Nepal—Assessment Letter for the Asian Development Bank
October 1, 2008

Despite the recent political turmoil, the macroeconomic situation is broadly stable. Real GDP growth in 2007/08 is estimated at 4¾ percent, led by a stronger-than expected expansion in the service and agriculture sectors. With monetary management by Nepal Rastra Bank (NRB) geared to maintaining the exchange rate peg to the Indian rupee, headline inflation remains broadly in line with price developments in India. Rising international food and fuel prices have pushed average inflation up to around 8 percent. The domestically financed budget deficit is estimated at below 2 percent of GDP, in line with projections. On the external side, rising imports and stagnant exports have led to a further deterioration in the trade deficit, but this will be more than offset in the current account by strong inflows of workers' remittances. The NRB international reserve position remains robust at around US$2 billion, equivalent to about 6 months of goods and services imports.

Going forward, Nepal's economic prospects depend on continued macroeconomic stability. The exchange rate peg to the Indian rupee should help contain inflation at levels close to those in India, while structural reforms and infrastructure investments are key to maintaining competitiveness over the medium term. Real GDP growth could rise to 5½ percent in 2008/09, subject to favorable agricultural performance and continued strength in the service sector. The unsettled political environment poses the most immediate risk to growth.

Sustainable fiscal policy is the cornerstone for protecting Nepal's macroeconomic environment—including the exchange rate peg and moderate levels of inflation. Nepal has maintained a prudent budget policy over the last several years. However, even if the highly ambitious revenue targets in the currently proposed 2008/09 budget are achieved, domestic financing implied by the budget would be somewhat above the 2 percent of GDP level recommended by the IMF staff. While this would not threaten near-term macroeconomic stability, such a policy cannot be sustained over the medium term without straining the banking system's ability to finance the budget deficit. Continued subsidies to the Nepal Oil Corporation remain a key threat to the government's budget position.[1]

While the macroeconomic performance has been stable, progress on structural reforms has been held back by the fragile political circumstances. In particular, little progress has been made to address institutional weaknesses in public financial management and the financial sector. Specifically,

- The rapid proliferation of banking licenses calls for stronger efforts to strengthen supervision and regulatory enforcement to maintain financial stability. The legal

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[1] The most recent joint World Bank and IMF debt sustainability analysis concluded that Nepal's external debt indicators have improved owing to the appreciation of the Nepalese rupee and lower than projected loan disbursements. In view of this, Nepal's external debt dynamics are assessed to be subject to a moderate risk of debt distress.

framework is improving but enforcement remains weak, and the application of the recently-introduced stricter licensing requirements will be an important signal of the authorities' willingness to tighten enforcement going forward.

- The June 2008 price adjustments for petroleum products are welcome, but further increases and the introduction of an automatic pricing mechanism are required to place the loss-making Nepal Oil Corporation's finances on a sustainable footing.

- The accounting, auditing, and reporting of public sector operations are inadequate. The budget coverage is confined to only the central budget with no information on quasi-fiscal activities, internal control procedures are not fully effective, and the management of spending is weak.

Status of IMF relations. The fifth and final review under the Poverty Reduction and Growth Facility was completed on November 9, 2007. The 2008 Article IV consultation was discussed by the Executive Board in May 2008. The next Article IV consultation is slated for the Spring of 2009.