July 2010
IMF Country Report No. 10/185

Nepal: 2010 Article IV Consultation and Request for Disbursement Under the Rapid Credit Facility—Staff Report; Staff Supplements; Public Information Notice on the Executive Board Discussion; Press Release on the Executive Board Discussion; and Statement by the Alternate Executive Director and Advisor for Nepal.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2010 Article IV Consultation with Nepal, the following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on March 8, 2010, with the officials of Nepal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 14, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff supplement on the joint IMF/World Bank Debt Sustainability Analysis.
- A staff supplement of May 25, 2010.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 28, 2010 discussion of the staff report that concluded the Article IV consultation.
- A Press Release summarizing the views of the Executive Board as expressed during its May 28, 2010 discussion of the staff report that completed the review.
- A statement by the Alternate Executive Director and Advisor for Nepal.

The document listed below has been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Nepal*
Selected Issues Paper

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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NEPAL

Staff Report for the 2010 Article IV Consultation and Request for Disbursement Under the Rapid Credit Facility

Prepared by the Staff Representatives for the 2010 Article IV Consultation with Nepal

Approved by Kalpana Kochhar and Christian Mumssen

May 14, 2010

Mission. A staff team—L. Papi (head), J. Yu, D. Nyberg (all APD), K. Ariyapruchya (MCM), and A. Pitt (Resident Representative)—visited Kathmandu during February 24–March 8, 2010. K. Kochhar (APD) joined the mission during February 27–March 2. Ms. Vongpradhip and Mr. Thapa (both OED) also participated in the discussions.

Previous Fund advice. The 2008 Article IV consultation was discussed by the Board on May 16, 2008. Directors commended the authorities for maintaining macroeconomic stability over the past several years despite the civil conflict and political upheavals. Directors encouraged the authorities to pursue a more active monetary policy and urged them to give renewed impetus to strengthening financial sector supervision and regulatory enforcement to maintain stability in the face of rapid banking sector growth. While fiscal policy has remained prudent, monetary policy has been passive and financial sector regulation only started to be tightened in late 2009.

Exchange rate regime. Nepal maintains a peg with the Indian rupee. Nepal has accepted the obligations of Article VIII, Sections 2, 3, and 4. Staff is in the process of seeking the information necessary to clarify the jurisdictional implications of certain foreign exchange measures and a potential multiple currency practice.

Economics statistics. Generally adequate for surveillance, with scope for improvement, in particular in the timeliness and coverage of fiscal data, the frequency and quality of national accounts data, and in the balance of payments, compilation of remittances, and official and private financial flows.

Consultation cycle. It is expected that the next Article IV consultation with Nepal will take place on the standard 12-month cycle.

Rapid Credit Facility (RCF). Staff supports the authorities' request for a disbursement under the RCF in an amount equivalent to SDR 28.52 million (40 percent of quota) to help address the economic impact of the global economic crisis.

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I. Staff Appraisal and Summary

1. **Nepal is undergoing a major political transition.** Relations among the main parties remain contentious as thorny issues regarding the army integration and the form of the state remain unresolved. Fresh elections will be held after the new constitution is approved, but the end-May deadline for drafting the new statute is likely to be missed.

2. **After years of macroeconomic stability, the global crisis is having a substantial, albeit somewhat delayed, impact on Nepal's economy and exposing its structural weaknesses.** The exchange rate peg and prudent fiscal policy have been anchors of stability. High remittances have resulted in rising reserves despite the lackluster export performance. Recently, however, reserves have declined as exports fell, remittances softened, and imports soared, resulting in a liquidity crunch.

3. **The outlook is challenging.** Real GDP growth is expected to slow to 3 percent in 2009/10 from 4¾ percent in 2008/09, due to a poor monsoon, export declines, softer remittances, and tighter monetary conditions. The current account is projected to shift to a 2 percent of GDP deficit, with reserves at 5 months of imports by year-end. Growth is anticipated to strengthen in 2010/11 and the current account position to improve, but risks are on the downside and stem mainly from weaker remittances, continued high imports, capital flight, heightened financial sector vulnerabilities, and political instability.

4. **Although the Nepalese rupee appears modestly overvalued, maintaining the peg should remain a key near-term policy objective.** The real effective exchange rate is 15 percent above its 10-year average. Standard methods of estimating exchange rate misalignment provide a wide range of estimates of overvaluation, with the lower end being when remittances are included. Nevertheless, the peg remains appropriate as remittances growth is expected to recover and import growth to moderate, and the peg is needed to continue to underpin macroeconomic and financial stability. Monetary policy needs to support the peg by maintaining short-term interest rates above those of India and liquidity management should be strengthened. Over the medium term, a basket that includes the Indian rupee as well as the dollar could be considered, as this would take into account the sources of remittances.

5. **Risks in the financial sector are coming to a head and need to be addressed urgently.** Rapid credit growth and proliferation of institutions fed asset price booms, especially in real estate, in an environment of weak supervision. Banks overextended themselves and their vulnerabilities were exposed by the recent liquidity squeeze. Stress tests indicate high vulnerability to liquidity and credit risks and financial institutions asset quality is likely to deteriorate. Financial institutions other than commercial banks are even weaker.

6. **The NRB's recent directives are welcome, but enforcement is crucial to their effectiveness.** The NRB needs to avoid diluting regulations and begin strictly enforcing them. Supervision should be stepped up to detect deterioration in financial institutions' soundness and intervene them as needed. Emergency liquidity support must be consistent with the peg and liquidity to individual institutions experiencing shortages should be provided at penalty rates or via

the bank rate window under heightened supervision. The amended Banks and Financial Institutions Act should be passed to strengthen the bank resolution framework and the authorities should also prepare contingency planning in case a systemic bank crisis were to develop. Savings and credit cooperatives should be brought under regulatory oversight.

7. **Bank licensing policy needs to be tightened, banking sector consolidation incentivized, and state-controlled bank reform tackled.** The licensing moratorium should be maintained and more stringent fit and proper criteria adopted. Consolidation should be encouraged, including by raising minimum paid up capital requirements and facilitating the trading of promoter shares. The authorities need to proceed with reforms and recapitalization of the state-controlled banks with losses absorbed by existing shareholders.

8. **Maintaining fiscal discipline during the political transition has been a remarkable achievement and although the debt reduction has created fiscal space, in the short run the peg calls for containing domestic borrowing close to current levels.** Fiscal policy has continued to be broadly prudent and public debt has declined to 40 percent of GDP. This has created fiscal space that could be used for much needed infrastructure, human capital, and the peace process provided spending quality is ensured. But, in the short term, the worsening external position requires that domestically financed deficits remain close to current levels.

9. **Tackling longstanding structural problems is essential to achieve high growth over the medium term.** The poor business climate, power shortages, inadequate infrastructure, weak governance, and difficult labor relations remain major impediments to moving to a higher growth path. Political stability and improved security are necessary conditions for progress in several of these areas.

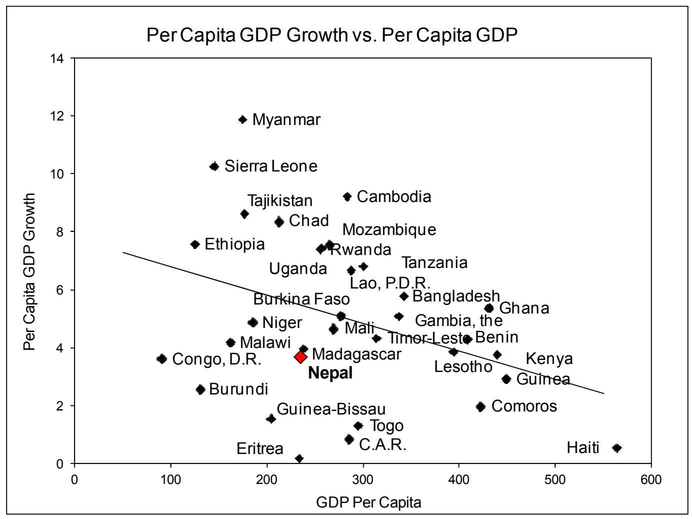
10. **Staff supports the authorities' request for a disbursement under the Rapid Credit Facility (RCF) to help address the impact of the global crisis.** The crisis is having a substantial, albeit somewhat delayed, impact, with a significant decline in exports, a sharp slowdown in remittances, and a worsening of economic confidence. This has contributed to a large deterioration in the current account balance and a decline in international reserves. The authorities are cognizant that urgent policy actions are needed to address rising external and financial sector risks, the interaction of which makes stabilizing reserves a top priority. The measures taken so far and the authorities' policy commitments under the RCF appropriately address the impact of the shocks. Rapid Fund support would help cushion the shock, boost confidence, and provide policy support during the political transition. The RCF could also serve as a bridge to a program with upper credit tranche conditionality that could support deeper reforms to address Nepal's entrenched structural problems. Nepal has adequate capacity to repay the Fund, and its risk of debt distress is moderate. The request is for access of 40 percent of quota (SDR 28.52 million), which is below the ceiling of 50 percent of quota permissible under the shocks window and consistent with Nepal's current balance of payment needs.

11. **Staff is in the process of seeking the information necessary to clarify the jurisdictional implications of certain foreign exchange measures and a potential multiple currency practice.**

II. Context: Economic Challenges in the Midst of a Major Political Transition

12. **Four years after the end of the conflict, Nepal's politics remain polarized.** Constituent Assembly elections were held in April 2008 in which the Unified Communist Party of Nepal (Maoist) emerged as the clear winner with nearly 40 percent of the seats. The first meeting of the Assembly abolished the monarchy and established the Federal Democratic Republic of Nepal. Despite the successful election, the political situation remained tense and the Maoist-led coalition lasted less than a year due to disagreements about the integration of Maoist combatants in the army. In June 2009, a 22-party coalition led by the United Marxist-Leninist Party (UML) took office without support of the Maoists. Relations among major parties remain contentious as thorny issues relating to army integration and the form of the state, including the federalist structure, remain unresolved. Fresh elections will be held once the new constitution is ready, likely not before late 2010.

13. **Nepal is one of the poorest countries in Asia, although social indicators have recently improved.** Political instability, poor governance, and supply bottlenecks, notably related to infrastructure and labor relations, have impeded economic growth (Figure 1). Although Nepal's per capita income and its human development index still lags regional comparators, the country has made rapid improvements in health and education indicators and reduced poverty significantly in recent years, driven by rising remittance inflows.



Poverty and Social Indicators

	Nepal		SAARC 1/	
	2000	2008 2/	2000	2008 2/
Population below poverty line (%)	41.8 1/	30.9 1/	34.3 1/	28.6 1/
GNI per capita, Atlas method US$	220.0	400.0	751.4	1468.6
Gross primary enrollment	116.7	123.9	104.0	105.9
Human development index	0.5	0.6	0.6	0.6
Infant mortality (per 1,000 live births)	62.9	43.1	58.8	45.2

Sources: Various U.N. Publications; World Bank, *World Development Indicators.*

1/ South Asian Association for Regional Cooperation (SAARC), including Bhutan, Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka. Afghanistan is not included.

2/ As latest available years.

14. **Supported by remittance inflows, macroeconomic stability has been broadly maintained in recent years, but the global crisis is having a delayed and substantial impact.** Real growth has averaged around 4 percent since the end of the conflict. The exchange rate peg to the Indian rupee has been instrumental in keeping inflation broadly in line with price developments in India. The fiscal stance has been cautious and public debt reduced to 40 percent of GDP. Strong remittance inflows in recent years—currently 21 percent of GDP, the highest in the region—have resulted in current account surpluses and allowed the build-up of reserves. At the same time, financial sector vulnerabilities have been growing as loose monetary conditions, combined with a fast-growing financial sector, contributed to credit and asset price booms. Recently, though, weaker remittances and a widening trade deficit have led to a significant decline in international reserves.

Inflow of Remittances, 2002-2009

	2002	2005	2008	2008	Annual change in $-value (in percent)		
	(in percent of GDP)			(in US$bn)	2006-08 (average)	Q/Q(-4)	Through
South Asia 1/	**5.9**	**7.0**	**9.1**	**72.4**	**24**	**20**	
Bangladesh	5.7	7.0	11.0	9.0	28	30	Dec-09
India	3.3	3.0	4.2	51.3	29	4	Sep-09
Nepal	11.0	13.8	19.5	2.5	30	11	Nov-09
Pakistan	4.8	3.9	4.2	7.0	18	25	Dec-09
Sri Lanka	4.5	7.1	6.5	2.6	14	30	Nov-09
Philippines	9.0	10.8	9.7	16.4	15	9	Nov-09

Sources: IMF (BOP Yearbook; World Economic Outlook); Country authorities;
World Bank remittances database-March 2009; CEIC Data Co. Ltd.

III. Recent Economic Developments and Outlook: After Years of Macroeconomic Stability, Risks are Rising

15. **The initial impact of the global crisis on Nepal had been limited, but the fall in exports and the recent sharp slowdown in remittances have had a substantial adverse effect.**[1] After a limited impact in 2008/09, the crisis began to affect Nepal substantially in the first half of 2009/10.[2]

- **Remittances.** As demand for workers fell owing to the crisis, the number of Nepalese workers leaving to work abroad declined by 12 percent in 2009 and the growth of remittances decelerated sharply to 17 percent in the first half of 2009/10 from 31 percent in the previous

[1] Transmission mechanisms from the global crisis seem to vary considerably across countries. While some advanced countries suffered a financial/banking crisis, most developing countries were primarily hit by an external demand effect, although some were also hit by terms-of-trade and to a lesser extent capital flows effects. See "Effects of the global financial crisis on medium and long-run growth in low-income countries," by A. Berg et al., forthcoming IMF manuscript.

[2] The fiscal year starts in mid-July.

year. This effect materialized with a significant delay because employment fell only after the production decline and because migrants typically received a lump-sum payment before termination of employment.

- **Trade balance.** Exports declined by 14 percent in the first half of 2009/10 as a result of lower demand and the appreciation of the Indian rupee: although exports to India declined by 6 percent, exports to other countries shrank by 26 percent. At the same time, imports soared by 46 percent—with gold almost tripling.[3] Most of the increase in imports can be attributed to entrenched expectations of continued strong remittance growth in line with recent years and to gold imports, which likely resulted from deteriorating confidence. The trade deficit widened to 28 percent of GDP.

- **Reserves.** These developments, combined with reported capital flight, reduced international reserves by 13 percent from the July 2009 peak to US$2.5 billion (5 months of imports) in March 2010 (Figures 2 and 3).

16. **Growth is slowing.** A poor monsoon, falling exports, and decelerating remittance growth suggest activity is weakening compared to an estimated growth of 4¾ percent in 2008/09. Monetary conditions have tightened and the fiscal impulse is small. In the first half of 2009/10, revenue grew 34 percent over the same period in the previous year, in excess of already ambitious budget targets, driven primarily by import-related taxes and duties. Current spending rose by over 40 percent, but slow capital project implementation is keeping the overall deficit to levels only slightly higher than last year (Figure 4).

17. **Inflation has been close to that of India.** Up to 2007/08, Nepal's inflation broadly mirrored India's price developments. In 2008/09, however, the inflation rate in Nepal at 13.2 percent was higher than India's, driven primarily by loose monetary conditions. More recently, at 11.8 percent (y/y) in January 2010, inflation is converging with India's, but pressures remain high as India's inflation is on the rise.

18. **After years of abundant liquidity, the recent reserve decline and ensuing liquidity squeeze have exposed financial sector weaknesses.** Rapid credit growth persisted up to March 2010 (30 percent y/y) fuelling sharp increases in real estate and stock market prices. Banks overextended themselves and credit-to-deposit (CD) ratios climbed to nearly 90 percent by January 2010, with several banks above 100 percent. Liquidity shortages, however, started emerging in December 2009 as net foreign assets declined. Broad money growth decelerated to 20 percent (y/y)

[3] In response to rapidly rising gold imports, in January 2010, the Nepal Rastra Bank (NRB) imposed a 40 percent margin requirement on letters of credit and guarantees used to finance gold imports. This was followed by restrictions on the quantity of gold that can be imported and similar measures applied to silver imports. On April 2, 2010, to protect the balance payments position, the NRB limited the use of foreign exchange for private travel to $2000 which can be obtained only twice a year compared to an unlimited number of times previously. Staff is examining whether this constitutes an exchange restriction.

in March 2010 from 28 percent in September 2009. As a result, interbank rates rose to 15 percent in January from 2 percent in September, until NRB liquidity injections reduced rates to about 9 percent. In response to the tighter liquidity conditions, commercial banks have reportedly reduced loan disbursements markedly, increased deposit and lending rates, and real estate transactions have plummeted. The stock market, which is dominated by financial institutions, has fallen 60 percent from its September 2008 peak and has not recovered in synch with other countries.

19. **The near-term outlook is challenging and risks are high.** The year 2009/10 is likely to see weaker economic activity and a sizeable current account deficit for the first time since 1998/99. The economy is expected to recover the following year and the current account position to improve. Weak remittances and exports, high imports, heightened financial sector vulnerabilities, and the unsettled political environment pose significant risks to this outlook.

- **Activity** is set to remain sluggish in 2009/10. A deficient monsoon will result in a poor harvest.[4] Soft remittances and exports and tighter monetary conditions will likely constrain overall growth to about 3 percent. Growth is expected to strengthen to about 4 percent in 2010/11 as employment conditions for migrants in host countries improve and external demand for Nepalese exports recovers.

- **Balance of payments.** The current account balance is projected to record a deficit of 2 percent of GDP as remittances are estimated to increase by only 9 percent in 2009/10 reflecting the slowdown in the Gulf region and Malaysia before recovering in 2010/11 in line with host country non-oil GDP growth (Box 1). Despite an expected moderation in the rest of the year, imports are projected to grow by 30 percent, while exports are anticipated to decline by 11 percent. External grants are projected to increase temporarily in the near term as donors step up their commitments to support the peace process. Reserves are projected to remain at around 5 months of imports, as a return of confidence brought about by strengthened policies and Fund support is anticipated to reverse capital outflows.

- **Inflation** is projected to gradually converge with India's CPI developments, averaging 12 percent in 2009/10 and 8 percent in 2010/11.

20. **Tackling long-standing structural problems is essential to achieve high growth over the medium term.** Over the past decade, progress on structural reform has been held back by the fragile political circumstances. Looking ahead, political stability and improved security are necessary for progress on structural reforms to improve the business climate and external competitiveness and diversify the economy. With Nepal located between two of the fastest growing economies in the world, steady progress on the political front, easing of supply-side constraints, and the development of Nepal's vast hydropower potential could lift growth to a higher path. However, assuming incremental progress on reforms, growth is projected to rise only slowly over the medium term, reaching 4¾ percent by 2014/15.

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[4] Agriculture accounts for a third of GDP.

Box 1. Nepal's Remittances: Trends and Projections

Remittances have become Nepal's most important source of foreign exchange and have supported domestic demand. By the end of 2008/09, remittances at 21 percent of GDP were three times exports and covered two thirds of imports. Remittances have sustained consumption and to a lesser extent investment. Over 80 percent of remittances come from the Gulf countries (GCCs) and Malaysia: migrants are employed mainly as construction workers, security guards, drivers and cooks, etc. Estimates of the number of migrants to India vary widely, but remittances from India are less than 15 percent of the total.

Figure 1. Outflow of Migrant Workers to GCC Countries and Malaysia, 2000-09

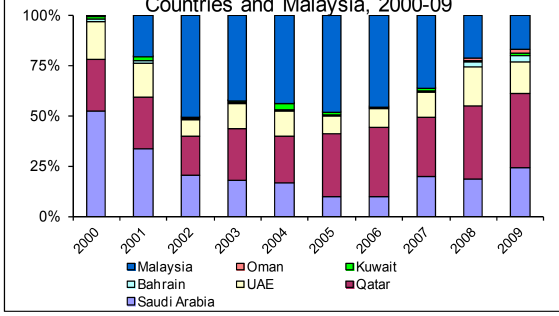
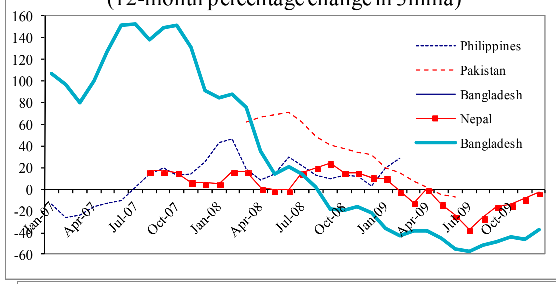
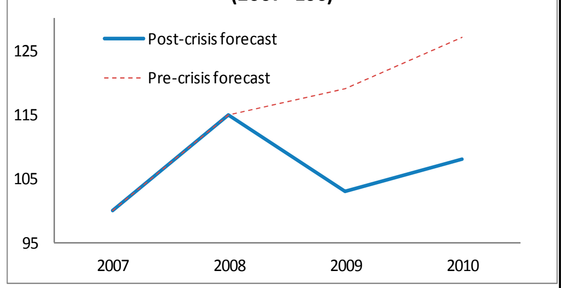


Figure 2: Gross outflow of workers (12-month percentage change in 3mma)



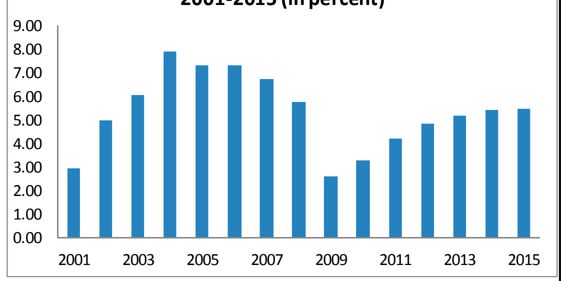
Nepal's remittances began to slow in the second half of 2009. The outflow of workers started declining in early 2009, and was down by 12 percent in 2009, although it picked up modestly in recent months. These trends suggest that the delayed impact of the global crisis results from the fact that remittances are linked to the employment cycle in host countries, which lags the production cycle. The recent pickup in outflow workers reflected increased demand from GCCs and Malaysia. Moreover, the government reached employment agreements with a few countries (Japan and Korea for instance) recently, which should boost remittances in the second half of 2010.

Figure 3. Forecast of LIC Remittance Index (2007=100)



The deceleration in remittances is expected to continue in the months ahead. Remittances and the stock of migrant workers lagged by 1 year are highly correlated.[5] Hence, remittance growth in 2009/10 is projected to slow to 9 percent from 31 percent in 2008/09, owing to the slower buildup in the stock of migrants abroad.

Figure 4. Non-oil GDP Growth of GCC Countries, 2001-2015 (in percent)



Other low-income countries (LICs) are also experiencing similar trends. Though less severe than exports, remittance flows to LICs have dropped significantly owing to the impact of the global recession, and are projected to recover somewhat but remain below pre-crisis levels in 2010.[6] Remittances to South

[5] The stock of migrants is estimated from outflow data.

[6] See *The Implications of the Global Financial Crisis for Low-Income Countries—An Update,* IMF, 2009; and *Migration and Development Brief*, No. 11, World Bank, 2009.

Asia may hold up better than in other regions due to the strong connection with Gulf Cooperation Council (GCC) countries.

A staff study suggests that Nepal's remittances could grow by 10–12 percent annually over the medium term. [7] The most important determinant of remittances is the non-oil GDP of GCC countries besides the stock of migrants. The real effective exchange rate (RER), though not significant, has a negative coefficient, implying that a real appreciation would deter remittances. GCC countries' non-oil GDP growth is projected to recover to 5½ percent over the medium term, but remain below its average of 7 percent preceding the global crisis. In addition, the RER has been appreciating in the past few years. Hence, Nepal's remittances are estimated to grow moderately by 10–12 percent annually in 2010/11–2014/15.

Authorities' Views

21. **The authorities are slightly more optimistic about the outlook for 2009/10.** They recently lowered growth projections to below 4 percent from 5½ percent, mainly reflecting the poor harvest but anticipating solid growth in industry and services. The authorities agree that remittances will be soft in 2009/10, but expect them to improve in coming months as more migrants are leaving and the government has negotiated new agreements with Saudi Arabia and Malaysia.

22. **Government officials agree that progress on structural reform is essential to move to a higher growth path over the medium term.** They are cognizant of the need to improve the business climate, but stress that the political transition must progress before a comprehensive structural reform agenda can be adopted.

IV. Policy Discussions: Managing External and Financial Sector Risks

The consultation focused on (i) maintaining continued macroeconomic stability in the context of a deteriorating external position and how Fund support could contribute to this end; and (ii) managing financial sector risks and reducing vulnerabilities.

A. Monetary and Exchange Rate Policy

23. **The exchange rate peg to the Indian rupee has provided an anchor for macroeconomic stability.** This arrangement, in place since 1993 at the current level, has fostered increasing integration between the two countries. The peg has been instrumental in anchoring inflation broadly in line with price developments in India during a period of significant political turmoil and focusing macroeconomic policies on supporting the peg.

24. **The Nepali rupee appears modestly overvalued.** The real effective exchange rate is 15 percent above its 10-year average, suggesting some loss of competitiveness as evidenced by a

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[7] See Almekinders, G., Maslova, S., and Z. Abenjola, 2009, *Bangladesh: Selected Issues*, IMF Staff Country Report No. 10/56 (Washington: International Monetary Fund).

shrinking share of world exports. The overall trade deficit has widened from 11 percent in 2001/02 to 21½ percent of GDP in 2008/09, stemming from both a decline in exports and an increase in imports. In assessing Nepal's exchange rate, however, the analysis must extend beyond the narrow trade deficit, which has been offset by growing remittances. Standard methods of estimating exchange rate alignment suggest overvaluation, but when remittances are taken into account the degree of overvaluation becomes modest (Box 2).

