INTERNATIONAL MONETARY FUND

IMF Country Report No. 11/318

NEPAL

2011 ARTICLE IV CONSULTATION

November 2011

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 2011 Article IV consultation with Nepal, the following documents have been released and are included in this package:

- **Staff Report** for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on August 15, 2011, 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 September 26, 2011. 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.
- **Informational Annex** prepared by the IMF.
- **Debt Sustainability Analysis** prepared by the staffs of the IMF and the World Bank.
- **Public Information Notice** (PIN)summarizing the views of the Executive Board as expressed during its October 19, 2011 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Nepal.

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

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

NEPAL

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

September 26, 2011

KEY ISSUES

Context. Living standards in Nepal have improved over the past decade, thanks to increased remittances, generally prudent fiscal policy, and supportive social programs. In recent years, however, maintaining macroeconomic stability has become increasingly difficult in a complex political environment. Financial risks are acute, and structural reforms are needed to enhance competitiveness. Addressing fundamental macro-financial challenges will be key to sustaining improvements in living standards.

Near term outlook and risks. Following a slowdown last year, growth is projected at 3¾ percent this fiscal year as a good agriculture harvest compensates for continued weak non-agriculture activity.[1] Inflation should decline in line with lower expected external pressures, and the balance of payments is projected to register a small surplus. Significant risks exist owing to banking system fragility.

Maintaining macroeconomic stability. Maintaining the exchange-rate peg requires firmer monetary policy, and targeted rather than blanket liquidity assistance to solvent banks facing short-term pressures. The fiscal stance, as measured by net domestic financing of the budget, is appropriately prudent, though achieving it will likely require spending restraint while safeguarding pro-poor outlays, and focused revenue effort. Domestic fuel price adjustment to eliminate unsustainable subsidies and adoption of an automatic price adjustment mechanism are recommended.

Managing banking sector stress. Asset quality has deteriorated and liquidity stress has magnified following sharp asset-price deflation. The underlying conditions that might give rise to systemic financial dislocation exist and need to be addressed with utmost priority, backed by broad political support. Supervisory, regulatory and corporate governance environments require strengthening and enhanced enforcement. Forbearance and blanket liquidity provision, key responses so far, will postpone but not solve problems. Now is also the time to establish crisis management policies, including importantly strengthening the legal basis for swift intervention by the Nepal Rastra Bank (NRB).

[1]The fiscal year begins in mid-July.

Approved By
Laura Papi and Christian Mumssen

Discussions took place in Kathmandu during July 31–August 15, 2011. The mission comprised J. Nelmes (head), J. Yu, A. Mohommad (all APD), M. Nkusu (SPR), D. Mendoza (MCM), and S. Panth (Senior Resident Representative).

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APPENDIX

INTRODUCTION

1. **Living standards have improved, but growth has been moderate and reforms delayed**. Good progress has been made toward Nepal's Millennium Development Goals. At the same time, real GDP growth averaged 3¾ percent over the past 10 years, compared to 7½ percent in India, Nepal's main trading partner. Consumption rather than investment has been the main driver, fueled by remittances, while competitiveness has eroded (Figure 1). Mixed progress was made in implementing policy commitments under the Rapid Credit Facility (RCF), approved in May 2010, in particular regarding financial sector reform (Appendix 1). Discussions have taken place on a successor program that could be supported by the Extended Credit Facility (ECF), whose aim would be to maintain macro-financial stability and strengthen the balance of payments in support of the authorities' growth and poverty reduction objectives. Further elaboration of, and support for, policies to address banking sector risks is important to develop a coherent program that could be supported by the Fund.

2. **The difficult political transition continues, with continuity of political leadership elusive.** Following eight months of a caretaker government, the coalition government that formed in February 2011 resigned six months later owing to delays in drafting a new Constitution and rehabilitating and integrating former combatants into the army. A new Prime Minster was elected in August 2011, another coalition government formed, and the Constituent Assembly and the interim Constitution were extended for a third time, to November 2011.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

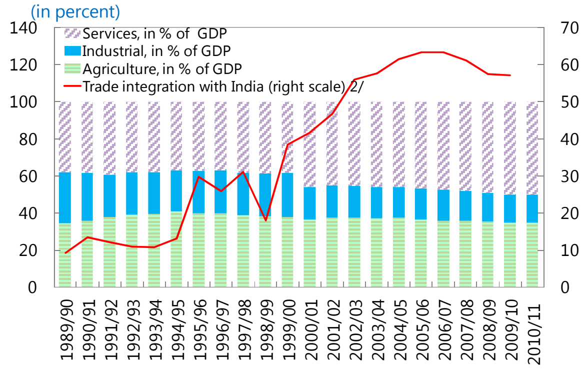
3. **Growth slowed in 2010–2011.** Private sector credit growth decelerated amid a liquidity crunch in the banking system following the bursting of the property bubble, and remittance growth slowed, related in early 2011 to turmoil in the Middle East (the source of around 50 percent of remittances) (Figure 2). Government spending was constrained by a seven-month delay in adopting the budget, raising uncertainty and causing policy tightening that was offset only at year-end owing to bunched spending. Agriculture production was boosted by favorable monsoons, but preliminary national accounts estimates indicate real GDP growth eased to 3½ percent in 2010–11.

Figure 1. A Longer-Term Perspective 1/

Despite rapid trade integration with India, Nepal's agricultural sector remains large and its manufacturing sector is shrinking.

Real GDP by Industry

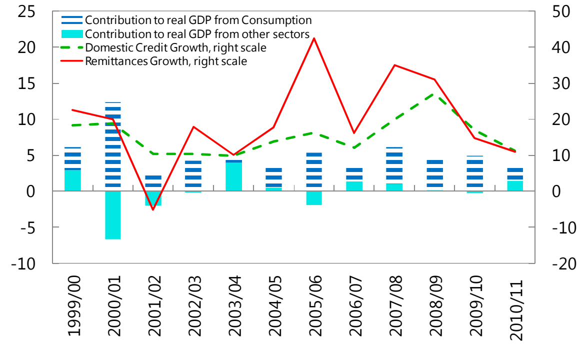
(in percent)



Consumption rather than investment has driven growth...

Domestic Credit Growth and Remittances

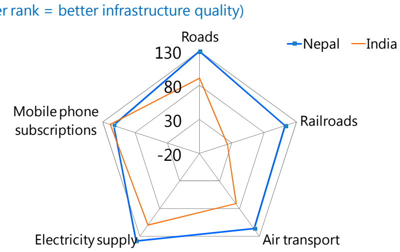
(In percent)



... partly because of underdeveloped infrastructure...

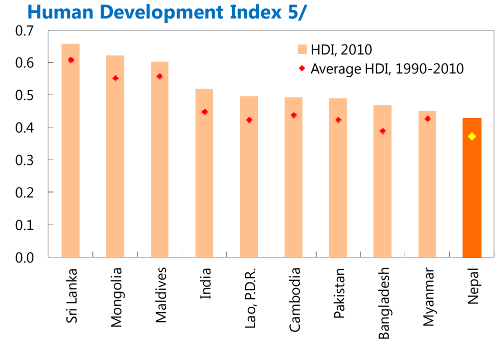
Infrastructure Quality

(Lower rank = better infrastructure quality)



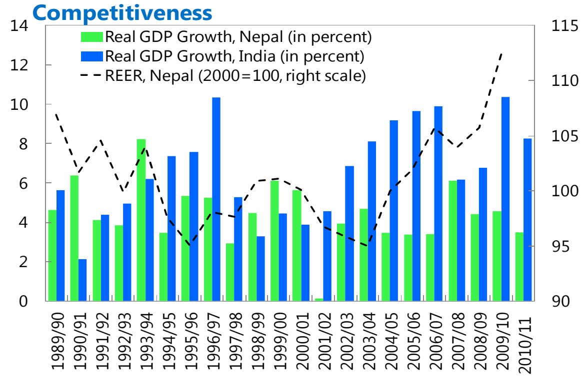
...and lagging human development compared to neighboring countries.

Human Development Index 5/



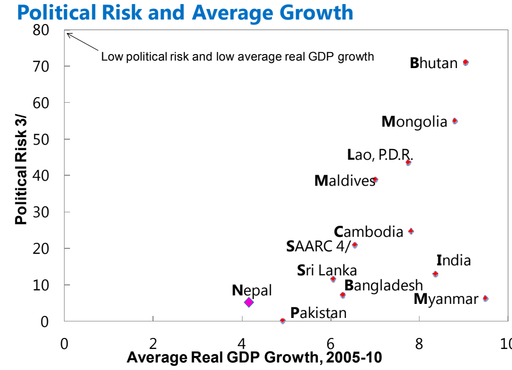
Competitiveness has eroded and the productivity gap with India widened.

Competitiveness



The difficult political situation has also held back growth.

Political Risk and Average Growth



Sources: Nepal authorities; IMF, World Economic Outlook, International Financial Statistics, World Bank, World Development Indicators, Country Policy and Institutional Assessment; UNDP, Human Development Report; World Economic Forum, Global Competitiveness Report 2010-11; and IMF staff estimates.

1/ Nepal's fiscal year starts in July.

2/ Defined as total trade with India in percent of total trade with the World.

3/ Political Stability & Absence of Violence/ Terrorism rank, 2009 from the World Bank Country Policy and Institutional Assessment.

4/ Calculated as a simple average of data in South Asian Association for Regional Cooperation member countries.

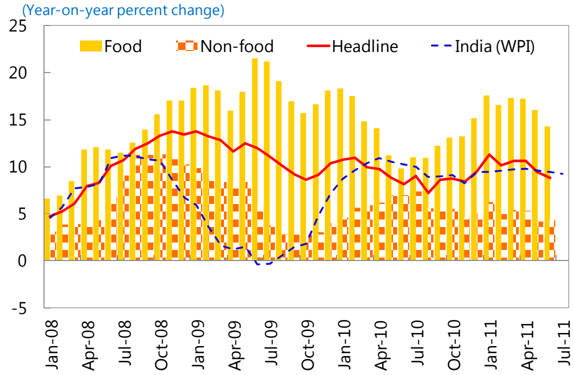
5/ A higher Human Development Index indicates a better score.

Figure 2. Recent Economic Developments

Inflation has hovered at or above double digits, led mainly by food inflation.

Inflation

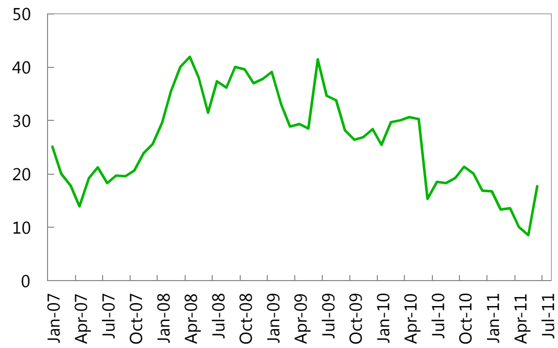
(Year-on-year percent change)



Remittance growth suffered from the global crisis and recent turmoil in the Middle East…

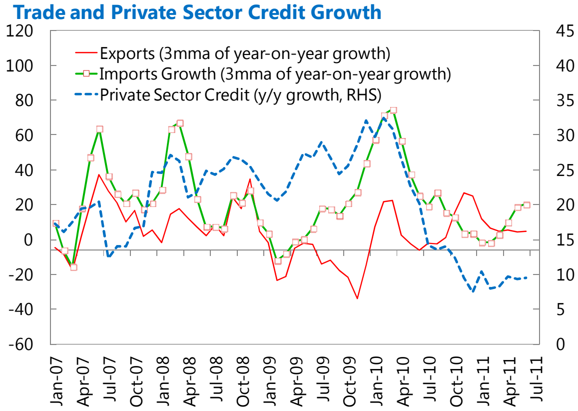
Remittances

(12-mma of year-on-year growth



…while credit and import growth slowed sharply following the bursting of the property bubble and higher gold import duties.

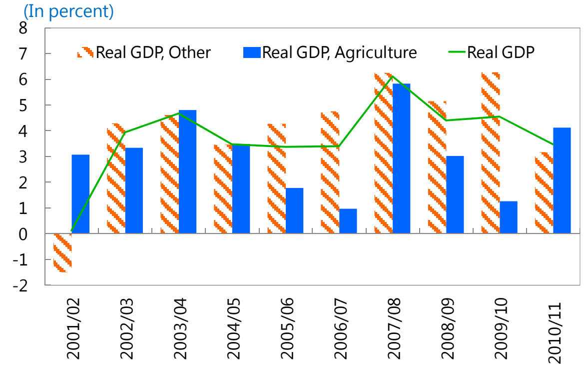
Trade and Private Sector Credit Growth



Non-agricultural activity is slowing, more than offsetting robust agricultural growth this year.

Real GDP Growth

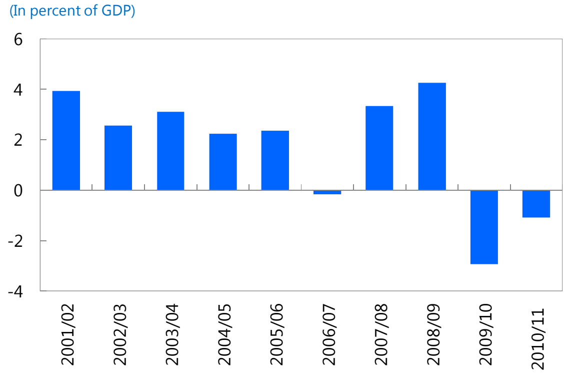
(In percent)



After a dramatic deterioration in 2009-10 the current account deficit narrowed in 2010-11…

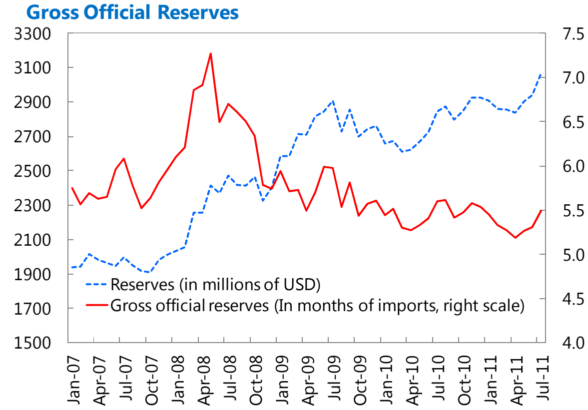
Current Account Balance

(In percent of GDP)



…but import cover of gross reserves has drifted down.

Gross Official Reserves



Sources: Nepalese Authorities; CEIC Data Co Ltd; and IMF staff estimates.

4. **Inflation has hovered around double digits**. Higher food and to a lesser extent domestic fuel prices, spill-overs from inflation in India, and accommodative monetary conditions in preceding years contributed to inflation that averaged around 9½ percent year-on-year in 2010–11. The minimum wage increased by about 30 percent, the first adjustment in three years, and civil service salaries are budgeted to rise by over 20 percent this year.

5. **The balance of payments was under pressure from high oil prices and weaker remittances, but ended the year with a modest surplus**. At year-end, donor disbursements increased, international oil prices subsided and remittances recovered. Along with sharply lower import growth, the current account deficit shrank to about 1 percent of GDP. International reserves increased to US$3.1 billion, with import coverage at 5½ months.[2]

Staff's views

6. **Real GDP growth is projected at 3¾ percent in 2011–12**. Agriculture is projected to benefit from good monsoons, and increased arrivals should boost tourism. However construction and manufacturing are expected to be constrained by policy uncertainty owing to the political environment, the adverse impact of lower asset prices, subdued real credit growth, and long-standing structural impediments. The real effective exchange rate has appreciated in recent years and appears overvalued, suggesting the external current account deficit is likely to remain under pressure over the medium term (Box 1).

7. **Inflation is projected to decline to around 8 percent**. This reflects mainly lower commodity prices due to good harvests (Box 2). Strong wage increases and higher-than-expected inflation pressure in India pose upside risks.

8. **The outlook is subject to an extraordinary degree of uncertainty, with risks on the downside.** The key risk involves a lack of decisive action to address banking sector problems. In a worst-case scenario, a loss of confidence or an adverse shock to remittances could lead to self-reinforcing systemic feedback between deposit and capital flight, with significant adverse macroeconomic consequences. On the upside, the growth outlook could be more positive if banking risks are contained, political uncertainty diminishes, and remittances grow by more than projected.

[2] The authorities are in the process of negotiating with the Russian Federation authorities the terms to clear official arrears, estimated at about $0.4 million.

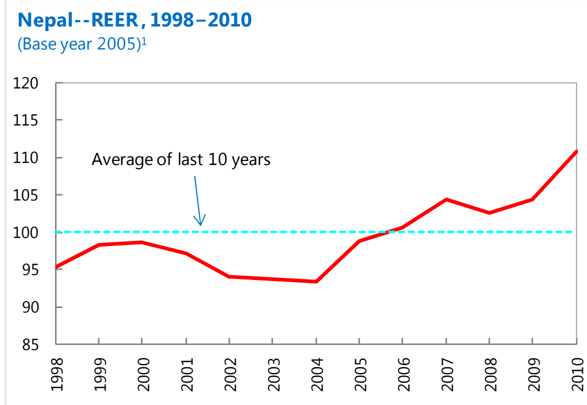
Box 1. Exchange Rate Assessment and Competitiveness

Nepal's real effective exchange rate (REER) appreciated by 8 percent over 2009-10. The appreciation has been accompanied by a loss of export market share and a deterioration of the external current account (CA), raising competitiveness concerns. In 2009–10, Nepal registered a very slight gain of market share in India while losing in the global market.

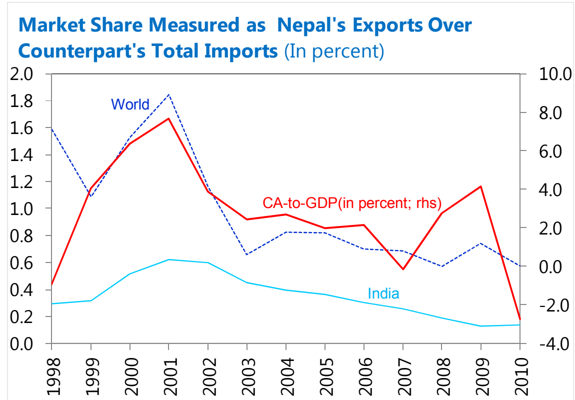
The exchange rate assessment suggests, on balance, that the Nepalese rupee is overvalued.

- The assessment is based on two of the CGER methodologies (the macroeconomic balance approach (MBA) and the external sustainability approach (ESA)) and the purchasing power parity (PPP) comparison.
- The MBA and ESA point to overvaluations in the 10 to 26 percent range.
- Under the PPP comparison, the Nepalese rupee is overvalued by about 19 percent. Results from this methodology must be treated with extra caution given the difficulty of estimating equilibrium PPP exchange rates.
- The estimates are subject to caveats owing to the uncertainties associated with the models and assumptions used and data limitations.

Nepal scores poorly on almost all survey-based competitiveness indicators, suggesting room for improvement in many areas.



[1] Normalized such that average of the last 10 years=100.

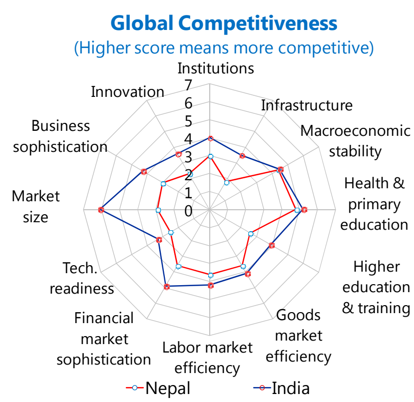


Nepal: Estimated exchange rate misalignment (in percent)

	Misalignment (+ is overval.)
MB approach [1]	14.4
ES approach under alternative benchmarks (mean) [2]	20.2
Stabilize NFL-to-GDP at 3.3 percent	10.2
Stabilize ext. debt-to-GDP at 24.1 percent	25.8
Stabilize ext. debt-to-GDP at 26.3 percent	24.6
PPP approach	19.3

[1] The current account norm underpinning the derived misalignment is an average estimate from pooled and fixed-effect models in CGER.

[2] The benchmarks of 3.3, 23.8, and 26.3 represent end-2010 ratios to GDP of Nepal's NFL, its ext. debt, and average ext. debt of LICs.

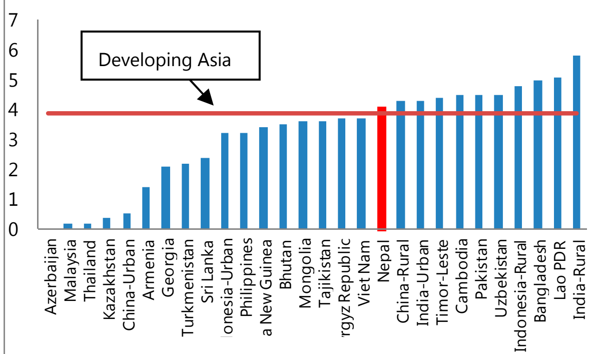


Source: World Economic Forum Global Competitiveness Report 2010-11.

