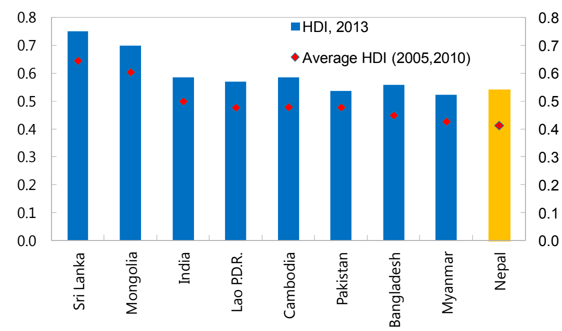
5. Nepal remains Asia's poorest country, despite progress in reducing poverty. After a decade-long civil war and the abolition of the monarchy in 2008, the country is undergoing a gradual transition to a federal democratic state. Poverty has been declining, from over 50 percent of the population in 2003/04 to just under 25 percent in 2010/11, thanks in part to rising remittances sent home by the growing number of Nepalese working mostly in GCC countries and Malaysia. Nevertheless, output per capita remains the lowest in the region, and further efforts are needed to improve living standards. The economy is primarily based on agriculture and services, the latter increasingly fuelled by remittances.

Per Capita GDP (PPP)
(In U.S. dollars)



Sources: World Bank, *WDI Database.*

Human Development Index (HDI)
(index)

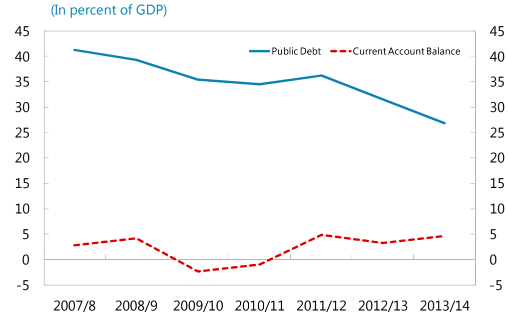


Source: UNDP, *Human Development Report 2014.*

6. Before the earthquake, Nepal's macroeconomic performance was broadly favorable but the government's weak budget implementation capacity held back growth and propped up the external position (Figures 1 and 2):

- Growth accelerated to 5.5 percent in 2013/14, thanks largely to a favorable monsoon. Average growth of 4 percent in the three previous years lagged neighboring countries.
- Inflation had been moderating, in line with developments in India, but at 6.8 percent (y/y) in mid-April 2015, a wedge of about 2 percentage points remained over Indian CPI.
- The fiscal position was in surplus the past two fiscal years, on account of under-execution of spending. As a result, public debt fell to 28 percent of GDP by mid-2014. The trend of budget under-execution has continued, indicating that a small fiscal surplus looks again likely in 2014/15 (mid-July 2014 to mid-July 2015).
- 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. Reserves rose to US$6.3 billion by mid-April 2015, equal to 29 percent of GDP and covering almost eight months of prospective imports.

Public Debt and Current Account Balance
(In percent of GDP)



Sources: Nepali authorities; and IMF staff estimates

THE IMPACT OF THE EARTHQUAKE

7. The disaster's impact is likely to be severe, both in the short and medium run (Figure 3):

- **Growth is expected to slow.** On June 8, Nepal's Central Bureau of Statistics released a revised GDP projection for 2014/15 with growth falling to 3.4 percent in the year to mid-July 2015, compared to staff's pre-earthquake baseline forecast of 5.0 percent. The tourism sector which generated about 2½ percent of GDP in foreign currency earnings last year has been particularly affected. As economic activity recovers and reconstruction gains momentum, growth is expected to gradually rebound to around 5.5 percent in 2016/17. Based also on experience in other fragile countries struck by natural disasters, potential growth is projected to be adversely affected by the earthquake, falling to around 4 percent over the medium term.

- **Inflation pressures are likely to rise.** Losses in agricultural production and damage to transport systems will lead to reduced supply of agricultural products, which account for some 40 percent of the CPI basket. Stepped-up foreign aid and higher inflows of remittances would further boost the liquidity in the financial system, putting pressure on the central bank which has been reluctant to sterilize foreign inflows. Over time, however, as agricultural production recovers and transportation infrastructure improves, inflation pressure should ease.

- **The fiscal impact of the earthquake will also be significant.** Revenue losses are unlikely to be fully offset by higher duty collection from increased reconstruction-related imports (to the extent these are ODA-financed, they may enter duty free). The much greater impact on the budget will be on the expenditure side because of damage to infrastructure and government properties. In addition to the reconstruction cost in the public sector, the government will likely have to provide financial assistance for the recovery of the business sector and to households, particularly for housing. Financial institutions may also need assistance to help overcome the effects of the earthquake (see last bullet). Donor support is expected to help fund a large part of the recovery and reconstruction expenses, but the government may also need to borrow more to meet the increased spending needs. Thus, both the fiscal deficit and public debt could likely increase in the medium-term.

- **The external current account will likely be pushed into deficit**. Imports of reconstruction-related materials will rise. Tourism receipts, a key source of Nepal's foreign exchange earnings, could fall by some 1½ percent of GDP in 2015/16 compared with 2013/14, and experience in other countries suggests that recovery could take several years. A temporary surge of remittances is likely as the Nepalese diaspora and migrant workers send more money home to support the reconstruction efforts. However, these one-off higher inflows will be more than offset by higher imports, pushing the current account to a deficit of about 4 percent of GDP on average during the next 5 years.

- **An urgent balance of payments has arisen, reflected in a financing gap**. Without the mobilization of substantial exceptional donor financing, the deterioration in the external current account would cause the central bank's foreign reserves to fall significantly in 2015/16 and over the medium term. As illustrated in Table 6, without the RCF disbursement and exceptional support from other donors—which could in part be catalyzed by the RCF disbursement—central bank reserves would fall to about 5 months of imports. This is well below Nepal's reserve adequacy metric suggesting that reserves should be maintained at the current level of about 7 months of imports (Box 2). It is envisaged that with concerted support from the Fund and development partners, Nepal's official reserves could be maintained at about 7 months of prospective imports (excluding construction-related imports) over the next few years.

- **The financial sector's asset quality would be expected to deteriorate**. The damages and economic disruption caused by the earthquake could affect the loan portfolio of banks, microfinance institutions and cooperatives, particularly in rural areas where borrowers lost lives and livelihoods. Initial estimates of the financial hit to the banks (NR 38 billion or about 1.8 percent of GDP) and the insurance sector (NR 3 billion, net of reinsurance provided by foreign reinsurers) seem manageable. However, more data and diagnostics are needed to allow accurate assessments of the impact of damage to real estate and there could still be a need for budgetary support for the financial sector.

8. The impact of the earthquake is subject to considerable margins of error:

- The Post-Disaster Needs Assessment (PDNA) was put together within 2 months after the first earthquake. Experience in other cases has shown that it is more important to get an earlier start to the reconstruction effort than to spend more time, aiming to obtain a more precise damage assessment.

- It remains to be seen how rapidly the private sector (e.g., tourist operators, farmers, and SMEs) can recover from the disaster. For instance, it could take some time for the tourism sector to regain the momentum of the last few years. In that case, the cumulative loss from the earthquake could be larger. The impact on remittances is also uncertain. Cross-country research has shown that remittances have typically increased in response to disasters, especially for countries that have large numbers of migrants living abroad, such as Nepal. [2] The inflow of remittances did indeed set a new record in the month after the disaster. But Nepal's case could be somewhat different. The bulk of its migrants move abroad alone, on a temporary basis. They have already been sending most of their earnings to their families back home and might not be able to provide a sustained higher

[2] World Bank Policy Research Working Paper 4972 analyzed a sample of disaster-struck low-income countries and found that for every US$1 of disaster cost, remittances would increase by US$0.5 for a country where the emigrant stock is about 10 percent of the origin country population, such as Nepal. In the subsequent year, the increase would be an additional US$1. Over a period of two years, remittances for such a country would increase by US$1.5.

flow of remittances in response to the disaster. There are also some indications that some migrants returned home to help with reconstruction.

- In addition to the amount of external financing received, the speed of Nepal's recovery will depend on the extent to which Nepal's absorptive capacity is increased by addressing implementation bottlenecks, as well as effective coordination among donors and implementing agencies within the government.

POLICY ISSUES AND DISCUSSIONS

Experience in other countries has shown that the recovery and reconstruction after a natural disaster such as the recent earthquake takes considerable time, especially in low-income countries with weak implementation capacity. In light of this, discussions focused on policy measures to support Nepal's recovery while maintaining macroeconomic and financial stability.

9. The aid pledges received from donors exceeded the authorities' expectations. Mobilizing sufficient fiscal resources for reconstruction had been considered a critical challenge. Immediately after the earthquake, before comprehensive estimates of the damage were available, Nepal's Cabinet called on donors to fund a NR 200 billion (equivalent to US$2 billion or about 10 percent of GDP) *Earthquake Relief Fund for Reconstruction and Rehabilitation*. Pledges of grants and loans totaling US$4 billion over the next 5 years will allow the government to scale up capital spending while keeping domestic government borrowing to a minimum and hence preventing crowding out domestic banks' financing of private sector reconstruction.

10. Thanks to the concessionality of the aid, Nepal's risk of debt distress remains low. In the context of the 2014 Article IV consultation the risk of debt distress was assessed to have improved from "moderate" to "low." Since then, public debt moderated more than projected, to 28 percent of GDP by mid-2014. An updated joint IMF/World Bank Debt Sustainability Analysis which takes into account the concessional loans offered by Nepal's development partners at the donor conference, concludes that Nepal's risk of debt distress remains low.

11. The authorities agreed that strengthening public financial management (PFM) will be key to the swift and efficient implementation of reconstruction efforts and enhance the quality of public investment both in the near- and longer-term. The earthquake has added urgency to the need to improve capital budget execution. Recent technical assistance by the IMF's Fiscal Affairs Department proposed practical measures that can be implemented by the authorities in the short-run (Box 3). These measures are aimed at strengthening medium-term budget planning, establishment of a robust appraisal function, development of targeted selection and prioritization criteria as well as improved use of the monitoring processes in project implementation. The authorities have taken steps in two areas:

- To speed up reconstruction in the country's districts most affected by the earthquake, the government announced the creation of the National Reconstruction Authority:

- ✓ The authorities note that this is an Extra-Ordinary Mechanism informed by international practices and is grounded on past experience in Nepal in dealing with natural disasters and shocks. The authority will be subject to a sunset clause of a maximum of six years.

- ✓ The Authority, which will have its own staff, will be led by the Prime Minister. A chief executive officer will be appointed to implement the reconstruction work, benefitting from the ability to fast-track public procurement, land acquisition and environmental impact assessments—steps that have emerged as stumbling blocks in recent years for speedy completion of projects.

- ✓ To allay concerns about transparency, accountability and the effective use of the earthquake relief funds, the authorities have committed to provide a substantial role for scrutiny and shared responsibility assigned to domestic civil society and international development partners.

- With regard to the implementation of the "regular" capital budget, steps are being taken to prevent delays and shortfalls. For instance, for spending items included in the approved budget, government bodies will no longer be required to obtain authorization from the District Development Committee, the line ministry and the NPC, a process that could take up to six months. As a result, after the adoption of the budget, government bodies should henceforth be able to immediately start the tendering process. Similarly, multi-year projects included in the approved budget in one year no longer need to be re-authorized at the start of each fiscal year. Moreover, going forward, a project will only be included in the budget if a feasibility study has been done, and if environmental assessment and land acquisition requirements have been completed.

- The recently secured consensus among major political parties to promulgate a new constitution and to hold elections for local governments as early as possible is expected to boost accountability with regard to the pace and quality of local government spending.

12. Staff recommended protecting priority social spending—including spending on health and education which has increased significantly in recent years—to mitigate the negative impact of the earthquake on poverty. Experience in other low-income countries has shown that the impact from natural disasters is more pronounced on poverty and social welfare as divestment of limited physical capital by the poor—such as the sale of livestock to fund current consumption—can lead to a long-term decline in productive capacity. A contingency plan should be developed in case the earthquake-related damage and cost to the budget turns out much larger than currently expected. Early estimates suggest that an additional 3 percent of Nepal's population has been pushed into poverty as a direct result of the earthquakes. This translates into as many as a million more poor people. In this context, it should be noted that Nepal's 13th Development Plan (2013-16) aims at graduating from least-developed country status by 2022. Key objectives of the Plan are to achieve an annual growth rate of 6 percent and bring down the percentage of the population living below the poverty line to 18 percent by FY2016.

13. The authorities agreed that monetary policy should remain accommodative, at least initially. Post-quake recovery and reconstruction will increase the private sector's financing needs. At the same time, larger aid inflows (on top of surging remittances) could lead to more excess liquidity available in the banking system. Against this background, monetary policy would aim at controlling the level and volatility of excess liquidity, but given the economic disruption, some increase in inflation is inevitable (due to higher transportation and business costs) and would be accommodated. As the economy recovers, however, the Nepal Rastra Bank (NRB) would closely monitor price developments and aim to keep Nepalese inflation close to that in India.

14. The authorities will continue to carry out reforms designed to mitigate financial sector risks which have been amplified by the earthquake. 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 in financial sector infrastructure—including the legal framework—and supervision and crisis preparedness. The NRB has in recent years taken a number of macro-prudential measures to curb risks, and improved its supervision, including with assistance of an MCM resident advisor. These efforts will continue as the NRB looks to build a new headquarters. DFID has restructured its ongoing TA program to respond to the impact of the earthquake and is working with the NRB to establish a disaster recovery centre. On June 29, the Executive Board of the World Bank approved a US$100 million *Post Disaster Second Financial Sector Stability Credit*. In this context, the authorities reiterated their commitment to a 2014–16 program of financial sector reforms focused on achieving two over-arching objectives; (i) to ensure the stability of the financial system by improving the quality of regulation, supervision, and transparency to levels closer to international norms; and, (ii) to start improving access to formal financial services. These objectives will be supplemented by measures designed to support the financial sector's recovery from the impact of the earthquake and put in place measures to ensure the operational resilience of the sector in the face of natural disasters.

15. A contingency strategy should be developed in case the earthquake-related damage to property results in much larger non-performing loans. So far, the estimates of the impact on banks' balance sheets seem manageable and the NRB's policy response—described in the PDNA as "carefully designed regulatory forbearance [allowing banks] to restructure the debts of viable SMEs and other borrowers for a limited period of time"—appropriate. However, it may take several more months before the true extent of the impact on the banks will be clear. If the impact is considerably larger than currently estimated, banks' ability to lend to the private sector might be severely constricted. In that case, the NRB might need to respond decisively within a well structured bank restructuring strategy that would need to be designed and implemented urgently. In this regard, the in-depth special inspections of 54 banks started in 2014 can provide important information and should therefore be completed.

16. Nepal's pegged exchange regime has generally served the country well and will be maintained. The country's competitiveness has weakened in recent years as external shocks, under-implementation of the government's capital budget and the slow pace of reforms stifled productive capacity, while loose monetary policies generated higher inflation than in trading partners (including India). Nevertheless, taking into account Nepal's unique dependence on large remittances inflows, the staff report for the 2014 Article IV consultation concluded that the real exchange rate of the Nepalese rupee is broadly in line with fundamentals.

17. Structural reforms will be crucial to improving competitiveness. Faster growth from improved competitiveness will be critical to support the recovery from the earthquake and reduce Nepal's vulnerabilities. While better public infrastructure would provide a significant impetus to inclusive growth, reforms to reduce the regulatory burden are a necessary complement. Accelerating the development of Nepal's vast hydropower potential and large privately-financed infrastructure projects would also provide a boost to confidence. The World Bank and the ADB have committed substantial funds to support a broad range of sectoral reforms. However, owing to slow project implementation and uptake of reforms, undisbursed project loan commitments from these two organizations now exceed 7 percent of GDP.

18. The authorities expressed interest in longer-term Fund engagement, possibly through the Extended Credit Facility (ECF). They agreed that an ECF-supported program aimed at improving governance and public financial management and addressing some of Nepal's entrenched structural challenges, including financial system weaknesses, could help speed up the recovery from the earthquake and set the stage for the next phase of Nepal's growth and development. Discussions will commence in the coming months.

