



NEPAL

February 2019

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR NEPAL

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Nepal, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 8, 2019 consideration of the staff report that concluded the Article IV consultation with Nepal.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 8, 2019, following discussions that ended on December 13, 2018, 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 January 24, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staffs of the IMF and the International Development Association (IDA).
- A **Statement by the Executive Director** for Nepal.

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

Selected Issues

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February 17, 2019

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IMF Executive Board Concludes 2019 Article IV Consultation with Nepal

On February 8, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Nepal.

Nepal's economy is enjoying a solid expansion, supported by ongoing reconstruction activity following the 2015 earthquakes and increased growth in manufacturing and tourism-related sectors. Real GDP is estimated to have expanded by 6.3 percent in FY 2017/18 (mid-July 2017 to mid-July 2018), and headline inflation averaged 4.2 percent, held down by subdued food-price inflation.

Government expenditure increased by 32.4 percent (year-on-year) in FY 2017/18, propelled by Nepal's transition to fiscal federalism and ongoing reconstruction spending. As in previous years, spending was concentrated in the last quarter of the fiscal year. Revenue growth was also substantial (18.9 percent). Nevertheless, the fiscal deficit increased to 6.5 percent of GDP, from 3.1 percent of GDP in FY 2016/17.

Private sector credit has been expanding very rapidly in recent years, posting 24 percent (y/y) growth in December 2018, following average growth rates above 20 percent since FY 2015/16.

The current account moved sharply into deficit position (8.2 percent of GDP in FY 2017/18), following a modest deficit of 0.4 percent in FY 2016/17. Imports grew by 27.4 percent (y/y), following a 30 percent expansion in FY 2016/17. Exports also expanded, by 15.5 percent, but this growth applied to a low base (exports comprised 3.1 percent of GDP in FY 2017/18). Nepal's substantial trade deficit is partly financed by buoyant remittance inflows, which grew by 10.2 percent (y/y) in FY 2017/18 and were equivalent to 25.1 percent of Nepal's GDP. As of December 2018, gross official foreign exchange reserves held by the Nepal Rastra Bank stood at US\$ 8.3 billion, having declined by approximately US\$1.2 billion from the record set in January 2018.

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.

The near-term outlook for growth is favorable but macroeconomic and financial vulnerabilities continue to build. Growth is expected to reach 6.5 percent in FY2018/19, supported by ongoing reconstruction, investment in hydro-power projects, and strong tourism-related activity. However, fiscal and credit policies are very expansionary leading to rising non-food inflation, a widening current account deficit, falling foreign exchange reserves, and a buildup of financial sector vulnerabilities. Risks are tilted to the downside, related to the financial sector and a possible slowdown in remittances.

Executive Board Assessment²

Executive Directors commended the authorities on the pick-up in economic activity in Nepal, supported by greater political stability, more reliable electricity supply, and reconstruction activity. Directors considered that the improved near-term outlook provides an opportunity to address macroeconomic and financial vulnerabilities and deep-seated structural weaknesses and boost prospects for long-term inclusive growth and the attainment of the Sustainable Development Goals.

Directors noted that expansionary fiscal and credit policies are putting pressure on the domestic economy, through higher non-food inflation and a buildup of financial sector risks, and a wider current account deficit. They recommended a policy tightening in the near term, including through fiscal consolidation, to avoid an abrupt slowdown, and promote a more durable economic expansion.

Directors welcomed the progress made in putting in place a fiscal federalism framework. They noted that public debt remains low and encouraged continued efforts to strengthen tax administration and increase domestic revenue mobilization. Directors observed that more needs to be done to ensure fiscal sustainability, make budgets more realistic and spending more efficient, and build implementation capacity. They agreed that with the devolution of responsibilities and resources to local and provincial levels, efforts should be focused on building policy implementation capacity and instituting a sound public financial management framework at the subnational level.

Directors considered that monetary policy should be tightened, including to support the exchange rate peg to the Indian rupee. They noted that the recently initiated review of the central bank act provides an important opportunity to strengthen the central bank's operational autonomy and accountability. While Nepal's external position in FY2017/18 was moderately weaker than that consistent with medium-term fundamentals and desirable policies, Directors expected that the proposed tightening of policies would help strengthen the external position.

² 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>.

To temper excessive credit growth, Directors encouraged a strengthening of macro-prudential policies alongside an acceleration of financial sector reforms. They concurred that banks should be encouraged to build additional capital and provisioning buffers against potential losses, and financial sector oversight and regulations should be further strengthened. Directors encouraged the authorities to continue implementing the 2014 FSAP recommendations, and strengthening the AML/CFT regime in line with international best practices.

Directors welcomed the authorities' efforts to strengthen competition, generate a more conducive environment for investment, and reduce corruption. They called for swift implementation of the structural reform agenda, including revising public procurement laws and easing obstacles to firm entry and operations. Directors emphasized that increasing foreign direct investment, strengthening governance and institutions, and enhancing access to finance, particularly for the underserved population outside major cities, remain top priorities.

Table 1. Nepal: Selected Economic Indicators, 2015/16–2019/20

	2015/16	2016/17	2017/18	2018/19		2019/20
				Est.	Projections	
Output and prices (annual percent change)						
Real GDP	0.6	7.9	6.3	6.5	6.3	6.3
Headline CPI (period average)	9.9	4.5	4.2	4.9	6.5	6.5
Headline CPI (end of period)	10.4	2.7	4.6	5.1	6.5	6.5
Fiscal Indicators (in percent of GDP)						
Total revenue and grants	23.3	24.4	25.5	29.2	29.4	29.4
of which: tax revenue	18.7	21.0	21.9	25.2	25.4	25.4
Expenditure	21.9	27.5	32.0	34.2	34.4	34.4
Expenses	16.5	19.6	23.1	26.8	27.0	27.0
Net acquisition of nonfinancial assets	5.5	7.9	8.9	7.4	7.4	7.4
Operating balance	6.8	4.8	2.4	2.4	2.4	2.4
Net lending/borrowing	1.4	-3.1	-6.5	-5.0	-5.0	-5.0
Statistical discrepancy	-0.9	-1.3	-3.1	0.0	0.0	0.0
Net financial transactions	-2.3	1.8	3.5	5.0	5.0	5.0
Net acquisition of financial assets	4.7	1.4	2.6	-0.1	-0.1	-0.1
Net incurrence of liabilities	2.4	3.2	6.0	4.9	4.9	4.9
Foreign	0.7	1.3	2.5	3.7	3.9	3.9
Domestic	1.7	1.9	3.6	1.2	1.0	1.0
Money and credit (annual percent change)						
Broad money	19.5	15.5	19.4	14.4	10.8	10.8
Domestic credit	17.4	20.2	26.1	21.3	18.1	18.1
Private sector credit	23.2	18.0	22.3	19.8	16.9	16.9
Velocity	1.0	1.0	1.0	0.9	1.0	1.0
Saving and Investment (in percent of nominal GDP)						
Gross investment	33.9	45.7	51.8	55.0	57.0	57.0
Gross fixed investment	28.7	31.8	34.1	36.2	37.5	37.5
Private	23.3	23.9	25.2	28.8	30.1	30.1
Central government	5.5	7.9	8.9	7.4	7.4	7.4
Change in stock	5.2	13.9	17.7	18.7	19.4	19.4
Gross national saving	40.2	45.4	43.6	45.4	44.5	44.5
Private	33.2	41.8	42.4	44.1	43.3	43.3
Central government	7.0	3.6	1.2	1.2	1.2	1.2
Balance of Payments						
Current account (in millions of U.S. dollars)	1,339	-93	-2,350	-2,778	-4,129	-4,129
In percent of GDP	6.3	-0.4	-8.2	-9.6	-12.5	-12.5
Trade balance (in millions of U.S. dollars)	-6,389	-8,446	-10,849	-12,899	-15,061	-15,061
In percent of GDP	-30.2	-33.9	-37.7	-44.6	-45.6	-45.6
Exports value growth (y/y percent change)	-28.8	9.9	15.5	5.3	8.0	8.0
Imports value growth (y/y percent change)	-7.4	30.0	27.4	17.9	16.2	16.2
Workers' remittances (in millions of U.S. dollars)	6,253	6,556	7,224	8,495	9,084	9,084
In percent of GDP	29.5	26.4	25.1	29.4	27.5	27.5
Gross official reserves (in millions of U.S. dollars)	8,574	9,264	9,304	8,558	6,788	6,788
In months of prospective GNFS imports	9.6	8.3	7.2	5.7	4.4	4.4
Memorandum items						
Public debt (in percent of GDP)	27.9	26.4	30.4	33.1	34.1	34.1
GDP at market prices (in billions of U.S. dollars)	21.2	24.9	28.8	28.9	33.0	33.0
Exchange rate (NPR/US\$; period average)	106.4	106.2	104.4	...	...	...
Real effective exchange rate (average, y/y percent change)	6.0	3.3	-0.1	...	...	...
Sources: Nepalese authorities; and IMF staff estimates and projections.						
1/ Fiscal year ends in mid-July.						



NEPAL

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

January 24, 2019

KEY ISSUES

Context. Following a prolonged period of tepid growth, economic activity in Nepal has picked up, reflecting cyclical factors and some structural improvements, especially in electricity supply. The improved outlook, greater political stability, and ongoing transition to a federal system provide an opening to address deep-seated structural weaknesses and boost long-term growth potential.

Outlook and Risks. The near-term outlook for growth is favorable but macroeconomic and financial vulnerabilities continue to build. Growth is expected to reach 6.5 percent in FY2018/19, supported by ongoing reconstruction, investment in hydro-power projects, and strong tourism-related activity. However, fiscal and credit policies are too expansionary leading to rising non-food inflation, a widening current account (CA) deficit, falling foreign exchange reserves, and a buildup of financial sector vulnerabilities. Risks are tilted to the downside, related to the financial sector and a possible slowdown in remittances.

Key policy recommendations. The policy priorities are to contain rising domestic demand pressures and external imbalance, and safeguard financial sector health. These policies, combined with actions to make Nepal's economy more competitive and attractive to investment, will help deliver stronger and more sustainable medium-term growth:

- Contain spending pressures, including from fiscal federalism implementation, to keep public debt and the CA on a sustainable path. This will require rationalization of the central government budget, as expenditure responsibilities are devolved. For sub-national governments, a medium-term plan which aligns spending needs with available funding is vital, and capacity building to ensure efficient use of resources.
- Monetary policy is too accommodative given the cyclical position of the economy and should be tightened to support the exchange rate peg to the Indian rupee, which has served Nepal well.
- Macroprudential policies should be used to slow credit growth and limit the buildup of financial sector risks.
- Structural reform priorities include easing obstacles to firm entry and operations—especially for foreign direct investment (FDI)—and enhancing access to finance, especially for the underserved outside major cities.

Approved By
Kenneth Kang (APD)
and Maria Gonzalez
(SPR)

Discussions took place in Kathmandu during December 2–13, 2018. The staff team comprised Mr. Almekinders (head), Ms. Sodsriwiboon, Mr. Blagrove, and Mr. Min (all APD), and was assisted by Mr. Bauer (Senior Resident Representative for Bhutan/India/Nepal) and Ms. Rana (local office). Mr. Agung and Ms. Pandit (both OED) also participated in the mission. Ms. Inoue, Ms. Gamwalla-Khadivi and Mr. Singh (all APD) assisted in the preparation of this report.

CONTENTS

INTRODUCTION	4
RECENT DEVELOPMENTS, OUTLOOK AND RISKS	4
POLICY DISCUSSIONS	8
A. Fiscal Policy	8
B. Monetary Policy	11
C. Safeguarding Financial Stability	12
D. Policies to Promote Sustainable and Inclusive Growth	16
E. Capacity Development	18
STAFF APPRAISAL	18
BOX	
1. Nepal’s Potential Growth and Comparison to Peers	21
FIGURES	
1. Recent Macro-Economic Developments	22
2. Recent Fiscal Developments	23
3. External Sector Developments	24
4. Monetary Sector Developments	25
5. Nepal and its Peers: Growth, Exports, FDI, Remittances and Human Development	26
TABLES	
1. Macroeconomic Framework—Baseline and Policy Scenarios	7
2. Macroeconomic Framework, 2015/16–2023/24 (Baseline)	27
3. Summary of Government Operations, 2016/17–2023/24 (Baseline)	28
4. Monetary Indicators, 2015/16–2023/24 (Baseline)	29
5. Balance of Payments, 2015/16–2023/24 (Baseline)	30
6. Commercial Banks’ Financial Soundness Indicators, 2013–2018	31

ANNEXES

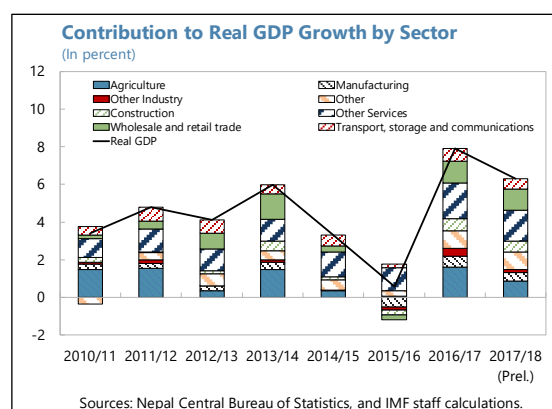
I. External Sector Assessment _____	32
II. Risk Assessment Matrix _____	36
III. Revenue-Enhancing Measures _____	37
IV. Progress in Implementing High-Priority FSAP Recommendations _____	38

INTRODUCTION

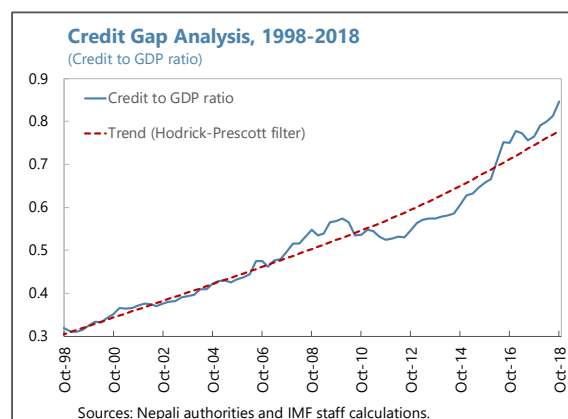
- 1. Nepal is benefitting from a period of political stability and more reliable electricity supply.** After a long period of frequent government changes, the general elections of late 2017 yielded a decisive victory for an alliance of the two major communist parties. The newly merged Nepal Communist Party now holds majorities at the federal level and in 6 of 7 provinces, giving its government a strong mandate for the next five years. At the same time, chronic shortages of electricity have been eliminated thanks to increased imports from India and a pick-up in domestic generation. More than three years after the earthquake, reconstruction continues, but substantial work is still needed.
- 2. Under the federal framework in the 2015 constitution, responsibility for the provision of many public services is being devolved to 7 provincial and 753 local governments.** The transition challenges are immense, including substantial pressure on the overall budget, limited government capacity at the subnational level, uncertainty on expenditure responsibilities and disputes over revenue sharing and taxation authority (see Selected Issues Chapter II). This is compounded by the adoption of new unfunded social mandates.
- 3. Amid weak policy implementation capacity, macroeconomic policies have become substantially more expansionary than advocated by past Fund advice.** The pickup of reconstruction activity and public investment is welcome but the scaling up of overall government spending exceeds the economy's aggregate absorptive capacity and is not yet anchored in a realistic medium-term expenditure framework to ensure quality and fiscal and external sustainability. Past efforts toward raising and stabilizing short-term interest rates under an interest rate corridor have been abandoned, resulting in a shift to accommodative monetary policy to spur credit and growth. Financial sector reforms continue, with the implementation of risk-based supervision and a Risk Management Directive, but rapid credit growth has increased financial vulnerabilities.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

- 4. Reconstruction activity and expansionary macroeconomic policies have supported a strong recovery while low food prices have kept headline inflation in check.** After two years of elevated growth, led by post-earthquake reconstruction activity, services and manufacturing, the economy is operating above its estimated potential. This has pushed up non-food inflation near a 2-year high of 6.3 percent in December (y/y). Subdued food inflation has held down headline inflation (3.7 percent, y/y).

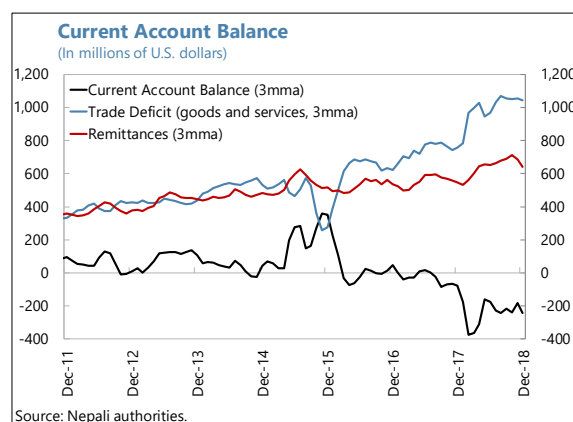


5. Excessive credit growth has increased macro-financial risks. Credit to the private sector expanded by 24 percent in December (y/y). Given Nepal's already high credit-to-GDP ratio, the expansion of credit over the past 12 months (NR 526 billion) is equivalent to 17 percent of GDP. Sustained strong private sector credit growth (21 percent per annum, on average over the past four years) has pushed the credit-to-GDP ratio significantly above trend and above levels observed in peer countries. A similar rise in 2008–10 was followed by a period of bank distress. The limited scope to diversify loan portfolios beyond the real estate, land, and construction sectors, combined with weak underwriting standards and risk management practices has contributed to a build-up of risks in the banking sector. These risks, however, are not properly picked up by financial soundness indicators, which still show record-low non-performing loans (NPLs) along with high profitability and capitalization, reflecting a high share of overdrafts (which facilitates evergreening), lax loan classification by banks, and weaknesses in the supervisory process.



6. External vulnerabilities are increasing but reserves are adequate and debt is low.

The current account deficit (CAD) widened sharply to 8.2 percent of GDP in FY2017/18 due to strong import demand and higher oil prices. Nepal's central bank reserves, which peaked at US\$9.5 billion in January on the sustained strength of remittances, fell to US\$8.3 billion in December (6 months of prospective imports), but are still well above reserve adequacy metrics applied to Nepal (Annex I). Application of the IMF's external balance assessment (EBA) based on the revised EBA-lite models suggests that Nepal's external position in FY2017/18 was moderately weaker than the level consistent with medium-term fundamentals and desirable policy settings (Annex I). External debt remains low (17 percent of GDP) and Nepal has a positive International Investment Position (10.6 percent of GDP). The closed capital account, the peg to the Indian rupee (INR), and the large share of trade with India have limited the spillovers from the recent increased INR volatility.



7. Some steps have recently been taken to curtail BOP pressures. In November, the maximum loan-to-value ratio on car loans was reduced from 65 to 50 percent. The limit for commercial banks' FX borrowing from foreign banks was raised from 25 to 50 percent of core capital. Moreover, Nepalis going abroad can henceforth only obtain up to US\$1,500 per person under the foreign exchange facility (was US\$2,500), although this measure will not affect

availability of foreign exchange for properly-documented current account transactions.¹ However, these steps are unlikely to have a major impact on BOP pressures.

8. The near-term outlook for growth is favorable but inflation, external sector, and financial-stability risks are rising.

- **Growth is expected to accelerate somewhat, to 6.5 percent in FY2018/19, well above its historical average.** Ongoing reconstruction, investment in hydro-power projects, a rebound in agricultural production, and strong tourism-related activity are key drivers. The economy's productive capacity (potential growth) is also assessed to have increased, thanks to reduced political uncertainty, as well as more reliable electricity supply (Box 1). Still, it will take time for domestic supply to catch up to demand, implying that the economy is currently operating above its estimated productive capacity.
- **Inflation is projected to increase, touching 6.5 percent in FY2019/20.** Notwithstanding recent benign food inflation, with the economy operating above potential driven by strong domestic demand, non-food inflation pressures are likely to push headline inflation higher.
- **The current account and fiscal deficits are projected to remain wide, at 9.6 and 5 percent of GDP, respectively, in FY2018/19.** The conditions driving these deficits—strong import growth and a substantial excess of government spending over revenues—are expected to persist in the near-term.

9. Under staff's baseline scenario, which reflects the authorities' established policies, elevated near-term growth will put substantial pressure on the domestic economy and the current account, implying a need for a marked slowdown later to avoid a balance-of-payments shortfall (see Table 1). A substantial fiscal deficit over the next two years—most notably driven by a large increase in government spending—and loose credit policy in pursuit of the authorities' ambitious growth targets (8 percent in the FY2018/19 budget), initially contribute to sustained strong growth exceeding potential but at the expense of worsening external and internal imbalances. However, the resulting rapid decline in reserves would likely force a disruptive adjustment (see the discussion of reserve adequacy in Annex I). In the face of a persistent unsustainable macroeconomic policy mix, declining private financing would be followed by declining official financing. This would force an abrupt policy tightening from FY2020/21 onward to sustain the exchange rate peg, slow the expansion of credit, expose macro-financial risks, and ultimately push down growth in the outer years.

10. Risks around the baseline outlook are tilted to the downside (see Risk Assessment Matrix, Annex II). To the extent that fiscal and credit policies turn out more expansionary than projected, growth could be higher in the near term than in staff's baseline projections. But this would also be associated with more pronounced balance of payments pressures, leading to greater

¹ Staff are assessing the recent measures from the perspective of the *Institutional View on Liberalization and Management of Capital Flows*, the Fund's macroprudential policy framework, and Nepal's Article VIII obligations.

pressure on the exchange-rate peg, and build-up of financial sector risks. On the other hand, downside risks to growth derive from subnational governments weak implementation capacity, financial sector vulnerabilities, and slowing remittances impacting financial sector liquidity.

Table 1. Nepal: Macroeconomic Framework—Baseline and Policy Scenarios ^{1/}

	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2018/19	2019/20	2020/21	2021/22	2022/23
	Est.	Baseline projections					Policy scenario projections				
Output and prices (annual percent change)											
Real GDP	6.3	6.5	6.3	4.5	4.5	5.0	6.3	5.2	5.3	6.0	7.0
CPI (period average)	4.2	4.9	6.5	6.2	5.7	5.5	4.9	6.0	5.8	5.6	5.3
CPI (end of period)	4.6	5.1	6.5	6.2	5.7	5.5	5.1	6.0	5.8	5.6	5.3
Fiscal Indicators (in percent of GDP)											
Total revenue and grants	25.5	29.2	29.4	29.9	30.2	30.6	29.2	29.3	29.9	30.2	30.6
of which: tax revenue	21.9	25.2	25.4	25.7	25.9	26.3	25.2	25.3	25.6	25.9	26.4
Expenditure	32.0	34.2	34.4	31.8	31.9	31.8	33.9	32.6	32.3	32.3	32.5
Expenses	23.1	26.8	27.0	25.4	25.4	25.3	26.8	25.6	24.9	24.6	24.5
Net acquisition of nonfinancial assets	8.9	7.4	7.4	6.4	6.5	6.5	7.1	7.0	7.4	7.7	8.0
Statistical discrepancy	-3.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing	-6.5	-5.0	-5.0	-1.9	-1.6	-1.2	-4.7	-3.3	-2.4	-2.1	-1.8
Net financial transactions	3.5	5.0	5.0	1.9	1.6	1.2	4.7	3.3	2.4	2.1	1.8
Net acquisition of financial assets	2.6	-0.1	-0.1	0.9	0.9	0.9	-0.1	-0.2	0.9	0.9	0.9
Net incurrence of liabilities	6.0	4.9	4.9	2.8	2.5	2.1	4.6	3.1	3.3	3.0	2.7
Foreign	2.5	3.7	3.9	2.6	2.3	1.9	3.6	2.8	3.0	2.7	2.4
Domestic	3.6	1.2	1.0	0.2	0.2	0.2	1.0	0.3	0.3	0.3	0.3
Balance of Payments											
Current account (in millions of U.S. dollars)	-2,350	-2,778	-4,129	-3,288	-2,577	-2,198	-2,715	-2,909	-2,119	-1,653	-1,850
In percent of GDP	-8.2	-9.6	-12.5	-9.1	-6.6	-5.1	-9.4	-8.9	-5.9	-4.2	-4.3
Trade balance (in millions of U.S. dollars)	-10,849	-12,899	-15,061	-15,091	-15,236	-15,509	-12,821	-13,814	-14,051	-14,576	-15,586
In percent of GDP	-37.7	-44.6	-45.6	-41.8	-38.8	-36.2	-44.4	-42.5	-39.4	-37.1	-35.8
Exports value growth (y/y percent change)	15.5	5.3	8.0	8.5	8.9	8.8	5.3	8.0	10.0	14.0	15.5
Imports value growth (y/y percent change)	27.4	17.9	16.2	0.7	1.5	2.3	17.2	7.8	2.3	4.5	7.6
Workers' remittances (in millions of U.S. dollars)	7,224	8,495	9,084	9,642	10,283	10,819	8,482	9,053	9,593	10,212	10,725
In percent of GDP	25.1	29.4	27.5	26.7	26.2	25.3	29.4	27.8	26.9	26.0	24.7
FDI (in millions of U.S. dollars)	169	318	363	397	432	471	318	488	641	785	870
In percent of GDP	0.6	1.1	1.1	1.1	1.1	1.1	1.1	1.5	1.8	2.0	2.0
Gross official reserves (in millions of U.S. dollars)	9,304	8,558	6,788	5,583	5,166	5,133	8,585	7,746	8,043	9,027	9,999
In months of prospective GNFS imports	7.2	5.7	4.4	3.6	3.2	3.0	6.1	5.4	5.3	5.5	5.7
Memorandum items											
Public debt (in percent of GDP)	30.4	33.1	34.1	33.8	33.5	32.6	32.7	32.4	32.6	32.4	31.7
GDP at market prices (in billions of U.S. dollars)	28.8	28.9	33.0	36.1	39.2	42.8	28.9	32.5	35.6	39.2	43.5
Private sector credit growth (in percent)	22.3	19.8	16.9	6.6	6.8	10.4	18.3	10.8	10.6	10.8	11.4

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

1/ Fiscal year ends in mid-July.