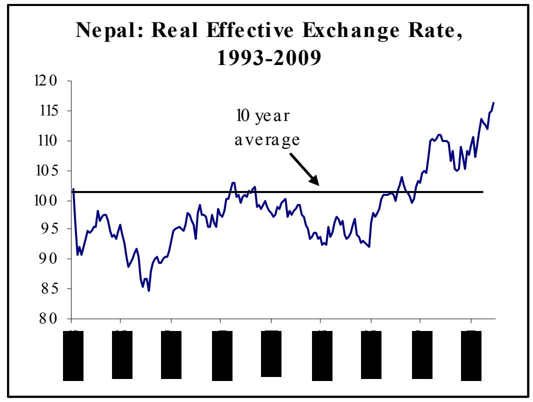
25. **In the current precarious political and economic climate, maintaining the peg should remain a key short-term policy objective.** The peg remains appropriate, given that remittances growth is expected to recover, albeit not to past years' levels, and import growth should moderate in response to recent measures and an anticipated slowdown in credit expansion. Moreover, abandoning the peg now could undermine confidence, leading to capital flight and lower bank deposits. Nepal also faces the challenges of India's tightening monetary policy and an appreciating Indian rupee. Hence, if Nepal's external position does not improve, pressure on reserves may continue. To maintain adequate reserve coverage, the authorities are considering measures to curb imports of consumption goods. Such measures, however, are distortionary and tightening import restrictions is not a substitute for sound macroeconomic policies to maintain external stability. In a worst-case scenario, reserves should not be allowed to fall below critical levels as re-pegging otherwise would become impossible. While a peg would likely remain the best nominal anchor even over the medium term, the widening productivity differential with India suggests that a basket including the Indian rupee and the dollar to take into account migrants' destinations could be considered. Reestablishing a credible new nominal anchor is often difficult, but the chances of a successful transition increases with an orderly and well-planned adoption of a new regime.[8]

26. **Monetary policy needs to support the peg, but liquidity management should avoid abrupt fluctuations in interest rates**. The NRB's liquidity management has been passive, contributing to rapid credit growth and inflation pressures: up to 2008/09 as reserves soared liquidity was largely left unsterilized, while in recent months liquidity dried up as reserves declined. While this is partly unavoidable given the peg, a more active liquidity management is warranted. In the upswing greater sterilization would have been desirable, while earlier liquidity injections would have been appropriate when liquidity tightened. Monetary policy needs to focus on short-term rates (instead of bank's excess reserves), which should be above those of India, with the premium depending on the balance of payments position and confidence. At present, monetary policy should remain tight to support the exchange rate and contain credit growth, and the NRB's general liquidity provision (via repos) should be consistent with the peg. Individual banks' temporary liquidity needs should be met at penalty rates through the Standard Lending Facility (SLF), while liquidity needs of banks without standard collateral should be addressed through the bank rate window under

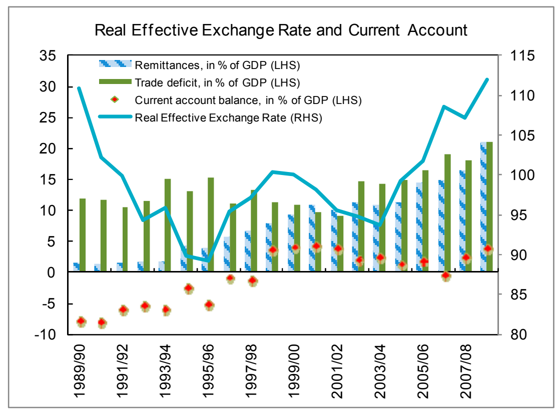
[8] See for example: Eichengreen et al. (1998) "Exit strategies: policy options for countries seeking greater exchange rate flexibility" *IMF Occasional Paper No. 168*, Washington DC, and Duttagupta et al. (2004) "From fixed to float: operational aspects of moving toward exchange rate flexibility," IMF Working Paper 04/126.

Box 2. Nepal—Exchange Rate Assessment

REER. Nepal's real effective exchange rate (REER) began appreciating from 2005: it has risen 21 percent since then and is 15 percent higher than its 10-year average. The bilateral RER with India has appreciated by 3 percent in the same period, with a greater deterioration since 2008.



Current Account. The trade deficit averaged 11 percent of GDP in 2000–04, but started widening in 2005. Nepal's export share in the world exports has trended down partly due to the expiration of the multi-fiber agreement. Imports have risen, partly financed by remittances and credit expansion. Remittances, though, have more than compensated the widening trade deficit, growing from 9 percent of GDP in 2000 to 21 percent in 2009 and yielding current account surpluses in 1998/99–2008/09.[9] But, soft remittances as a result of the global recession and soaring imports are likely to push the current account into a deficit in 2009/10.



Reserves. With the capital and financial account being small, reserves reached a peak of US$ 2.9 billion and 6 months of imports in July 2009, before dropping to US$2.5 billion and 5 months of imports in January 2010.

Econometric approaches. Different methodologies produce a wide range of estimates, but all point to some overvaluation of the Nepalese rupee. Of course, standard caveats apply.

- **Augmented PPP.** According to the augmented PPP approach, which focuses solely on trade competitiveness, the degree of exchange rate misalignment is estimated by comparing prices and accounting for differentials in per capita GDP across countries. Reflecting the substantial inflation differential with the United States, Nepal's bilateral real exchange rate vis-à-vis the US dollar appreciated by 16 percent from 2005 to end-2008/09. Meanwhile, Nepal's real per capita GDP grew by no more than 10 percent, compared to over 20 percent in India—Nepal's main trading partner. Based on a cross country regression of prices on income levels using the

[9] The year 2006/07 was the only exception when the current account was -0.1 percent of GDP because of a sharp increase in imports.

International Comparison Program (ICP) database for 146 countries, Nepal's price level is 19 percent higher than what is should be given the income level.

- **External sustainability (ES).** Using elasticities calculated by Tokarick (2009), the ES–based estimate shows that the Nepalese rupee would have to depreciate by 7 percent to stabilize the level of international investment position over the medium term.

- **Equilibrium real exchange rate.** The ERER approach is based on a panel regression of the real effective exchange rate on fundamentals— terms of trade, relative productivity, relative government consumption—as well as remittance flows, which are found to be significant.[10] The estimations show that Nepal's REER is overvalued by about 8 percent.

- **Macro balance approach.** Nepal's current account norm is a deficit of 1.8 percent of GDP, estimated including standard variables and remittances. Using the macro balance approach and using the standard CGER elasticity of 4.3 percent, the currency is 9.5 percent overvalued. However, using the Nepal-specific trade elasticity (32.7%) based on Tokarick (2009) points to only 1 percent overvaluation. The latter elasticity takes into account (i) the composition of Nepal's exports and imports; (ii) incomplete pass through of changes in exchange rates and international prices to import and export prices; and (iii) Nepal's price-taking behavior on international markets.

heightened NRB oversight and conditionality and limited to solvent institutions. Clarifying modalities of access to the bank rate window would be useful.

Authorities' Views

27. **The authorities are strongly committed to maintaining the current peg.** They view the exchange rate peg as fundamental to economic stability and will take additional measures to stem capital flight and import growth if pressure on reserves continues. In a medium-term perspective, the authorities are aware of the widening productivity differential with India and the tension this places on the fixed exchange rate regime. However, they expect continued labor mobility and remittance inflows to offset the loss of competitiveness.

28. **The NRB views the current liquidity situation as temporary and expects it to ease soon.** Central bank officials anticipate the liquidity situation to normalize as remittance growth is recovering and government spending is expected to increase in the last quarter of the fiscal year. The NRB also notes that banks are reluctant to access the bank rate window owing to reputational risks. Hence, the authorities had felt appropriate injecting liquidity via repos during the December-January liquidity squeeze with interbank lending distributing the funds to the institutions in need. They noted

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[10] See *External competitiveness and the real exchange rate in Bangladesh,* Almekinders and Maslova (2009).

that no tiering had been observed in the interbank market, suggesting that banks were deemed sound. Going forward, as stated in the attached letter of intent, the authorities are committed to addressing individual banks' liquidity needs through the supplementary liquidity facility. Since the end of the mission, the authorities introduced measures to lengthen the maturity of repos, a new refinancing facility for the export, tourism, and power sectors, and allowed banks to count call deposits toward the statutory liquidity requirement.

B. Financial Sector Reform

29. **Nepal's financial sector has grown very rapidly in recent years and strained the NRB's supervisory capacity (Box 3).** Some of the growth in the financial sector reflects a natural deepening of the financial system in Nepal. However, the rapid proliferation of banking sector licenses and credit expansion has coincided with sharp rises in real estate and stock prices. In this context, international experience suggests that rapid credit growth often precedes real estate price busts. The proliferation of bank and finance companies has strained NRB's supervisory capacity: the enforcement of prudential standards is uneven and regulatory forbearance common. The two state-controlled banks, accounting for 1/5 of system assets, continue to operate with negative capital.

30. **Stress tests indicate high vulnerability to credit and liquidity risks (Box 3).** Nearly all banks would be below the minimum capital adequacy ratio (CAR) if the largest borrower defaulted. Reportedly, large borrowers are highly leveraged and engage in multiple banking. A 30 percent fall in real estate prices could increase private banks' non-performing loans (NPLs) by more than 20 percentage points as the majority of these loans were issued in the past two years at inflated prices: the capital of the majority of private banks would fall below the minimum CAR. Banks' liquidity positions are vulnerable to standard shocks: five to nine banks would become illiquid within three to five days of deposit withdrawals. In a stress scenario, these shocks are likely to be highly correlated and reinforce each other.

31. **Systemic risks in the financial sector are coming to a head.** Following lax lending standards and reportedly prevalent ever-greening, tighter liquidity, high interest rates, and a standstill in real estate transactions will likely lead to rising loan defaults. Risks are exacerbated by poor governance and transparency, and the pledging of promoters' shares, which diminishes banks' fresh capital and leads to excessive risk taking because promoters have little to lose. Although data are scarce, financial institutions other than commercial banks are generally considered even weaker than class-A banks. Distress in some financial institutions could trigger deposit runs, which would spread quickly in the absence of a decisive policy response. Finally, if credit seizes up, a systemic banking crisis may follow, while the peg will constrain the NRB's ability to provide liquidity. In this context, maintaining adequate NRB reserves would help support confidence in the financial system and a turnaround in the external position would easy banks' liquidity problems.

Box 3. Nepal: Risks to Financial Stability[11]

Although Nepal's key financial soundness indicators on overall appear sound and compare well internationally, financial stability appears to be at a turning point. The CAR is low in Nepal because of the undercapitalization of the state controlled banks, but private banks have CARs above 12 percent. The profitability of banks is high reflecting the credit and asset price booms of the past 5 years. Financial soundness indicators, however, are lagging indicators and the impact of a correction in asset prices or a credit crunch on banks' balance sheets has yet to be reflected on them. At the same time, there are indications that real estate transactions have declined substantially and prices have started to fall in some locations. In addition, the recent liquidity crunch has shown the system's vulnerability to tighter liquidity conditions, as CD ratios have climbed since July 2009 and banks can also pledge the securities they hold to satisfy the statutory liquidity requirement. Finally, a confidence crisis could spread quickly as financial institutions' business models are very similar.

Selected Financial Soundness Indicators, 2009 1/

	Nepal	Bangladesh	Cambodia	India	Thailand	Vietnam
Capital adequacy ratio	5.6	10.1	25.6	13.2	14.2	8.2
Nonperforming loans (%)	3.4	11.2	2.7	2.4	5.8	3.0
Bank provisions to NPLs	152.9	50.1	n.a	52.6	80.0	81.7
Return on assets	2.3	1.3	3.1	1.1	1.0	n.a
Liquid assets to total assets	29.1	n.a	38.6	n.a	n.a	13.5
Loan/deposit ratio	74.5	n.a	85.5	73.9	102.7	89

Sources: Authorities; and IMF staff estimates.
1/ Cambodia, Bangladesh, Thailand, Vietnam data, 2008.

Regulatory gaps and forbearance have contributed to an environment of excessive risk-taking. In contrast to international best practice, Nepalese bank promoters can pledge bank shares as collateral to obtain loans. Such so-called margin lending diminishes "skin in the game," depletes banks' fresh capital, and threatens the stability of Nepal's financial system. Currently, there are 10 private commercial banks in which 20–90 percent of promoter shares are pledged. Regulatory forbearance such as the unresolved status of the two under-capitalized state banks, postponements in the applicability of the new banks' minimum paid up capital and the new single borrower's limit, fosters moral hazard particularly when risks to financial stability are high.

Supervisory blind spots in the non-banking sector pose a risk to overall financial stability. The non-banking sector, consisting of development banks, finance companies, micro-credit development banks, saving and credit cooperatives, and non-governmental organizations (NGOs), accounts for

[11] See Selected Issues Paper, A*n Analysis of Systemic Risks in Nepal's Banking Sector in the Wake of the Global Crisis*

about 17 percent of the financial system. Cooperatives and NGOs are required to be licensed and regulated by the NRB but many are not. Currently 16 cooperatives are licensed and an estimated 3,200 are not. A number of large cooperatives were found to have inadequate loan loss provisioning and, possibly, fraud. Reportedly, many cooperatives are funded by commercial bank promoters. A crisis in the non-banking sector could quickly spill over into the banking sector.

Stress tests suggest that commercial banks are more vulnerable to asset quality and liquidity shocks than exchange rate and interest shocks.

- A 30 percent fall in real estate prices is estimated to increase banks' non-performing loans (NPLs) by more than 20 percentage points and reduce the capital of 14 private banks below the minimum CAR. Although banks' direct exposure to real estate and housing loans is not particularly high at about 20 percent as of January 2010, loan classification appears to have some gaps and banks' total exposure to real estate, including loans secured by land and buildings, is approximately 70 percent. Anecdotes suggest that the price of real estate has quintupled in the Kathmandu area in the last several years. Credit growth to the real estate sector more than doubled in 2009. In addition, the majority of loans are estimated to have been issued in the past two years at inflated real estate collateral value.

- Concentration risk is high. A default of the largest borrower would result in the most banks falling failing to meet their minimum CAR. A default of the three to five largest borrowers would result in the insolvency of many banks. Reportedly, large borrowers are highly leveraged and borrow from several banks: it is unclear whether the same collateral is pledged for multiple loans.

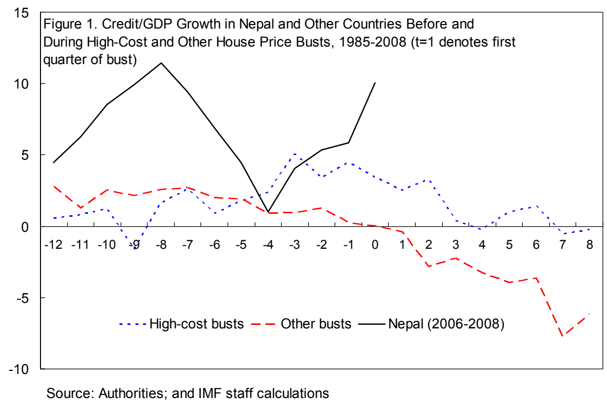
- Banks' liquidity positions are vulnerable to standard shocks. Five to nine banks would become illiquid within 3 to 5 days of deposit withdrawals at a daily rate of 8–10 percent. A stronger shock of 15 percent would result in the majority of banks becoming illiquid.

- Banks' balance sheets are resilient to the direct effects of an exchange rate shock (vis-à-vis the US dollar) due to the low level of dollarization.

- The impact of an interest shock would also be limited. The impact of a 300 bps increase in interest rates on CAR is -0.4 percentage points for all banks due to its modest effect on the net interest income on private banks given that loans can be repriced quickly by banks, while a substantial portion of deposits are at 1 year fixed rates.

- Risks are concentrated. Combined shocks to the interest rate, exchange rate, and asset quality shows that risks are concentrated in two private banks. In an environment of tightened liquidity, rising interest rates and declining asset quality, risks are likely to have high correlation.

International experience and Nepal's macroeconomic indicators suggest that the risk of a costly real estate bust and subsequent financial crisis is significant. International experience suggests that large deviations in the ratios of credit, the current account, and investment to GDP often precede real estate price busts.[12] Strong growth in the shares of credit and investment to GDP in Nepal are consistent with patterns observed in the run-up to a housing price bust and subsequent output loss. In addition, the current account has deteriorated markedly this year. Finally, given that most loans are collateralized with real estate and that Nepal's financial sector is large compared to the size of the economy (total banking assets are 56 percent of GDP), the risk of a housing price bust with a large subsequent output loss is significant.



32. **The NRB recently issued a set of prudential measures aimed at containing credit and liquidity risks in the banking sector**:

- *Licensing policy.* In July 2009**,** the NRB imposed a moratorium on bank license applications while the licensing policy is being reviewed. This moratorium was lifted in April 2010 for microfinance banks (class D) and eased for development banks (class B), with the aim to promote banking service provision in rural areas.

- *Single borrower and real estate loan exposure limits*. Single borrower limits will be lowered to 25 percent of capital from 50 percent initially by July 2010, but the deadline was later moved to January 2011. Banks are required to gradually lower exposure to real estate loans (real estate and housing) to 25 (40) percent of total loans by end of 2009/10. Both limits will be lowered by 10 percentage points by end-2011/12 and by an additional 5 percentage points by end-2012/13. Loans above the limit will be penalized by provisioning on the basis of a risk weight of 150 percent.

- *Loan-to-value limit.* Banks are limited to issuing loans of no more than 60 percent of fair market value of collateral or project.

- *Credit-to-deposit ratio limit.* Each bank's credit-to-deposit ratio is not to exceed 95 percent by end of 2009/10, 85 percent by end of 2010/11 and 80 percent by end-2011/12.

- *Bank restructuring.* The NRB has begun liquidation of Nepal Development Bank (NDB) after a lengthy court approval. The NRB has also completed the restructuring of the Nepal Bangladesh Bank (NBB), but has restored the equity of the anchor investors, albeit diluted.

[12] See for example "Lessons for Monetary Policy from Asset Price Fluctuations," *World Economic Outlook* (IMF October 2009).

33. **These prudential measures are welcome, but enforcement is crucial for effectiveness.** The loan-to-value limit hinges on realistic valuations and the real estate exposure restrictions on correct classification. Lower credit-to-deposit ratios are appropriate,[13] but if they were to prove too stringent because overall deposit growth slows substantially, bank-by-bank time bound action plans would become necessary; failure to comply with such plans should be penalized.

34. **The authorities need to act urgently to safeguard financial stability. Key steps include:**

- **The solvency and liquidity risks of banks should be thoroughly assessed.** Stress tests can help identify vulnerable institutions and prioritize intensified supervision. The NRB should be provided with adequate resources for this task, but in the short run, supervision could be assisted by international organizations or independent qualified firms. Corrective action should be promptly applied.
- **The NRB's credibility must be strengthened.** The deferral of the dates of applicability of new banks' minimum paid up capital and of the new single borrower's limit, and the return of the NBB to original shareholders are regrettable. Further lapses in supervisory discipline and dilution of regulations will undermine the NRB's supervisory effectiveness at a time when strong credibility is needed to curb excessive risk-taking in the financial sector. The NRB needs to be backed at the highest political level and have strong and stable leadership.
- **Additional measures.** The Prompt Correction Action framework should have greater automaticity in triggering action by decreasing MOF discretion and be strictly implemented. Pledging of promoters' shares should be banned and a plan devised to phase out existing pledges. The postponement of the minimum paid up capital for new banks should be reversed. Savings and credit cooperatives should be brought under regulatory oversight.

35. **Stepping up contingency planning is imperative.** Key elements of crisis preparedness include a clear framework for emergency liquidity support using existing tools but along the lines advocated in paragraph 14, strengthening the bank resolution framework, and developing an action plan for crisis management. The amended Banks and Financial Institutions Act (BAFIA), if approved by Parliament, would go some way in bolstering the bank resolution framework and resolve inconsistencies between existing laws regarding liquidation of financial institutions.

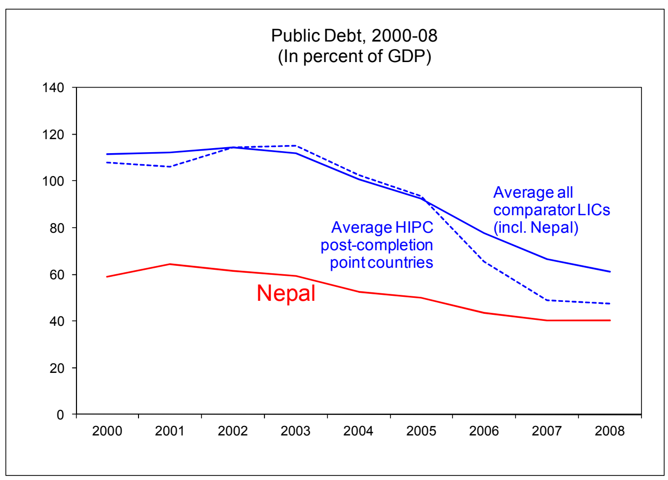
36. **Licensing policy needs to be tightened, consolidation incentivized, and state-controlled bank reform tackled.** The licensing moratorium should be maintained in light of the NRB's stretched supervisory capacity. The issuance of any new licenses should be postponed. While increased financial service provision in rural areas is desirable, international experience suggests that this objective can be achieved through mobile and agent banking without expanding the number of financial institutions. More stringent fit and proper criteria for bank owners should be adopted and

[13] The definition of the CD ratio under the NRB regulation includes also core capital in the denominator, together with deposits. Most commercial banks already comply with the July 2010 limits.

applied to new and existing banks. Consolidation should be encouraged, including by raising minimum capital requirements substantially in a short time frame and facilitating public trading of promoters' shares. The government needs to decide on a strategy to ensure that the state-controlled banks are adequately capitalized under appropriate management. The cost of bringing the capital to zero, estimated at 2–3 percent of GDP, should be borne by the government and existing shareholders.

Authorities' Views

37. **The NRB acknowledges that risks to financial stability have increased but view them as manageable.** They are concerned about real estate exposure, but mainly for financial institutions other than commercial banks and especially credit and savings cooperatives. They also anticipate that the regulations recently introduced would limit banks' risk taking and note that financial institutions have already become more cautious in extending loans and have raised interest rates to mobilize deposits. NRB officials share the view that asset quality is likely to deteriorate, but pointed to banks' high reserve coverage and the fact that loans are mainly short term and well collateralized. They deem liquidity to be the main risk facing the financial system and see a need for banks to improve their asset/liability management.



38. **The authorities have plans to strengthen the financial system.** The moratorium on commercial bank applications will be maintained although applications for licenses already in the pipeline will be processed. This could add up to four commercial banks to the system. They also point out that financial inclusion needs to be enhanced as a large number of people and regions remain under-banked and hence rural development bank licenses should be considered more favorably. The NRB has produced draft guidelines on risk management, which should be issued to banks soon. The authorities are also open to entertaining options to penalize pledging of promoter shares, including by deducting them from capital. Government officials reaffirmed their commitment to passing the amended BAFIA, but cautioned that the timeframe for parliamentary approval was highly uncertain. Finally, the authorities agree with the need to prepare contingency plans and have requested the World Bank to provide technical assistance in this area.

C. Fiscal Policy

39. **Maintaining fiscal discipline during the political transition has been a remarkable achievement.** Fiscal policy continues to be broadly prudent, partly because limited capacity constrains capital outlays and import growth has buoyed revenue. The government's plans to reduce

the domestically financed deficit for 2009/10 to 1.6 percent of GDP are welcome. However, as revenue targets appear ambitious, the deficit is likely to be close to 2 percent of GDP.

40. **The debt reduction has created fiscal space, but in the short run maintaining the peg calls for containing domestic borrowing close to current levels.** With external debt within thresholds, the debt sustainability analysis indicates that Nepal is at moderate risk of debt distress (see Annex 1). This fiscal room could be used for building infrastructure and human capital, and for the peace process, provided spending quality is ensured. But, in the short term the worsening external position requires that domestically financed deficits remain close to current levels, while the overall deficit could be expanded provided it is funded with external grants or concessional debt.

41. **The main considerations in determining the appropriate fiscal stance are[14]:**

- *Debt level target.* Nepal's external debt, with an NPV of debt-to-GDP ratio of 21¾ percent, and an NPV of debt-to-exports-and remittances ratio of 63 percent, is well within DSA thresholds. Nepal's public debt is well below the average of comparators. However, contingent liabilities of some 2–3 percent of GDP arising from the required recapitalization of state-owned banks, and potential additional liabilities stemming from the weak financial sector suggest that adequate cushions be maintained. In sum, a public debt target of around 40 percent would be appropriate to anchor fiscal policy. To stabilize the public debt-to-GDP ratio in the long run at this level, the overall deficit could rise to 3½ percent of GDP, and the domestically financed deficit would be in the range of 2¼–2½ percent of GDP, higher than in previous years.

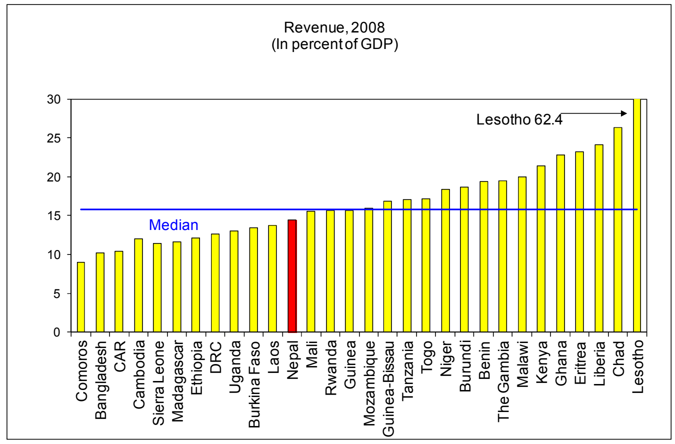
- *Support for the peg and demand management.* The expected slowdown in output growth would suggest a more expansionary fiscal stance in the short term. However, inflationary pressures remain high, and the peg to the Indian rupee requires that domestically financed deficits remain contained.

- *Crowding out and borrowing costs.* A high money-to-GDP ratio suggests that, in the longer run, a somewhat higher domestic debt burden can be accommodated. However, in the short run, the expected slowdown in money growth due to the deteriorating external position, public sector borrowing may need to be contained to leave sufficient room for private credit and control interest costs.

42. **The authorities have made significant strides in mobilizing revenue.** Domestic revenues increased from 10¾ percent of GDP in 2005/06 to 14½ percent of GDP in 2008/09 driven by reforms in customs administration and the Inland Revenue Department, but also supported by increasing imports as a share of GDP. Fund TA has contributed to this success. However, to finance the significant spending needs to support growth and poverty reduction while maintaining an overall

[14] See Selected Issues Paper, *Nepal—Considerations in the Choice of the Fiscal Stance*.

deficit consistent with the objectives outlined above, revenue would need to be bolstered further. The authorities are making continued progress. They have developed a comprehensive reform strategy for the customs department, and embarked on a range of measures to curb tax evasion, broaden the tax base, and improve the audit function of the Large Taxpayers Office, as well as of the IRD in general. Nonetheless, the projected decline in imports as a percentage of GDP will test the authorities' ability to maintain recent revenue gains and put them on a broader basis.



43. **The composition of spending is increasingly tilted towards current expenditure.** Some increase in current spending is well-justified and can be expected to yield significant benefits in the longer term, e.g. in health and education (where Nepal is below regional comparators but is embarking on a significant expansion) and on security. However, such spending commitments are difficult to reverse, and the authorities will need to be careful not to limit the room for higher capital expenditure, in particular investment in infrastructure (transportation and power). At the same time, the ability of the government to execute investments of a larger scale without external assistance is limited, and enhancing implementation capacity should be an urgent priority. In this regard, reforms aimed at improving the coverage of financial information and the accounting system (including with Fund TA), monitoring expenditure, and coordinating donor activity should help.