ACCESS AND CAPACITY TO REPAY

19. The Nepalese authorities have requested a disbursement under the Fund's Rapid Credit Facility in the equivalent of SDR 35.65 million (US$50 million), equivalent to 50 percent of quota. The disbursement, which amounts to ¼ percent of GDP, will provide much needed financial support to address urgent balance of payments and fiscal needs resulting from the April 25, 2015 earthquake. The amount represents only a small share of the earthquake's cumulative impact on the budget and balance of payments over the coming years. The Fund's support complements financing from other multilateral institutions, most notably the Asian Development Bank and the World Bank, as well as bilateral development partners. Along with the macroeconomic framework provided by the Fund to help identify Nepal's financing needs, the Fund's financial support is also expected to play a catalytic role in firming up the generous aid pledged by other development partners and donors.

20. Nepal has adequate capacity to repay the Fund despite outstanding RCF and ECF disbursements. As most of Nepal's public debt is concessional, its debt service is low relative to projected foreign reserves and government revenue. Nepal's debt to GDP ratio has decreased in recent years and the bulk of its debt is long term and owed to the World Bank and ADB.

21. The authorities are committed to undertake an update of the safeguards assessment. A safeguards assessment was undertaken in May 2011 in connection with the 2010 RCF disbursement. The assessment noted that the external audit mechanism needed improvement, since the audit procedures did not meet international standards. Also, the NRB's financial reporting would be strengthened by resolving the many qualifications raised by the external auditors each year.

STAFF APPRAISAL

22. Nepal was hit by a powerful earthquake. Many lives were lost and the damage to houses, government buildings and infrastructure is large. Reconstruction will take time and will require the assistance of the international community. In this context, as outlined in their letter accompanying this staff report, the authorities have requested a disbursement of Fund resources equivalent to 50 percent of quota under the shocks window of the Rapid Credit Facility. Before the earthquake, Nepal's macroeconomic performance was broadly favorable but the government's weak budget implementation capacity held back growth and propped up the external position.

23. The authorities' main challenge has been to boost their capacity to plan, prioritize, and implement capital spending. To address the persistent under-implementation of the capital budget notwithstanding strong revenue performance, the authorities are simplifying administrative procedures for capital spending and they have established a National Reconstruction Authority to speed up reconstruction in the country's districts that were affected the most by the earthquake. Coordination between the National Reconstruction Authority and the annual budget process is crucial to ensure the transparent, accountable, and effective use of the earthquake relief funds.

24. The authorities remain committed to medium term fiscal and debt sustainability. The fiscal balance is expected to turn into a deficit in 2015/16, owing to earthquake-related spending, but the authorities have sought, and obtained pledges for, grants and concessional resources to finance capital expenditure related to the rehabilitation and reconstruction and safeguard debt sustainability.

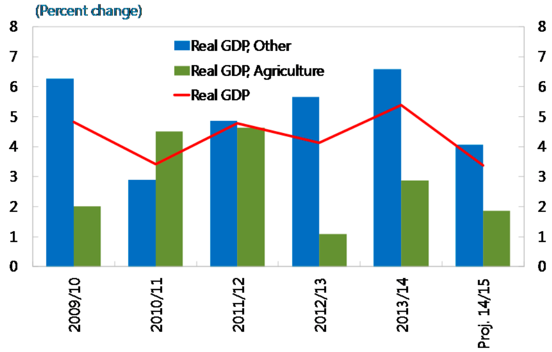
25. The authorities are also committed to maintain financial sector stability. So far, the estimates of the impact on banks' balance sheets seem manageable and the central bank's policy response of temporary limited regulatory flexibility with regard to the restructuring of the debts of viable SMEs and other borrowers appropriate. A contingency strategy should be developed in case the earthquake-related damage to property results in much larger non-performing loans.

26. Staff supports the authorities' request for a disbursement under the Rapid Credit Facility in the amount of SDR 35.65 million (50 percent of quota, equivalent to US$50 million). Staff support is based on the severity of the damages, the urgent balance of payments need, and the authorities' policy commitments, including seeking grants and concessional resources to finance earthquake-related capital expenditures. The latter, along with the authorities' track record and commitment to fiscal prudence, mitigate risks for the Fund.

Figure 1. Recent Macroeconomic Developments

Growth averaged 4.5 percent in recent years but is expected to slow in 2014/15 due to the earthquake.

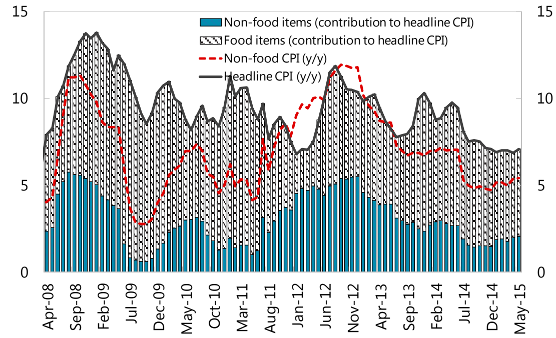
Real GDP Growth
(Percent change)



Sources: Nepali authorities; and IMF staff estimates.

Inflation remains stubbornly high at around 7 percent...

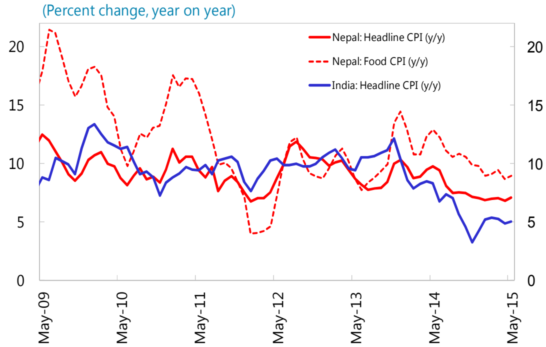
Consumer Price Inflation
(Percent change, year-on-year)



Sources: Nepali authorities; and IMF staff estimates.

...and is higher than inflation in India owing to rising food prices.

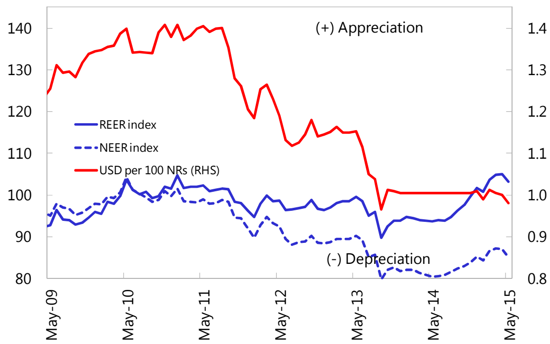
Consumer Prices
(Percent change, year on year)



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

In combination with the stable nominal exchange rate, this has put the REER 12 percent above the 2013/14 average.

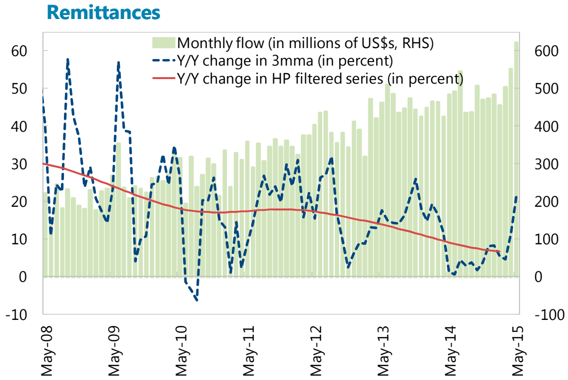
Exchange Rates



Sources: Nepali authorities; and IMF staff estimates.

The growth of remittances picked up in May...

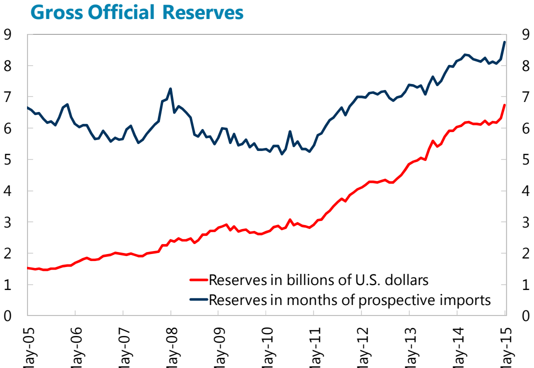
Remittances



Sources: Nepali authorities; and IMF staff estimates.

...pushing reserves to a new record of US$6.7 billion.

Gross Official Reserves

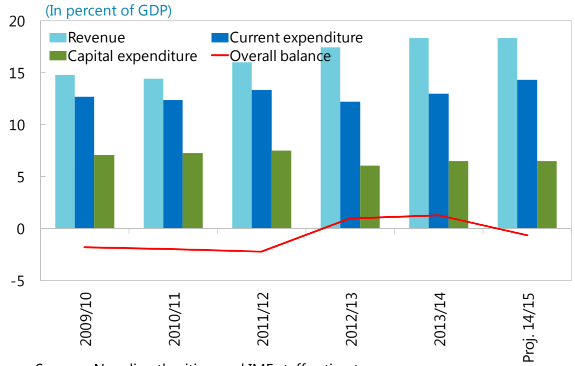


Sources: Nepali authorities; and IMF staff estimates.

Figure 2. Recent Fiscal and Monetary Developments

Strong revenue growth combined with lackluster capital spending has kept the budget in surplus.

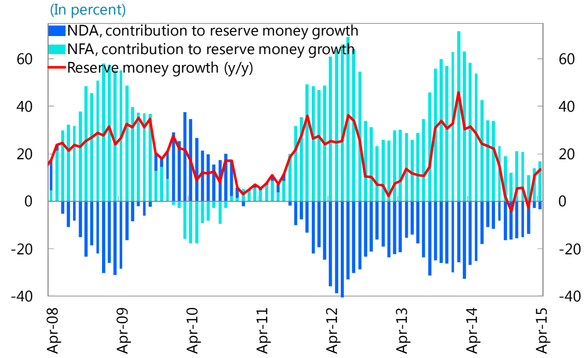
Fiscal Performance
(In percent of GDP)



Sources: Nepali authorities; and IMF staff estimates.

Rising government deposits at the central bank and stable NFA are keeping reserve money in check.

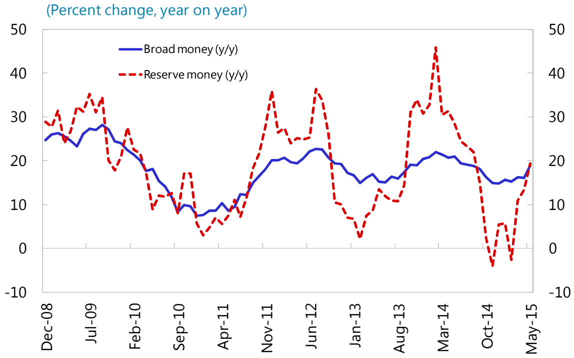
Central Bank Balance Sheet
(In percent)



Sources: Nepali authorities; and IMF staff estimates.

Broad money growth rose to 19 percent in May (y/y)....

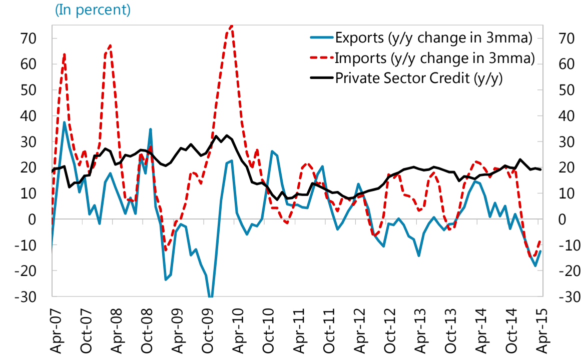
Nepal: Monetary aggregates
(Percent change, year on year)



Sources: Nepali authorities; and IMF staff estimates.

...about equal to the rate of private credit growth.

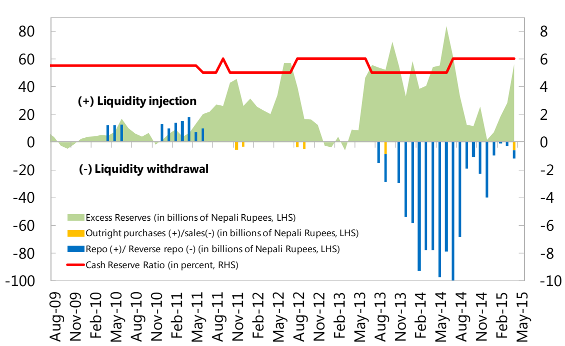
Private Sector Credit and Trade
(In percent)



Sources: Nepali authorities; and IMF staff estimates.

Excess reserves have moderated since mid-2014, on slower reserve money growth and the higher cash reserve ratio.

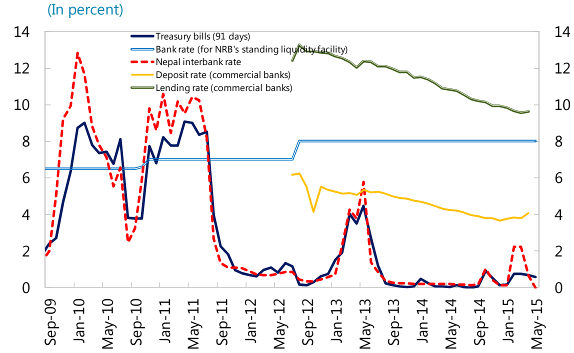
Excess Reserves and Open Market Operations



Sources: Nepali authorities; and IMF staff estimates.

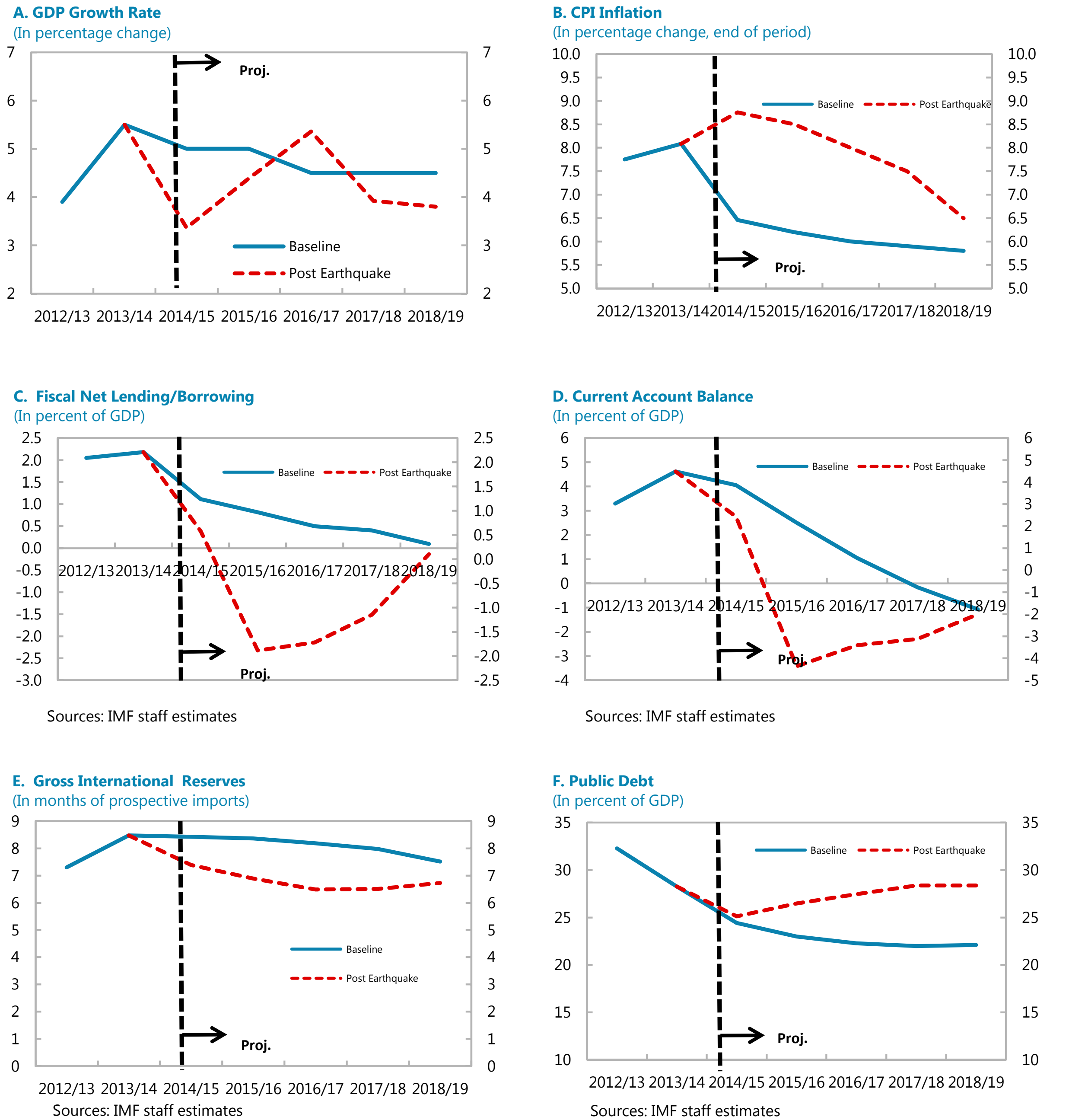
As a result, the interbank interest rate has ticked up, and deposit and lending rates have bottomed out.