11. Staff recommended withdrawing policy stimulus in the near term to avoid an abrupt slowdown later and lay the foundation for sustained stronger medium-term growth (Table 1).

In this policy scenario, the expansion of public spending is scaled back at the central government level, while still accommodating post-earthquake reconstruction activity, and monetary and macro-financial policies are tightened. These measures would limit domestic demand pressures, contain the CAD, and stem the decline in reserves. The moderation of credit growth would also help limit the build-up of financial sector risks. Although near-term growth is more measured in this scenario, additional fiscal space and a stronger external balance of payments would enable higher growth in

the medium-term, better aligned with the projected gradual increase in Nepal's productive capacity. The medium-term outlook would be bolstered by a swift implementation of structural reforms aimed at easing obstacles to firm entry and operations and strengthening governance and institutions.

Authorities' Views

12. The authorities were more optimistic than staff on the near-term growth outlook, emphasizing that substantial structural changes and forthcoming measures to improve the investment climate will pay important dividends. They underscored stronger growth is critical to alleviate poverty and achieve the sustainable development goals (SDGs). They also thought that potential growth had risen more rapidly than estimated by staff. The authorities pointed out that strong import growth and the large CAD were partly driven by imports of construction materials and capital goods, which would contribute to capital accumulation, growth and import substitution. They highlighted that the level of foreign exchange reserves remained comfortable and expected strong remittance inflows and efforts to mobilize external resources to help finance the large trade deficit. The authorities expected balance-of-payments pressures to ease once reconstruction activity slowed and noted that they would aim to keep the economy on a high-growth path while containing stability risks.

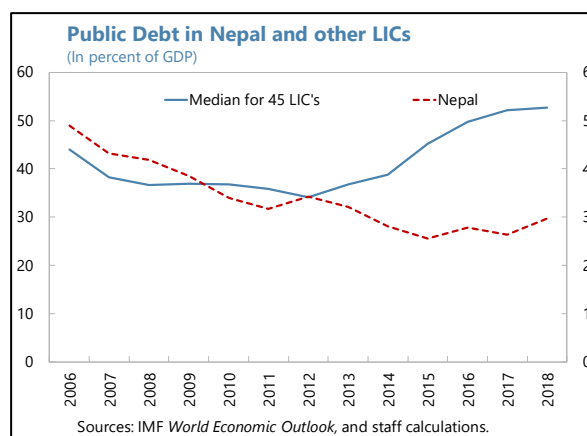
POLICY DISCUSSIONS

Discussions focused on policies needed to stem rising balance of payments pressures, safeguard financial stability, and structural reforms to ensure high, sustainable and inclusive growth.

A. Fiscal Policy

13. The transition to fiscal federalism, alongside ongoing reconstruction spending, has increased expenditure substantially leading to a sharply wider fiscal deficit:

- The general government deficit rose to 6.5 percent of GDP in FY2017/18 (from 3.1 percent in FY2016/17), thus providing a strongly positive impulse of about 3.2 percent of GDP (Table 3). Public debt ticked up in 2017/18, to 30 percent of GDP, but remains well below other low-income countries. The joint World Bank/IMF Debt Sustainability Analysis indicates that Nepal's risk of debt distress remains low.

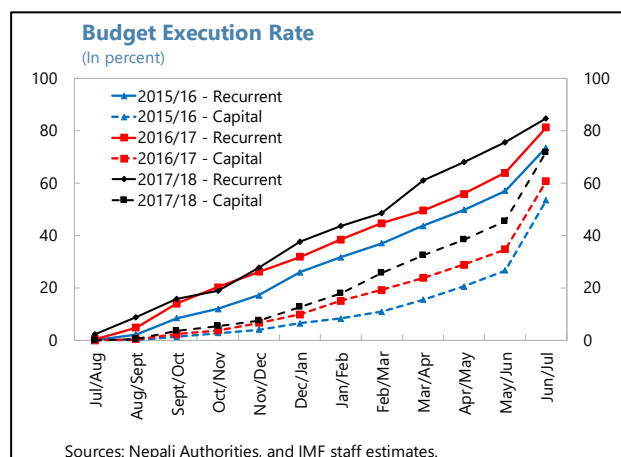


- Full implementation of the FY2018/19 budget would raise the deficit to 8 percent of GDP, implying a further fiscal impulse of 1.3 percent of GDP, owing to markedly higher transfers to

and revenue sharing with subnational governments and notwithstanding a targeted revenue increase of 5 percent of GDP.

14. Based on revenue and spending execution so far and remaining implementation capacity constraints, staff's baseline projection is a fiscal deficit of 5 percent of GDP in FY2018/19.

Aided by rising imports, rupee depreciation and a wide-ranging tax package (Annex III), revenues are projected to rise by 29 percent in FY2018/19 in the baseline (somewhat less than budgeted and subject to downside risk in view of the heavy reliance on import taxation). Despite improved disbursements of capital expenditure so far, some under-execution of investment is expected for the full year, reflecting both the legacy of an unrealistically large budget envelope and uneven spending capacity of local and provincial governments.



Policy Recommendations

15. Fiscal policy should make a larger contribution toward containing domestic demand pressures and shoring up external stability, while providing resources for remaining reconstruction projects, the operation of subnational governments, and protecting pro-poor spending. Specifically,

- Staff recommended more front-loaded fiscal consolidation and an improved composition of expenditure in the medium-term. The policy scenario advocates lowering government expenditure by 0.3 and 1.8 percent of GDP in FY 2018/19 and 2019/20, relative to the baseline, to reduce fiscal deficits and maintain foreign exchange reserve coverage above 5 months of imports. Spending cuts should be focused on recurring elements of the central government budget, in the broader context of the reassignment of key spending responsibilities to subnational governments and the need to decide on the target size of the overall government under fiscal federalism. These spending reductions would have only a modest impact on growth, as these types of recurrent spending generally carry low fiscal multipliers.
- The redistribution of resources across all levels of government within the federal system should take into account the absorptive capacity of the economy and preserve fiscal sustainability. Hence, over time, both financial and human resources will need to shift from the central to subnational governments.
- Developing implementation capacity, especially at the subnational levels, is an immediate priority to ensure reasonable economic returns of government spending and efficiency gains from decentralization.

- Infrastructure development should be prioritized, while continuing with post-earthquake reconstruction, and resources should be targeted toward achieving Nepal's SDGs. High-quality capital spending financed by concessional donor inflows should be accommodated since it keeps the debt burden in check while allowing for the needed infrastructure push.

16. Continued improvements in revenue performance will be important to maintain a strong fiscal position and meet capital spending needs. Staff welcomed the authorities' efforts to increase domestic revenue mobilization. The preparation of the draft unified tax code is ongoing and expected to be presented to the Federal Legislature by mid-July 2019. Staff encourages the authorities to finalize the draft and implement the code without further delay. The recently released Inland Revenue Management Second Strategic Plan 2018/19-2022/23 should provide a sound basis for the strengthening of tax policy and tax administration. The Department of Customs is reforming its operations, based on the 6th Customs Reform and Modernization Strategies and Action Plan of 2017-2021, along with donor assistance.

17. Staff welcomed the authorities' efforts aimed at the effective and efficient implementation of fiscal federalism (see Selected Issues Chapter II).

- Capacity issues at subnational levels should be addressed through training, standardization, and the use of technology. A comprehensive assessment of the resources needed by subnational governments to deliver on their expenditure mandates set out in the Constitution should be conducted expediently. Transfers should then be gradually adjusted to match responsibilities and needs.
- The process of setting up robust public financial management (PFM) systems at the subnational level should be completed promptly. Subnational governments should make use of the central e-procurement system.
- A Fiscal Responsibility and Budget Management Bill should be adopted to ensure fiscal discipline and increase accountability. A realistic medium-term expenditure framework should be reinstated, and medium-term budget planning should be developed to guide annual budget planning while ensuring fiscal prudence and consistency with broader macroeconomic management.

18. Strengthening PFM in the central government also remains a priority. Concerns over the efficiency of public spending persist, illustrated by substantial end-of-year bunching in expenditure. To improve budget planning and promote efficient spending, immediate action should focus on establishing proper planning, selection, and implementation of major capital projects, spread more evenly throughout the year (see Box 3 in the [staff report for Nepal's 2015 RCF Request](#)).

Authorities' Views

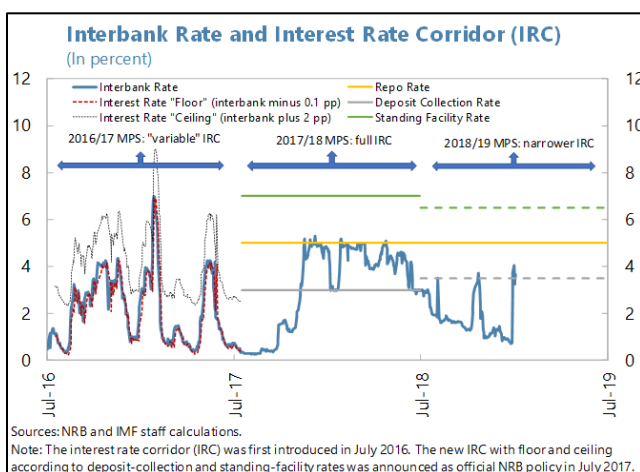
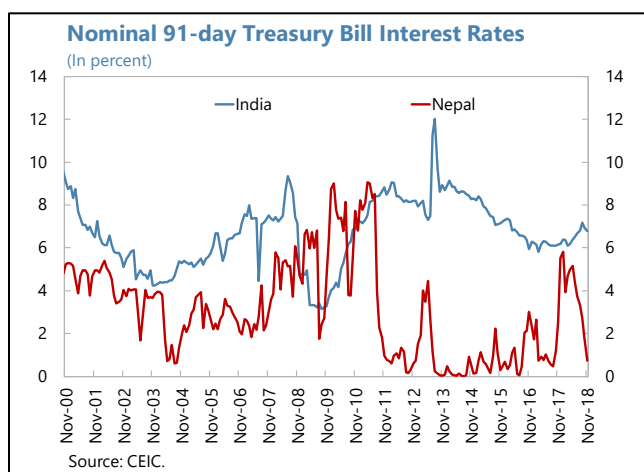
19. The authorities broadly agreed with the staff's assessment and fiscal policy advice. The authorities noted that the transition to fiscal federalism and the pickup of reconstruction

activities necessitated an increase in government spending, although they expected it could be compressed later to ensure that the general government budget envelope would not expand unduly. They also underscored that important efforts had been made to improve revenue administration and were confident that the revenue targets would be achieved.

20. Fiscal federalism is proceeding as planned, with key legislation and institutions being put in place. The authorities highlighted that the first budget of the government of Nepal under the federal system had successfully settled key issues such as fiscal transfers and revenue sharing. They underscored the importance of setting up the local consolidated funds, which would help monitor financial transactions of subnational governments. Medium-term expenditure frameworks would be set up at all levels of governments. This would provide for a more transparent and comprehensive fiscal policy framework.

B. Monetary Policy

21. The peg to the Indian rupee continues to serve as a transparent nominal anchor for monetary policy but the current stance of monetary policy is too accommodative. In recent months the NRB has taken no actions to mop up excess liquidity, leading to substantial interbank interest rate volatility, with rates generally falling considerably beneath the interest rate corridor (IRC) floor (3.5 percent). The persistent interest-rate gap relative to India (where, for example, the interbank rate is currently 6.5 percent) puts pressure on Nepal's pegged exchange-rate regime. Furthermore, low and volatile short-term interest rates hamper financial-market development and discourage saving. Staff analysis (see Selected Issues Chapter I) shows that non-food inflation in Nepal is largely determined by domestic factors, suggesting monetary policy can play a role in guiding domestic inflation rates.



Policy Recommendations

22. The monetary policy stance needs to be tightened to rein in imbalances and support the exchange rate peg. Very low short-term nominal interest rates are not appropriate for an economy assessed to be operating above its productive capacity. The first step is for the NRB to resume using its IRC, by actively mopping up excess liquidity when needed, bringing interbank rates back towards the mid-point of the target range (5 percent). Adhering to the IRC will impart greater stability on interbank rates and thus improve the transmission of the NRB's chosen policy stance. In staff's view, the corridor itself should also be moved higher over time to better align short-term nominal interest rates in Nepal with those in India. Higher interest rates would also help contain core inflation.

23. A framework needs to be developed to regularly review the appropriateness of the policy stance, beyond the annual Monetary Policy Statement. As a start, communication regarding the quarterly reviews conducted by the NRB—which are now in their third year—should be enhanced and used to assess and explain the appropriateness of the policy stance.

24. In the context of the recently initiated review of the NRB Act, staff recommends amendments to strengthen the central bank's operational autonomy. The 2016 amendment to the NRB Act allows the government to issue directives regarding currency, banking and finance, which weakens the NRB's autonomy. As highlighted by the 2014 Financial Sector Assessment Report (FSAP, Annex IV), the composition of the NRB board—with a representative from the ministry of finance, and three other government-appointed directors—further undermines autonomy. Given these considerations, the top priority in amending the Act should be to ensure operational autonomy. Staff notes the NRB's ongoing efforts to enhance its audit and control environment and encourages further progress.

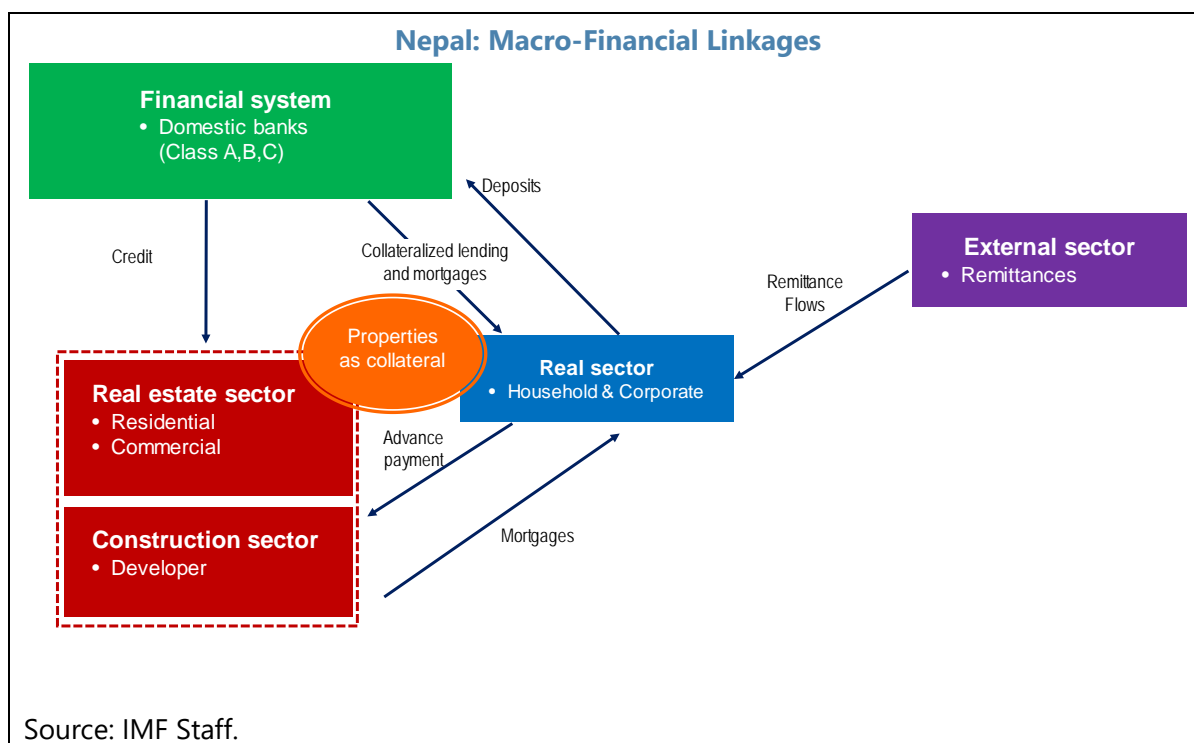
Authorities' Views

25. The authorities emphasized the need for accommodative monetary policy to boost growth while maintaining financial sector stability. They noted the need to closely monitor the expansion of credit at the sectoral level, to ensure it is predominantly concentrated in productive and priority sectors. Inflation pressures were assessed as moderate, allaying concerns about economic overheating.

C. Safeguarding Financial Stability

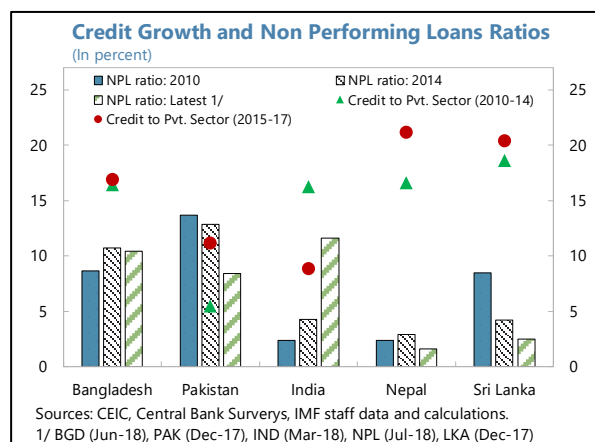
26. The ongoing sharp credit expansion, which meets the criteria commonly used in the literature to define a credit boom, raises concerns about the quality of lending. Prolonged rapid credit growth has been fueled by high remittances inflows, along with weak financial sector oversight. An important share of bank lending is channeled to real estate related lending, as well as overdrafts and working capital collateralized by land and real estate. As a consequence, the rapid credit growth has fueled a sustained rise in asset prices which may prompt future corrections, and likely built up substantial credit and liquidity risks in the banking system. The requirement to

allocate 25 percent of credit to priority sectors (including minimums to agriculture, hydropower and tourism) may also affect underwriting standards.



27. The authorities have taken welcome steps to strengthen regulation and supervision to contain banking sector risks. These efforts have been supported by a series of World Bank Development Policy Credits (DPCs), as well as technical assistance from the IMF and DfID. The central bank is moving toward risk-based banking supervision, macroprudential measures have been introduced to curb risky lending, and a fourfold increase in minimum paid-up capital was phased in.

28. Notwithstanding these steps, the reported financial soundness indicators likely mask vulnerabilities. Upon the completion of the capital raising plan, the capital adequacy ratio of Class A banks amounted to 14.6 percent in mid-July 2018, with that of state-owned banks rising to 17.3 percent. Amid strong credit growth, non-performing loans fell to 1.4 percent of total loans, which is very low in comparison to neighboring countries. Nevertheless, the perception remains that significant weaknesses and vulnerabilities persist and may have risen with rapid credit expansion, given weak lending and loan classification standards, as well as connected lending, evergreening and poor risk-management practices (see Selected Issues Chapter III). Recent steps to lower the base rate

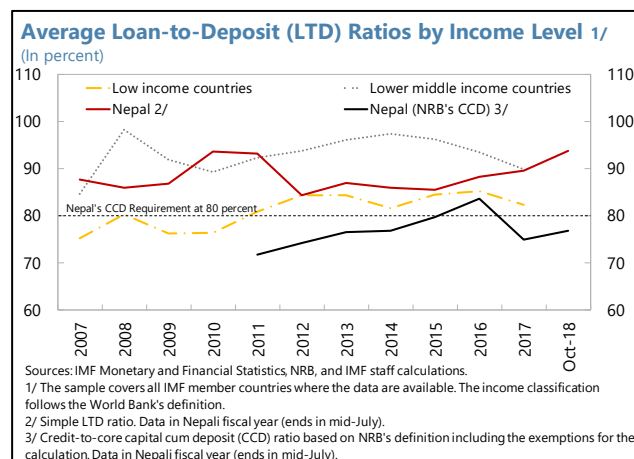


and relax lending standards regarding margin loans will likely raise risks.

Policy Recommendations

29. To ensure that credit growth slows to a sustainable pace, macro-prudential measures should be tightened.

- Existing macroprudential measures, including the loan-to-value ratios on car loans and residential real estate, and limits on real estate sector exposure have helped to contain credit growth, but need to be tightened further. Staff welcomes the authorities' stated intention to adhere to the ceiling on the loan-to-deposit (LTD) ratio—so-called credit-to-core capital cum deposit (CCD) ratio.² Several carve-outs have been introduced over time to provide more room for credit growth. These carve-outs, including the recent decision to allow funds obtained through interbank borrowing to count as deposits, should be phased out and the authorities should resist banks' pressures for further effective relaxation of the CCD ratio and other macroprudential rules.



- The recent decision to allow subnational governments to deposit half of their funds in commercial banks contributes to an undue loosening of liquidity conditions and should not be renewed.
- Additional tightening measures such as an increase in reserve requirement ratio can be considered if loan growth accelerates on rising remittances.

30. Building on recommendations from the 2017 Article IV consultation and the 2014 FSAP (Annex IV), efforts to strengthen financial sector oversight and reduce vulnerabilities should be deepened:

- Given data and supervisory weaknesses, as well as the cyclical position of the economy, banks should build additional capital and provisioning buffers against potential losses.
- Staff welcomes the November 2017 conversion of the Risk Management Guideline to a Directive. A useful next step would be to issue the revised risk management guidelines, which

² The LTD ratio is a common macroprudential liquidity tools. According to the [IMF's Macroprudential Policy Survey](#), 19 countries maintained a LTD ceiling in 2016. The idea is to mitigate systemic liquidity risks by requiring banks to hold stable liabilities (deposits) to fund their illiquid assets such as loans. Nepal's low and lower-middle income peers generally establish the ceiling at around 80 percent. Unlike in Nepal, the calculation of the ratio is typically simply based on loans and deposits.

have been drawn up by the NRB with supportive technical assistance by SARTTAC. This would provide banks a structured approach to the management of key risks (e.g. credit, liquidity, operational, market, and interest rate risk) and allow supervisors to refer to the expectations set out in the guidelines.

- Staff welcomes the authorities' intention to introduce additional policy provisions to control personal as well as overall overdraft lending. Further, staff recommends introduction of a directive to govern practices related to revolving lending, including working capital loans. The requirement for a clean-up period for revolving loans needs to be introduced to help curb ever-greening practices.
- Supervisors should be empowered to follow up on the findings of their inspections and recommendations for corrective actions should be rigorously enforced to provide for a more assertive supervisory approach.³
- On the regulatory front, the central bank's lender of last resort policy, last updated in 2011, needs to be further clarified and aligned with standard central bank practices with respect to emergency liquidity assistance.

31. Nepal lags its peers in financial inclusion with large gaps between cities and remote districts and between men and women. Staff welcomes the recently launched Financial Inclusion Action Plan. International experience suggests significant potential benefits from financial inclusion in terms of growth and poverty reduction (see Selected Issues Chapter IV). Going forward, Nepal should gradually move away from mandating credit provision to specific economic sectors and pursue a more holistic approach to address financial inclusion gaps. Specifically, directed credit and priority sector lending should be gradually phased out and be replaced, as appropriate, with price-based support instruments. Staff welcomes the plan to establish a supervisory mechanism for financial cooperatives given the vast number of cooperatives and their linkages to banks as well as the importance of cooperatives to provide financial services particularly in remote areas and to underserved groups.

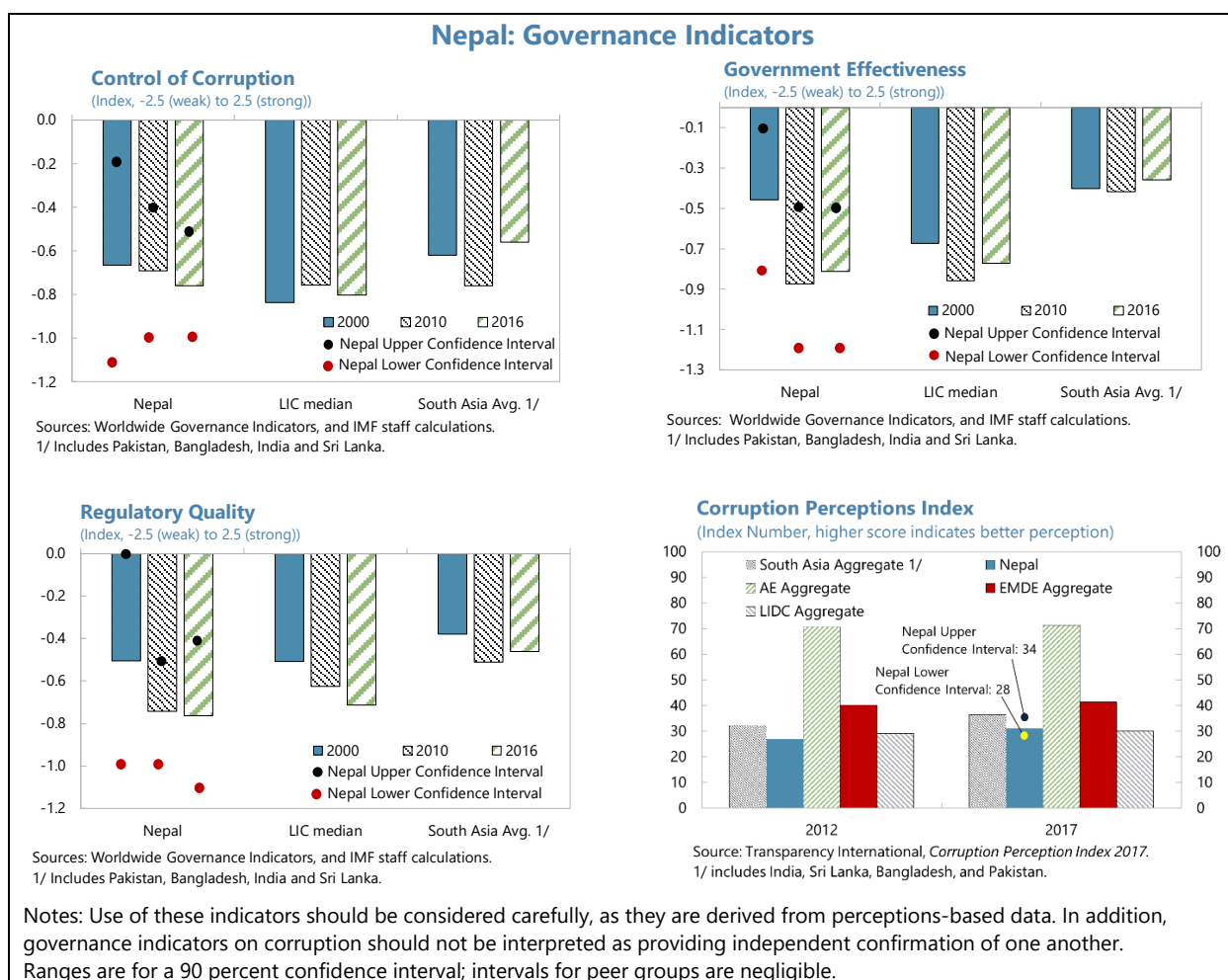
Authorities' Views

32. The authorities believed that credit growth would remain within the limit set by the monetary policy. They underscored strong credit expansion was needed to support growth and alleviate poverty, while highlighting that the CCD ratio ceiling controls excessive credit growth. The authorities felt that the risk-based supervision being implemented was helping to make the financial sector safer.