Box 2. A Closer Look at Inflation[1]

High inflation in Nepal can have deleterious effects on the poor, and has caused the exchange rate to appreciate in real terms.

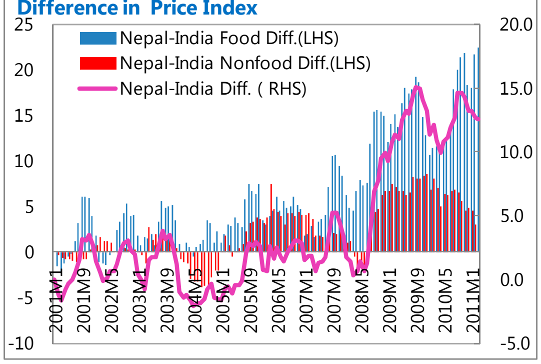
Figure 1. Vulnerability to Food Price Change: Increase in Percentage of Poor Given Food Price Increase of 20%



Source: Asian Development Bank

Although Nepal maintains an open border with India and pegs its currency to the Indian rupee, Nepal's inflation rate—food and, to a lesser extent, nonfood—has been consistently higher than India's since 2007–08. Food price increases have cumulatively contributed about ¾ of overall CPI inflation, while nonfood contributed the remaining ¼. Food price inflation has been more volatile than nonfood.

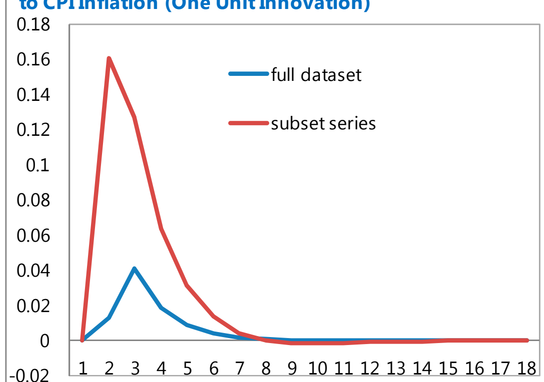
Figure 2. Nepal over India: Cumulative Difference in Price Index



To identify factors driving Nepal's inflation, a VAR model is estimated including external spillovers from India, international oil prices, the nominal effective exchange rate, and domestic monetary factors. It further distinguishes between food and nonfood price inflation, and is estimated separately on a full dataset ranging from 2000 to 2011 and a subset of data series from 2007 to 2011. The main findings are as follows:

- The main driving forces behind Nepal's inflation—food and nonfood—are India's inflation and movements of international oil prices.
- Responsiveness to international oil prices and the exchange rate has increased in recent years. In the study of the subset series, an appreciating nominal effective exchange rate reduces inflation with a lag of 3 months.
- Monetary factors matter for nonfood price inflation and, to a lesser extent, for food price inflation, though the monetary effects fade out quickly. However, there is no evidence that monetary policy has been actively adopted to manage inflation. Rather, the VAR indicates monetary conditions have accommodated inflation shocks.

Figure 3. Impulse Response of Broad Money to CPI Inflation (One Unit Innovation)



[1]See Selected Issues Paper: *Inflation Dynamics in Nepal*.

Authorities' views

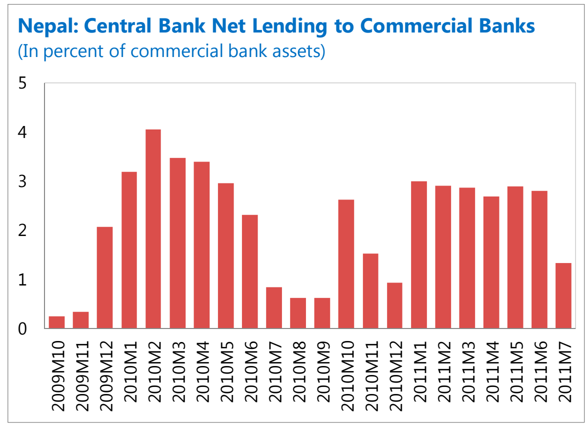
9. **The authorities are more optimistic about growth and inflation in 2011–12**. They project real growth of 5 percent, based on timely budget implementation, receding banking sector stress, and a more positive investment climate in expectation of political stability. Inflation is expected to decline to 7 percent, mainly owing to lower external pressures.

POLICY THEME #1—MAINTAINING MACROECONOMIC STABILITY AND EXTENDING LIVING STANDARDS GAINS

A. Monetary and Exchange Rate Policy

10. **After earlier tightening, monetary policy eased**. Interest rates rose above those in India in late-2010 (Figure 3). However, as bank liquidity strains increased, NRB lending to banks increased in early 2011, the cash reserve requirement was cut from 5½ to 5 percent, and special liquidity assistance was provided to individual banks through two new windows, at slightly penal rates. The interbank interest rate fell to around one percent among Class A commercial banks, significantly below the rate in India, but it remained elevated among Class B and C banks given uncertainty over balance sheets.[3] Government t-bill rates declined to below 3 percent.

11. **Capital controls were tightened to counter reserve pressure in early 2011.** Limits were placed on electronic (ATM) deposit withdrawals via Indian banks. As well, large-value Indian rupee sales were directed to take place exclusively through the banking system, and partly as a consequence, for a period of time during the height of the liquidity squeeze, the exchange rate vis-à-vis the Indian rupee in the informal cash market depreciated relative to the official rate.[4]



Staff's views

12. **Maintaining the exchange-rate peg to the Indian rupee remains the key near-term policy priority.** Over the years the peg has provided a stable and transparent nominal anchor. Abandoning it now would create significant uncertainty given weaknesses in the banking sector, likely leading to deposit and capital flight. At the same time, the peg would become unsustainable in the face of persistent and widespread unsterilized liquidity provision,

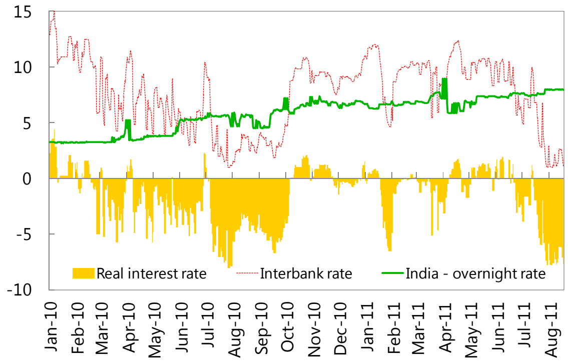
[3] The larger commercial banks (75 percent of the system), and smaller development banks and finance companies are designated Class A, B and C institutions, respectively (see Box 5).

[4] A gold import restriction imposed in early 2010 was eased and import tariffs were raised.

Figure 3. Monetary and Financial Sector Developments

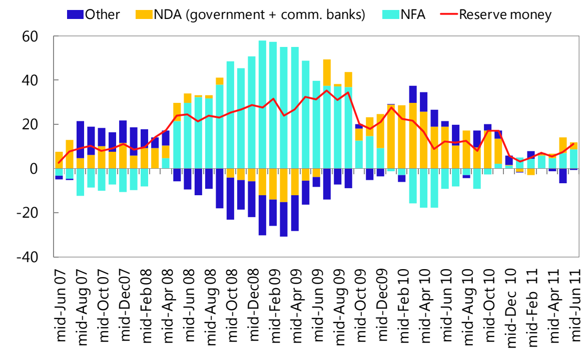
Interbank rates rose above those in India in late-2010, but fell below in mid-2011.

Interbank Rates
(In percent)



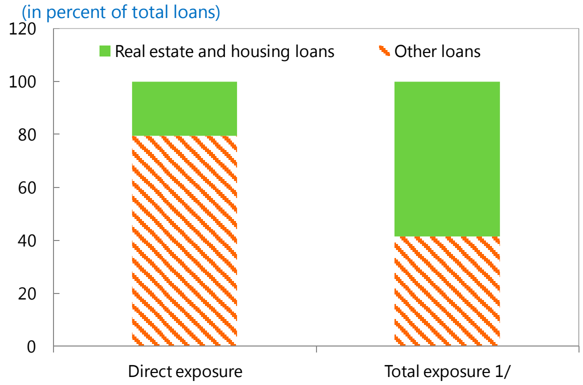
Reserve money growth is picking up.

Contribution to Reserve Money Growth
(Year-on-year; in percent)



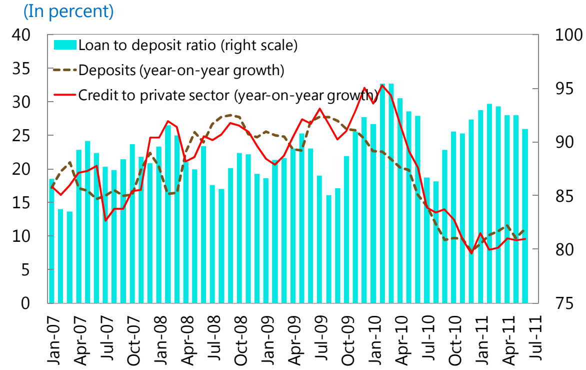
The banking sector remains highly exposed to the real estate sector.

Real Estate Exposure as of 2010/11
(in percent of total loans)



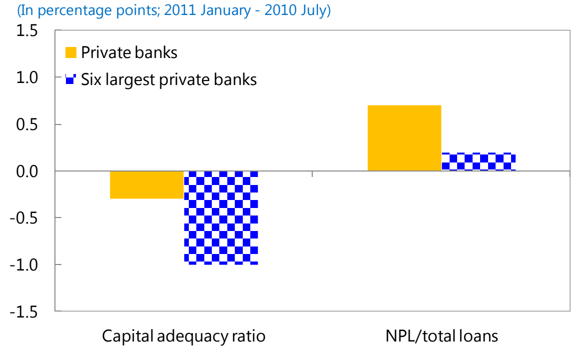
As deposit growth declined, liquidity pressure rose.

Loan to Deposit Ratio and Credit/Deposit Growth
(In percent)



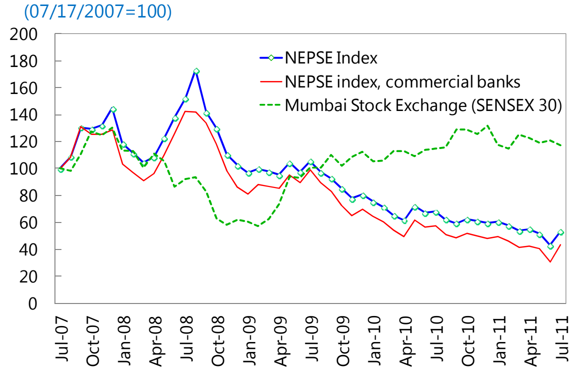
FSIs also indicate rising liquidity risks and deteriorating asset quality, though they are lagging indicators.

Change in Commercial Banks' Financial Soundness Indicators
(In percentage points; 2011 January - 2010 July)



The stock market, dominated by financial institutions, has trended downward.

Stock Market Performance
(07/17/2007=100)



Sources: Nepalese Authorities; Nepal Stock Exchange (NEPSE); and IMF staff estimates.
1/ Includes loans collateralized with real estate properties (as of January 2011).

or if international reserves were to fall substantially. Moreover, the real effective exchange rate appears overvalued, suggesting that the external position will remain under pressure, with reserve coverage of imports slipping over coming years below comfortable levels.[5] Addressing this overvaluation will require structural reforms over the medium term to boost productivity, an adjustment in the peg, or both.

13. **A tighter monetary-policy stance is recommended to support the peg**. Special liquidity assistance for solvent banks to weather short-term liquidity constraints is critical, but monetary conditions have eased broadly, as indicated by the fall in interbank and t-bill interest rates. With the current account in deficit and reserve coverage of imports having drifted down, the easing appears unwarranted. A firmer monetary policy stance, and targeted rather than blanket liquidity assistance, is recommended to help contain import and credit growth and stem capital outflows to support the peg. This policy constellation also reduces banks' profitability, but is required to avoid an even greater dislocation that would arise from a disorderly abandonment of the peg.

[5] Recent research suggests the optimal level of reserves for fragile low income countries with fixed exchange rates is close to eight months of imports, significantly higher than exist now in Nepal. See *Assessing Reserve Adequacy*, IMF Policy Paper, February 2011.

14. **Capital controls can complement but not substitute for appropriate macro-policy settings.** Given the open border capital controls are easily circumvented through informal channels, as evidenced by the depreciation of the exchange rate in the informal cash market, and by the fall in international reserves in late-2009 and early-2010.

15. **Better interest-rate control would enhance policy signaling and deepen money markets.** Introducing a standing deposit facility would create an interest-rate corridor for policy rates. Adopting the interbank interest rate as the proximate operational policy indicator, and more active liquidity management operations, would stabilize interest rates within the corridor and provide a more stable environment for banks' liquidity management operations.

16. **One Article VIII restriction has been lifted, although another exists**. The restriction on quantitative limits on foreign exchange for leisure travel was removed in early 2011. The Industrial Enterprises Act places a 75 percent limit on the conversion and transfer to foreign currency of salaries of non-residents from countries where convertible currency is in circulation. Since the limit applies to amounts that may be less than net salaries, it gives rise to an exchange restriction under Article VIII. Staff is investigating if this measure is also discriminatory.

Authorities' views

17. **The authorities believe the exchange rate peg should remain the key policy target.** They recognize the overvaluation challenge, but note that this reflects to a large extent structural constraints that need to be addressed to enhance productivity. The authorities aim to maintain reserves at 6 months of imports, although they recognize that macroeconomic developments may make this task challenging.

18. **The NRB notes that monetary policy should support growth in addition to the peg**. Money growth has been low and deposit rates are above those in India, indicating monetary conditions are not overly loose, while liquidity assistance to banks is necessary to restore confidence. The reduction in the interbank rate is largely seasonal, and should increase in coming months with a pick-up in lending, and increased deposit withdrawals during the festival season. However, if deposit rates decline, the authorities will consider liquidity-draining operations.

19. **The authorities are committed to removing Article VIII restrictions**. They noted that the restriction in the Industrial Enterprises Act has existed for some time, but has not been enforced.

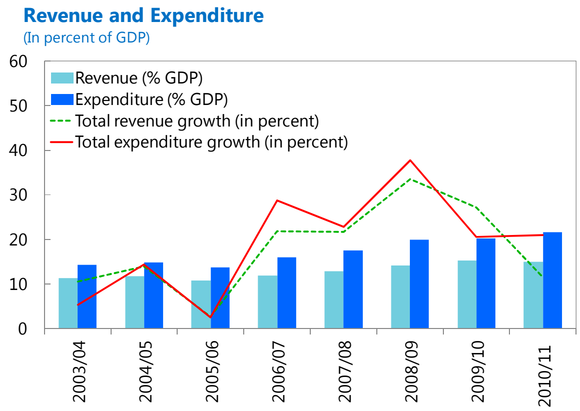
B. Preserving Fiscal Prudence and Improving Public Financial Management

20. **The political impasse undermined budget execution in 2010–11**. The budget was implemented by ordinance for the first seven months of the year, before being adopted by the Constituent Assembly in February 2011. As a result of the delay, and also reflecting slower economic activity, lower import growth, and a net reduction in import tariffs, revenue and current spending were lower than budgeted (Figure 4). Capital spending and associated external financing were also lower than budgeted, owing partly to weak public financial management (PFM) systems. Net domestic financing (NDF) of the budget deficit amounted to 2¾ percent of GDP, compared to around 2 percent budgeted.

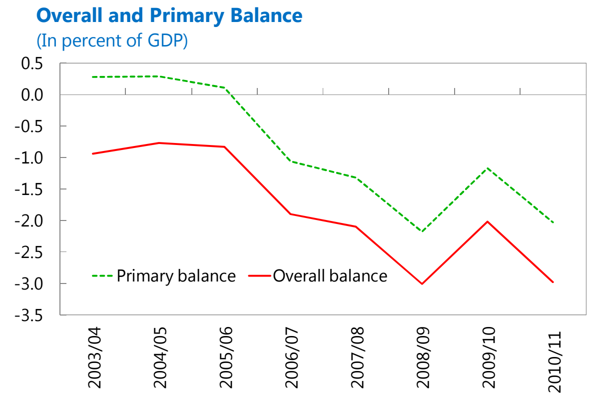
21. **The 2011–12 budget targets net domestic financing at 2 percent of GDP**. Revenues are budgeted to increase robustly, with strong contributions from import-related taxes. Some excises were raised, while capital gains taxes on real-estate and securities transactions were halved and exemptions on infrastructure investment extended. Current spending is budgeted to increase significantly, led by a 22 percent rise in civil service salaries. Capital spending and associated foreign assistance inflows are also budgeted to rise.

Figure 4. Fiscal Developments

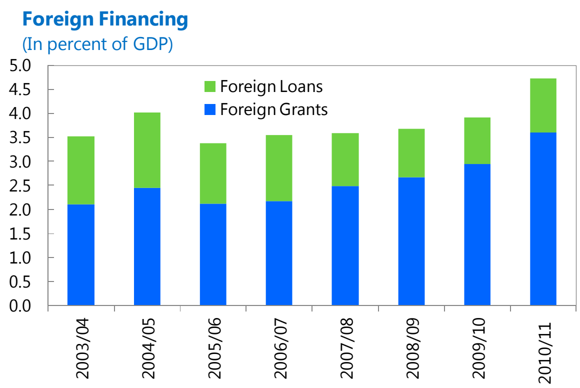
Revenue and expenditure growth has slowed since 2008/09.



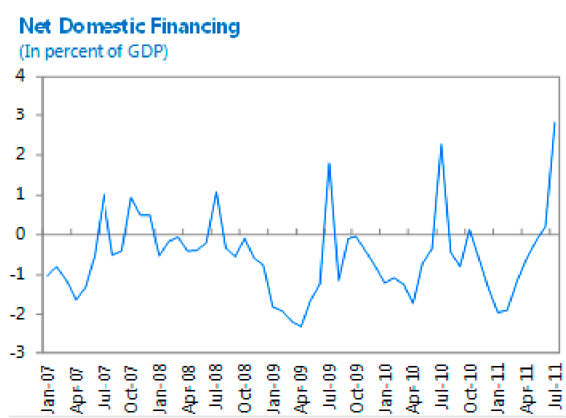
As a consequence, the fiscal balance has deteriorated recently.



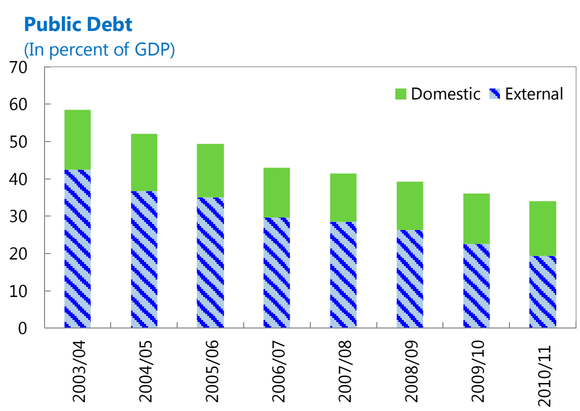
Despite somewhat higher foreign grants than in previous years…



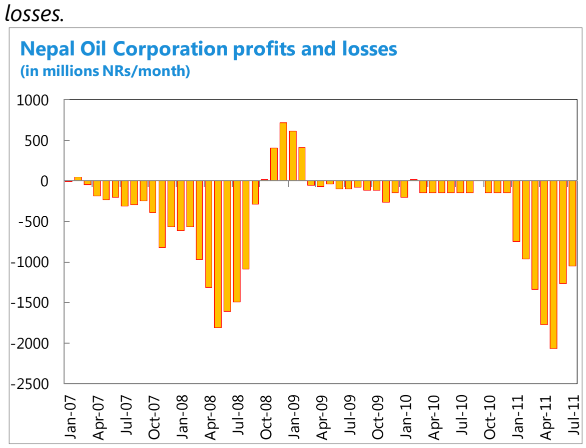
…net domestic financing rose above historical levels.



The debt profile improved…



…but the Nepal Oil Corporation is again incurring large losses.



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

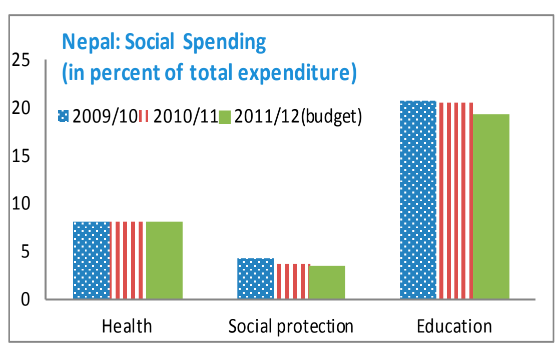
22. **Losses at the Nepal Oil Corporation increased sharply late last year.** Domestic fuel prices were increased a number of times, though shortages arose because of difficulty financing imports from India. For 2010-11, losses amounted to ½ percent of GDP, and arrears on loans from the government stood at about the same amount. New LPG subsidies were announced in early 2011-12.