Interest Rates
(In percent)



Sources: Nepali authorities; and IMF staff estimates.

Figure 3. Earthquake Impact on Key Macro-Variables

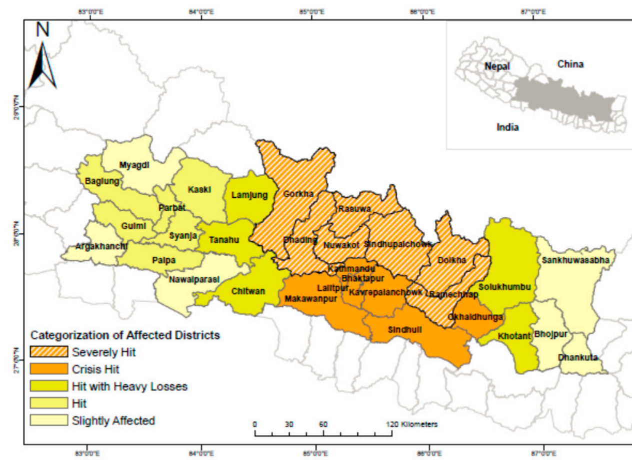


Box 1. Nepal: Damage from the 2015 Earthquake

A Massive earthquake and hundreds of aftershocks caused widespread damage. The Post Disaster Needs Assessment (PDNA) estimates recovery and reconstruction costs at US$7 billion over the next five years.

On April 25, 2015, a magnitude 7.8 earthquake struck the historic district of Gorkha in Nepal, about 76 km northwest of Kathmandu. This was the most severe earthquake that Nepal, an earthquake prone country, has experienced since the magnitude 8.4 earthquake that hit in 1934, killing more than 10,000 people. The April 25 earthquake was followed by more than 300 aftershocks greater than magnitude 4.0, including one measuring 7.3 on May 12. To date, there are more than 8,800 casualties and 22,300 injuries. An estimated 8 million people have been affected. Fourteen of the country's 75 districts were declared 'crisis-hit' (see Figure 1) for the purpose of prioritizing rescue and relief operations, and another 17 neighbouring districts are partially affected. Poorer, rural areas have been more adversely affected than towns and cities due to their inferior quality of houses, and more females died than males because of roles that assign indoor chores to women. The loss of life could have been much higher were in not for the fact that the first earthquake took place on a Saturday, the weekly holiday, and during the daytime.

Figure 1. Categories of Earthquake-Affected Districts



Source: GoN/MoHA as of 21 May 2015

Days after the May 12 aftershock, the government of Nepal called for a Post Disaster Needs Assessment (PDNA) to be carried out under the leadership of the National Planning Commission (NPC), with the purpose of assessing the impact of the disaster and defining a recover strategy, including funding implications, for the restoration of livelihoods, economy and services, rehabilitation and reconstruction of housing and infrastructure. Over 250 officials and experts from the government and 30 development partner agencies were organized into 23 thematic groups. Each group had a dedicated Joint Secretary assigned from the directly relevant line ministry and the NPC to work together with a lead agency on the part of development partners. These joint teams undertook an intensive exercise of data collection, field visits and verification, from May 22 to June 10.[2] The key findings of the PDNA were presented at the International Conference on Nepal's Reconstruction (ICNR) on 25 June.

The PDNA follows a methodology developed by the European Union, the World Bank and the UN system for post-disaster assessments and recovery planning to ensure sector-to-sector comparability and homogeneity in the definition of basic concepts of damages, losses and post-disaster recovery needs. The assessment builds on the initial and detailed sector damage assessments undertaken by central and local governments and the clusters established by the government with

Box 1. Nepal: Damage from the 2015 Earthquake (concluded)

support from development partners. For each sector or thematic group, the PDNA works with three main concepts: (i) damage, (ii) losses, and (iii) recovery needs. Damage represents the value of destroyed physical assets, and losses represents the losses and higher costs of production of goods and services arising from the disaster. The recovery needs estimates do not not simply consider the replacement value (particularly with respect to the housing sector), but take into account the cost of reconstruction with better specifications, equipment, improved governance and risk reduction while maintaining fiscal prudence and acceptable levels of recovery.

The total value of disaster effects (damages and losses) caused by the earthquake is estimated at NR 706 billion (US$ 7 billion). Of that amount, NR 517 billion (or 76 percent) represents the value of destroyed physical assets, and NR 189 billion (24 percent) reflects economic losses from the disaster (see Table 1). Disaster effects are spread unevenly between public and private sectors, with the private sector sustaining about 3.3 times the value of damages and losses of the public sector.

Almost fifty percent of the damage and loss occurred in the housing and human settlements sector: 498,852 houses were destroyed and 256,697 houses were partially damaged as of May 28. Healthcare infrastructure, including health facilities, toilets, and water systems have been destroyed and nearly 7,000 schools were completely or significantly damaged. Among the productive sectors, tourism has been severly affected and the overall impact of the earthquake will go beyond the 14 most affected districts, with tourist arrivals likely staying low for a few years. Aside from the Kathmandu Valley, the central and western regions that have been affected by the earthquake are essentially rural and dependent on agriculture for livelihood. The widespread loss of livestock in these areas, a main source of income for households, will potentially cause a severe income shock in the short term.

Table 1. Disaster Effects (NR billions)

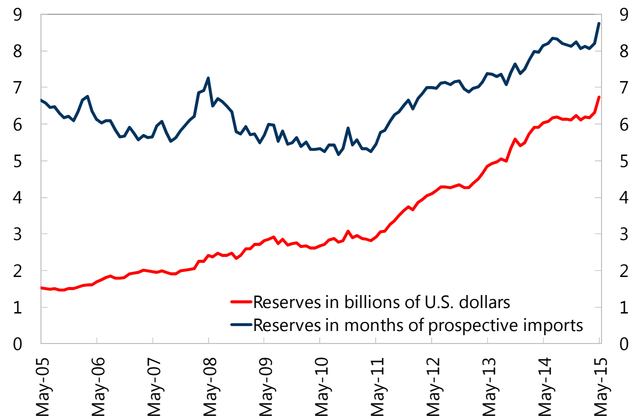
	Damage + Losses	Share
Social Sectors		***57.8***
Housing and human settlements	350.5	49.6
Health and Education	38.9	5.5
Cultural heritage	19.2	2.7
Productive Sectors		***25.2***
Agriculture	28.4	4.0
Irrigation	0.4	0.1
Commerce	17.0	2.4
Industry	19.3	2.7
Tourism	81.2	11.5
Finance	31.9	4.5
Infrastructure Sectors		***9.5***
Electricity	21.2	3.0
Communications	8.7	1.2
Community Infrastructure	3.3	0.5
Transport	22.1	3.1
Water and Sanitation	11.4	1.6
Cross-cutting Issues		***7.5***
Governance	18.8	2.7
Disaster Risk Reduction	0.2	0.0
Environment and Forestry	34.0	4.8
Total	706.5	***100***

Box 2. Nepal: Assessing Reserve Adequacy

Nepal's reserves have risen in recent years and now exceed standard "rules of thumb" thresholds for adequacy. In view of the peg to the Indian rupee, the need to be able to absorb external shocks and the low opportunity cost of holding reserves, Nepal's reserves should be maintained at the current level of about 7 months of imports.

Nepal's international reserves have grown steadily over the last five years, driven in large part by remittance inflows. At the end of 2013/14 reserve holdings (including the central bank's holdings of Indian rupees) stood at US$6.17 billion, corresponding to 8.3 months of prospective import cover (Figure 1).[1] As of May 2015, reserve holdings peaked at US$6.7 billion. Nepal's reserve position is higher than suggested by standard "rules of thumb," such as coverage of 3 months of imports of goods and services, 100 percent of short-term debt and 20 percent of broad money in the economy (Table 1).

Gross Official Reserves



Sources: Nepali authorities; and IMF staff estimates.

IMF WP/11/249 develops a framework to determine the optimal levels of reserves specifically in low income countries. Taking into account the exchange rate regime, it assumes that countries try to maximize the net benefit of holding international reserves by balancing the cost of holding reserves against the benefits of precautionary reserve holdings as insurance against adverse external shocks.

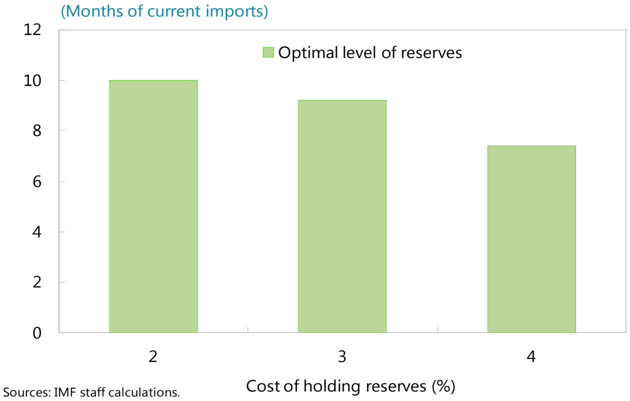
Table 1. Rules of Thumb: Reserves Coverage in 2013/14

Reserves coverage in months of imports	8.3
Reserves as a share of short term external debt	3333%
Reserves as a share of broad money (M2)	38%

Calibrating the model for Nepal yields optimal levels of reserves of about 7 months of import cover depending on assumptions about the cost of holding reserves (Figure 2):

- The opportunity cost of holding reserves can be seen as the sterilization cost incurred by the central bank when it purchases foreign exchange (see IMF 2013).[1] This is proxied using the return on 364 day T-bills adjusted for an exchange rate risk premium, resulting in an opportunity cost of 1.9 percent. This implies optimal reserve holdings equivalent to 10 months of imports coverage.
- The opportunity costs could also be approximated by the return on investing the funds in Nepal's economy. For instance, the government could decide to invest more in transportation infrastructure. This would likely provide for good economic returns. However, at the moment bottlenecks in capital budget execution prevent Nepal from reaping the full benefits from such additional investment.

Figure 2. Optimal Levels of Reserves
(Months of current imports)



Sources: IMF staff calculations.

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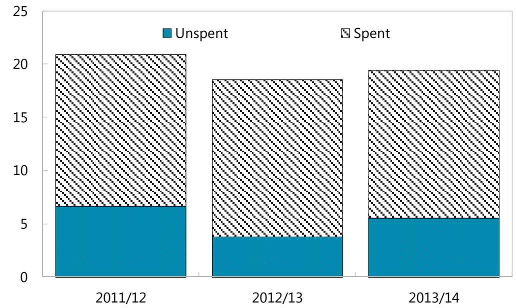
[1] IMF (2013), "Assessing Reserve Adequacy – Further Considerations," IMF Policy Paper, November 13, 2013.

Box 3. Raising Capital Budget Execution in Post-Earthquake Nepal

Capital budget execution has remained weak. Over the past three fiscal years, about 20 percent of the national budget (or some 4.3 percent of GDP) was allocated to capital spending annually. However, about a quarter of the capital budget remained unspent each year and capital spending averaged only 3¼ percent of GDP per annum, notwithstanding the large infrastructure gaps and slight revenue over-performance.

Capital Budget
(In percent of budget target)



Sources: Nepali Authorities; and IMF Staff Estimates

The execution of capital expenditure also lags behind recurrent expenditure and is concentrated towards the end of the fiscal year. In 2012/13 and 2013/14 more than a third of actual capital expenditure was realized during the final month of the fiscal year. Furthermore, despite an increase in the year-on-year growth of capital expenditure from 5 to 20 percent, budget execution actually fell from 80 to 72 percent between 2012/13 and 2013/14.

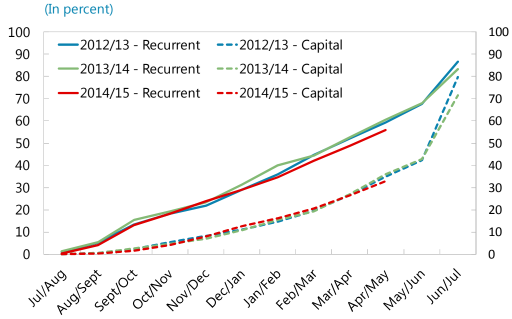
Summary of Fiscal Developments

	2012/13	2013/14	2013/14 Apr/May	2014/15 Apr/May
Revenues				
Growth (y/y, %)				
Tax revenue	26	20	19	15
VAT	16	21	19	12
Customs	31	19	18	11
Total Revenues	21	21	19	12
Execution (%)				
% of budget	102	101	79	74
% of projected	103	102	81	79
Expenditure 1/				
Growth (% y/y)				
Recurrent	2	21	28	4
Capital	5	20	37	18
Execution (% budget)				
Recurrent	87	83	61	56
Capital	80	72	36	33

1/ Expenditure figures based on treasury data
Sources: Nepali authorities; and IMF staff estimates.

Nepal's arrangements for capital budget management require fundamental changes in order to increase the efficiency of capital expenditure. Recent FAD PFM technical assistance missions[1] have concluded that Nepal falls short in many aspects of good international practices in capital budget management, and have identified several issues in the areas of planning, allocation and delivery, including:

Budget Execution Rate
(In percent)



Sources: Nepali authorities; and IMF staff estimates.

- *Planning*. The government's 13th Development Plan provides limited guidance to the capital budget planning and prioritization. Furthermore, the guidelines for project preparation and approvals are not strictly observed and the approval process is not obvious.
- *Allocation*. The share of "priority projects" is too high. This places undue pressure on the allocation of available resources; results in underfunding; stretches the delivery period; and leads to cost overruns. The capital budget process also has a short-term focus and planning is poorly matched with the budget allocation process.
- *Delivery*. Resource allocation issues lead to uncertainty and thus hamper project implementation. Monitoring practices are ineffective although a number of institutions are involved (including NPC and MOF), and little attention is given to implementation plans and management of project adjustments.

Box 3. Raising Capital Budget Execution in Post-Earthquake Nepal (concluded)

Establishing proper and transparent planning, selection and implementation for major capital projects is a priority. Among other recommendations, the FAD PFM technical assistance mission proposed that a specialized organizational unit be established in the NPC to manage the appraisal, approval and monitoring of the preparation of the capital budget projects. Furthermore, the mission recommended that responsibilities of the MOF and NPC be clearly defined, with the MOF focusing on the budget formulation process and NPC making sure that the government's development strategy is reflected in the budget. Should the authorities be interested in implementing the mission's recommendation, then the Fund (FAD) can respond by providing resources to assist the establishment of improved planning, selection and implementation for major capital projects. This could consist of the provision of intensive technical assistance in various modalities ranging from an HQ mission to a resident long-term advisor.

Past FAD PFM technical assistance has already identified some practical measures that can improve capital budget execution and that are implementable in the short run. These include but are not limited to:

- *Planning*. The medium-term expenditure framework should be reestablished and strengthened to complement medium-term budget planning. In addition, a robust and competent function for appraisal of major capital projects should be established, preferably in the NPC. This function should also be responsible for developing the appraisal system and for preparing and streamlining relevant regulations and guidelines. Finally, mechanisms for independent review of major projects should be introduced as soon as possible to carry out obligatory reviews of all major projects based on the terms of reference provided by the NPC project appraisal office.
- *Allocation*. Better targeted selection and prioritization criteria should be developed based on cost benefit analyses, project life cycle and future recurrent costs, project readiness for implementation, as well as associated risks. Consolidated information should be presented to decision-makers, including priority ratings and future maintenance and operational costs.
- *Delivery*. Efforts should be directed to refine, streamline and enforce rules and procedures for project implementation, adjustments and completion, Evaluations of major projects should be continued and the findings of these evaluations should be used to readjust projects and inform future project design

The damage wrought by the earthquake has made addressing Nepal's infrastructure gap more urgent, thus underscoring the importance of boosting the government's ability to manage capital expenditure as well as complex reconstruction projects**.** The authorities' plan to establish the National Reconstruction and Rehabilitation Implementation Committee is comparable to reconstruction efforts of other countries that have experienced natural disasters.[2] However, international experience shows that what is crucial for an effective and rapid post-disaster recovery is a comprehensive reconstruction plan that clearly outlines recovery objectives and implementation strategies. In the case of Nepal, such a plan should be underpinned by effective coordination mechanisms that will enhance the ability of line ministries to execute their capital and reconstruction budgets.