³ The assessment of Basel Core Principles of Effective Banking Supervision, conducted for the 2014 FSAP, highlighted that concentration of operational decisions at the NRB Board weakens the supervisory process by limiting the agility of supervisory action and risks introducing non-technical considerations into supervisory decisions.

D. Policies to Promote Sustainable and Inclusive Growth

33. To sustain strong growth over the medium-term, the economy’s productive capacity must be increased through higher investment and greater competition—this entails strengthening institutions and reducing corruption. Perceptions-based indicators suggest corruption is a significant problem in Nepal, even relative to its South-Asia peers (see text figure on governance indicators). Some surveys put it among the most problematic factors for doing business, behind only infrastructure and political stability.⁴ Examples of corruption in Nepal include key facets of the public procurement process, such as facilitation payments, favoritism in awarding contracts and lack of proper costing. This is critically important, as these issues lead to misappropriation of public resources and chronic underinvestment due to frequent project delays.



34. FDI remains low as a share of GDP. FDI comprised just 0.6 percent of GDP in FY2017/18, though this is up from 0.3 percent of GDP in FY2015/16. A key obstacle to FDI is the complexity of the current approval system.

⁴ *Global Competitiveness Report*, World Economic Forum, 2017/18.

Policy Recommendations

35. To improve the timeliness and quality of execution of investment projects under the public procurement process, several amendments to existing laws are warranted. The public procurement act should be strengthened, extending the scope of misconduct which can be pursued as corruption by the Commission for the Investigation of the Abuse of Authority (CIAA). Such an amendment could impose penalties for improper project assessment, for example relating to a lack of thorough costing and not ensuring that contractors are suitably prepared to carry out a project. In addition, contracts awarded under the procurement process should feature a well-enforced performance guarantee, with penalties for contractors who do not perform. Adopting reforms discussed elsewhere in this report to strengthen central bank governance, simplify and reduce discretion in the regulatory framework, and strengthen financial sector oversight would further reduce vulnerabilities to corruption. Indications are that the current government is treating corruption as a serious issue. The Prime Minister has repeatedly stated publicly a zero-tolerance policy on corruption, and encouraged the CIAA to fulfill its mandate—this has led to numerous arrests and the investigation of thousands of complaints over the past year. This is encouraging and should continue.

36. Staff welcomes the authorities' reform plans to improve the investment climate. Steps to encourage foreign direct investment are particularly important. These include:

- The amendments to the foreign investment and technology transfer act (FITTA) should clarify and simplify foreign investment policies, including introducing a single window to facilitate firm regulatory compliance and streamlining regulations surrounding investment approvals and profit repatriation.
- The Investment Board of Nepal Act should be strengthened, and public-private partnerships could be enhanced by amending the government's public-private partnership (PPP) policy to clarify roles of stakeholders. A pipeline of viable PPP projects should be maintained, focusing on economically high-priority sectors such as transportation and energy.
- Care should be taken to ensure that labor laws do not reduce overall labor market flexibility and impede formal-sector activity. Although well-intended, the new labor law, which seeks to provide greater social benefits to employees funded through higher employer insurance and social security contributions, may disproportionately impact smaller businesses, by raising effective labor costs and eroding competitiveness.

37. Having several successful investment projects—those which engage reputable investors and are completed in a timely fashion—will be critical in catalyzing further investment. The planned investment summit in March 2019 provides an excellent opportunity to showcase improvements in Nepal's investment climate, underpinned by legal reforms currently in progress. Ensuring that investment pledges translate into subsequent activity will be key.

Authorities' Views

38. The authorities underscored their commitment to improve the investment climate in Nepal, including through revisions to existing laws and improvements in governance. Ahead of the investment summit in March of 2019, the overhaul of more than three dozen investment-related laws is nearly complete. The authorities emphasized that corruption is being reduced by enhancing transparency mechanisms, increasing accountability of officials and minimizing discretionary powers in their decision making—the example of increased customs revenues was presented as a success story relating to enhanced transparency regarding transactions values and improved enforcement of existing laws associated with accountability. Efforts are also underway to revise the public procurement law; gains are expected from bringing more projects under the formal system and making better use of IT. Implementing Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) measures and bringing them in line with international standards in the context of the second AML/CFT National Strategy and Action Plan for 2019-2024 was seen as another key priority to strengthen governance.

E. Capacity Development

39. The Fund is providing significant support to capacity development in Nepal. To make better use of training and technical assistance, including from SARTTAC, the authorities should select officials for various training courses on the basis of matching job responsibilities with course offerings. And the existing staff-rotation policies of the NRB need to be reviewed to allow specialized officials (e.g. bank supervisors, accountants, statisticians, etc.) to stay in their positions for more extended periods.

40. A 2018 safeguard monitoring mission found limited progress in strengthening safeguards at the NRB. Most recommendations from the 2016 assessment remain outstanding. Key areas that need to be strengthened include external and internal audit arrangements, and financial reporting practices. In addition, recommendation to bolster NRB's autonomy and internal controls remain outstanding. Staff is providing technical assistance to strengthen the internal audit function and will continue to engage the authorities on necessary remedial steps in other areas.

41. Statistics are broadly adequate for surveillance purposes, but there is room for improvement. National accounts statistics are only available with an annual frequency and have an outdated base year (2000/01). Rebasing the national accounts is urgent, including to update the composition of GDP and address large data discrepancies.

STAFF APPRAISAL

42. Economic activity in Nepal has picked up considerably. Against the background of greater political stability and more reliable electricity supply, the recovery has been driven by reconstruction activity as well as expansionary macroeconomic policies. Strong growth of domestic demand is pushing up non-food inflation but subdued food inflation is containing headline inflation.

43. The near-term outlook for growth is favorable but macroeconomic stability risks are rising. Growth is expected to rise to 6.5 percent in FY2018/19, well above its potential. Nevertheless, under staff's baseline scenario, substantial fiscal deficits over the next two years alongside expansionary credit policies in pursuit of the authorities' ambitious growth targets put substantial pressure on the domestic economy and the current account. This would likely force an abrupt policy tightening to safeguard stability and push down growth in the medium term.

44. Risks to the outlook are tilted to the downside. Near-term growth could turn out higher to the extent that fiscal and credit policies are more expansionary than expected, but this would also raise external pressures and the build-up of financial sector risks. Key downside risks to growth derive from weak implementation capacity of subnational governments, financial sector vulnerabilities, and slowing remittances impacting liquidity conditions.

45. The improved near-term outlook provides an opportunity to address deep-seated structural weaknesses and boost long-term growth prospects. To manage fiscal and external-sector pressures, avoid an abrupt slowdown later, and promote a more durable economic expansion, policy stimulus should be withdrawn in the near term. Scaling back central government spending and tightening monetary and macroprudential policies would reduce pressure on the current account by constraining import demand and foster a pace of expansion more consistent with the economy's current domestic productive capacity. Alongside a swift implementation of structural reforms, this should pay dividends in terms of more stable and higher future growth.

46. Progress has been made with putting in place a fiscal federal framework but more needs to be done to ensure sustainability, make budgets more realistic and spending more efficient, and build implementation capacity. Public debt remains low and staff welcomes the ongoing efforts to strengthen tax administration and increase domestic revenue mobilization. While significant resources are being allocated to subnational governments, the general government budget must not expand unduly. With the devolution of responsibilities and resources to local and provincial levels, ultimately the central government will need to shrink. Efforts should focus on building policy implementation capacity and instituting a sound public financial management framework at the subnational level. This will help deliver on the promise of better delivery of government services under the federal system.

47. The peg to the Indian rupee continues to serve as a transparent nominal anchor and should be supported by a tighter monetary policy stance. To tighten policy, reduce interest-rate volatility, and improve the transmission of monetary policy, the IRC should be upheld and interbank rates should be brought back to its mid-point. In the context of the recently-initiated review of the central bank act, the central bank's operational autonomy and accountability should be strengthened. Staff assesses that Nepal's external position in FY2017/18 was moderately weaker than the level consistent with medium-term fundamentals and desirable policy setting. The proposed tightening of policies would help strengthen the external position in the short term. Central bank reserves remain adequate.

48. Macro-prudential measures need to be tightened to temper excessive credit growth and financial sector reforms should to be accelerated. Staff welcomes the authorities' intention to maintain the 80 percent limit on the CCD ratio, but carve-outs to the ratio should be phased out. Banks should also be encouraged to build additional capital and provisioning buffers against potential losses, and financial-sector oversight and regulations should be further strengthened. Overall, these policies should help mitigate financial vulnerabilities and contribute to a more sustainable expansion of credit.

49. Staff welcomes the authorities' ongoing efforts to make Nepal's economy more competitive, generate a more conducive environment for investment, and reduce corruption. Staff encourages a swift implementation of the authorities' structural reform agenda aimed at easing obstacles to firm entry and operations. Increasing foreign direct investment, strengthening governance and institutions, and enhancing access to finance, particularly for the underserved population outside major cities, are top priorities.

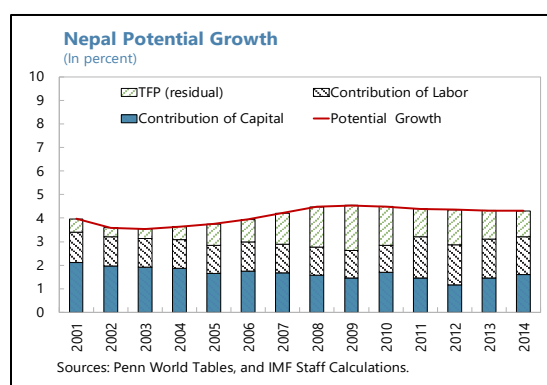
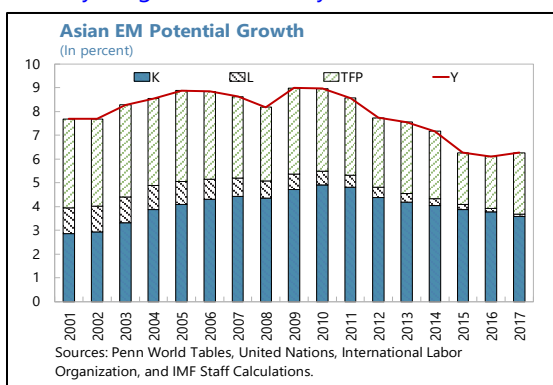
50. It is proposed that the next Article IV consultation takes place on the standard 12-month cycle.

Box 1. Nepal's Potential Growth and Comparison to Peers

Real GDP growth in Nepal averaged 4.4 percent over the past two decades, implying little catchup in standard of living relative to more advanced countries. However, recent improvements in the power sector and policy stability bode well for a sustained improvement in the economy's growth potential in coming years.

Relative to a group of EM Asian economies, potential growth in Nepal has been subdued, historically.

Decomposing potential growth into its drivers using a standard Cobb-Douglas production function reveals weak total factor productivity (TFP) growth, relative to a group of Asian EMs, and capital deepening which has proceeded relatively slowly. Slow TFP growth comes against a backdrop of a productivity level well below that in peers, suggesting substantial room for catchup if the right policies can be put in place. The main recent constraints to potential growth have come from electricity shortages, transportation infrastructure, political instability, weak governance, and access to finance (see e.g., [Nepal: Systematic Country Diagnostic, February 2018, World Bank](#))



Increases in the quantity and coverage of electricity supply, as well as its reliability, should boost productivity. Substantial generation capacity is expected to come online in the next two fiscal years, boosted by some large and many smaller hydropower projects. Numerous studies highlight positive links between firm productivity and electricity supply and reliability (see e.g., [WB Policy Research WP8468](#)).

If the growth momentum can be sustained in coming years, Nepal will join an elite group of countries who have enjoyed 'persistent growth accelerations.' The literature on these durable, meaningful increases in a country's growth rate ascribes them to a variety of factors, but institutional and structural changes often play a key role. In the adjoining figure, the IMF baseline projection for the level of GDP in Nepal is compared to two more optimistic variants—one in which Nepal grows at 6 percent over the medium-term, and another in which it grows at 8 percent—as well as a set of growth acceleration episodes in other countries.

These persistent growth accelerations are rare—[IMFWP18/52](#) identifies only 95 of them in a set of 125 countries, over the period from 1970-2014. As illustrated in the chart, if growth follows the IMF baseline path in coming years, Nepal would find itself in the midst of a broadly 'average' persistent growth acceleration—this would be a truly noteworthy feat. Growth at 8 percent would imply that Nepal was benefitting from an especially strong persistent growth acceleration, in the upper end of the distribution of those ever witnessed, on par with the experience of China in the early 2000s. However, staff views such a strong growth scenario as unsustainable, leading to severe economic imbalances in Nepal.

Nepal Projections, relative to other persistent growth accelerations
(Percent increase in real per capita GDP level, relative to pre-acceleration starting point)

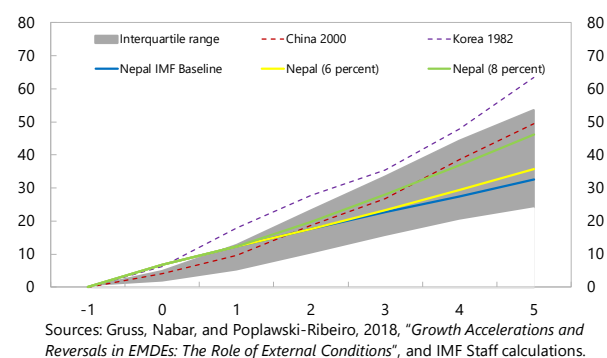
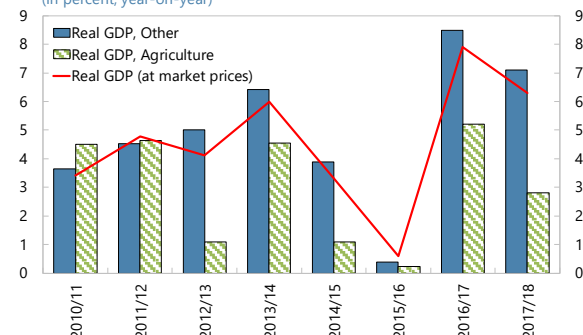


Figure 1. Nepal: Recent Macro-Economic Developments

Real GDP growth remained strong in 2017/18, propelled by construction, manufacturing, and services.

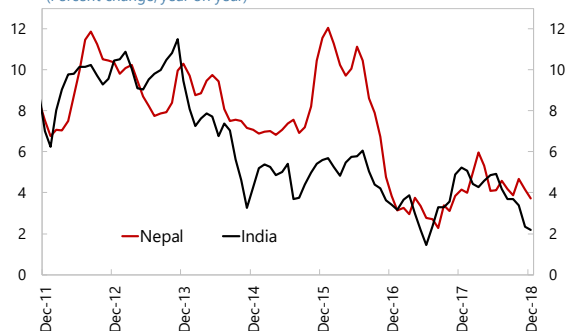
Real GDP Growth
(In percent, year-on-year)



Source: Nepal Central Bureau of Statistics.

Given similar food-price dynamics, inflation rates in India and Nepal have moved closely together.

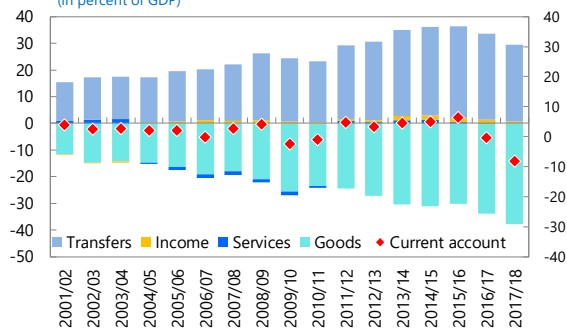
Consumer Price Index in Nepal and India
(Percent change, year on year)



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

The current account has moved into substantial deficit position, as domestic strength has fueled import growth.

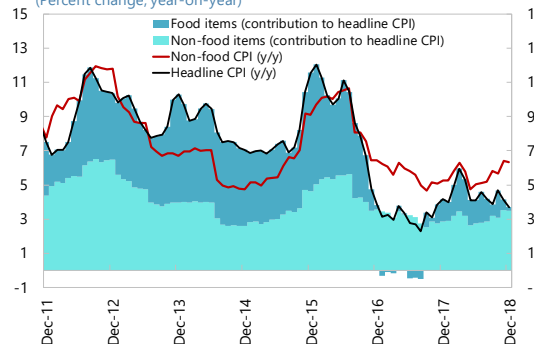
Current Account
(in percent of GDP)



Sources: Nepali authorities, and IMF staff estimates.

Headline inflation has been contained, primarily on low food prices as non-food inflation has been inching up.

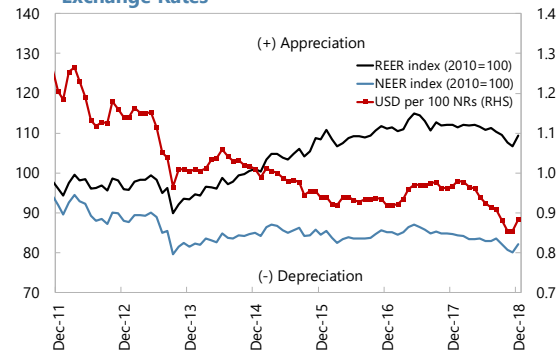
Consumer Price Index
(Percent change, year-on-year)



Sources: Nepali authorities; and IMF staff estimates.

The exchange rate has depreciated, as part of a broader EM weakening trend and the peg to the Indian rupee.

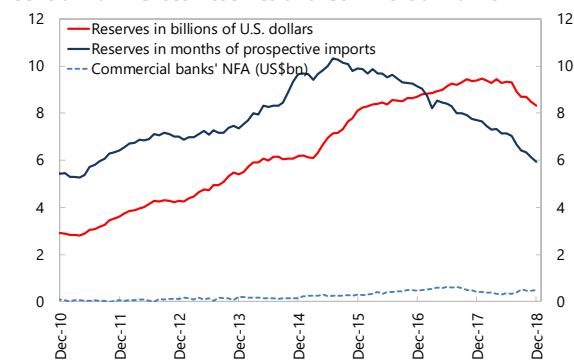
Exchange Rates



Sources: Nepali authorities; and IMF staff estimates.

In recent months, financing this deficit has entailed a drawdown of foreign exchange reserve holdings.

Central Bank Gross Reserves and Commercial Banks NFA

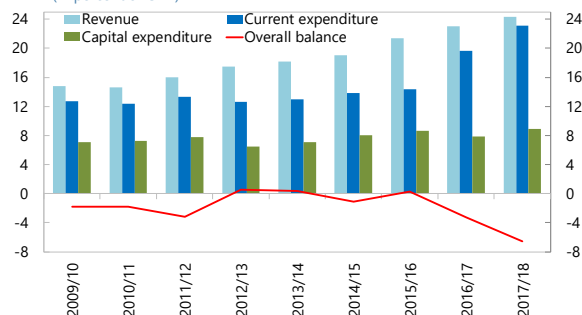


Sources: Nepali authorities; and IMF staff estimates.

Figure 2. Nepal: Recent Fiscal Developments

Rapid expansion of government expenditures led to large deficit in FY 2017/18.

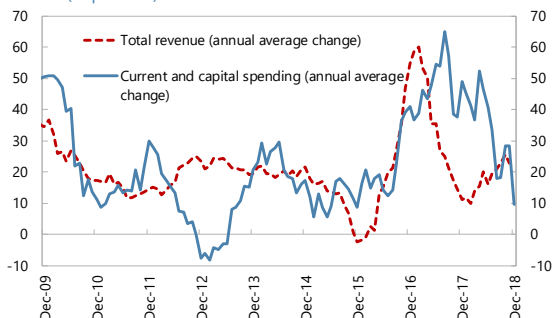
Fiscal Performance
(In percent of GDP)



Sources: Nepali authorities; and IMF staff estimates.
Note: Overall balance calculated as total revenue and grants minus expenditure.

Revenue and spending have both grown rapidly, as the budget envelope is expanding under fiscal federalism

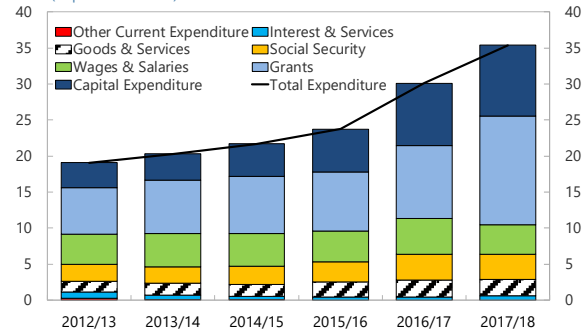
Government Revenue and Spending
(In percent)



Source: Nepali authorities.

Increasing grants related to fiscal federalism, and capital expenditures due to reconstruction drove the increase in government spending

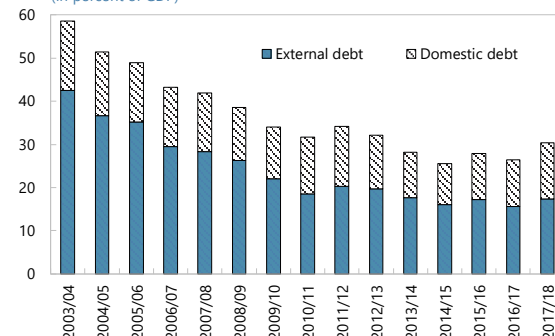
Fiscal Expenditure
(In percent of GDP)



Sources: Nepali Authorities, and IMF staff estimates.

As a result, public debt has begun to edge higher, albeit from a low level.

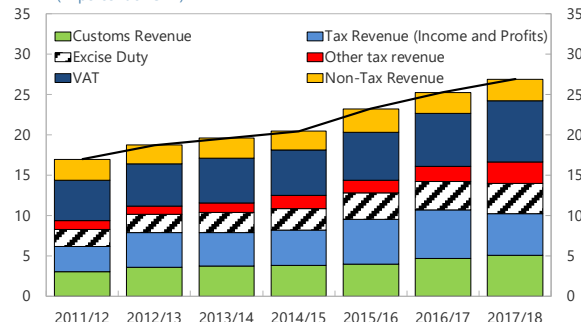
Public Debt
(In percent of GDP)



Sources: Nepali authorities, and IMF staff estimates.

The main source of revenue growth in FY 17/18 was improvements in VAT collection, and customs revenues

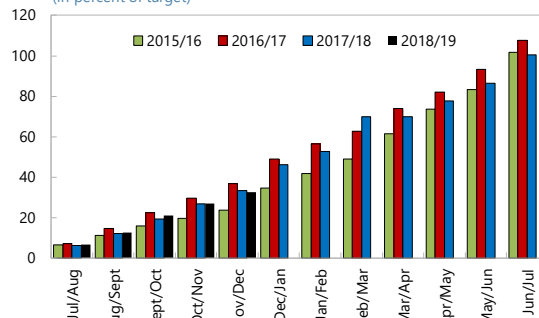
Fiscal Revenue
(In percent of GDP)



Sources: Nepali Authorities, and IMF staff estimates.

Revenue collection thus far in FY 18/19 has been strong, compared to previous years

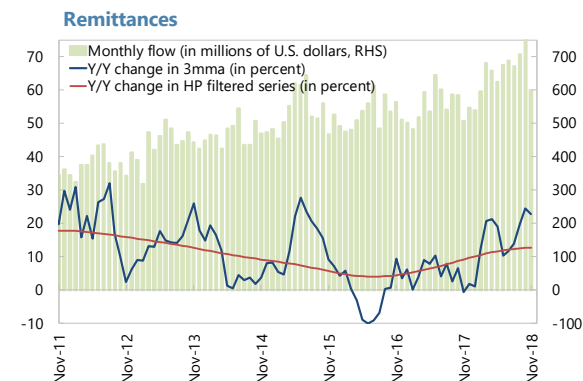
Revenue Collection Rate
(In percent of target)



Sources: Nepali Authorities, and IMF staff estimates.

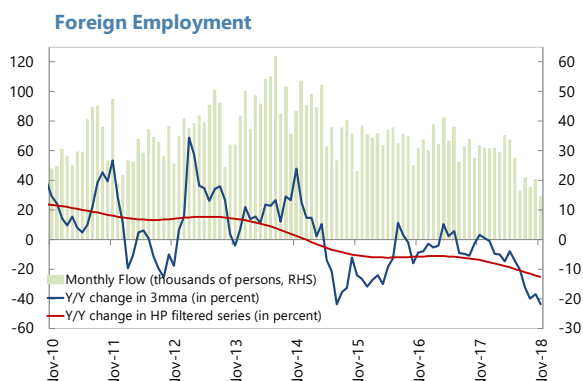
Figure 3. Nepal: External Sector Developments

The growth of remittances has firmed to 23 percent (y/y) in recent months. This reflects formalization efforts...