Staff's views

23. **The timely adoption of the budget this year is welcome and its net domestic financing target is appropriate.** Even though debt levels have declined, the near-term space for fiscal policy to support growth is constrained by the need to support the exchange-rate peg and to moderate inflation pressures. Moreover, given liquidity strains among banks, NDF in excess of 2 percent of GDP would likely crowd out private sector credit. The debt sustainability analysis indicates a moderate risk of debt distress in light of possible fiscal costs associated with heightened banking stress, indicating a conservative budget is appropriate.[6]

24. **Continued revenue administration reform efforts are encouraged.** Revenues as a share of GDP fell last year, reversing a commendable trend. Further administration gains are possible, but targets for 2011-12 appear ambitious in light of the modest outlook for economic activity and import growth. Effort should focus on improving domestic revenue yields and reducing the reliance on imports, including by rationalizing exemptions and incentives (Box 3). Collection of VAT arrears by large taxpayers (estimated at over 1 percent of GDP) is key, while tax amnesties should be avoided. Sustained gains over the medium term will be needed to support infrastructure spending and attainment of the MDGs.

25. **The rise in, and composition of, current spending is a concern**. The increase in salaries is substantially above the rate of inflation, but social spending as share of total expenditure is budgeted to decline. Current spending has increased by 4 percentage points of GDP over the last five years, compared to an increase of 2¾ percentage points in capital expenditure, and spending quality is difficult to monitor under a weak PFM framework. The budget's capital spending plans broadly prioritize development appropriately, but execution has consistently underperformed. Upside risk exists owing to rehabilitation and integration of former combatants.

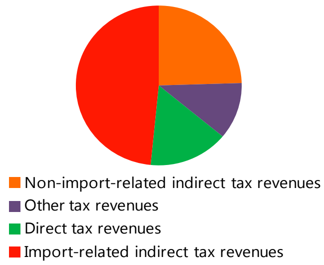


[6] See also *Nepal—Considerations in the Choice of the Fiscal Stance*, Selected Issues, May 17, 2010.

Box 3. Sustaining Revenue Gains[1]

Good progress in revenue administration has been made in recent years, though Nepal's revenue-to-GDP ratio remains below most other low income countries. Revenues rely on imports, while income tax collections make up a smaller share. If import growth moderates in line with a more sustainable balance of payments position and tariff rates decline with trade agreements, this revenue structure will be unlikely to generate sustainable revenue growth. Income tax and VAT collections will have to play a larger role, but widespread use of tax incentives and exemptions has undermined their productivity.

Nepal: Revenue Structure



Nepal: Revenue Comparison (in percent of GDP)

Country	Total tax revenues	Revenue from: Goods and services taxes	Income tax	Trade taxes
Nepal	13.2	6.0	2.9	4.0
LIC average	15.2	6.0	5.0	3.5
India	16.9	6.7	7.5	1.5
China	17.5	9.9	4.5	0.9

Data sources: WEO (data as of 2010), GFS (data as of 2009).

Various VAT exemptions, including on electricity and on cooperatives and agricultural companies with turnover above the presumptive tax threshold, should be eliminated as they erode the tax base and are not always effective in lowering the tax burden on intended beneficiaries. This could yield revenue gains of up to ¾ percent of GDP.

Income tax incentives could be reformed to improve targeting, thereby increasing revenue productivity. Specific measures could involve conditioning tax holidays and rebates on investment, shorter expiration limits for tax rebates, and increased use of investment tax allowances and accelerated depreciations. Such measures could yield revenue gains of up to 1½ percent of GDP.

Nepal: International Comparison of Tax Yields

Country	Income tax yield	VAT yield (GDP-based)	VAT yield (consumption-based)
Nepal	0.12	0.35	0.39
LIC average	0.19	0.40	0.43
India	0.25	0.67	0.99
China	0.15	0.58	1.16
Thailand	0.26	1.10	1.63
Vietnam	0.33	0.95	1.31
Bangladesh	0.07	0.20	0.24
Sri Lanka	0.14	0.31	0.36

Data sources: WEO (data as of 2010), GFS (data as of 2009).
Note: Revenue yields are calculated as the ratio of revenue collections as percent of GDP (or consumption, in the case of VAT) over the respective tax rate. Standard corporate rate used for income tax.

[1]See Selected Issues Paper: *Nepal's Tax Regime*.

26. **Contingency plans are recommended to meet the budget's NDF target**. Absent additional measures, NDF could reach 3¼ percent of GDP in 2011–12. Revenue refocusing, and restraining administrative expenses and unproductive subsidies while safeguarding poverty and social sector spending, are priorities. Moreover, an automatic price adjustment mechanism should be implemented to eliminate NOC losses.

27. **PFM reforms to strengthen budget execution, reporting, and auditing will instill greater confidence in budget systems**. It is recommended that the coverage, timeliness and quality of monthly budget execution reporting be enhanced, including initiating coverage of poverty alleviation programs. The appointment of an Auditor General would improve accountability and facilitate procurement and spending execution, and will send a positive signal to donors.

Authorities' Views

28. **The authorities remain committed to a prudent fiscal policy stance**. They reiterated that the NDF ceiling would not be breached, and measures, including reductions in unproductive current expenditures and low-priority capital projects, or additional external concessional financing, would be pursued if required.

29. **The authorities are confident the revenue target is attainable.** They expect economic activity and import growth to be robust, and action plans to enhance tax administration have been made in both the Customs and Inland Revenue Departments, with technical assistance from the IMF. On import-related revenue, the authorities plan to improve the valuation of goods and crack down on under-invoicing, an important source of revenue shortfall.

C. Extending the Gains in Living Standards

30. **The authorities have prepared a Three Year Plan Approach Paper (TYP), their poverty reduction strategy**. Poverty alleviation, employment creation, inclusive and equitable development, and meeting the MDGs by 2015 are the Plan's main priorities (Box 4). Also, the new government announced measures to tackle corruption and strengthen public governance.

Staff's views

31. **Migration and remittances have driven welcome improvements in living standards**. The share of households receiving remittances increased from 30 percent in 2003–4 to 55 percent in 2010–11. While per-capita remittances have more than quadrupled, less than a tenth of remittances are spent on capital formation including education. Non-agriculture domestic

Box 4. Poverty Reduction and the MDGs[1]

Early results from the Nepal Livings Standards Survey (NLSS-III) for the year 2010-11 indicate significant improvements compared to the previous survey undertaken in 2003-4. Access to sanitation, safe drinking water, education and health has improved. Nominal per capita income of the bottom fifth of those surveyed quadrupled, while it doubled for the top fifth. Self-reported perceptions of income inadequacy declined from 67 percent of households in 2003-04 to 49 percent in the latest survey.

Nepal has made good progress towards its MDGs according to the UN and World Bank. An MDG needs assessment was recently undertaken by the UNDP, involving a detailed costing exercise for achieving each Goal. It indicates that some of the targets will require significant financing to achieve.

The Approach Paper to the Three Year Plan (TYP), Nepal's poverty reduction strategy, targets real GDP growth of 5½ percent and inflation of 7 percent per year, and net domestic financing (NDF) of deficits at around 2¼ percent of GDP. Reserve coverage is targeted at 6 months of imports.

The plan's growth target is commendable but optimistic given the structural impediments that exist, and in light of historical growth of 3¾ percent. The targeted inflation rate is higher than that projected for India over the medium term, risking further real exchange rate appreciation and possible losses in competitiveness, and suggesting the reserve target may be difficult to achieve. The NDF target is appropriate, though revenue gains will require ongoing effort.

Will Nepal Achieve it's Millenium Development Goals?

	On target	Close to target	Far from target	No data
Goal 1: Eradicate Extreme Poverty and Hunger				
1a: Halve the proportion of people whose income is less than $1.25 a day		√		
1b: Achieve full and productive employment and decent work for all			√	
1c: Reduce by half the proportion of people who suffer from hunger		√		
Goal 2: Achieve universal primary education		√		
Goal 3: Promote Gender Equality and Empower Women	√			
Goal 4: Reduce Child Mortality	√			
Goal 5: Improve Maternal Health				
5a: Reduce the maternal mortality ratio by three-quarters		√		
5b: Achieve universal access to reproductive health			√	
Goal 6: Combat HIV/AIDS, Malaria and other diseases				
6a: Halt and reverse the spread of HIV/AIDS	√			
6b: Achieve universal access to treatment for HIV/AIDS for all those who need it		√		
6c: Halt and reverse the incidence of malaria and other major diseases	√			
Goal 7: Ensure Environmental Sustainability				
7a. Climate change and GHG emission				√
7b1. Reverse loss of forest		√		
7b2. Reduce biodiversity loss				√
7c1. Halve proportion of population without sustainable access to improved water source	√			
7c2. Halve proportion of population without sustainable access to improved sanitation		√		
7d. Improve lives of slum dwellers				√
Goal 8: Develop a Global Partnership for Development				√

Sources: Global Monitoring Report, World Bank 2011 and 2010 Progress Report of Nepal's MDGs, UNDP.

[1]See Millennium Development Goals Needs Assessment for Nepal, UNDP, 2011.

employment generation has been weak—only 13 percent of employment arises in non-farm wage work.

32. **The remittance-based model of income generation, while clearly beneficial, is not optimal in the long run**. It arises in part from weak domestic employment opportunities and is subject to shocks that are difficult to address with domestic policy. Migration may also have unpredictable long-term social effects on rural society, as a large number of working age men and women depart, leaving behind the young and the old.

33. **Tackling longstanding structural problems is essential to achieve high and sustainable growth and employment generation**. The poor business climate, inadequate infrastructure, and weak governance and rule of law remain major impediments to moving to a higher growth path. The recently announced measures to improve governance are welcome. The TYP also broadly recognizes the challenges. Its emphasis on infrastructure improvement is appropriate, and is broadly reflected in the 2011–12 budget, although the gestation period to raise growth and employment is likely to be long, and execution of capital spending needs to improve.

Authorities' views

34. **The authorities recognize the need to remove structural bottlenecks, especially in the electricity sector**. To this end, a master plan will be prepared for hydro power development, including an assessment of generation potential to be updated every ten years. An additional 750 MW of hydro projects are under construction, expected to come on-stream by 2014–15, more than doubling installed capacity at present. The TYP also emphasizes rural development in a public-private partnership (PPP) framework. To provide stability to the investment climate, the authorities intend to develop an overarching 20-year vision for growth and development, within which rolling plans of shorter horizons would be executed.

POLICY THEME #2—MANAGING FINANCIAL SECTOR STRESS

35. **Banking-sector stress intensified significantly in early-2011**. A number of the smaller development banks and finance companies ran into severe distress, with institutions accounting for about 11 percent of their total deposits requiring emergency liquidity assistance from the NRB, in some cases resulting in prompt corrective action and intensive supervision.

36. **Liquidity strains rose** due to ever-greening of non-performing loans, falling profitability, and increased competition for deposits. Even though credit growth has slowed, loan-to-deposit ratios remain high. Pressures are more intense among Class B and C institutions as deposits shifted to the perceived safety of Class A banks, and as interbank lines to those institutions seized amid concern over balance sheets.

37. **Commercial banks' financial soundness indicators show a small deterioration, but the data likely understate**

substantially the weaknesses. One half of commercial banks report NPL ratios below one percent, a very low number suggesting under-reporting (Box 5). Onsite inspections of some institutions applying for liquidity assistance reveal serious governance failures, impaired assets, and financial interconnectedness.

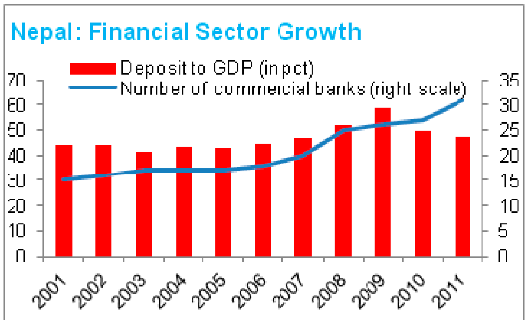
38. **Indicators suggest asset quality has deteriorated**. About half of bank lending either funds or is collateralized by real estate, the market for which has largely frozen. Where transactions have taken place, prices have fallen by around 50 percent since their peak, and the stock market—dominated by financial institution listings—has declined to about one third of its peak. A number of factors contributed, including previous years' excessive credit growth, weak supervision and enforcement of prudential regulations, and a liberal bank licensing policy. Inadequate governance and risk management in banks has heightened systemic fragility and financial interconnectedness, including through connected lending, and possible cross shareholding among banks arising from pledging of equity shares as loan collateral. Preliminary data indicate about one third of all financial institutions extend loans collateralized by other institutions' promoter shares, with some having substantial exposure relative to their paid-up capital.

39. **The budget announced expanded deposit insurance.** Coverage is to be increased and extended to include commercial banks in addition to B and C institutions, however the share of deposits covered and thus the program's capital needs are yet to be determined due to data inadequacies.

40. **Earlier welcome strengthening of prudential regulations by the NRB has given way to forbearance**. The loan classification and provisioning regulation was improved, new risk management guidelines issued, eligibility criteria for licensing upgrades tightened, and a limit on personal overdraft loans established. A new bylaw was issued to facilitate mergers, but it provides forbearance to merged institutions. More recently, prudential limits on loans collateralized by shares and on residential real estate exposure were eased. Financial institutions have been allowed to recognize interest and principal payments received in the first month of 2011–12 in last fiscal year's accounts, permitting the reporting of higher profits and lower non-performing loans.

Box 5. Financial Soundness Indicators and Bank Stress Tests

The banking system comprises 31 Class A, 87 Class B, and 80 Class C institutions, accounting for 75, 12½ and 12½ percent of banking system assets, respectively.



Sources: Nepal Rastra Bank; and IMF staff estimates.

Nepal's banking sector has expanded rapidly. Since 2005 the number of Class A banks almost doubled, their assets almost tripled, and credit growth peaked at more than 30 percent in early 2010. Private banks accounted for all of this growth, while assets of the insolvent state banks as a share of the sector's total declined. In mid-2011, private banks accounted for more than 80 percent of Class A banks' assets, with the 6 largest banks accounting for 35 percent. In addition, there are reportedly about 8000 largely unsupervised credit cooperatives whose financial condition is unknown. This shadow banking sector poses risks to financial stability, and competes for liquidity with the commercial banks by offering high interest rates to attract deposits.

Financial soundness indicators reported by Class A commercial banks deteriorated only moderately since the global crisis, though these are lagging indicators. They do not likely reflect the full impact of the collapse in real estate, and there are significant data integrity issues related to weak governance and supervision.

Stress tests undertaken on the Class A banks by the NRB indicate credit and liquidity risks as of April 2011, though because of the aforementioned data issues, the results may be overly optimistic.

Credit risk: In a scenario where 15 percent of performing loans downgrade to substandard, 15 percent of substandard loans downgrade to doubtful, and 25 percent of doubtful loans downgrade to loss loans, and 5 percent of performing loans downgrade to loss, 20 private banks accounting for 68 percent of system deposits would see their CAR dropping below 10 percent. In a scenario simulating falling real estate prices where 25 percent of performing real estate and home loans become loss loans, 13 private banks accounting for 48 percent of system deposits would see their CAR fall below 10 percent.

Liquidity risk: The scenario assumes customers withdraw for five consecutive days a share of deposits that increases to 10 percent. In the first four days, 5 banks would become illiquid, and the number of illiquid banks would rise to 19 in the fifth day, accounting for about 70 percent of deposits.

Financial Soundness Indicators (class A banks)

	State Banks		Private Banks		6 Largest Private Banks	
	2010M7	2011M4	2010M7	2011M4	2010M7	2011M4
CAR	-17.5	-16.5	13.4	13.6	12.4	11.9
NPL Ratio	6.4	8.1	1.2	2.1	1.3	1.6
CD Ratio	53.7	60.0	84.8	92.4	82.5	87.4
Liquid Ratio	31.1	23.4	30.3	25.0	30.4	27.4

Source: Nepali authorities; and IMF staff estimates.

41. **The legal regime for bank intervention entails significant delays.** Both the NRB Act and the Banking and Financial Institutions Act (BAFIA, revisions to which have been under Parliamentary consideration for some years) provide the NRB options to intervene troubled financial institutions, and underpin the prompt corrective action (PCA) framework, but overlaps and conflicts raise uncertainty. Moreover, declaring a bank insolvent requires an appellate court ruling and the appointment of a special investigation to determine the institution's viability, delaying action by months, and causing forbearance in the full application of the PCA framework.

42. **Restructuring of the two state-owned banks has proceeded very slowly**. They account for 14 percent of system deposits combined, and continue to operate with negative capital in a weak governance environment. World Bank funding for an audit of Nepal Bank Limited (NBL) by an international firm has been made available, but the authorities' selection of an audit firm has been slow, and as a consequence the financing is likely to expire unused.

43. **Amendments to the Anti-Money Laundering Act were endorsed by the Constituent Assembly in May**. In June 2011 the FATF called on Nepal to implement its action plan. The authorities have developed, with IMF technical assistance (TA), a national AML/CFT strategy to be adopted by the Council of Ministers. Follow-up IMF TA aims to review and propose amendments to the AML/CFT legal framework and enhance supervisory capacity.

Staff's views

44. **Recent stress in the banking system is a strong call to action.** Although major difficulties have surfaced only at smaller institutions thus far, balance-sheet weaknesses also likely exist in others, reflecting governance shortfalls, similar business models, and financial interconnectedness. In this context, an under-reporting of NPLs by a large number of banks is a serious concern. Identification of systemically important institutions and subsequent diagnostic assessments have yet to begin, and with data inadequacies, the true extent of problems is not yet known with certainty, though IMF technical assistance should help gather and analyze critical information.[7] Notwithstanding, failure of, or loss of confidence in, a group of smaller institutions could lead to contagion and deposit flight, accompanied by pressure on the exchange-rate peg.

45. **International experience is relevant for Nepal**. Warning signs of latent systemic fragility, which have also arisen in Nepal, include prior rapid growth in bank credit, significant asset price cycles, weak legal institutions that slow resolution procedures,

[7] An IMF resident banking supervision advisor was recently appointed by the NRB.

policy lethargy, and liquidity shortages.[8] Regulatory forbearance and liquidity support are common initial reactions, and while these buy time, they do not solve underlying capital deficiencies and often increase future resolution costs.

46. **International experience also shows output losses and fiscal costs associated with bank crises can be substantial**. A sharp contraction in real GDP, reserves loss and exchange rate depreciation can take place. Were fiscal costs on the order of those experienced in a range of countries facing similar circumstances to arise in Nepal, public debt levels would become unsustainable. Under such an illustrative scenario, annual fiscal effort of at least 3 percentage points of GDP over the medium term would be required to re-establish debt sustainability.

International Comparison of Banking Crises and Intervention Costs

Country	Start	Fiscal Cost 1/	Reserve Loss 2/	Depreciation 3/	Output Loss 4/
Benin	1988	17.0			1.9
Brazil	1994	13.2	31.6	72.6	
Dominican Republic	2003	22.0			15.5
Ecuador	1998	21.7	11.8	17.6	6.5
Indonesia	1997	56.8	44.0	39.2	67.9
Jamaica	1996	43.9	15.2	-3.1	30.1
Malaysia	1997	16.4	20.6	10.5	50.0
Mexico	1994	19.3	33.9	43.1	51.3
Nicaragua	2000	13.6	7.2	2.9	
Senegal	1988	17.0			25.4
Sri Lanka	1989	5.0	49.2	9.9	2.2
Thailand	1997	43.8	15.8	36.3	97.7
Uruguay	2002	20.0	52.7	43.5	28.8
Venezuela	1994	15.0	39.4	36.5	9.6
Vietnam	1997	10.0			19.7
Russia	1998		19.5	72.6	
Average		***22***	***28***	***32***	***31***
Maximum		***57***	***53***	***73***	***98***

Sources: "Systemic Banking Crises: A New Database", IMF Working paper 08/224, November 2008; and IMF staff estimates.
1/ In percent of GDP.
2/ Cumulative loss over first 2 quarters of reserve losses in the crisis year (% of previous year end-of-period reserves).
3/ Total depreciation over first 2 quarters of depreciation in the crisis year (in percent).
4/ Cumulative loss of real GDP over 4 years after crisis against trend, % of trend real GDP.

47. **Upgrading the legal framework is essential for crisis management**. A priority is to clarify intervention powers and center that authority in the NRB, with actions subject to review only after the fact if intervention decisions are found to be arbitrary. Additionally, the BAFIA and the NRB Act should be revised to ensure consistency and close gaps.