44. **The introduction of an automatic fuel pricing mechanism remains an important measure to contain quasi-fiscal costs.** Although the Nepal Oil Corporation (NOC) is running a small deficit at current prices, the past year's decline in international fuel prices was not fully passed through to consumers, allowing NOC to partly repay private sector and government loans. Should international fuel prices rise further, the financial position of NOC would again be threatened. The introduction of an automatic fuel pricing mechanism would serve to depoliticize the setting of fuel prices and prevent a recurrence of fuel shortages and government subsidies and/or loans. The Nepal Electricity Authority is also suffering losses, as electricity tariffs have not been adjusted for several years.

Authorities' Views

45. **MOF officials are confident that the budget deficit will remain broadly in line with budget targets.** While they have lowered their projected inflows of foreign grants and loans to a level closer to staff projections, they remain confident about meeting the upwardly revised revenue targets. On the expenditure side, a supplementary budget will regularize higher current expenditure on account of unbudgeted outlays for security sector reform and civil service wage increases. The authorities expect that higher recurrent expenditure will be financed by higher revenues, which

combined with lower than budgeted capital spending, will result in a lower domestically financed deficit than budgeted.

46. **The authorities remain committed to maintaining a prudent fiscal stance**. They concur with staff's analysis that the rapid consolidation of public debt has created some fiscal space, but agree that fiscal policy will need to remain tight in the near term owing to the current precarious external situation**.** They note that pressures are building up for higher spending, but continue to be optimistic about further revenue gains from ongoing reforms. The authorities indicate that they will continue to raise fuel prices in small increments to keep NOC losses in check, while raising electricity tariffs at a time when lengthy power cuts have become routine may not be politically feasible.

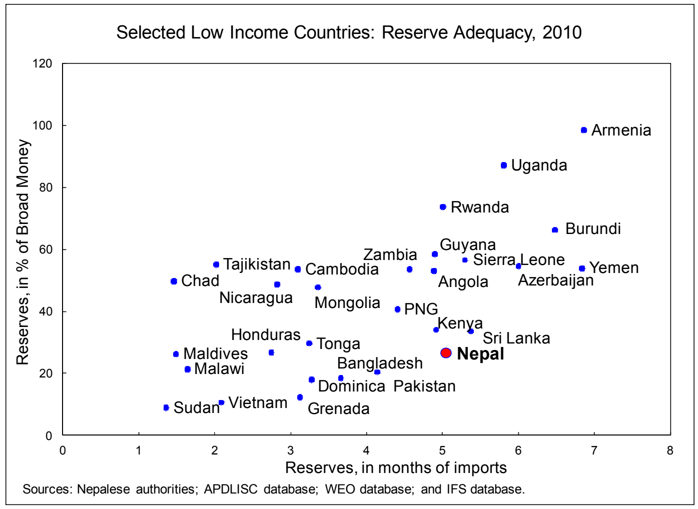
47. **The authorities share staff's concern about low capital spending.** They attribute the chronic under-spending on investment mainly to capacity constraints. At the same time, the authorities emphasize that higher spending on health and education should also be considered investment, although it is not classified as capital expenditure.

D. Structural Reform

48. **Despite broad consensus on the PRSP strategy, the political turmoil has impeded implementation of structural reforms.** After extensive consultations, a poverty reduction strategy was adopted in 2003, covering the period 2003–07, followed by an interim strategy for 2007–10. The Poverty Reduction Strategy Paper objectives include macroeconomic stability, institution building and structural reforms to raise growth. While significant progress has been made in revenue reform over the past few years, progress in other structural areas has been slow as a result of the unsettled political situation. Tackling continued difficult labor relations, inadequate infrastructure, electricity outages, and governance concerns remains key to bolster growth, reduce poverty, and diversify the economy, thus reducing its vulnerability to shocks.

E. Request for a Disbursement Under the Rapid Credit Facility

49. **Nepal is facing an urgent balance of payments need as a result of the global crisis.** The impact of the global crisis on the Nepalese economy has been multifaceted as outlined in paragraph 15. Exports are projected to decline by about US$100 million in 2009/10, with exports of woolen carpets, garments and pulses—the three largest exports—declining by over 30 percent. In addition, the non-oil terms of trade deteriorated in the first half of 2009/10 and rising international oil prices added pressure to the balance of payments. The sharp slowdown in remittances and the worsening economic confidence also contributed to the significant deterioration in the current account balance (equivalent to 6 percentage points of GDP). The international reserve position of the NRB has in the course of six months declined by US$400 million as the balance of payments turned into deficit after years of surpluses.



50. **Stabilizing reserves is imperative to boost confidence both in the currency peg and the financial sector.** Although the current level of reserves may appear adequate by some standard metrics, substantial financial sector vulnerabilities require a larger reserve cushion. When compared with other LICs, Nepal's reserves offer adequate import cover (five months), but are relatively low in percent of broad money, a key indicator in the context of risks of capital flight. The open border and extensive trade links with India present challenges in enforcing capital control regulations and highlight the importance of maintaining confidence in the peg and financial sector through adequate reserve coverage. The decline in reserves triggered liquidity stress in the financial system and sharply higher interest rates. Confidence was shaken as the rapid decline in reserves underscored the fragility of the external situation and exposed vulnerabilities in the financial and real estate sectors. Stabilizing reserves is therefore critical to prevent a vicious circle in which doubts about the peg translate into deposit withdrawals from banks, which in turn generate pressures on reserves.

51. **To address the impact of the global crisis, the authorities have requested a disbursement under the Rapid Credit Facility (RCF) in the amount of SDR28.52 million (40 percent of quota)**. The level of access (below the ceiling of 50 percent of quota permissible under the exogenous shocks window of the RCF) is in line with Nepal's immediate balance of payments need. Specifically, the RCF would cover \$43 million of a \$85 million balance of payments gap, which is staff's estimate of the amount needed to stabilize reserves in the short term.[15] The remaining gap is expected to be met through other sources, including donor support, which could be catalyzed with the approval of an RCF.

52. **The authorities' policy commitments in the attached letter of intent appropriately address the impact of the shocks.** Although the authorities are not in a position to implement fundamental structural reforms at present because of the political transition, the NRB and the MOF have taken measures and made commitments that are sufficient to address the exogenous shock and put the balance of payments on a sustainable path.

53. **Nepal has adequate capacity to repay the Fund and has committed to safeguard Fund resources.** Access of SDR 28.5 million would not jeopardize Nepal's debt sustainability. At 24 percent of GDP, Nepal's external debt is low by international standards. Nepal remains at

[15] While a higher reserve level may be desirable in light of the pegged exchange rate regime, the short-term target of US\$2.7 billion would signal an improved external position and help boost confidence.

moderate risk of debt distress as headline debt indicators have improved recently. The NPV of external debt-to-exports-and-remittances is currently at 63 percent and the debt service-to-revenue has declined in recent years as a result of prudent fiscal policy and impressive revenue gains.

54. **The RCF could also serve as a bridge to an upper credit tranche arrangement that could support reforms to address some of Nepal's entrenched structural challenges.** Once the new Constitution is approved and after the elections, the authorities intend to address also the structural challenges that Nepal is facing and would like to progress to a longer Fund-supported program, possibly an Extended Credit Facility. Rapid Fund assistance under the RCF would provide financial and policy support to help address financial and external sector vulnerabilities in a critical phase of the political transition until a longer-term structural adjustment policy agenda can be formulated.

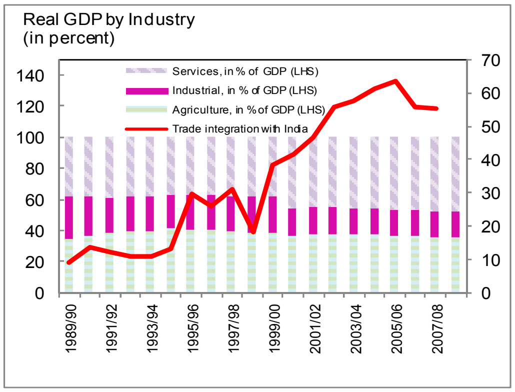
Authorities' view: see attached LOI.

F. Other Issues

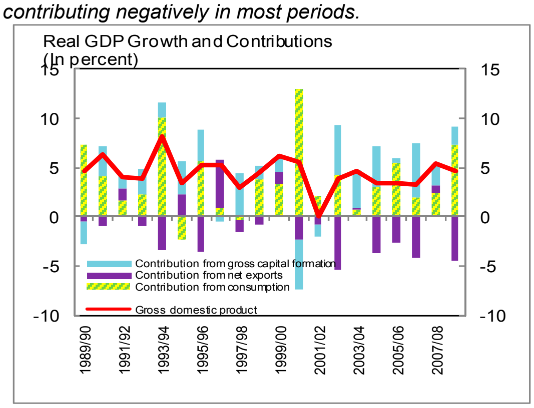
55. **The Financial Action Task Force (FATF)'s International Cooperation Review Group has identified deficiencies in Nepal's anti-money laundering/combating terrorist financing (AML/CFT) system, which should be addressed.** The key deficiencies identified by FATF are: (i) money laundering and terrorist financing have not been criminalized in a way which is fully in line with the AML/CFT standard; and (ii) insufficient measures to freeze, seize, and confiscate the proceeds of crime or of money laundering or funds linked to a terrorist financing offense. Nepal has yet to enact legislation to enable the rendering of the full range of mutual legal assistance in AML/CFT investigations, prosecutions, and related proceedings. Nepal's entire AML/CFT framework will be subject to assessment by the Asia/Pacific on Money Laundering (APG), the FATF style regional body in September 2010. This assessment will also provide Nepal with a comprehensive set of recommendations to improve is AML/CFT system. The IMF, through its AML/CFT Topical Trust Fund, will initially be assisting Nepal improve its AML/CFT framework by providing advice on the development of a national strategy which could lead to further technical assistance to implement the recommendations made by the APG.

Figure 1. Nepal: A Long-Term Perspective 1/

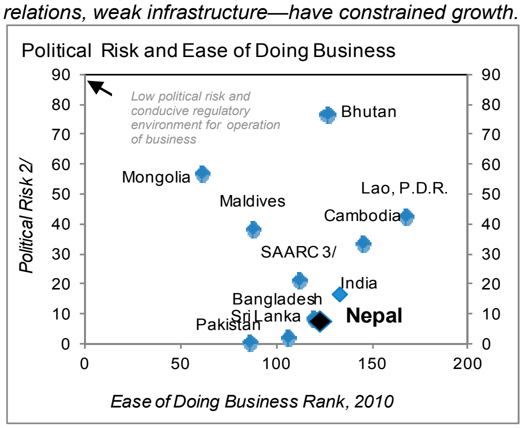
Despite increasing trade integration with India, Nepal's economic structure has changed little over the past two decades.



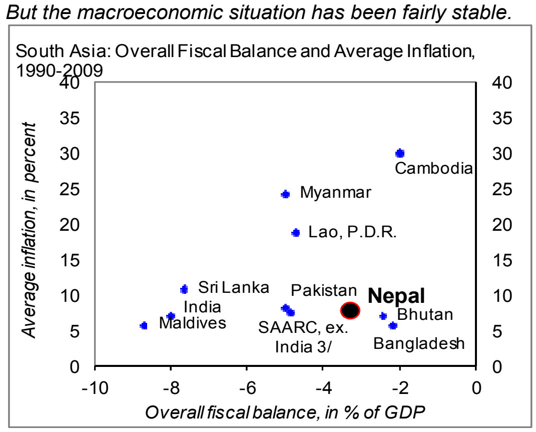
Economic growth has been driven mainly by consumption and, to a lesser extent, investment, with net exports contributing negatively in most periods.



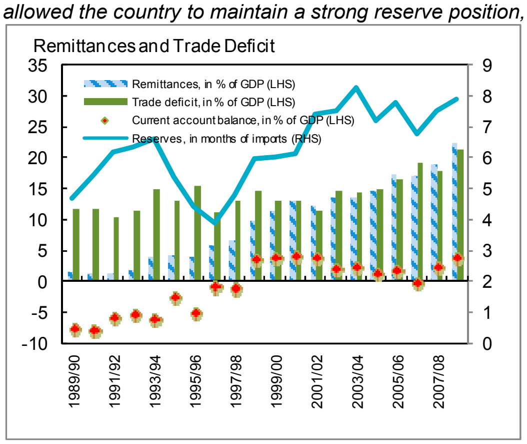
Structural impediments—political instability, difficult labor relations, weak infrastructure—have constrained growth.



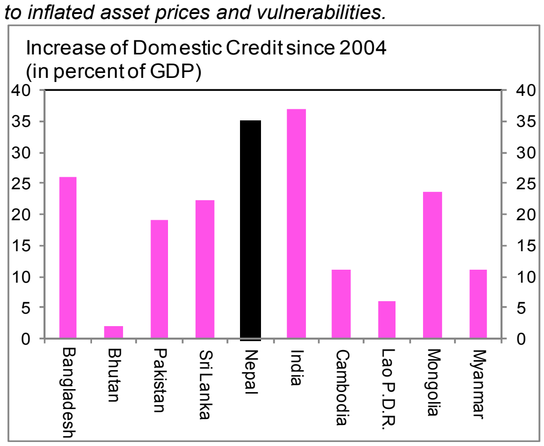
But the macroeconomic situation has been fairly stable.



Remittances, which have reached 20% of GDP, have allowed the country to maintain a strong reserve position,



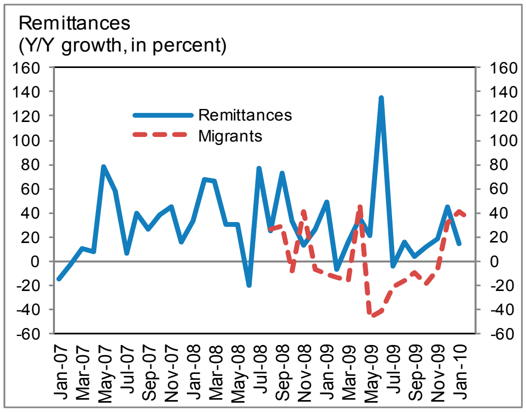
but remittances have fuelled credit growth, which has led to inflated asset prices and vulnerabilities.



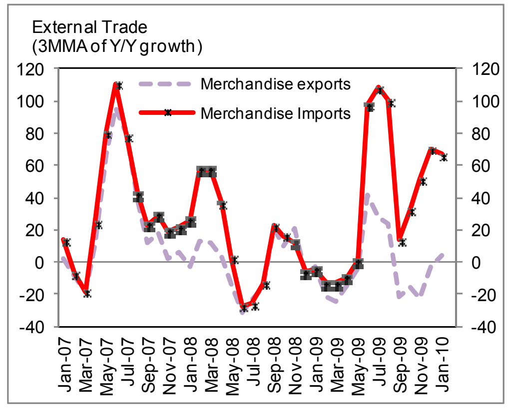
Sources: Nepalese authorities; IMF, *World Economic Outlook, International Financial Statistics, Direction of Trade*; World Bank, *World Development Indicators, Doing Business Report, Country Policy and Institutional Assessment*; UNDP, *Human Development Report*; and IMF staff estimates.
1/ Nepal's fiscal year starts in July.
2/ Political Stability & Absence of Violence/ Terrorism rank, 2008 from the World Bank *Country Policy and Institutional Assessment.*
3/ Calculated as a simple average of data in South Asian Association for Regional Cooperation member countries.

Figure 2. Nepal: Recent Developments

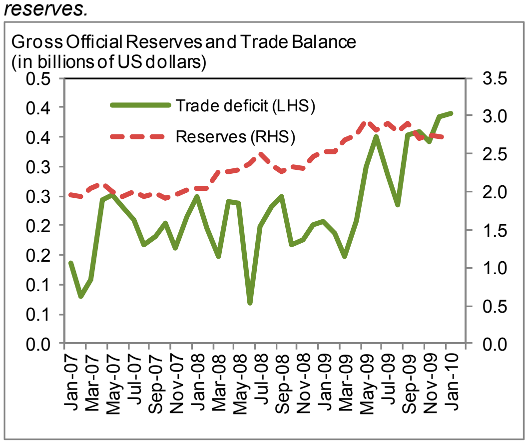
Migrants and remittances growth have dipped starting in mid-2009, suggesting a delayed impact of the global crisis.



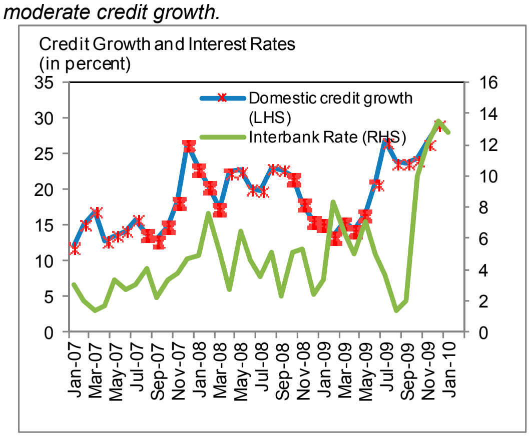
At the same time, import demand surged and export performance continued to be lackluster.



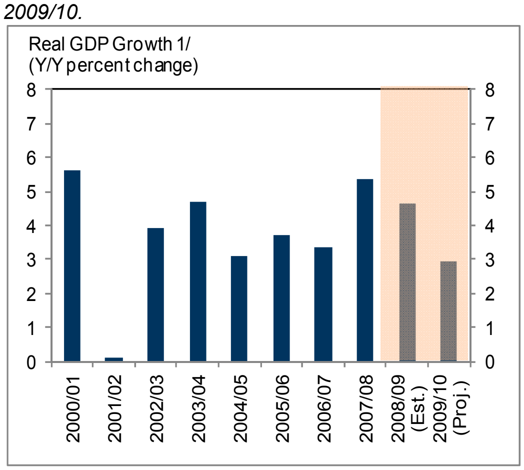
A widening trade deficit ensued, financed by a drawdown in reserves.



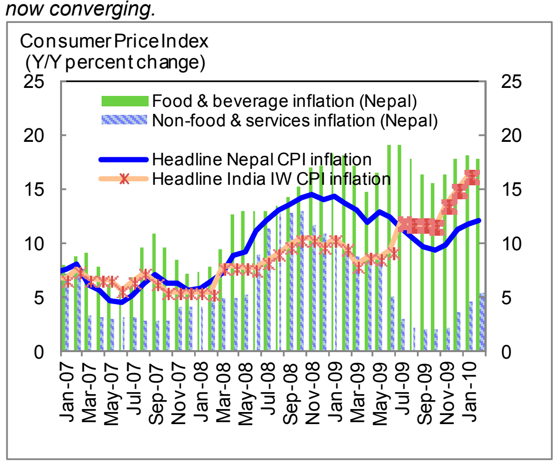
The liquidity squeeze that followed is expected to moderate credit growth.



In sum, a slowdown in economic activity is anticipated for 2009/10.



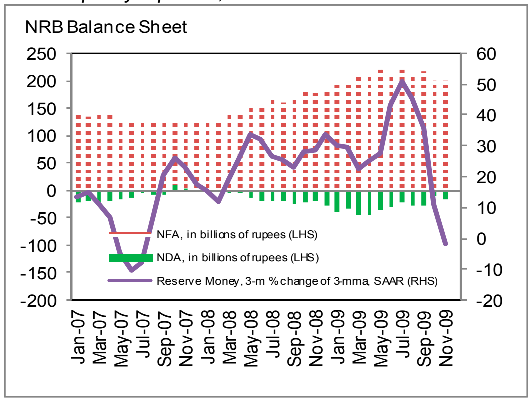
Inflation, which was higher than that of India in 2008/09, is now converging.



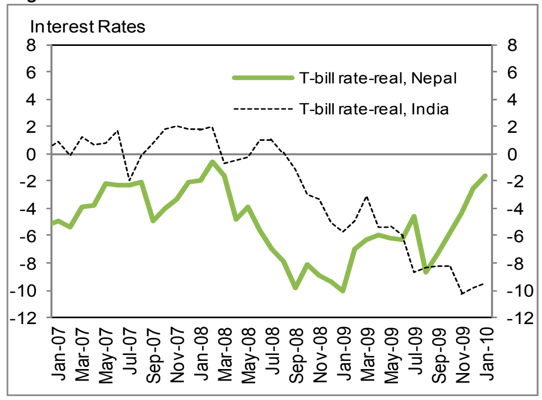
Sources: Nepalese Authorities; CEIC Data Co Ltd; and IMF staff estimates.
1/ Nepal's fiscal year starts in July.

Figure 3. Nepal: Monetary and Financial Sector Developments

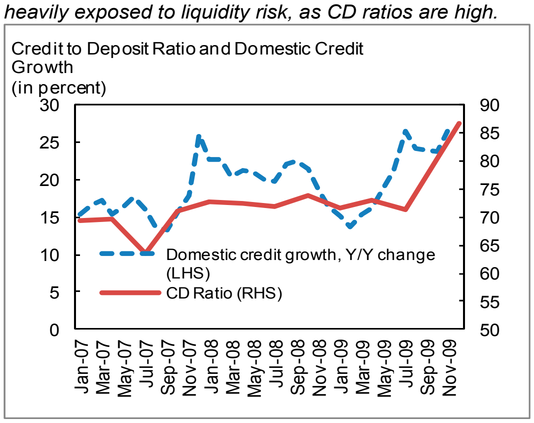
Reserve money growth has been driven by the NRB reserve accumulation in the past two years until the recent liquidity squeeze,



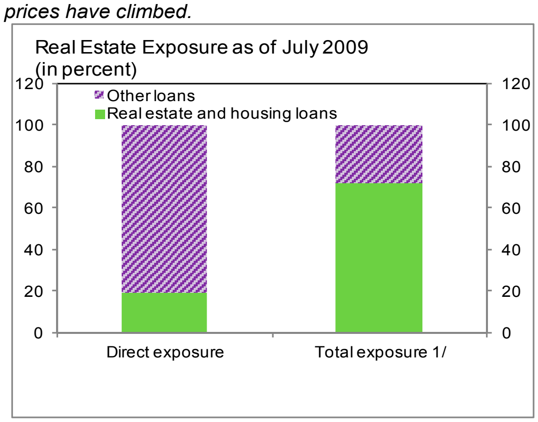
which drove up sharply interest rates, that has been negative in real terms.



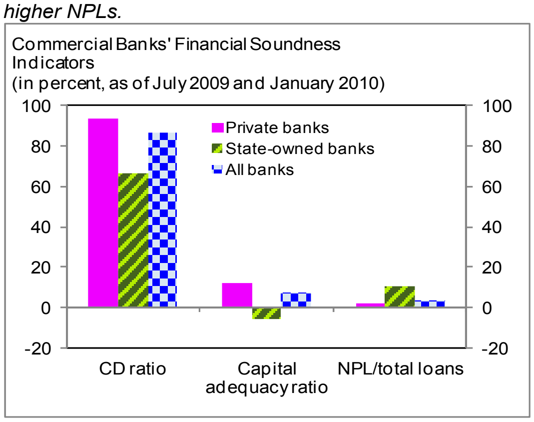
After the rapid credit expansion of recent years, banks are heavily exposed to liquidity risk, as CD ratios are high.



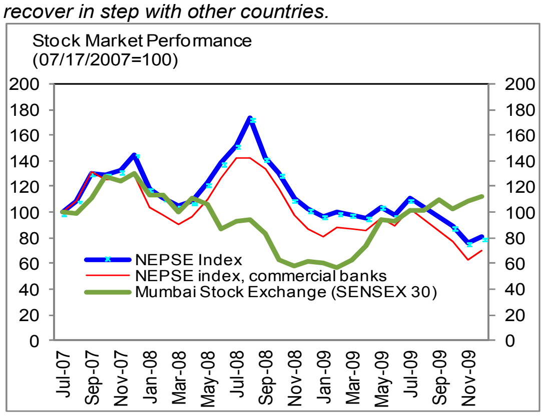
Banks have also high exposure to real estate, whose prices have climbed.



Public banks have lower CD ratios, but lower CAR and higher NPLs.



The stock market, which is dominated by financial companies, fell sharply in late 2008, but has failed to recover in step with other countries.

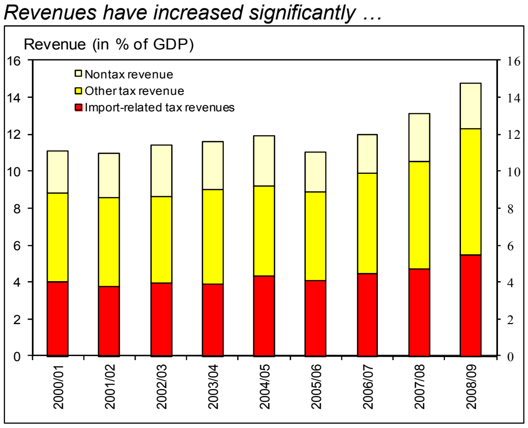


Sources: Nepalese Authorities and IMF staff estimates.

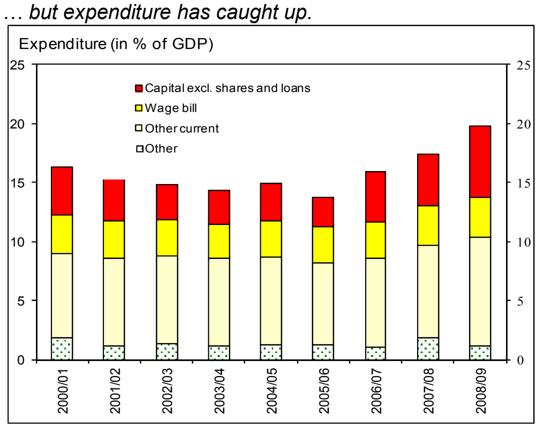
1/ Includes loans collateralized with real estate properties (as of July 2009).

Figure 4. Nepal: Fiscal Sector Developments 1/

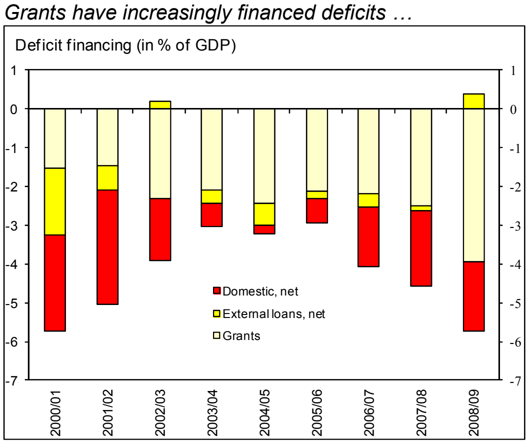
Revenues have increased significantly …



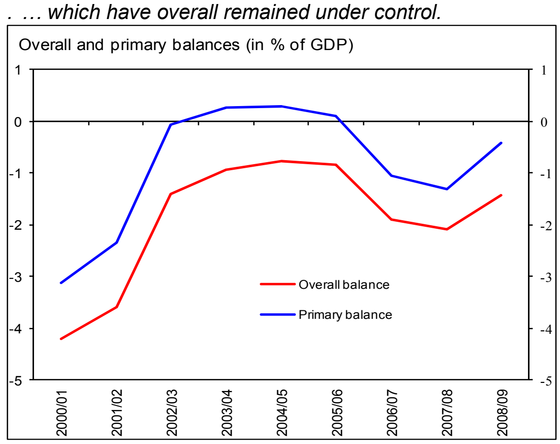
… but expenditure has caught up.