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[1] More details are contained in the following reports:

Strengthening the Budget Formulation Process: The Way Forward, IMF Fiscal Affairs Department Technical Assistance Report, May 2014.

Strengthening Capital Budget Management to Support Stronger Economic Growth, IMF Fiscal Affairs Department Technical Assistance Report, November 2014.

[2] For example, Pakistan (Earthquake Reconstruction and Rehabilitation Authority), Chile (Reconstruction Committee), and China (Committee for Restoration and Reconstruction) among others.

Table 1. Nepal: Selected Economic Indicators, 2010/11–2015/16 1/

	2010/11	2011/12	2012/13	2013/14	2014/15		2015/16	
					Baseline	Post-quake	Baseline	Post-quake
Output and prices (annual percent change)								
Real GDP	3.4	4.8	4.1	5.4	5.0	3.4	5.0	4.4
CPI (period average)	9.6	8.3	9.9	9.0	7.1	7.6	6.3	8.6
CPI (end of period)	9.7	11.5	7.7	8.1	6.5	8.8	6.2	8.5
Nonfood CPI (end of period)	7.6	11.2	7.2	6.8	…	…	…	…
Fiscal Indicators (in percent of GDP)								
Total revenue and grants	17.7	18.7	19.3	20.8	21.3	20.3	21.6	21.8
Expenditure	18.7	19.3	17.2	18.6	20.2	19.9	20.8	24.1
Expenses	15.2	15.9	14.2	15.3	16.3	16.0	16.6	17.6
Net acquisition of nonfinancial assets	3.4	3.4	3.0	3.3	3.9	3.9	4.2	6.6
Net lending/borrowing	-1.0	-0.6	2.1	2.2	1.1	0.4	0.8	-2.3
Net acquisition of financial assets	1.0	1.6	1.1	0.9	1.5	1.0	1.5	1.5
Net incurrence of liabilities	2.0	2.2	-1.0	-1.3	0.4	0.6	0.7	3.8
Foreign	-0.3	-0.2	-0.3	-0.1	0.5	0.6	0.9	2.8
Domestic	2.3	2.4	-0.6	-1.2	-0.1	0.0	-0.2	1.0
Money and credit (annual percent change)								
Broad money	12.3	22.7	16.3	19.1	15.5	13.1	16.5	18.3
Domestic credit	13.7	8.0	16.9	13.9	14.5	11.6	18.0	25.7
Private sector credit	13.1	11.3	20.2	18.3	18.2	14.6	20.2	26.4
Velocity	1.5	1.4	1.3	1.2	1.2	1.2	1.2	1.2
Balance of Payments								
Current account (in millions of U.S. dollars)	-181	909	635	908	880	585	594	-809
In percent of GDP	-1.0	4.8	3.3	4.6	4.1	2.8	2.5	-3.4
Trade balance (in millions of U.S. dollars)	-4,470	-4,605	-5,247	-6,082	-6,412	-6,575	-7,230	-8,361
In percent of GDP	-23.5	-24.4	-27.2	-30.8	-29.6	-31.0	-30.4	-35.4
Exports value growth (y/y percent change)	13.2	5.0	-3.1	5.4	2.0	-6.0	5.0	1.0
Imports value growth (y/y percent change)	10.2	3.4	10.9	14.3	4.9	6.1	11.7	23.8
Workers' remittances (in millions of U.S. dollars)	3,545	4,414	4,931	5,543	5,826	6,163	6,251	6,700
In percent of GDP	18.6	23.4	25.6	28.0	26.9	29.0	26.3	28.4
Gross official reserves (in millions of U.S. dollars)	3,085	4,307	4,972	6,172	6,737	6,665	7,401	6,622
In months of prospective GNFS imports	5.8	7.2	7.3	8.5	8.4	7.4	8.4	6.9
Memorandum items								
Public debt (in percent of GDP)	14.7	13.7	32.3	28.3	24.4	25.1	23.0	26.5
GDP at market prices (in billions of Nepalese rupees)	1,367	1,527	1,695	1,942	2,170	2,125	2,423	2,409
GDP at market prices (in billions of U.S. dollars)	19.0	18.9	19.3	19.8	…	…	…	…
Exchange rate (NRs/US$; period average)	71.9	81.0	88.0	98.2	…	…	…	…
Real effective exchange rate (eop, y/y percent change)	1.2	-4.6	-2.3	-9.3	…	…	…	…

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

[1] Fiscal year ends in mid-July.

Table 2. Nepal: Summary of Government Operations, 2010/11–2015/16 1/

	2010/11	2011/12	2012/13	2013/14	2014/15			2015/16		
					Budget 2/	Baseline	Post-quake	Baseline	PDNA 3/	Post-quake
	(In billions of Nepalese rupees)									
Total revenue and grants	242	285	327	404	496	463	430	523	620	526
Total revenue	197	244	296	357	423	408	391	460	510	459
Tax revenue	172	207	260	312	375	360	342	406	460	405
Non-tax revenue	26	38	36	45	48	48	48	54	50	55
Grants	44	41	31	47	73	55	40	63	110	66
Expenditure	255	295	292	362	516	439	422	503	730	582
Expenses	208	243	240	298	399	354	340	401	562	423
Of which : Interest payments	13	15	14	12	23	23	23	15	34	11
Salaries and allowances	45	53	51	68	90	81	81	107	109	108
Net acquisition of nonfinancial assets	47	51	52	64	117	85	82	102	168	158
Operating balance	34	42	86	106	97	109	90	121	58	102
Net lending/borrowing	-13	-10	35	42	-19	24	8	20	-110	-56
Net financial transactions	13	10	-35	-42	19	-24	-8	-20	134	56
Net acquisition of financial assets	14	24	18	18	50	33	21	36	36	36
Net incurrence of liabilities	27	34	-16	-25	69	8	13	17	170	92
Foreign	-4	-2	-5	-2	29	11	13	22	63	68
Domestic	32	36	-11	-23	40	-2	0	-5	107	25
	(In percent of GDP, unless otherwise indicated)									
Total revenue and grants	17.7	18.7	19.3	20.8	23.4	21.3	20.3	21.6	25.4	21.8
Total revenue	14.4	16.0	17.5	18.4	19.9	18.8	18.4	19.0	20.9	19.1
Tax revenue	12.6	13.5	15.3	16.1	17.6	16.6	16.1	16.7	18.9	16.8
Non-tax revenue	1.9	2.5	2.1	2.3	2.3	2.2	2.3	2.2	2.1	2.3
Grants	3.3	2.7	1.8	2.4	3.5	2.5	1.9	2.6	4.5	2.7
Expenditure	18.7	19.3	17.2	18.6	24.3	20.2	19.9	20.8	29.9	24.1
Expenses	15.2	15.9	14.2	15.3	18.8	16.3	16.0	16.6	23.0	17.6
Of which : Interest payments	0.9	1.0	0.8	0.6	1.1	1.1	1.1	0.6	1.4	0.5
Salaries and allowances	3.3	3.5	3.0	3.5	4.2	3.7	3.8	4.4	4.5	4.5
Net acquisition of nonfinancial assets	3.4	3.4	3.0	3.3	5.5	3.9	3.9	4.2	6.9	6.6
Operating balance	2.5	2.7	5.1	5.5	4.6	5.0	4.2	5.0	2.4	4.2
Net lending/borrowing	-1.0	-0.6	2.1	2.2	-0.9	1.1	0.4	0.8	-4.5	-2.3
Net financial transactions	1.0	0.6	-2.1	-2.2	0.9	-1.1	-0.4	-0.8	5.5	2.3
Net acquisition of financial assets	1.0	1.6	1.1	0.9	2.3	1.5	1.0	1.5	1.5	1.5
Net incurrence of liabilities	2.0	2.2	-1.0	-1.3	3.2	0.4	0.6	0.7	7.0	3.8
Foreign	-0.3	-0.2	-0.3	-0.1	1.4	0.5	0.6	0.9	2.6	2.8
Domestic	2.3	2.4	-0.6	-1.2	1.9	-0.1	0.0	-0.2	4.4	1.0
Memorandum items										
Primary balance	0.0	0.4	2.9	2.8	0.2	2.2	1.5	1.4	-3.1	-1.9
Reconstruction-related expenditure	...	...	...	...	...	...	...	...	...	3.0
Public debt	14.7	13.7	32.3	28.3	...	24.4	25.1	23.0	...	26.5
Domestic	14.6	13.7	12.2	10.4	...	6.9	7.1	6.0	...	7.3
External	0.0	0.0	20.0	17.9	...	17.5	18.0	17.0	...	19.2
GDP (in billion of Nepalese rupees)	1,367	1,527	1,695	1,942	2,125	2,170	2,125	2,423	2,439	2,409

Sources: Data provided by the Nepalese authorities, and Fund staff estimates and projections.

1/ Fiscal year ends in mid-July. Table refers to central government operations as contained in the budget.

2/ Based on the authorities' data and Fund staff assumptions.

3/ Based on the authorities' data from Post-Disaster Needs Assessment (PDNA) and Fund staff assumptions.

Table 3. Nepal: Monetary Indicators, 2011/12–2015/16 1/

	2011/12	2012/13	2013/14	May 2015	2014/15		2015/16	
					Baseline	Post-quake	Baseline	Post-quake
	(In billions of Nepalese rupees, end-period)							
Nepal Rastra Bank								
Reserve money	319	354	437	463	495	485	582	571
Net domestic assets	-54	-111	-150	-214	-179	-182	-182	-112
Claims on public sector	17	2	-1	-66	17	18	16	22
Claims on private sector	5	5	4	5	5	5	5	5
Claims on banks & financial institutions	0	3	2	3	4	7	5	22
Other items (net)	-77	-121	-154	-155	-204	-212	-208	-161
Net foreign assets	374	465	586	676	674	667	764	683
Monetary Survey								
Broad money	1,131	1,315	1,566	1,763	1,808	1,771	2,107	2,095
Narrow money	264	302	355	390	551	539	642	638
Quasi-money	867	1,014	1,211	1,372	1,257	1,231	1,465	1,457
Net domestic assets	756	847	967	1,055	1,123	1,093	1,331	1,401
Domestic credit	986	1,153	1,313	1,420	1,503	1,465	1,773	1,841
Credit to public sector	176	179	162	93	143	145	139	174
of which : Credit to central government	154	154	140	57	119	121	114	146
Credit to private sector	810	973	1,151	1,328	1,360	1,319	1,634	1,667
Other items(net)	-230	-305	-346	-365	-380	-372	-442	-440
Net foreign assets	375	468	599	707	685	678	776	694
	(Twelve-month percent change)							
Reserve money	36.4	10.9	23.3	19.4	13.5	11.1	17.5	17.7
Broad money	22.7	16.3	19.1	19.0	15.5	13.1	16.5	18.3
Net domestic assets	7.1	12.0	14.1	18.0	16.1	13.0	18.5	28.2
Domestic credit	8.0	16.9	13.9	15.8	14.5	11.6	18.0	25.7
Credit to public sector	-4.9	1.9	-9.9	-16.3	-11.9	-10.1	-2.6	19.4
Credit to private sector	11.3	20.2	18.3	19.0	18.2	14.6	20.2	26.4
Net foreign assets	73.4	25.0	28.0	20.5	14.3	13.1	13.3	2.4
Memorandum items								
Velocity	1.4	1.3	1.2	1.2	1.2	1.2	1.2	1.2
Multiplier	3.5	3.7	3.6	3.8	3.7	3.7	3.6	3.7
Private credit (in percent of GDP)	53.0	57.4	59.3	63.4	62.7	62.1	67.4	69.2
GDP at market prices (in billions of NR)	1,527	1,695	1,942	2,094	2,170	2,125	2,423	2,409

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

[1] Prior to July 2010, broad money survey consists of central bank and commercial banks only. After July 2010, broad money survey includes development banks and finance companies as well.

Table 4. Nepal: Balance of Payments, 2011/12–2019/20

	2011/12	2012/13	2013/14	2014/15		2015/16		2016/17		2017/18		2018/19		2019/20	
				Baseline	Post-quake	Baseline	Post-quake	Baseline	Post-quake	Baseline	Post-quake	Baseline	Post-quake	Baseline	Post-quake
							(in million US dollars)								
Current account	909	635	908	880	585	594	-809	267	-664	-44	-648	-313	-382	-587	-121
Current account (excluding official transfers)	515	378	547	487	309	179	-1,328	-161	-1,140	-486	-1,150	-765	-883	-1,089	-636
Trade balance	-4,605	-5,247	-6,082	-6,412	-6,575	-7,230	-8,361	-8,099	-9,078	-9,002	-9,849	-9,888	-10,416	-10,863	-11,046
Exports, f.o.b.	1,008	977	1,030	1,050	968	1,103	978	1,164	1,031	1,233	1,093	1,307	1,158	1,385	1,227
Imports, f.o.b.	-5,613	-6,224	-7,112	-7,462	-7,543	-8,333	-9,339	-9,263	-10,109	-10,236	-10,942	-11,195	-11,574	-12,249	-12,273
Services (net)	175	87	214	207	-139	221	-610	225	-367	233	-313	239	-211	244	-130
Receipts	893	1,083	1,277	1,354	1,063	1,483	875	1,587	1,055	1,704	1,230	1,817	1,423	1,937	1,601
Of which : tourism	380	390	473	521	319	570	118	610	130	655	226	698	359	744	475
Payments	-718	-995	-1,063	-1,148	-1,202	-1,262	-1,486	-1,362	-1,422	-1,472	-1,543	-1,579	-1,635	-1,693	-1,731
Income	147	146	334	347	340	368	366	394	403	423	438	451	464	481	491
Credit	274	263	403	434	425	463	460	496	507	532	551	567	583	605	618
Debit	-127	-117	-69	-87	-85	-95	-94	-102	-104	-109	-113	-116	-120	-124	-127
Current transfers	5,192	5,648	6,442	6,739	6,959	7,235	7,797	7,746	8,378	8,303	9,076	8,885	9,781	9,551	10,563
Credit, of which:	5,254	5,732	6,477	6,834	7,052	7,339	7,900	7,858	8,491	8,422	9,200	9,013	9,912	9,687	10,702
General government	394	257	362	393	288	415	532	428	491	442	517	452	518	501	533
Workers' remittances	4,414	4,931	5,543	5,826	6,163	6,251	6,700	6,710	7,265	7,208	7,884	7,737	8,548	8,307	9,273
Debit	-62	-84	-34	-95	-93	-104	-103	-111	-114	-120	-124	-127	-131	-136	-139
Capital account	221	117	173	205	149	216	295	222	199	229	198	234	213	260	209
Financial account	303	-50	-19	-515	32	-137	431	100	601	334	865	321	867	597	910
Direct investment	112	102	33	48	48	63	63	78	78	93	93	108	108	226	231
Portfolio investment	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Other investment (net)	191	-152	-51	-563	-16	-200	368	22	524	242	773	213	760	371	679
MT debt (net)	11	-13	45	102	152	127	683	164	573	265	623	331	544	371	444
Other (net)	180	-139	-96	-665	-168	-326	-315	-141	-49	-23	150	-118	216	0	235
Errors and omissions	228	37	126	0	127	0	0	0	0	0	0	0	0	0	0
Overall balance	1,661	739	1,189	570	893	673	-84	589	136	520	415	242	698	270	998
Financing	-1,661	-739	-1,189	-570	-893	-673	84	-589	-136	-520	-415	-242	-698	-270	-998
Change in reserve assets (- =increase)	-1,222	-665	-1,200	-565	-888	-664	43	-581	-128	-514	-410	-238	-694	-270	-994
Use of IMF resources (net)	-3	-5	-6	-5	-5	-9	41	-8	-8	-5	-5	-4	-4	-4	-4
IMF Disbursements	0	0	0	0	0	0	50	0	0	0	0	0	0	0	0
IMF Repayment	3	5	6	5	5	9	9	8	8	5	5	4	4	4	4
Memorandum items															
Current account (in percent of GDP)	4.8	3.3	4.6	4.1	2.8	2.5	-3.4	1.0	-2.6	-0.2	-2.3	-1.1	-1.3	-1.9	-0.4
Current account, excl. grants (in percent of GDP)	2.7	2.0	2.8	2.2	1.5	0.8	-5.6	-0.6	-4.4	-1.8	-4.1	-2.6	-2.9	-3.5	-2.0
Trade balance (in percent of GDP)	-24.4	-27.2	-30.8	-29.6	-31.0	-30.4	-35.4	-31.9	-34.9	-33.0	-34.9	-34.0	-34.8	-35.0	-34.9
Exports (in percent of GDP)	5.3	5.1	5.2	4.8	4.6	4.6	4.1	4.6	4.0	4.5	3.9	4.5	3.9	4.5	3.9
Imports (in percent of GDP)	29.8	32.3	36.0	34.4	35.5	35.1	39.5	36.4	38.9	37.5	38.8	38.5	38.7	39.5	38.8
Exports (y/y percent change)	5.0	-3.1	5.4	2.0	-6.0	5.0	1.0	5.5	5.5	6.0	6.0	6.0	6.0	6.0	6.0
Imports (y/y percent change)	3.4	10.9	14.3	4.9	6.1	11.7	23.8	11.2	8.2	10.5	8.2	9.4	5.8	9.4	6.0
Remittances (in percent of GDP)	23.4	25.6	28.0	26.9	29.0	26.3	28.4	26.4	27.9	26.4	27.9	26.6	28.6	26.8	29.3
Remittances (y/y percent change)	24.5	11.7	12.4	5.1	11.2	7.3	8.7	7.3	8.4	7.4	8.5	7.3	8.4	7.4	8.5
Total external debt (in percent of GDP)	0.0	20.0	17.9	17.5	18.0	17.0	19.2	17.1	19.3	17.1	19.5	17.3	19.8	17.6	19.7
Debt service (in percent of current account receipts)	6.7	4.9	6.2	5.7	5.7	4.9	4.9	4.8	4.8	4.7	4.7	4.6	4.6	4.6	4.6
Gross official reserves (in millions of U.S. dollars)	4,307	4,972	6,172	6,737	6,665	7,401	6,622	7,982	6,750	8,496	7,159	8,734	7,853	9,004	8,847
In months of prospective GNFS imports	7.2	7.3	8.5	8.4	7.4	8.4	6.9	8.2	6.5	8.0	6.5	7.5	6.7	7.2	7.1
excluding reconstruction-related imports	…	…	…	…	8.3	…	7.5	…	6.9	…	6.7	…	6.8	…	…
As a share of broad money (in percent)	33.9	36.0	37.9	…	…	…	…	…	…	…	…	…	…	…	…
Nominal GDP (in millions of U.S. dollars)	18,852	19,270	19,770	…	21,239	…	…	…	…	…	…	…	…	…	…