48. **Enhanced supervision and data accuracy are critical to identify problems early**. On-site inspections should be immediately initiated for institutions that have received liquidity assistance, and appropriate corrective actions taken. Systemically-important institutions should be identified, including among smaller institutions, by analyzing financial interconnectedness, including through inter-bank lending and loans collateralized by shares, and then subject to priority on-site inspection.

49. **Stronger regulation and enforcement would help contain risks**. Triggers for prompt corrective action should be expanded to include liquidity, asset quality and governance shortfalls, and their application used fully and more consistently. Banks' governance structures should be reported to the NRB, and time-bound plans to

[8] See Laeven and Valencia, 2010, *Resolution of Banking Crises; The Good the Bad and the Ugly*, IMF WP/10/146, Claessens et al, 2011, *Crisis Management and Resolution: Early Lessons from the Financial Crisis*, IMF SDN/11/05, and Reinhart and Rogoff, 2009, *This Time is Different: Eight Centuries of Financial Folly, Princton University Press*,

correct deficiencies enforced. As well, application of risk management guidelines to all financial institutions is recommended, and discretionary accounting treatments should be avoided.

50. **Lending collateralized by equity shares places capital at risk.** Exercising share collateral in the event of default can result in cross-share holdings among banks, weakening the net capital position of the system as a whole. Capping the ratio of share-collateralized loans to core capital at 20 percent is recommended, down from the current 100 percent limit. At the same time, consideration should be given to phasing out the restriction on trading in promoter shares, to reduce the incentive for owners to use them as loan collateral.

51. **Staff recommends strengthening safeguards to make the NRB's liquidity financing more targeted and less risky.** The NRB's two new special liquidity financing facilities should be merged into one. Application of penalty rates and the requirement for receiving institutions to provide high-frequency reports and submit a liquidity resolution plan are welcome. To minimize potential risks to NRB capital and any related contingent fiscal liability, it is recommended that borrowers also be subject to heightened supervision, meet the capital adequacy requirement or be subject to prompt corrective action, and have restrictions placed on insiders' transactions to prevent asset stripping.

52. **The moratorium on new bank licenses imposed last year is welcome and should be strictly enforced**. As the number of banks has over-stretched supervisory capacity, the moratorium should be extended to microfinance institutions. As well, licensing criteria should be strengthened to identify beneficial shareholders.

53. **Restructuring the state-owned banks would reduce moral hazard and signal to other banks that forbearance is being tackled**. The delay in NBL's diagnostic assessment by an international auditor is concerning. This is a first step in designing a coherent restructuring plan, and should be undertaken expeditiously.

54. **Mandatory participation in the deposit insurance program is important to enhance its effectiveness.** A short deadline for enrollment and payment of premiums for all covered institutions is recommended. Deposit profiles for all institutions are needed to determine the program's capital needs, and to estimate possible contingent fiscal liabilities.

Authorities' views

55. **The authorities believe that problems are concentrated in small institutions and can be managed.** They consider that focusing on mergers and tax incentives to reinvigorate the real estate

market will preserve confidence. They emphasize that forbearance and liquidity assistance are temporary measures, and agree on the need to strengthen the emergency liquidity assistance framework. However, lending against share collateral is seen as small (two percent of total loans), and restricting the practice would have an adverse impact on the stock market and confidence.

56. **More intensive on-site supervision is needed and being initiated.** Non-performing loans are recognized as being under-reported, but important drivers of liquidity shortage include delayed government spending and the shifting of institutional deposits from the smaller banks. Supervision remains constrained by capacity weakness and lack of staff, but improvement efforts and regular stress testing of banks are being undertaken, supported by IMF technical assistance. However, an international audit of NBL would be difficult to undertake if it requires significant domestic financing. The licensing moratorium will be maintained, but microfinance institutions will be allowed to open in remote areas to enhance access to finance for poverty reduction.

57. **A crisis management framework is being developed**. The authorities have established high-level and technical oversight committees. They agree the legal framework would benefit from further refinement, however they are constrained in committing to further amendments to BAFIA in the near term due to Parliamentary procedures. They emphasized that interconnectedness is prevalent among some institutions, increasing the complexity of resolution and the need for strong political support.

STAFF APPRAISAL

58. **Nepal has achieved commendable progress in living standards, though the outlook is challenging.** Cementing gains in livelihoods while broadening the base of economic activity and job creation will require a stable macroeconomic and financial environment, and increased investment in infrastructure with improved governance.

59. **The pre-eminent near-term risk stems from banking-sector strains.** International experience suggests close attention must be paid to warning signals of latent fragility, as hard-won macroeconomic and social gains would be unwound in the event of systemic financial dislocation. Implementing preventative measures is a critical priority, for which broad political support will need to emerge to overcome vested interests. Staff is concerned about an over-reliance on regulatory forbearance and

blanket liquidity provision, as these buy time but do not address fundamental problems related to non-performing loans and weak governance. Staff welcomes the recent intensification of supervision and strongly encourages strengthening of safeguards on the NRB's liquidity provision to troubled banks. Strict enforcement of prudential regulations and an effective resolution framework are urgently needed, as is tangible progress in restructuring insolvent state banks, which would send a strong positive signal. The licensing moratorium should be strictly enforced.

60. **A coherent bank resolution framework requires legal changes to facilitate timely intervention and resolution of problem banks by the NRB**. In the interim, the risks in and structure of all institutions need to be well understood. The merger bylaw should be revised to eliminate forbearance, and the authorities are encouraged to identify professionals to participate in various resolution options, including conservatorships, bridge banks and liquidations. As a general rule, resolutions should minimize costs to the public sector, shareholders should bear the first losses, and mergers should be avoided if the partners are weak.

61. **The exchange-rate peg continues to underpin macro-financial stability, but requires consistent monetary policy settings**. The peg has provided needed discipline for policy formulation through the political transition and in an environment of limited capacity. Support for the peg calls for a tighter monetary stance than currently exists. Emergency liquidity assistance should be provided to solvent banks while overall monetary control is maintained through sterilization, and solvency shortfalls addressed through prudential measures.

62. **The exchange rate appears overvalued**. Structural weaknesses that limit investment and productivity need to be addressed to reverse the overvaluation. Were sustained and significant adverse exchange rate pressures to materialize, however, reserves preservation and adjustment of the peg should be considered.

63. **The authorities' commitment to prudent fiscal policy and revenue administration reform is commendable**. Public debt levels have declined, though a moderate risk of debt distress exists given possible fiscal costs associated with heightened banking stress, calling for continued prudence. This year's budget target for domestic borrowing is appropriate. As the revenue targets appear ambitious and spending pressure has increased, the authorities are encouraged to draw up contingency plans focusing on current spending restraint while protecting pro-poor outlays. A re-orientation of the revenue structure towards domestic sources will be required to generate sustained gains, needed

to finance higher levels of spending on infrastructure and human capacity development over the medium term. Domestic fuel prices should be adjusted to eliminate losses, NOC arrears should be cleared, and an automatic domestic fuel price adjustment mechanism implemented.

64. **Staff does not recommend approval of retention of the exchange restriction subject to Article VIII**. All foreign nationals should be allowed to repatriate salary amounts at least equal to their salary net of applicable income taxes.

65. **Staff welcomes the authorities' interest in a program that could be supported by the ECF as soon as a political consensus emerges**. Designing a coherent approach to address banking-sector risks, in particular the legal framework for crisis management, backed by a degree of political continuity and support to take meaningful measures is important for further progress. Staff will remain intensively engaged with the authorities including on program discussions given elevated macro-financial risks.

66. **It is recommended that the next Article IV consultation takes place on the standard 12-month cycle**.

Table 1. Nepal: Selected Economic Indicators

	2008/09	2009/10	2010/11	2011/12
			Est.	Proj.
Output and prices (annual percent change)				
Real GDP	4.4	4.6	3.5	3.8
Non-agricultural GDP	4.1	5.4	3.1	2.9
CPI (period average)	12.6	9.6	9.5	8.0
CPI (end of period)	11.1	9.0	9.4	8.1
Fiscal Indicators (in percent of GDP)				
Total revenue and grants	16.6	18.0	18.4	18.3
Expenditure	19.2	19.0	20.1	21.0
Expenses	16.4	16.1	16.8	17.7
Net acquisition of NFA	2.8	2.9	3.3	3.3
Net lending/borrowing	-2.6	-1.0	-1.8	-2.7
Net acquisition of FA	-0.4	-1.0	-1.2	-1.1
Net domestic financing	3.0	2.0	2.8	3.3
Money and credit (annual percent change)				
Broad money	27.3	14.1	9.5	11.1
Domestic credit	27.1	16.8	13.2	15.0
Private sector credit	29.0	14.2	11.8	6.4
Velocity	1.6	1.6	1.7	1.7
Investment and saving (in percent of nominal GDP)				
Gross investment	31.5	35.8	35.0	32.8
Private	24.6	28.6	27.1	24.8
Central government	6.9	7.2	7.9	8.0
Gross national saving	35.7	33.4	34.1	32.0
Balance of payments				
Current account (in millions of U.S. dollars)	536	-378	-167	-156
In percent of GDP	4.2	-2.4	-0.9	-0.8
Trade Balance (in millions of U.S. dollars)	-2,707	-4,078	-4,474	-4,975
In percent of GDP	-21.1	-26.0	-24.4	-24.4
Exports value growth (percent change)	0.5	-6.1	13.9	9.0
Imports value growth (percent change)	14.1	36.4	10.4	10.8
Gross official reserves (in millions of U.S. dollars)	2,907	2,844	3,098	3,180
In months of imports of goods and services	6.0	5.4	5.4	5.0
Memorandum items				
Public debt (percent of GDP)	39	36	34	35
GDP at market prices (in billions of Nepalese rupees)	988	1,171	1,327	1,487
GDP at market prices (in billions of U.S. dollars)	12.9	15.7	18.3	20.4
Exchange rate (Nrs/US$; period average)	76.9	74.5	72.4	…
Real effective exchange rate (eop, y/y percent change)	3.5	7.3	…	…

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

Table 2. Nepal: Summary of Government Operations 1/

	2008/09	2009/10	2010/11		2011/12	
			Budget	Est.	Budget	Proj.
	(In billions of Nepalese rupees)					
Total revenue and grants	163.8	210.3	279.7	243.6	305.5	272.3
Total revenue	137.4	175.8	214.4	195.8	235.4	223.5
Tax revenue	117.0	154.7	188.7	171.8	209.2	198.9
Non-tax revenue	20.4	21.1	25.6	24.0	26.2	24.6
Grants	26.4	34.5	65.3	47.8	70.1	48.8
Expenditure	189.2	221.9	301.0	266.9	332.8	313.0
Expenses	161.8	188.2	244.2	222.5	271.4	263.5
of which:						
Interest payments	8.2	10.0	12.5	12.5	16.6	16.6
Salaries and allowances	34.4	41.9	44.4	46.3	55.4	55.4
Contingencies 2/	...	...	...	...	2.3	...
Net Acquisition of NFA	27.5	33.7	56.8	44.4	61.5	49.5
Net lending/borrowing	-25.5	-11.6	-21.3	-23.3	-27.3	-40.7
Net Acquisition of FA	-4.2	-12.1	-16.6	-16.2	-19.4	-16.6
Foreign	0.0	0.0	0.0	0.0	0.0	0.0
Domestic (net)	-4.2	-12.1	-16.6	-16.2	-19.4	-16.6
Sale of equity	-4.1	-4.7	-3.7	-4.9	-6.9	-5.1
lending minus repayment	-0.2	-7.3	-12.9	-11.3	-12.5	-11.5
Net Incurrence of Liabilities	29.7	23.7	37.9	39.5	46.8	57.3
Foreign	-0.2	0.5	10.2	2.8	16.0	7.5
Domestic	29.9	23.2	27.7	36.6	30.8	49.8
Contingency measures 3/						19.0
	(In percent of GDP)					
Total revenue and grants	16.6	18.0	21.1	18.4	20.5	18.3
Total revenue	13.9	15.0	16.2	14.8	15.8	15.0
Tax revenue	11.8	13.2	14.2	12.9	14.0	13.4
Non-tax revenue	2.1	1.8	1.9	1.8	1.8	1.7
Grants	2.7	3.0	4.9	3.6	4.7	3.3
Expenditure	19.2	19.0	22.7	20.1	22.3	21.0
Expenses	16.4	16.1	18.4	16.8	18.2	17.7
of which:						
Interest payments	0.8	0.9	0.9	0.9	1.1	1.1
Salaries and allowances	3.5	3.6	3.3	3.5	3.7	3.7
Contingencies 2/					0.2	
Net Acquisition of NFA	2.8	2.9	4.3	3.3	4.1	3.3
Net lending/borrowing	-2.6	-1.0	-1.6	-1.8	-1.8	-2.7
Net Acquisition of FA	-0.4	-1.0	-1.3	-1.2	-1.3	-1.1
Foreign	0.0	0.0	0.0	0.0	0.0	0.0
Domestic (net)	-0.4	-1.0	-1.3	-1.2	-1.3	-1.1
Sale of equity	-0.4	-0.4	-0.3	-0.4	-0.5	-0.3
lending minus repayment	0.0	-0.6	-1.0	-0.8	-0.8	-0.8
Net Incurrence of Liabilities	3.0	2.0	2.9	3.0	3.1	3.9
Foreign	0.0	0.0	0.8	0.2	1.1	0.5
Domestic	3.0	2.0	2.1	2.8	2.1	3.3
Contingency measures 3/						1.3
Memorandum items:						
Primary balance (in percent of GDP)	-1.8	-0.1	-0.7	-0.8	-0.7	-1.6
Public debt (in percent of GDP)	39.2	35.9	34.5	33.8	33.9	34.7
Domestic	13.0	13.5	14.0	14.7	14.5	16.4
External	26.1	22.4	20.6	19.2	19.4	18.2
Social spending (as a share of expenditure) 4/	--	33.2	--	32.5	30.7	--
GDP (in Billion of Nrs)	988	1,171	1,327	1,327	1,491	1,487

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

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

2/ Contingencies represent budgeted expenditures that are to be spent only if revenues materialized in line with budget assumptions. These expenditures were excluded under IMF Staff projections for FY 2011/12.

3/ For staff projection, contingency measures refer to expenditure reductions or revenue increases needed to meet the budgeted NDF target.

4/ Social spending includes expenditures on education, health and social protection.

Table 3. Nepal: Central Government Balance Sheet

	2009				2010			2011		
	Opening balance	Transactions	Other economic flows	Closing/ Opening balance	Transactions	Other economic flows	Closing/ Opening balance	Transactions	Other economic flows	Closing/ Opening balance
	(in billion Nepalese Rupees)									
Net financial worth	...	...	...	...	...	...	...	...	...	...
Financial assets	...	...	...	...	...	...	...	...	...	...
Currency and deposits	...	...	...	...	...	...	...	...	...	...
Securities other than shares	...	...	...	...	...	...	...	...	...	...
Loans	...	...	...	...	...	...	...	...	...	...
Other	...	...	...	...	...	...	...	...	...	...
Liabilities										
Securities other than shares	105.7	21.1	-6.1	120.6	17.0	5.5	143.1	30.7	-1.0	172.8
Loans	244.7	8.7	13.4	266.7	6.6	3.9	277.3	8.7	-10.3	275.7
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Fiscal liabilities(in percent of GDP)	43.0			39.2			35.9			33.8
Nominal GDP	816			988			1171			1327

Table 4. Nepal: Reserve Money and Monetary Survey

	2008/09	2009/10	2010/11	2011/12 Proj.
	(In billions of Nepalese rupees, end-period)			
Reserve money	196	219	234	247
Net domestic assets of NRB	-23	16	23	23
Claims on public sector	33	49	54	54
Claims on private sector	3	4	5	5
Claims on commercial banks	0	5	8	8
Other items (net)	-60	-42	-45	-44
Net foreign assets of NRB	219	203	212	225
	(Contribution to reserve money growth)			
Reserve money (y/y percent change)	35	12	7	6
Net domestic assets of NRB	-2	20	3	0
Net foreign assets of NRB	37	-8	4	6
	(In billions of Nepalese rupees, end-period)			
Broad money	631	720	788	876
Narrow money	196	218	228	265
Quasi-money	434	501	560	611
Net domestic assets	406	507	572	646
Domestic credit	556	649	735	845
Credit to public sector	117	149	175	249
Credit to private sector	438	501	560	596
Other items(net)	-150	-143	-163	-199
Net foreign assets	225	213	217	230
	(Twelve-month percent change)			
Broad money	27	14	10	11
Net domestic assets	25	25	13	13
Domestic credit	27	17	13	15
Credit to public sector	20	27	18	42
Credit to private sector	29	14	12	6
Net foreign assets	31	-5	2	6
	(Contribution to broad money growth)			
Broad money (y/y percent change)	27	14	10	11
Net domestic assets	17	16	9	9
Domestic credit	24	15	12	14
Credit to public sector	4	5	4	9
Credit to private sector	20	10	8	5
Net foreign assets	11	-2	0	2

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

Table 5. Nepal: Balance of Payments

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
						Proj.		
	(in millions of U.S. dollars unless otherwise indicated)							
Current account	535.9	-378.0	-167.1	-156.3	-192.4	-255.9	-313.4	-361.7
Current account (excluding official transfers)	208.8	-678.7	-488.1	-520.9	-600.7	-685.0	-761.1	-850.4
Trade balance	-2,707.1	-4,077.9	-4,473.6	-4,974.6	-5,595.6	-6,286.4	-7,059.4	-7,924.6
Exports, f.o.b.	904.1	848.8	966.6	1,053.2	1,126.9	1,205.8	1,290.6	1,381.5
Imports, f.o.b.	-3,611.1	-4,926.7	-5,440.2	-6,027.8	-6,722.4	-7,492.2	-8,350.0	-9,306.1
Services (net)	-135.5	-220.1	-120.3	-118.3	-122.8	-129.3	-128.3	-129.7
Receipts	683.2	686.8	744.0	796.1	852.7	915.1	984.1	1,055.1
Of which: tourism	361.6	378.1	345.4	369.6	395.5	423.1	452.8	484.5
Payments	-818.7	-907.0	-864.3	-914.4	-975.5	-1,044.4	-1,112.4	-1,184.8
Income	152.0	122.5	106.0	111.6	120.1	129.3	139.0	146.1
Credit	213.5	200.4	245.7	265.3	289.2	315.2	343.6	371.1
Debit	-61.5	-77.9	-139.7	-153.7	-169.1	-186.0	-204.6	-225.0
Current transfers	3,226.5	3,797.5	4,320.8	4,824.9	5,405.8	6,030.5	6,735.2	7,546.5
Credit, of which:	3,329.6	3,866.3	4,367.1	4,878.1	5,467.0	6,100.9	6,816.2	7,639.6
General government	327.1	300.7	321.0	364.6	408.2	429.0	447.7	488.7
Workers remittances	2,712.0	3,113.3	3,558.6	4,001.7	4,500.9	5,062.4	5,697.7	6,412.7
Debit	-103.1	-68.8	-46.3	-53.2	-61.2	-70.4	-81.0	-93.1
Capital account	80.6	169.0	223.2	334.2	312.2	335.8	345.7	380.6
Financial account	24.4	64.6	96.0	-89.7	-69.6	-62.2	-16.9	4.7
Direct investment	23.7	38.3	90.3	52.4	57.1	62.3	67.9	74.0
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment (net)	0.7	26.3	5.7	-142.1	-126.7	-124.5	-84.7	-69.3
Errors and omissions	-206.0	42.1	-51.7	0.0	0.0	0.0	0.0	0.0
Overall balance	434.8	-102.3	100.5	88.1	50.2	17.7	15.4	23.6
Financing	-434.8	102.3	-100.5	-88.1	-50.2	-17.7	-15.4	-23.6
Change in reserve assets (- =increase) 1/	-433.8	62.4	-96.0	-81.3	-36.0	-3.0	-3.0	-3.3
Use of IMF resources (net)	-1.0	39.9	-4.5	-6.8	-14.2	-14.7	-12.4	-20.3
IMF Disbursements	0.0	42.1	0.0	0.0	0.0	0.0	0.0	0.0
IMF Repayment	1.0	2.2	4.5	6.8	14.2	14.7	12.4	20.3
Exceptional Financing	0.0	0.0	0.0	0.0				
Arrears to Russia (+ =increase)	0.0	0.0	0.0	0.0				
Memorandum items:								
Current account (in percent of GDP)	4.2	-2.4	-0.9	-0.8	-0.8	-1.0	-1.1	-1.1
Current account, excl. grants (in percent of GDP)	1.6	-4.3	-2.7	-2.6	-2.6	-2.6	-2.7	-2.7
Trade balance (in percent of GDP)	-21.1	-26.0	-24.4	-24.4	-23.9	-24.3	-24.6	-25.1
Exports (in percent of GDP)	7.0	5.4	5.3	5.2	4.8	4.7	4.5	4.4
Imports (in percent of GDP)	28.1	31.4	29.7	29.6	28.8	29.0	29.1	29.5
Remittances (in percent of GDP)	21.1	19.8	19.4	19.6	19.2	19.6	19.9	20.3
Exports (y/y percent change)	0.5	-6.1	13.9	9.0	7.0	7.0	7.0	7.0
Imports (y/y percent change)	14.1	36.4	10.4	10.8	11.5	11.5	11.5	11.5
Remittances (y/y percent change)	30.9	14.8	14.3	12.5	12.5	12.5	12.5	12.5
Non-oil real GDP growth of GCC countries	6.9	3.5	4.6	5.3	5.7	5.9	6.1	6.1
Debt service (in percent of current account receipts)	3.1	3.2	3.4	3.1	2.9	2.7	2.5	2.3
Gross official reserves (in millions of U.S. dollars)	2,907	2,844	3,098	3,180	3,216	3,219	3,222	3,225
In months of imports	6.0	5.4	5.4	5.0	4.5	4.1	3.7	3.4
As a share of broad money (in percent)	35.6	29.5	27.9	26.5	24.1	21.8	19.7	17.3
ratio over remittances	1.1	0.9	0.9	0.8	0.7	0.6	0.6	0.5
Nominal GDP (in millions of U.S. dollars)	12,852	15,710	18,321	20,370	23,382	25,861	28,669	31,565

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

1/ Excludes valuation changes from 2010-11.