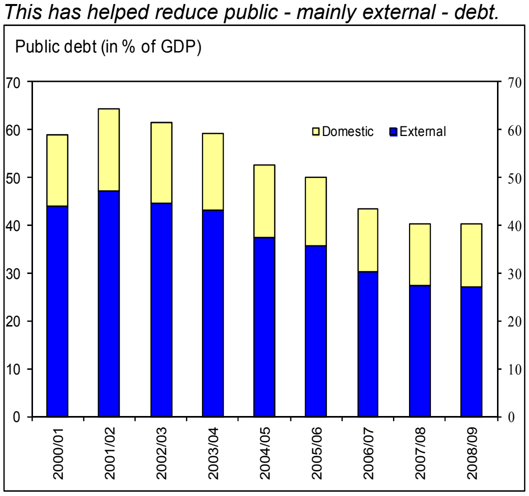
Grants have increasingly financed deficits …



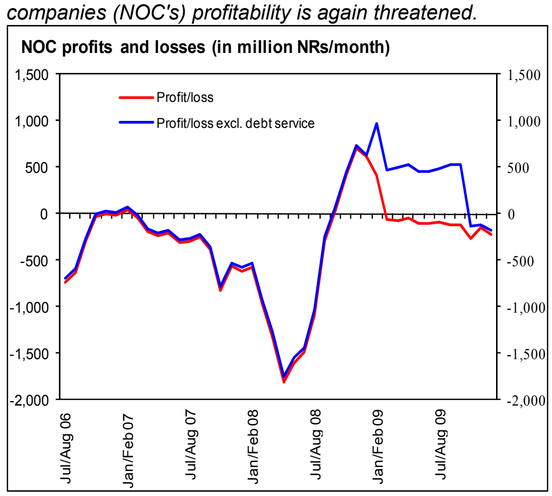
. … which have overall remained under control.



This has helped reduce public - mainly external - debt.



After recovering from large losses in 2008, the state oil companies (NOC's) profitability is again threatened.



Sources: Nepalese authorities; and IMF staff estimates.
1/ Nepal's fiscal year starts in July.

Table 1. Nepal: Millennium Development Goals, 1990–2008 1/

	1990	1995	2000	2005	2008
Eradicate extreme poverty and hunger 2/					
Population below $2 per day (in percent)	…	…	…	…	…
Poverty gap at $2 per day (in percent)	…	…	…	…	…
Percentage share of income or consumption held by poorest 20 percent	…	7.6	…	6.1	…
Prevalence of child malnutrition (in percent of children under 5)	…	…	…	49.3 (2006)	…
Population below minimum level of dietary energy consumption (in percent)	...	...	...	...	...
Achieve universal primary education 3/					
Net primary enrollment ratio (in percent of relevant age group)	…	…	72.8	80.0	80.0
Percentage of cohort reaching grade 5 (in percent)	…	…	45.8	61.0	62.0
Primary completion rate, total (in percent of relevant age group)	51.0	…	66.0	75.0	78.0
Youth literacy rate (in percent of ages 15–24)	50.5	…	70.5	79.0	79.0
Promote gender equality 4/					
Ratio of girls to boys in primary and secondary education (in percent)	60.0	71.0	77.1	89.5	98.3
Ratio of young literate females to males (in percent of ages 15–24)	…	…	…	…	…
Share of women employed in the nonagricultural sector (in percent)	…	…	15.1	…	…
Proportion of seats held by women in national parliament (in percent)	6.0	3.0	6.0	5.9	33.2
Reduce child mortality 5/					
Under 5 mortality rate (per 1,000)	142.0	117.4	85.4	62.2	55.0
Infant mortality rate (per 1,000 live births)	98.8	83.3	62.9	48.1	43.0
Immunization, measles (in percent of children under 12 months)	57.0	56.0	71.0	74.0	81.0
Improved maternal health 6/					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	…	…	…	830.0	…
Births attended by skilled health staff (in percent of total)	7.0	9.0	11.9	19.0	19.0
Combat HIV/AIDS, malaria, and other diseases 7/					
Contraceptive prevalence rate (in percent of women ages 15–49)	…	…	37.0	…	…
Number of children orphaned by HIV/AIDS	…	…	…	…	…
Incidence of tuberculosis (per 100,000 people)	243.0	219.9	198.9	180.0	…
Incidence of tuberculosis (per 100,000 people)	243.0	220.0	199.0	180.0	173.0
Prevalence of HIV, female (in percent of ages 15-24)	…	…	…	0.3	0.3
Prevalence of HIV, male (in percent of ages 15-24)	…	…	…	1.0	1.0
Prevalence of HIV, total (in percent of population ages 15-49)	0.1	0.3	0.5	0.5	0.5
Tuberculosis cases detected under DOTS (in percent)	…	5.0	57.0	67.0	66.0
Ensure environmental sustainability 8/					
CO2 emissions (metric tons per capita)	0.0	0.1	0.1	0.1	…
Forest area (in percent of total land area)	33.7	30.5	27.3	25.4	…
GDP per unit of energy use (PPP$ per kg. oil equivalent)	...	...	...	...	…
Improved water sources (in percent of population)	72.0	78.0	83.0	89.0	89.0
Improved sanitation facilities (in percent of population)	9.0	15.0	20.0	27.0	27.0
Nationally protected areas (in percent of total land area)	…	…	…	16.0	16.0
Develop a global partnership for development 9/					
Aid per capita (current US$)	22.0	20.0	16.0	16.0	21.0
Debt service (PPG and IMF only, % of exports, excluding workers' remittances)	15.0	8.0	7.0	8.0	9.0
Fixed line and mobile telephones (per 100 people)	0.3	0.4	1.1	2.6	15.0
Internet users (per 100 people)	0.0	0.0	0.2	0.8	1.4
Personal computers (per 100 people)	…	0.1	0.3	0.5	…
Youth unemployment rate (in percent of total labor force ages 15–24)	…	…	…	…	…
General indicators					
Adult literacy rate (in percent of people ages 15 and over)	33.0	…	49.0	57.0	57.0
Aid (in percent of GNI)	11.6	9.7	7.0	5.2	…
External debt (in percent of GNI)	44.7	54.7	52.0	39.0	…
Fertility rate, total (births per woman)	5.1	4.6	4.0	3.1	3.0
Gross capital formation (in percent of GDP)	18.1	25.2	24.3	26.5	31.8
GNI per capita (in U.S. dollars)	190.0	200.0	220.0	300.0	400.0
Life expectancy at birth (in years)	54.5	57.9	60.5	62.7	64.0
Population (millions)	19.1	21.7	24.4	27.1	28.6
Total fertility rate (births per woman)	5.1	4.6	4.0	3.1	3.0
Trade (in percent of GDP)	32.2	59.5	55.7	44.1	44.7

Source: World Development Indicators database, January 2010.

1/ In some cases the data are for earlier or later years than those stated.

2/ Goal 1 targets: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger.

3/ Goal 2 targets: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

4/ Goal 3 targets: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.

5/ Goal 4 targets: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

6/ Goal 5 targets: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

7/ Goal 6 targets: Halt by 2015, and begin to reverse, the spread of HIV/AIDS. Halt by 2015, and begin to reverse, the incidence of malaria and other major diseases.

8/ Goal 7 targets: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.

9/ Goal 8 targets: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

Table 2. Nepal: Selected Economic Indicators, 2006/07–2010/11

	2006/07	2007/08	2008/09	2009/10	2010/11
				Projections	
Output and prices (percent change)			(Percent change)		
Real GDP	3.3	5.3	4.7	3.0	4.0
CPI (period average)	6.4	7.7	13.2	11.8	8.0
CPI (end of period)	5.1	12.1	11.4	12.1	6.0
Fiscal Indicators (in percent of GDP)			(In percent of GDP)		
Total revenue and grants	14.0	15.3	16.9	19.9	20.0
Total expenditure and net lending	15.9	17.4	17.2	22.4	22.8
Current expenditure	10.6	11.2	11.8	15.1	15.6
Capital expenditure and net lending	5.3	6.2	5.4	7.2	7.2
Overall deficit before grants	4.1	4.6	2.7	6.2	6.8
Overall deficit after grants	1.9	2.1	0.2	2.4	2.8
Net domestic financing	1.6	1.9	0.8	2.1	2.2
Money and credit (percent change)			(Percent change, end-of-period)		
Broad money	14.0	25.3	27.7	10.6	..
Domestic credit	12.0	19.8	26.6	18.2	..
Private sector credit	12.3	24.3	28.3	19.4	..
Balance of payments			(In millions of U.S. dollars, unless otherwise indicated)		
Current account (in millions of U.S. dollars)	-13.8	344.0	536.3	-305.8	-0.3
In percent of GDP	-0.1	2.7	4.3	-2.1	0.0
Trade Balance (in millions of U.S. dollars)	-1,977	-2,265	-2,707	-3,890	-3,980
In percent of GDP	-19.1	-18.0	-21.5	-26.4	-25.5
Exports value growth (percent change)	13.4	-4.6	0.5	-11.0	6.3
Imports value growth (percent change)	25.8	8.4	14.1	30.0	3.0
Gross official reserves (in millions of U.S. dollars)	1,996	2,473	2,907	2,670	2,876
In months of imports of goods and services	6	7	6	5	5
Memorandum items					
Public external debt (percent of GDP)	30.2	27.4	27.0	23.8	21.7
GDP at market prices (in billions of Nepalese rupees)	728.2	818.4	969.8	1,116.1	1,254.1
GDP at market prices (in billions of U.S. dollars)	10.3	12.6	12.6	14.7	15.6
Exchange rate (Nrs/US$; period average)	70.5	65.0	76.9	…	…
Real effective exchange rate (eop, y/y percent change	9.5	-4.3	7.3	…	…

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

Table 3. Nepal: Summary of Government Operations, 2006/07–2010/11 1/

	2006/07	2007/08	2008/09	2009/10		2010/11
				Budget	Staff Proj.	Projections
	(in billions of Nepalese rupees)					
Total revenue and grants	102.0	125.3	164.2	229.5	222.5	250.8
Total revenue	86.2	104.9	139.8	172.6	179.8	200.7
Tax revenue	72.0	86.2	119.0	150.1	157.6	175.5
Non-tax revenue 2/	14.2	18.7	20.8	22.4	22.2	25.2
Grants	15.8	20.4	24.4	57.0	42.7	50.2
Expenditure	115.8	142.3	166.4	263.1	249.5	285.8
Current	77.1	91.5	114.1	160.6	168.8	195.4
Of which: Interest payments	6.2	6.4	8.0	9.7	9.7	17.3
Capital and net lending	38.7	50.8	52.3	102.5	80.7	90.3
Excluding shares and loans	30.8	35.5	36.3	86.9	68.2	76.4
Overall balance before grants	-29.7	-37.4	-26.6	-90.5	-69.6	-85.1
Overall balance after grants	-13.9	-17.0	-2.2	-33.6	-26.9	-34.9
Financing	13.9	17.0	2.2	33.6	26.9	34.9
Net foreign loans	2.5	1.1	-5.3	10.3	3.8	6.9
Gross disbursements	10.1	9.0	3.7	21.6	15.1	18.8
Amortization	7.5	7.9	9.0	11.3	11.3	11.9
Net domestic financing	11.3	15.9	7.5	23.3	23.1	28.0
	(In percent of GDP)					
Total revenue and grants	14.0	15.3	16.9	20.7	19.9	20.0
Total revenue	11.8	12.8	14.4	15.6	16.1	16.0
Tax revenue	9.9	10.5	12.3	13.6	14.1	14.0
Non-tax revenue 2/	2.0	2.3	2.1	2.0	2.0	2.0
Grants	2.2	2.5	2.5	5.1	3.8	4.0
Expenditure	15.9	17.4	17.2	23.8	22.4	22.8
Current	10.6	11.2	11.8	14.5	15.1	15.6
Of which: Interest payments	0.8	0.8	0.8	0.9	0.9	1.4
Capital and net lending	5.3	6.2	5.4	9.3	7.2	7.2
Excluding shares and loans	4.2	4.3	3.7	7.8	6.1	6.1
Overall balance before grants	-4.1	-4.6	-2.7	-8.2	-6.2	-6.8
Overall balance after grants	-1.9	-2.1	-0.2	-3.0	-2.4	-2.8
Financing	1.9	2.1	0.2	3.0	2.4	2.8
Net foreign loans	0.3	0.1	-0.5	0.9	0.3	0.6
Gross disbursements	1.4	1.1	0.4	1.9	1.4	1.5
Amortization	1.0	1.0	0.9	1.0	1.0	0.9
Net domestic financing	1.6	1.9	0.8	2.1	2.1	2.2
Memorandum items:						
Primary balance (percent of GDP)	-1.1	-1.3	0.6	-2.2	-1.5	-1.4
Public debt (percent of GDP)	43.4	40.3	40.3	38.3	37.4	36.1
Domestic	13.2	12.9	13.3	13.7	13.6	14.4
External	30.2	27.4	27.0	24.6	23.8	21.7
GDP (in Billions of Nepalese rupees)	728.2	818.4	969.8	1,106.9	1,116.1	1,254.1

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

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

2/ Includes privatization receipts.

Table 4. Nepal: Reserve Money and Monetary Survey, 2006/07–2009/10

	2006/07	2007/08	2008/09	2009/10	
				Mar	Jul (proj.)
Reserve money	(In billions of Nepalese rupees, end-period)				
Reserve money	119	145	196	201	196
Net domestic assets of NRB	-7	-20	-23	15	15
Claims on public sector	17	15	33	28	29
Claims on private sector	9	4	4	3	3
Claims on commercial banks	2	1	0	26	24
Other items (net)	-35	-39	-60	-43	-41
Net foreign assets of NRB	126	165	219	187	181
	(Contribution to reserve money growth)				
Reserve money	8	21	35	22	0
Net domestic assets of NRB	12	-11	-2	37	20
Net foreign assets of NRB	-5	32	37	-16	-19
Monetary survey	(In billions of Nepalese rupees, end-period)				
Broad money	395	495	633	676	700
Narrow money	127	154	196	205	213
Quasi-money	269	341	436	470	487
Net domestic assets	263	324	412	488	519
Domestic credit	365	437	554	613	655
Credit to public sector	91	97	117	105	134
Credit to private sector	274	340	436	508	521
Other items(net)	-102	-113	-142	-124	-136
Net foreign assets	132	171	221	188	181
	(Twelve-month percent change)				
Broad money	14	25	28	20	11
Net domestic assets	27	23	27	41	26
Domestic credit	12	20	27	30	18
Credit to public sector	11	6	21	32	14
Credit to private sector	12	24	28	30	19
Net foreign assets	-5	30	29	-13	-18
	(Contribution to broad money growth)				
Net domestic assets	16	15	18	25	17
Credit to government	3	2	4	4	3
Credit to private sector	9	17	19	21	13
Net foreign assets	-2	10	10	-5	-6

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

Table 5. Nepal: Balance of Payments, 2006/07–2014/15

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
				Projections					
	(in millions of U.S. dollars unless otherwise indicated)								
Current account	-13.8	344.0	536.3	-305.8	-0.3	-22.3	-104.1	-220.0	-305.2
Current account (excluding official transfers)	-234.7	69.6	209.3	-869.2	-666.8	-699.5	-792.5	-901.4	-976.9
Trade balance	-1977.4	-2264.8	-2707.1	-3890.0	-3980.3	-4386.5	-4841.9	-5343.0	-5894.2
Exports, f.o.b.	942.9	899.7	904.1	804.5	855.0	908.2	955.7	1005.4	1057.4
Imports, f.o.b.	2920.3	3164.5	3611.1	4694.5	4835.3	5294.7	5797.7	6348.5	6951.6
Services (net)	-128.5	-161.0	-135.5	-319.9	-359.6	-385.5	-436.1	-490.6	-510.9
Receipts	491.9	613.2	683.2	715.1	775.0	837.3	894.7	952.8	1016.4
Of which: tourism	155.3	270.8	361.6	394.4	443.2	487.8	534.9	588.3	647.1
Payments	620.4	774.3	818.7	1034.9	1134.6	1222.9	1330.8	1443.4	1527.3
Income	114.0	115.4	152.0	157.4	172.2	184.4	196.9	203.0	208.9
Credit	222.4	195.2	213.5	230.6	249.0	262.7	277.1	285.5	294.0
Debit	108.4	79.9	61.5	73.2	76.8	78.3	80.2	82.4	85.1
Current transfers	1978.0	2654.4	3227.0	3746.7	4167.4	4565.4	4977.0	5410.5	5891.0
Credit, of which:	2042.5	2692.7	3329.6	3864.8	4298.3	4710.2	5137.1	5587.4	6086.2
General government	220.8	274.4	327.1	563.4	666.5	677.2	688.4	681.4	671.7
Workers remittances	1535.7	2071.6	2712.0	2956.0	3325.5	3724.6	4134.3	4589.1	5093.9
Debit	64.5	38.2	102.7	118.1	130.9	144.9	160.2	176.9	195.2
Capital account	68.2	114.9	80.6	82.0	87.1	93.3	100.3	108.1	117.2
Financial account	-32.0	68.7	68.3	-190.7	123.9	114.3	115.3	106.8	153.4
Direct investment	5.6	4.3	23.7	32.7	37.6	47.1	58.8	73.5	84.6
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment (net)	-37.5	64.5	44.6	-223.5	86.3	67.3	56.5	33.3	68.8
Errors and omissions	137.7	-65.7	-250.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	160.1	461.9	434.9	-414.6	210.7	185.4	111.5	-5.1	-34.6
Financing	-160.1	-461.9	-434.9	414.6	-210.7	-185.4	-111.5	5.1	34.6
Change in reserve assets (- =increase)	-195.5	-476.3	-433.8	332.8	-206.4	-178.9	-97.9	19.2	51.0
PRGF(net)	36.4	15.9	-1.1	-3.3	-4.3	-6.5	-13.5	-14.1	-11.9
Financing gap	0.0	0.0	0.0	85.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Current account (in percent of GDP)	-0.1	2.7	4.3	-2.1	0.0	-0.1	-0.6	-1.1	-1.4
Current account, excl. grants (in percent of GDP)	-2.3	0.6	1.7	-5.9	-4.3	-4.2	-4.4	-4.6	-4.6
Trade balance (in percent of GDP)	-19.1	-18.0	-21.5	-26.4	-25.5	-26.2	-26.9	-27.5	-28.0
Exports (in percent of GDP)	9.1	7.1	7.2	5.5	5.5	5.4	5.3	5.2	5.0
Imports (in percent of GDP)	28.3	25.1	28.6	31.9	30.9	31.6	32.2	32.7	33.0
Remittances (in percent of GDP)	14.9	16.5	21.5	20.1	21.3	22.2	22.9	23.6	24.2
Exports (y/y percent change)	13	-5	0	-11	6	6	5	5	5
Imports (y/y percent change)	26	8	14	30	3	10	10	10	10
Remittances (y/y percent change)	16	35	31	9	13	12	11	11	11
Non-oil GDP growth of GCC countries	7	6	3	3	4	5	5	5	5
Total external debt (in percent of GDP)	30	27	27	24	22	20	19	18	17
Debt service (in percent of current account receipts	4	3	3	3	3	3	3	3	3
Gross official reserves (in millions of U.S. dollars) 1/	1996	2473	2907	2670	2876	3055	3153	3134	3083
(In months of imports)	6	7	6	5	5	5	5	4	4
Nominal GDP (in millions of U.S. dollars)	10331	12588	12615	14721	15638	16764	18017	19426	21053

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

1/ Includes assumed coverage of financing gap.

Table 6. Nepal: Macroeconomic Framework, 2008/09-2014/15

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
		Projections					
Growth and prices			(percent change)				
Real GDP	4.7	3.0	4.0	4.2	4.4	4.7	4.8
CPI (period average)	13.2	11.8	8.0	5.5	5.0	5.0	5.0
CPI (end of period)	11.4	12.1	6.0	5.0	5.0	5.0	5.0
Fiscal Indicators			(In percent of GDP)				
Total revenue and grants	16.9	19.9	20.0	20.0	20.0	19.8	19.6
Total expenditure and net lending	17.2	22.4	22.8	22.9	23.0	23.0	23.1
Current expenditure	11.8	15.1	15.6	15.6	15.5	15.4	15.5
Capital expenditure and net lending	5.4	7.2	7.2	7.3	7.4	7.5	7.6
Overall balance before grants	-2.7	-6.2	-6.8	-6.7	-6.6	-6.4	-6.5
Overall balance after grants	-0.2	-2.4	-2.8	-2.9	-3.0	-3.1	-3.5
Net domestic financing	0.8	2.1	2.2	2.3	2.3	2.4	2.6
External Trade			(percent change)				
Merchandise exports (in U.S. dollar terms)	0.5	-11.0	6.3	6.2	5.2	5.2	5.2
Merchandise Imports (in U.S. dollar terms)	14.1	30.0	3.0	9.5	9.5	9.5	9.5
Balance of payments		(In millions of U.S. dollars unless otherwise indicated)					
Current account	536.3	-305.8	-0.3	-22.3	-104.1	-220.0	-305.2
In percent of GDP	4.3	-2.1	0.0	-0.1	-0.6	-1.1	-1.4
Capital and financial account	148.9	-108.8	211.0	207.6	215.6	214.9	270.6
In percent of GDP	1.2	-0.7	1.3	1.2	1.2	1.1	1.3
Overall balance	434.9	-414.6	210.7	185.4	111.5	-5.1	-34.6
In percent of GDP	3.4	-2.8	1.3	1.1	0.6	0.0	-0.2
External indicators		(in millions of U.S. dollars unless otherwise indicated)					
Gross official reserves (end-of-period)	2,907	2,670	2,876	3,055	3,153	3,134	3,083
In months of imports	6.1	5.4	5.3	5.1	4.9	4.4	4.1
Public external debt	3,403	3,501	3,396	3,411	3,463	3,534	3,663
Public external debt (in percent of GDP)	27.0	23.8	21.7	20.3	19.2	18.2	17.4
Debt service (in percent of current account receipts)	2.9	3.5	3.2	3.0	2.9	2.7	2.6

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

Table 7. Nepal: Indicators of Capacity to Repay the Fund, 2010-2020 1/

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Fund obligations based on existing credit (in millions of SDRs)											
Principal	2.9	2.9	6.8	10.0	8.6	7.1	7.1	3.2	0.0	0.0	0.0
Charges and interests	0.0	0.0	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Fund obligations based on existing and prospective credit (In millions of SDRs)											
Principal	2.9	2.9	6.8	10.0	8.6	10.0	12.8	8.9	5.7	5.7	2.9
Charges and interests	0.0	0.0	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Total obligations based on existing and prospective credit											
SDR millions	2.9	2.9	7.0	10.2	8.7	10.1	12.9	9.0	5.8	5.7	2.9
Nepalese Rupee billions	0.3	0.4	0.9	1.3	1.1	1.4	1.7	1.2	0.8	0.8	0.4
Percent of government revenue	0.2	0.2	0.4	0.5	0.4	0.4	0.5	0.3	0.2	0.2	0.1
Percent of exports and remittances	0.1	0.1	0.2	0.3	0.2	0.2	0.3	0.2	0.1	0.1	0.0
Percent of debt service 2/	1.2	1.0	2.3	3.3	2.7	2.9	3.3	2.1	1.2	1.1	0.5
Percent of GDP	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Percent of quota	4.0	4.0	9.8	14.2	12.2	14.2	18.1	12.6	8.1	8.1	4.0
Outstanding Fund Credit											
SDR millions	74.1	71.3	64.5	54.5	46.0	36.0	23.2	14.3	8.6	2.9	0.0
Nepalese Rupee billions	8.8	8.8	8.2	7.1	6.1	4.8	3.1	1.9	1.1	0.4	0.0
Percent of government revenue	4.9	4.4	3.7	2.8	2.2	1.6	0.9	0.5	0.3	0.1	0.0
Percent of exports and remittances	2.5	2.2	1.8	1.4	1.1	0.8	0.5	0.3	0.1	0.0	0.0
Percent of debt service 2/	30.7	25.0	21.7	17.7	14.5	10.4	5.9	3.3	1.8	0.5	0.0
Percent of GDP	0.8	0.7	0.6	0.5	0.4	0.3	0.2	0.1	0.0	0.0	0.0
Percent of quota	104.0	100.0	90.5	76.5	64.5	50.5	32.5	20.0	12.0	4.0	0.0
Net use of Fund Credit (in millions of SDRs)	25.7	-2.9	-7.0	-10.2	-8.7	-10.1	-12.9	-9.0	-5.8	-5.7	-2.9
Disbursements	28.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments and repurchases	2.9	2.9	7.0	10.2	8.7	10.1	12.9	9.0	5.8	5.7	2.9
Memorandum items: (in billions of Nepalese Rupees)											
Nominal GDP	1116.1	1254.1	1380.2	1513.6	1664.7	1831.0	2018.7	2225.6	2453.8	2705.3	2982.6
Exports and Remittances	349.1	402.7	455.0	507.8	567.0	631.1	684.3	742.1	805.1	873.6	948.2
Government Revenue	179.8	200.7	223.6	248.0	275.2	304.7	336.9	372.6	412.0	455.6	503.7
Debt Service 2/	28.7	35.4	37.6	39.8	41.8	46.6	52.3	58.6	65.4	72.9	80.9

Sources: IMF staff estimates and projections.

1/ includes expected disbursement (SDR 28.52 million) under the requested RCF as of June 2010.

2/ Total debt service includes IMF repurchases and repayments.

ATTACHMENT I

Kathmandu, May 13, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Strauss-Kahn:

1. **Nepal is in the midst of a major political transition.** Following the comprehensive peace accord which ended the 10-year armed conflict in 2006 and Constituent Assembly elections in April 2008, the political parties remain focused on completing the peace process and the promulgation of the new constitution, after which general elections will be held. Despite the progress of the past several years, the political situation remains fragile and the government's ability to implement comprehensive structural reform is currently limited.

2. **The global crisis is having a delayed and substantial impact on our economy:**

- **Remittance deceleration.** Nepal is heavily dependent on remittances—constituting over 20 percent of GDP. Owing to the global crisis the outflow of Nepali workers abroad decreased by 12 percent during 2009. As a result of fewer Nepalis leaving to work abroad, the growth of remittances halved to 17 percent year-on-year in the first half of 2009/10 from an average of 34 percent in 2005–08.