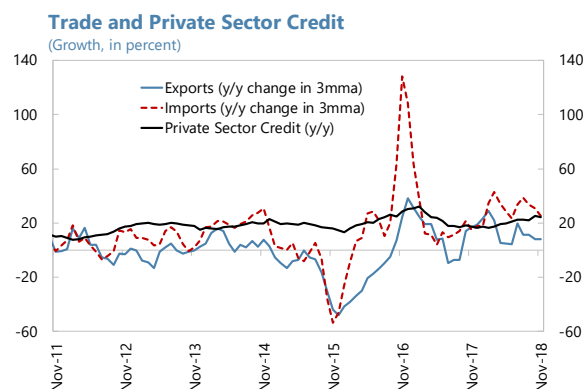
Sources: Nepali authorities; and IMF staff estimates.

...as the number of Nepali migrant workers taking up jobs abroad has slowed.



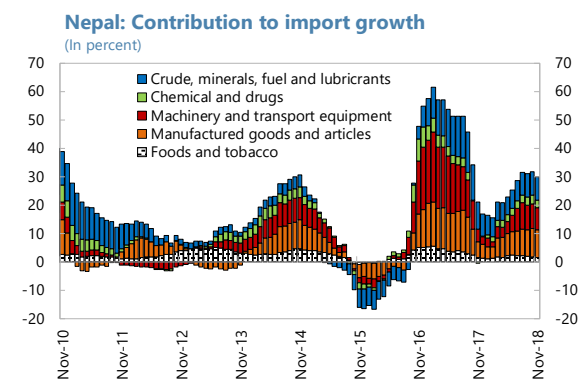
Sources: Nepali authorities; and IMF staff estimates.

Import growth has been very strong...



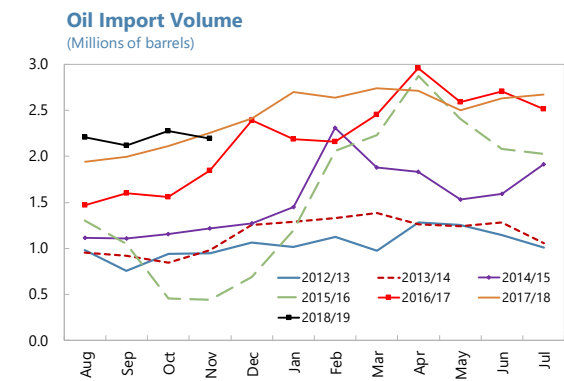
Sources: Nepali authorities; and IMF staff estimates.

...in part due to increased imports of machinery and transport equipment over the past year



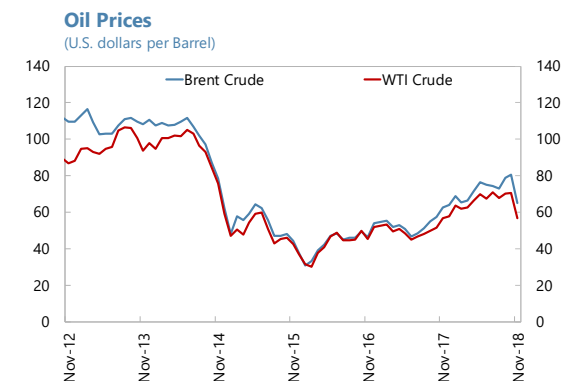
Sources: Nepali Authorities and IMF staff calculations.

A rising pace of economic expansion has entailed increasing oil imports in each successive year...



Sources: Nepali authorities; and IMF staff estimates.

...this fact, alongside higher oil prices, is putting substantial upward pressure on imports



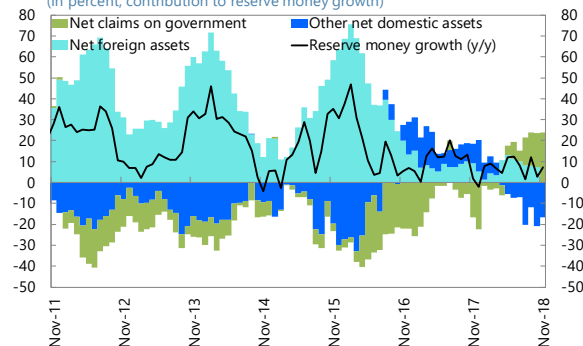
Source: Bloomberg Financial L.P.

Figure 4. Nepal: Monetary Sector Developments

Reserve money growth remains subdued, primarily due to the moderating contribution of Net Foreign Assets

Central Bank Balance Sheet

(In percent, contribution to reserve money growth)

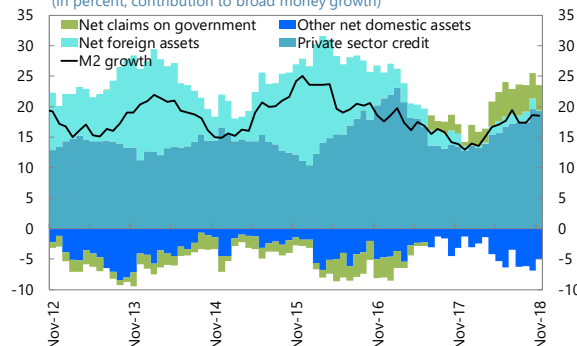


Sources: Nepali authorities; and IMF staff estimates.

Broad money expanded by 19 percent (y/y) in November, driven by rapid private sector credit growth.

Broad Money Growth

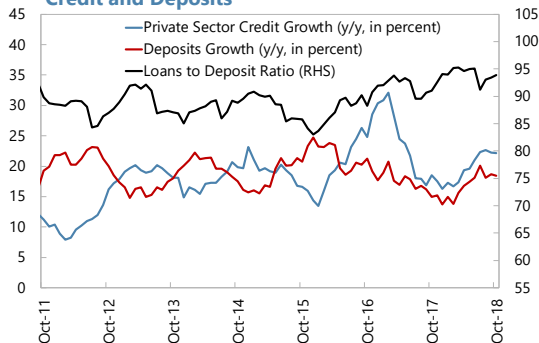
(In percent, contribution to broad money growth)



Sources: Nepali authorities; and IMF staff estimates.

Credit growth has been exceeding deposit growth, thus increasing the loan-to-deposit ratio

Credit and Deposits

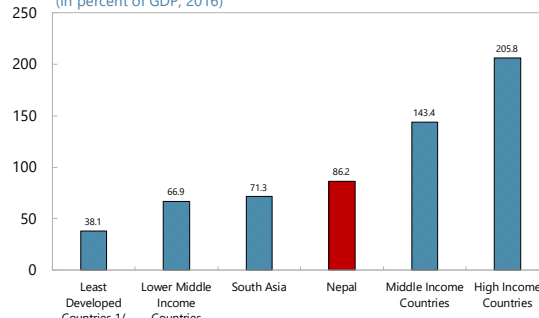


Sources: Nepali Authorities and IMF staff Calculations.

Nepal's credit-to-GDP ratio is among the highest in its peer group

Domestic Credit Provided by Financial Sector

(In percent of GDP, 2016)

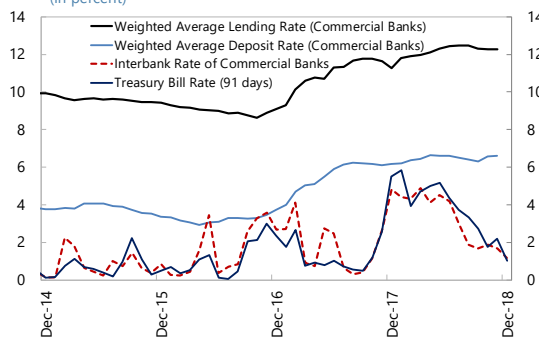


Source: World Bank, World Development Indicators, 1/ UN Classification.

Monetary conditions remain accommodative, with short-term rates falling below 1 percent. They had stabilized at 4 percent by mid-2018, in the interest rate corridor.

Nepal: Interest Rates

(In percent)

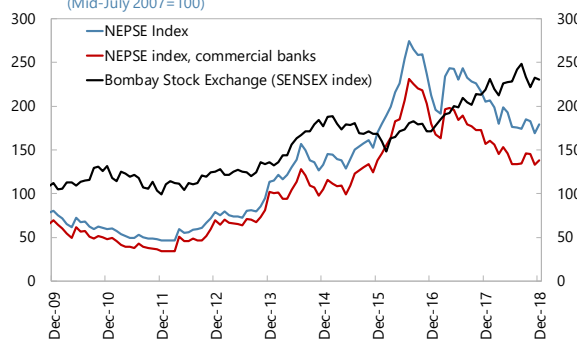


Source: NRB.

Equities have lost 35 percent of their value from the mid-2016 peak, which followed a two-year bull run.

Stock Market Performance in Nepal and India

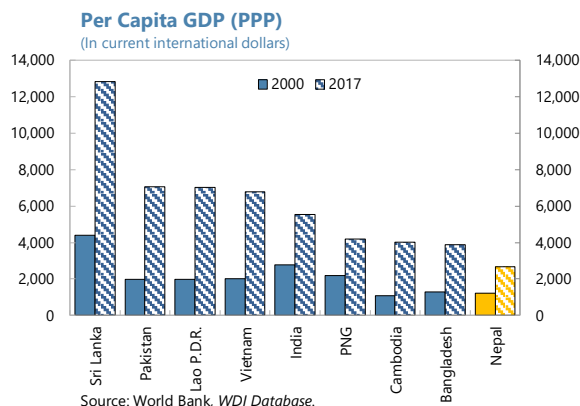
(Mid-July 2007=100)



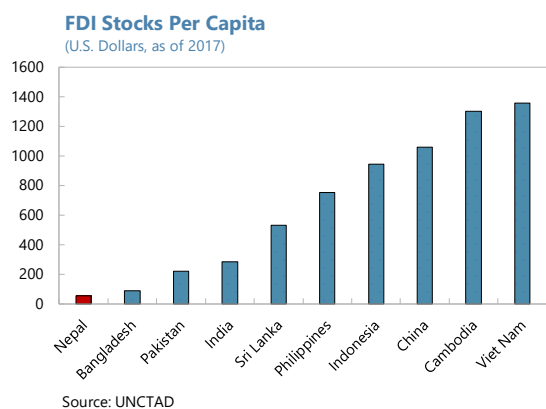
Sources: Nepali authorities; and IMF staff estimates

Figure 5. Nepal and its Peers: Growth, Exports, FDI, Remittances and Human Development

Nepal is among the lowest income countries in South Asia

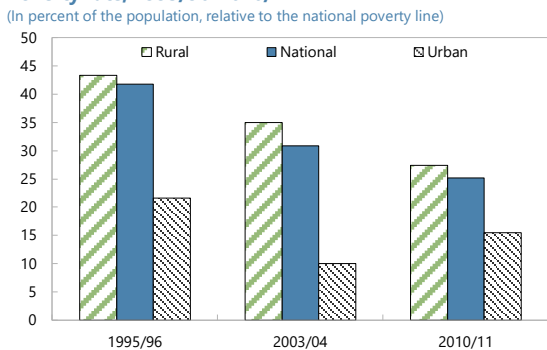


Nepal lags peers in attracting FDI inflows.

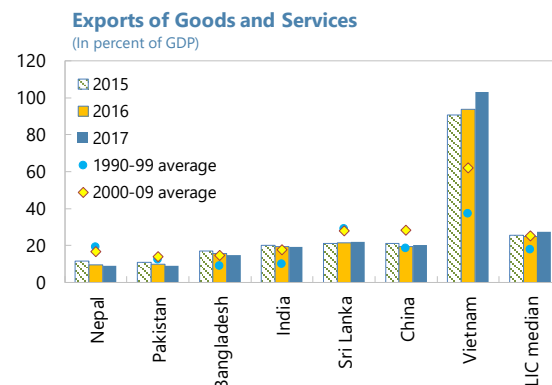


Remittances have also been instrumental in lowering the poverty rate. Poverty remains higher in rural areas.

Poverty rate, 1995/96-2010/11

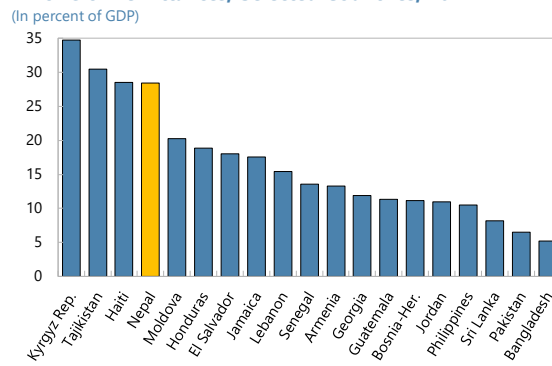


Nepal's exports to GDP ratio has been declining.



On the other hand, remittances are among the highest in the world. This helps finance the large trade deficit.

Inflows of Remittances, Selected Countries, 2017



The decline in poverty is reflected in an improvement in Nepal's UNDP Human Development Index.

Human Development Index (HDI)

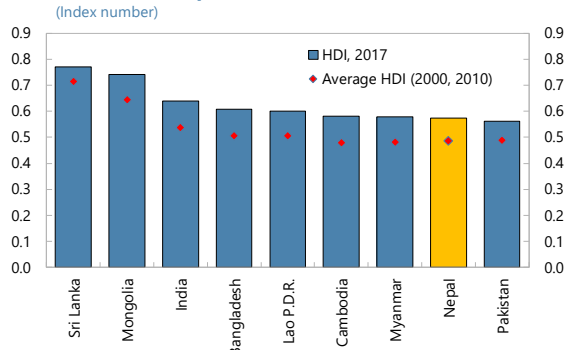


Table 2. Nepal: Macroeconomic Framework, 2015/16–2023/24 (Baseline)1/

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	
				Est.	Projections					
Output and prices (annual percent change)										
Real GDP	0.6	7.9	6.3	6.5	6.3	4.5	4.5	5.0	5.0	
Headline CPI (period average)	9.9	4.5	4.2	4.9	6.5	6.2	5.7	5.5	5.3	
Headline CPI (end of period)	10.4	2.7	4.6	5.1	6.5	6.2	5.7	5.5	5.3	
Fiscal Indicators (in percent of GDP)										
Total revenue and grants	23.3	24.4	25.5	29.2	29.4	29.9	30.2	30.6	30.8	
of which: tax revenue	18.7	21.0	21.9	25.2	25.4	25.7	25.9	26.3	26.6	
Expenditure	21.9	27.5	32.0	34.2	34.4	31.8	31.9	31.8	32.0	
Expenses	16.5	19.6	23.1	26.8	27.0	25.4	25.4	25.3	25.3	
Net acquisition of nonfinancial assets	5.5	7.9	8.9	7.4	7.4	6.4	6.5	6.5	6.7	
Operating balance	6.8	4.8	2.4	2.4	2.4	4.5	4.9	5.3	5.6	
Net lending/borrowing	1.4	-3.1	-6.5	-5.0	-5.0	-1.9	-1.6	-1.2	-1.1	
Statistical discrepancy	-0.9	-1.3	-3.1	0.0	0.0	0.0	0.0	0.0	0.0	
Net financial transactions	-2.3	1.8	3.5	5.0	5.0	1.9	1.6	1.2	1.1	
Net acquisition of financial assets	4.7	1.4	2.6	-0.1	-0.1	0.9	0.9	0.9	0.9	
Net incurrence of liabilities	2.4	3.2	6.0	4.9	4.9	2.8	2.5	2.1	2.0	
Foreign	0.7	1.3	2.5	3.7	3.9	2.6	2.3	1.9	1.4	
Domestic	1.7	1.9	3.6	1.2	1.0	0.2	0.2	0.2	0.6	
Money and credit (annual percent change)										
Broad money	19.5	15.5	19.4	14.4	10.8	3.0	4.0	7.4	9.3	
Domestic credit	17.4	20.2	26.1	21.3	18.1	6.1	6.2	9.4	10.6	
Private sector credit	23.2	18.0	22.3	19.8	16.9	6.6	6.8	10.4	11.2	
Velocity	1.0	1.0	1.0	0.9	1.0	1.0	1.1	1.1	1.2	
Saving and Investment (in percent of nominal GDP)										
Gross investment	33.9	45.7	51.8	55.0	57.0	54.1	52.0	49.6	47.9	
Gross fixed investment	28.7	31.8	34.1	36.2	37.5	35.7	34.3	32.7	31.6	
Private	23.3	23.9	25.2	28.8	30.1	29.3	27.8	26.2	24.9	
Central government	5.5	7.9	8.9	7.4	7.4	6.4	6.5	6.5	6.7	
Change in stock	5.2	13.9	17.7	18.7	19.4	18.5	17.7	16.9	16.3	
Gross national saving	40.2	45.4	43.6	45.4	44.5	45.0	45.4	44.5	43.3	
Private	33.2	41.8	42.4	44.1	43.3	41.9	42.0	40.6	39.2	
Central government	7.0	3.6	1.2	1.2	1.2	3.1	3.4	3.8	4.2	
Balance of Payments										
Current account (in millions of U.S. dollars)	1,339	-93	-2,350	-2,778	-4,129	-3,288	-2,577	-2,198	-2,118	
In percent of GDP	6.3	-0.4	-8.2	-9.6	-12.5	-9.1	-6.6	-5.1	-4.5	
Trade balance (in millions of U.S. dollars)	-6,389	-8,446	-10,849	-12,899	-15,061	-15,091	-15,236	-15,509	-16,305	
In percent of GDP	-30.2	-33.9	-37.7	-44.6	-45.6	-41.8	-38.8	-36.2	-34.9	
Exports value growth (y/y percent change)	-28.8	9.9	15.5	5.3	8.0	8.5	8.9	8.8	6.0	
Imports value growth (y/y percent change)	-7.4	30.0	27.4	17.9	16.2	0.7	1.5	2.3	5.2	
Workers' remittances (in millions of U.S. dollars)	6,253	6,556	7,224	8,495	9,084	9,642	10,283	10,819	11,268	
In percent of GDP	29.5	26.4	25.1	29.4	27.5	26.7	26.2	25.3	24.1	
Gross official reserves (in millions of U.S. dollars)	8,574	9,264	9,304	8,558	6,788	5,583	5,166	5,133	5,143	
In months of prospective GNFS imports	9.6	8.3	7.2	5.7	4.4	3.6	3.2	3.0	3.0	
Memorandum items										
Public debt (in percent of GDP)	27.9	26.4	30.4	33.1	34.1	33.8	33.5	32.6	31.9	
GDP at market prices (in billions of U.S. dollars)	21.2	24.9	28.8	28.9	33.0	36.1	39.2	42.8	46.7	
Exchange rate (NPR/US\$; period average)	106.4	106.2	104.4	...	...	...	...	...	...
Real effective exchange rate (average, y/y percent change)	6.0	3.3	-0.1	...	...	...	...	...	...

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

1/ Fiscal year ends in mid-July.

Table 3. Nepal: Summary of Government Operations, 2016/17–2023/24 (Baseline) 1/

	2016/17		2017/18		2018/19		2019/20	2020/21	2021/22	2022/23	2023/24
	Budget	Actual	Budget	Proj.	Budget	Proj.	Projections				
	(In billions of Nepalese rupees)										
Total revenue and grants	645	765	767	1,045	981	1,117	1,264	1,409	1,580	1,761	
Total revenue	613	728	732	986	940	1,072	1,202	1,341	1,506	1,680	
Tax revenue	554	658	659	879	847	965	1,083	1,210	1,360	1,518	
Central Government	...	...	...	838	806	919	1,032	1,153	1,297	1,449	
Sub-national Government	...	...	...	41	41	46	51	57	63	69	
Non-tax revenue	59	64	73	107	94	106	119	131	146	162	
Grants	32	72	34	59	40	46	62	68	74	81	
Expenditure	727	1,139	963	1,314	1,148	1,308	1,343	1,485	1,644	1,825	
Recurrent expenditure	519	804	696	1,000	900	1,027	1,073	1,182	1,308	1,443	
<i>Of which:</i> Interest payments	10	31	16	26	23	25	27	27	27	27	
Salaries and allowances	119	131	112	117	104	118	88	98	108	119	
Grants & subsidies	244	186	197	171	149	168	166	181	198	218	
Fiscal transfer	...	232	212	328	277	313	347	384	425	470	
Revenue sharing and collection at sub-national levels	...	...	...	155	155	182	203	227	255	281	
Capital expenditure	209	335	267	314	249	281	270	303	336	383	
Operating balance	126	-1	71	45	81	90	191	227	273	318	
Net lending/borrowing	-83	-336	-196	-269	-167	-191	-79	-76	-63	-65	
Statistical discrepancy	-35	-103	-92	0	0	0	0	0	0	0	
Net financial transactions	48	234	104	269	167	191	79	76	63	65	
Net acquisition of financial assets	37	75	78	97	-3	-5	38	42	47	52	
Foreign	3	0	4	0	0	0	0	0	0	0	
Domestic (net)	34	75	74	97	-3	-5	38	42	46	51	
Sale of equity	17	55	38	58	40	42	25	28	31	34	
Lending minus repayment	26	20	16	39	17	19	13	14	15	17	
Change in cash/deposit	-9	0	20	0	-60	-66	0	0	0	0	
Net incurrence of liabilities	85	309	182	366	165	186	117	118	110	116	
Foreign	35	184	75	229	124	148	109	109	99	82	
Domestic	50	125	107	137	40	38	8	9	10	34	
	(In percent of GDP, unless otherwise indicated)										
Total revenue and grants	24.4	25.4	25.5	31.1	29.2	29.4	29.9	30.2	30.6	30.8	
Total revenue	23.2	24.2	24.3	29.3	28.0	28.2	28.5	28.8	29.2	29.4	
Tax revenue	21.0	21.9	21.9	26.2	25.2	25.4	25.7	25.9	26.3	26.6	
Central Government	...	...	...	24.9	24.0	24.2	24.4	24.7	25.1	25.4	
Sub-national Government	...	...	...	1.2	1.2	1.2	1.2	1.2	1.2	1.2	
Non-tax revenue	2.2	2.1	2.4	3.2	2.8	2.8	2.8	2.8	2.8	2.8	
Grants	1.2	2.4	1.1	1.8	1.2	1.2	1.5	1.5	1.4	1.4	
Expenditure	27.5	37.9	32.0	39.1	34.2	34.4	31.8	31.9	31.8	32.0	
Recurrent expenditure	19.6	26.7	23.1	29.8	26.8	27.0	25.4	25.4	25.3	25.3	
<i>Of which:</i> Interest payments	0.4	1.0	0.5	0.8	0.7	0.7	0.6	0.6	0.5	0.5	
Salaries and allowances	4.5	4.3	3.7	3.5	3.1	3.1	2.1	2.1	2.1	2.1	
Grants & subsidies	9.2	6.2	6.6	5.1	4.4	4.4	3.9	3.9	3.8	3.8	
Fiscal transfer	...	7.7	7.0	9.8	8.2	8.2	8.2	8.2	8.2	8.2	
Revenue sharing and collection at sub-national levels	...	...	...	4.6	4.6	4.8	4.8	4.9	4.9	4.9	
Net acquisition of nonfinancial assets	7.9	11.1	8.9	9.3	7.4	7.4	6.4	6.5	6.5	6.7	
Operating balance	4.8	0.0	2.4	1.3	2.4	2.4	4.5	4.9	5.3	5.6	
Net lending/borrowing	-3.1	-11.2	-6.5	-8.0	-5.0	-5.0	-1.9	-1.6	-1.2	-1.1	
Statistical discrepancy	-1.3	-3.4	-3.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Net financial transactions	1.8	7.8	3.5	8.0	5.0	5.0	1.9	1.6	1.2	1.1	
Net acquisition of financial assets	1.4	2.5	2.6	2.9	-0.1	-0.1	0.9	0.9	0.9	0.9	
Foreign	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Domestic (net)	1.3	2.5	2.5	2.9	-0.1	-0.1	0.9	0.9	0.9	0.9	
Sale of equity	0.6	1.8	1.3	1.7	1.2	1.1	0.6	0.6	0.6	0.6	
Lending minus repayment	1.0	0.7	0.5	1.2	0.5	0.5	0.3	0.3	0.3	0.3	
Change in cash/deposit	-0.3	0.0	0.7	0.0	-1.8	-1.7	0.0	0.0	0.0	0.0	
Net incurrence of liabilities	3.2	10.3	6.0	10.9	4.9	4.9	2.8	2.5	2.1	2.0	
Foreign	1.3	6.1	2.5	6.8	3.7	3.9	2.6	2.3	1.9	1.4	
Domestic	1.9	4.2	3.6	4.1	1.2	1.0	0.2	0.2	0.2	0.6	
Memorandum items											
Primary balance	-2.8	-10.2	-6.0	-7.3	-4.3	-4.4	-1.2	-1.1	-0.7	-0.7	
Fiscal impulse	4.5	7.4	3.2	1.3	-1.7	0.1	-3.1	-0.2	-0.4	0.0	
Public debt	26.4	...	30.4	...	33.1	34.1	33.8	33.5	32.6	31.9	
External	15.7	...	17.4	...	20.2	21.8	22.5	23.0	23.0	22.5	
Domestic	10.7	...	13.0	...	12.8	12.3	11.3	10.5	9.6	9.3	
Resources for sub-national governments (billions of NPR)	...	...	...	483	432	541	602	667	742	820	
(in percent of GDP)	...	...	...	14.4	12.8	14.2	14.3	14.3	14.4	14.4	
<i>Of which:</i> Fiscal Transfers	...	...	...	328	277	313	347	384	425	470	
Revenue Sharing	...	...	...	114	114	182	203	227	255	281	
Revenue collection at sub-national governments	...	...	...	41	41	46	51	57	63	69	
GDP (billions of NPR)	2,643	3,007	3,007	3,361	3,361	3,803	4,222	4,662	5,165	5,712	

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

1/ Fiscal year ends in mid-July.