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

Table 5. Nepal: Macroeconomic Framework, 2011/12–2019/20 1/

	2011/12	2012/13	2013/14	2014/15		2015/16		2016/17		2017/18		2018/19		2019/20	
				Baseline	Post-quake	Baseline	Post-quake	Baseline	Post-quake	Baseline	Post-quake	Baseline	Post-quake	Baseline	Post-quake
Output and prices (annual percent change)															
Real GDP	4.8	4.1	5.4	5.0	3.4	5.0	4.4	4.5	5.4	4.5	3.9	4.5	3.8	4.5	3.8
CPI (period average)	8.3	9.9	9.0	7.1	7.6	6.3	8.6	6.1	8.2	5.9	7.8	5.9	7.0	5.7	6.1
CPI (end of period)	11.5	7.7	8.1	6.5	8.8	6.2	8.5	6.0	8.0	5.9	7.5	5.8	6.5	5.7	5.7
Nonfood CPI (end of period)	11.2	7.2	6.8	...	...	...	...	...	...	...	...	...	...	...	...
Fiscal Indicators (in percent of GDP)															
Total revenue and grants	18.7	19.3	20.8	21.3	20.3	21.6	21.8	21.8	21.9	22.1	22.2	22.2	22.3	22.4	22.4
Expenditure	19.3	17.2	18.6	20.2	19.9	20.8	24.1	21.3	24.1	21.7	23.7	22.1	22.5	22.3	22.7
Expenses	15.9	14.2	15.3	16.3	16.0	16.6	17.6	16.9	17.6	17.3	17.8	17.6	17.9	17.5	17.9
Net acquisition of nonfinancial assets	3.4	3.0	3.3	3.9	3.9	4.2	6.6	4.3	6.5	4.4	5.9	4.5	4.5	4.8	4.8
Net lending/borrowing	-0.6	2.1	2.2	1.1	0.4	0.8	-2.3	0.5	-2.1	0.4	-1.5	0.1	-0.1	0.1	-0.3
Net acquisition of financial assets	1.6	1.1	0.9	1.5	1.0	1.5	1.5	1.5	1.5	1.8	1.8	1.8	1.8	2.0	2.0
Net incurrence of liabilities	2.2	-1.0	-1.3	0.4	0.6	0.7	3.8	1.0	3.6	1.3	3.3	1.7	1.9	1.9	2.3
Foreign	-0.2	-0.3	-0.1	0.5	0.6	0.9	2.8	1.2	1.8	1.1	1.7	1.3	1.4	1.3	1.0
Domestic	2.4	-0.6	-1.2	-0.1	0.0	-0.2	1.0	-0.2	1.8	0.2	1.5	0.3	0.5	0.6	1.2
Money and credit (annual percent change)															
Broad money	22.7	16.3	19.1	15.5	13.1	...	...	...	...	...	...	...	...	...	...
Domestic credit	8.0	16.9	13.9	14.5	11.6	...	...	...	...	...	...	...	...	...	...
Private sector credit	11.3	20.2	18.3	18.2	14.6	...	...	...	...	...	...	...	...	...	...
Velocity	1.4	1.3	1.2	1.2	1.2	...	...	...	...	...	...	...	...	...	...
Balance of Payments															
Current account (in millions of U.S. dollars)	909	635	908	880	585	594	-809	267	-664	-44	-648	-313	-382	-587	-121
In percent of GDP	4.8	3.3	4.6	4.1	2.8	2.5	-3.4	1.0	-2.6	-0.2	-2.3	-1.1	-1.3	-1.9	-0.4
Trade balance (in millions of U.S. dollars)	-4,605	-5,247	-6,082	-6,412	-6,575	-7,230	-8,361	-8,099	-9,078	-9,002	-9,849	-9,888	-10,416	-10,863	-11,046
In percent of GDP	-24.4	-27.2	-30.8	-29.6	-31.0	-30.4	-35.4	-31.9	-34.9	-33.0	-34.9	-34.0	-34.8	-35.0	-34.9
Exports value growth (y/y percent change)	5.0	-3.1	5.4	2.0	-6.0	5.0	1.0	5.5	5.5	6.0	6.0	6.0	6.0	6.0	6.0
Imports value growth (y/y percent change)	3.4	10.9	14.3	4.9	6.1	11.7	23.8	11.2	8.2	10.5	8.2	9.4	5.8	9.4	6.0
Workers' remittances (in millions of U.S. dollars)	4,414	4,931	5,543	5,826	6,163	6,251	6,700	6,710	7,265	7,208	7,884	7,737	8,548	8,307	9,273
In percent of GDP	23.4	25.6	28.0	26.9	29.0	26.3	28.4	26.4	27.9	26.4	27.9	26.6	28.6	26.8	29.3
Gross official reserves (in millions of U.S. dollars)	4,307	4,972	6,172	6,737	6,665	7,401	6,622	7,982	6,750	8,496	7,159	8,734	7,853	9,004	8,847
In months of prospective GNFS imports	7.2	7.3	8.5	8.4	7.4	8.4	6.9	8.2	6.5	8.0	6.5	7.5	6.7	7.2	7.1
Memorandum items															
Reconstruction-related expenditure (in percent of GDP)	...	...	...	...	...	...	3.0	...	2.7	...	1.8	...	...	...	...
Public debt (in percent of GDP)	13.7	32.3	28.3	24.4	25.1	23.0	26.5	22.3	27.5	22.0	28.4	22.1	28.4	22.6	28.8
GDP at market prices (in billions of Nepalese rupees)	1,527	1,695	1,942	2,170	2,125	2,423	2,409	2,686	2,748	2,974	3,077	3,277	3,369	3,595	3,671
GDP at market prices (in billions of U.S. dollars)	18.9	19.3	19.8	...	...	...	...	...	...	...	...	...	...	...	...
Exchange rate (NRs/US$; period average)	81.0	88.0	98.2	...	...	...	...	...	...	...	...	...	...	...	...
Real effective exchange rate (eop, y/y percent change)	-4.6	-2.3	-9.3	...	...	...	...	...	...	...	...	...	...	...	...

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

[1] Fiscal year ends in mid-July.

Table 6. Nepal: External Financing Requirements and Sources, 2013/14–2019/20

(In millions of U.S. dollars)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
		Projections					
Gross external financing requirements	**-296**	**171**	**1793**	**1352**	**1164**	**843**	**580**
Current account excluding official transfers (+ = deficit)	-563	-309	1328	1140	1150	883	636
Amortization of medium- and long-term debt	171	185	150	163	165	177	178
Of which: Asian Development Bank	64	78	83	84	84	87	87
Of which: World Bank	45	52	55	55	56	57	57
Of which: Paris Club	12	21	22	22	23	23	23
Other net capital outflows	96	295	315	49	-150	-216	-235
Available financing	**-439**	**312**	**904**	**812**	**631**	**394**	**250**
Current and capital grants excluding exceptional financing	518	425	413	455	494	524	554
Medium- and long-term borrowing	216	338	394	416	458	460	462
Of which: Asian Development Bank	...	190	190	190	190	190	190
Of which: World Bank	...	115	170	190	230	230	230
FDI, net	33	48	63	78	93	108	231
Portfolio investment, net	0	0	0	0	0	0	0
Gross reserves accumulation (+ = decrease)	-1206	-498	34	-136	-414	-698	-998
Exceptional financing	**0**	**0**	**889**	**539**	**534**	**450**	**330**
IMF: Prospective arrangement	0	0	50	0	0	0	0
Asian Development Bank	0	0	70	50	60	60	10
World Bank	0	0	150	50	50	50	0
Other development partners	0	0	619	439	424	340	320
Of which: current and capital grants	0	0	400	220	205	190	170
Of which: loans	0	0	219	219	219	150	150
Memorandum items							
Gross official reserves (in millions of U.S. dollars)	6172	6665	6622	6750	7159	7853	8847
In months of prospective imports excl. reconstruction-related imports	8.5	8.3	7.5	6.9	6.7	6.7	7.1
Gross official reserves without exceptional financing	6172	6665	5733	5322	5196	5440	6104
In months of prospective imports excl. reconstruction-related imports	8.5	8.3	6.5	5.5	4.9	4.7	4.9

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

Appendix I. Letter of Intent

July 17, 2015

Ms. Christine Lagarde
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431, USA

Dear Ms. Lagarde:

1. The April 25 devastating earthquake and repeated aftershocks have taken a big toll on life, property, cultural heritage and the ambient natural environment. More than 8,800 people have been killed and 22,300 injured, over half a million houses destroyed and another quarter million damaged and three million people rendered homeless. Early estimates suggest that an additional 3 percent of Nepal’s population has been pushed into poverty as a direct result of the earthquakes. This translates into as many as a million more poor people.

2. The recently completed Post-Disaster Needs Assessment (PDNA) estimates the total value of the damages to properties at NR 517 billion or US$ 5.15 billion. Together with estimated economic losses of NR 189 billion or US$ 1.89 billion the total estimated cost of the earthquake amounts to NR 706 billion or US$ 7 billion, equivalent to nearly one third of the Gross Domestic Product (GDP).

3. The disaster has set back Nepal's efforts to graduate from least developed country status. The agriculture and tourism sectors have been hit hard. We expect economic growth to slow to around 3.04 percent in 2014/15, considerably slower than anticipated prior to the earthquake even though the disaster struck when nine months of the fiscal year had already passed. The total recovery and reconstruction need to be borne by the budget will amount to NR 670 billion or US$ 6.7 billion, or about 31 percent of GDP over the period 2015/16–2020/21. Borrowing such a large amount in the domestic market would reduce the availability of domestic funds for the private sector. In addition to “crowding out” much-needed private sector activity, domestic government borrowing would undo Nepal's sustained efforts to bring

down the public debt. There is also an important external stability aspect to the necessary reconstruction effort as it is expected to boost imports of reconstruction-related materials. Together with shortfalls in foreign currency earnings from tourism and export, this is expected to push the external current account into deficit and lead to a decline in Nepal's foreign reserves, even after taking into account an increase in remittances from migrant workers to help their families' rebuilding efforts.

4. In mobilizing fiscal resources for recovery and reconstruction, Nepal will seek external grants and concessional loans as much as possible before resorting to domestic borrowing. So far, including in the context of the June 25 International Conference on Nepal's Reconstruction (ICNR), we have secured indicative support of about NR 408 billion or US$ 4.08 billion for reconstruction from development partners for the period 2015/16-2019/20. We intend to review development projects that had been in the pipeline before the earthquake and reprioritize them to exploit synergies with reconstruction projects.

5. Nepal's external position has remained strong. The current account surplus reached 4.6 percent of GDP in 2013/14 as remittances continued to grow rapidly. By mid-April 2015, on the eve of the earthquake, central bank reserves reached US$6.3 billion, equal to 29 percent of GDP and covering almost 8 months of prospective imports of goods and service. However, in view of the very large reconstruction needs, the Government of Nepal would like to request financial assistance from the International Monetary Fund to address Nepal's urgent balance of payments need and prevent an immediate and severe economic disruption as reconstruction activity gets under way in earnest. The assistance would be a disbursement of SDR 35.65 million (approximately US$ 50 million) under the Rapid Credit Facility (RCF) to ease the pressure on our fiscal resources and official foreign reserves. We would request that the funds be disbursed as direct budget support to the Ministry of Finance's account at the Nepal Rastra Bank (NRB, Nepal's central bank). We have been holding extensive discussions with our key development partners on possible financial support and we expect that Fund assistance would help catalyze additional inflows of external resources. Strong support from development partners will allow us to maintain official foreign reserves at about 7 months of prospective non-reconstruction-related imports over the next three years, which will give us an adequate buffer to protect against external shocks and to maintain the exchange rate peg to the Indian rupee.

6. One of the key challenges has been to effectively and efficiently implement the government's capital budget. This was the case even before the earthquake. We recognize that addressing bottlenecks in capital spending implementation has become even more important in view of the high post-disaster reconstruction needs. To speed up reconstruction in the districts most affected by the earthquake, a law has been already enacted that establishes a Reconstruction Authority whose operations are closely coordinated with the annual budget process. In addition, as part of a broader push to improve capital budget execution we will implement measures aimed at strengthening budget planning, establishment of a robust appraisal function, development of targeted selection and prioritization criteria as well as improved use of monitoring processes in project implementation. In this regard, Nepal intends to take advantage of the recommendations made by a recent technical assistance mission from the IMF's Fiscal Affairs Department. With the successful mobilization of funds and implementation of reconstruction projects, the fiscal balance is expected to turn into a deficit and public debt is expected to rise. Nevertheless, we remain committed to maintain public debt levels consistent with a "low" risk of debt distress rating.

7. We intend to maintain an accommodative monetary policy stance to support economic recovery and ensure that banks have sufficient liquidity. Given the economic disruption, some increase in inflation may be inevitable. Once economic conditions normalize, we will aim to keep inflation in the neighborhood of that in India. Nepal will continue to implement the financial sector reform program. In fact, the earthquake has raised the stakes for our efforts to strengthen the legal framework and institutional capacity for bank supervision and regulation and for financial crisis management and bank resolution.