- **Trade balance deterioration.** Exports have declined by 14 percent so far this fiscal year due to falling demand.[1] While exports to India have dropped by 6 percent, exports to other countries are down by 26 percent, reflecting the appreciation of the Indian rupee. At the same time, as imports continued to soar (by 46 percent) on the assumption that remittances growth would continue in line with previous years, the trade deficit has risen by 67 percent in the first half of 2009/10, reaching 28 percent of GDP. In sum, the 2009/10 current account is set to record a sizeable deficit of 2 percent of GDP, the first deficit since 1997/98.

- **Reserve drain.** These developments, combined with net capital outflows, have in just a few months reduced international reserves by US$ 400 million (13 percent) from their July 2009 peak to US$ 2.5 billion in March 2010. Reserves now cover only 5 months of imports compared to 6 months as recently as October 2009.

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[1] Nepal's fiscal year begins in mid-July.

3. **The impact of these shocks on Nepal's economy has been significant.**

- **Liquidity and financial sector.** The slowdown in remittance growth contributed to a financial sector liquidity squeeze, which drove up interest rates and exposed financial sector weaknesses. As reserves fell, some banks experienced liquidity stress as banks' credit-to-deposit ratios are high. The Nepal Rastra Bank's (NRB) liquidity injections have since lowered interbank interest rates and banks are reported to have reduced new loan disbursements. But, asset quality is likely to deteriorate in the coming months as roll-over and liquidity risks increase.

- **Economic activity.** Decelerating remittance growth, tightening liquidity conditions, and a poor monsoon suggest activity is weakening: real GDP in 2009/10 is projected to fall to less than 4 percent compared to 4¾ percent in 2008/09. This slowdown will make the government's efforts to accelerate economic growth and reduce poverty on a sustainable basis more difficult.

4. **The government of Nepal recognizes that the deteriorating external position and the financial sector require immediate attention.** The speed with which reserves have declined over the past months is worrisome. While we have capital controls in place, our open border and extensive trade links with India present challenges in enforcing these regulations. Against this background and financial sector vulnerabilities, we view a relatively high reserve coverage as essential. To address these challenges, we are committed to strong macroeconomic policies to safeguard external and financial sector stability.

Policies to Address Shocks

5. **The NRB has recently introduced measures to improve the provision of liquidity:**

- The terms for repo transactions were lengthened from 28 to 45 days—similar to measures taken in many other countries during the crisis;

- Commercial banks' call deposits can count towards meeting the statutory liquidity ratio; and

- A new refinancing facility to channel credit to the export, power and tourism sectors has been introduced.

We expect these measures to contribute to an easing of liquidity conditions in the coming months and promote credit provision to priority sectors, while overall liquidity conditions remain consistent with the peg.

6. **The NRB has taken measures to safeguard financial sector stability.** The rapid credit growth in recent years—fueled partly by remittance inflows—has created asset price

bubbles, particularly in the real estate and housing markets. To strengthen the health of the financial sector and financial stability, we have recently taken several prudential measures.

- **Licensing policy.** The NRB imposed a moratorium in December 2009 on new bank licenses while the policy is being reviewed. However, to promote the provision of financial services in rural areas, the moratorium has been lifted for microfinance institutions (class D) and eased for development banks (class B).

- **Lower single borrower limits**. Single borrowing limits will be lowered to 25 percent of capital by July 2010, with exceptions for some infrastructure projects such as hydropower, cable cars, and the planned fast track road linking Kathmandu with the Terai region.

- **Real estate limits.** Banks are required to lower exposure to real estate loans (and housing) to 25 (40) percent of total loans by end-2009/10. Both limits will be further lowered by 10 percentage points by end 2010/11 and by an additional 5 percentage points by end 2011/12. Loans above the limit will be penalized by provisioning requirements on the basis of a risk weight of 150 percent.

- **Loan-to-value limits**. Commercial banks loans cannot exceed 60 percent of fair market value of collateral or project.

- **Credit-to-deposit ratio limits**. Commercial banks credit-to-deposit ratios should not exceed 95 percent by end-2009/10, 85 percent by end-2010/11, and 80 percent by end-2011/12.

- **Facilitating bank restructuring**. The NRB has begun liquidation of Nepal Development Bank (NDB) and also completed the restructuring of the Nepal Bangladesh Bank.

- **Risk management.** The NRB has drafted risk management guidelines that will be issued to commercial banks by July 2010.

We recognize that some of these new prudential measures will be challenging for the commercial banks to meet. In this context, we reaffirm our commitment to enforcing existing regulations and developing bank-by-bank time bound actions plans if necessary.

7. **We remain fully committed to maintaining financial stability and support the current peg.** The peg to the Indian rupee has been and continues to be a key anchor for Nepal's economic stability. We have taken strong measures to stem the balance of payments deficit. The NRB recently raised margin requirements on gold and silver imports and introduced quantitative limits on gold and silver imports. The government has also raised tariffs on gold imports, and is considering measures to curb imports of consumption goods to safeguard foreign exchange resources for growth-enhancing imports of capital goods. In the

mid-term review of monetary policy, to protect the balance of payments position, the NRB also limited the availability of the passport foreign facility to twice a year and $2,000 per transaction. The NRB and the Government of Nepal will take additional measures as necessary. We are aware that maintaining quantitative limits on the availability of foreign exchange for leisure travel may give rise to an exchange restriction under Article VIII of the IMF's Articles. In this context, we commit to removing any restrictions that may arise from these measures by March 2011 as the balance of payments situation is expected to improve. Remittance growth is expected to recover in 2010 as the host countries of our workers recover and import growth should moderate over the coming year in response to recent measures and tighter liquidity conditions. However, we do not anticipate that remittances growth will recover to the levels prevailing before the crisis, and generating strong export growth in the near term will remain difficult. In a longer-term perspective, the widening productivity differential with India presents challenges but we anticipate that continued labor mobility to offset competitiveness losses. Once the peace process is concluded, we expect to advance structural reform to address the productivity gap.

8. **While the measures outlined above are important in the short term to support the balance of payments position, we are cognizant that liquidity provision needs to be consistent with the peg.** Against the background of a challenging external situation, monetary policy needs to remain tight and interest rates above those of India. While NRB liquidity provision through blanket repos has succeeded in normalizing interbank rates during the recent liquidity squeeze, going forward, individual banks' liquidity needs will be met through the Supplementary Liquidity Facility at penalty rates. For solvent banks without adequate collateral, the bank rate window will be used under heightened NRB oversight and conditionality. The modalities for accessing the bank rate window will be further clarified by July 2010 in our continuing effort to improve communication with banks and the public. The NRB remains committed to intervening insolvent banks, as demonstrated in the case of the Nepal Bangladesh Bank and the Nepal Development Bank.

9. **We are committed to strengthening financial sector supervision further to safeguard financial stability and enhance the NRB's capacity and credibility.** Before end-July 2010, the NRB will begin a thorough assessment of the health of the financial sector, including solvency and liquidity risks, through stress testing and special on-site inspections. In this area, we welcome the possibility of a Fund resident technical assistance advisor. To the extent shortcomings are identified, corrective action will be taken promptly and regulatory forbearance eschewed. Beginning in 2010/11, the NRB will also introduce penalties for pledging of promoters' shares by deducting them from bank capital, in line with international practice. We will also strive to improve the timeliness and accuracy of data compilation, in particular in the financial sector.

10. **Contingency planning will be enhanced.** With technical assistance from the World Bank, the NRB will develop a contingency plan in case financial sector stress breaks into a crisis. We will seek to expedite passage by the Constituent Assembly of the amended Bank

and Financial Institutions Act (BAFIA), which would strengthen the bank resolution framework.

11. **The bank licensing policy will remain restrictive and financial sector consolidation will be encouraged.** The NRB's supervisory capacity has not been developed in line with the rapid growth of the financial sector. Against this background, further licensing of commercial banks will remain very restrictive and the supervisory capacity of the NRB will be strengthened commensurate with the expansion of the financial sector. To ensure access to financial services in rural areas, the NRB will work with commercial banks and microfinance institutions to encourage provision of services through mobile banking and agent banking, without additional banks entering the financial system. We will also promote banking sector consolidation by facilitating the public trading of promoters' shares by July 2010.

12. **We remain committed to reforming two state-owned banks.** Although progress has been made in strengthening the management of Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB), a comprehensive strategy is needed to bring the banks back to solvency. To build on the reforms to date, we will begin recapitalizing NBL in 2010/11 and continue our efforts to strengthen the management of both banks.

13. **The fiscal stance will remain prudent.** While the fiscal consolidation over the past years has created some fiscal space, the current external situation calls for a continued cautious fiscal stance to support the peg and maintain macroeconomic stability. We will keep domestic financing to around 2 percent of GDP in 2010/11 and increase it moderately to around 2½ percent in 2011/12 provided the external situation improves. In addition,

- On revenue administration, we will continue to build on the recent improvements to increase the revenue-to-GDP ratio. We have developed a comprehensive reform strategy for the customs department, measures to curb tax evasion, broaden the tax base, and improving the audit function of the large tax payer office, with the help of Fund technical assistance.

- We are committed to easing capacity constrains in capital spending. Recurrent spending will be restrained, while health, education and security expenditure will be safeguarded.

- We also intend to improve the coverage of the financial information, the accounting system, monitoring expenditure, and systems to coordinate donor activity.

- We will ensure that the financial health of the Nepal Oil Corporation (NOC) is safeguarded and we will continue our strategy of incremental price adjustments as needed to avoid losses of the NOC.

Request for Access under the Rapid Credit Facility

14. **Despite these measures, the pressure on the NRB's international reserves and the financial sector is expected to continue in the near term.** Against this background, the Government of Nepal requests access of 40 percent of quota (SDR 28.52 million) through the Rapid Credit Facility based on the urgent balance of payment needs and the strength of our macroeconomic adjustment polices. Access at this level is motivated based on the need to safeguard reserve adequacy and maintain confidence in the face of significant external and financial sector risks. In addition to our commitments above, to benchmark our progress, we are committed to meeting a set of Indicative Targets for end-2009/10, including the NRB's net international reserves and net domestic assets, and the government's net domestic financing (Table 1). We also expect that Fund financial support will serve as a bridge to an Extended Credit Facility, which we hope to start negotiating later this year.

15. **The RCF will also provide policy support for our poverty reduction strategy.** Our current Plan/Poverty Reduction Strategy Paper objectives include macroeconomic stability, institution building and structural reforms to raise growth and reduce poverty. We expect Fund financial support and our policy commitments under the RCF to have a catalytic effect on confidence, helping to catalyze international donor support and strengthen macroeconomic stability. An interim poverty reduction plan covering the period mid-2007 to mid-2010 is currently in place. Moving forward, a three-year plan covering mid-2010 to mid-2013 with special focus on employment and equity is being formulated in consultation with stakeholders.

16. **We are committed to completing a safeguards assessment.** In this context, we are liaising with Fund staff to conduct an external audit for the NRB in accordance with international standards, and authorize Fund staff to have access to the external audit reports and hold discussion with the auditors.

17. **The Government of Nepal and the NRB agree to publish this letter.**

Sincerely yours,

/s/	/s/
Surendra Pandey	Yuba Raj Khatiwada
Minister of Finance	Governor, Nepal Rastra Bank

Nepal: Indicative Targets

		Jul-09	Mar-10	Jul-10
		Actual	Actual	Indicative targets
I.	Floor on net international reserves of the NRB (in millions of US dollars) 1/	2792	2581	2,400
II.	Ceiling on net domestic assets of the NRB (in millions of Nrs.) 2/	-23,179	14,517	15,500
III.	Net dometic financing of the budget deficit (ceiling on cumulative flow from beginning of FY, in million Nrs) 3/	23,174	-9,194	23,500
IV.	Ceiling on contracting or guaranteeing of new nonconcessional external debt(in millions of US dollars) 4/	0	0	0
V.	Ceiling on accumulation of external payments arrears (in millions of US dollars) 5/	0	0	0

1/ Net international reserves of the Nepal Rastra Bank (NRB) will be calculated as gross international reserves including holdings of nonconvertible currencies less international reserve liabilities. Holdings of Indian rupees will be converted into U.S. dollars at the program exchange rate of 45 Indian rupees per U.S. dollar; holdings of other nonconvertible currencies will be converted into U.S. dollars at market exchange rates. Assets denominated in SDRs will be converted at the program exchange rate of 1.57 U.S. dollars per SDR. Gross international reserves consist of monetary gold holdings of the NRB, holdings of SDRs, Nepal's reserve position in the IMF, cash in foreign currencies, and foreign currency assets held abroad that are under the direct and effective control of the NRB and readily available. International reserve liabilities consist of all outstanding liabilities of Nepal to the IMF and any convertible currency liabilities to nonresidents with an original maturity of up to one year.

2/ Net domestic assets of the NRB will be calculated as the difference between domestic assets and liabilities of the NRB. Domestic assets consist of claims by the NRB on the government, state-owned enterprises, financial institutions, banks, the private sector and other assets as reported in the NRB's balance sheet. Domestic liabilities consist of government deposits, capital accounts, and other liabilities as reported in the NRB's balance sheet.

3/ Net domestic financing of the budget deficit is defined as the sum of net credit to government by the banking system (NRB and deposit money banks), net changes in holdings of treasury bills and other government securities by nonbanks, and privatization receipts by the government.

4/ The definition of debt, for the purposes of the program, is set out in Executive Board Decision N. 12274, Point 9, as revised on August 24, 2000.

5/ The indicative target on nonaccumulation of external arrears is continuous.

INTERNATIONAL MONETARY FUND

NEPAL

Staff Report for the 2010 Article IV Consultation and Request for Disbursement Under the Rapid Credit Facility

Informational Annex

Prepared by the Asia and Pacific Department
(in consultation with other departments)

May 17, 2010

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APPENDIX I: NEPAL—FUND RELATIONS
(As of February 28, 2010)

I. Membership Status: Joined 9/06/61; Article VIII, Sections 2, 3, and 4 on May 30, 1994.

II. General Resources Account:	**SDR Million**	**Percent Quota**
Quota	71.30	100.00
Fund holdings of currency	71.30	99.99
Reserve position in Fund	0.01	0.02

III. SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	68.10	100.00
Holdings	63.71	93.56

IV. Outstanding Purchases and Loans:	**SDR Million**	**Percent Quota**
ECF arrangements	48.47	67.99

V. Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
ECF	11/19/03	11/18/07	49.90	49.90
ECF	10/05/92	10/04/95	33.57	16.79
SAF	10/14/87	10/13/90	26.11	26.11

VI. Projected Obligations to Fund (in millions of SDRs; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2010	2011	2012	2013	2014
Principal	2.85	2.85	6.77	9.98	8.55
Charges/interest	0.02	0.02	0.12	0.10	0.07
Total	2.87	2.87	6.89	10.08	8.63

VII. Exchange Rate Arrangement

In February 1993, Nepal unified its exchange rate and eliminated the multiple currency practice associated with the previous dual exchange rate arrangement. In October 1997, the exchange arrangement of Nepal was reclassified as that pegged to a single currency unit from pegged to a currency composite. The Nepalese rupee is pegged to the Indian rupee at a rate of 1.6. Currently, all merchandise imports (except for a few goods restricted for security or related reasons) are freely available through an open general license system, with foreign exchange provided through the banking system at the market exchange rate. Nepal maintains an exchange restriction subject to Article VIII of the Fund's Articles arises from quantitative limits on the availability of foreign exchange for leisure travel abroad since the NRB's approval is not freely given in cases in which a resident requires foreign exchange for the purpose of making a bona fide payment for such transactions. In Nepal, residents use a foreign exchange facility called the Passport Facility to obtain foreign exchange in respect of leisure travels. The facility, which is run by authorized banks and financial institutions, has a monetary limit of $2,000 and cannot be used for more than two times per year. The monetary limit is further reduced to $1,000 for travelers to Tibet of China and SAARC countries (excluding India), if they travel by land. Foreign exchange applicants may go to the NRB to obtain additional foreign exchange but the current policy of the NRB is not to provide foreign exchange beyond these limits even if the bona fide nature of the request is proved. As of February 26, 2010, the exchange rate for the Nepalese rupee (Nr) was US$1=Nrs. 74.15.

VIII. Safeguards Assessments

A safeguards assessment of the Nepal Rastra Bank (NRB) was completed in 2002. The assessment concluded that substantial risks exist in the area of external and internal audits, and the internal control system of the NRB. A safeguards monitoring assessment was completed in October 2004. Staff findings and recommendations were reported in IMF Country Report No. 02/205. The NRB has made limited progress in the implementation of these recommendations, particularly with respect to the use of international standards in financial reporting and external audit and strengthening of internal controls in the NRB. The absence of external audit of the Nepal Rastra Bank in accordance with international standards is a key safeguards risk.

IX. 2008 Article IV Consultation

The Executive Board discussed the staff report for the 2008 Article IV consultation (IMF Country Report No. 08/181) on May 16, 2008. It was proposed that the Article IV consultations take place on the 12-month cycle.

X. Technical Assistance Since 2001

	Purpose	**Year**
MCM	Accounting	2004–06
	Central bank and banking reform	2001–02
	Internal Audit	2004–07
	Monetary policy	2003
	Monetary operations	continuous
	Strengthening central bank accounting and controls	2005
	Foreign exchange reserves management	2003–07
	Financial Sector Supervision	2006–07
	Liquidity management	2003
FAD	Implementation of a large tax payer unit	2003
	Review of tax policy and VAT administration	2003
	Tax and customs administration reform	2003–04, 2006–10

	Follow up on the LTO and customs administration reform	2004, 2006–07, 2010
	Tax/customs policy (fiscal reform)	2003, 2007
	Revenue Administration	2007, 2009
	Fiscal Transparency Legislation	2007
	Peripatetic LTU Advisor	2007–08
	Treasury Single Account	2008–09
	Capacity Building Workshop	2009–10
LEG	Redrafting of income tax laws	2000–01, 2007
	Income Tax Act	2003
	Banking Law	2004–05
	Fiscal Law	2007
	Fiscal Transparency	2007
STA	Multisector statistics	2001, 2003, 2008–09
	Balance of payments statistics	2002–04
	Producer prices statistics	2002–05
	Monetary statistics	2003
	National accounts	2003, 2005–06, 2008

XI. Resident Representative/Advisor

Mr. Alexander Pitt has been the Resident Representative since August 2006.

ANNEX II. NEPAL—RELATIONS WITH THE WORLD BANK GROUP

(As of March 3, 2010)

I. PARTNERSHIP IN NEPAL'S DEVELOPMENT STRATEGY

Nepal's decade-long conflict formally ended in November 2006. In 2008, the country voted in a Constituent Assembly (CA), named a President, elected a Prime Minister, formed a coalition government, and set about the task of writing a new constitution by 2010, with a new round of elections planned for 2011. It also abolished the monarchy and declared Nepal a federal democratic republic, vastly altering administrative and decision-making powers. The current Prime Minister has been leading Nepal's coalition government since May 2009. He has set himself two top priorities – delivering the new constitution and completing the peace process.

The key challenges facing a new Government at this juncture are to rebuild the legitimacy of the state, sustain the peace, maintain law and order, and deliver benefits to those traditionally excluded and to society at large. The National Planning Commission is preparing a new Three Year Plan. The central focus of the Plan is on employment creation, with a short run emphasis on public works programs (based on labor intensive infrastructure projects) until the investment climate improves and private sector investment takes over in creating sustainable jobs.

Thirty-eight donors operate in Nepal. The challenge for donors is to transition from scattered donor projects and programs outside Government to harmonized delivery through Government systems and institutions. However, Government needs to strengthen its capacity to manage resources efficiently with greater focus on results.

II. IMF-WORLD BANK COLLABORATION IN SPECIFIC AREAS

A. Areas in which the Bank Leads and There is No Direct IMF Involvement

The areas in which the Bank leads the policy dialogue and there is no direct IMF involvement are the social sectors, infrastructure, environment, and agriculture.

In ***education***, the Bank has encouraged Nepal's decentralization efforts to achieve more effective delivery of public services and has played a pivotal role in supporting the transfer of public schools to community management. Along with other donors, the Bank is actively supporting Nepal's well-formulated, ten-year primary education reform program. IDA resources support the ***Education for All (EFA)*** project, which closed recently, and the ongoing ***School Sector Reform Project (SSRP)***. The EFA Sector Wide Approach (SWAp) pooled together the government and donor funds, which financed over ninety percent of the expenditures of the primary education sub-sector. The SSRP builds on EFA and brings together GON and 12 development partners – of which 9 partners pool their resources with those of the GON, and 3 development partners who support the program directly. The ***Higher Education Project*** supports improving quality and relevance of higher education and research through a set of incentives for promoting effective management and financial sustainability of academic institutions, and improving access for academically qualified under-privileged students, including girls, dalits and educationally disadvantaged janajati to higher education through financial assistance and enhanced capacity of higher education schools.

In ***health***, the Bank has been supporting the devolution of sub-health posts to local communities, and the development of a sector-wide reform strategy. A ***Health Sector Reform Project*** seeks to address inequities and improve the health of the Nepalese as a means to develop healthy and capable human power to support poverty alleviation. The project seeks to expand access to, and increase the use of, essential health care services, especially by underserved populations. To support both human health and animal health, an ***Avian Influenza Control Project*** is under implementation.

To support broad-based growth, the Bank supports investments in several key ***infrastructure*** sectors. The ***Power Development Project*** (PDP) is helping to develop the country's hydropower potential to meet electricity demand, improve access of rural areas to electricity services and promote private sector participation. The ***Road Sector Development Project*** provides all-season road access in select hill districts. The recently closed ***Telecommunications Sector Reform Project*** supported sectoral policy reforms in addition to the provision of greater rural access to telecommunications services through the introduction of a private operator.

To support ***rural development***, the ***Nepal Irrigation and Water Resources Management Project*** aims to improve irrigated agriculture productivity and management of selected irrigation schemes, and enhance institutional capacity for integrated water resources management. At the same time, project finance is supporting decentralization to improve service delivery by promoting grassroots-driven, bottom-up planning and community-based management. The ***Rural Access Improvement and Decentralization Project*** (RAIDP) helps to improve governance and service delivery for rural infrastructure, while at the same time promoting agricultural and rural economic growth, and generating employment through direct project investments in rural transport infrastructure. The ***Rural Water Supply and Sanitation Project*** aims to improve rural water supply and sanitation sector institutional performance and mainstream the "Board" (Rural Water Supply and Sanitation Fund Development Board) approach into the Government's system. It also supports communities to form inclusive local water supply and sanitation user groups that can plan, implement, and operation drinking water and sanitation infrastructure that delivers sustainable health, hygiene, and productivity benefits to rural households.

After a long gap, the Bank re-engaged in the agriculture sector through the recently approved ***Agriculture Commercialization and Trade Project***. It aims to improve the competitiveness of smallholder farmers and the agribusiness sector in selected commodity value chains and 25 districts supported by the project. To address the food insecurity issues, a ***Social Safety Net Project*** is under implementation. It addresses the short and medium term implications of the global food crisis for the country by strengthening the agricultural production and safety net mechanisms on a broad scale. The objective is to ensure access to food and basic needs for vulnerable households in the short term in food insecure districts.

Recognizing that Nepal's development agenda is closely intertwined with peace building, a ***Peace Support Project*** is under implementation. The project aims to contribute to the peace process by providing interim cash transfers and services to conflict-affected groups.

While many of the Bank's investment/sector operations mentioned above also support ***social inclusion***, a more direct initiative in this area that received Bank support is the ***Poverty Alleviation Fund (PAF)***. PAF channels resources to the poorest groups in rural communities by creating infrastructure, employment and income-generating opportunities. Bank financing through the PAF project supports implementation of the fund in 75 districts.

B. Areas in which the Bank Leads and its Analysis Serves as Input into the IMF Program

The Bank takes the lead in assisting Nepal with ***public expenditure analysis***. A new PER is underway to be delivered in FY10 focusing specifically in education and health sectors. In addition, the Bank's intensive dialogue and technical assistance have been supporting the reforms, including the development of a credible Medium Term Expenditure Framework (MTEF) since 2002. This framework covers the whole budget but more specifically to prioritize public expenditure to ensure efficient budget allocations for priority programs and projects.

C. Areas of Shared Responsibility

The Bank and the IMF—together with other external development partners—provided assistance during the preparation of the PRS and the subsequent PRS Progress Reports. In addressing the PRS pillar on good governance, the Bank and the IMF are assisting in the area of civil service reform through policy dialogue and TA towards ensuring an autonomous and professional civil service as well as fiscal sustainability.

Financial sector reform is a fundamental area for Bank/IMF involvement. Since the mismanagement of key financial institutions was a major element of poor governance, progress in implementing financial sector reform has been the litmus test of political commitment to governance reform. The Bank and the Fund are helping the GoN resolve the current vulnerability in the financial sector by assisting them with stress testing and strengthening the NRB's capacity to prepare various scenarios and contingency planning. The Bank and the IMF are helping to strengthen the central bank's authority and regulatory capacity, improve the financial health and restructure of the two largest state banks, and upgrade the legislative and institutional framework for the financial sector. The ***Financial Sector Technical Assistance*** project supports: (i) the restructuring and reengineering of the Central Bank; (ii) introduction of professional management teams into the two large ailing commercial banks (the first step toward eventual restructuring); (iii) capacity building towards enhanced credit information; and (iv) upgrading of staff training in financial institutions. The recently closed ***Financial Sector Restructuring*** project supported strengthening of the Central Bank and deepening the reform process within the two banks.

III. WORLD BANK GROUP STRATEGY AND LENDING OPERATIONS

In June 2009, an ***Interim Strategy Note (ISN)*** was presented to the Bank's Board of Directors. Given the transitional nature of Nepal's situation, with a new government, a new constitution being drafted and elections for the federal state expected in 2011, the Bank Group prepared an ISN covering FY10 and 11. This joint IDA-IFC strategy aims to leverage Bank and IFC resources and realize synergies. It builds on the areas which have shown to be robust and to modalities of implementation tailored to Nepalese traditions. Further, the Bank also took on board the lessons of working in countries in post-conflict situations: to be modest and to keep it simple. The strategy will improve IDA project's sensitivity to the root causes of the conflict and social tensions by adopting a "peace filter".

Supporting the overarching goal of promoting peace and development, the strategy is organized around three themes that emerged during consultations within the Bank Group and with the Government, donor partners, and civil society. The first theme addresses the cluster of challenges facing the State in adapting and constructing the systems, institutions, and capacities needed for the new Nepal. The second focuses on overcoming constraints and bottlenecks faced by the productive sector, especially in terms of productivity, connectivity and sustainability. The third theme concentrates on expanding and honing service delivery programs that can increase opportunities and well-being, especially for the poor and excluded. Social inclusion and promoting peace cut across all of these themes as a necessary foundation for the new Nepal. Within each of these themes, the strategy identifies specific areas where the Bank Group can make a difference, ranging from concessional IDA lending to the Government, engagement with the private sector through the IFC, advisory services, and support for regional initiatives.