Table 4. Nepal: Monetary Indicators, 2015/16–2023/24 (Baseline) 1/

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
						Projections			
(In billions of Nepalese rupees, end-period)									
Nepal Rastra Bank									
Reserve money	547	657	710	817	779	726	745	816	899
Net domestic assets	-366	-296	-308	-178	-10	67	126	191	264
Claims on public sector	-109	-82	-49	154	312	315	382	476	583
Claims on private sector	4	4	5	5	6	7	7	8	9
Claims on banks & financial institutions	7	7	12	16	16	16	16	16	16
Other items (net)	-269	-225	-277	-353	-344	-271	-279	-309	-345
Net foreign assets	913	953	1,018	994	789	659	619	625	635
Monetary Survey									
Broad money	2,245	2,592	3,094	3,539	3,923	4,042	4,202	4,513	4,935
Narrow money	503	569	669	702	784	808	839	900	983
Quasi-money	1,741	2,022	2,425	2,837	3,139	3,234	3,363	3,613	3,952
Net domestic assets	1,289	1,577	2,040	2,485	3,091	3,344	3,548	3,854	4,265
Domestic credit	1,793	2,156	2,719	3,299	3,895	4,132	4,389	4,802	5,313
Credit to public sector	101	159	276	374	475	486	493	499	530
<i>of which</i> : Credit to central government	75	128	236	334	437	445	453	463	496
Credit to private sector	1,692	1,997	2,443	2,925	3,420	3,647	3,896	4,303	4,784
Other items(net)	-505	-579	-679	-814	-804	-788	-840	-948	-1,048
Net foreign assets	956	1,015	1,054	1,054	832	698	654	659	670
(Twelve-month percent change)									
Reserve money	4.6	20.1	8.1	15.0	-4.6	-6.8	2.6	9.4	10.2
Broad money	19.5	15.5	19.4	14.4	10.8	3.0	4.0	7.4	9.3
Net domestic assets	14.0	22.4	29.4	21.8	24.4	8.2	6.1	8.6	10.7
Domestic credit	17.4	20.2	26.1	21.3	18.1	6.1	6.2	9.4	10.6
Credit to public sector	-34.1	57.5	73.7	35.2	27.0	2.4	1.5	1.3	6.1
Credit to private sector	23.2	18.0	22.3	19.8	16.9	6.6	6.8	10.4	11.2
Net foreign assets	28.0	6.1	3.9	0.0	-21.1	-16.1	-6.3	0.7	1.7
Memorandum items									
Velocity	1.0	1.0	1.0	0.9	1.0	1.0	1.1	1.1	1.2
Multiplier	4.1	3.9	4.4	4.3	5.0	5.6	5.6	5.5	5.5
Private credit (in percent of GDP)	75.1	75.6	81.2	87.0	89.9	86.4	83.6	83.3	83.8
GDP at market prices (in billions of NPR)	2,253	2,643	3,007	3,361	3,803	4,222	4,662	5,165	5,712

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

1/ Fiscal year ends in mid-July.

Table 5. Nepal: Balance of Payments, 2015/16–2023/24 (Baseline) 1/

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
	Projections								
	(in millions of US dollars)								
Current account	1,339	-93	-2,350	-2,778	-4,129	-3,288	-2,577	-2,198	-2,118
Current account (excluding official transfers)	947	-935	-2,633	-3,126	-4,526	-3,821	-3,147	-2,812	-2,778
Trade balance	-6,389	-8,446	-10,849	-12,899	-15,061	-15,091	-15,236	-15,509	-16,305
Exports, f.o.b.	704	774	894	941	1,016	1,102	1,199	1,305	1,382
Imports, f.o.b.	-7,092	-9,219	-11,743	-13,840	-16,077	-16,192	-16,435	-16,813	-17,688
Services (net)	92	26	18	184	202	264	322	258	496
Receipts	1,302	1,492	1,697	1,935	2,210	2,413	2,623	2,735	3,062
<i>Of which</i> : tourism	393	552	643	876	1,001	1,093	1,187	1,296	1,493
Payments	-1,210	-1,466	-1,680	-1,751	-2,008	-2,150	-2,301	-2,477	-2,566
Income	320	294	210	356	406	444	483	527	574
Credit	405	490	660	663	757	827	899	982	1,070
Debit	-85	-196	-450	-307	-351	-383	-417	-455	-495
Current transfers	7,316	8,032	8,271	9,580	10,323	11,095	11,855	12,525	13,118
Credit, of which:	7,351	8,069	8,327	9,623	10,373	11,148	11,913	12,588	13,187
General government	392	841	283	348	397	533	571	614	660
Workers' remittances	6,253	6,556	7,224	8,495	9,084	9,642	10,283	10,819	11,268
Debit	-36	-37	-56	-43	-49	-54	-58	-64	-69
Capital account	159	125	169	122	139	213	228	246	264
Financial account	-91	255	1,344	1,915	2,224	1,880	1,941	1,930	1,874
Direct investment	55	127	169	318	363	397	432	471	537
Portfolio investment	0	0	0	0	0	0	0	0	0
Other investment (net)	-146	128	1,175	1,597	1,861	1,483	1,509	1,459	1,338
<i>Of which</i> : Trade credit	146	144	556	644	746	760	780	804	847
Official loans	170	426	764	1,071	1,271	920	906	817	663
Errors and omissions	245	316	1,086	0	0	0	0	0	0
Overall balance	1,652	603	249	-742	-1,766	-1,195	-407	-23	20
Memorandum items									
Current account (in percent of GDP)	6.3	-0.4	-8.2	-9.6	-12.5	-9.1	-6.6	-5.1	-4.5
Current account, excl. grants (in percent of GDP)	4.5	-3.8	-9.1	-10.8	-13.7	-10.6	-8.0	-6.6	-6.0
Trade balance (in percent of GDP)	-30.2	-33.9	-37.7	-44.6	-45.6	-41.8	-38.8	-36.2	-34.9
Exports (in percent of GDP)	3.3	3.1	3.1	3.3	3.1	3.1	3.1	3.0	3.0
Imports (in percent of GDP)	33.5	37.1	40.8	47.9	48.7	44.9	41.9	39.3	37.9
Exports (y/y percent change)	-28.8	9.9	15.5	5.3	8.0	8.5	8.9	8.8	6.0
Imports (y/y percent change)	-7.4	30.0	27.4	17.9	16.2	0.7	1.5	2.3	5.2
Remittances (in percent of GDP)	29.5	26.4	25.1	29.4	27.5	26.7	26.2	25.3	24.1
Remittances (y/y percent change)	1.0	4.8	10.2	17.6	6.9	6.1	6.6	5.2	4.1
FDI (in percent of GDP)	0.3	0.5	0.6	1.1	1.1	1.1	1.1	1.1	1.2
Total external debt (in percent of GDP)	17.3	15.7	17.4	20.2	21.8	22.5	23.0	23.0	22.5
Gross official reserves (in millions of U.S. dollars)	8,574	9,264	9,304	8,558	6,788	5,583	5,166	5,133	5,143
In months of prospective imports	9.6	8.3	7.2	5.7	4.4	3.6	3.2	3.0	3.0
As a share of broad money (in percent)	40.9	36.9	...	...	...	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	21,186	24,880	28,812	28,922	33,035	36,067	39,234	42,825	46,664

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

1/ Fiscal year ends in mid-July.

Table 6. Nepal: Commercial Banks' Financial Soundness Indicators, 2013–2018 1/

	2013	2014	2015	2016	2017	2018
	(in percent)					
Capital adequacy						
Capital fund to risk weighted assets	13.4	12.6	12.2	12.9	14.7	14.1
Tier 1 capital to risk weighted assets	11.8	11.0	10.4	11.4	13.4	12.8
Asset quality						
NPLs to total loans	1.9	2.5	2.1	1.5	1.4	1.3
Loan loss provision to total loans	2.4	2.9	2.7	2.2	2.1	1.9
Earnings and profitability						
Return on equity (ROE)	28.2	26.9	28.0	17.8	18.8	15.0
Return on assets (ROA)	1.7	1.5	1.5	1.8	1.8	1.6
Interest income to gross income	83.4	82.6	78.9	78.7	79.7	84.5
Non-interest expenditures to gross income	18.3	18.9	21.1	19.4	17.9	15.2
Employees expenses to non-interest expenditures	43.1	44.6	45.0	46.4	48.4	50.8
Liquidity						
Liquid assets to total assets	25.3	24.4	24.7	23.0	19.3	18.4
Liquid assets to total deposits	30.4	29.2	29.4	26.9	23.5	22.8
Exposure to real estate						
Share of real estate and housing loans	16.1	15.1	14.9	14.9	14.2	13.4
Share of loans collateralized by land and buildings	50.9	51.7	52.5	59.9	59.1	59.7

Source: Nepalese authorities.

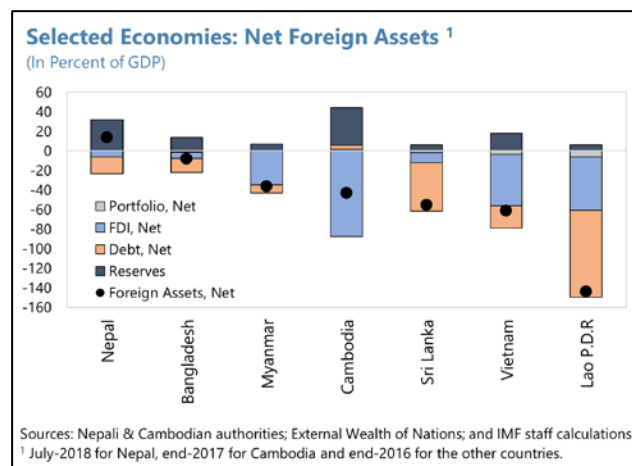
1/ Data for "A" class banks excluding state owned banks. Data presented as at the end of the fiscal year (i.e. in mid-July for the year indicated).

Annex I. External Sector Assessment

Nepal's external position in 2017/18 was moderately weaker than the level consistent with medium-term fundamentals and desirable policy settings. The weakness of the current account and overall balance of payments has become more pronounced in the first 5 months of 2018/19. In the short term, improving the external position requires tighter fiscal and monetary policies. Medium-term policies need to focus on improving the business climate and productivity and competitiveness. These are also needed to maintain reserve adequacy and support the peg to the Indian rupee which continues to serve Nepal well.

1. Nepal's net foreign assets (NFA) position is considerably stronger than in peers.

Nepal's NFA position stood at US\$3 billion (10.6 percent of GDP) as at mid-2018. Central bank reserves exceed public external debt. At the same time, private sector external debt and external liabilities related to foreign direct investment (FDI) are small. The former relates to persistent government capital budget implementation bottlenecks alongside rising government revenues from remittances-financed imports. The latter relates to Nepal's difficult business climate which has held back domestic and foreign private investment. A continuation of the expansionary fiscal policy of the past two years and an improvement of the business climate would boost FDI inflows and thereby lead to a deterioration of Nepal's NFA position, bringing it more in line with developing country peers. As Nepal is at present a net creditor, there are no immediate sustainability concerns.



2. On the other hand, the IMF's revised EBA-lite models^{1,2} indicate that Nepal's current account is moderately weaker than the current account norm and Nepal's REER is moderately more appreciated than the equilibrium REER:

- Following a string of current account surpluses in recent years, Nepal recorded a current account deficit of 8.2 percent of GDP in FY2017/18. This compares with a current account norm—which is derived from a current account panel regression on macroeconomic

¹ The following changes have been made to the EBA-lite models: (i) aid and remittances are no longer explanatory variables in current account and REER regressions. Data on outward migration is used instead; (ii) shocks, such as from natural disasters and armed conflicts, are explicitly incorporated in the models; (iii) social insurance policies are explicitly incorporated; and (iv) the models separate cyclical factors from structural financial policies. Given Nepal's large remittances to GDP ratio, the change under (i) has important implications. Shocks from natural disasters are also important in Nepal.

² These models were applied using mid-2018 data for Nepal and end-2017 data for other countries.

fundamentals, policy variables, and cyclical factors—of a deficit of 2.5 percent of GDP in FY2017/18. Assuming an elasticity of the trade balance with respect to changes in the REER of -0.17, this indicates that the REER would need to depreciate by about 32 percent to close the current account gap (-5.6 percent of GDP).

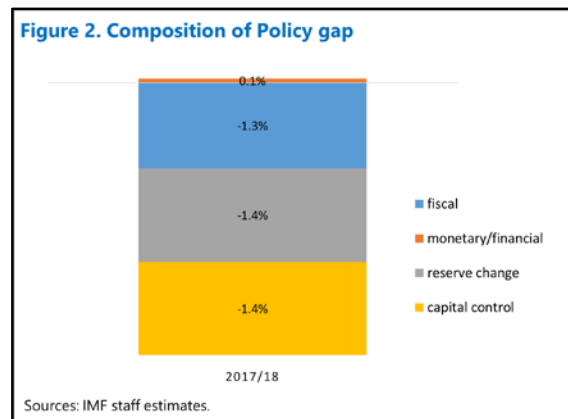
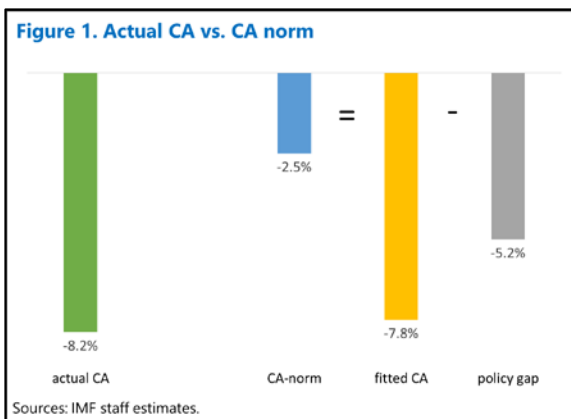
- *Nepal's REER has appreciated in recent years.* For instance, the average REER during FY2017/18 was about 14 percent more appreciated than the average during 2010–14. According to the revised EBA-lite REER model, by mid-2018, Nepal's REER was 33 percent more appreciated than the equilibrium REER derived from a panel regression for 126 countries.
- *The current account deficit and the REER overvaluation are likely overestimated.* Net errors and omissions in the balance of payments amounted to 3¼ percent of GDP in FY2017/18, up from 1¼ percent of GDP on average in the two preceding years.³ The current account deficit could be overstated to the extent that the errors and omissions are mainly related to informal transactions not captured in workers' remittances and compensation of employees. Correcting the current account deficit for the large positive errors and omissions reduces the current account gap to 1.9 percent of GDP and overvaluation of the REER to 11 percent as of July 2018. In recent months the REER of the Nepalese rupee has depreciated as the Indian rupee has depreciated vis-à-vis the U.S. dollar and inflation has remained contained.

Table 1. The results of EBA-lite models

Revised EBA-lite-CA	
CA actual	-8.2%
CA norm	-2.5%
CA gap	-5.6%
REER gap	32.2%
Revised EBA-lite-IREER	
ln(REER) actual	4.71
ln(REER) norm	4.38
REER gap	32.6%

Sources: IMF staff estimates

3. The revised EBA-lite models illustrate that the recent deterioration of Nepal's external position is closely associated with expansionary fiscal and monetary policies. In the CA-model,



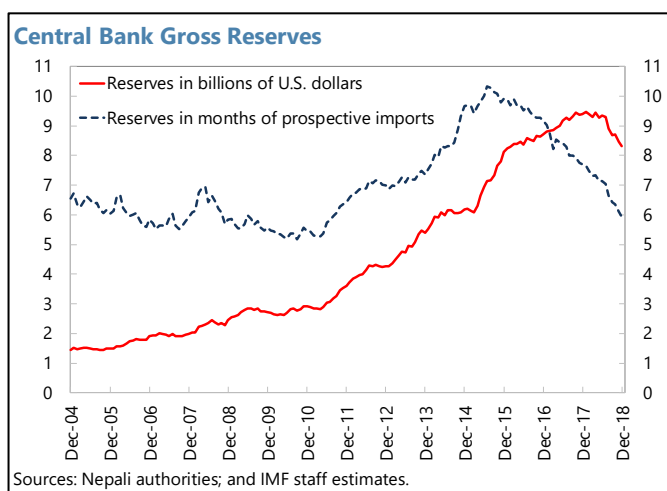
³ The large net errors and omissions would introduce further uncertainty in a forecast of the current account and therefore complicate an external assessment based on data for FY2018/19 as recommended by EBA-Lite guidance.

the CA-norm is divided into the fitted value from the panel regression (fundamentals) and policy gap. The policy gap is the difference between current and desirable level of policies³. Fiscal and monetary policies mainly constitute the policies in calculating the policy gap. According to the revised model, closing Nepal’s policy gap would convert the current account gap from a large negative to a much smaller negative. In other words, the REER and the external position would be assessed to be broadly in line with fundamentals and desirable policy settings. This would also safeguard Nepal’s medium-term external sustainability. In this model, the desirable fiscal policy stance is considered to be consistent with a cyclically-adjusted fiscal deficit of 2.8 percent of GDP, which is tighter than the FY2017/18 outturn by 2.6 percentage points of GDP. Similarly, in this model foreign exchange reserves are advised to grow in line with nominal GDP (a stable foreign reserves-to-GDP ratio). By contrast, the actual forex reserves-to-GDP ratio decreased by 2.3 percentage points in July 2018 (y/y) due mainly to the expansionary fiscal and monetary policies.

4. Concerns about the competitiveness of Nepal’s exports go beyond the level of the real exchange rate. The infrastructure gap, restrictive labor regulations, and, until recently, power shortages, make for a difficult business environment that has been holding back foreign and domestic investment. The new government is embarking on policies and initiatives to address impediments to private-sector led growth.

5. Capital flows consist mostly of concessional loans and trade credit. FDI comprised just 0.6 percent of GDP in FY2017/18. A key obstacle to FDI is the complexity of the current approval system. Nepal’s capital account remains mostly closed. Therefore, portfolio flows are zero. In FY2017/18 there was a marked increase in disbursements of concessional loans. Moreover, the surge in imports was accompanied by a large increase in trade credits.

6. Foreign exchange intervention and reserve adequacy. Nepal’s central bank reserves reached a record US\$9.5 billion in January 2018. About a quarter of Nepal’s reserves are held in



	Months of imports of G&S 1/	Percent of Exports of G&S	Percent of M2	Percent of GDP
Indonesia	8	67	32	13
Malaysia	6	46	25	33
Philippines	8	97	33	26
Singapore	6	50	44	86
Thailand	9	65	37	44
Sri Lanka	3	39	18	8
Myanmar	7	77	33	18
Mongolia	5	44	53	27
Lao P.D.R.	1	17	10	6
Cambodia	5	54	55	40
Vietnam	2	22	14	22
Median	6	50	33	26
Nepal (Dec 2018)	6.0	274	30	29

Sources: IMF, WEO; and staff estimates.
1/ In months of prospective imports of goods and services.

³ The policy gap is defined as “{(current policy level of the country) - (desirable policy level of the country)} - {(current policy level of world average) - (desirable policy level of world average)}”

Indian rupees. Reflecting balance of payments pressures and exchange rate valuation changes, reserves fell to US\$8.3 billion in December 2018. Traditional metrics and regional comparisons suggest that the current level of Nepal's foreign exchange reserves—equivalent to about 6 months of prospective imports of goods and services and 30 percent of broad money—is adequate.⁴⁶ However, Nepal's elevated risk of natural disasters and the country's experience over the past two decades, when reserves always remained above 5 months of prospective imports, underscores the need to tighten macroeconomic policies to stem the rapid decline in reserves observed in recent months and prevent them from falling below the threshold of 5 months of import.

⁴ See "[Guidance Note on Assessing Reserve Adequacy and Related Considerations](#)" June 2016.

⁶ Applying the Assessing Reserve Adequacy (ARA) tool for credit-constrained economies with fixed exchange rate regime to Nepal indicates an adequate level of reserves of 2.4 months of current imports of goods and services, which is considerably lower than the current reserve level. Nepal is assessed to be "credit constrained" for the purpose of this exercise given that it does not regularly borrow from international capital markets—defined as at least one issuance of bonds per year in the last five years—and is not rated to be "investment grade." The relevant ARA metric is $0.3 \times \text{short-term external debt} + 0.2 \times \text{other external debt} + 0.05 \times \text{broad money (M2)} + 0.1 \times \text{exports of goods and services}$.

Source of Risk	Location of Source	Relative Likelihood	Time Horizon	Expected Impact	Main Impacts → Recommended Policy Actions
Volatile oil prices 2/	External	M	ST, MT	M	Mixed effects: in the short-term, puts increased pressure on the current account through higher oil imports; medium-term, may improve external employment prospects for Nepali migrants, strengthening remittance inflows → Continue developing hydroelectric capacity to lessen dependence on oil imports; tighten stance of fiscal policy
Rising protectionism and retreat from multilateralism 3/	External	H	ST, MT	L	Although Nepal's exports to the rest of the world are extremely limited, current account sustainability is highly dependent on remittance inflows which are tied to external employment prospects, which are dependent on steady global activity. → Maintain sound policy frameworks, including improving the investment climate to reduce dependence on remittance inflows.
Cyber-attacks 4/	External	M	ST	M – H	Safeguards monitoring report (2018) identified significant vulnerability to cyber risks at the NRB, due to weak IT infrastructure and practices. → In the broader context of overall strengthening of NRB capacity, such as efforts to improve governance and organizational setup, focus also on enhancing capacity in the NRB's IT department.
Excessively expansionary fiscal and monetary policy	Domestic	M	ST, MT	M	Meeting budget spending targets, or falling short on revenue targets, would entail an even looser stance of fiscal policy than already envisaged, further contributing to balance-of-payments pressures and possibly inefficient spending given weak implementation capacity. Looser monetary policy and higher credit growth than assumed in the baseline would also add to demand growth and BOP pressures and increase the buildup of financial sector risks. → Closely monitor monthly revenue and expenditure outturns, adjusting the latter downward if needed. Going forward, aim for more realistic budgets and a medium-term fiscal plan. → Tighten macroprudential policies to contain credit growth.
Financial sector vulnerabilities, exposed by waning remittances	Domestic	M	ST, MT	H	A slowdown in deposit growth, emanating from waning remittance inflows and associated softening of real estate prices, could affect liquidity and expose existing loan-portfolio weaknesses. → Exercise supervisory, corrective, and sanctioning powers more forcefully, including through more pro-active risk-based supervision.
Natural disaster	Domestic	L	ST, MT	H	Nepal is highly vulnerable to natural disasters, such as earthquakes and floods. → Adhere to disaster-proof building codes; build fiscal space and reserve buffers; enhance financial safety nets.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("L" (low) is meant to indicate a probability below 10 percent, "M" (medium) a probability between 10 percent and 30 percent, and "H" (high) a probability of 30 percent or more). The RAM reflects staff views on the source of risks and level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

2/ Risks to oil prices are broadly balanced. Prices could rise sharply due to steeper-than-anticipated export declines in some producers, or drop further if downside global growth risks materialize or supply exceeds expectations.

3/ Global imbalances and fraying consensus about the benefits of globalization lead to escalating and sustained trade actions and spreading isolationism. This threatens the global trade system, regional integration, labor mobility as well as cross-border policy collaboration. This could yield increased financial-market volatility and have negative consequences for global growth.

4/ These attacks could target financial, transport, or communication infrastructure and broader private and public institutions.

Annex III. Revenue-Enhancing Measures

In the context of a Domestic Revenue Mobilization Pilot, Annex II of the [staff report for the 2017 Article IV Consultation](#) noted the strong growth in domestic revenue achieved in Nepal in recent years. This was facilitated by rapid growth of the tax base—with rising remittances propelling consumption and imports—alongside sustained efforts to strengthen tax administration, including at customs. The new government has accelerated efforts to modernize the tax system and strengthen core tax and customs administration. Performance during the first five months of the fiscal year (revenue increase by 32 percent (y/y)) indicates that the central government may be able to raise the revenue to GDP ratio by 3½ percent of GDP to 26.8 percent of GDP in FY2018/19.

1. A number of measures has recently been introduced to streamline the tax structure, remove exemptions, broaden the tax base, and strengthen enforcement. For instance,

I. Revenue-enhancing measures related to changes of the tax structure and tax base.

- (i) *Unification of VAT refunds.* Various additional refunds and exemptions for VAT previously allowed have been abolished, including the VAT rebate facility on imports of mobile phones, oil and ghee. The current system allows for standard VAT refunds, more aligned with international practice.
- (ii) *Base-broadening for property tax.* Land and real estate property worth more than NR 1 million are now subject to property tax. The threshold has been lowered from NR 3 million.
- (iii) *Introduction of health hazard tax on tobacco.* In addition to the existing taxes on tobacco products, the government has begun to levy a 25 paisa health hazard tax for every cigarette, bidi and cigar. Similarly, NR 25 per kilogram health hazard tax has been imposed on import or domestic production of chewing tobacco.
- (iv) *Increased excise duty for vehicles.* Excise duty on automobiles was raised by up to 40 percent depending on engine size.

II. Revenue-enhancing measures related to tax administration and enforcement.

- (i) *Efforts to reduce under-reporting of tax liabilities.* Import reference prices have been updated. Import documents are increasingly being matched with export documents from exporting countries. An integrated customs management system—the UNCTAD Automated System for Customs Data (ASYCUDA) World—has been rolled out to all main customs offices. The system is expected to help modernizing customs operations and improving revenue collection, while reducing transaction time and costs.
- (ii) *Efforts to strengthen accounting systems.* Businesses' tax filings are increasingly being cross-checked against income statements submitted to banks in support of loan applications.
- (iii) *Incentives for tax authorities.* Performance indicators and rewards for tax authorities are linked with the achievement of revenue collection target. In addition, a zero-tolerance policy for revenue leakage and misappropriation of funds has been adopted.
- (iv) *E-payment system for taxation.* A fully-fledged electronic tax payment system is being prepared. Currently, only large taxpayers are connected to the system and able to file and pay taxes online. The full adoption of the system will significantly reduce the costs of tax administration and compliance cost of taxpayers.