8. Nepal will continue to peg the Nepalese Rupee to the Indian Rupee. This arrangement has served Nepal well in minimizing market volatility. Our country's competitiveness should benefit from our efforts to improve implementation of the government's capital budget which we expect to encourage private sector investment.

9. The government attaches great importance to implementing its agenda of structural reforms aimed at fostering macroeconomic stability and growth and reducing poverty as laid out in Nepal's 13th Development Plan (2013-16) which aims at graduating from least-developed country status by 2022. Over the past few years, the treasury single account (TSA) has been rolled out to all 75 districts. Reforms in revenue administration have been pushing up the

revenue to GDP ratio. The overall business climate has improved. And we are looking to accelerate the development of Nepal's vast hydropower potential.

10. The Government of Nepal values its cooperation with the IMF and takes its obligations seriously. We will not introduce measures or policies that would compound balance of payments difficulties. We do not intend to impose new or intensify existing restrictions on the making of payments and transfers for current international transactions, trade restrictions for balance of payments purposes, or multiple currency practices, or to enter into bilateral payments agreements which are inconsistent with Article VIII of the Fund's Articles of Agreement. Furthermore, we are committed to undergo an update of the safeguards assessment made by the Fund in 2011 in connection with Nepal's request for assistance under the Rapid Credit Facility in 2010. The audited financial statement for the year ended July 16, 2014 has been published on the NRB website. In addition, we have already authorized the external auditor of the NRB to share relevant documents and hold discussions with Fund staff. Given that financing from the IMF will be used for budget support, a memorandum of understanding will be established between the Government of Nepal and the NRB on their respective responsibilities for servicing financial obligations to the IMF.

11. We authorize the Fund to publish this Letter of Intent and the staff report for the request for disbursement under the RCF.

Sincerely yours,

/s/	/s/
The Hon. Ram Sharan Mahat	Chiranjibi Nepal
Minister of Finance	Governor
Government of Nepal	Nepal Rastra Bank

INTERNATIONAL MONETARY FUND

NEPAL

REQUEST FOR DISBURSEMENT UNDER THE RAPID CREDIT FACILITY—DEBT SUSTAINABILITY ANALYSIS

July 17, 2015

Approved By
Kalpana Kochhar and Ranil Salgado (IMF) and Satu Kahkonen (IDA)

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

This low-income debt sustainability analysis (LIC DSA) updates the joint IMF/World Bank DSA from May 2014. Nepal's risk of debt distress continues to be assessed to be low. Generally prudent fiscal policy and low execution of capital spending budgets have continued to underpin declining levels of public debt.[1] *Higher financing requirements driven by post-earthquake reconstruction and higher public investment expenditures are expected to be manageable under the assumption that they are temporary and that financing terms are favorable. As a result, indicators of the public external debt stock and public debt service ratios remain comfortably within the policy-dependent indicative thresholds, even under stress tests, due to the assumed continued high level of concessionality of official borrowing.*[2]

BACKGROUND

1. **The April 25, 2015 earthquake was a major shock to the economy but the risk of debt distress is expected to remain low.** The earthquake is expected to have a significant short-term effect on growth, as key sectors of the economy have been affected, most notably

[1] The risk rating is determined using the LIC DSA framework. Nepal's fiscal year starts in mid-July. For example, fiscal year 2014 extends from mid-July 2013 until mid-July 2014.

[2] The thresholds are determined based on Nepal's policy performance rating, which is "medium" according to the CPIA score which averaged 3.31 in 2011–13. Nepal continues to receive large amounts of remittances, averaging 25.7 percent of GDP and 237.3 percent of exports of goods and services per annum during the past three years. As remittances exceed relevant thresholds (10 percent of GDP and 20 percent of exports of goods and services) they are incorporated into the analysis.

agriculture and tourism.[3] Reconstruction needs are significant and have pushed up gross external financing requirements over the next 4–5 years. The baseline scenario assumes that the financing gap will be filled primarily with loans. Even with the resulting increased borrowing, the risk of debt distress remains low, thanks to the low starting level of external debt and the high concessionality of new debt.

2. The present value of external debt undershot the 2014 projection in the previous DSA, but is expected to rise somewhat over the medium term. The previous DSA projected the present value (PV) of public and publicly-guaranteed (PPG) external debt to decline to 13.6 percent of GDP in 2014 and to fall by almost 2 percent of GDP over the next five projection years. This DSA compares as follows:

- The continued low execution of foreign-financed capital spending, higher-than-expected economic growth and a higher-than-expected GDP deflator in U.S. dollar terms pushed the PV of PPG external debt down to 10.7 percent of GDP in 2014, 2.9 percent of GDP lower than projected in the previous DSA. This provides the new base to project the path of external public debt in the current DSA.

- Unlike the decline over the medium term projected in the previous DSA, the PV of PPG external debt is now projected to rise by 1.4 percent of GDP over the next 6 projection years, to 12.1 percent of GDP by 2020, owing to the increased concessional external borrowing to help finance the post-earthquake reconstruction (Table 1a).

3. The total stock of public debt in Nepal declined in 2014 to 28.3 percent of GDP from 32.3 percent in 2013, largely reflecting prudent fiscal policy and favorable economic growth.

- External debt stood at 17.9 percent of GDP by the end of FY 2013/2014 (US$3.5 billion), of which 86 percent was concessional borrowing from the World Bank and the Asian Development Bank (ADB). Japan was the largest bilateral creditor, followed by Korea, India and China.

Nepal: Structure of External Public Debt, 2014

	Value (in million USD)	In percent of GDP	NPV (in million USD)
Public debt	3,531	17.9	2,468
Multilateral	3,215	16.3	2,435
Asian Development Bank	1,502	7.6	1,245
World Bank	1,582	8.0	1,028
IMF	36	0.2	32
Other	95	0.5	130
Official Bilateral	333	1.7	33
Paris Club	225	1.1	10
Non-Paris Club	108	0.5	23
Commerical	-	-	-

Source: Nepali authorities; Fund staff estimates.

- Domestic debt declined from 12.2 percent of GDP in 2012/13 to 10.4 percent by the end of FY2013/14, as low budget execution resulted in a budget surplus.

[3] The Post Disaster Needs Assessment estimates preliminary headline damage at around US$5bn (24 percent of GDP). Economic losses (e.g. the impact on the economy due to the slowdown in economic activities in the aftermath of the earthquake, such as through forgone revenue in tourism, etc.) are estimated at around 9 percent of GDP.

Nepal: Public Domestic Debt 1/

(in billions of Nepalese rupees unless otherwise stated)

	2012	2013	2014
Government bonds 2/	209	207	202
Treasury Bills	131.6	136.5	136.5
Development Bonds	57.5	51.6	47.1
National Savings Bonds	15.7	15.7	16.6
Citizen Savings Bonds	4.1	3.2	1.5
Foreign Employment Bonds	0.0	0.1	0.1
Special Bonds	0.2	0.0	0.0
Memorandum items:			
Total domestic debt outstanding as percent of GDP	13.7	12.2	10.4
NRB overdrafts (+) / deposits (-)	-2	-14	-31

Source: Nepali authorities; Fund staff estimates

[1] Fiscal years ending in mid-July

4. **The authorities have taken several measures in recent years to enhance debt management capacity, but further improvement is needed in several areas.** World Bank staff conducted a Debt Management Performance Assessment (DeMPA) in August 2014. Compared to an earlier assessment, in February 2010, it was found that progress had been made on cash flow forecasting and cash balance management, as well as on coordination with macro policy. On the latter, the assessment highlighted the recent creation of separate open market committees—for public debt management and monetary management. The DeMPA called for improving the effectiveness of managerial oversight on the debt management functions. It was also recommended to task one entity with the preparation of a comprehensive debt management strategy, analyze the cost and risks of the debt portfolio, and make debt service forecasts more robust.

MACROECONOMIC ASSUMPTIONS

5. **Macroeconomic assumptions for the current DSA are consistent with the macroeconomic framework underlying the current Rapid Credit Facility (RCF) arrangement.** The main differences from the previous DSA include (Box 1): (i) a deterioration in growth prospects; (ii) slower revenue gains relative to the previous DSA, reflecting short-run revenue losses related to the earthquake followed by a gradual recovery over the medium term; and (iii) a deteriorating current account in the near and medium term, driven by rising imports of reconstruction-related materials, which more than offset temporarily stronger remittances. In the long term, however, the current account is expected to recover somewhat.

- Real GDP growth is expected to fall from 5.4 percent in 2013/14 to 3.4 percent in 2014/15, due to significant economic losses resulting from the earthquake. Growth is expected to gradually recover over the medium term as reconstruction gains momentum. The baseline assumes improved budget execution of capital spending compared to the previous DSA in line with authorities' efforts in this area and with intensified reconstruction efforts. However, experience in other fragile countries struck by natural disaster suggests that potential growth is likely to be adversely affected by the earthquake. In light of this, growth in the medium and long run is projected around 4 percent, lower than the 4.5 percent assumed previously.

- Fiscal policy is expected to remain responsible. Revenue is expected to deteriorate in the short term and slowly recover thereafter, while the expenditure effect on the budget related to reconstruction and investment expenditure is expected to dominate over the medium term. The resulting higher fiscal deficits reflect these expenditures—the primary balance is expected to deteriorate from a surplus of 1.9 percent of GDP in 2014 to a deficit of 1.4 percent in 2035. Net incurrence of liabilities is projected to rise from -1.3 percent of GDP in 2013/14 to an average of 3.0 percent over the next five years, decreasing to 1.0 percent towards the end of the DSA horizon. This path is consistent with a stable debt profile. Financing of the deficit is expected to tilt increasingly towards domestic sources (net domestic financing rising to 1.7 percent of GDP in the long term), as public financial management improves and external loans decline relative to GDP.

Box 1. Macroeconomic Assumptions Table

	Previous DSA			Current DSA				Current vs. Previous	
	2014	**MT**	**LT**	**2014**	**2015**	**MT**	**LT**	**MT**	**LT**
Real growth (%)	4.8	4.7	4.5	5.4	3.4	4.2	4.0	-0.5	-0.5
Inflation (GDP deflator, %)	8.8	7.1	5.0	8.7	5.9	7.2	5.0	0.1	0.0
Revenues and grants (% GDP)	21.1	21.7	22.5	20.8	20.3	22.1	22.8	0.4	0.3
Grants (% GDP)	2.8	2.5	2.3	2.4	1.9	2.6	2.3	0.0	0.0
Primary expenditure (% GDP)	21.4	22.9	24.0	18.9	20.9	24.5	24.2	1.6	0.2
Net acquisition of non-financial assets (% GDP)	3.7	4.4	5.2	3.3	3.9	5.7	5.0	1.3	-0.2
Primary deficit (% GDP)	0.3	1.1	1.5	-1.9	0.6	2.3	1.4	1.2	-0.1
Net incurrence of liabilities	1.3	2.1	2.5	-1.3	0.6	3.0	1.0	0.9	-1.5
Net domestic financing (% GDP)	1.0	1.0	1.5	0.9	1.0	1.7	1.7	0.7	0.2
Exports of G&S (y/y growth)	4.1	7.2	6.0	12.0	-11.9	7.2	6.5	0.0	0.5
Imports of G&S (y/y growth)	10.9	10.2	6.1	13.2	7.0	10.1	7.6	-0.1	1.6
Remittances (y/y growth)	15.0	7.9	6.0	12.4	11.2	8.5	8.5	0.6	2.5
Current account balance (% GDP)	4.2	0.9	-0.8	4.6	2.8	-2.0	1.3	-2.9	2.1

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

- The external current account is projected to move from a sizeable surplus in 2013/14 to moderate deficits over the medium term. The exchange rate peg with the Indian rupee is assumed to remain at the current level over the projection period. Import growth is expected to moderate in line with remittances. Export growth is projected to increase only moderately, reflecting weak competitiveness due to significant infrastructure bottlenecks. As a consequence, the ratio of exports to GDP is expected to gradually decline over the medium term.

- Relative to the previous DSA, the baseline assumes additional external financing of approximately US$2.7 billion from 2015/16 to 2019/20 in order to meet post-earthquake reconstruction related financing needs. This is the amount of new pledges of financial assistance in the form of grants and loans announced by Nepal’s development partners in the context of the International Conference on Nepal's Reconstruction (ICNR) held in

Kathmandu on June 25, 2015 (See Table 6 in the accompanying Staff Report for Request for Disbursement under the Rapid Credit Facility). About forty percent of this additional financing is assumed to come in the form of grants and the remainder in the form of loans.

EXTERNAL DEBT SUSTAINABILITY

A. Baseline

6. **Under the baseline scenario, Nepal's external debt indicators remain well below indicative sustainability thresholds** (Figure 1 and Table 1b). As in the previous DSA, remittances are formally included in the analysis as inflows remained robust even before the earthquake, reaching 28 percent of GDP in 2013/14. However, debt dynamics may be susceptible to volatility in remittance flows, as captured under standard shocks, discussed below. Over the medium term, the present value (PV) of external debt stabilizes at a level equal to: 9 percent of GDP + remittances, 29 percent of exports + remittances, and 60 percent of revenues. The ratio of debt service-to-exports + remittances stabilizes at 2 percent over the medium term, while the ratio of debt service to revenues stabilizes at 3 percent.

B. Stress Tests and Alternative Scenarios

7. **Debt dynamics remain resilient to standard shocks**. These stress tests include shocks to GDP growth, exports, non-debt creating flows, and a combination of these shocks, as well as a onetime 30 percent nominal depreciation shock. Under the most severe shock (to non-debt creating flows, capturing a remittance shock), the PV of debt to exports + remittances rises rapidly over the next three years but stays below the threshold, and thereafter declines again, while all other indicators remain well below the thresholds.

PUBLIC DEBT SUSTAINABILITY

8. **Under the baseline, the ratio of public debt to GDP rises gradually from 28.3 percent in 2014 to 31.2 percent in 2035.** In PV terms, public debt to GDP also increases from 21.1 percent in 2014 to 25.6 percent by 2035, while as a ratio of revenues and grants, the PV of public debt rises from 101.5 percent in 2014 to 108.4 percent by 2035. As with the 2014 DSA, the composition of public debt is projected to tilt towards higher domestic debt, from 37 percent in 2014 to 51 percent of total public debt in 2035.

9. **Debt dynamics remain resilient under standard stress tests.** In the context of the PV of public debt-to-GDP ratio, the most extreme shocks are the real GDP growth at historical average minus one standard deviation and the permanently lower GDP growth. These tests result in the PV of public debt-to-GDP ratio increasing to 31 percent by 2035, again staying well below the 56 percent threshold.

10. Contingent liabilities arise mainly from the operations of state owned enterprises (SOEs), and rising pension costs need to be addressed to head off future risks:

- Nepal Oil Corporation (NOC) and Nepal Electricity Authority (NEA) have been the two biggest loss-making SOEs, on average making combined losses of 1½ percent of GDP a year, and needing frequent government bail-outs despite periodic (though not automatic) price adjustments to recover costs. However, as a result of the decline in international oil prices during the second half of 2014, NOC's losses have been reduced. In fact, in early 2015 retail prices exceeded NOC's breakeven prices.

- Civil service pension liabilities, currently at a modest 1¼ percent of GDP, rise to 1½ percent by 2025, and can be addressed through adequate parametric reforms in the medium term according to a 2014 IMF TA mission on pension reforms.