The Lending Program: In FY10, IDA financing was approved for the School Sector Reform Project and the Rural Access Improvement and Decentralization Additional Financing Project for total new commitments of US$175 million. Two more projects are in the pipeline for FY10 – the Second Health and HIV/AIDS project and Social Safety Net Additional Financing project.

Bank Assistance Program in Nepal: The Nepal country portfolio includes 22 operations with a net commitment value of US$937 million, of which 14 are IDA funded projects (US$905 million) and 8 are Trust Funded operations (US$32 million). The table below shows the distribution of IDA/TF support according to the major ISN pillars, with 5 percent of funds contributing to state-building and the peace process, 42 percent to the building blocks for sustainable growth and 53 percent to improving service delivery, particularly at the community level. About 45 percent of our financial assistance involves community management at the local level.

Economic and Sector Work: In addition to the lending program, the Bank is also engaged in supporting a wide range of analytic work to deepen knowledge and underpin future policy decisions and to prepare an informed basis for project-related assistance. For example, the Bank team, with support from bilateral partners DFID and Denmark, is working closely with the Central Bureau of Statistics to carry out the next Living Standards Survey (NLSS 3) which will produce core data on poverty trends and access to service. Analysis of migration and remittances is also on-going, and study findings are expected to inform policy choices relating to job skills development, macro-economic management, and targeting of infrastructure and services. Support for MTEF and for assessing risks and opportunities for improving financial sector management and services has been provided in the past year, and analysis of international experience on specialized topics (such as fiscal decentralization) is being carried out at the request of the Constituent Assembly committees. Advice has been provided on ways to improve existing social protection systems, including targeting, and on the design of a national social protection framework.

A cluster of analytic exercises are underway related to adaptation of water resource management and river hydrology, climate change, and risk reduction related to earthquakes, floods, and glacial lake outbursts (the disaster risk work is being carried out jointly with other development partners). In the field of water resource management, the Bank water team has supported the establishment of a geographic information system (GIS) for WECS, development of river basin modeling, and capacity building for modeling within the GON, and the next analytic step is to update the master plans for the three major river basins in Nepal, taking an integrated basin management view. The climate change team, in collaboration with ADB, DFID, and the governments for Denmark and Norway, among others, has supported important national and regional collaboration last year in preparation for the Copenhagen Climate Change Conference.

Lastly, the Bank is also supporting several regional programs that involve and will benefit Nepal. The regional water initiative is working towards building the information base and national and regional coalitions that will be needed to take concerted action over the medium to long term to address the region's river management issues. The Global Tiger Initiative is bringing together the tiger range countries to protect the habitat of this severely endangered species and Nepal has agreed to host the regional secretariat that will focus on the illegal trade in tiger parts. The cross-border energy program comprises advisory services to assist in its financial assistance for hydropower and transmission line investments that could lay the basis for such trade. Work is now starting to operationalize assistance in this area.

Table II.1. IDA and Recipient-Executed Trust Funds

As of January 31, 2010

	Project Name	Board Date	Revised Closing Date	Net Comm ($m)	Disb to date ($m)
Pillar I: State-building					
	Peace Support Project	5/6/2008	6/30/2011	50.0	19.7
	Legal and Judicial Reforms (IDF)	8/22/2007	12/22/2010	0.41	0.3
	Strengthening Capacity of PPMO (IDF)	7/16/2008	4/1/2012	0.48	0.1
	Sub-total Pillar I			**50.9**	**20.1**
Pillar II: Sustainable Growth					
	Power Development	5/22/2003	12/31/2012	164.0	18.2
	Micro-hydro Project (TF)	6/30/2007	6/30/2016	1.96	0.0
	Rural Access Improve. & Decentrali	6/21/2005	12/31/2013	77.0	21.2
	Road Sector Development Project	12/6/2007	6/30/2012	42.6	21.3
	Irrig & Water Res Mgmt Proj	12/6/2007	6/30/2013	64.3	4.6
	Agr Commercialization & Trade	6/4/2009	6/30/2015	20.0	0.0
	NP Financial Sector TA	12/19/2002	12/31/2011	9.5	7.7
	NP Financial Sector TA (DFID)	7/1/2003	2/29/2012	10.7	8.0
	Sub-total Pillar II			**390.1**	**81.0**
Pillar III: Service Delivery					
	Rural Water Supply & Sanitation	6/1/2004	12/31/2010	52.3	26.7
	Biogas Support Program (CDCF)	8/1/2004	11/30/2015	7.00	0.8
	Biogas Support Program IV (DFID)	10/4/2007	10/31/2010	5.00	0.6
	Second Higher Education Project	2/22/2007	1/15/2014	60.0	5.5
	Targetted Secondary School Stipend (JSDF)	1/2/2009	7/2/2013	1.90	0.3
	School Sector Reform Program	9/22/2009	12/15/2014	130.0	0.0
	Nepal Health Sector Program Project	9/9/2004	7/15/2010	100.0	64.1
	Avian Flu	1/19/2007	7/31/2011	18.2	8.3
	NP Social Safety Net - Food Crisis	9/30/2008	9/30/2010	16.7	11.9
	NP Social Safety Net (GFC TF)	8/15/2008	3/31/2011	5.0	5.0
	PAF II	12/6/2007	9/30/2012	100.0	31.7
	Sub-total Pillar III			**496.1**	**154.9**
	Total Pillars I, II, and III			**937.1**	**256.0**

A. Activities of the International Finance Corporation (IFC) in Nepal

Investment Services: As of end January 2010, the IFC's outstanding balance portfolio in Nepal is US$31.3 million in two power generation projects, one airline, one tourism project, and three trade finance facilities. Given the political uncertainty and the state of transition Nepal is going through, opportunities for investments remain limited. However, IFC is considering new investments in hydropower, agri-business and the financial sector. In 2005, IFC launched the Global Trade Finance Program (GTFP), which offers confirming banks partial or full guarantees on issuing banks' payment risk. In FY07, IFC signed two Nepali Banks, Bank of Kathmandu and Nepal Industrial and Commercial Bank, to the GTFP (US$4 million each) and added Himalayan Bank in June 2009. One or two more banks are likely to be added to the GTFP this year. The IFC is also considering equity investments in commercial banks and microfinance institutions, and loans to agri-business and hydropower.

B. IFC Advisory Services

Privatization/Corporate Advisory Services: IFC's main delivery mechanism for technical assistance for small and medium enterprises (SMEs) in Nepal is through the South Asia Enterprise Development Facility (IFC-SEDF). This facility—funded by IFC in partnership with Norway and the United Kingdom — delivers TA programs to increase access for SMEs to financing and business development services, improve the business environment for SMEs and develop linkages with larger enterprises. IFC will also provide technical assistance to the poultry sector by strengthening the SMEs/ farmer linkages with large firm supply chains. On the infrastructure side, IFC has initiated discussions with the GoN on providing advisory services for a possible privatization/restructuring of Nepal Airlines, Kathmandu airport international terminal and Nepal Telecom.

Access to Finance: IFC-SEDF had signed a Partner Financial Institution MOU with three Banks - Himalayan Bank, NIC Bank and the Bank of Kathmandu in 2007 and hopes to sign at least one more MoU soon. The MOUs outline specific programs to assist the banks with institutional capacity building that will help enhance the quality of service to the bank's SME clients.

IFC is also helping strengthen the financial infrastructure through a Credit Bureau Strengthening Project aimed at making the newly privatized Credit Bureaus commercially viable and helping operationalize the Secured Transaction Registry. Future advisory work with banks will include developing energy efficiency lending programs, and agribusiness risk sharing financial instruments. IFC will also launch SME Venture Fund which will provide capital and technical assistance to SMEs in agriculture, tourism and other sectors in Nepal.

Investment Climate Advisory: Investment Climate Reform program builds on the FIAS-SEDF Investment Climate Mini Diagnostic (February-March 2007) which uncovered constraints to investment in terms of excessively rigid labor regulations, non-transparent and inconsistent tax administration, and inefficient licensing regimes. At the institutional level, the Study pointed out poor coordination among the agencies, as well as lack of PSD strategy and reform mechanisms. Finally, the Study recommended beginning broad reforms by establishing Special Economic Zones (SEZ) based on globally competitive legal and regulatory regime.

Over 2008 and 2009, the Nepal Investment Climate Reform Program (ICRP, phase I) has (i) raised awareness and support by the private sector associations and the relevant government ministries to creation of Public-Private Dialogue (PPD), a results-focused mechanism for identifying reforms and developing solutions; and further improved the draft SEZ framework which currently awaits for the Constituent Assembly approval. Finally, IFC has raised donor support to continue broad investment climate reforms in three key areas: (i) strengthening Public-Private Dialogue on investment climate issues, (ii) Regulatory Reforms to reduce the cost of doing business, and (iii) development of effective SEZ program catalyzing FDI and domestic investment.

The Next Steps Include:
On PPD, operationalizing the mechanism and put in place effective Secretariat and the Working Groups; on Regulatory Reforms, finalizing the scope of assistance and commence specific diagnostic of business procedures and processes prioritized for reforms; on SEZ, completing formulation of the regulatory regime following adoption of the SEZ Act, and continue building institutional capacity of the SEZ Authority.

Questions on IDA may be referred to Ms. Paralkar (458–9050) or on the IFC to Mr. Paul Barbour (473−7349).

ANNEX III. NEPAL—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Country Program

As of 31 December 2009, cumulative lending to Nepal was $2,972.150 million, comprising 117 sovereign loans ($2,422 million), 5 non sovereign loans ($50 million), and 16 ADF grants ($495.650 million). Sectors covered through AsDB loans and grants are agriculture and natural resources; education, energy, finance, public sector management (law, economic and public policy), transport and ICT, water supply and other municipal infrastructure and services and multisector. AsDB's total country program for Nepal in 2009 comprised a total of $163.5 million in grants and $172.8 million in concessional loans, including the Education Sector Cluster Program (subprogram. 3; loan: $25 million and grant: $70 million); Energy Access and Efficiency Improvement Project I (loan: $65 million); Air Transport Capacity Enhancement Project (loan: $70 million and grant: $10 million); Second Small Towns Water Supply and Sanitation Sector Project (grant: $45.1 million); Emergency Flood Damages Rehabilitation (grant: $25.6 million) and a national contribution to South Asia Tourism Infrastructure Development Project (loan: $12.75 million and grant: $12.75 million). The significant increase in the new commitment of loans and grants in 2009 was mainly due to ADB's crisis response which allocated an additional $400 million of ADF to ADB's poorest member countries, and additional ADF resources provided by the replenishment of ADF X.

Undisbursed funds of $717.03 million represent 63 percent of the total portfolio amount as of 31 December 2009.

Loans and Grants by the Asian Development Bank, 1969–2009

(As of 31 December 2009)

	1968–2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
	(In millions of U.S. dollars)									
Loans										
Agriculture and natural resources	656.23	0	0	20	70	0	0	0	0	0
Education	61.1	19.6	30	0	20	0	30	0	0	25
Energy	364.4	0	0	0	0	0	0	0	0	65
Finance	7.3	0	0	0	0	0	56	0	0	0
Industry and trade	129.18	0	0	0	0	0	0	0	0	0
Public sector management		30		35	0	0	0	0	0	0
Transport and ICT	236.86	46	0	0	20	0	0	0	0	70
Water supply and other municipal infrastructure and services	224	0	0	39	0	0	0	0	0	0
Multisector	127.06	0	30	0	0	0	0	0	0	0
Regional Cooperation										12.75
Total loans							86	0	0	172.8
Grants										
Agriculture and natural resources							18	0	0	0
Education							2	0	8	70
Finance							8.7	0	0	0
Public sector management							0	0	106.3	0
Transport and ICT							55.2	0	25	10
Water supply and other municipal infrastructure and services									0	45.1
Multisector								100	0	25.6
Regional Cooperation								9		12.75
Total grants							83.9	109	139.3	163.5
Total approved (loan and grant)	1,806.13	95.6	60	94	110	0	169.9	109	139.3	336.3
Gross disbursements	1,220.60	57.3	28.2	33.5	22	43.7	108.0	102.3	127.1	199.5
Technical Assistance										
Total approved	98.03	4.03	4.02	4.17	3.16	2.05	6.4	7.22	4.55	5.7
Gross disbursements	54.1	5	3.9	4.17	4.2	3.6	2.04	4.6	4.58	6.77

Technical Assistance

Since 1968, AsDB has provided Nepal with technical assistance in most sectors. As of 31 December 2009, ADB approved 288 technical assistance projects totaling $127.8 million. There are currently 39 ongoing TAs, including 5 Japan Fund for Poverty Reduction (JFPR) projects.

Private Sector Operations

Developing a strong and dynamic private sector is essential to the long-term economic growth of Nepal. AsDB aims to strengthen the role of the private sector in Nepal through prudent investments in its infrastructure sector. The AsDB's public sector lending and technical assistance program have also been helping Nepal to create a more conducive policy and legal environment for private sector development. At the end of 2009, cumulative approvals for 4 private sector projects in Nepal amounted to $58.64 million while ADB's outstanding exposure to non-sovereign projects totaled $8.8 million, representing 0.2% of ADB's total non-sovereign portfolio.

APPENDIX IV: NEPAL—STATISTICAL ISSUES

Economic and financial data are generally adequate for surveillance, with scope for improvement, in particular in the timeliness and coverage of fiscal data, and in balance of payments compilation of remittances, and official and private financial flows. Nepal provides core data to the Fund and releases data in government and central bank publications. It has been a participant in the General Data Dissemination System (GDDS) since May 2001. Metadata were initially posted on the Dissemination Standards Bulletin Board in May 2001 and last updated in January 2009. A multisector statistics mission visited Kathmandu in January 2001.

Real Sector Statistics

The Central Bureau of Statistics (CBS) compiles **national accounts** using the methodology of the *1993 SNA*. Key estimates include GDP by industry (in current and constant prices) and by expenditure categories (current prices), and gross national income and savings. There are shortcomings due to lack of comprehensive and regular data sources. The limited source data suffer from inconsistencies, lags in availability, and insufficient detail. There are also shortcomings in record keeping by agencies, and access to records is not timely due to processing lags. Reflecting source data problems, compilation methods rely heavily on fixed ratios derived from surveys or ad hoc assumptions—for example, household consumption expenditure estimates are based on extrapolations of the 2003/04 benchmark living standard survey. STA missions in April 2005 and July 2006 provided support to the development of quarterly national accounts (QNA) and the rebasing of the annual national accounts to 2000/01 from 1994/95. These missions and other developments are within the context of a broader Asian Development Bank (AsDB) project aimed at strengthening the national accounts.

The **consumer price index** (CPI) offers limited coverage based on dated expenditure weights derived from a 1995/96 household expenditure survey. Coverage is limited to urban areas while the consumption basket refers to a subset of the population, excluding: the upper and lower two income deciles; single person households; households with more than eight persons; and households obtaining more than 50 percent of their consumption from own production or less than 50 percent of their income in cash. The national index aggregates regional indices using population weights rather than recommended expenditure weights.

The **wholesale price index** (WPI) was developed by the Nepal Rastra Bank (NRB) and first published in July 2001. The weights for the WPI, based on 1999/2000 data, are derived using a commodity flow approach with prices related to the first commercial transaction point. CBS compilation methods need improvement to implement weekly or bi-weekly price collection; the number of price quotations should be increased; and procedures for adjusting for quality differences require implementation. The CBS, with STA assistance, is developing a monthly **producer price index** (PPI) series, to replace the manufacturing price index, which is based on unit values rather than actual transaction prices. The PPI is expected to more accurately measure industrial sector inflation and improve deflation in the national accounts..

Government Finance Statistics

A revised **budget classification** system, introduced in 2004/05 and subsequently refined, has substantially improved fiscal statistics, in particular the division between current and capital spending. However, fiscal data by functional and economic classification are provided on an irregular basis with varying degrees of coverage. In addition, large amounts are still allocated to the contingency account, and monthly reporting of development spending excludes amounts directly paid by donors. Moreover, a number of fees collected outside the budget and the operations of local governments are not reported in the annual budget.

More timely data on **revenue and expenditure** are needed for effective fiscal control. A financial management project is underway and a system of 'flash' reporting covering selected districts that account for the bulk of expenditure is being developed. Further improvement of fiscal data collected by the Financial Comptroller General's Office would permit the Ministry of Finance (MoF) to monitor more effectively actual revenue collections and expenditures, and to provide assessments during the course of the fiscal year. Such improvements will require further computerization in MoF regional offices, as well as donor financing and additional TA.

Consolidated accounts for the **public enterprise sector** are not compiled on a regular basis, and financial reporting by many individual enterprises is subject to long delays. Fund staff has assisted the authorities in processing surveys of public enterprises.

Government finance statistics are regularly reported for publication in the *Government Finance Statistics Yearbook,* but not the *International Finance Statistics.*

Monetary and Financial Statistics

Monetary data provided to the Fund by the NRB have been subject to revisions with lags of up to 12 months, complicating program monitoring. Monetary and financial statistics are compiled under the methodology of the IMF's 1984 *Guide to Monetary and Financial Statistics*. To update the NRB's compilation methods to the framework of *Monetary and Financial Statistics Manual, 2000* (*MFSM*), a 2008 STA mission recommended to:

(i) include development banks and finance companies in the institutional coverage of monthly monetary statistics[1] and, based on this expanded coverage, compile a monthly *broad money/depository corporations survey*; (ii) adopt *center of economic interest* criteria for classifying residents and nonresidents and for distinguishing resident/nonresident positions of the financial institutions, instead of the currently used criteria based on citizenship and currency of denomination; (iii) adopt the principle of *effective control* for distinguishing between public and private nonfinancial corporations; (iv) ensure that the IMF-related accounts are fully reflected in the NRB's balance sheet in accordance with the IMF Finance Department's instructions; (v) value monetary gold, SDR holdings, securities, and holdings of shares/equities based on the end-period fair value/market price; (vi) incorporate accruals in the outstanding amount of financial asset or liability instead of maintaining them on separate accounts; (vii) monitor activities of other, smaller deposit-taking institutions (namely, Postal Savings Bank, Micro Credit Development Banks, Savings and Credit Cooperatives, Citizens' Investment Trust) and include them in the institutional coverage of *broad money/depository corporations survey* when their deposit-taking activities become more significant; (viii) use *Statement of Assets and Liabilities* (Form No. 1), instead of the more aggregated set of data currently used, as the basis for compiling monetary accounts for commercial banks, development banks and finance companies; and (ix) start regular monthly reporting of monetary data in the SRF format for the NRB (SRF-1SR) and other depository corporations (SRF-2SR) based on the compilation system agreed with the mission.

External Sector Statistics

The NRB compiles and disseminates balance of payments statistics in conformity with the fifth edition of the Balance of Payments Statistics Manuel (BPM5), but does not compile statistics on the international investment position. Nepal has benefited from five STA balance of payments missions since the multisector statistics mission of 2001. Staffing has been increased and in September 2003, the authorities began disseminating balance of payments in BPM5 format. Nevertheless, other STA recommendations have not yet been fully implemented and net errors and omissions remain large. Work is still underway to improve the estimation of workers' remittances and the source data for private capital flows, but further work is needed to improve the recording of oil transactions, grants, foreign direct investment, short-term inflows, and other private capital flows.

Trade data compiled separately by the NRB, the Customs Department, and the Trade Promotion Center (overseas trade only) exhibit discrepancies. Export and import price indices are not compiled.

[1] Data provided to the mission indicates that the ratio of deposits at development banks and finance companies relative to total deposits at deposit-taking institutions was approximately 13 percent at end-2006/2007.

Incomplete and conflicting data on government **external grants and loans** complicate the estimation of foreign financing. The NRB monitors cash disbursements and repayments, but most commodity aid and direct payment are excluded. MoF reporting is also incomplete and not timely. With technical assistance from the United Kingdom's DFID, a new database with comprehensive data on disbursements, repayments, and the stock of outstanding government debt has been developed and is currently being refined. However, reporting of direct external grants remains problematic.

Nepal—Table of Common Indicators Required for Surveillance

(As of March 25, 2010)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	Jan. 2010	Mar. 2010	D and M	W and M	D and M
International reserve assets and reserve liabilities of the Monetary Authorities[1]	Jan. 2010	Mar. 2010	W	W	M
Reserve/base money	Jan. 2010	Mar. 2010	M	M	M
Broad money	Jan. 2010	Mar. 2010	M	M	M
Central bank balance sheet	Jan. 2010	Mar. 2010	M	M	M
Consolidated balance sheet of the banking system	Jan. 2010	Mar. 2010	M	M	M
Interest rates[2]	Jan. 2010	Mar. 2010	W and M	W and M	W and M
Consumer price index	Feb. 2010	Mar. 2010	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Jan. 2010	Mar. 2010	W	W	W
Revenue, expenditure, balance and composition of financing[3] – central government	Jan. 2010	Mar. 2010	W	W	W
Stocks of central government and central government-guaranteed debt[5]	2008/09	Jan. 2010	A	A	A
External current account balance	Jan. 2010	Mar. 2010	M	M	M
Exports and imports of goods and services	Jan. 2010	Mar. 2010	M	M	M
GDP/GNP	2008	May 2009	A	A	A
Gross external debt	2008/09	Jan. 2010	A	A	A

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND

NEPAL

Joint IMF/World Bank Debt Sustainability Analysis

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

Approved by Kalpana Kochhar and Christian Mumssen (IMF)
and Ernesto May and Sudarshan Gooptu (World Bank)

May 14, 2010

Nepal remains at moderate risk of debt distress. The risk rating is assessed using the Low-Income Country Debt Sustainability Analysis (LIC-DSA) framework and remittances have been incorporated given their importance in the economy[1]*. Despite a better starting point compared to the previous DSA, the baseline is weaker due to a delayed impact of the global crisis, limited progress in addressing structural impediments, and financial sector vulnerabilities. In addition to standard stress tests, a financial stress scenario is generated to reflect financial vulnerabilities and the associated risks. Though debt dynamics are resilient to standard stress tests, debt indicators breach the thresholds for a sustained period under the financial stress scenario.*

The results highlight the need to contain risks arising from financial vulnerabilities. As a consequence, the fiscal stance should remain tight in the short run, but could be more accommodative in the medium term to support economic growth provided the financial vulnerabilities are addressed. Moreover, stronger and more stable growth, combined with foreign financing at favorable terms, would help Nepal make progress toward achieving its MDG targets while containing risks to debt sustainability.

I. Background

1. **Nepal's total public debt stock is estimated at 40 percent of GDP at end 2008/09 (in nominal terms), having declined from 64 percent of GDP in 2001/02**. In 2008/09, external public debt was US$3.4 billion (27 percent of GDP), of which about US$3.1 billion was owed to multilateral institutions, mostly IDA and the AsDB. The bilateral debt stock is estimated at US$ 0.3 billion, with Japan representing the largest creditor accounting for about three quarters. Domestic debt stood at around 13 percent of GDP, 4 percentage points lower than in 2001/02.

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[1] The debt sustainability analysis is prepared together with the World Bank.

II. Macroeconomic Assumptions

2. **Baseline projections of public and publicly guaranteed debt (PPG) are based on the following key assumptions:**

- Real sector: Real GDP growth is projected to decline to 3 percent in 2009/10, pick up gradually to 4¾ percent over the medium term, and reach 5½ percent in the long run. The projections are weaker than those in the previous DSA on account of a delayed impact of the global crisis, limited progress in addressing structural impediments to growth, and financial sector vulnerabilities. Removing or alleviating these obstacles will require time but could set Nepal on a higher growth path. Inflation is assumed to be about 12 percent in 2009/10 and gradually decline to 5 percent over the medium term, in line with India's inflation projection and anticipating somewhat higher inflation in non-tradables as a result of remittances inflows. The exchange rate is assumed to remain pegged to the Indian rupee at the current level over the projection period.

- Fiscal sector: The revenue-to-GDP ratio is projected to rise gradually from 14½ percent in 2008/09 to 17 percent in 2020/21 as there is still room for revenue administration gains, stabilizing at that level thereafter. Official grants are projected to decline gradually from 4 percent of GDP in 2008/09 to 3 percent in 2014/15 as international assistance for the peace process unwinds. Expenditure as a share of GDP is projected to rise from 19¾ percent in 2008/09 to around 23½ percent in the medium term and beyond due to sound revenue performance and the need to improve capital spending. As a result, the overall fiscal deficit (including grants) is projected to rise gradually from 1½ percent of GDP in 2008/09 to 3½ percent of GDP in the medium term, consistent with stability in the public debt-to-GDP ratio. Net domestic financing is projected to increase from 1¾ percent of GDP in 2008/09 to about 2½ by 2014/15, stabilizing at that level thereafter.

- External sector: Exports of goods and services are projected to grow at an average of about 7 percent over the projection period supported by tourism and growth in partner countries. After growing by over 30 percent annually in the past few years, remittances are projected to slow and grow by an annual average of 12 percent over the medium term, and by about 8 percent thereafter[2]. Imports of goods and services are expected to grow by an average of about 8 percent over the projection period in

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[2] The projection of remittances is based on empirical study by IMF staff, which shows that the key determinants of remittances are non-oil GDP growth of GCC countries and stock of migrant workers. Please refer to "Remittances in South Asia and the Philippines: Determinants and Outlook", Almekinders and Abenoja (2009). In practice, however, additional factors such as host country immigration policy and migrants' confidence in Nepal's economy might also matter.

line with economic activity and remittances. As a consequence, the current account balance is projected to shift from a small surplus in previous years to a deficit of 2 percent of GDP in 2009/10, and gradually move close to balance in the long run.

- Financial sector: The financial sector has overextended itself in recent years in an environment of loose monetary policy, weak supervision, and proliferation of financial institutions. Rapid credit growth has fueled asset price booms, rendering the banking system subject to significant credit and liquidity risks. Moreover, two state-controlled banks, accounting for one fifth of the system, are operating with significant negative capital. Stress tests combined with costs of financial crises in other countries suggest that contingent liabilities of a financial sector restructuring in Nepal could be in the order of 8–12 percent of GDP.[3]

- In sum, macroeconomic assumptions are weaker compared to the previous DSA, mainly due to a delayed impact of the global crisis, heightened banking sector weaknesses, and persistent structural impediments. Over the projection period, average GDP growth is projected at 5 percent compared to 5½ in the previous DSA. Average export growth is projected at 7 percent compared to 8 percent in the last DSA, while average import growth is expected to remain close to the estimated 8 percent in the last DSA.

- Consistent with the previous DSA, the grant element of new borrowing is projected to decline gradually as Nepal begins to develop its hydropower potential partly with commercial lenders, and new non-traditional donors increase assistance.

III. External Debt Sustainability

A. Baseline

3. **Remittances are formally included in the DSA**. In the previous DSA, remittances were not included in the estimate of the indicative thresholds. However, workers' remittances in Nepal[4] are relatively large in comparison to exports or GDP—equivalent to over 21 percent of GDP or three times the exports in 2008/09—and constitute a relatively stable source of foreign exchange inflows. Therefore, in line with recent guidelines[5], remittances are added to exports and GDP as denominators in the calculation of debt burden ratios.