Annex IV. Progress in Implementing High-Priority FSAP Recommendations

Recommendations	Responsible Authority	Time Line	Progress to date
Financial Stability Oversight			
Refocus monetary policy operations on domestic liquidity management to reduce excess reserves, and especially their volatility, with appropriate burden sharing of costs between the financial system and the budget. Introduce Treasury sterilization bonds.	NRB	Short term (ST)	Not done An interest rate corridor (IRC) was operated during FY2017/18, leading to the stabilization of short-term interest rate. However, since July 2018 monetary operations have become largely accommodative again.
Undertake a thorough Asset Quality Review (AQR) to identify the extent of problem loans in banks' balance sheets (with TA support).	NRB	ST	Fully Implemented A Special Inspection Program (SIP) to review asset quality was conducted in 2015.
Conduct an in-depth review and financial analysis of loan portfolios during bank examinations.	NRB	ST/ Medium term (MT)	In process Loan portfolio reviews are performed on a regular basis during on-site inspections. The reviews increasingly focus on asset quality and borrowers' financials.
Reinforce efforts to address financial infrastructure shortcomings in the Payments System, clearing, credit information, collateral registry, and debt recovery areas.	NRB/MOF	ST/MT	In process <ul style="list-style-type: none"> • A Payment and Settlement System Department was established in 2015. Directives for Payment Institutions and Licensing Policy for Payment-Related Institutions were issued in 2016. Nepal Payment System Development Strategy was issued, and Payment System Oversight Framework of 2018 was published. A real-time gross settlement system is expected to be operational in September 2019. • The Payment and Settlement Act is before parliament. Payment System Oversight Bylaws are under discussion. • Nepal Financial Reporting Standards (NFRS) were adopted by Class A banks in FY2016/17. • Limited progress has been made regarding the strengthening of the credit information bureau, the collateral registry and debt recovery areas.

Recommendations	Responsible Authority	Time Line	Progress to date
Financial Sector Oversight			
A. Banking Sector			
<ul style="list-style-type: none"> • Redefine supervisory approach by: integrating risk-based off-site and on-site supervision; • increasing analytical capacity through training; • introducing supervisory management information systems (MIS); • developing a dedicated human resources (HR) rotation policy; and • streamlining the NRB board participation in operational decisions. 	NRB	ST/MT	In Process Risk-based on-site supervision is being implemented for Class A banks. SARTTAC TA has been received to help extend it to off-site supervision, following the installation of the Supervisory Information System (SIS) planned for August 2019. Regular training is being provided for on-site and off-site supervisors, and unit-wise rotation policy is being implemented. No action taken on streamlining the NRB Board's participation in operational decisions.
<p>Ensure effective compliance with supervisory directives and guidelines by:</p> <ul style="list-style-type: none"> • performing a thorough follow up of the implementation of supervisory recommendations; • proactive, earlier, and stronger corrective actions. 	NRB	MT	In Process The onsite inspection and enforcement unit in the Banking Supervision Department continue to follow up on the implementation of supervisory recommendations. Risk Management Directive was issued in November 2017, in order to strengthen the effective enforcement of major components of Risk Management Guidelines.
Review licensing regulations and policy to strengthen the licensing process and support a consolidation of the sector. Once completed, re-license all Classes A, B, and C banks that meet the new reinforced requirements, with an appropriate phase-in period, into a single-license category.	NRB	MT	Not done
Granting the NRB explicit consolidated supervision powers, amending the legal framework to incorporate a comprehensive definition of related parties and controlling interests.	NRB	MT	Not done The Bank and Financial Institutions Act (BAFIA) 2016 defined the terms "Related Party" and "Controlling Interest". But the NRB has not been granted consolidated supervision powers in the amended NRB Act and BAFIA.
B. Non-banking Sector			
Divide the CIT into two separate legal entities, segregating the capital market business, to be placed under the supervision of the Securities Board of Nepal (SEBON), from the pension fund business.	MOF/SEBON	ST	Not done
Place the EPF and CIT pension fund business under the joint supervision of the Insurance Board (IB) and NRB.	IB/NRB/MOF	MT	Not done
Strengthen the operational independence of the IB and SEBON.	SEBON/IB/MOF	ST	Not done For now, the focus is on strengthening the capacity of the IB and the SEBON.

Recommendations	Responsible Authority	Time Line	Progress to date
Crisis Management			
Revise Prompt Corrective Action (PCA) policy to require stronger supervisory action, including designation of problematic status at an earlier stage of capital depletion.	NRB	ST	Fully implemented The revision was completed (PCA Bylaws 2074 (2016/17))
Develop and implement a banking financial institution (BFI) Supervision Enforcement policy that presumes certain enforcement action based on CAMELS ratings.	NRB	MT	In process The supervisory adjustments in risk weighted assets are currently tied up with CAMELS ratings.
Revise NRB Act to clarify emergency liquidity assistance (ELA) provisions.	NRB/MOF	ST	In process The NRB Act Amendment extended the tenure for refinancing and lender of last resort facilities from 6 months to 1 year. The ELA framework is under consideration with expected completion by end-FY18/19.
Revise NRB Act to grant it special resolution regime powers.	NRB/MOF	ST	Fully implemented A separate section (Chapter 9A) has been added to the NRB Act, which provides special resolution regime powers to the NRB. It includes sections which provide power to liquidate an institution, appoint a Special Administration Group, establish Bridge Institution/Unit, etc.
Establish a national financial crisis coordinating committee comprised of all financial sector, regulatory, and supervisory agencies. Develop each individual agency's crisis contingency plans and roll up individual agency plans into a national crisis contingency plan.	MOF/NRB/IB /SEBON	ST/MT	In process A high-level Financial Sector Coordination Committee is in place. Chaired by the Finance Minister, and comprising NRB, SEBON, and IB representatives, it coordinates financial sector issues and policy changes. Crisis contingency plans still need to be developed.
Crisis simulations should be conducted periodically.	MOF/NRB/IB /SEBON	MT	Not done



NEPAL

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 24, 2019

Prepared By

Asia and Pacific Department

CONTENTS

FUND RELATIONS	2
INFORMATION ON THE ACTIVITIES OF OTHER IFIS	5
STATISTICAL ISSUES	6

FUND RELATIONS

(As of November 30, 2018)

Membership Status: Joined September 6, 1961; accepted Article VIII, Sections 2, 3, and 4 on May 30, 1994.

General Resources Account:

	SDR Million	Percent Quota
Quota	156.90	100.00
Fund holdings of currency	140.92	89.82
Reserve position in Fund	15.98	10.19

SDR Department:

	SDR Million	Percent Allocation
Net cumulative allocation	68.10	100.00
Holdings	4.81	7.06

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
RCF Loans	47.06	29.99

Financial Arrangements: (In SDR Million)

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

Projected Obligations to Fund:

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

		Forthcoming			
	2018	2019	2020	2021	2022
Principal	2.85	5.70	2.85	7.13	7.13
Charges/interest		0.68	0.69	0.68	0.68
Total	2.85	6.39	3.54	7.81	7.81

Exchange Rate Arrangement

The exchange rate arrangement of Nepal is a conventional peg to a single currency unit. The Nepalese rupee is pegged to the Indian rupee at a rate of NRs 1.6 per Indian rupee. 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 December 21, 2018, the exchange rate of the Nepalese rupee (Nr) was US\$1=Nrs. 111.53. 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.

Safeguards Assessments

An update safeguards assessment of the Nepal Rastra Bank (NRB) was completed in February 2016 with respect to the Rapid Credit Facility approved on July 31, 2015. The assessment found that the NRB had made limited progress in improving its safeguards framework and addressing recommendations from the previous assessment (2011). In particular, the quality of the external audit continued to fall short of international standards and priority should be given to engaging an auditor with requisite experience. The legal framework should also be enhanced to strengthen the central bank's autonomy and governance arrangements. The assessment concluded that strong commitment from the NRB Board and management is essential to improve the internal audit function and reinforce controls in key areas, including foreign reserves management and currency operations.

A safeguards monitoring mission to the NRB was undertaken in May 2018 to follow up on the status of safeguards recommendations from the 2016 assessment. The mission found limited progress on implementation of recommendations, and the NRB's autonomy was further weakened by subsequent amendments to the NRB Act. Concerted effort by the NRB are needed to achieve meaningful progress on safeguards recommendations.

2017 Article IV Consultation

The 2017 Article IV Consultation Staff Report (IMF Country Report No. 17/74) was prepared by IMF staff for the Executive Board's consideration on a lapse-of-time basis and was published in March 2017. Consultations with Nepal are held on the standard 12-month Article IV consultation cycle.

Technical Assistance (since 2017 Article IV Consultation)

	Purpose	Year
MCM	Strengthening Internal Audit	2018
	Cyber Security	2018
SARTTAC	Financial Soundness Indicators	2017
	Liquidity Forecasting and Management	2017
	Financial Supervision and Regulation	2017
	Strengthening Fiscal Reporting	2018
	Budget Formulation and Good Practices	2018
	Government Finance Statistics and Public Sector Debt Statistics Training	2018
	Price Statistics Training	2018

Resident Representative

Mr. Andreas Bauer has been the Senior Resident Representative since June 15, 2016. He is based in New Delhi.

INFORMATION ON THE ACTIVITIES OF OTHER IFIS

Information on the activities of other IFIs in Nepal can be found at:

- World Bank: <http://www.worldbank.org/en/country/nepal/overview>
- Asian Development Bank: <https://www.adb.org/sites/default/files/publication/27783/nep-2017.pdf>

STATISTICAL ISSUES

As of January 9, 2019

I. Assessment of Data Adequacy for Surveillance
<p>General: Economic and financial data are broadly adequate for surveillance, with scope for improvement especially in updating the base year of the national account, more detailed price statistics, and the timeliness and quality of balance of payments data.</p>
<p>National Accounts: The Central Bureau of Statistics (CBS) compiles national accounts using the 1993 SNA standard. Key estimates include annual GDP by industry and by expenditure categories (in current and constant prices), and gross national income and savings. Some expenditure categories continue to be affected by limited source data, particularly for household final consumption. The CBS has plans to release a major revision of the national accounts, which incorporates improved source data and updated methodologies, and will update the base year for the constant price measures from 2000/01 to 2010/11, during 2019. The compilation of the new benchmark year for the national accounts and its rebasing is being supported by the World Bank. Quarterly GDP estimates are compiled but not disseminated.</p>
<p>Price Statistics: The Nepal Rastra Bank (NRB) compiles the consumer price index (CPI). A new CPI series with 2014/15 as base year (from previous base year of 2005/06) has been released in October 2015 based on a new household expenditure survey. Initial plans had been made to transfer the responsibility of compiling the CPI from the NRB to the Central Bureau of Statistics (CBS). A core inflation series is not published, although underlying data necessary to calculate such a series appear to be available. NRB also publishes a wholesale price index (WPI), with weights based on 1999/2000 data. Broadly, the index covers agricultural commodities (49.6 percent), domestic manufactured goods (20.4 percent), and imported goods (30 percent). The CBS has received TA to update and expand the producer price index (PPI) to include other economic sectors. Current PPI coverage is restricted to manufacturing. As well, an index of wages and salaries is compiled and published, with base year 2004/05.</p>
<p>Government Finance Statistics: The authorities began to compile fiscal data in accordance with IMF's Government Finance Statistics Manual 2001 (GFSM 2001) in 2011. The budget classification in the GFSY return needs further improvement in a number of areas; for example, to exclude financing transactions from the functional classification of expenditure; make a clearer distinction between revenue and transactions in nonfinancial assets (and also ensuring the type of non-financial assets are correctly recorded); clarify whether transactions are correctly classified as financial assets or subsidies and capital payments to enterprises; and other improvements to ensure full consistency with the GFSM 2001. Meanwhile, the treasury single account system (TSA) has been rolled out to all 75 districts including Kathmandu, which allows for more timely and accurate fiscal data reporting and monitoring. However, a number of fees collected outside the budget, foreign aid directly paid by donors, the operations of extra-budgetary entities and local governments are not reported in the annual budget, and there is no compilation of the government's balance sheet in accordance with the GFSM 2001. It is expected that after the 2018 Article IV mission, some data on assets and liabilities will be become available and that the authorities will re-start their submission to the WB/IMF Public Sector Debt Database. Government</p>

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

Monetary and Financial Statistics: The Nepal Rastra Bank (NRB) reports the Standardized Report Forms (SRFs) 1SR for central bank, 2SR for other depository corporations (ODCs), and 5SR for monetary aggregates for publication in the IMF's *International Financial Statistics* on a monthly basis with a lag of about one month. The coverage of monthly monetary statistics has been expanded to include development banks and finance companies, and the NRB now compiles and publishes an expanded broad money survey, which is a significant step forward. However, there are some inconsistencies in the reporting of positions between the NRB and the ODCs. Minimizing these will further improve data quality.

Financial Soundness Indicators: the NRB reports the 12 core financial soundness indicators (FSIs) and 8 of the 13 encouraged FSIs for deposit takers, 2 FSIs for the other financial corporations (OFCs), one FSI for households, and 2 FSIs for real estate markets—on a quarterly basis—for posting on the IMF's FSI website. FSIs are reported with a lag of about 4 months.

External Sector Statistics: The NRB compiles and disseminates balance of payments (BOP) statistics in conformity with the fifth edition of the *Balance of Payments Statistics Manual (BPM5)*. BOP statistics present several shortcomings in terms of coverage, classification, and data sources. Key shortcomings in BOP statistics are: (i) underestimation of imports, and to a lesser extent exports; (ii) significant problems in measurement of remittances; (iii) incompleteness of data on foreign grants, making it difficult to classify current vs. capital, and official vs. private grants; (iv) absence of direct investment data; and (v) unrecorded financial flows. In February 2015, the NRB started reporting international investment position (IIP) data following the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6)*.

Since 2012, NRB has been receiving technical assistance (TA) in the external sector statistics (ESS) that include the areas of BOP, IIP and external debt statistics (EDS). During the 2016 STA mission has continued redesigning the International Reporting System (ITRS), the main collection source for compiling BOP and IIP, assisted the authorities in improving the surveys for collecting direct investment and trade credit data, and provided hands-on training on how to operate working files for the compilation of BOP in *BPM6* format.

Overall the quality of BOP data has improved with the support of IMF STA TA and training of the NRB staff through ESS IMF HQ and regional courses.

II. Data Standards and Quality

Nepal has implemented the recommendations of enhanced General Data Dissemination System (e-GDDS). Its National Summary Data Page was launched in June 2017 and is available at <https://www.nrb.org.np/red/nsdp/>.

Data ROSC on fiscal transparency was published in October 2007.

Nepal—Table of Common Indicators Required for Surveillance
(As of December 31, 2018)

	Date of latest observation	Date received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷
Exchange Rates	12/18	12/18	D and M	W and M	W and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	11/18	12/18	M	M	M
Reserve/Base Money	11/18	12/18	M	M	M
Broad Money	11/18	12/18	M	M	M
Central Bank Balance Sheet	11/18	12/18	M	M	M
Consolidated Balance Sheet of the Banking System	11/18	12/18	M	M	M
Interest Rates ²	11/18	12/18	D and M	W and M	W and M
Consumer Price Index	10/18	11/18	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	10/18	11/18	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	10/18	11/18	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	07/18	11/18	M/A	M/A	M/A
External Current Account Balance	10/18	11/18	M	M	M
Exports and Imports of Goods and Services	10/18	11/18	M	M	M
GDP/GNP	2017/18	08/18	A	A	A
Gross External Debt	2017/18	08/18	A	A	A
International Investment Position ⁶	Q2/18	08/18	Q	Q	Q

¹ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

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 Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁷ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).



NEPAL

January 24, 2019

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—DEBT SUSTAINABILITY ANALYSIS

Approved By
**Kenneth Kang and
Maria Gonzalez (IMF)
and Lalita Moorty (IDA)**

Prepared by the staffs of the International Monetary Fund and the International Development Association.

Nepal	
Joint Bank-Fund Debt Sustainability Analysis	
Risk of external debt distress	<i>Low</i>
Overall risk of debt distress	<i>Low</i>
Granularity in the risk rating	<i>Not Applicable</i>
Application of judgment	<i>No</i>

Nepal's risk of external debt distress remains low. Under the revised IMF/World Bank Debt Sustainability Analysis Framework for Low Income Countries (LIC-DSF), all debt and debt service ratios are projected to remain below relevant indicative threshold values. Following a prolonged decline, to 25 percent of GDP in mid-2015, the sum of external and domestic public debt rose to 30 percent of GDP in mid-2018. A further rise in total public debt is projected, to about 35 percent of GDP in the medium term and about 42 percent of GDP in the long term, owing to continuing fiscal and current account deficits, as the authorities implement fiscal federalism and aim to put the economy on a higher growth path. Stress tests suggest that debt burden indicators are vulnerable to growth/exports shocks and natural disasters. This underscores the importance of implementing sound macro-economic policies. Efforts to improve the business climate and competitiveness through high-quality public investment and structural reforms would support growth and expand foreign exchange income streams.

PUBLIC DEBT COVERAGE

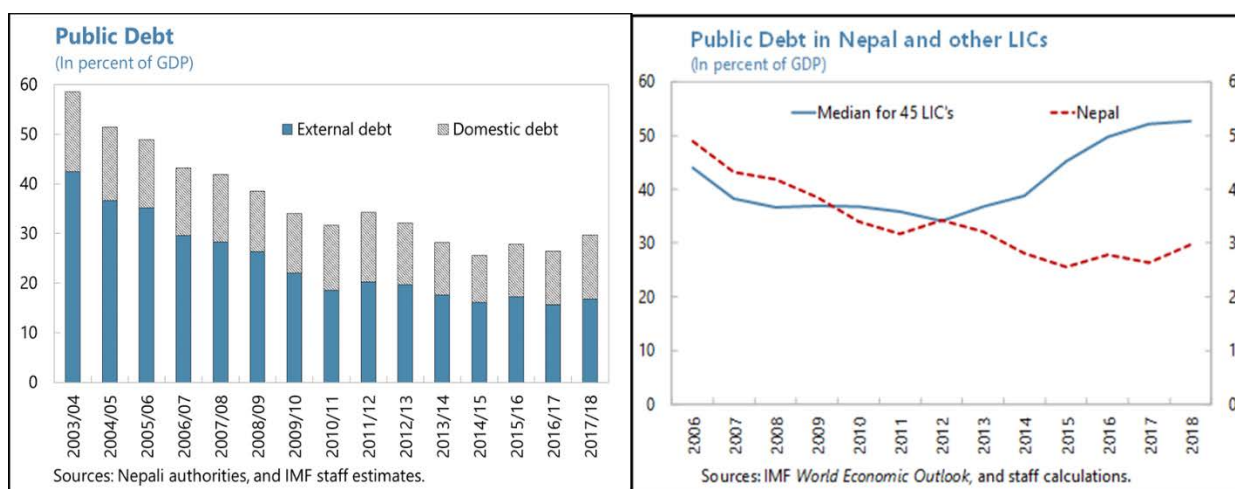
1. Public debt in this analysis includes the central government’s external and domestic debts.

As of mid-July 2018, Nepal’s state and local governments had no debt and the government has not provided any guarantees for debts of state-owned enterprises (SOEs). Furthermore, Nepal’s SOEs had no debt except for funds on-lent to them by the central government (4 percent of GDP in July 2018), which is already included in central government debt. The Nepal Rastra Bank (NRB, Nepal’s central bank) borrowed from the IMF through the Rapid Credit Facility and on-lent the funds (about US\$50 million) to the government.

Subsectors of the public sector		Check box
1	Central government	X
2	State and local government	X
3	Other elements in the general government	X
4	o/w: Social security fund	X
5	o/w: Extra budgetary funds (EBFs)	X
6	Guarantees (to other entities in the public and private sector, including to SOEs)	X
7	Central bank (borrowed on behalf of the government)	X
8	Non-guaranteed SOE debt	X

BACKGROUND ON DEBT

2. As a result of expansionary policies, public debt rose to 30 percent of GDP by mid-2018. The recent rise in the public debt ratio followed a prolonged decline, to 25 percent of GDP in mid-2015. However, even with the recent rise, Nepal’s public debt remains low compared to other low-income countries. The mid-2018 public debt ratio considerably exceeds what was projected in the previous DSA (23 percent of GDP). This reflects the assumed limited scaling up of capital spending due to weak implementation capacity as well as the assumption that the government would finance part of the higher spending by drawing on deposits at the central bank (about 5 percent of GDP in mid-2016). However, these deposits remain substantial (NR 126 billion in mid-2018, equivalent to 4.2 percent of GDP).



3. External public debt amounted to US\$4.8 billion (17.4 percent of GDP) by mid-2018.

Because of the high degree of concessionality, the net present value (PV) of the external debt is estimated at about 13.2 percent of GDP. The bulk of Nepal's external debt was owed to multilateral creditors, (e.g., the Asian Development Bank and the World Bank), whose loans had low interest rates (1 percent on average) and long maturities (26 years on average). Japan was the largest bilateral creditor, followed by China, Korea and India.

Nepal: External Public Debt, at end FY2017/18 1/			
	In millions of US\$	In percent of GDP	In percent of external debt
Total external	4,781	17.4%	100%
Multilateral	4,297	15.7%	90%
AsDB	1,960	7.1%	41%
IDA	2,160	7.9%	45%
Bilateral	484	1.8%	10%
Paris Club	277	1.0%	6%
non-Paris Club	207	0.8%	4%

Source: Nepalese authorities; and IMF staff estimates.
1/ Nepal's fiscal year starts in mid-July. For example, FY2017/18 covers mid-July 2017 to mid-July 2018.

4. Domestic public debt amounted to 13 percent of GDP by mid-2018. About 40 percent of this

is treasury bills with a maturity of up to 1 year (91-day, 182-day, and 364-day treasury bills with broadly similar total outstanding amounts). Medium- to long-term debt comprises mostly development bonds with maturities of 3-15 years and interest rates of 3-6.5 percent per annum.

Nepal: Public Domestic Debt, at end FY2017/18			
	In billions of Nepalese rupees	In percent of GDP	In percent of domestic debt
Total domestic	391	13.0%	100%
Treasury bills	156	5.2%	40%
Treasury bonds	235	7.8%	60%
Development bonds	232	7.7%	59%
Others	3	0.1%	1%

Sources: Nepalese authorities; and IMF staff estimates.

5. No official data is available on signed PPP contracts and private external debt¹. Accordingly, for this debt sustainability analysis, the default magnitude of the contingent liability stress test is used, amounting to 6.8 percent of GDP, which is broken down into PPP projects (1.8 percent of GDP²) and financial market (5 percent of GDP).

- Until recently, the Nepal Oil Corporation (NOC) and the Nepal Electricity Authority (NEA) were the two largest loss-making SOEs of Nepal. However, price adjustments of electricity and petroleum products, alongside improvements in the management of these SOEs have

1 The country's coverage of public debt		The entire public sector, including SOEs		
		Default	Used for the analysis	Reasons for deviations from the default settings
2	Other elements of the general government not captured in 1.	0 percent of GDP	0	
3	SoE's debt (guaranteed and not guaranteed by the government) 1/	2 percent of GDP	0	
4	PPP	35 percent of PPP stock	1.84	
5	Financial market (the default value of 5 percent of GDP is the minimum value)	5 percent of GDP	5	
Total (2+3+4+5) (in percent of GDP)			6.8	

1/ The default shock of 2% of GDP will be triggered for countries whose government-guaranteed debt is not fully captured under the country's public debt definition (1.). Since it is already included in the government debt (1.) and risks associated with SoE's debt not guaranteed by the government is assessed to be negligible, the country team reduces this to 0%.

¹ However, according to the World Bank's PPI database, PPP contracts worth about 5.3 percent of GDP had been signed as of 2015.

² 1.8 percent of GDP = 5.3 percent of GDP (PPP contracts as of 2015) * 35 percent of shock (default setting).

improved the financial results of these SOEs. As of July-2018, the NOC and NEA's debt amounted to about 4 percent of GDP. Their debts are all owed to the government.

- According to the 2014 IMF TA mission on "Reform Options for Public Sector Pension", civil service pension liabilities, which are not included in the debt stock, remain modest and are projected to remain stable over the next decade under the present public pension scheme. Increasing liabilities could be addressed through relevant reforms.