Table 6. Nepal: Macroeconomic Framework

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
						Proj.		
Growth and prices				(percent change)				
Real GDP	4.4	4.6	3.5	3.8	3.8	3.8	3.8	3.9
CPI (period average)	12.6	9.6	9.5	8.0	7.6	7.3	6.8	6.0
CPI (end of period)	11.1	9.0	9.4	8.1	7.2	7.0	6.5	6.0
Fiscal Indicators				(In percent of GDP)				
Total revenue and grants	16.6	18.0	18.4	18.3	18.5	18.5	18.5	18.6
Expenditures	19.2	19.0	20.1	21.0	20.4	20.5	20.5	20.6
Expenses	16.4	16.1	16.8	17.7	16.9	16.9	16.9	17.0
Net acquisition of NFA	2.8	2.9	3.3	3.3	3.6	3.6	3.6	3.6
Net lending/borrowing	-2.6	-1.0	-1.8	-2.7	-2.0	-2.0	-2.0	-2.0
Net acquisition of FA	-0.4	-1.0	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0
Net domestic financing	3.0	2.0	2.8	3.3	2.5	2.5	2.5	2.5
External Trade				(Percent change)				
Merchandise exports (in U.S. dollar terms)	0.5	-6.1	13.9	9.0	7.0	7.0	7.0	7.0
Merchandise Imports (in U.S. dollar terms)	14.1	36.4	10.4	10.8	11.5	11.5	11.5	11.5
Balance of payments				(In millions of U.S. dollars unless otherwise indicated)				
Current account	535.9	-378.0	-167.1	-156.3	-192.4	-255.9	-313.4	-361.7
In percent of GDP	4.2	-2.4	-0.9	-0.8	-0.8	-1.0	-1.1	-1.1
Capital and financial account	104.9	233.6	319.3	244.5	242.6	273.6	328.8	385.3
In percent of GDP	0.8	1.5	1.7	1.2	1.0	1.1	1.1	1.2
Overall balance	434.8	-102.3	100.5	88.1	50.2	17.7	15.4	23.6
In percent of GDP	3.4	-0.7	0.5	0.4	0.2	0.1	0.1	0.1
External indicators				(In millions of U.S. dollars unless otherwise indicated)				
Gross official reserves (end-of-period)	2,907	2,844	3,098	3,180	3,216	3,219	3,222	3,225
In months of imports	6.0	5.4	5.4	5.0	4.5	4.1	3.7	3.4
Public external debt	3,336	3,522	3,587	3,716	3,867	3,988	4,137	4,324
Public external debt (in percent of GDP)	26.1	22.4	19.2	18.2	16.5	15.4	14.4	13.7
Debt service (in percent of current account receipts)	3.1	3.2	3.4	3.1	2.9	2.7	2.5	2.3

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

Appendix 1. Nepal: Progress on Policy Commitments Under the Rapid Credit Facility 1/

Policy Commitments	Status
Monetary and Exchange Rate Policy	
Maintain short term interest rates above Indian levels to discourage capital flight and help to maintain peg with Indian rupee.	Partially met. Interest rates declined significantly below India's in mid-2011.
Remove quantitative restrictions on availability of foreign exchange for leisure travel by March 2011, as it may give rise to an exchange restriction under Article VIII of IMF's Articles.	Met
Net international reserves at NRB not to fall below 2.4 billion US dollars by July 2010.	Met
Net domestic assets of NRB not to exceed Nrs 15.5 billion by July 2010.	Not met
Fiscal Policy	
Net domestic financing of budget deficit by NRB not to exceed Nrs 23.5 billion by July 2011.	Not met
Take actions to prevent mounting NOC losses.	Partially met
Financial Sector Policy	
Install resident supervisor from IMF for banking supervision	Met
Maintain restrictive policy towards new bank licenses	Met
Stress testing and on-site supervision	Partially met
Develop contingency plan to deal with financial crisis	Limited progress
Expedite passage of amended BAFIA through Parliament	Not met
Application of PCA	Partially met, but forbearance applied.
Eschew regulatory forbearance	Not met
Improve timeliness and quality of financial sector data	Limited progress
Clarify modalities for accessing bank rate window; meet individual banks' liquidity needs through SLF at penalty rates	Met
Deduct pledged promoters' shares from bank capital	Not met
Facilitate public trading of promoters' shares	Not met
Reform the two state owned banks, NBL and RBB	Not met
Undertake safeguards assessment	Met. 2011 assessment recommends appointing international auditor, strengthening cash reserve management, and internal audit of NRB data compilation process for program monitoring purposes.

Source: IMF Staff
1/ The RCF was approved by the IMF Executive Board on May 28, 2010.

INTERNATIONAL MONETARY FUND

NEPAL

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

September 26, 2011

Prepared By: Asia and Pacific Department

CONTENTS

ANNEX I. FUND RELATIONS

(As of August 31, 2011)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	71.3	100.00
Fund holdings of currency	71.28	99.98
Reserve position in Fund	0.02	0.03

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	68.1	100.00
Holdings	59.4	87.21

Outstanding Purchases and Loans:

	SDR Million	Percent Allocation
RCF Loans	28.52	40.00
ECF arrangements	44.20	61.99

Financial Arrangements: (In SDR Million)

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
ECF	11/19/03	11/18/07	49.9	49.9
ECF	10/05/92	10/04/95	33.57	16.79
SAF	10/14/87	10/13/90	26.11	26.11

Projected Obligations to Fund:

(in millions of SDRs; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2011	2012	2013	2014	2015
Principal	1.43	6.77	9.98	8.55	9.98
Charges/interest	0.01	0.21	0.19	0.16	0.14
Total	1.43	6.98	10.17	8.72	10.12

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. As of August 15, 2011, the exchange rate for the Nepalese rupee (Nr) was US$1=Nrs. 72.8.

The restriction on quantitative limits on foreign exchange for leisure travel was removed in early 2011. The Industrial Enterprises Act places a 75 percent limit on the conversion and transfer to foreign currency of salaries of non-residents from countries where convertible currency is in circulation. Since the limit applies to amounts that may be less than net salaries, it gives rise to an exchange restriction under Article VIII. Staff is investigating whether this measure is also discriminatory.

Safeguards Assessments

A safeguards assessment of the NRB was concluded in May 2011. The assessment noted that the external audit mechanism needed improvement, since the audit procedures did not meet international standards. Transparency of the financial statements should be enhanced by resolving qualifications raised by the external auditors.

2010 Article IV Consultation

The Executive Board discussed the staff report for the 2010 Article IV consultation (IMF Country Report No. 10/185) on May 28, 2010. It was proposed that the Article IV consultations take place on the 12-month cycle.

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
	Monetary Policy Operations and Enhancing Banking Supervision	2010
	Bank Supervision and Crisis Management	2011
FAD	Implementation of a Large Tax Payer Unit	2003
	Review of Tax Policy and VAT Administration	2003
	Tax and Customs Administration Reforms/Modernization	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
	Extension of LT Treasury Advisor	2010
	PFM Stocktake	2010
	Long Term Revenue Administration	2011
LEG	Redrafting of Income Tax Laws	2000-01, 2007
	Income Tax Act	2003
	Banking Law	2004-05
	Fiscal Law	2007
	Fiscal Transparency	2007
	AML/CFT National Strategy	2010, 2011
STA	Multisector Statistics	2001, 2003, 2008-09
	Balance of Payments Statistics	2002-04, 2010
	Producer Prices Statistics	2002-05
	Monetary Statistics	2003, 2009, 2011
	National Accounts	2003, 2005-06, 2008

Resident Representative

Mr. Sanjaya Panth has been the Senior Resident Representative since November 1, 2010. He is based in New Delhi, India.

ANNEX II. RELATIONS WITH THE WORLD BANK GROUP

(As of August 31, 2011)

A. Partnership in Nepal's Development Strategy

Nepal is passing through a momentous and prolonged political transition. In the past five years, Nepalis have witnessed the signing of a peace agreement between the Maoists and the state, a new Interim Constitution, the election of a Constituent Assembly (which declared Nepal a federal republic), four governments, and the rise of strong ethnic identity movements. A new Prime Minister from the UCPN-Maoist party took office in August 2011.

Donor harmonization and coordination has improved over the last couple of years and new partnerships have been forged. Coordination among development partners has focused on leveraging the comparative advantages of each partner. Joint work on education and health sector-wide approaches (SWAps) intensified with a focus on improving development results. Last year, AusAID, GAVI[1] and USAID started to provide funding through the health SWAp mechanism, in addition to DFID and IDA. In non-SWAp sectors, joint work is proceeding to move towards harmonized policy approaches and delivery mechanisms over the medium term (in areas such as rural water, support to municipalities, and vocational training). During 2010, the local donor community in Nepal, coordinated by the United Nations (UN), collectively drafted a "Peace and Development Strategy" with the goal of assessing the current status of the peace process, identifying peace and development linkages, and offering development community support in identified priority areas. ADB and IDA have partnered to jointly address the challenge of public procurement reform. Similarly, nine development partners have formed a Public Financial Management (PFM) Donor Group to coordinate donor support for strengthening PFM systems and the accountability role of civil society. IDA is the lead partner for the PFM donor group, and a PFM multi-donor trust fund was activated in December 2010.

[1] The Global Alliance for Vaccines and Immunization.

B. IMF-World Bank Collaboration in Specific Areas

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 through the ongoing ***School Sector Reform Project (SSRP)***. This Sector Wide Approach (SWAp) 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 sector***, the Bank has been working closely with the government and development partners in supporting the government's sector program since 2004. The ***Second HNP and HIV/AIDS Project*** is assisting the Government in improving the equitable delivery of health care services, specifically by increasing access to essential health care services and their utilization by the underserved and the poor. To support both human health and animal health, a recently closed project, ***Avian Influenza Control Project*** was 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.

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 grassroot-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 ***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. The recent PAF monitoring data and impact evaluation studies show that this program has resulted in enhancing income and consumption levels. Monitoring data shows that 66% of households covered under PAF have obtained a minimum income increase of 15% (in real terms) and have achieved an average increase in income of 82.5% in real terms and 145% in nominal terms. Rigorous impact evaluation studies completed in mid-FY11 indicate that overall there has been a 31% increase in the consumption of PAF households over 2007-2010 and a decline of 2% in the welfare of control households during this same period. PAF has covered 40 poorest districts, supporting 14,831 Community Organizations and 405,000 poor households, and has benefitted more than 513,000 total beneficiary households. Of the total number of poor households supported currently, 57% are Dalit and Janajati. The program's positive effect is also seen in access to services (agriculture centers, community forest groups, farmers' groups) and women's empowerment.

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 road sector PER was delivered in FY11. 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). This framework has applied since FY04 to the prioritization of the development budget to ensure efficient budget allocations for priority projects.

Areas of shared responsibility

The Bank and the IMF continues to provide assistance in the overall management of the country's macroeconomic aggregates. The Bank and the IMF have assisted in debt management through technical assistance, joint Debt Sustainability Analysis and policy dialogue to ensure that the overall debt stock and fiscal deficits are within reasonable limits. To sustain the impressive revenue growth, in addition, the Bank and the IMF continue to provide policy advise and technical assistance. The IMF provides assistance in tax audits and general revenue administration, while the Bank is looking into identifying tax loopholes and measures to fill them. Both institutions are providing assistance in terms of the on-going custom reform plan. The Bank and the IMF are also helping the government strengthen the Public Finance Management. In particular, the two institutions complement each other in establishing "single treasury accounts" and in consolidating the fiscal reporting system.

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 IMF are helping to strengthen the central bank's supervisory 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 (seen as the first step toward eventual restructuring); (iii) capacity building towards enhanced credit information; and (iv) upgrading of staff training in financial institutions. Also, in view of the vulnerabilities in the financial sector seen after the cooling of the real estate boom, both institutions are helping the Central Bank in collecting more accurate and timely financial information and further strengthening forward-looking supervision of the Central Bank.

C. World Bank Group Strategy and Lending Operations

In June 2009, an Interim Strategy Note (ISN) was discussed by the Bank's Board of Directors. Given the transitional nature of Nepal's situation, with a new government, and a new constitution being drafted, the Bank Group prepared an ISN covering FY10 and FY11. This joint IDA-IFC strategy aims to leverage Bank and IFC resources and realize synergies. It builds on the areas that have shown to be robust and to modalities of implementation tailored to Nepali 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 adopted a 'peace filter' to improve IDA's sensitivity to the root causes of conflict and social tensions. The Bank's board will discuss a new joint IDA-IFC ISN covering FY12-FY13 on September 15, 2011.

Supporting the overarching goal of promoting peace and development, the current 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.

FY11 Lending Program: In FY11, IDA financing was approved for seven projects for a total of US$289 million (see Table II.1). This includes two regional projects.

Table II.1. FY11 IDA Projects

Project	US$mln
Road Sector Development Project AF	75.0
Enhanced Vocational Education and Training Project	50.0
Poverty Alleviation Fund AF	65.0
Emerging Towns Project	25.0
Kabeli Transmission Project	38.0
Strengthening Region Cooperation for Wildlife[2]	38.0
Cross-Border Transmission Project[3]	3.0
Total FY11 Actual	***289.0***

[2] Country portion of the regional project.

[3] Includes only the country IDA share for the two regional projects.

Bank Assistance Program in Nepal: As of end-June 2011, the Nepal country portfolio includes 19 IDA funded projects (2 of which are regional) and 9 active trust funds, with a net commitment value of US$$1.3 billion[4]. IDA support is concentrated in the service delivery sectors (52%) with a focus on community managed activities, followed by sustainable growth investments (43%) in the power, road, agriculture, and finance sectors.

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. 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. Recent completions include: analysis of migration and remittances, investment climate assessment, road sector PER, assessing fiscal space for health, hazard risk management, gender and social exclusion assessment and analysis of multi-dimensional exclusion index.

[4] Includes only the country IDA share for the two regional projects.

IDA is also actively supporting Nepal's participation in regional and multilateral global initiatives with other donors. For example, at the regional level, the IDA water and nutrition teams work closely with DFID to channel support to Nepal from the South Asia Water Initiative (SAWI) and South Asia Food and Nutrition Security Initiative (SAFANSI). At the global level, Nepal is the only country in the world that has been selected to participate in two Climate Investment Fund (CIF) Pilot Programs – the Scaling Up Renewable Energy Program (SREP) and the Pilot Program for Climate Resilience (PPCR). Both these CIF Programs involve formal joint mission work between the ADB, IDA, and IFC, as well as collaboration with local donors (such as DFID, Denmark, the United States, and others) to ensure complementarity with local programs. In addition, the team works closely with DFID and other donors to coordinate efforts in support of climate change mitigation and adaptation, and to explore opportunities for collaborative and/or coordinated funding of key analyses. For example, in the roads sector, programmatic analytical work is underway using a joint peer review process, with donors active in the sector each taking the lead on an agreed priority theme for analysis. Finally, IDA is supporting a regional program of transmission links to enable energy trade between Nepal, India and Bangladesh as well as a Regional Wildlife Program to assist participating governments to build capacity, institutions and incentives to collaborate in tackling illegal wildlife trade and other conservation threats to habitats in border areas.

Table II.2. Active IDA Projects

	Project ID	Project Name	Board Approval	Revised Closing Date	Net Comm Amt.	Percent Disb	Disb. Ratio
1	P100342	Avian Flu	1/19/2007	7/31/2011	16.0	87.2%	57.6
2	P099296	Irrig & Water Res Mgmt Proj	12/6/2007	6/30/2013	64.3	34.3%	22.5
3	P113002	Social Safety Nets Project	9/30/2008	9/30/2013	64.5	75.1%	67.9
4	P105860	PAF II	12/6/2007	6/30/2014	192.5	51.2%	97.5
5	P087140	Agric Commercialization & Trade	6/4/2009	6/30/2015	20.0	11.5%	6.6
6	P043311	POWER DEVELOPMENT PROJECT	5/22/2003	12/31/2012	164.0	34.7%	12.2
7	P112893	Kabeli Transmission Project	5/10/2011	6/30/2015	38.0	0.0%	
8	P083923	Rural Access Improve. & Decentraliz	6/21/2005	12/31/2013	77.0	37.7%	7.1
9	P095977	Road Sector Development Project	12/6/2007	6/30/2015	117.6	45.3%	158.5
10	P071285	Rural Water Supply & Sanitation Proj	6/1/2004	8/30/2011	52.3	81.5%	46.7
11	P120265	Emerging Towns Project	5/10/2011	7/31/2016	25.0	0.0%	
12	P071291	Fincl Sector Technical Assistance	12/19/2002	12/31/2011	8.5	125.8%	5.7
13	P090967	Second Higher Education Project	2/22/2007	1/15/2014	60.0	38.8%	15.2
14	P113441	School Sector Reform Program	9/22/2009	12/15/2014	130.0	34.2%	33.5
15	P104015	Enhanced Vocational Educ & Trng	4/21/2011	10/30/2015	50.0	0.0%	
16	P117417	Second HNP and HIV/AIDS Project	4/20/2010	7/15/2015	129.2	17.1%	16.7
17	P110762	Peace Support Project	5/6/2008	6/30/2012	50.0	44.6%	9.1
18	P115767	Northeast Regional Electr. Transmiss*	6/21/2011	12/31/2016	33.0	0.0%	
19	P121210	Wildlife Protection*	4/7/2011	12/31/2016	3.0	0.0%	
		Total			***1,294.8***		
*	*includes*	*only country IDA share*					

Activities of the International Finance Corporation (IFC) in Nepal

Investment Services: IFC's committed investment portfolio in Nepal stood at US$27 million as of March 2011, consisting of three power generation projects, one airline, one tourism project, one microfinance institution, one Financial Sector ICT service company, and four trade finance facilities. In FY2011, IFC provided four trade finance facilities (for US$9 million in total) and signed one additional facility (of US$5 million) under IFC's Global Trade Finance Program to date. In FY2010 and FY2009, IFC committed US$14 million and US$15 million, respectively, including IFC's first power investment in Nepal in a decade (for US$6.5 million), IFC's first ever investment in microfinance in Nepal (for US$0.3 million), a US$10 million long-term debt in aviation as well as GTFP trade facilities. After having a low level of activity during FY2002-FY2007 due mainly to the conflict, IFC re-opened an office in Kathmandu in January 2008 with the objective of scaling up both investment and advisory operations. IFC's program successfully rebounded, focusing on increased access to finance and infrastructure, as well as support to help improve investment climate.

IFC Advisory Services: IFC is engaged broadly in four areas, including investment climate, financial market and access to finance, sustainable business, and Public-Private Partnerships (PPPs) and has been more active in the former three areas thus far. IFC's work on ***Investment Climate Reform Project (ICRP)*** began in Nepal in 2007. In FY11, IFC, with funding support from DFID, embarked on a new three-year ICRP that consists of three mutually-reinforcing components: (i) Public Private Dialogue (PPD); (ii) Regulatory Reforms; and (iii) Special Economic Zones (SEZ). Through this program, IFC has assisted with the establishment of Nepal Business Forum (NBF). As a Public Private Dialogue (PPD) mechanism, NBF helps the government set up reforms at the national and sub-national level. IFC's ***Financial Markets and Access to Finance (A2F)*** advisory work focuses on financial infrastructure, sustainable energy financing and SME lending, microfinance, credit information bureaus, secured transaction registries and support to long-term lending institutions. IFC increasingly plays a key advisory role in diverse areas, including credit bureau and collateral registry, sustainable energy and water finance project, microfinance project, SME finance project, and in particular "Payments, Remittances and Securities Settlement Systems (PRSSS)". Furthermore, IFC is providing advisory support to promote ***sustainable business practices*** in the private sector, helping to strengthen environment, social and governance aspects and SMEs through linkages to IFC's investments. In the area of climate change, IFC, in partnership with the World Bank and ADB, is implementing the Strategic Program on Climate Resilience (SPCR) and Scaling up Renewable Energy (SREP) projects in benefit for the private sector in Nepal.