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[3] See Selected Issues Paper, *An Analysis of Systemic Risks in Nepal's Banking Sector in the Wake of the Global Crisis.*

[4] Nepal is classified as a medium performer based on its three year average CPIA score during 2007–2009.

[5] In reference to "Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries" by the International Development Association and International Monetary Fund.

4. **Under the baseline, Nepal's external debt indicators are well below the indicative thresholds[6] (Table 3b and Figure 1)**. Long-term projections indicate that most ratios are set to improve: the PV of external public debt-to-GDP-and-remittances is projected to decline from 16 percent to 8 percent by 2029/30; the PV of external public debt-to-revenue is projected to fall from 119 percent to 57 percent; and PV of external public debt-to-exports-and-remittances ratio is projected to decline from 63 percent to 41 percent.

Nepal: Indicative External Debt Burden Indicators

	Indicative Thresholds	Nepal: 2009/10	Nepal: Projected average 2009/10-2029/30
NPV of debt, in percent of			
exports and remittances	135.0	63.3	41.3
GDP and remittances	36.0	16.0	10.3
revenue	250.0	119.4	74.8
Debt service, in percent of			
exports and remittances	18.0	4.3	2.7
revenues	30.0	8.2	4.9

B. Stress Test and Alternative Scenario

5. **The DSA is resilient to standard stress tests**. The standard shocks include slower GDP growth, softer remittances and exports, lower US dollar GDP deflator and a one-time exchange rate depreciation.[6] Bound tests indicate that debt indicators do not breach the thresholds except that the PV of debt-to-export-and-remittance ratio exceed the threshold for one year only.

6. **The standard stress tests, however, do not capture Nepal's structural weaknesses, in particular the financial vulnerabilities and the associated risks and the country's dependence on remittances**. Weaker remittances inflows could trigger balance of payments shocks, expose banking sector weaknesses, impede growth, and exert pressures on the exchange rate. Hence, an alternative scenario that combines a slowdown in remittances and GDP growth, a 30 percent one-time exchange rate depreciation, and the potential cost of financial sector restructuring is also presented.[7] The potential net fiscal costs of a financial restructuring is estimated to be 8–12 percent of GDP. Under this scenario, the PV of debt-to-

[6] The LIC-DSA framework compares debt burden indicators to indicative policy-based thresholds. The thresholds are based on the empirical finding that low-income countries with stronger policies and institutions tend to have a higher debt carrying capacity.

GDP-and-remittances ratio increases significantly, peaking at 47 percent in 2011/12 and staying above the threshold for seven consecutive years (Figure 1); the PV of debt-to-revenue ratio would breach the threshold for nine years, and PV of debt-to-exports-and-remittances for four years. Under this country-specific scenario, the liquidity indicators, such as debt service-to-revenue and debt-service-to-exports-and-remittances, remain below the thresholds.

IV. PUBLIC DEBT SUSTAINABILITY

7. **Under the baseline scenario, the PV of public debt-to-GDP ratio declines slightly from 33 percent in 2009/10 to 31 percent by 2029/30 (Table 2a, Figure 2).** Over the same period, the PV of public debt-to-revenue ratio declines from 165 percent to 156 percent, and the public debt service-to-revenue ratio declines from 12¾ percent to 12¼ percent. Unlike the previous DSA that indicated further declines of these ratios, the current DSA expects them to generally stabilize as the debt level has declined and fiscal space has been created, which could accommodate a higher deficit. There is also room for a shift in the composition of public debt towards more domestic debt because of a fairly large financial sector and partially captive domestic market. The domestic component of public debt is projected to increase from 40 percent of the total in 2009/10 to 61 percent in 2029/30.

8. **Stress tests suggest vulnerabilities to shocks**. A shock modeled as real GDP growth at historical average minus one standard deviation in 2011–12 causes the PV of debt-to-GDP ratio to increase from 32½ percent in 2009/10 to 38¼ percent in 2029/30; the PV of debt-to-revenues ratio increases from 165 to 190½ percent; and the debt service-to-revenue ratio increases from 12¾ percent to 19½ percent. The most extreme stress test in the medium-term is a 10 percent of GDP increase in other debt-creating flows in 2011, which causes the PV of debt-to-GDP ratio to peak at 41½ percent in 2011 and stand at 37¾ percent in 2020, and the PV of debt-to-revenue ratio to peak at 207¾ percent in 2011 and stand at 190¼ percent in 2020.

V. AUTHORITIES' VIEW

9. **The authorities concurred with the overall assessment.** They pointed out that the inclusion of remittances in the analysis was highly appropriate given the important role they play in the economy. They acknowledged the vulnerabilities of the financial sector, and the associated risks to debt sustainability.

[7] The shocks to GDP growth and current transfers are equivalent to the historical average minus one standard deviation in 2011/12. The shock to exchange rate is a one-time 30 percent nominal depreciation in 2011/12.

VI. Conclusion

10. **Nepal's external debt dynamics are subject to a moderate risk of distress**. While with remittances formally included in the analysis, the baseline scenario is more favorable than previously and debt burden indicators are well below the indicative thresholds, heighted financial sector vulnerabilities and the potential fiscal costs of financial sector restructuring add considerable risks. Both the baseline scenario and standard stress tests indicate resilient debt dynamics in which debt indicators do not breach the thresholds on a sustained basis, but they are likely to underestimate debt distress as the financial sector vulnerabilities and associated risks are not captured.

11. **A country-specific scenario reflecting possible financial stress indicates sustained breach of the indicative debt thresholds.** The results highlight the weakness in debt dynamics associated with financial vulnerabilities, which, if they were to materialize, could bring about significant distress. As a consequence, Nepal's fiscal policy stance should remain tight in the short run, but could be more accommodative in the medium term to support economic growth while maintaining sound debt dynamics provided financial sector vulnerabilities are addressed. Moreover, stronger and more stable GDP growth combined with foreign financing at favorable terms—preferably through grants—would help Nepal make progress toward achieving its MDG targets while containing risks to debt sustainability.

12. **A Fund-supported program may help reduce macroeconomic and financial vulnerabilities and the ensuing threats to debt dynamics.** The authorities have requested Fund financial support under the Rapid Credit Facility to support reserves as they implement policies to strengthen the financial sector and mitigate risks arising from the deceleration of remittance inflows. Such policies would reduce the risk of the alternative financial stress scenario materializing and thereby reduce threats to debt dynamics. Disbursement of Fund resources of SDR 28.5million (($43.1 million) would have little impact on the baseline scenario.

Table 1a.Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2007-2030
(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2007	2008	2009	Average	Standard Deviation	2010	2011	2012	2013	2014	2015	2010-15 Average	2020	2030	2016-30 Average
Public sector debt 1/	43.4	40.3	40.3			37.4	36.1	35.7	35.5	35.4	35.7		36.1	35.2	
o/w foreign-currency denominated	30.2	27.4	27.0			23.8	21.7	20.3	19.2	18.2	17.4		14.8	13.8	
Change in public sector debt	-6.6	-3.1	0.0			-2.9	-1.3	-0.4	-0.2	-0.1	0.2		0.0	0.1	
Identified debt-creating flows	-7.0	-1.2	-3.2			-2.6	-0.4	0.1	0.2	0.3	0.5		0.0	0.0	
Primary deficit	0.9	1.3	-0.6	0.7	1.2	1.6	1.4	1.6	1.8	2.0	2.3	1.8	2.1	2.2	2.1
Revenue and grants	14.0	15.3	16.9			19.9	20.0	20.0	20.0	19.8	19.6		19.9	20.0	
of which: grants	2.2	2.5	2.5			3.8	4.0	3.8	3.6	3.3	3.0		3.0	3.0	
Primary (noninterest) expenditure	14.9	16.6	16.3			21.5	21.4	21.6	21.8	21.9	22.0		22.0	22.2	
Automatic debt dynamics	-7.9	-2.5	-2.6			-4.2	-1.9	-1.5	-1.6	-1.8	-1.8		-2.0	-2.1	
Contribution from interest rate/growth differential	-2.7	-3.0	-3.0			-2.0	-1.4	-1.2	-1.3	-1.6	-1.6		-1.6	-1.7	
of which: contribution from average real interest rate	-1.0	-0.8	-1.2			-0.9	0.0	0.3	0.2	0.0	0.0		0.1	0.1	
of which: contribution from real GDP growth	-1.6	-2.2	-1.8			-1.2	-1.5	-1.5	-1.5	-1.6	-1.6		-1.7	-1.8	
Contribution from real exchange rate depreciation	-5.2	0.5	0.3			-2.2	-0.5	-0.4	-0.2	-0.2	-0.2		...	...	
Other identified debt-creating flows	0.0	0.0	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)	0.0	0.0	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	0.3	-1.9	3.2			-0.2	-0.9	-0.5	-0.4	-0.4	-0.3		0.0	0.0	
Other Sustainability Indicators															
PV of public sector debt	…	…	35.0			32.9	32.5	32.4	32.5	32.5	32.8		32.4	31.1	
o/w foreign-currency denominated	…	…	21.8			19.2	18.1	17.1	16.2	15.3	14.5		11.2	9.7	
o/w external	...	...	21.8			19.2	18.1	17.1	16.2	15.3	14.5		11.2	9.7	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	4.6	4.1	2.2			4.1	4.3	4.4	4.5	4.7	5.0		4.7	4.6	
PV of public sector debt-to-revenue and grants ratio (in percent)	…	…	207.0			164.8	162.3	162.2	162.6	164.1	166.8		163.1	155.6	
PV of public sector debt-to-revenue ratio (in percent)	…	…	243.1			203.9	202.9	200.2	198.3	196.8	196.9		192.1	183.1	
o/w external 3/	…	…	150.9			119.4	113.2	105.6	98.9	92.7	87.2		66.3	56.9	
Debt service-to-revenue and grants ratio (in percent) 4/	26.5	18.4	16.2			12.8	14.2	14.0	13.6	13.2	13.6		13.2	12.2	
Debt service-to-revenue ratio (in percent) 4/	31.4	22.0	19.0			15.8	17.7	17.3	16.6	15.9	16.0		15.6	14.3	
Primary deficit that stabilizes the debt-to-GDP ratio	7.5	4.4	-0.5			4.4	2.8	2.0	1.9	2.1	2.1		2.0	2.1	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	3.3	5.3	4.7	4.1	1.7	3.0	4.0	4.2	4.4	4.7	4.8	4.2	5.0	5.5	5.3
Average nominal interest rate on forex debt (in percent)	1.3	1.2	1.1	1.3	0.1	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.2	1.2	1.2
Average real interest rate on domestic debt (in percent)	-2.8	-2.4	-7.3	-0.6	3.3	-6.2	0.8	2.2	1.8	0.9	0.9	0.1	1.0	1.0	1.0
Real exchange rate depreciation (in percent, + indicates depreciation)	-15.4	1.8	1.3	-2.0	5.9	-8.3	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	7.7	6.7	13.2	5.9	3.1	11.8	8.0	5.6	5.0	5.0	5.0	6.7	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	0.2	0.2	0.0	0.1	0.1	0.4	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grant element of new external borrowing (in percent)	...	...	...	…	…	43.9	43.9	43.8	43.8	43.8	43.7	43.8	43.6	43.2	...

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.

Table 2a.Nepal: Sensitivity Analysis for Key Indicators of Public Debt 2010-2030

	Projections							
	2010	2011	2012	2013	2014	2015	2020	2030
PV of Debt-to-GDP Ratio								
Baseline	33	32	32	32	33	33	32	31
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	33	32	31	30	29	29	25	20
A2. Primary balance is unchanged from 2010	33	33	32	32	32	32	29	26
A3. Permanently lower GDP growth 1/	33	33	33	33	34	34	36	42
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011-2012	33	33	34	35	35	36	38	38
B2. Primary balance is at historical average minus one standard deviations in 2011-2012	33	33	33	33	33	33	33	31
B3. Combination of B1-B2 using one half standard deviation shocks	33	33	33	33	33	34	35	35
B4. One-time 30 percent real depreciation in 2011	33	41	41	40	40	39	36	32
B5. 10 percent of GDP increase in other debt-creating flows in 2011	33	42	41	41	40	40	38	34
PV of Debt-to-Revenue Ratio 2/								
Baseline	165	162	162	163	164	167	163	156
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	165	159	155	151	148	145	122	98
A2. Primary balance is unchanged from 2010	165	163	162	162	161	161	147	131
A3. Permanently lower GDP growth 1/	165	163	164	166	169	173	181	206
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011-2012	165	166	170	173	177	183	188	190
B2. Primary balance is at historical average minus one standard deviations in 2011-2012	165	165	166	166	167	170	165	157
B3. Combination of B1-B2 using one half standard deviation shocks	165	163	163	164	167	172	173	172
B4. One-time 30 percent real depreciation in 2011	165	205	203	201	200	200	182	161
B5. 10 percent of GDP increase in other debt-creating flows in 2011	165	208	207	203	204	204	190	169
Debt Service-to-Revenue Ratio 2/								
Baseline	13	14	14	14	13	14	13	12
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	13	14	14	11	10	8	1	0
A2. Primary balance is unchanged from 2010	13	14	14	14	13	13	9	7
A3. Permanently lower GDP growth 1/	13	14	14	14	14	15	17	23
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011-2012	13	14	14	15	16	17	19	20
B2. Primary balance is at historical average minus one standard deviations in 2011-2012	13	14	14	15	15	15	14	12
B3. Combination of B1-B2 using one half standard deviation shocks	13	14	14	13	12	14	15	16
B4. One-time 30 percent real depreciation in 2011	13	16	17	17	18	19	19	17
B5. 10 percent of GDP increase in other debt-creating flows in 2011	13	14	17	45	17	34	16	15

Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

Table 3a.: External Debt Sustainability Framework, Baseline Scenario, 2007-2030 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical 0 Average 0	Standard Deviation	Projections									
	2007	2008	2009			2010	2011	2012	2013	2014	2015	2010-2015 Average	2020	2030	2016-2030 Average
External debt (nominal) 1/	**32.8**	**29.6**	**29.4**			**26.0**	**24.1**	**22.7**	**21.5**	**20.5**	**19.6**		**16.8**	**15.4**	
o/w public and publicly guaranteed (PPG)	30.2	27.4	27.0			23.8	21.7	20.3	19.2	18.2	17.4		14.8	13.8	
Change in external debt	-5.3	-3.3	-0.2			-3.4	-2.0	-1.4	-1.1	-1.1	-0.8		-0.4	0.0	
Identified net debt-creating flows	-4.6	-8.7	-4.5			1.1	-1.2	-1.1	-0.7	-0.2	0.2		-1.4	-1.5	
Non-interest current account deficit	**-0.3**	**-3.0**	**-4.5**	**-3.3**	**1.5**	**1.8**	**-0.3**	**-0.1**	**0.3**	**0.9**	**1.2**		**-0.3**	**-0.2**	0.0
Deficit in balance of goods and services	20.4	19.3	22.5			28.6	27.8	28.5	29.3	30.0	30.4		26.8	19.3	
Exports	13.9	12.0	12.6			10.3	10.4	10.4	10.3	10.1	9.9		8.7	7.0	
Imports	34.3	31.3	35.1			38.9	38.2	38.9	39.6	40.1	40.3		35.5	26.3	
Net current transfers (negative = inflow)	-19.1	-21.1	-25.6	-17.7	3.6	-25.5	-26.7	-27.2	-27.6	-27.9	-28.0		-26.3	-19.1	-23.8
o/w official	-2.1	-2.2	-2.6			-4.1	-4.3	-4.0	-3.8	-3.5	-3.2		-3.1	-3.0	
Other current account flows (negative = net inflow)	-1.5	-1.2	-1.5			-1.4	-1.4	-1.3	-1.3	-1.3	-1.2		-0.8	-0.4	
Net FDI (negative = inflow)	**-0.1**	**0.0**	**-0.2**	**0.0**	**0.1**	**-0.2**	**-0.2**	**-0.3**	**-0.3**	**-0.4**	**-0.4**		**-0.5**	**-0.7**	-0.6
Endogenous debt dynamics 2/	**-4.3**	**-5.6**	**0.2**			**-0.4**	**-0.7**	**-0.7**	**-0.7**	**-0.7**	**-0.7**		**-0.6**	**-0.6**	
Contribution from nominal interest rate	0.4	0.3	0.3			0.3	0.3	0.3	0.3	0.3	0.2		0.2	0.2	
Contribution from real GDP growth	-1.1	-1.4	-1.4			-0.7	-1.0	-1.0	-0.9	-0.9	-0.9		-0.8	-0.8	
Contribution from price and exchange rate changes	-3.6	-4.4	1.3			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	**-0.7**	**5.4**	**4.3**			**-4.5**	**-0.8**	**-0.3**	**-0.5**	**-0.9**	**-1.0**		**1.0**	**1.5**	
o/w 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/	...	...	24.2			21.5	20.4	19.4	18.5	17.6	16.7		13.2	11.2	
In percent of exports	...	...	192.2			208.2	196.1	186.7	180.2	174.6	170.0		152.5	160.7	
PV of PPG external debt	**...**	**...**	**21.8**			**19.2**	**18.1**	**17.1**	**16.2**	**15.3**	**14.5**		**11.2**	**9.7**	
In percent of exports	**...**	**...**	**172.9**			**186.4**	**173.7**	**164.3**	**157.7**	**151.9**	**147.3**		**129.4**	**138.3**	
In percent of government revenues	**...**	**...**	**150.9**			**119.4**	**113.2**	**105.6**	**98.9**	**92.7**	**87.2**		**66.3**	**56.9**	
Debt service-to-exports ratio (in percent)	**12.5**	**11.2**	**9.5**			**12.8**	**12.2**	**11.9**	**11.5**	**11.4**	**11.2**		**8.3**	**6.9**	
PPG debt service-to-exports ratio (in percent)	**12.5**	**11.2**	**9.5**			**12.8**	**12.2**	**11.9**	**11.5**	**11.4**	**11.2**		**8.3**	**6.9**	
PPG debt service-to-revenue ratio (in percent)	**14.7**	**10.5**	**8.3**			**8.2**	**8.0**	**7.6**	**7.2**	**6.9**	**6.6**		**4.2**	**2.8**	
Total gross financing need (Billions of U.S. dollars)	0.4	0.1	-0.2			0.7	0.5	0.5	0.6	0.7	0.9		0.6	0.9	
Non-interest current account deficit that stabilizes debt ratio	5.0	0.2	-4.3			5.2	1.7	1.3	1.5	2.0	2.1		0.0	-0.1	
Key macroeconomic assumptions															
Real GDP growth (in percent)	3.3	5.3	4.7	4.1	1.7	3.0	4.0	4.2	4.4	4.7	4.8	4.2	5.0	5.5	5.3
GDP deflator in US dollar terms (change in percent)	10.5	15.7	-4.2	4.8	6.5	13.3	2.1	2.8	2.9	2.9	3.5	4.6	5.0	5.0	4.9
Effective interest rate (percent) 5/	1.3	1.2	1.1	1.3	0.1	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.2	1.2	1.2
Growth of exports of G&S (US dollar terms, in percent)	20.6	5.4	4.9	3.8	14.2	-4.3	7.3	7.1	6.0	5.8	5.9	4.6	7.3	8.7	7.9
Growth of imports of G&S (US dollar terms, in percent)	27.8	11.2	12.5	11.4	10.9	29.3	4.2	9.2	9.4	9.3	8.8	11.7	7.3	7.5	7.3
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	43.9	43.9	43.8	43.8	43.8	43.7	43.8	43.6	43.2	43.5
Government revenues (excluding grants, in percent of GDP)	11.8	12.8	14.4			16.1	16.0	16.2	16.4	16.5	16.6		16.9	17.0	16.9
Aid flows (in Billions of US dollars) 7/	0.2	0.3	0.3			0.7	0.8	0.8	0.8	0.8	0.9		1.4	4.0	
o/w Grants	0.2	0.3	0.3			0.6	0.6	0.6	0.6	0.6	0.6		1.0	2.8	
o/w Concessional loans	0.0	0.0	0.0			0.1	0.2	0.2	0.2	0.2	0.2		0.4	1.2	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			4.4	4.6	4.5	4.3	3.9	3.7		3.7	3.8	3.8
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			85.7	84.8	84.2	83.6	82.6	80.6		79.6	78.0	79.1
Memorandum items:															
Nominal GDP (Billions of US dollars)	10.3	12.6	12.6			14.7	15.6	16.8	18.0	19.4	21.1		33.9	93.1	
Nominal dollar GDP growth	14.2	21.8	0.2			16.7	6.2	7.2	7.5	7.8	8.4	9.0	10.3	10.8	10.4
PV of PPG external debt (in Billions of US dollars)			2.7			2.8	2.8	2.8	2.9	2.9	3.0		3.8	9.0	
(PVt-PVt-1)/GDPt-1 (in percent)						0.2	0.3	0.3	0.3	0.3	0.4	0.3	0.7	1.0	0.8
Gross remittances (Billions of US dollars)	1.5	2.1	2.7			3.0	3.3	3.7	4.1	4.6	5.1		7.8	15.4	
PV of PPG external debt (in percent of GDP + remittances)	...	...	17.9			16.0	14.9	14.0	13.2	12.4	11.7		9.1	8.3	
PV of PPG external debt (in percent of exports + remittances)	...	...	63.8			63.3	57.1	52.4	48.8	45.4	42.6		35.2	41.1	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	3.5			4.3	4.0	3.8	3.6	3.4	3.2		2.3	2.0	

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 3b.Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2010-2030
(In percent)

	Projections							
	2010	2011	2012	2013	2014	2015	**2020**	2030
PV of debt-to-GDP+remittances ratio								
Baseline	16	15	14	13	12	12	**9**	8
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2010-2030 1/	16	13	11	8	6	3	0	0
A2. New public sector loans on less favorable terms in 2010-2030 2	16	15	15	14	14	13	**12**	14
A3. Financial Sector Stress Scenario	16	35	47	46	45	43	33	18
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011-2012	16	15	14	13	13	12	**9**	8
B2. Export value growth at historical average minus one standard deviation in 2011-2012 3/	16	16	16	15	14	13	**10**	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2011-2012	16	15	15	14	13	12	**10**	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2011-2012 4/	16	23	29	25	24	22	**17**	11
B5. Combination of B1-B4 using one-half standard deviation shocks	16	23	29	26	24	23	**17**	11
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	16	19	18	17	16	15	**12**	11
PV of debt-to-exports+remittances ratio								
Baseline	63	57	52	49	45	43	**35**	41
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2010-2030 1/	63	50	40	31	21	12	0	0
A2. New public sector loans on less favorable terms in 2010-2030 2	63	58	55	52	50	48	**47**	67
A3. Financial Sector Stress Scenario	63	115	154	149	145	139	112	77
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011-2012	63	56	52	48	45	42	**35**	41
B2. Export value growth at historical average minus one standard deviation in 2011-2012 3/	63	63	67	62	58	54	**44**	47
B3. US dollar GDP deflator at historical average minus one standard deviation in 2011-2012	63	56	52	48	45	42	**35**	41
B4. Net non-debt creating flows at historical average minus one standard deviation in 2011-2012 4/	63	117	147	92	87	81	**66**	53
B5. Combination of B1-B4 using one-half standard deviation shocks	63	114	150	96	89	84	**68**	54
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	63	56	52	48	45	42	**35**	41
PV of debt-to-revenue ratio								
Baseline	119	113	106	99	93	87	**66**	57
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2010-2030 1/	119	98	79	60	41	23	0	0
A2. New public sector loans on less favorable terms in 2010-2030 2	119	115	110	106	102	99	**89**	93
A3. Financial Sector Stress Scenario	119	262	357	347	337	323	**239**	122
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011-2012	119	113	108	101	94	89	**68**	58
B2. Export value growth at historical average minus one standard deviation in 2011-2012 3/	119	118	122	114	107	101	**76**	59
B3. US dollar GDP deflator at historical average minus one standard deviation in 2011-2012	119	116	113	106	99	93	**71**	61
B4. Net non-debt creating flows at historical average minus one standard deviation in 2011-2012 4/	119	159	199	187	176	166	**124**	73
B5. Combination of B1-B4 using one-half standard deviation shocks	119	159	206	194	183	173	**129**	76
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	119	158	148	138	129	121	**93**	80

Table 3b.Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2010-2030 (continued)
(In percent)

Debt service-to-exports+remittances ratio

Baseline	4	4	4	4	3	3	**2**	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2010-2030 1/	4	4	4	3	3	3	2	0
A2. New public sector loans on less favorable terms in 2010-2030 2	4	4	4	4	4	4	**3**	3
A3. Financial Sector Stress Scenario	4	5	5	6	6	5	4	5
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011-2012	4	4	4	4	3	3	**2**	2
B2. Export value growth at historical average minus one standard deviation in 2011-2012 3/	4	4	4	4	4	4	**3**	2
B3. US dollar GDP deflator at historical average minus one standard deviation in 2011-2012	4	4	4	4	3	3	**2**	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2011-2012 4/	4	6	6	4	4	4	**3**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	4	6	6	4	4	4	**3**	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	4	4	4	4	3	3	**2**	2

Debt service-to-revenue ratio

Baseline	8	8	8	7	7	7	**4**	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2010-2030 1/	8	8	7	6	6	5	3	0
A2. New public sector loans on less favorable terms in 2010-2030 2	8	8	8	7	7	7	**5**	5
A3. Financial Sector Stress Scenario	8	11	13	13	13	12	**8**	8
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011-2012	8	8	8	7	7	7	**4**	3
B2. Export value growth at historical average minus one standard deviation in 2011-2012 3/	8	8	8	8	7	7	**4**	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2011-2012	8	8	8	8	8	7	**5**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2011-2012 4/	8	8	8	9	8	8	**5**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	8	8	9	9	9	8	**5**	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	8	11	11	10	10	9	**6**	4
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	41	41	41	41	41	41	**41**	41

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.