BACKGROUND ON MACRO FORECASTS

6. Growth and inflation: After the sharp slowdown following the 2015 earthquakes and trade disruption, the Nepalese economy has recovered considerably. The economy expanded by 7.9 percent in 2016/17 and 6.3 percent in FY2017/18, aided by reconstruction activity and strong growth of the services sector. Under staff's baseline scenario, which reflects the authorities' established policies, elevated near-term growth (6.5 percent in FY2018/19 and 6.3 percent in FY2019/20) puts substantial pressure on the domestic economy and the current account, implying a need for a marked slowdown later to avoid a balance-of-payments shortfall (Text Table 1). A substantial fiscal deficit over the next two years—most notably driven by a large increase in government spending—and loose credit policy in the pursuit of the authorities' ambitious growth targets (e.g., 8 percent in the FY2018/19 budget), initially lead to a further acceleration of growth. However, the resulting rapid decline in reserves would likely force an abrupt policy tightening from FY2020/21 onward to sustain the exchange rate peg, slowing the expansion of credit, exposing macro-financial risks, and ultimately pushing down growth in the outer years. In the medium-term, growth is expected to average about 5 percent, higher than in the previous DSA by about 1 percentage point, on substantially improved electricity supply after the completion of a large-scale hydropower plant (Upper Tamakoshi) and many other smaller projects. The inflation rate remained stable at 4.2–4.5 percent annually in FY2016/17 and FY2017/18 but is expected to rise to 4.9 percent in FY2018/19

Text Table 1. Macroeconomic Assumptions Underlying The Current and Previous DSA 1/

	Previous DSA			Current DSA					Current vs. Previous	
	2016/17	MT	LT	16/17	17/18	18/19	MT	LT	MT	LT
Real growth (%)	5.5	4.0	3.8	7.9	6.3	6.5	5.1	4.5	1.1	0.7
CPI (period average, %)	6.7	6.9	6.5	4.5	4.2	4.9	5.3	5.0	-1.6	-1.5
Revenues and grants (% GDP)	24.1	24.0	24.4	24.4	25.5	29.2	30.3	30.5	6.3	6.1
Grants (% GDP)	1.8	1.8	1.5	1.2	1.1	1.2	1.4	1.2	-0.4	-0.3
Primary expenditure (% GDP)	26.0	25.3	25.4	27.1	31.5	33.5	31.7	33.0	6.4	7.6
Net acquisition of non-financial assets (% GDP)	6.0	5.7	5.5	7.9	8.9	7.4	6.7	7.2	1.0	1.7
Primary deficit (% GDP)	1.8	1.3	1.7	2.8	6.0	4.3	1.4	2.5	0.1	0.8
Net incurrence of liabilities (% GDP)	-0.3	1.3	1.7	3.2	6.0	4.9	2.7	3.7	1.4	2.0
Net domestic financing (% GDP)	1.8	0.8	1.2	1.9	3.6	1.2	0.4	0.6	-0.4	-0.6
Exports of G&S (y/y growth)	14.8	6.8	6.0	6.1	12.3	11.0	9.1	8.0	2.3	2.0
Imports of G&S (y/y growth)	22.3	7.4	6.1	7.5	35.1	16.2	5.5	5.7	-1.9	-0.4
Remittances (y/y growth)	3.4	5.6	6.0	4.8	10.2	17.6	5.8	4.1	0.2	-1.9
Current account balance (% GDP)	-0.3	-1.8	-1.4	-0.4	-8.2	-9.6	-7.2	-3.5	-5.4	-2.1

Note: MT (medium term) is the average over the next 5 years (2019/20-2023/24), and LT (long term) is the average over the following 7-20 years.

Sources: Nepalese authorities; and IMF staff estimates

1/ Nepal's fiscal year starts in mid-July. For example, FY2018/19 runs from mid-July 2018 to mid-July 2019.

and 6.5 percent in FY2019/20, reflecting strong domestic demand, before easing to 5.3 percent in the medium term.

7. External sector: Until recently, Nepal's large trade deficit was offset by large remittances from overseas workers. However, strong import growth fueled by expansionary macro-economic policies turned the current account balance into a large deficit in FY2017/18 (8.2 percent of GDP) even though remittances have remained resilient (25 percent of GDP in FY2017/18). Export growth has remained sluggish owing to the lack of domestic production facilities and low international competitiveness. In the baseline, the current account deficit is projected to widen this year and next year before policies are tightened from FY2020/21 onwards. The large current account deficit in FY2017/18 did not lead to a commensurate increase in external debt or decline in reserves. This reflects large positive net errors and omissions in the balance of payments (3.8 percent of GDP in FY2017/18). To the extent that these positive net errors and omissions are mainly related to informal transactions not captured in workers' remittances and compensation of employees, Nepal's current account deficit would be over-stated. External borrowing is expected to remain largely concessional. External debt is projected to increase gradually over the projection period, to around 23 percent of GDP by 2020/21 and around 33 percent of GDP by 2038/39.

8. Fiscal: The fiscal policy stance has been expansionary in the last two years. The overall fiscal deficit widened to 6.5 percent of GDP in FY2017/18, due to rising government spending pressure in relation to the rapid transition to fiscal federalism and the expansion of capital spending. Historically, the fiscal balance was at around balanced level, which contributed to the decline in the public debt for the last 10 years. The primary deficit is projected to improve gradually over the medium term. It is projected to be 4.3 percent of GDP in FY2018/19, and to average 1.4 percent of GDP over the medium term.

9. Domestic debt: Public domestic debt is projected to decrease to 10 percent over the medium term and decrease further to 7 percent of GDP in the long term.

10. Realism of the baseline (Figure 4): Cross country experience suggests that the baseline fiscal adjustment of Nepal (4.5 percentage points in 3 years) is rather optimistic as is in the upper quartile of the distribution of past adjustments of the primary fiscal deficit. However, the staffs assess the adjustment to be plausible because of Nepal's track record of low fiscal deficits and surpluses (0.6 percent of primary surplus-to-GDP ratio, 10-year average of 2007–2016). Fiscal multipliers suggest a rather pessimistic growth path compared to the baseline scenario, but the baseline assumes enhanced growth effects from the upcoming completion of large hydro-power plants. Finally, contribution of public capital to GDP growth in the baseline projection is in line with historical experiences.

COUNTRY CLASSIFICATION AND DETERMINATION OF SCENARIO STRESS TESTS

11. Country classification: The new debt sustainability framework for low income countries (LIC-DSA) uses a composite indicator (CI) in capturing the different factors affecting a country's debt carrying capacity. The CI captures the impacts of the different factors through a weighted average of the World Bank's

Country Policy and Institutional Assessment (CPIA) score, the country's real GDP growth, remittances, foreign exchange reserves, and world growth³. The calculation of the CI is based on 10-year averages of the variables, across 5 years of historical data and 5 years of projection. Nepal's CI score is calculated to be 3.24, which lies in the range of *strong* rating.

12. Stress tests: The new LIC-DSF includes stress tests to assess the sensitivity of projected debt burden indicators to changes in assumptions. In this analysis, all stress tests were kept at their default settings (historical average minus one standard deviation, or the baseline projection minus one standard deviation, whichever is lower) with additionally including tailored scenario stress test for Nepal. In order to reflect Nepal's vulnerability to natural disasters, such as the large-scale 2015 earthquakes, the natural disaster shock was applied as one of the stress test. A one-off shock of 10 percentage points of GDP to the debt-to-GDP ratio in the second year (FY2019/20) of the projection period is assumed, and real GDP growth and exports were lowered by 1.5 and 3.5 percentage points, respectively, in the year of the shock for the stress test.

Nepal: Debt Carrying Capacity and Thresholds		
Debt Carrying Capacity		
Final	the current vintage	based on the previous
Strong	Strong 3.24	Strong 3.24
Application thresholds		
External debt burden thresholds		
PV of debt in % of		
Exports		240
GDP		55
Debt service in % of		
Exports		21
GDP		23
Total public debt benchmark		
PV of total public debt in % of GDP		70

EXTERNAL AND PUBLIC SUSTAINABILITY

13. According to the external DSA, Nepal's risk of external debt distress is low. In the baseline scenario, the PV of external debt and debt service ratios are projected to remain stable and do not breach their respective thresholds throughout the projection period. Moreover, the debt and debt service ratios also remain below the thresholds in the stress tests.

14. Nepal's external debt sustainability is projected to be affected mostly by exports. In the stress tests, the most extreme shock is the combination of all shocks (real GDP growth, primary balance, exports, current transfers/FDI flows and national currency depreciation) at half of the magnitude. Among the various shocks, the exports shock affects the PV of debt ratios the most. The natural disaster shock is also important for Nepal.

15. The risk of public debt (external + domestic) distress is also low. Public debt is projected to gradually increase from 30 percent of GDP in mid-2018 to 42 percent of GDP in FY2038/39 under the baseline scenario, but to remain below the 70 percent benchmark. The PV of the debt-to-GDP ratio is projected to remain stable below 30 percent of GDP over the projection period, due mainly to the assumed

³ The details on the methodology can be found in the new LIC-DSF guidance note: <https://www.imf.org/en/Publications/Policy-Papers/Issues/2018/02/14/pp122617guidance-note-on-lic-dsf>

continued concessional nature of external borrowing. The debt service-to-revenue ratio is assessed to be stable over the projection period, and to remain within 10 percent of GDP in 2028/29.

16. Public debt is most vulnerable to a growth shock. A growth shock (1 standard deviation from the baseline) in 2018/19–2019/20 would lead to a rise of the PV of debt-to-GDP ratio to 38 percent of GDP in 2028/29. The debt service-to-revenue ratio would also be affected most by a growth shock, which is calculated to be 14.1 percent in 2028/29.

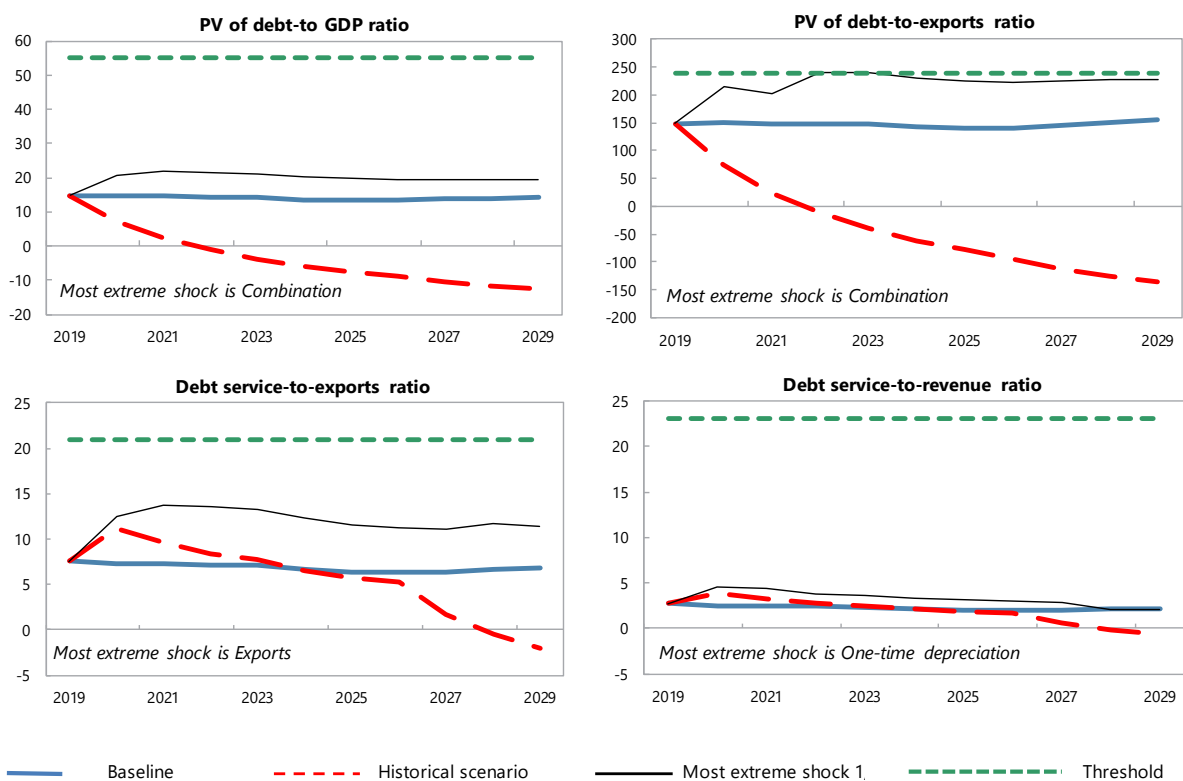
VIEWS OF THE AUTHORITIES

17. The authorities were in broad agreement with the analysis and assessment of DSA. The authorities emphasized that their efforts are mainly focused on achieving the domestic revenue target and mobilizing more concessional external financings, in support of the government objective to achieve higher growth. The authorities also expressed confidence that, even with expansionary macro-economic policies, Nepal would continue to be at a low risk of debt distress.

CONCLUSION

18. Nepal's overall risk of debt distress is low. Both in the baseline scenario and in the stress tests, all debt and debt service indicators remain below the indicative threshold values. On this basis, the staffs assess that Nepal's risk of public debt distress is low. Having said that, key risk factors regarding Nepal's debt sustainability over the projection period are growth and exports shocks, as well as the possible recurrence of natural disasters. The Nepalese government should continue to make efforts to improve domestic productivity through quality public investment in infrastructures and by strengthening natural disaster prevention and preparedness. It is also important to achieve a long-term sustainable growth path by strengthening the macro-economic policy framework and tighten monetary and fiscal policy relative to the expansionary policies of the past two years. Efforts to develop more rigorous analysis on the contingent liabilities should be pursued. Data collection on debts of contingent liabilities from public-private partnerships and external private sector debt would help future debt sustainability analysis. Once the fiscal federalism is fully implemented, it will also be important to compile debt data for state and local governments.

Figure 1. Nepal: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2019–2029



Customization of Default Settings		
	Size	Interactions
Tailored Tests		
Combined CLs	No	
Natural Disasters	No	No
Commodity Prices ^{2/}	n.a.	n.a.
Market Financing	n.a.	n.a.

Note: "Yes" indicates any change to the size or interactions of the default settings for the stress tests. "n.a." indicates that the stress test does not apply.

Borrowing Assumptions for Stress Tests*		
	Default	User defined
Shares of marginal debt		
External PPG MLT debt	100%	
Terms of marginal debt		
Avg. nominal interest rate on new borrowing in USD	0.9%	0.9%
USD Discount rate	5.0%	5.0%
Avg. maturity (incl. grace period)	34	34
Avg. grace period	6	6

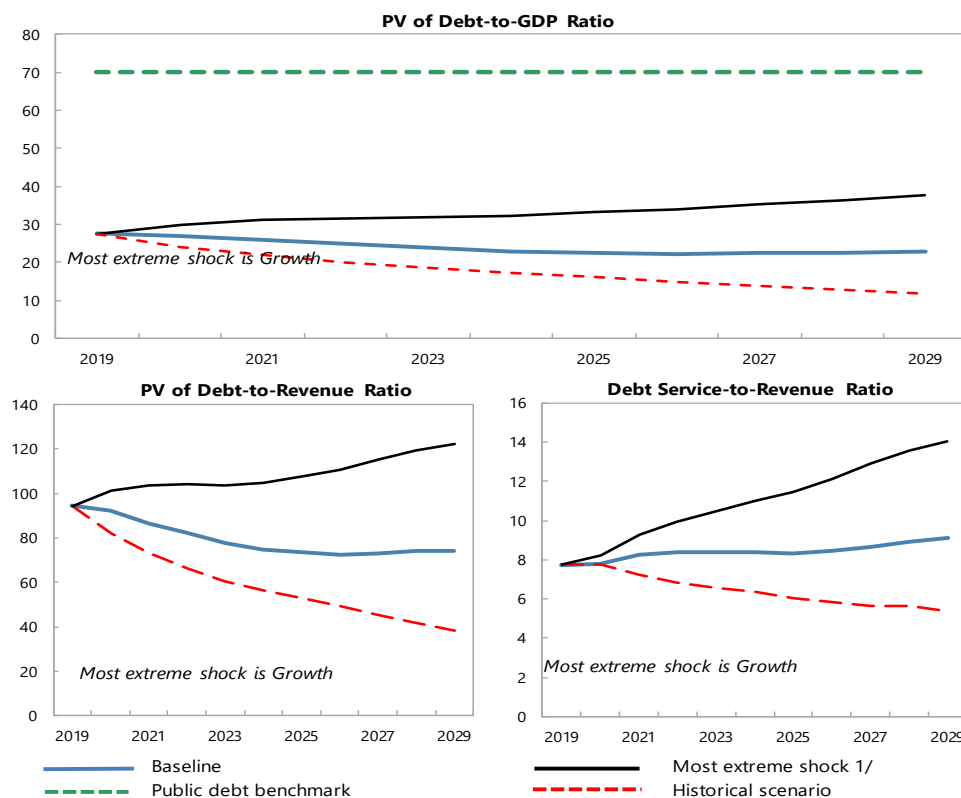
* Note: All the additional financing needs generated by the shocks under the stress tests are assumed to be covered by PPG external MLT debt in the external DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in or before 2029. Stress tests with one-off breaches are also presented (if any), while these one-off breaches are deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most extreme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

2/ The magnitude of shocks used for the commodity price shock stress test are based on the commodity prices outlook prepared by the IMF research department.

Figure 2. Nepal: Indicators of Public Debt under Alternative Scenarios, 2019–2029



Borrowing Assumptions for Stress Tests*	Default	User defined
Shares of marginal debt		
External PPG medium and long-term	59%	59%
Domestic medium and long-term	37%	37%
Domestic short-term	4%	4%
Terms of marginal debt		
External MLT debt		
Avg. nominal interest rate on new borrowing in USD	0.9%	0.9%
Avg. maturity (incl. grace period)	34	34
Avg. grace period	6	6
Domestic MLT debt		
Avg. real interest rate on new borrowing	-1.7%	-1.7%
Avg. maturity (incl. grace period)	7	7
Avg. grace period	1	1
Domestic short-term debt		
Avg. real interest rate	-5%	-5.0%

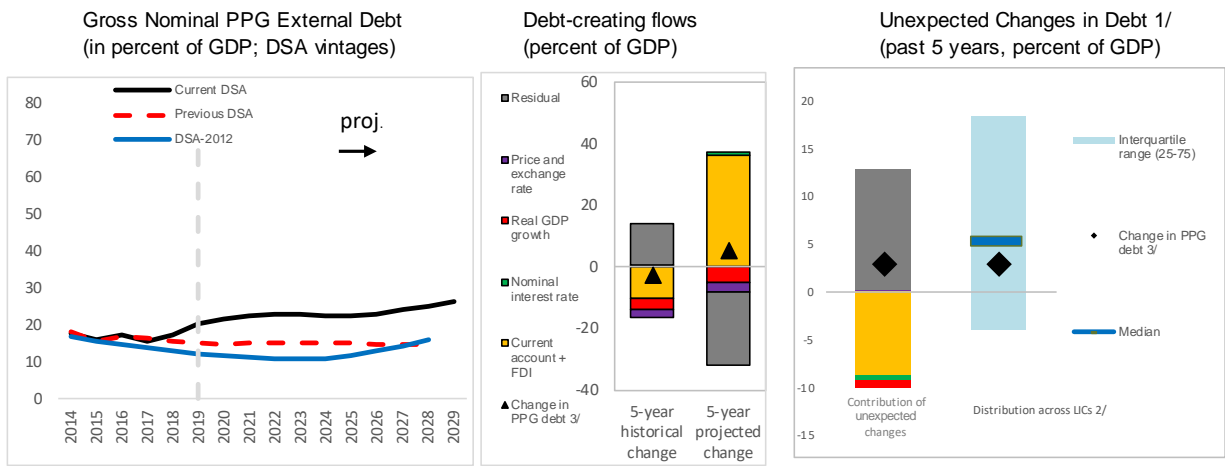
* Note: The public DSA allows for domestic financing to cover the additional financing needs generated by the shocks under the stress tests in the public DSA. Default terms of marginal debt are based on baseline 10-year projections.

Sources: Country authorities; and staff estimates and projections.

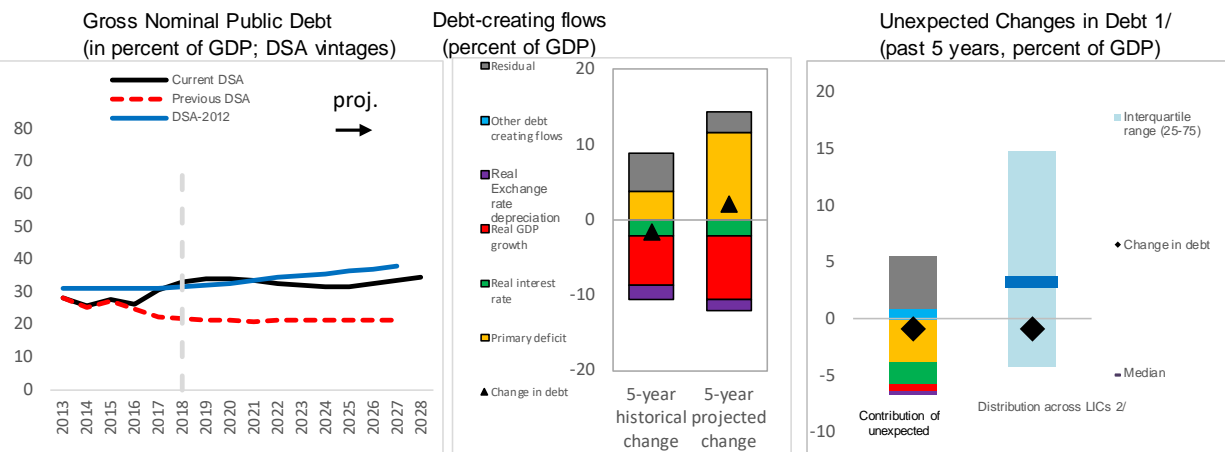
1/ The most extreme stress test is the test that yields the highest ratio in or before 2029. The stress test with a one-off breach is also presented (if any), while the one-off breach is deemed away for mechanical signals. When a stress test with a one-off breach happens to be the most extreme shock even after disregarding the one-off breach, only that stress test (with a one-off breach) would be presented.

Figure 3. Nepal: Drivers of Debt Dynamics – Baseline Scenario

External Debt



Public debt



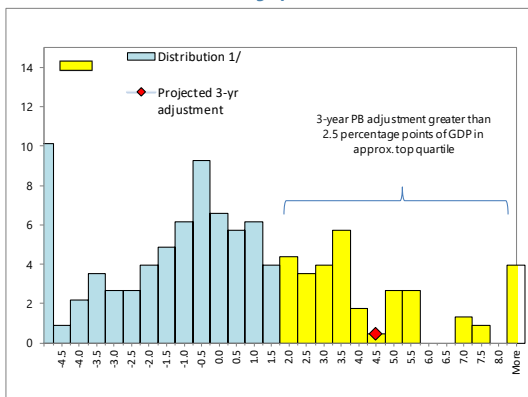
1/ Difference between anticipated and actual contributions on debt ratios.

2/ Distribution across LICs for which LIC DSAs were produced.

3/ Given the relatively low private external debt for average low-income countries, a ppt change in PPG external debt should be largely explained by the drivers of the external debt dynamics equation.

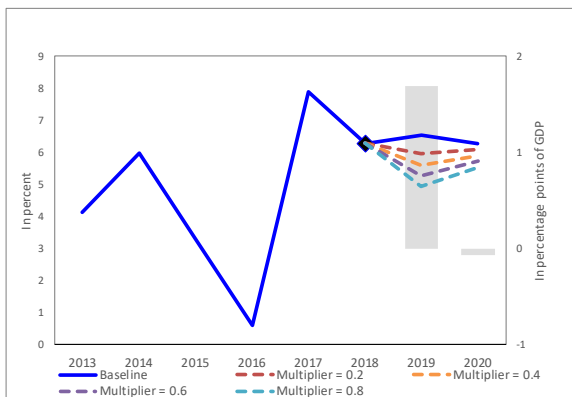
Figure 4. Nepal: Realism Tools

**3-Year Adjustment in Primary Balance
(Percentage points of GDP)**



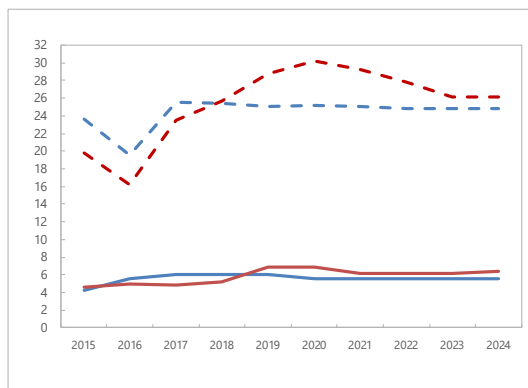
1/ Data cover Fund-supported programs for LICs (excluding emergency financing) approved since 1990. The size of 3-year adjustment from program inception is found on the horizontal axis; the percent of sample is found on the vertical axis.

Fiscal Adjustment and Possible Growth Paths 1/



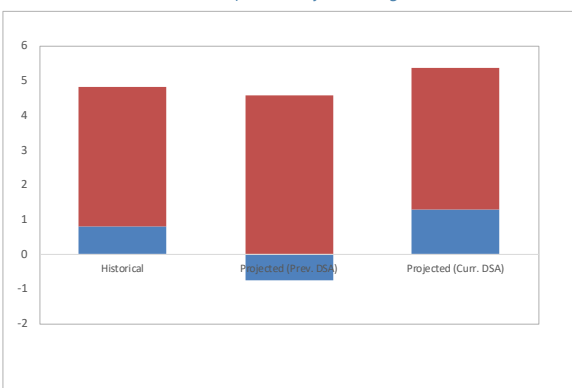
1/ Bars refer to annual projected fiscal adjustment (right-hand side scale) and lines show possible real GDP growth paths under different fiscal multipliers (left-hand side scale).