Going forward, IFC will seek to continue the programs aligned with the three strategic pillars of IFC's regional South Asia Strategy which include: (a) Inclusive Growth; (b) Climate Change; and (c) Regional and Global Integration. IFC continues to focus on investment climate to lay the ground for attracting investments, access to finance and financial sector development to promote efficient and innovate ways of financial access, and infrastructure strengthening to facilitate people's access and economic development. Building on its global and regional experiences, IFC remains interested in providing support for the development of PPPs in Nepal. IFC will also seek to leverage the co-location of the IFC and World Bank offices, aiming for greater collaboration and interaction in Nepal, particularly in the areas of financial markets, infrastructure, climate change, and business enabling environment.

Questions on IDA may be referred to Ms. Paralkar (458-9050) and on the IFC to Ms. Junko Oikawa (473−4954).

ANNEX III. RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Country Program

The Asian Development (AsDB) began lending to Nepal in 1969. As of 31 December 2010, Nepal has received 145 loans/grants—118 sovereign Asian Development Fund (ADF) loans ($2,577.082 million), 5 non sovereign loans ($50 million), and 22 ADF grants ($603.25 million) totaling $3,210.34 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 communication, and water supply, sanitation, and other municipal infrastructures.

The assistance program for 2010 comprised eight projects with a total of $107.6 million in ADF grants and $154.9 million in concessional loans. The programs and projects include the Community Irrigation Project (grant $26.4 million); Project for Raising Incomes of Small and Medium Farmers (grant $20.1 million); Detailed Engineering Study for Upper Seti (grant $2.5 million); Rural Finance Sector Development Cluster Program II (loan $60.4 million and grant $12.1 million); Transport Project Preparatory Facility (grant $12 million); Kathmandu Sustainable Urban Transport (loan $20 million and grant $20 million); Secondary Towns Integrated Urban Environmental Improvement (loan $60 million); and Subregional Transport Enhancement Project (loan $24.5 million and grant $24.5 million).

Technical Assistance

Since 1968, AsDB has approved 302 technical assistance projects totaling $148.3 million (as of 31 December 2010), covering most sectors.

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 2010, cumulative approvals for 4 private sector projects in Nepal amounted to $58.64 million.

Sovereign Loans and Grants by the Asian Development Bank, 1968–2010

(As of 31 December 2010)

	1968–2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
(In millions of U.S. dollars)											
Loans											
Agriculture and natural resources	656.2	0.0	0.0	20.0	70.0	0.0	0.0	0.0	0.0	0.0	0.0
Education	61.1	19.6	30.0	0.0	20.0	0.0	30.0	0.0	0.0	25.0	0.0
Energy	364.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	65.0	0.0
Finance	7.3	0.0	0.0	0.0	0.0	0.0	56.0	0.0	0.0	0.0	60.4
Industry and trade	127.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public Sector Management		30.0		35.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transport and communication	236.9	46.0	0.0	0.0	20.0	0.0	0.0	0.0	0.0	70.0	13.5
Water supply, sanitation and other municipal infrastructure and services	224.0	0.0	0.0	39.0	0.0	0.0	0.0	0.0	0.0	0.0	70.0
Multisector	127.1	0.0	30.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Regional Cooperation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	12.8	11.0
Total Loans	***1804.1***	***95.3***	***60.0***	***94.0***	***110.0***	***0.0***	***86.0***	***0.0***	***0.0***	***172.8***	***154.9***
Grants											
Agriculture and natural resources	0.0	0.0	0.0	0.0	0.0	0.0	18.0	0.0	0.0	0.0	46.5
Education	0.0	0.0	0.0	0.0	0.0	0.0	2.0	0.0	8.0	70.0	0.0
Energy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.5
Finance	0.0	0.0	0.0	0.0	0.0	0.0	8.7	0.0	0.0	0.0	12.1
Public Sector Management	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	106.3	0.0	0.0
Transport and communication	0.0	0.0	0.0	0.0	0.0	0.0	55.2	0.0	25.0	10.0	25.5
Water supply, sanitation and other municipal infrastructure and services	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	45.1	10.0
Multisector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	100.0	0.0	25.6	0.0
Regional Cooperation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	9.0	0.0	12.8	11.0
Total Grants	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*83.9*	*109.0*	*139.3*	*163.5*	*107.6*
Total Approved (Loan and Grant)	***1806.1***	***95.3***	***60.0***	***94.0***	***110.0***	***0.0***	***169.9***	***109.0***	***139.3***	***336.2***	***262.5***
Gross disbursements (Loans and grants)	***1220.6***	***57.3***	***28.2***	***33.5***	***22.0***	***43.7***	***108.0***	***102.3***	***127.1***	***199.5***	***111.2***
Technical assistance											
Total approved	98.0	4.0	4.0	4.2	3.2	2.1	5.8	7.2	4.6	5.7	10.5
Gross disbursements	54.1	5.0	3.9	4.2	4.2	3.6	2.0	4.6	4.6	6.8	14.2

ANNEX IV. STATISTICAL ISSUES

Economic and financial data are generally adequate for surveillance, with scope for improvement especially in fiscal (external financing) data, and the timeliness and quality of balance of payments data. 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.

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, inconsistencies, lags in availability, insufficient detail, and shortcomings in record keeping by agencies. Under an Asian Development Bank (AsDB) project to strengthen national accounts, STA missions in April 2005 and July 2006 provided support to the development of quarterly national accounts (QNA), expected to be disseminated starting next year, and the rebasing of the annual national accounts to 2000/01 from 1994/95.

The authorities released a new **consumer price index** (CPI) with 2005/06 as the base year, compared to the previous index, which was based on a 1995/96 household expenditure survey. The new index has lower weights for food and higher weights for non-food and services. 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.

Government Finance Statistics

Authorities compile fiscal data in accordance with IMF's 2001 *Government Finance Statistics* (GFS). 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. Large amounts are still allocated to the contingency account, and monthly reporting of development spending excludes amounts directly paid by donors. 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. Government finance statistics are regularly reported for publication in the *Government Finance Statistics Yearbook,* but not in 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. Monetary and financial statistics are compiled according to 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, inter alia, broadening the coverage of monthly monetary statistics to 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*.

[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.

A recently concluded (2011) STA mission recommended, among others, that NRB (i) separately identify positions with local governments and uniformly treat local governments as a money-holding sector (ii) review and revise accounting for coins issued so that NRBs balance sheet reflects coins issued, at face value (iii) Resume reporting monthly monetary data in the format of SRF 1SR for the central bank and SRF 2SR for commercial banks; and resume reporting monthly monetary data in the format of SRF 2SR covering the entire ODC sector**.**

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. Other STA recommendations have not yet been fully implemented and net errors and omissions remain large. Work is still underway to improve estimation of workers' remittances and source data for private capital flows; 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. 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 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 September 26, 2011)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	Aug. 2011	Sept. 2011	D and M	W and M	D and M
International reserve assets and reserve liabilities of the Monetary Authorities[1]	Jul. 2011	Sept. 2011	M	M	M
Reserve/base money	Jul. 2011	Sept. 2011	M	M	M
Broad money	Jul. 2011	Sept. 2011	M	M	M
Central bank balance sheet	Jul. 2011	Sept. 2011	M	M	M
Consolidated balance sheet of the banking system	Jul. 2011	Sept. 2011	M	M	M
Interest rates[2]	Sept. 2011	Sept. 2011	D and M	D and M	D and M
Consumer price index	Jul. 2011	Sept. 2011	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Jul. 2011	Aug. 2011	W	W	W
Revenue, expenditure, balance and composition of financing[3] – central government	Jul. 2011	Aug. 2011	W	W	W
Stocks of central government and central government-guaranteed debt[5]	2009/10	Feb. 2011	A	A	A
External current account balance	Jul. 2011	Sept. 2011	M	M	M
Exports and imports of goods and services	Jul. 2011	Sept. 2011	M	M	M
GDP/GNP	2010/11	May 2011	A	A	A
Gross external debt	2009/10	Feb. 2011	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

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

September 26, 2011

Approved By
Laura Papi and Christian Mumssen (IMF) and Jeffrey D. Lewis and Ernesto May (World Bank)

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

Nepal remains at moderate risk of debt distress.[1] *The baseline external public debt sustainability indicators are more favorable compared to the previous Debt Sustainability Analysis (DSA), and external debt dynamics are resilient to standard stress tests, however total public debt ratios increase gradually over the projection period. External debt indicators breach the thresholds under an alternative scenario developed to analyze risks arising from heightened financial sector stress, highlighting the urgent need to address financial sector vulnerabilities. A prudent fiscal stance remains appropriate, and net domestic financing of deficits should be contained to around 2½ percent of GDP or less. Stronger efforts to improve the absorption capacity for foreign financing would release pressure on the domestic debt market, while structural reforms to boost long-run growth and revenue generation would improve overall public debt sustainability. The DSA results would change if large-scale external borrowing on commercial terms were to arise, for example to fund hydro development.*

[1] The risk rating is determined using the Low-Income Country Debt Sustainability Analysis (LIC-DSA) framework. Nepal's fiscal years starts mid-July.

BACKGROUND

1. Nepal's total public debt stock is estimated at 36 percent of GDP at the end of 2009–10, having declined from 60 percent of GDP ten years ago. External public debt stood at US$ 3½ billion (22½ percent of GDP) at the end of 2009-10. The World Bank and the AsDB account for about 86 percent of the debt stock. The remainder is owed to bilateral donors, among which Japan is the main creditor accounting for about 7 percent of total external public debt. The domestic public debt stock stood at 13½ percent of GDP. In addition to public debt, private external debt stood at 1¾ percent of GDP, comprised entirely of trade credits.

MACROECONOMIC ASSUMPTIONS

2. The macroeconomic assumptions are less optimistic compared to the previous DSA due to the lack of progress on structural reforms and loss of competitiveness (Box 1).

- Real GDP growth is projected to rise from 3½ percent in 2010-11 to 4 percent in the long run, on par with historical experience. Inflation is projected to fall gradually in line with a projected easing of external inflation pressure over the longer term to about 5 percent, below Nepal's historical average.

- The external current account is expected to remain in deficit, due mainly to the impact of weaker competitiveness on the trade balance. Exports are projected to grow by about 7 percent per year in the long run, tourism should provide support, while imports are projected to grow by 8 percent per year. Remittance growth has slowed markedly, and in the medium term is projected to stabilize at around 12 percent before easing to around 7 percent in the long run, similar to the previous DSA.

- Government revenues including grants are projected to increase by about ½ percentage points of GDP in the long run, as enhanced administration more than offsets an unwinding of grant assistance for the peace process. Primary expenditure is projected to rise by about the same amount, such that the primary fiscal deficit remains around 2 percent of GDP. Net domestic financing is projected to gradually decline to around 2½ percent of GDP in the long run (from 2¾ percent in 2010-11), and access to external financing is projected to increase slightly to about 1 percentage point of GDP.

- The peg to the Indian rupee is assumed to remain at the current level over the projection period. With inflation relatively high over the medium term, this implies a real exchange rate appreciation.

- The concessionality of foreign loan terms is projected to decline gradually reflecting an increase in borrowing from non-traditional donors on relatively less favorable terms, for example to finance hydropower projects.

Box 1. Macro Assumptions Comparison Table

	Previous DSA		Current DSA			Differences (current vs. previous)	
	MT	LT	2011	MT	LT	MT	LT
Real growth (%)	4.2	5.3	3.5	3.8	4.0	-0.4	-1.3
Inflation (GDP deflator, %)	6.7	5.0	9.5	7.5	5.2	0.8	0.2
Nominal GDP (Bil. Nepalese Rupees)	1808	8096	1327	2050	8653	242	557
Revenue and grants (% GDP)	19.9	20.0	18.6	18.8	19.0	-1.0	-1.0
Grants (% GDP)	3.6	3.0	3.6	3.0	2.6	-0.6	-0.4
Primary expenditure (% GDP)	21.7	22.0	20.6	20.9	21.0	-0.8	-1.0
Primary deficit (% GDP)	1.8	2.1	2.0	2.1	2.0	0.3	-0.1
Net domestic financing, NDF (% GDP)	2.4	2.5	2.8	2.7	2.5	0.3	0.0
Net external financing, NEF (% GDP)	0.7	1.0	0.2	0.5	0.9	-0.2	-0.1
Exports of G&S (% GDP)	10.2	7.9	9.3	8.5	6.8	-1.8	-1.0
Imports of G&S (% GDP)	39.3	30.9	34.4	33.4	32.8	-5.9	1.9
Remittances (% GDP)	18.8	12.5	19.4	15.4	12.0	-3.4	-0.4
Noninterest Current account deficit (% GDP)	0.6	0.0	0.7	0.8	2.6	0.2	2.6

Note. MT stands for medium term and reflects average over the next 5 years, and LT refers to long term and generally reflects the average over the last 15 years of the projection period. For GDP, both in dollars in local currency, MT and LT reflect figures for 2015 and 2031, respectively. Fiscal numbers are estimated/projected using GFS 1986 format.

EXTERNAL DEBT SUSTAINABILITY

A. Baseline

3. **Under the baseline debt projections, Nepal's debt indicators are well-below the indicative thresholds (Table 3b, Figure 1).**[2] As in the previous DSA, remittances are formally included in the analysis, given their importance in Nepal's economy and as a source of foreign exchange inflows—equal to about 19 percent of GDP and two times exports of goods and services in 2010–11.[3] Projections indicate that debt ratios are set to improve over the long term.

[2] 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. Nepal is classified as a medium performer based on its three year CPIA score during 2008-2010.

[3] Remittances are added to exports and GDP in debt indicator denominators. See *Nepal: Joint IMF/World Bank Debt Sustainability Analysis*, May 2010, and *Staff Guidance Note on the Application of the Joint Fund-Bank DSA for Low-Income Countries*, SM/10/16, 01/25/2010.

Nepal: Indicative External Debt Burden Indicators

	Indicative thresholds	Nepal: 2010/11	Nepal: projected average 2010/11-2030/31
PV of debt, in percent of:			
GDP and remittances	36	11.2	7.4
exports and remittances	135	46.7	33.0
revenue	250	89.8	54.4
Debt service, in percent of:			
exports and remittances	18	3.2	2.1
revenues	30	6.2	3.4

B. Stress Tests and Alternative Scenario

4. Nepal's debt is resilient to standard stress tests. The standard stress tests include two-year shocks to real GDP growth, lower export growth, lower transfers and FDI, a combination of the previous three shocks, and a one-time exchange rate depreciation.[4] The most severe stress tests are lower transfers (i.e. remittances) and the combination of shocks, though debt indicator thresholds are not breached in either case (Figure 1).

5. The standard stress tests do not capture the potential risks to debt sustainability stemming from financial sector fragility in Nepal. Credit quality has deteriorated and liquidity strains increased significantly following the bursting of a bubble in the real estate market, to which financial institutions are highly exposed and where prices have fallen by around 50 percent from their peak. Some smaller institutions have run into severe distress, with a large number requiring emergency liquidity assistance. Systemic fragilities are heightened by inadequate governance and risk management in banks, and a proliferation of financial institutions and financial interconnectedness in an environment of weak supervision. Moreover, two state banks accounting for about 14 percent of system deposits continue to operate with negative capital. Financial sector vulnerabilities are examined in a hypothetical financial stress scenario that could arise from a loss of confidence or an adverse shock to remittances leading to self-reinforcing feedback between deposit and capital flight, and systemic dislocation in the banking system. It assumes reserves loss, a one-time depreciation of the exchange rate, and a sharp contraction in output. The fiscal costs of financial sector restructuring are assumed at 27 percent of GDP over a 4 year period, which is in line with the average cost experienced in a range of countries under similar circumstances.[5] Slightly more than half of this cost is assumed to be foreign financed. Under this scenario, the PV of external debt-to-GDP-and-remittances ratio increases significantly, peaking at 38 percent in 2014–15 and remaining above the threshold until 2016–17 (see Figure 1). The PV of external debt-

[4] Standard stress tests assume shocks to these variables based on means and standard deviations of historical distributions.

[5] See Laeven and Valencia, *Systemic Banking Crises: A New Database*, IMF Working Paper 08/224.

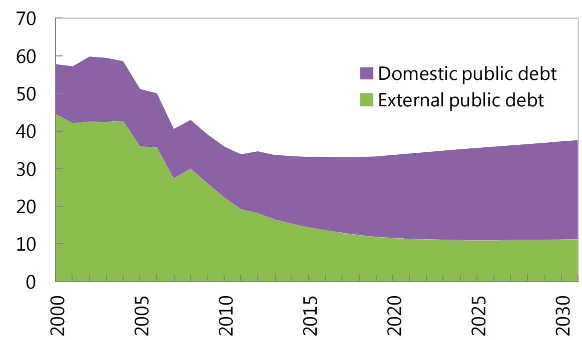
to-exports-and-remittances would be at or above the threshold in 2015 and from 2023 onward, and the ratio to revenues would breach the threshold for over 10 years. The debt service indicators increase while remaining below thresholds.

PUBLIC DEBT SUSTAINABILITY

6. Under the baseline scenario, the PV of public debt is on a gradual rising trend over the projection period. As a share of GDP, the PV of public debt increases from 28 percent in 2010–11 to 35 by the end of the projection period. In percent of revenue and grants, the PV of public debt increases from 151 percent to 184 percent.

7. Although the total level of public debt remains within reasonable bounds, its composition is projected to shift towards more domestic debt, reflecting the higher share of domestic compared to foreign financing of deficits. In the context of the current exchange-rate peg and if competitiveness and financial sector vulnerabilities are not addressed, a significant increase in public domestic debt would be increasingly difficult to accommodate. As a result, real interest rates would likely increase, possibly leading to a crowding out of private sector credit or a curtailment of primary fiscal expenditures on poverty and development related goals.

Evolution of the Composition of Public Debt
(% GDP, 2000–2031)



8. Stress tests suggest vulnerabilities to shocks. The largest adverse impact arises under the heightened financial stress scenario outlined above (Table 2). Among the standard stress tests, the largest impact on public debt arises from a one-time increase in other debt-creating flows. This would increase the PV of debt-to-GDP by close to 10 percentage points and leave it at higher levels for a prolonged period. Under the same stress scenario, debt service indicators show a significant spike from 11 percent of revenues to a peak of 36 percent.

AUTHORITIES' VIEW

9. The authorities concurred with the DSA and its policy messages. They are cognizant of the risk that financial sector stress poses to debt indicators. However, they suggest that weaknesses are limited to a few banks and are unlikely to develop into a broader problem. They also recognize the need to improve absorption of donor funds to curb the increase in domestic debt.

CONCLUSION

10. Nepal faces a moderate risk of external public debt distress. Although none of the external debt burden indicators breach the thresholds in the baseline scenario, under a heightened financial stress scenario, the debt burden rises notably, with external debt breaching thresholds. This underscores the need to implement reforms to address financial sector weaknesses in a timely manner. The analysis also suggests that a significant increase in domestic debt would threaten private sector credit or development-related primary expenditures. This highlights the importance of containing net domestic financing of deficits to around 2½ percent of GDP or less, through fiscal discipline, revenue efforts, and increased use of donor financial support.