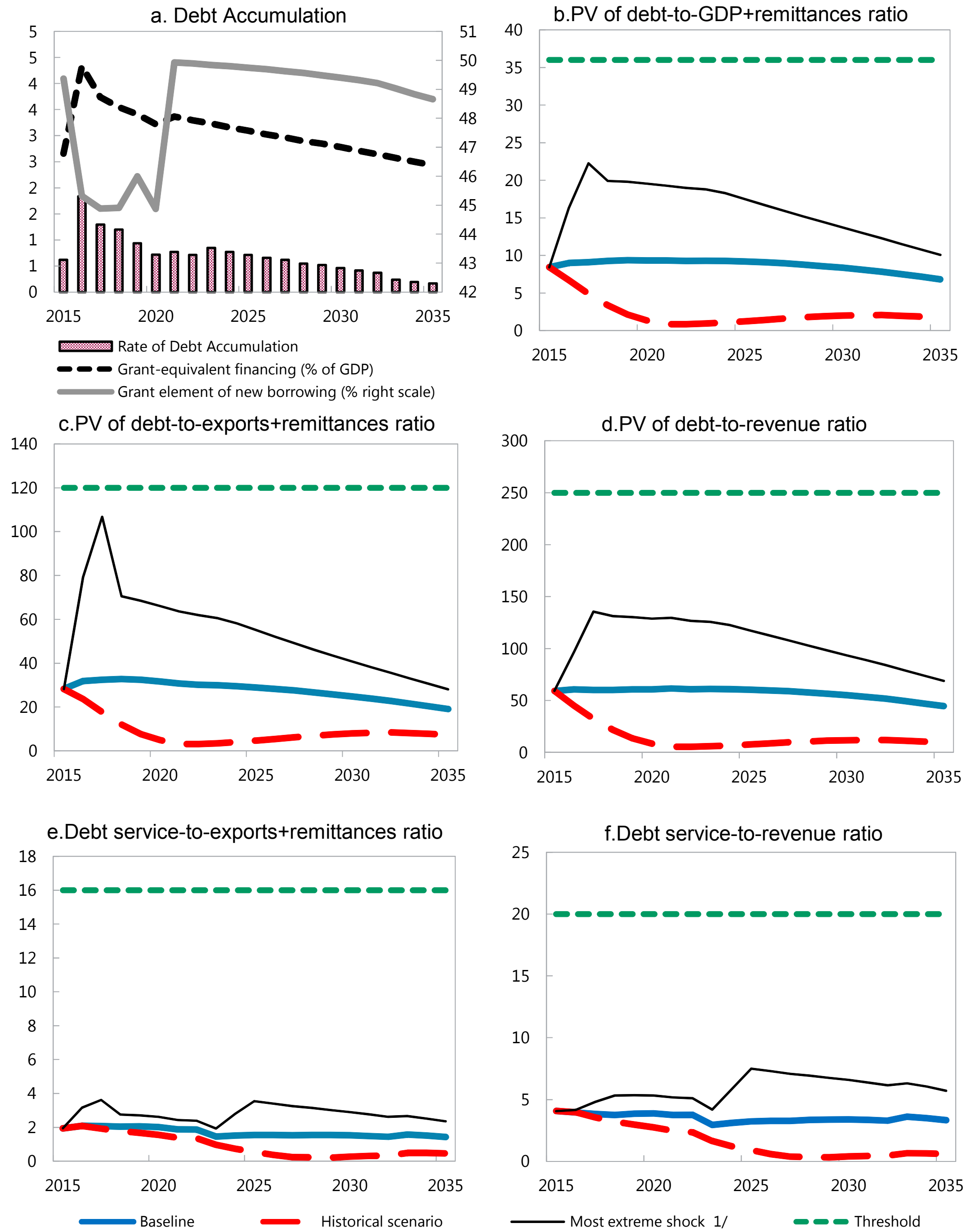
AUTHORITIES' VIEWS

11. The authorities broadly concurred with the findings of the DSA. While underscoring their commitment to a prudent borrowing policy, they noted the country's large reconstruction need in the aftermath of the earthquake. The authorities will seek to mobilize concessional borrowing to finance the reconstruction effort and put the economy on a path of higher growth and faster poverty reduction.

CONCLUSION

12. The DSA suggests Nepal's risk of debt distress is low. Generally prudent fiscal policy and low execution of capital spending budgets have continued to underpin declining levels of public debt. Higher financing requirements driven by post-earthquake reconstruction and higher public investment expenditures are expected to be manageable under the assumption that they are temporary and that financing terms are favorable. As a result, indicators of the public external debt stock and public debt service ratios remain comfortably within the policy-dependent indicative thresholds, even under stress tests, due to the assumed continued high level of concessionality of official borrowing.

Figure 1. Nepal: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2015–2035 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025. In figure b. it corresponds to a Non-debt flows shock; in c. to a Non-debt flows shock; in d. to a Combination shock; in e. to a Non-debt flows shock and in figure f. to a Combination shock

Table 1a. Nepal: External Debt Sustainability Framework, Baseline Scenario, 2012–2035 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/	Standard 6/	Projections									
				Average	Deviation							2015-2020			2021-2035
	2012	2013	2014			2015	2016	2017	2018	2019	2020	Average	2025	2035	Average
External debt (nominal) 1/	**22.9**	**20.2**	**17.9**			**18.0**	**19.2**	**19.3**	**19.5**	**19.8**	**19.7**		**19.8**	**15.2**	
of which: public and publicly guaranteed (PPG)	22.7	20.0	17.9			18.0	19.2	19.3	19.5	19.8	19.7		19.8	15.2	
Change in external debt	2.8	-2.7	-2.3			0.1	1.2	0.1	0.3	0.3	-0.1		-0.1	-0.7	
Identified net debt-creating flows	-5.2	-4.3	-5.2			-3.5	2.5	1.3	1.3	0.2	-1.0		-2.8	-2.8	
Non-interest current account deficit	**-5.0**	**-3.5**	**-5.0**	**-2.3**	**2.5**	**-2.8**	**3.4**	**2.5**	**2.2**	**1.1**	**0.2**		**-1.5**	**-1.7**	-1.5
Deficit in balance of goods and services	23.5	26.8	29.7			31.6	38.0	36.3	36.0	35.5	35.3		37.1	45.5	
Exports	10.1	10.7	11.7			9.6	7.8	8.0	8.2	8.6	8.9		9.4	9.4	
Imports	33.6	37.5	41.3			41.2	45.8	44.3	44.2	44.1	44.2		46.5	55.0	
Net current transfers (negative = inflow)	-27.5	-29.3	-32.6	-23.7	5.0	-32.8	-33.0	-32.2	-32.1	-32.7	-33.4		-36.9	-45.5	-39.5
of which: official	-2.1	-1.3	-1.8			-1.4	-2.3	-1.9	-1.8	-1.7	-1.7		-1.8	-2.0	
Other current account flows (negative = net inflow)	-1.0	-0.9	-2.1			-1.6	-1.6	-1.6	-1.6	-1.7	-1.7		-1.7	-1.7	
Net FDI (negative = inflow)	**-0.6**	**-0.5**	**-0.2**	**-0.2**	**0.2**	**-0.2**	**-0.3**	**-0.3**	**-0.3**	**-0.4**	**-0.7**		**-0.7**	**-0.7**	-0.7
Endogenous debt dynamics 2/	**0.4**	**-0.3**	**0.0**			**-0.5**	**-0.7**	**-0.9**	**-0.6**	**-0.6**	**-0.5**		**-0.6**	**-0.5**	
Contribution from nominal interest rate	0.2	0.2	0.5			0.0	0.0	0.1	0.1	0.1	0.2		0.2	0.1	
Contribution from real GDP growth	-1.0	-0.9	-1.1			-0.6	-0.7	-0.9	-0.7	-0.7	-0.7		-0.8	-0.6	
Contribution from price and exchange rate changes	1.1	0.4	0.5			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**8.0**	**1.6**	**2.9**			**3.7**	**-1.3**	**-1.2**	**-1.0**	**0.1**	**1.0**		**2.7**	**2.1**	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	10.7			10.9	11.5	11.7	11.9	12.1	12.1		12.2	9.6	
In percent of exports	...	...	92.0			113.8	147.1	145.2	144.2	139.8	135.2		129.9	102.1	
PV of PPG external debt	**...**	**...**	**10.7**			**10.9**	**11.5**	**11.7**	**11.9**	**12.1**	**12.1**		**12.2**	**9.6**	
In percent of exports	**...**	**...**	**92.0**			**113.8**	**147.1**	**145.2**	**144.2**	**139.8**	**135.2**		**129.9**	**102.1**	
In percent of government revenues	**...**	**...**	**58.4**			**59.2**	**60.5**	**60.2**	**60.2**	**60.7**	**60.6**		**60.4**	**44.6**	
Debt service-to-exports ratio (in percent)	**10.6**	**9.5**	**11.2**			**7.8**	**9.6**	**9.3**	**9.0**	**8.9**	**8.6**		**7.0**	**7.6**	
PPG debt service-to-exports ratio (in percent)	**10.6**	**9.5**	**11.2**			**7.8**	**9.6**	**9.3**	**9.0**	**8.9**	**8.6**		**7.0**	**7.6**	
PPG debt service-to-revenue ratio (in percent)	**6.7**	**5.8**	**7.1**			**4.1**	**4.0**	**3.8**	**3.8**	**3.8**	**3.9**		**3.2**	**3.3**	
Total gross financing need (Billions of U.S. dollars)	-0.6	-0.2	-0.7			-0.5	0.9	0.8	0.7	0.5	0.1		-0.7	-1.3	
Non-interest current account deficit that stabilizes debt ratio	-7.8	-0.8	-2.7			-2.9	2.2	2.4	1.9	0.9	0.3		-1.4	-1.0	
Key macroeconomic assumptions															
Real GDP growth (in percent)	4.8	4.1	5.4	4.3	0.9	3.4	4.4	5.4	3.9	3.8	3.8	4.1	4.0	4.0	4.0
GDP deflator in US dollar terms (change in percent)	-5.4	-1.8	-2.6	6.2	8.6	3.9	6.5	4.5	4.5	2.1	2.0	3.9	2.0	2.0	2.0
Effective interest rate (percent) 5/	0.9	0.9	2.5	1.1	0.5	0.1	0.3	0.3	0.5	0.7	1.0	0.5	1.0	1.0	1.0
Growth of exports of G&S (US dollar terms, in percent)	11.7	8.4	12.0	6.9	7.3	-11.9	-8.8	12.6	11.4	11.1	9.6	4.0	6.0	6.9	6.5
Growth of imports of G&S (US dollar terms, in percent)	0.6	14.0	13.2	14.7	9.0	7.0	23.8	6.5	8.3	5.8	6.0	9.6	7.8	8.0	7.6
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	49.4	45.3	44.9	44.9	46.0	44.9	45.9	49.7	48.7	49.5
Government revenues (excluding grants, in percent of GDP)	16.0	17.5	18.4			18.4	19.1	19.4	19.7	19.9	19.9		20.2	21.6	20.6
Aid flows (in Billions of US dollars) 7/	0.7	0.5	0.6			0.5	0.8	0.9	0.9	0.9	1.0		1.4	2.1	
of which: Grants	0.5	0.3	0.5			0.4	0.6	0.7	0.7	0.7	0.8		1.0	1.6	
of which: Concessional loans	0.2	0.1	0.1			0.1	0.2	0.2	0.2	0.2	0.2		0.4	0.6	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			2.7	4.3	3.7	3.5	3.4	3.2		3.1	2.4	2.9
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			76.7	69.3	72.7	73.0	75.7	78.5		80.4	85.8	81.9
Memorandum items:															
Nominal GDP (Billions of US dollars)	18.9	19.3	19.8			21.2	23.6	26.0	28.2	29.9	31.7		42.6	77.0	
Nominal dollar GDP growth	-0.8	2.2	2.6			7.4	11.2	10.1	8.6	6.0	5.8	8.2	6.1	6.1	6.1
PV of PPG external debt (in Billions of US dollars)			2.2			2.3	2.7	3.0	3.3	3.6	3.8		5.1	7.3	
(PVt-PVt-1)/GDPt-1 (in percent)						0.6	1.8	1.3	1.2	0.9	0.7	1.1	0.7	0.2	0.5
Gross workers' remittances (Billions of US dollars)	4.4	4.9	5.5			6.2	6.7	7.3	7.9	8.5	9.3		14.0	31.6	
PV of PPG external debt (in percent of GDP + remittances)	...	...	8.4			8.4	9.0	9.1	9.3	9.4	9.3		9.2	6.8	
PV of PPG external debt (in percent of exports + remittances)	...	...	27.0			28.2	31.9	32.4	32.8	32.4	31.6		29.0	19.1	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	3.3			1.9	2.1	2.1	2.0	2.1	2.0		1.6	1.4	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

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

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

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

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

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

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

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

Table 1b. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015–2035

(In percent)

	Projections							
	2015	2016	2017	2018	2019	2020	**2025**	2035
PV of debt-to-GDP+remittances ratio								
Baseline	8	9	9	9	9	9	**9**	7
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	8	7	5	3	2	1	**1**	2
A2. New public sector loans on less favorable terms in 2015-2035 2	8	9	10	11	11	11	**12**	11
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	8	9	9	9	9	9	**9**	7
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	8	9	9	9	9	9	**9**	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	8	9	10	10	10	10	**10**	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	8	16	22	20	20	20	**18**	10
B5. Combination of B1-B4 using one-half standard deviation shocks	8	15	22	19	19	19	**17**	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	8	11	11	12	12	12	**12**	8
PV of debt-to-exports+remittances ratio								
Baseline	28	32	32	33	32	32	**29**	19
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	28	24	18	12	8	5	**5**	7
A2. New public sector loans on less favorable terms in 2015-2035 2	28	34	36	38	38	38	**39**	30
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	28	31	32	32	32	31	**29**	19
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	28	30	32	32	32	31	**28**	19
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	28	31	32	32	32	31	**29**	19
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	28	79	107	70	68	66	**55**	28
B5. Combination of B1-B4 using one-half standard deviation shocks	28	65	90	61	59	57	**48**	25
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	28	31	32	32	32	31	**29**	19
PV of debt-to-revenue ratio								
Baseline	59	61	60	60	61	61	**60**	45
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	59	45	33	22	14	9	**8**	10
A2. New public sector loans on less favorable terms in 2015-2035 2	59	64	67	69	72	74	**81**	71
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	59	60	61	61	62	61	**61**	45
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	59	57	58	58	59	59	**59**	44
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	59	65	69	69	70	70	**70**	51
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	59	99	134	129	128	127	**115**	66
B5. Combination of B1-B4 using one-half standard deviation shocks	59	97	135	131	130	129	**118**	69
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	59	83	83	82	83	83	**83**	61

Table 1b. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015–2035 (continued)

(In percent)

Debt service-to-exports+remittances ratio

Baseline	2	2	2	2	2	2	**2**	1
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	2	2	2	2	2	2	**1**	0
A2. New public sector loans on less favorable terms in 2015-2035 2	2	2	2	2	2	2	**2**	2
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	2	2	2	2	2	2	**2**	1
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	2	2	2	2	2	2	**2**	1
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	2	2	2	2	2	2	**2**	1
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	2	3	4	3	3	3	**4**	2
B5. Combination of B1-B4 using one-half standard deviation shocks	2	3	3	2	2	2	**3**	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	2	2	2	2	2	2	**2**	1