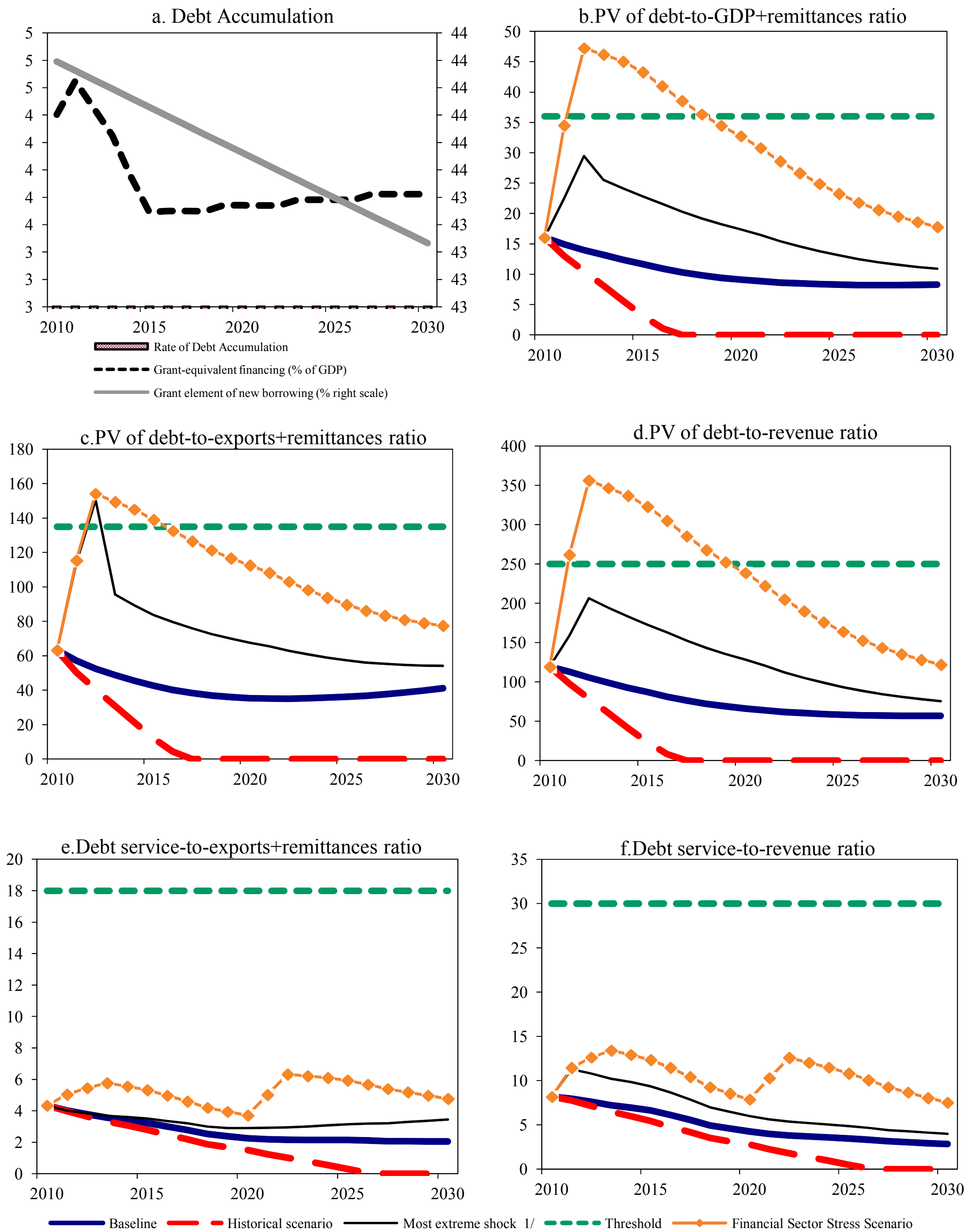
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

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.

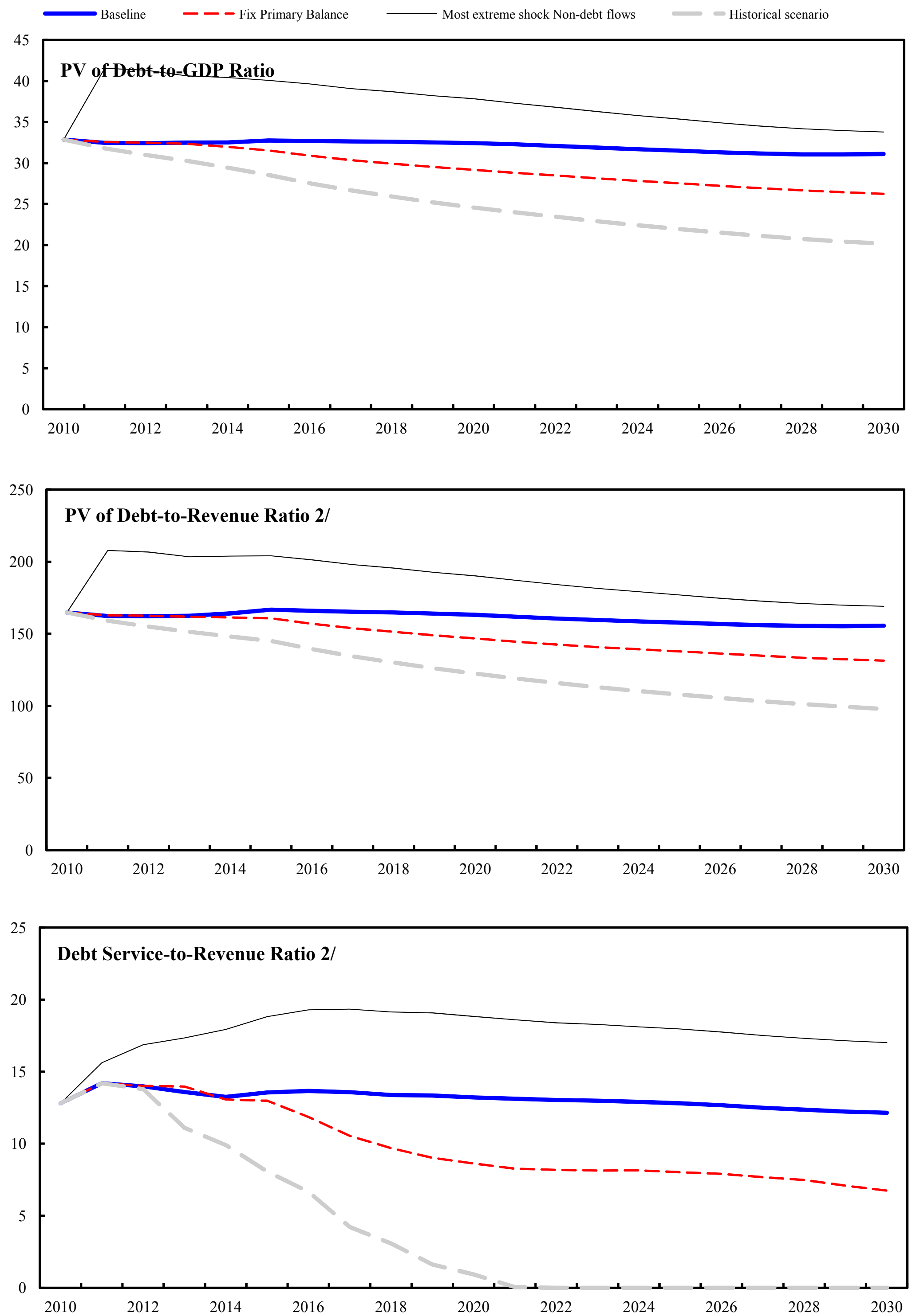
Figure 1. Nepal: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2010-2030 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2020. In figure b. it corresponds to a Combination shock; in c. to a Combination shock; in d. to a Combination shock; in e. to a Terms shock and in figure f. to a One-time depreciation shock

Figure 2.Nepal: Indicators of Public Debt Under Alternative Scenarios, 2010-2030 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2020.
2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

NEPAL

Staff Report for the 2010 Article IV Consultation and Request for Disbursement Under the Rapid Credit Facility

Supplementary Information

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by Kalpana Kochhar and Christian Mumssen

May 25, 2010

1. **Fund staff has determined that Nepal maintains an exchange restriction subject to Article VIII, arising from quantitative limits on the availability of foreign exchange for leisure travel abroad**. On April 2, 2010, to protect the balance of payments position, the Nepal Rastra Bank (NRB) limited the use of the Passport Facility—through which residents can obtain foreign exchange for leisure travels up to US$ 2000—to no more than two times per year. The limit on the amount of foreign exchange that can be obtained is further reduced to US$1,000 for travelers to Tibet of China and SAARC countries (excluding India). The current policy of the NRB is not to provide foreign exchange beyond these limits even if the bona fide nature of the request is proved. These limits constitute an exchange restriction inconsistent with Nepal's obligations under Article VIII of the Fund's Articles.

2. **Approval of retention of this restriction is not recommended by the staff**. Since the restriction is discriminatory among Fund members given that there are two different monetary limits, the staff does not recommend approval of this restriction.

3. **Further information is needed to clarify the jurisdictional implications of several other exchange measures.** These measures include the foreign exchange facilities for entrepreneurs and students, and a potential multiple currency practice.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/75
FOR IMMEDIATE RELEASE
June 17, 2010

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2010 Article IV Consultation with Nepal

On May 28, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Nepal.[1]

Background

Four years after the end of the civil conflict, Nepal remains in political transition, with a new constitution being drafted and fresh elections expected once the constitution is approved. Despite being one of the poorest countries in Asia, Nepal is making progress on social outcomes.

Macroeconomic stability has been maintained in the past few years, but the global crisis is having a delayed impact on Nepal's economy and exposing its structural weaknesses. The exchange rate peg and prudent fiscal policy have been anchors of stability. By end 2008/09[2], public debt had declined to 40 percent of GDP from 64 percent in 2001/02, and foreign exchange reserves had increased to 6 months of import cover due to robust remittance inflows. In the first half of 2009/10, however, remittances growth slowed and exports declined by 14 percent which combined with soaring imports caused reserves to decline by about 13 percent. A liquidity crunch ensued in the banking system as banks have overextended themselves over the past years in an environment of accommodative monetary policy, weak supervision, and proliferation of financial institutions.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.
[2] Nepal's fiscal year begins in July.

The near-term economic outlook is challenging. Real GDP growth is expected to slow to 3 percent in 2009/10 from an estimated 4¾ percent in 2008/09, due to a poor monsoon, softer remittances, and tighter monetary conditions. The external current account is projected to record a deficit of 2 percent of GDP in 2009/10 due to a deteriorating trade deficit and decelerating remittances. At the same time, inflation is projected at 12 percent by end 2009/10. Fiscal policy remains prudent, and the authorities plan to reduce the 2009/10 net domestic financing to 1.6 percent of GDP from the budgeted 2.1 percent. However, capital spending remains low, owing mainly to capacity constraints. It is anticipated that real GDP growth will recover to 4 percent in 2010/11 reflecting expected stronger remittances on the back of the recovery in the Gulf countries and Malaysia (the main host countries of Nepalese workers) and that the current account will move close to balance, although the situation remains fragile.

In the near term, risks are on the downside and stem mainly from weaker remittances, continued high imports, capital flight, heightened financial sector vulnerabilities, and political instability. Credit and liquidity risks in the banking system are high. Tackling structural problems remains essential to achieve high growth over the medium term. While Nepal's potential is high, progress is required in addressing the poor business climate, power shortages, inadequate infrastructure, weak governance, and difficult labor relations. Political stability and improved security are necessary conditions for progress in several of these areas.

Against this background, the 2010 Article IV consultation focused on (i) maintaining continued macroeconomic stability in the context of a deteriorating external position and how Fund financial assistance could contribute to this end; and (ii) managing financial sector risks and reducing vulnerabilities.

Executive Board Assessment

Executive Directors observed that, after years of macroeconomic stability, Nepal's economy is experiencing a substantial, albeit somewhat delayed, impact of the global crisis, which is exposing the country's structural weaknesses. External and financial sector risks have risen as evidenced by the significant deterioration of the current account, the reserve decline, wavering confidence, and banking sector liquidity stress.

Against this background, Directors welcomed the authorities' commitment and efforts to safeguard external and financial stability. They viewed maintaining the exchange rate peg as a key short-term objective to shore up confidence, observing that it has served Nepal well so far by providing macroeconomic stability. In the medium term, a number of Directors recommended a reconsideration of the type of peg as well as alternative options for a nominal anchor. Directors stressed the need for monetary policy to support the peg by maintaining short-term interest rates above those of India, and suggested that liquidity management be strengthened to avoid abrupt fluctuations in interest rates. They also stressed that emergency liquidity support needs to be consistent with the peg. Directors encouraged the authorities to phase out the import and foreign exchange restrictions.

Directors took note of significant credit and liquidity risks in the financial sector. They welcomed the recent macroprudential measures adopted by the Nepal Rastra Bank to limit banks' liquidity risk and exposure to the real estate sector, but stressed that enforcement will be crucial for their effectiveness. Directors encouraged the authorities to strengthen the bank resolution framework, including through the passage of the amended Banks and Financial Institutions Act, enhance contingency planning, and expand regulatory oversight over savings and credit cooperatives.

Directors noted that bank licensing policy needs to be tightened and financial sector consolidation facilitated. They observed that the rapid proliferation of financial institutions has stretched the authorities' supervisory capacity, and welcomed the recent licensing moratorium. Directors also encouraged the authorities to proceed with the restructuring of the two state-controlled banks.

Directors commended the authorities' fiscal prudence, and supported its continuation. They noted that, although improved debt dynamics have created room for higher spending, a tight fiscal stance remains justified in the short term to support the exchange rate peg. They encouraged further efforts to curb tax evasion and broaden the tax base.

Directors reiterated that tackling long-standing structural problems remains essential to achieve high growth over the medium term. Key areas for improvement are the business climate, governance, infrastructure and labor relations.

Directors viewed the arrangement under the Rapid Credit Facility (RCF) as helpful in cushioning the shock from the global crisis and boosting confidence. They hoped that the RCF would serve as a bridge to a program addressing Nepal's structural challenges that could be supported by an arrangement under the Extended Credit Facility.

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Nepal: Selected Economic Indicators, 2006/07–2010/11

	2006/07	2007/08	2008/09	2009/10	2010/11
				Projections	
Output and prices (percent change)			(Percent change)		
Real GDP	3.3	5.3	4.7	3.0	4.0
CPI (period average)	6.4	7.7	13.2	11.8	8.0
CPI (end of period)	5.1	12.1	11.4	12.1	6.0
Fiscal Indicators (in percent of GDP)			(In percent of GDP)		
Total revenue and grants	14.0	15.3	16.9	19.9	20.0
Total expenditure and net lending	15.9	17.4	17.2	22.4	22.8
Current expenditure	10.6	11.2	11.8	15.1	15.6
Capital expenditure and net lending	5.3	6.2	5.4	7.2	7.2
Overall deficit before grants	4.1	4.6	2.7	6.2	6.8
Overall deficit after grants	1.9	2.1	0.2	2.4	2.8
Net domestic financing	1.6	1.9	0.8	2.1	2.2
Money and credit (percent change)			(Percent change, end-of-period)		
Broad money	14.0	25.3	27.7	10.6	..
Domestic credit	12.0	19.8	26.6	18.2	..
Private sector credit	12.3	24.3	28.3	19.4	..
Balance of payments			(In millions of U.S. dollars, unless otherwise indicated)		
Current account (in millions of U.S. dollars)	-13.8	344.0	536.3	-305.8	-0.3
In percent of GDP	-0.1	2.7	4.3	-2.1	0.0
Trade Balance (in millions of U.S. dollars)	-1,977	-2,265	-2,707	-3,890	-3,980
In percent of GDP	-19.1	-18.0	-21.5	-26.4	-25.5
Exports value growth (percent change)	13.4	-4.6	0.5	-11.0	6.3
Imports value growth (percent change)	25.8	8.4	14.1	30.0	3.0
Gross official reserves (in millions of U.S. dollars)	1,996	2,473	2,907	2,670	2,876
In months of imports of goods and services	6	7	6	5	5
Memorandum items					
Public external debt (percent of GDP)	30.2	27.4	27.0	23.8	21.7
GDP at market prices (in billions of Nepalese rupees)	728.2	818.4	969.8	1,116.1	1,254.1
Exchange rate (Nrs/US$; period average)	70.5	65.0	76.9	…	…
Real effective exchange rate (eop, y/y percent change)	9.5	-4.3	7.3	…	…

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

Press Release No. 10/219
FOR IMMEDIATE RELEASE
May 28, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US$ 42.05 Million Disbursement Under Rapid Credit Facility for Nepal

The Executive Board of the International Monetary Fund (IMF) today approved a disbursement of an amount equivalent to SDR 28.52 million (about US$ 42.05 million) under the Rapid Credit Facility (RCF) for Nepal to help address the economic impact of the global economic crisis. The Board's approval enables the immediate disbursement of the full amount.

Nepal has been hit hard, albeit with some time lag, by the recent global economic downturn. The country is experiencing a significant decline in exports, a sharp slowdown in remittances and a worsening of economic confidence, which has contributed to a large deterioration in the current account balance and a decline in international reserves as well as a liquidity crunch in the banking sector. The RCF for Nepal aims at addressing external and financial risks and helping catalyze possible donor support.

The RCF, which provides a rapid and flexible financial assistance for low-income countries that face an urgent balance of payments need, does not require any explicit program-based conditionality or review, but economic policies 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 5½ years, and a final maturity of 10 years.

The Executive Board also concluded the 2010 Article IV consultation with Nepal today. A Public Information Notice will be published in due course.

Following the Executive Board's discussion on Nepal, Mr. Naoyuki Shinohara, Deputy Managing Director and Acting Chair, stated:

"Nepal is facing considerable external and financial risks. A substantial, albeit delayed, impact of the global crisis has led to a significant deterioration of the current account, a loss of international reserves, and a liquidity crunch in the banking sector. The external shock exposed the country's structural weaknesses, its reliance on remittances, and the build-up of risks in the financial sector.

"The government's policy program, supported by the IMF, is aimed at addressing these risks and stabilizing international reserves. At the core of the program are a tight monetary and fiscal policy stance to support the exchange rate peg, which remains Nepal's anchor for macroeconomic stability, and efforts to improve financial sector soundness.

"The Nepal Rastra Bank has taken steps to tighten monetary policy through, inter alia, raising the Standing Liquidity Facility rate. Building on a strong track record of fiscal prudence, including during the political transition, the government has committed to maintaining the domestically financed budget deficit close to 2 percent of GDP in the 2010/11 budget. The authorities have introduced macro prudential measures to limit banks' liquidity risk and exposure to the real estate sector, and imposed a partial bank licensing moratorium. They are also committed to strengthening supervision, enhancing contingency planning, encouraging financial sector consolidation, and reforming the two state-owned banks.

"The authorities' program is strong and well focused. If fully implemented and provided the external situation improves as envisaged, it is expected to restore Nepal's macroeconomic stability and lay more favorable conditions for higher growth and poverty reduction. This program could also serve as a bridge to a successor Fund arrangement, which would help address the country's structural challenges."

Statement by Adrian Chua, Alternate Executive Director for Nepal and Nara Thapa, Advisor to Executive Director
May 28, 2010

1. Since the last Article IV consultation in March 2008, significant political developments have taken place within Nepal and a severe economic crisis has unfolded at the global level. The interim government formed after the end of the decade-long civil conflict successfully conducted the constituent assembly (CA) elections in April 2008. The first meeting of the CA ended the more than two-century old monarchy. The two-year term for CA is almost complete and the writing of the new constitution is underway. Political parties are holding dialogues on key issues. The authorities are confident that differences on major constitutional issues will be resolved, and the drafting of the constitution will be completed soon.

Macroeconomic situation and outlook

2. Notwithstanding the decade-long civil conflict and political transition, Nepal has so far maintained macroeconomic stability. Prudent macroeconomic policies implemented under the recent PRGF-supported Fund program, the final review of which was successfully concluded in November 2007, played a significant role in underpinning macroeconomic stability. Economic growth, albeit modest, was maintained. Inflation remained largely stable. Backed by strong remittances, the accumulation of international reserves was at a comfortable level, which ensured the overall macroeconomic and external stability.

3. The adverse global economic environment has now affected the Nepali economy, raising risks for macroeconomic stability. Economic growth is expected to decelerate from 4.7 percent in 2008/09 to less than 4 percent in 2009/10 on account of poor agricultural performance. Average inflation is projected to hover around 10.7percent, reflecting the global price developments especially price movement in India. The overall balance of payments position has slipped into a deficit on account of a widening current account deficit, putting pressures on international reserves. The delayed impact of the global economic crisis has resulted in a significant decline in merchandise exports and slowdown in remittances. A deficit in the balance of payments has also caused liquidity shortages, posing risks to the financial sector stability. The authorities are facing the challenges of ensuring the external sector stability and strengthening the financial sector stability amid fluid political transition.

Request for a disbursement under the RCF

4. Against this backdrop, the authorities are requesting a disbursement under the Rapid Credit Facility (RCF) in an amount equivalent to SDR 28.52 million (40 percent of quota). The authorities hope that the proposed arrangement with the Fund will help

bridge the external financing gap and will also play a catalytic role in mobilizing donor support for meeting Nepal's development needs. The authorities expect that the arrangement with the Fund will help safeguard the financial sector stability and stabilize the overall macroeconomic situation. The RCF is considered as a bridge to an ECF under which the authorities plan to initiate structural reforms aimed at accelerating economic growth and alleviating poverty.

Monetary and exchange rate policy

5. The authorities are focused on keeping the monetary policy tight and modulating liquidity, aiming to contain inflation and balance of payments deficit. The authorities also view the currency peg with the Indian rupee as fundamental to economic stability and take it as an overall anchor for the conduct of monetary policy in Nepal. Notwithstanding the current level of the peg remaining unchanged since 1993 and the Nepali rupee in real terms appearing slightly overvalued on account of some price and productivity differential with India, the authorities have no intention to change the level of the peg in the current macroeconomic and political situation.

6. To achieve these objectives and smoothen the credit crunch situation, the authorities have rationalized policy instruments in the recent mid-term monetary policy review. Market-based open market operations continue to be the primary tools for the short term liquidity management. The authorities have extended the term of repo transaction from 28 days to 45 days and have allowed commercial banks' call deposits to be counted for statutory liquidity ratio (SLR). With a view to ensure credit availability to productive sector amid tights liqudity condition the refinancing facility window has been introduced. This will help avail credit to export, power and tourism sector. The new refinancing provision has been taken as booster for sagging confidence in the financial market. As the refinancing facility has been limited for a maximum period of six months, it is likely to ease liquidity squeeze in the short term and prevent banks for using it on a long-term basis. Penal interest rates are applied on the standing liquidity facility (SLF) to prevent banks from using the emergency liquidity facility excessively. The authorities consider the current tighter liquidity situation as temporary arisen on account of slowdown in remittances and a higher rate of credit growth than deposit. Once the growth in remittances recovers and the credit growth is reined in, the authorities expect the pressure on liquidity to ease soon.

Financial sector reforms

7. The authorities are aware of both opportunities and challenges arising from the rapid growth of the banking sector. Aided by a rapid growth in remittances, the recent development of the banking sector has deepened the financial system in Nepal. Excluding the two state controlled banks, namely Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB), capital adequacy ratio for private banks has remained above 12 percent; non-performing loans have come down to 3.4 percent and the profitability of banks as reflected by return to asset ratio is relatively high.

8. However, the authorities are cognizant that the proliferation of banks has overstretched the supervisory capacity of the central bank. The authorities are also aware of risks that high credit-to-deposit ratios and significant exposure to real estate pose to the financial sector stability. The authorities have taken a serious note of the recent stress test results showing high vulnerability to credit and liquidity risks. The authorities will continue to assess the health of the financial sector through stress tests.

9. In response to these emerging risks, the authorities have recently adopted a number of prudential measures aimed at stabilizing the financial sector. The authorities have imposed a moratorium on license applications while they review the licensing policy. However, the authorities have eased the moratorium with respect to micro finance banks and development banks with a view to expanding banking services to the rural areas. To further improve the health of the financial sector, the authorities have also adopted a number of macro-prudential measures recently. To address the excessive leverage built up in recent times, the authorities have directed banks to gradually lower the credit-deposit ratio to 80 percent over the medium term. To prevent asset prices from building further and rein in the credit expansion to the real estate, the limit on loan-to-value has been fixed at 60 percent of fair market value of collateral. Likewise, the authorities have also planned to lower the single borrower limit from 50 percent to 25 percent of capital with effect from January 2011. Regarding sectoral exposure of credit to real estate and housing loans, a limit has been fixed at 40 percent of total loans in real estate and housing loans.

10. While the two large government controlled commercial banks have been put under the outside management with the financial assistance from the World Bank, the central bank has also started restructuring some private sector banks. While Nepal Development Bank has been liquidated, the central bank has completed the process of restructuring Nepal Bangladesh Bank. To put in place the bank resolution framework, the authorities have readied the amended Banks and Financial Institutions Act (BAFIA) for parliamentary approval. As for the contingency planning for the financial sector, the authorities are seeking technical assistance from the World Bank.

11. The authorities consider that a strong international reserve position is key to financial sector stability. Hence, the authorities have taken strong measures to strengthen the balance of payments position. In an effort to safeguard foreign exchange resources, the authorities have raised margin requirements as well as quantitative limits on gold and silver imports. With a view to preventing capital flight, the authorities have temporarily limited the availability of passport facility for leisure travel to twice a year and $2000 per transaction. The authorities are committed to relaxing such restriction by March 2011 when the balance of payments situation is expected to turn around.

Fiscal policy

12. Despite the difficult political situation, the authorities are committed to maintaining fiscal discipline. Notwithstanding pressures on peace-related expenditures and wages, the overall public expenditure has been contained. Although capital spending has remained lower than expected, the authorities have maintained social spending resulting in relatively improved social indicators.

13. In the face of a relatively lower level of economic growth, revenue collection has been accelerated from 10.7 percent in 2005/06 to 14.5 percent of GDP in 2008/09. A significant rise in imports fueled by substantial growth in remittances has boosted revenue. A number of revenue administration reforms aimed at broadening tax base and reducing tax evasion have also contributed to the growth in revenue. The authorities also appreciate the technical assistance they have received from the Fund on public financial management.

14. As a result of these developments, domestic financing of budget deficit is projected to remain at 1.6 percent and overall budget deficit to hover around 2 percent of GDP. The prudent management of public finances in Nepal has led to a gradual reduction in debt level from 64 percent in 2002/03 to 40 percent of GDP in 2008/09. This not only has reduced debt risks and made the public debt sustainable but also has created a fiscal space for social and physical capital spending going forward.

Structural reforms

15. Nepal has a track record of structural reforms relating to government finance, public enterprises and financial sector during the earlier Fund programs. Given the national focus on drafting a new constitution and taking forward the peace process to its logical conclusion, it has been difficult to initiate structural reforms further. The authorities consider structural reforms pertaining to public enterprises especially the Nepal Oil Corporation (NOC) are key to streamlining public resources for accelerating economic growth and reducing poverty. The authorities look forward to implementing a medium term Fund program as the political situation stabilizes with the completion of the peace process and the promulgation of a new constitution.

Conclusion

16. The authorities express their commitment to adopting prudent macroeconomic policies and seek the support of Board members for their request for a disbursement under the RCF. The authorities broadly share the staff analysis and accept the policy advice as presented in the Article IV report. We wish to thank the mission team for constructive dialogues they had in Kathmandu during February 24- March 8, 2010.

17. The authorities consent to the publication of the staff report and the letter of intent.