Table 1. Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2008-2031
(In percent of GDP, unless otherwise indicated)

	Actual			Average	Standard Deviation	Estimate	Projections								
	2008	2009	2010			2011	2012	2013	2014	2015	2016	2011-16 Average	2021	2031	2017-31 Average
Public sector debt 1/	43.0	39.2	35.9			33.8	34.7	33.7	33.4	33.2	33.2		35.5	39.6	
o/w foreign-currency denominated	30.0	26.1	22.4			19.2	18.2	16.5	15.4	14.4	13.7		12.7	12.6	
Change in public sector debt	2.4	-3.8	-3.2			-2.1	0.8	-1.0	-0.3	-0.2	0.0		0.4	0.4	
Identified debt-creating flows	-1.4	-1.4	-4.9			-2.2	0.7	-1.1	-0.4	-0.3	-0.1		0.3	0.4	
Primary deficit	1.3	2.2	1.2	1.0	1.2	2.1	2.8	2.0	1.9	1.9	1.9	2.1	2.0	2.1	2.0
Revenue and grants	15.3	16.8	18.2			18.6	18.7	18.9	18.9	18.9	19.0		19.0	19.0	
of which: grants	2.5	2.7	3.0			3.6	3.3	3.0	2.9	2.7	2.7		2.6	2.6	
Primary (noninterest) expenditure	16.7	19.0	19.3			20.7	21.6	20.9	20.9	20.8	20.9		20.9	21.1	
Automatic debt dynamics	-2.2	-3.6	-6.0			-4.3	-2.1	-3.1	-2.3	-2.2	-1.9		-1.7	-1.8	
Contribution from interest rate/growth differential	-2.8	-3.0	-2.5			-1.8	-1.5	-1.6	-1.5	-1.5	-1.4		-1.1	-1.2	
of which: contribution from average real interest rate	-0.4	-1.1	-0.8			-0.6	-0.3	-0.3	-0.3	-0.2	-0.1		0.3	0.3	
of which: contribution from real GDP growth	-2.3	-1.8	-1.7			-1.2	-1.2	-1.3	-1.2	-1.2	-1.2		-1.4	-1.5	
Contribution from real exchange rate depreciation	0.6	-0.7	-3.5			-2.5	-0.6	-1.5	-0.8	-0.7	-0.6		...	...	
Other identified debt-creating flows	-0.5	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	-0.5	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	3.8	-2.4	1.6			0.1	0.1	0.1	0.1	0.1	0.1		0.1	0.1	
Other Sustainability Indicators															
PV of public sector debt	...	...	29.2			28.1	29.1	28.6	28.6	28.6	28.8		31.1	34.9	
o/w foreign-currency denominated	...	...	15.7			13.4	12.7	11.4	10.6	9.9	9.3		8.3	7.8	
o/w external	...	...	15.7			13.4	12.7	11.4	10.6	9.9	9.3		8.3	7.8	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	15.9	15.6	14.6			16.1	18.1	18.2	18.1	18.8	19.5		21.7	24.3	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	160.8			151.3	155.4	151.4	151.0	151.4	151.3		164.1	184.0	
PV of public sector debt-to-revenue ratio (in percent)	...	...	192.1			187.7	188.4	179.6	178.1	176.4	176.1		190.7	213.6	
o/w external 3/	...	...	103.4			89.8	82.1	71.6	66.2	60.9	56.8		51.0	48.0	
Debt service-to-revenue and grants ratio (in percent) 4/	18.2	16.2	13.4			11.1	11.9	11.8	11.9	12.0	12.2		13.2	13.5	
Debt service-to-revenue ratio (in percent) 4/	21.7	19.3	16.0			13.8	14.4	14.0	14.0	14.0	14.2		15.3	15.7	
Primary deficit that stabilizes the debt-to-GDP ratio	-1.0	6.0	4.4			4.2	2.0	3.0	2.2	2.1	1.9		1.6	1.7	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	6.1	4.4	4.6	4.0	1.6	3.5	3.8	3.8	3.8	3.8	3.9	3.8	4.0	4.0	4.0
Average nominal interest rate on forex debt (in percent)	1.1	0.9	1.0	1.0	0.1	0.9	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.0	1.0
Average real interest rate on domestic debt (in percent)	-1.2	-9.1	-6.6	-1.5	4.0	-3.4	-1.3	-1.6	-1.3	-0.8	-0.1	-1.4	0.8	0.8	0.7
Real exchange rate depreciation (in percent, + indicates depreciation)	2.2	-2.3	-14.1	-3.7	6.9	-11.8	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	5.6	16.0	13.4	7.0	4.4	9.5	8.0	7.6	7.3	6.8	6.0	7.5	5.0	5.0	5.2
Growth of real primary spending (deflated by GDP deflator, in percent)	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	...	...	...	43.9	43.9	43.9	43.9	43.9	43.8	43.9	43.6	43.1	...

Sources: Country authorities; and staff estimates and projections.
1/ These debt statistics cover the general government. They exclude non-financial public enterprises. Debt is reported net of government deposits at the NRB.
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 2. Nepal: Sensitivity Analysis for Key Indicators of Public Debt 2011-2031

	Projections							
	2011	2012	2013	2014	2015	2016	2021	2031
PV of Debt-to-GDP Ratio								
Baseline	28	29	29	29	29	29	31	35
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	28	28	26	26	25	25	25	25
A2. Primary balance is unchanged from 2011	28	28	28	28	29	29	32	36
A3. Permanently lower GDP growth 1/	28	29	29	29	29	30	35	45
A4. Financial sector stress scenario	28	62	68	72	75	71	64	69
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012-2013	28	30	30	30	31	31	35	40
B2. Primary balance is at historical average minus one standard deviations in 2012-2013	28	29	28	28	28	29	31	35
B3. Combination of B1-B2 using one half standard deviation shocks	28	28	28	28	28	29	32	37
B4. One-time 30 percent real depreciation in 2012	28	35	33	33	32	32	33	35
B5. 10 percent of GDP increase in other debt-creating flows in 2012	28	38	37	36	35	35	36	37
PV of Debt-to-Revenue Ratio 2/								
Baseline	151	155	151	151	151	151	164	184
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	151	147	139	135	133	130	131	131
A2. Primary balance is unchanged from 2011	151	152	149	150	151	152	169	187
A3. Permanently lower GDP growth 1/	151	156	153	154	156	157	181	233
A4. Financial sector stress scenario	151	340	378	398	413	394	358	388
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012-2013	151	158	158	160	162	163	183	212
B2. Primary balance is at historical average minus one standard deviations in 2012-2013	151	153	150	150	150	150	163	184
B3. Combination of B1-B2 using one half standard deviation shocks	151	151	146	147	149	150	168	194
B4. One-time 30 percent real depreciation in 2012	151	185	176	173	171	169	175	184
B5. 10 percent of GDP increase in other debt-creating flows in 2012	151	202	195	190	188	184	189	198
Debt Service-to-Revenue Ratio 2/								
Baseline	11	12	12	12	12	12	13	14
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	11	12	11	7	8	7	6	3
A2. Primary balance is unchanged from 2011	11	12	12	10	12	12	14	14
A3. Permanently lower GDP growth 1/	11	12	12	12	13	13	16	22
A4. Financial sector stress scenario	11	18	25	28	30	30	25	28
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2012-2013	11	12	12	13	14	14	17	18
B2. Primary balance is at historical average minus one standard deviations in 2012-2013	11	12	12	10	12	12	13	13
B3. Combination of B1-B2 using one half standard deviation shocks	11	12	11	9	10	11	14	15
B4. One-time 30 percent real depreciation in 2012	11	13	14	14	15	15	16	17
B5. 10 percent of GDP increase in other debt-creating flows in 2012	11	12	15	36	20	25	17	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. Nepal: External Debt Sustainability Framework, Baseline Scenario, 2008-2031 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average	Standard Deviation	Projections									
	2008	2009	2010			2011	2012	2013	2014	2015	2016	2011-2016 Average	2021	2031	2017-2031 Average
External debt (nominal) 1/	**31.8**	**28.0**	**24.1**			**20.7**	**19.7**	**17.9**	**16.8**	**15.8**	**15.1**		**14.2**	**13.7**	
o/w public and publicly guaranteed (PPG)	30.0	26.1	22.4			19.2	18.2	16.5	15.4	14.4	13.7		12.7	12.6	
Change in external debt	3.3	-3.8	-3.9			-3.4	-1.0	-1.8	-1.1	-1.0	-0.8		-0.3	-0.2	
Identified net debt-creating flows	-7.8	-5.1	-2.9			-0.3	-0.2	-0.1	0.1	0.3	0.4		0.7	3.6	
Non-interest current account deficit	**-3.0**	**-4.4**	**2.2**	**-2.5**	**2.1**	**0.7**	**0.6**	**0.7**	**0.9**	**1.0**	**1.0**		**1.3**	**4.3**	2.6
Deficit in balance of goods and services	19.3	22.1	27.4			25.1	25.0	24.5	24.8	25.1	25.5		27.2	24.7	
Exports	12.1	12.4	9.8			9.3	9.1	8.5	8.2	7.9	7.7		7.6	6.2	
Imports	31.4	34.5	37.1			34.4	34.1	32.9	33.0	33.0	33.2		34.8	30.9	
Net current transfers (negative = inflow)	-21.2	-25.1	-24.2	-18.6	3.8	-23.6	-23.7	-23.1	-23.3	-23.5	-23.9		-25.4	-20.3	-23.3
o/w official	-2.2	-2.5	-1.9			-1.8	-1.8	-1.7	-1.7	-1.6	-1.5		-1.7	-1.8	
Other current account flows (negative = net inflow)	-1.2	-1.4	-1.0			-0.7	-0.7	-0.7	-0.6	-0.6	-0.6		-0.5	-0.1	
Net FDI (negative = inflow)	**0.0**	**-0.2**	**-0.2**	**-0.1**	**0.1**	**-0.5**	**-0.3**	**-0.2**	**-0.2**	**-0.2**	**-0.2**		**-0.3**	**-0.3**	-0.3
Endogenous debt dynamics 2/	**-4.8**	**-0.5**	**-4.9**			**-0.5**	**-0.5**	**-0.5**	**-0.5**	**-0.4**	**-0.4**		**-0.4**	**-0.4**	
Contribution from nominal interest rate	0.3	0.3	0.2			0.2	0.2	0.2	0.1	0.1	0.1		0.1	0.1	
Contribution from real GDP growth	-1.4	-1.4	-1.0			-0.7	-0.7	-0.6	-0.6	-0.6	-0.6		-0.5	-0.5	
Contribution from price and exchange rate changes	-3.6	0.6	-4.1			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	**11.1**	**1.3**	**-1.0**			**-3.1**	**-0.8**	**-1.8**	**-1.2**	**-1.3**	**-1.1**		**-0.9**	**-3.8**	
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/	...	...	17.4			15.0	14.2	12.8	12.0	11.3	10.7		9.9	9.0	
In percent of exports	...	...	177.9			160.4	156.6	151.7	146.8	142.2	138.3		130.2	144.4	
PV of PPG external debt (in percent of GDP and remittances)	**...**	**...**	**13.1**			**11.2**	**10.6**	**9.6**	**8.9**	**8.2**	**7.7**		**6.9**	**6.7**	
In percent of exports and remittances	**...**	**...**	**53.1**			**46.7**	**44.2**	**41.1**	**38.2**	**35.5**	**33.1**		**28.8**	**35.0**	
In percent of government revenues	**...**	**...**	**103.4**			**89.8**	**82.1**	**71.6**	**66.2**	**60.9**	**56.8**		**51.0**	**48.0**	
Debt service-to-exports-and-remittances ratio (in percent)	**4.3**	**3.8**	**3.8**			**3.2**	**3.0**	**2.9**	**2.7**	**2.5**	**2.4**		**1.7**	**1.8**	
PPG debt service-to-exports-and-remittances ratio (in percent)	**4.3**	**3.8**	**3.8**			**3.2**	**3.0**	**2.9**	**2.7**	**2.5**	**2.4**		**1.7**	**1.8**	
PPG debt service-to-revenue ratio (in percent)	**9.6**	**8.9**	**7.4**			**6.2**	**5.6**	**5.1**	**4.7**	**4.3**	**4.1**		**3.1**	**2.5**	
Total gross financing need (Billions of U.S. dollars)	-0.1	-0.2	0.7			0.5	0.5	0.6	0.7	0.8	0.9		1.3	6.2	
Non-interest current account deficit that stabilizes debt ratio	-6.3	-0.6	6.1			4.1	1.6	2.5	1.9	2.0	1.8		1.6	4.5	
Key macroeconomic assumptions															
Real GDP growth (in percent)	6.1	4.4	4.6	4.0	1.6	3.5	3.8	3.8	3.8	3.8	3.9	3.8	4.0	4.0	4.0
GDP deflator in US dollar terms (change in percent)	14.5	-1.9	16.9	6.6	6.7	12.7	7.1	10.6	6.6	6.8	6.0	8.3	5.0	5.0	4.4
Effective interest rate (percent) 5/	1.1	0.9	1.0	1.0	0.1	0.9	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.0	1.0
Growth of exports of G&S (US dollar terms, in percent)	5.4	4.9	-3.3	2.6	20.5	11.4	8.1	7.0	7.1	7.3	7.1	8.0	6.9	9.2	7.0
Growth of imports of G&S (US dollar terms, in percent)	11.2	12.5	31.7	16.2	7.7	8.1	10.1	10.9	10.9	10.8	10.9	10.3	7.9	7.9	8.0
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	43.9	43.9	43.9	43.9	43.9	43.8	43.9	43.6	43.1	43.4
Government revenues (excluding grants, in percent of GDP)	12.9	14.2	15.2			15.0	15.5	15.9	16.0	16.2	16.3		16.3	16.3	16.3
Aid flows (in Billions of US dollars) 7/	0.3	0.3	0.5			0.8	0.9	0.9	1.0	1.0	1.1		1.6	3.9	
o/w Grants	0.3	0.3	0.5			0.7	0.7	0.7	0.7	0.8	0.8		1.2	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	1.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			4.1	3.9	3.5	3.4	3.2	3.2		3.2	3.2	3.2
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			86.7	83.9	83.3	84.0	83.6	83.5		82.3	79.9	81.4
Memorandum items:															
Nominal GDP (Billions of US dollars)	12.5	12.9	15.7			18.3	20.4	23.4	25.9	28.7	31.6		44.9	108.2	
Nominal dollar GDP growth	21.5	2.4	22.2			16.6	11.2	14.8	10.6	10.9	10.1	12.4	9.2	9.2	8.6
PV of PPG external debt (in Billions of US dollars)			2.5			2.5	2.6	2.7	2.7	2.8	2.9		3.7	8.5	
(PVt-PVt-1)/GDPt-1 (in percent)						0.3	0.4	0.4	0.3	0.3	0.3	0.3	0.5	0.8	0.6
Gross workers' remittances (Billions of US dollars)	2.1	2.7	3.1			3.6	4.0	4.5	5.1	5.7	6.4		9.6	17.4	
PV of PPG external debt (in percent of GDP + remittances)	...	...	13.1			11.2	10.6	9.6	8.9	8.2	7.7		6.9	6.7	
PV of PPG external debt (in percent of exports + remittances)	...	...	53.1			46.7	44.2	41.1	38.2	35.5	33.1		28.8	35.0	
Debt service of PPG external debt (in percent of exports + remittances)	...	...	3.8			3.2	3.0	2.9	2.7	2.5	2.4		1.7	1.8	

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, 2011-2031

(In percent)

	Projections							
	2011	2012	2013	2014	2015	2016	**2021**	2031
PV of debt-to-GDP+remittances ratio								
Baseline	11	11	10	9	8	8	**7**	7
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011-2031 1/	11	9	7	5	3	1	**0**	0
A2. New public sector loans on less favorable terms in 2011-2031 2	11	11	10	10	9	9	**9**	11
A3. Financial sector stress scenario	11	33	35	37	38	36	32	31
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	11	11	10	9	8	8	**7**	7
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	11	12	12	11	11	10	**9**	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	11	11	11	10	9	9	**8**	8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	11	16	19	17	15	14	**12**	8
B5. Combination of B1-B4 using one-half standard deviation shocks	11	17	22	19	18	16	**14**	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	11	14	12	12	11	10	**9**	9
PV of debt-to-exports+remittances ratio								
Baseline	47	44	41	38	36	33	**29**	35
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011-2031 1/	47	38	29	20	12	4	**0**	0
A2. New public sector loans on less favorable terms in 2011-2031 2	47	46	44	42	40	39	**39**	57
A3. Financial sector stress scenario	47	129	129	134	136	130	132	153
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	47	44	41	38	35	33	**29**	35
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	47	53	61	56	52	48	**40**	43
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	47	44	41	38	35	33	**29**	35
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	47	84	102	71	66	62	**51**	44
B5. Combination of B1-B4 using one-half standard deviation shocks	47	84	112	75	70	65	**53**	44
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	47	44	41	38	35	33	**29**	35
PV of debt-to-revenue ratio								
Baseline	90	82	72	66	61	57	**51**	48
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011-2031 1/	90	71	53	36	21	7	**0**	0
A2. New public sector loans on less favorable terms in 2011-2031 2	90	85	76	73	69	66	**69**	78
A3. Financial sector stress scenario	90	252	282	298	311	293	**258**	240
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	90	83	74	68	62	58	**52**	49
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	90	90	92	85	78	73	**64**	52
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	90	88	85	78	72	67	**60**	56
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	90	117	134	124	114	106	**91**	60
B5. Combination of B1-B4 using one-half standard deviation shocks	90	122	160	148	136	127	**108**	70
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	90	114	99	92	84	79	**70**	66

Table 3b. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2011-2031 (continued)
(In percent)

	Debt service-to-exports+remittances ratio							
Baseline	3	3	3	3	3	2	**2**	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011-2031 1/	3	3	3	3	2	2	**1**	0
A2. New public sector loans on less favorable terms in 2011-2031 2	3	3	3	3	3	3	**2**	3
A3. Financial sector stress scenario	3	6	8	8	9	9	**8**	10
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	3	3	3	3	3	2	**2**	2
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	3	3	3	3	3	3	**2**	2
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	3	3	3	3	3	2	**2**	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	3	4	4	3	3	3	**3**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	3	4	4	3	3	3	**3**	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	3	3	3	3	3	2	**2**	2
	Debt service-to-revenue ratio							
Baseline	6	6	5	5	4	4	**3**	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2011-2031 1/	6	6	5	5	4	4	**1**	0
A2. New public sector loans on less favorable terms in 2011-2031 2	6	6	5	5	5	5	**4**	4
A3. Financial sector stress scenario	6	12	17	18	20	19	16	16
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	6	6	5	5	4	4	**3**	3
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	6	6	5	5	5	4	**3**	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	6	6	6	6	5	5	**4**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	6	6	6	6	5	5	**5**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	6	6	6	6	6	6	**5**	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 5/	6	8	7	7	6	6	**4**	3
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.

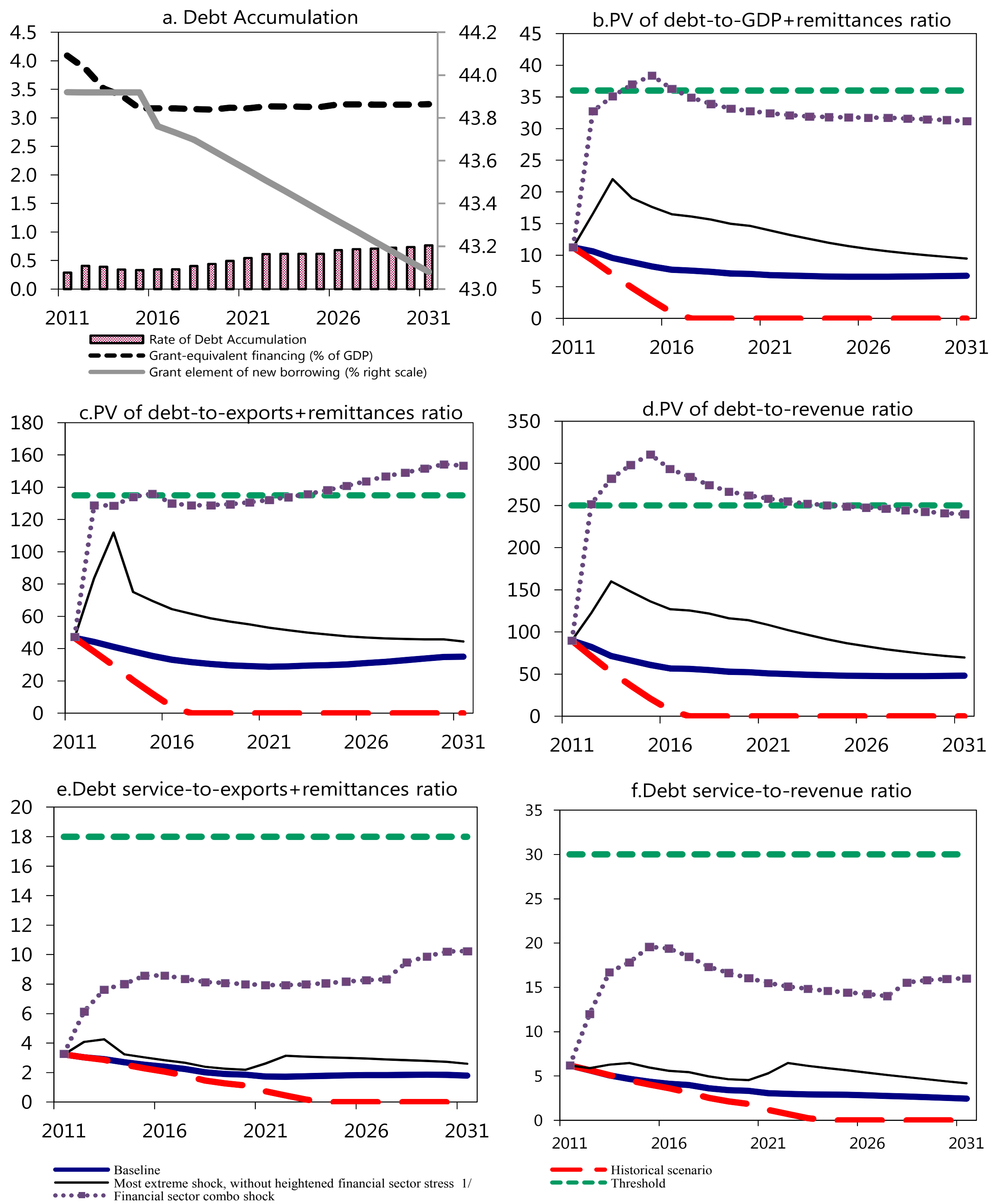
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

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.