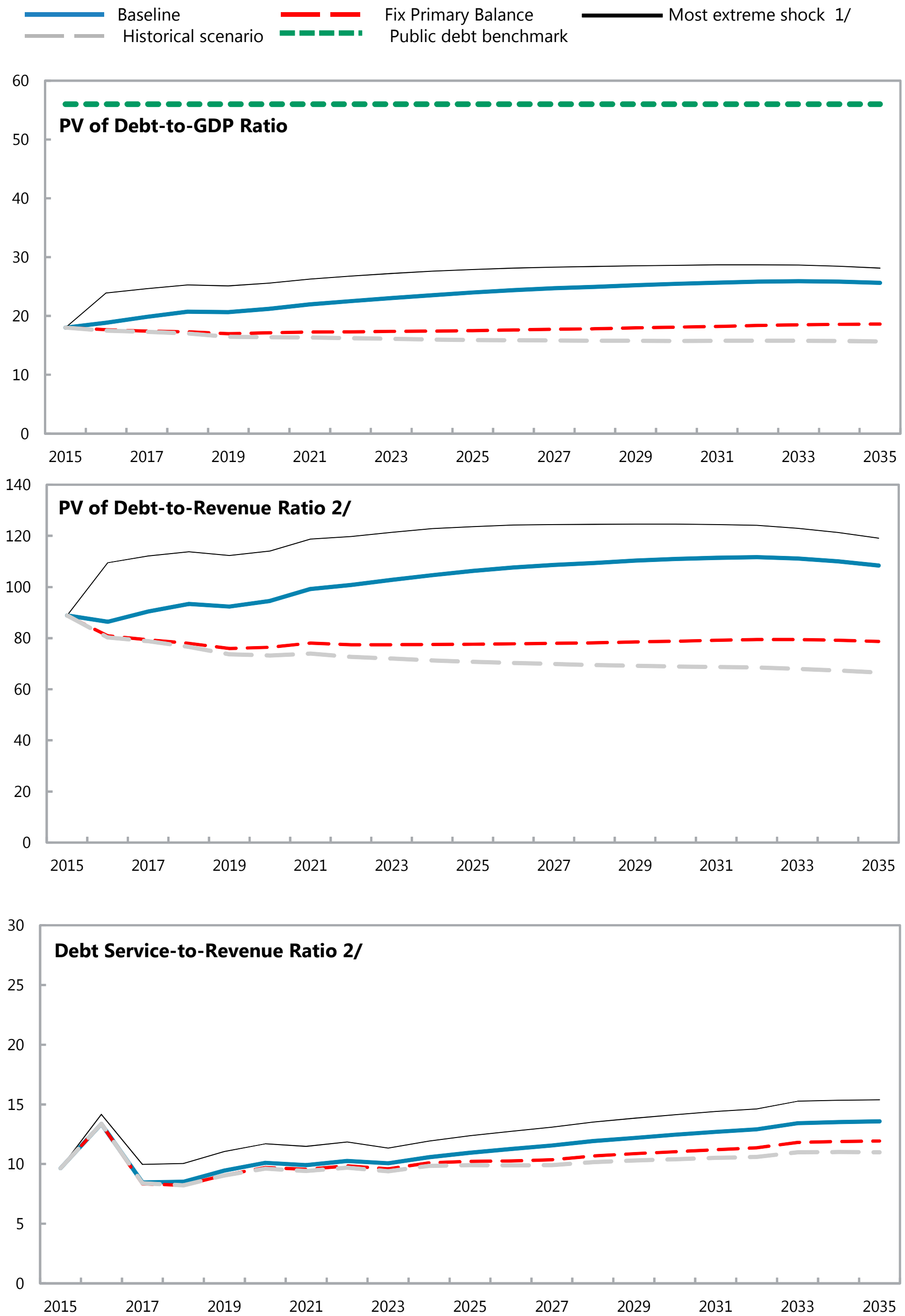
Debt service-to-revenue ratio

Baseline	4	4	4	4	4	4	**3**	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	4	4	4	3	3	3	**1**	1
A2. New public sector loans on less favorable terms in 2015-2035 2	4	4	4	4	4	5	**5**	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	4	4	4	4	4	4	**3**	3
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	4	4	4	4	4	4	**3**	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	4	4	4	4	4	5	**4**	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	4	4	5	5	5	5	**7**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	4	4	5	5	5	5	**7**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	4	6	5	5	5	5	**5**	5
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	48	48	48	48	48	48	**48**	48

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly a an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 2. Nepal: Indicators of Public Debt Under Alternative Seniors, 2015–2035 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025.

2/ Revenues are defined inclusive of grants.

Table 2a. Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2012–2035

(In percent of GDP, unless otherwise indicated)

	Actual			Average 5/	Standard Deviation 5/	Estimate	Projections								
	2012	2013	2014			2015	2016	2017	2018	2019	2020	2015-20 Average	2025	2035	2021-35 Average
Public sector debt 1/	36.4	32.3	28.3			25.1	26.5	27.5	28.4	28.4	28.8		31.6	31.2	
of which: foreign-currency denominated	22.7	20.0	17.9			18.0	19.2	19.3	19.5	19.8	19.7		19.8	15.2	
Change in public sector debt	1.9	-4.2	-4.0			-3.1	1.4	1.0	0.9	0.0	0.5		0.4	-0.5	
Identified debt-creating flows	2.9	-3.1	-5.3			-1.0	1.3	0.9	0.9	0.0	0.5		0.4	-0.5	
Primary deficit	1.2	-1.8	-1.9	0.3	1.3	0.6	3.0	3.2	2.7	1.2	1.5	2.0	1.6	0.6	1.4
Revenue and grants	18.7	19.3	20.8			20.3	21.8	21.9	22.2	22.3	22.4		22.6	23.6	
of which: grants	2.7	1.8	2.4			1.9	2.7	2.6	2.5	2.5	2.5		2.4	2.0	
Primary (noninterest) expenditure	19.9	17.5	18.9			20.9	24.8	25.1	24.9	23.6	23.9		24.2	24.3	
Automatic debt dynamics	1.8	-1.3	-3.3			-1.6	-1.7	-2.2	-1.9	-1.3	-1.1		-1.2	-1.1	
Contribution from interest rate/growth differential	-1.8	-1.7	-2.2			-1.8	-1.1	-1.8	-1.4	-0.8	-1.1		-1.2	-1.1	
of which: contribution from average real interest rate	-0.2	-0.2	-0.6			-0.9	-0.1	-0.4	-0.4	0.2	0.0		0.0	0.1	
of which: contribution from real GDP growth	-1.6	-1.4	-1.6			-0.9	-1.1	-1.3	-1.0	-1.0	-1.0		-1.2	-1.2	
Contribution from real exchange rate depreciation	3.6	0.4	-1.1			0.2	-0.6	-0.5	-0.4	-0.4	0.0		...	...	
Other identified debt-creating flows	-0.1	-0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	-0.1	-0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-1.0	-1.0	1.3			-2.1	0.1	0.0	0.0	0.0	0.0		0.0	0.0	
Other Sustainability Indicators															
PV of public sector debt	...	...	21.1			18.0	18.8	19.9	20.7	20.6	21.2		24.0	25.6	
of which: foreign-currency denominated	...	...	10.7			10.9	11.5	11.7	11.9	12.1	12.1		12.2	9.6	
of which: external	...	...	10.7			10.9	11.5	11.7	11.9	12.1	12.1		12.2	9.6	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	6.2	4.1	1.9			3.5	6.5	5.7	5.4	4.2	4.6		5.1	5.3	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	101.5			88.9	86.4	90.5	93.4	92.4	94.5		106.3	108.4	
PV of public sector debt-to-revenue ratio (in percent)	...	...	115.0			98.0	98.8	102.6	105.1	103.9	106.4		118.6	118.7	
of which: external 3/	...	...	58.4			59.2	60.5	60.2	60.2	60.7	60.6		60.4	44.6	
Debt service-to-revenue and grants ratio (in percent) 4/	12.4	15.0	13.3			9.7	13.4	8.5	8.5	9.5	10.1		10.9	13.6	
Debt service-to-revenue ratio (in percent) 4/	14.5	16.5	15.1			10.6	15.3	9.6	9.6	10.6	11.4		12.2	14.9	
Primary deficit that stabilizes the debt-to-GDP ratio	-0.7	2.4	2.1			3.7	1.6	2.2	1.8	1.2	1.0		1.2	1.1	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	4.8	4.1	5.4	4.3	0.9	3.4	4.4	5.4	3.9	3.8	3.8	4.1	4.0	4.0	4.0
Average nominal interest rate on forex debt (in percent)	1.0	1.9	3.4	1.3	0.8	0.1	0.3	0.3	0.5	0.7	1.0	0.5	1.0	1.0	1.0
Average real interest rate on domestic debt (in percent)	-0.4	-2.7	-8.0	-4.0	3.2	...	3.5	-1.6	-1.7	0.7	2.0	0.6	1.6	1.7	1.6
Real exchange rate depreciation (in percent, + indicates depreciation)	19.1	2.0	-5.6	-3.5	10.7	1.2	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	6.6	6.6	8.7	9.0	3.7	5.9	8.6	8.3	7.7	5.5	5.0	6.8	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	11.1	-8.5	14.0	1.7	6.3	13.9	24.2	6.7	3.1	-1.8	5.3	8.6	4.2	3.9	4.1
Grant element of new external borrowing (in percent)	...	...	...	...	...	49.4	45.3	44.9	44.9	46.0	44.9	45.9	49.7	48.7	...

Sources: Country authorities; and staff estimates and projections.

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

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

3/ Revenues excluding grants.

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

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

Statement by Marzunisham Omar, Executive Director for Nepal and Thomas Benjamin Marcelo, Senior Advisor to the Executive Director Executive Board Meeting July 31, 2015

On behalf of our Nepal authorities, we would like to thank the Managing Director for her commitment in supporting the recovery and reconstruction of Nepal following the devastating earthquakes in April and May 2015. We would also like to commend the staff for their prompt response and hard work in order to bring for the Board's consideration the request of Nepal for access under the Rapid Credit Facility (RCF) of the Poverty Reduction and Growth Trust (PRGT). The authorities are very much appreciative of the Fund's policy advice and technical assistance in key areas as well as the catalytic role that the Fund is playing in mobilizing support for Nepal.

The authorities strongly appreciate the outpourings of support received from the international community in response to the devastating earthquakes. This includes the swift and continuing provision of humanitarian aid by several countries and organizations. The authorities welcome the generous pledges by bilateral and multilateral donors of about US$4 billion in grants and concessional loans for the reconstruction efforts to be disbursed over a period of five years, as announced at the International Conference on Nepal's Reconstruction on 25 June 2015. The authorities reaffirm their commitment to ensure the effective use of these financial resources for the rehabilitation and reconstruction efforts.

Damage Assessment and Economic Outlook

An earthquake on April 25 and a powerful aftershock on May 12 devastated Nepal, resulting in extensive damage to two-thirds of the country's districts, particularly in the central and western parts of the country. More than 8,800 people lost their lives and more than 22,300 people were injured. Over half a million houses were destroyed and another quarter million was damaged, rendering three million people homeless. Around half a million buildings were also destroyed. The authorities estimate that an additional 3 percent of Nepal's population, as many as a million people, has been pushed into poverty as a direct result of the earthquakes, on top of the 25 percent who were estimated to already be living below the poverty line.

The total value of damages and losses in production are estimated at about US$7 billion, equivalent to nearly one-third of the country's GDP. The earthquakes are expected to result in an initial slowdown in economic activity and will strain Nepal's external position. As such, the disaster has set back efforts to further develop the economy and enable Nepal to graduate from least developed country status.

The economic growth rate of Nepal over the past five years averaged 4.5 percent. This year, the economy was initially projected to grow at 5.2 percent compared to the growth of 3.5 percent last year. The damage to property has adversely affected productive capacity. Further, the devastation caused by the earthquakes has particularly affected the agriculture and tourism sectors, and the growth outlook in 2014/2015 has been revised downwards to

3.04 percent, the lowest in eight years. The growth recovery will largely be determined by the vigor of the reconstruction effort. The authorities expect GDP growth to register 6 percent in 2015/2016 on account of the significant public and private sector investments in reconstruction and expansion in economic activities.

Inflation, which has averaged 9.3 percent in the past five years, had moderated to less than 7.5 percent in the eleven months of 2014/2015. Inflationary pressures are expected to build up on account of supply-side bottlenecks, an expansionary budget to finance reconstruction efforts, and upward pressure on wages of both skilled and unskilled workers. However, the authorities expect that inflation will be contained to a single digit.

Fiscal deficit is expected to emerge as revenues fall and expenditures rise reflecting efforts by authorities to provide assistance to earthquake-affected businesses and households, including vulnerable groups in the short-term, while supporting the reconstruction efforts.

The fall in foreign exchange receipts from exports and tourism and increased imports of reconstruction-related goods are expected to push the current account into deficit. This will strain Nepal's external position and the pace of public sector reconstruction will importantly depend on the amount of external financing that Nepal receives to rebuild. The authorities expect that without the mobilization of substantial grants and concessional loans, foreign reserves would decline significantly over the medium term even as they expect an increase in workers' remittances to support their families.

Request for Financial Assistance

The authorities would like to request for financial assistance under the RCF to address Nepal's urgent balance of payments need and mitigate the risks of economic disruption as reconstruction activity gets under way. The assistance would be a disbursement of SDR35.65 million (approximately US$50 million) under the RCF to ease the pressure on Nepal's fiscal resources and foreign exchange reserves. The authorities are requesting for the funds to be disbursed as budget support to the account of the Ministry of Finance at the Nepal Rastra Bank (NRB). The IMF's involvement is also expected to help catalyze further donor support for the reconstruction efforts.

Policy Framework

Fiscal Policy. The Nepal authorities have established the National Reconstruction Authority under the leadership of the Prime Minister to coordinate the swift and efficient implementation of rehabilitation and reconstruction activities in the next five years. The authorities recently unveiled the annual budget for 2015/2016, and allocated more than US$8 billion for reconstruction and development. Based on the annual budget, the authorities have allocated US$740 million to the National Reconstruction Fund. In addition to the reconstruction efforts, the authorities have prioritized budget allocation to agriculture, education, health, tourism, infrastructure development, connectivity and the construction of hydroelectric power plants.

The authorities welcome the debt sustainability analysis, which highlights that Nepal's risk of debt distress continues to remain low, underpinned by prudent debt management and fiscal policy. They acknowledge the urgency to accelerate public investment in the aftermath of the earthquakes. The authorities reaffirm their commitment to a prudent borrowing policy and will seek external grants and concessional loans to finance the reconstruction efforts and put the economy on a path of higher growth and faster poverty reduction.

The authorities will also strengthen public financial management to accelerate capital expenditure through improved budget planning, project selection, implementation and results monitoring. In particular, budget allocation for unimplemented and slow moving projects will be realigned to ongoing and better performing programs and projects. Projects that have detailed feasibility studies and whose environmental assessment and land acquisition requirements have been completed will be prioritized for implementation. The authorities have also allocated funds for project development. They are also introducing changes to the procurement law to fast track public procurement and facilitate project implementation. The authorities appreciate the technical assistance provided by the Fund in public financial management and will consider the recommendations to further improve Nepal's arrangements for capital budget management.

Monetary Policy. The Nepal authorities have adopted a cautious and balanced stance of monetary policy to support economic recovery as well as to contain inflationary pressure expected to arise from fiscal expansion.

Given the economic disruption, some increase in inflation is inevitable. Once economic conditions normalize, the authorities will aim to keep inflation close to that in India. The authorities will continue to maintain a pegged exchange rate to the Indian rupee, which has served well in minimizing market volatility.

Financial Sector Policy. To help ease the impact of the devastating earthquakes, the NRB has put in place regulatory relief for banks in the affected areas, so that the banks could extend the same to their customers. Among others, the temporary relief measures covers loan-loss provisioning and loan rescheduling. The NRB also waived approval to open a branch and launch mobile and branchless banking in the market center of selected earthquake-affected areas. An Economic and Rehabilitation Fund was also established under the NRB, to provide a refinancing facility and interest subsidy on loans extended to earthquake-affected areas covering residential construction, agriculture, business and tourism development.

Even before the earthquakes, the authorities were cognizant of the importance of financial inclusion and have pursued various policies and programs to improve access to financial services. These policies and programs include among others, branching policy outside of Kathmandu, provision of interest-free loans to facilitate the establishment of branches in underserved areas, introduction of branchless banking and mobile banking, and implementation of financial literacy and financial consumer protection initiatives. The authorities recently announced a nationwide campaign to encourage households to open at least one bank account by ensuring that cash transfers by the government will only be done through bank accounts.

The authorities will likewise continue to implement the financial sector reform program to strengthen the legal framework and institutional capacity for bank supervision and regulation and for financial crisis management and bank resolution.

Structural Reforms. The authorities are determined to implement its ambitious structural reform agenda under Nepal's 13th Development Plan (2013-2016), which aims at graduating from least developed country status by 2022. The authorities are undertaking the necessary structural reforms to improve competitiveness and the business environment. The authorities have identified as priority areas, infrastructure, especially transportation and energy, education and training, increasing SME access to finance, and strengthening social safety nets. The authorities acknowledge the importance of public-private partnerships in addressing the infrastructure gaps, particularly in increasing energy supply through hydroelectric power generation.

International Response

The Nepal authorities would like to reiterate their gratitude to staff for their productive engagement on policy and the speed and flexibility of their response in the aftermath of the earthquakes. The authorities have found the discussions productive, are grateful for the insightful analysis provided by staff, and will closely consider all aspects of the Fund's policy advice. The authorities are committed to undergo an update of the Safeguards Assessment undertaken by the Fund in 2011 in connection with the 2010 RCF disbursement. This will provide an opportunity to further examine the external audit mechanism and financial reporting framework of the NRB.

The Nepal authorities look forward to the Board's approval of a disbursement under the Rapid Credit Facility of the PRGT. This will assist the authorities in the enormous task of catalyzing further resources for rehabilitation and reconstruction. The appointment of a full-time IMF Resident Representative in Nepal to reinforce the effectiveness of the Fund's engagement with Nepal will likewise be much appreciated.

The authorities consent to the publication of the staff report and the Letter of Intent.