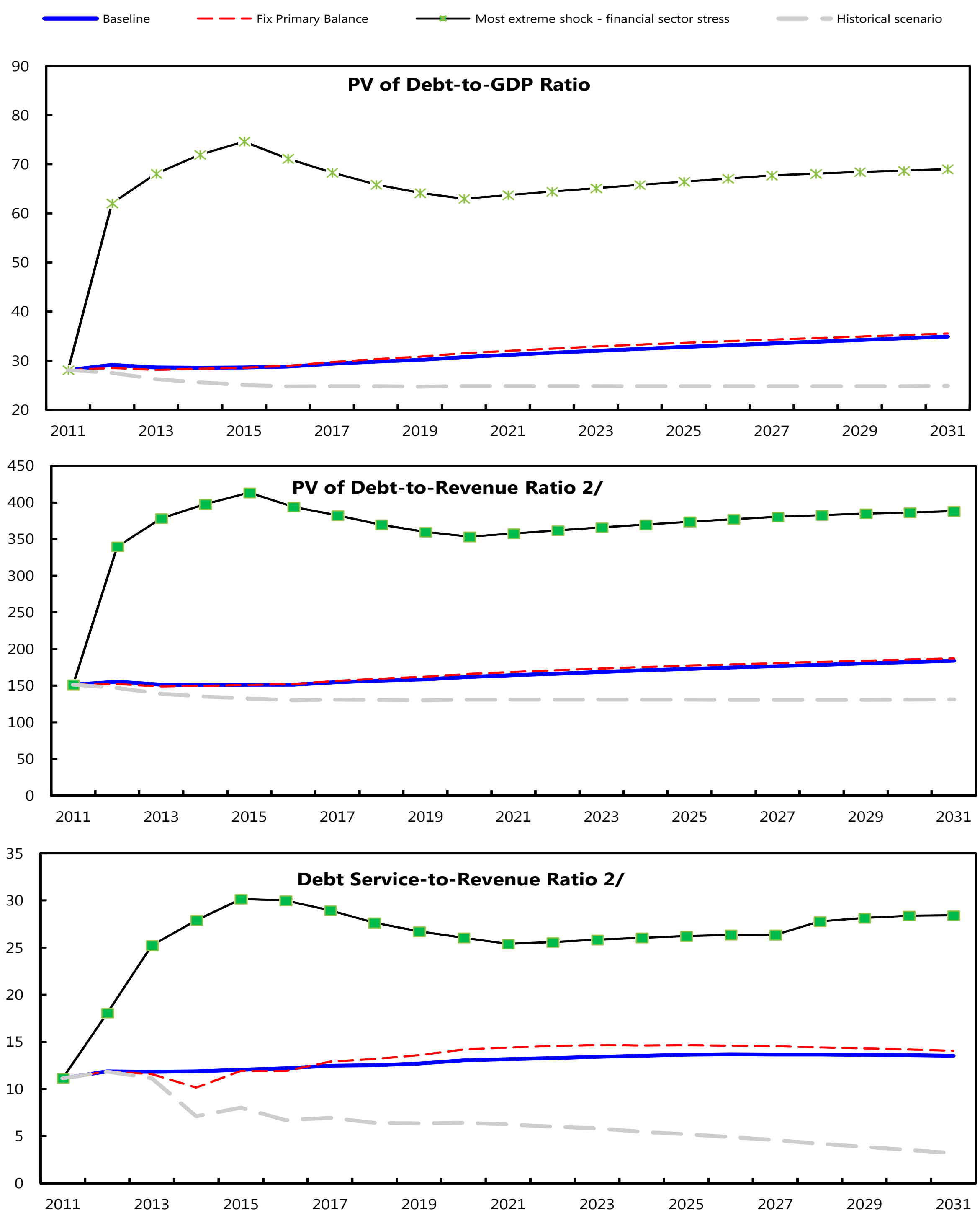
Figure 1. Nepal: Indicators of Public and Publicly Guaranteed External Debt
Under Alternative Scenarios, 2011-2031 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2021. 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 Non-debt flows shock and in figure f. to a Combination shock

Figure 2. Nepal: Indicators of Public Debt Under Alternative Scenarios, 2011-2031 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2021.
2/ Revenues are defined inclusive of grants.

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IMF Executive Board Concludes 2011 Article IV Consultation with Nepal

On October 19, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Nepal.[1]

Background

Living standards in Nepal have improved markedly over the past decade thanks to increased remittances, supportive social programs, and generally prudent fiscal policy that almost halved public debt as a share of GDP. Notable progress has also been made towards the Millennium Development Goals. However, productivity growth has not kept pace with neighboring countries, and structural reforms needed to boost growth and enhance competitiveness have lagged. At the same time, Nepal remains in a lengthy political transition: the Constituent Assembly and the interim Constitution were recently extended for a third time to November 2011.

Maintaining macroeconomic and financial stability has become increasingly challenging since the last Article IV consultation in May 2010, with financial sector risks in particular elevated. Inflation has remained high, averaging about 9½ percent in 2010-11.[2] The balance of payments was under pressure for most of the year due to high oil prices, slowing remittances, and weakening competitiveness, though it ended with a modest surplus. The

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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 mid-July.

adoption of the budget by the Constituent Assembly was delayed by 7 months due to the political situation. Revenue and spending underperformed the budget targets, net domestic financing exceeded its target, and large losses were incurred by the Nepal Oil Company. Reflecting these developments and heightened stress in the banking system, growth slowed to 3½ percent from 4½ percent the previous year. Mixed progress was made in implementing policy commitments under the Rapid Credit Facility (RCF), approved in May 2010.

Banking sector risks have intensified as financial institutions proliferated in an environment of weak supervision. Asset quality has deteriorated and liquidity pressures increased following the bursting of a bubble in the real estate market, to which banks are significantly exposed. In response, monetary policy eased and liquidity support was extended to institutions in stress, regulatory forbearance measures were implemented, and a widening of deposit insurance was announced. Restructuring of the weak state banks and reform of key bank legislation have been delayed.

The outlook is subject to high degree of uncertainty, with risks on the downside chiefly owing to banking sector fragility. Real GDP growth is expected at 3¾ percent in 2011-12, with good agriculture output compensating for subdued non-agriculture activity. Inflation should ease to 8 percent due to an expected moderation in India's inflation and a stabilization of commodity prices. The external current account deficit is projected to remain around 1 percent of GDP, but the import cover of foreign reserves is expected to decline. The 2011-12 budget appropriately targets net domestic financing of 2 percent of GDP; however, achieving this will not be easy given ambitious revenue targets set against the backdrop of moderate activity and a significant increase of current spending.

Against this background, the 2011 Article IV consultation focused on maintaining macroeconomic stability and managing financial sector risks.

Executive Board Assessment

Executive Directors welcomed Nepal's generally prudent fiscal performance, the improvements in living standards, and the progress toward the achievement of the Millennium Development Goals. Looking ahead, Directors stressed that Nepal's macroeconomic environment has become increasingly challenging, requiring decisive actions to address financial sector fragility while maintaining macroeconomic stability and poverty reduction efforts.

Directors urged the authorities to address the substantial risks in the financial sector with utmost priority. They viewed regulatory forbearance as unsustainable, and stressed the need to strengthen supervision, the regulatory environment, and banks' corporate governance, while merging and improving the central bank's emergency liquidity facilities. Directors encouraged the authorities to develop an effective crisis management framework that would facilitate timely intervention and resolution of problem banks. They advised the authorities to press ahead with restructuring the weak state banks—with a few Directors stressing an audit of Nepal Bank Limited by a reputable international auditor—and to strictly enforce the moratorium on new bank licenses.

Directors underlined that continued fiscal prudence remains essential to ensuring macroeconomic stability. They commended the authorities for continuously improving debt dynamics, and for the timely adoption of the 2011-12 budget with an appropriate target for net domestic financing. Given the challenging backdrop of moderate activity and a significant increase of current spending, Directors encouraged the authorities to boost revenue by further strengthening administration and refocusing the tax structure toward domestic sources. Efforts are also needed to restrain administrative expenses and to phase out unproductive subsidies while safeguarding pro-poor spending. Directors called on the authorities to enhance the public finance management framework and to introduce an automatic fuel price adjustment mechanism to limit the losses of the Nepal Oil Corporation.

Directors emphasized that the exchange rate peg has served Nepal well and continues to be a near-term policy priority, and safeguarding it requires a firmer monetary policy stance and targeted rather than blanket liquidity provision for solvent banks facing short-term pressures. They noted the staff's assessment that the exchange rate appears overvalued, and stressed the importance of boosting productivity. At the same time, if sustained and significant downward exchange-rate pressure were to emerge, preservation of official reserves and an adjustment of the peg would need to be considered. Directors welcomed the authorities' commitment to remove the exchange restriction to comply with Article VIII of the Fund's Articles of Agreement.

Directors encouraged the authorities to press ahead with structural reforms to raise productivity and potential growth. Addressing key structural bottlenecks, along with macro-financial stability, would help Nepal achieve higher sustainable growth and promote poverty reduction, and Directors expected these issues to be at the core of a strong reform program that could be supported by an Extended Credit Facility (ECF) arrangement.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Nepal: Selected Economic Indicators

	2008/09	2009/10	2010/11	2011/12
			Est.	Proj.
Output and prices (annual percent change)				
Real GDP	4.4	4.6	3.5	3.8
Non-agricultural GDP	4.1	5.4	3.1	2.9
CPI (period average)	12.6	9.6	9.5	8.0
CPI (end of period)	11.1	9.0	9.4	8.1
Fiscal Indicators (in percent of GDP)				
Total revenue and grants	16.6	18.0	18.4	18.3
Expenditure	19.2	19.0	20.1	21.0
Expenses	16.4	16.1	16.8	17.7
Net acquisition of NFA	2.8	2.9	3.3	3.3
Net lending/borrowing	-2.6	-1.0	-1.8	-2.7
Net acquisition of FA	-0.4	-1.0	-1.2	-1.1
Net domestic financing	3.0	2.0	2.8	3.3
Money and credit (annual percent change)				
Broad money	27.3	14.1	9.5	11.1
Domestic credit	27.1	16.8	13.2	15.0
Private sector credit	29.0	14.2	11.8	6.4
Velocity	1.6	1.6	1.7	1.7
Investment and saving (in percent of nominal GDP)				
Gross investment	31.5	35.8	35.0	32.8
Private	24.6	28.6	27.1	24.8
Central government	6.9	7.2	7.9	8.0
Gross national saving	35.7	33.4	34.1	32.0
Balance of payments				
Current account (in millions of U.S. dollars)	536	-378	-167	-156
In percent of GDP	4.2	-2.4	-0.9	-0.8
Trade Balance (in millions of U.S. dollars)	-2,707	-4,078	-4,474	-4,975
In percent of GDP	-21.1	-26.0	-24.4	-24.4
Exports value growth (percent change)	0.5	-6.1	13.9	9.0
Imports value growth (percent change)	14.1	36.4	10.4	10.8
Gross official reserves (in millions of U.S. dollars)	2,907	2,844	3,098	3,180
In months of imports of goods and services	6.0	5.4	5.4	5.0
Memorandum items				
Public debt (percent of GDP)	39	36	34	35
GDP at market prices (in billions of Nepalese rupees)	988	1,171	1,327	1,487
GDP at market prices (in billions of U.S. dollars)	12.9	15.7	18.3	20.4
Exchange rate (Nrs/US$; period average)	76.9	74.5	72.4	…
Real effective exchange rate (eop, y/y percent change)	3.5	7.3	…	…

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

Statement by Der Jiun Chia, Executive Director for Nepal and Ramesh Kumar Pokharel, Advisor to Executive Director October 19, 2011

The Nepalese authorities would like to express their appreciation to the IMF team for the fruitful dialogue during this year's Article IV consultation in Kathmandu. Authorities recognize the challenges facing the economy highlighted in the staff assessment and remain committed to pursue measures to achieve a more vibrant and long-lasting growth in Nepal.

Recent Developments and Macroeconomic Outlook

1. Living standards in Nepal have improved markedly on the strength of increased remittances and supportive social programs in recent years. Notable progress has also been made towards achieving the Millennium Development Goals. The economy continued to post positive growth averaging 3.8 percent in last three years, albeit lower than the historical trend. Average inflation was double digits in the last three years, but some headway was achieved in containing inflation in the latter part of 2010. Meanwhile, prudent fiscal policy by the authorities allowed the halving of public debt as a share of GDP over the past decade to 34 percent in 2010. Some upheavals in the financial sector last year, however, prompted challenges for sustained financial development in Nepal. The stress in the financial system is now stabilized and gradually recovering.

2. On the political front, significant developments have taken place in Nepal. A new Prime Minister was elected on August 29, 2011, after a 7-month delay of the election, a new coalition government was formed and a full cabinet was appointed. The Constituent Assembly and the interim Constitution have been extended for a third time, to November 2011. The authorities are confident that the peace process will soon be concluded and a new Constitution will be promulgated in November this year. The authorities' optimism is founded on the broad support of the various political parties for the new Prime Minister. All these political developments are expected to result in greater political stability going forward. In turn, this should promote an improved business environment conducive to durable economic growth.

3. The authorities expect the economy to grow at a faster rate of 5 percent in the current fiscal year, owing to favorable monsoon resulting in a good harvest, timely budget implementation, receding banking sector stress, and a more positive investment climate in expectation of political stability. Inflation is expected to decelerate to 7 percent in the current fiscal year. In recent months, CPI inflation is hovering around the annual target of 7 percent, reflecting the global price developments and price movements in India. On the external front, with higher growth of exports than that of imports, the current account deficit is narrowing. For the current fiscal year, an overall BOP surplus of Rs. 5 billion is targeted, and there are signs that this target is achievable. For the first month of the current fiscal year, a BOP surplus of Rs. 8.3 billion was recorded.

Monetary and exchange rate policy

4. The authorities recognize the need to calibrate carefully the conduct of monetary policy taking into account the currency peg, the fragile economic growth and developments in the financial system. Authorities view that money growth has so far been low and deposit rates are above those in India. However, authorities are monitoring closely movements of deposit rates and stand ready to conduct monetary policy operations promptly once signs of excess liquidity in the money stream start to emerge. The authorities also view that maintaining the currency peg with the Indian rupee is fundamental to Nepal's economic stability as it serves as a stable and transparent anchor for the conduct of monetary policy.
The authorities believe that the exchange rate peg should remain to be the key policy target. However, authorities recognize the risk of real exchange rate misalignment and potential loss of trade competitiveness. In this regard, they are committed to enhancing productivity by addressing structural constraints, which impedes international competitiveness. Meanwhile, the authorities aim to maintain reserves equivalent to six months of imports, although they recognize that macroeconomic developments could make this task challenging.

Fiscal policy

5. The authorities remain committed to a prudent fiscal policy stance. Notwithstanding pressures on peace-related expenditures and wages, the overall public expenditures are projected to be held at 21 percent of GDP in the current fiscal year. Capital spending will prioritize projects which will have significant impact on economic development, while social spending will remain appropriate to preserve the progress attained in improving social indicators. Authorities reiterated that net domestic financing (NDF) ceiling will not be breached during the current fiscal year since they are prepared to institute additional measures, if necessary, including further optimization of current expenditures, postponing low priority capital projects, or securing external concessional financing.

6. The authorities are confident that the revenue target equivalent to 18 percent of GDP for the current fiscal year is attainable on the strength of sustained economic growth and enhanced tax administration. As regards the latter, action plans have been adopted to improve tax administration in both the Customs and Inland Revenue Departments, with technical assistance from the IMF. On import-related revenue, the authorities will work on the accurate valuation of goods and crack down on under-invoicing of imports, which is a major source of revenue leakage.

Financial Sector Stability

7. The rapid growth of remittances in recent years has resulted in financial deepening and contributed to the notable expansion of Nepal's banking sector. However, this significant growth of the banking sector created challenges that authorities recognized. Authorities believe that the problems are confined to a small section of banking system and particularly to the B and C class of financial institutions, which are overexposed to real estate sector and that the banking system overall continues to be sound. In particular, capital adequacy ratio of banks has remained well above the Basel standards, excluding the two state-controlled banks.

The ratio of non-performing loans to gross total loan has stayed below 3 percent and the profitability of banks as reflected by return on asset ratio is still encouraging.

8. Authorities believe that the recent banking sector problems, which are concentrated in small financial institutions, are coming under control and are manageable. Bank mergers and tax incentives to reinvigorate the real estate market will help preserve confidence in the system. Authorities emphasized that forbearance and liquidity assistance are temporary measures. Authorities are in agreement with staff's recommendation to strengthen the emergency liquidity assistance framework. More recently, the amount of liquidity financing extended to banks by the central bank has declined and there are positive signs of recovery in real estate lending. Authorities view that the amount of lending against share collateral is not significant (less than two percent of total loans) and restricting this practice immediately could adversely impact on stock market confidence amid the observed decline in stock prices in the past 18 months.

9. Authorities are cognizant that the proliferation of banks has overstretched the supervisory capacity of the central bank. Authorities emphasized that they have put in place several measures in recent period to ensure financial sector stability and effective financial services. In particular, a moratorium was adopted on the licensing of new financial institutions, except 'D' class financial institutions (micro finance) authorized to provide banking services in unbanked and under banked areas of the country. A law was implemented recently that encourages merger and acquisition of banks and financial institutions. This was complemented by the introduction of provisions in the budget for FY 2010/11 that waived registration fees on mergers and acquisition upon the recommendation of the central bank. Moreover, the restructuring process of the two state controlled banks is continuing.

10. In order to monitor asset quality, on-site supervision of all financial institutions has been intensified with more focus on the banks under PCA. Supervisory departments will be strengthened further for this purpose.

11. Directives have been issued to banks to conduct stress test. In addition, a liquidity monitoring framework will be prepared and implemented in order to strengthen forward-looking analysis for liquidity management of banks and financial institutions. Measures related to liquidity management, reforms in the capital market, balanced expansion of banks and financial institution and control of financial crimes will all be expedited.

12. A High Level Financial Sector Coordination Committee (HLFSCC) has been constituted to monitor progress and recommend policy actions to promote financial sector stability. The committee frequently meets to assess the issues of the financial sector including those in the saving and credit cooperatives and is ready to take the necessary action as and when required.

13. Monitoring and supervision of banks and financial institutions will be made more effective by enhancing the capacity of Nepal Rastra Bank. The authorities believe that such capacity building efforts requires regular engagement of development partners in longer-term horizon. The authorities appreciate the technical assistance provided by the Fund in this area.

Structural reforms

14. The authorities consider the structural reform to be key to promoting higher economic growth and reducing poverty. As the political situation stabilizes with the anticipated completion of the peace process and promulgation of a new Constitution, authorities are of the view that the political will to pursue with greater vigor, significant medium-term structural reforms supported by development partners could be engendered more specifically in the area of infrastructure development and public enterprises reforms.

15. The authorities recognize the need to remove structural bottlenecks, especially in the hydropower sector. Authorities consider hydro power to have strong export potential and can become a prime driver of economic growth in Nepal. In this regard, a master plan will be prepared for hydro power development, including an assessment of power generation potential. To date, an additional 750 MW of hydro projects are under construction. These are expected to be operational in 2014–15, more than doubling the present installed capacity. The master plan will also emphasize rural development in a public private partnership (PPP) framework. Investment in rural micro hydro power projects, farm to market roads, and commercialization of rural agro-products could be some of the potential areas where PPP could be promoted. To provide stability to the investment climate, the authorities intend to develop a 20-year vision for growth and development, within which rolling plans of shorter horizons would be executed.

Reinstatement of IMF Resident Representative in Nepal

16. Given the challenges facing Nepal's economy and the banking sector, authorities intend to continue engaging the Fund for valuable policy advice. Authorities believe that the presence of a full-time Resident Representative in Nepal will help reinforce the effectiveness of Fund engagement with Nepal, and therefore view that this position which was abolished in October 2010 should be reinstated.