**Public and Private Investment Rates
(% of GDP)**



— Gov. Invest. - Prev. DSA — Gov. Invest. - Current DSA
 - - - Priv. Invest. - Prev. DSA - - - Priv. Invest. - Current DSA

**Contribution to Real GDP growth
(percent, 5-year average)**



■ Contribution of other factors
 ■ Contribution of government capital

Table 1. Nepal: External Debt Sustainability Framework, Baseline Scenario, 2018–2039
(In percent of GDP, unless otherwise indicated)

	Actual	Projections								Average 8/	
	2018	2019	2020	2021	2022	2023	2024	2029	2039	Historical	Projections
External debt (nominal) 1/	17.4	20.2	21.8	22.5	23.0	23.0	22.5	26.3	34.7	19.9	23.1
of which: public and publicly guaranteed (PPG)	17.4	20.2	21.8	22.5	23.0	23.0	22.5	26.3	34.7	19.9	23.1
Change in external debt	1.8	2.8	1.5	0.7	0.5	0.0	-0.5	1.1	0.6		
Identified net debt-creating flows	5.4	7.4	10.3	7.1	4.5	3.0	2.3	1.8	0.0	-3.7	4.0
Non-interest current account deficit	8.0	9.5	12.4	9.0	6.4	5.0	4.4	4.0	2.6	-1.8	6.1
Deficit in balance of goods and services	37.6	44.0	45.0	41.1	38.0	35.6	33.9	28.8	16.0	28.4	35.5
Exports	9.0	9.9	9.8	9.7	9.7	9.4	9.5	9.2	9.0		
Imports	46.6	53.9	54.7	50.9	47.8	45.0	43.4	38.0	24.9		
Net current transfers (negative = inflow)	-28.7	-33.1	-31.3	-30.8	-30.2	-29.2	-28.1	-23.3	-16.6	-28.9	-28.0
of which: official	-1.0	-1.2	-1.2	-1.5	-1.5	-1.4	-1.4	-1.2	-1.2		
Other current account flows (negative = net inflow)	-0.9	-1.4	-1.4	-1.4	-1.4	-1.4	-1.4	-1.4	3.2	-1.3	-1.4
Net FDI (negative = inflow)	-0.6	-1.1	-1.1	-1.1	-1.1	-1.1	-1.2	-1.4	-1.4	-0.4	-1.2
Endogenous debt dynamics 2/	-2.0	-1.0	-1.0	-0.7	-0.8	-0.9	-0.9	-0.9	-1.2		
Contribution from nominal interest rate	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2		
Contribution from real GDP growth	-0.9	-1.1	-1.1	-0.9	-0.9	-1.1	-1.1	-1.0	-1.4		
Contribution from price and exchange rate changes	-1.3	...	...	...	...	...	...	...	...
Residual 3/	-3.7	-4.6	-8.7	-6.4	-4.0	-3.0	-2.8	-0.7	0.6	2.4	-3.2
of which: exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Sustainability indicators											
PV of PPG external debt-to-GDP ratio	13.2	14.8	14.6	14.5	14.4	14.0	13.6	14.3	14.7		
PV of PPG external debt-to-exports ratio	147.3	148.5	149.7	148.9	147.5	148.8	142.4	155.4	163.8		
PPG debt service-to-exports ratio	8.7	7.6	7.3	7.3	7.1	7.2	6.7	6.8	7.7		
PPG debt service-to-revenue ratio	3.2	2.7	2.5	2.5	2.4	2.3	2.2	2.1	2.4		
Gross external financing need (Million of U.S. dollars)	2352.6	2640.6	3953.9	3091.9	2352.5	1944.1	1800.0	2313.4	3154.8		
Key macroeconomic assumptions											
Real GDP growth (in percent)	6.3	6.5	6.3	4.5	4.5	5.0	5.0	4.5	4.5	4.6	4.9
GDP deflator in US dollar terms (change in percent)	9.0	-5.8	7.5	4.5	4.1	4.0	3.8	4.0	4.0	4.2	3.4
Effective interest rate (percent) 4/	1.4	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.6	1.0	0.8
Growth of exports of G&S (US dollar terms, in percent)	14.4	11.0	12.2	9.0	8.7	5.7	10.0	8.2	8.5	6.0	8.7
Growth of imports of G&S (US dollar terms, in percent)	25.6	16.2	16.0	1.4	2.2	3.0	5.0	5.6	-11.5	13.6	6.6
Grant element of new public sector borrowing (in percent)	...	50.7	50.6	50.8	50.8	50.7	50.7	50.9	51.1	...	50.8
Government revenues (excluding grants, in percent of GDP)	24.3	28.0	28.2	28.5	28.8	29.2	29.4	29.4	29.1	18.3	29.0
Aid flows (in Million of US dollars) 5/	329.6	1011.3	1171.4	1126.6	1161.0	1161.7	1127.0	2093.3	3995.8		
Grant-equivalent financing (in percent of GDP) 6/	...	2.9	2.5	3.0	2.8	2.7	2.6	2.4	2.4	...	2.6
Grant-equivalent financing (in percent of external financing) 6/	...	63.9	66.4	67.0	67.8	69.1	69.7	67.5	67.5	...	67.3
Nominal GDP (Million of US dollars)	28,812	28,922	33,035	36,067	39,234	42,825	46,664	70,484	161,726		
Nominal dollar GDP growth	15.8	0.4	14.2	9.2	8.8	9.2	9.0	8.7	8.7	9.0	8.5
Memorandum items:											
PV of external debt 7/	13.2	14.8	14.6	14.5	14.4	14.0	13.6	14.3	14.7		
In percent of exports	147.3	148.5	149.7	148.9	147.5	148.8	142.4	155.4	163.8		
Total external debt service-to-exports ratio	8.7	7.6	7.3	7.3	7.1	7.2	6.7	6.8	7.7		
PV of PPG external debt (in Million of US dollars)	3817.0	4150.0	4433.6	4832.2	5226.9	5603.3	6003.8	9236.3	21758.9		
(Pvt-Pvt-1)/GDPt-1 (in percent)	...	1.2	1.0	1.2	1.1	1.0	0.9	1.1	1.2		
Non-interest current account deficit that stabilizes debt ratio	6.2	6.7	10.8	8.2	5.9	5.0	4.8	2.9	2.0		

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - p(1+g)] / (1+g+p+g)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and p = 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.

The large residuals in 2019 and 2020 are mainly related to the drawdowns of foreign exchange reserves (-3.0 percent and -5.6 percent of GDP, respectively, for 2019 and 2020).

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

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

6/ 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).

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

8/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Definition of external/domestic debt	Currency-based
Is there a material difference between the two criteria?	No

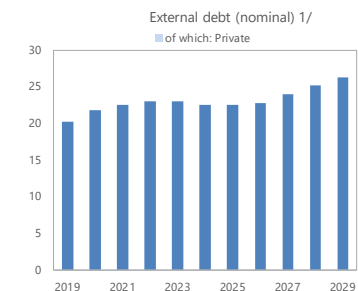
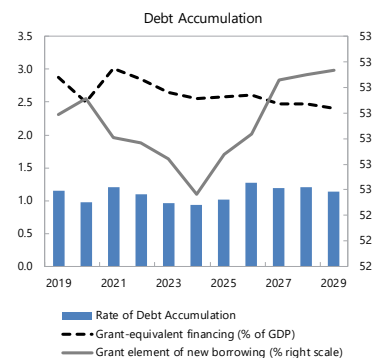


Table 2. Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2018–2039

(In percent of GDP, unless otherwise indicated)

	Actual		Projections							Average 6/	
	2018	2019	2020	2021	2022	2023	2024	2029	2039	Historical	Projections
Public sector debt 1/	30.4	33.1	34.1	33.8	33.5	32.6	31.9	34.5	41.8	31.7	33.0
of which: external debt	17.4	20.2	21.8	22.5	23.0	23.0	22.5	26.3	34.7	19.9	23.1
Change in public sector debt	4.0	2.6	1.0	-0.3	-0.4	-0.8	-0.8	0.9	0.5		
Identified debt-creating flows	4.3	2.6	1.1	-1.2	-1.3	-1.7	-1.7	0.1	-0.1	-2.2	-0.3
Primary deficit	6.0	4.3	4.4	1.2	1.1	0.7	0.7	2.4	2.7	0.3	2.0
Revenue and grants	25.5	29.2	29.4	29.9	30.2	30.6	30.8	30.6	30.3	20.5	30.3
of which: grants	1.1	1.2	1.2	1.5	1.5	1.4	1.4	1.2	1.2	20.8	32.2
Primary (noninterest) expenditure	31.5	33.5	33.7	31.2	31.3	31.3	31.5	33.0	33.0		
Automatic debt dynamics	-1.7	-1.7	-3.3	-2.5	-2.3	-2.4	-2.3	-2.3	-2.8		
Contribution from interest rate/growth differential	-1.9	-2.1	-2.5	-2.0	-1.9	-2.0	-2.0	-1.9	-2.3		
of which: contribution from average real interest rate	-0.3	-0.3	-0.5	-0.5	-0.4	-0.4	-0.4	-0.4	-0.5		
of which: contribution from real GDP growth	-1.6	-1.9	-1.9	-1.5	-1.4	-1.6	-1.6	-1.5	-1.8		
Contribution from real exchange rate depreciation	0.2	...	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Recognition of contingent liabilities (e.g., bank recapitalization)	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		
Other debt creating or reducing flow (please specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual	-0.2	0.5	-0.8	0.4	0.5	0.5	0.5	0.4	0.2	0.9	0.3
Sustainability indicators											
PV of public debt-to-GDP ratio 2/	26.9	27.6	27.1	26.0	25.0	23.8	23.0	22.7	22.0		
PV of public debt-to-revenue and grants ratio	105.6	94.6	92.3	86.7	82.6	77.8	74.6	74.1	72.4		
Debt service-to-revenue and grants ratio 3/	4.7	7.8	7.8	8.3	8.4	8.4	8.4	9.1	7.7		
Gross financing need 4/	7.2	6.6	6.7	3.7	3.6	3.3	3.2	5.2	5.0		
Key macroeconomic and fiscal assumptions											
Real GDP growth (in percent)	6.3	6.5	6.3	4.5	4.5	5.0	5.0	4.5	4.5	4.6	4.9
Average nominal interest rate on external debt (in percent)	1.3	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.7	1.0	0.8
Average real interest rate on domestic debt (in percent)	-2.5	-0.9	-2.4	-2.1	-1.8	-1.6	-1.5	-1.7	-1.4	-3.8	-1.7
Real exchange rate depreciation (in percent, + indicates depreciation)	1.1	...	...	...	...	...	...	...	...	-1.9	...
Inflation rate (GDP deflator, in percent)	7.1	4.9	6.5	6.2	5.7	5.5	5.3	5.5	5.5	9.0	5.6
Growth of real primary spending (deflated by GDP deflator, in percent)	23.3	13.3	7.1	-3.4	4.8	5.1	5.6	5.1	4.5	13.7	5.4
Primary deficit that stabilizes the debt-to-GDP ratio 5/	1.9	1.7	3.3	1.5	1.4	1.5	1.4	1.5	2.2	0.7	1.6
PV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		

Sources: Country authorities; and staff estimates and projections.

1/ Coverage of debt: The entire public sector, including SOEs. Definition of external debt is Currency-based.

2/ The underlying PV of external debt-to-GDP ratio under the public DSA differs from the external DSA with the size of differences depending on exchange rates projections.

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

4/ 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 and other debt creating/reducing flows.

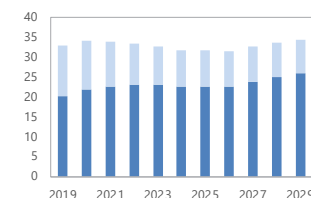
5/ Defined as a primary deficit minus a change in the public debt-to-GDP ratio (-): a primary surplus, which would stabilize the debt ratio only in the year in question.

6/ Historical averages are generally derived over the past 10 years, subject to data availability, whereas projections averages are over the first year of projection and the next 10 years.

Definition of external/domestic debt	Currency-based
Is there a material difference between the two criteria?	No

Public sector debt 1/

■ of which: local-currency denominated
■ of which: foreign-currency denominated



■ of which: held by residents
■ of which: held by non-residents

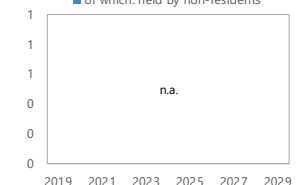


Table 3. Nepal: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2019–2029
(In percent)

	Projections										
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
PV of debt-to-GDP ratio											
Baseline	14.8	14.6	14.5	14.4	14.0	13.6	13.4	13.2	13.6	14.0	14.3
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2039 1/	14.8	7.2	2.4	-1.1	-3.7	-5.9	-7.4	-9.0	-10.5	-11.6	-12.4
B. Bound Tests											
B1. Real GDP growth	14.8	14.2	14.6	14.5	14.3	14.0	14.0	14.1	14.2	14.3	14.3
B2. Primary balance	14.8	15.4	16.1	15.9	15.6	15.2	15.0	14.9	15.3	15.6	15.8
B3. Exports	14.8	14.2	15.4	15.2	14.9	14.6	14.5	14.6	14.6	14.5	14.4
B4. Other flows 2/	14.8	17.1	20.4	20.0	19.5	19.0	18.7	18.6	18.3	17.9	17.5
B5. One-time 30 percent nominal depreciation	14.8	16.7	10.5	10.7	10.6	10.6	10.8	11.2	11.4	12.0	12.4
B6. Combination of B1-B5	14.8	20.6	21.9	21.5	20.9	20.1	19.7	19.4	19.4	19.4	19.4
C. Tailored Tests											
C1. Combined contingent liabilities	14.8	16.6	16.5	16.4	16.1	15.7	15.5	15.4	15.8	16.1	16.4
C2. Natural disaster	14.8	17.9	17.9	18.0	17.8	17.5	17.5	17.5	18.0	18.4	18.8
Threshold	55	55	55	55	55	55	55	55	55	55	55
PV of debt-to-exports ratio											
Baseline	148.5	149.7	148.9	147.5	148.8	142.4	141.4	141.1	146.4	151.0	155.4
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2039 1/	148.5	73.6	24.3	-10.8	-39.4	-62.3	-78.6	-96.3	-112.4	-124.6	-134.5
B. Bound Tests											
B1. Real GDP growth	148.5	137.4	137.5	136.7	138.7	135.1	135.5	138.2	139.9	141.2	142.0
B2. Primary balance	148.5	157.6	164.8	163.7	165.8	159.4	158.7	158.8	164.1	168.1	171.7
B3. Exports	148.5	169.6	209.3	207.3	209.5	203.4	203.2	206.0	207.2	207.2	206.5
B4. Other flows 2/	148.5	175.5	209.4	205.7	206.6	199.4	197.8	198.4	196.6	193.0	189.1
B5. One-time 30 percent nominal depreciation	148.5	137.4	86.6	88.0	90.7	89.6	91.5	95.6	98.7	103.7	107.7
B6. Combination of B1-B5	148.5	214.8	202.9	239.2	239.9	228.9	225.9	223.7	226.1	227.2	228.4
C. Tailored Tests											
C1. Combined contingent liabilities	148.5	170.4	169.8	168.8	171.1	164.6	164.1	164.1	169.7	173.8	177.7
C2. Natural disaster	148.5	186.6	187.3	187.8	192.0	186.7	187.8	189.5	196.9	202.4	207.7
Threshold	240	240	240	240	240	240	240	240	240	240	240
Debt service-to-exports ratio											
Baseline	7.6	7.3	7.3	7.1	7.2	6.7	6.3	6.4	6.4	6.6	6.8
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2039 1/	7.6	11.1	9.6	8.4	7.7	6.6	5.7	5.2	1.8	-0.5	-2.0
B. Bound Tests											
B1. Real GDP growth	7.6	10.6	10.2	9.8	9.7	8.9	8.4	8.2	7.8	7.8	7.7
B2. Primary balance	7.6	7.3	7.5	7.4	7.4	7.0	6.6	6.6	7.0	7.5	7.7
B3. Exports	7.6	12.4	13.7	13.5	13.3	12.3	11.6	11.2	11.1	11.7	11.5
B4. Other flows 2/	7.6	10.6	10.8	11.0	10.8	9.9	9.4	9.0	10.2	11.5	11.1
B5. One-time 30 percent nominal depreciation	7.6	10.6	10.2	9.0	8.9	8.2	7.7	7.5	7.2	5.1	5.2
B6. Combination of B1-B5	7.6	11.8	13.1	12.8	12.6	11.6	10.9	10.6	12.3	12.6	12.2
C. Tailored Tests											
C1. Combined contingent liabilities	7.6	7.3	7.7	7.5	7.5	7.0	6.7	6.7	6.7	6.9	7.1
C2. Natural disaster	7.6	7.5	8.1	7.9	8.0	7.5	7.1	7.2	7.2	7.5	7.7
Threshold	21	21	21	21	21	21	21	21	21	21	21
Debt service-to-revenue ratio											
Baseline	2.7	2.5	2.5	2.4	2.3	2.2	2.0	2.0	2.0	2.1	2.1
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2039 1/	2.7	3.9	3.3	2.8	2.5	2.1	1.8	1.7	0.6	-0.1	-0.6
B. Bound Tests											
B1. Real GDP growth	2.7	3.9	3.8	3.6	3.4	3.2	3.0	2.8	2.7	2.7	2.6
B2. Primary balance	2.7	2.5	2.6	2.5	2.4	2.3	2.1	2.1	2.2	2.4	2.4
B3. Exports	2.7	3.7	3.6	3.5	3.3	3.0	2.8	2.7	2.7	2.8	2.7
B4. Other flows 2/	2.7	3.7	3.7	3.7	3.5	3.2	3.0	2.9	3.2	3.6	3.5
B5. One-time 30 percent nominal depreciation	2.7	4.6	4.3	3.8	3.6	3.3	3.1	3.0	2.9	2.0	2.0
B6. Combination of B1-B5	2.7	4.0	4.1	4.0	3.8	3.5	3.3	3.1	3.6	3.7	3.5
C. Tailored Tests											
C1. Combined contingent liabilities	2.7	2.5	2.6	2.5	2.4	2.3	2.1	2.1	2.1	2.2	2.2
C2. Natural disaster	2.7	2.5	2.7	2.6	2.5	2.4	2.2	2.2	2.2	2.3	2.3
Threshold	23	23	23	23	23	23	23	23	23	23	23

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Includes official and private transfers and FDI.

Table 4. Nepal: Sensitivity Analysis for Key Indicators of Public Debt, 2019–2029

	Projections										
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
PV of Debt-to-GDP Ratio											
Baseline	27.6	27.1	26.0	25.0	23.8	23.0	22.6	22.2	22.4	22.5	22.7
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2039 1/	28	24	22	20	18	17	16	15	14	13	12
B. Bound Tests											
B1. Real GDP growth	28	30	31	32	32	32	33	34	35	36	38
B2. Primary balance	28	29	30	28	27	26	25	25	25	25	25
B3. Exports	28	28	28	27	26	25	24	24	24	24	24
B4. Other flows 2/	28	31	33	32	30	29	29	28	28	27	27
B5. One-time 30 percent nominal depreciation	28	29	25	23	21	19	17	16	15	14	13
B6. Combination of B1-B5	28	28	27	25	23	23	22	22	22	22	22
C. Tailored Tests											
C1. Combined contingent liabilities	28	32	30	29	28	26	26	25	25	25	25
C2. Natural disaster	28	35	33	32	31	30	29	28	28	29	29
Public debt benchmark	70	70	70	70	70	70	70	70	70	70	70
PV of Debt-to-Revenue Ratio											
Baseline	94.6	92.3	86.7	82.6	77.8	74.6	73.4	72.7	73.3	73.9	74.1
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2039 1/	95	82	73	66	61	56	53	49	46	42	38
B. Bound Tests											
B1. Real GDP growth	95	101	104	104	104	105	108	111	115	119	122
B2. Primary balance	95	99	99	93	88	84	82	80	80	81	80
B3. Exports	95	95	93	89	84	80	79	78	78	78	78
B4. Other flows 2/	95	105	110	105	99	95	93	91	91	90	88
B5. One-time 30 percent nominal depreciation	95	98	85	76	68	62	57	53	49	46	42
B6. Combination of B1-B5	95	96	90	81	77	73	72	71	72	73	73
C. Tailored Tests											
C1. Combined contingent liabilities	95	109	102	96	90	86	84	82	82	82	82
C2. Natural disaster	95	118	112	106	100	96	94	93	93	94	94
Debt Service-to-Revenue Ratio											
Baseline	7.8	7.8	8.3	8.4	8.4	8.4	8.3	8.4	8.6	8.9	9.1
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2019-2039 1/	8	8	7	7	7	6	6	6	6	6	5
B. Bound Tests											
B1. Real GDP growth	8	8	9	10	10	11	11	12	13	14	14
B2. Primary balance	8	8	9	9	10	10	9	9	10	10	10
B3. Exports	8	8	8	8	8	9	8	9	9	9	9
B4. Other flows 2/	8	8	8	9	9	9	9	9	9	10	10
B5. One-time 30 percent nominal depreciation	8	8	9	8	8	8	8	8	8	8	8
B6. Combination of B1-B5	8	8	8	8	8	8	8	8	9	9	9
C. Tailored Tests											
C1. Combined contingent liabilities	8	8	10	10	10	10	10	10	10	9	10
C2. Natural disaster	8	8	10	11	11	11	11	11	11	10	11

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, GDP deflator and primary deficit in percent of GDP.

2/ Includes official and private transfers and FDI.

**Statement by Juda Agung, Executive Director for Nepal and
Ranjana Pandit, Advisor to Executive Director
February 8, 2019**

On behalf of the Nepalese authorities, we would like to express our appreciation to the International Monetary Fund mission team for the constructive discussion and policy dialogue during the 2018 Article IV consultation. The authorities acknowledge the staff's constructive report and broadly concur with the policy recommendations.

Recent Economic Developments and Outlook

Nepal has recently transitioned into the federal government system with successful completion of 3 tiers of election and established federal, state and local level governments. With a strong political mandate, the present government has been creating conducive environment, advancing its reform agenda and boosting investment activities to foster high, sustainable and inclusive growth, while at the same time maintaining socio-economic stability.

Following an extended period of repressed growth, economic activity has now rebounded. Real GDP growth stood at 6.3 percent in fiscal year 2017/18 and is projected to remain at around 8 percent in current fiscal year 2018/19. Our authorities are more optimistic regarding the near and medium-term growth outlook targeting to reach double digit growth, underpinned by acceleration in reconstruction activities, substantial structural changes, initiatives to improve the investment climate, and accommodative fiscal and monetary policy. They underscored that stronger growth is critical to alleviate poverty and achieve the sustainable development goals (SDGs) and graduate to the middle-income country status by 2030.

Inflation has remained subdued in the last two years. Average annual inflation moderated to 4.2 percent in fiscal year 2017/18, down from 4.5 percent a year earlier. The average overall inflation rate stood at 4.1 percent as of mid-December 2018 with food and non-food inflation remaining at 0.5 percent and 6.3 percent respectively. Subdued inflation is largely due to low inflation in India, ease in the supply of goods and rise in agriculture output.

On external sector front, the overall BOP recorded a deficit of 1.1 million dollars at the end of fiscal year 2017/18 and widened to 750 million dollars in mid-December of 2018. The widening deficit was mainly driven by imports of construction materials and capital goods for post-earthquake reconstruction activities and is expected to decline when reconstruction is completed. The authorities have undertaken measures to curtail non-priority imports to ease the pressure in the external sector. The authorities highlighted that the level of foreign exchange reserves remains comfortable and is adequate to cover imports of merchandise goods and services for 7.8 months. In addition, remittance inflows are expected to remain strong due mainly to government efforts to control informal trade and financial transactions as well as other effective measures including improved customs management.

Fiscal Policy and Management

The authorities welcome the joint World Bank/IMF Debt Sustainability Analysis, which assesses that the risk of debt distress in Nepal remains low. This is supported by prudent fiscal policies and debt management over the years. The authorities are very much aware of the growing fiscal deficit, but stress that the transition to fiscal federalism and the pickup of reconstruction activities necessitated an increase in government spending. Our authorities expect that the fiscal deficits will normalize and will not be expanded excessively once resources and responsibilities to local and state government are fixed.

The authorities highlight that the fiscal federalism is working smoothly even within the first 6 month of the first federal budget in Nepal. There is a rule-based and transparent fiscal transfer and revenue sharing mechanism in place. The authorities emphasize that the setting

up of the local consolidated funds would help monitor financial transactions of sub-national governments. Medium-term expenditure framework which would provide for a more transparent and comprehensive fiscal policy framework will be set up at all levels of governments.

Government revenue collection remains encouraging as the growth of revenue exceeded 26 percent in the first six months of this fiscal year compared to an average growth of 20 percent in the last decade. Our authorities highlight the important efforts that have been made to reform revenue administration. These include measures to increase revenue collection such as improvement of the tax system, a strategic plan for inland revenue management, reforms to customs valuation and customs control through customs risk management, adoption of e- payment system, set up of a revenue board, and further strengthening of revenue administration, zero tolerance in revenue leakage activities, among others.

A Public Expenditure Review Commission has been established to review public financial management. Currently, the Commission is reviewing the ongoing development projects and their evaluation, investment procedure, program budgeting framework and integrated social security system as well as the fiscal rule.

Monetary, Exchange Rate and Financial Sector

The authorities are of the view that the current monetary policy stance is appropriate, with the objective of maintaining price and external sector stability while facilitating high and sustainable economic growth. The real interest rate on deposits is positive as the average deposit rate has consistently remained above 6 percent while inflation has been averaging about 4 percent in recent times. The authorities concur with staff's assessment that the peg to the Indian rupee continues to serve as a transparent nominal anchor.

As staff raised concerns about recent credit growth and its possible impact for stability, the authorities underscore that they continue to ensure that credit growth will remain conducive for supporting growth while at the same time it is not excessive and is sound. The authorities also continue to closely monitor the expansion of credit at the sectoral level, to ensure it is predominantly concentrated in productive and priority sectors.

The financial sector remains sound and transparent, with adequate capital and low non-performing loans (1.6 percent in mid-July 2018). Various macro prudential measures such

as CCD ratio, limits on real estate exposures, CRR as well as Loan to Value (LTV) ratio on car loan have been put in place to maintain financial soundness. Risk based supervision practices have been revised into risk profile of full scope and targeted supervision modality to examine the different risk categories to make the financial sector safer.

The authorities largely agree with staff for the necessary reform to financial sector oversight and stress that the implementation of recommendations from the 2017 Article IV consultation, the 2014 FSAP reform efforts along with safeguarding recommendations from the 2016 assessment will continue.

On the financial inclusion front, Nepal Rastra Bank (NRB) has launched the Financial Inclusion Action Plan and introduced various directives and guidelines to the micro finance institutions working in the rural areas. Substantial progress has been made by the bank in financial inclusion complimented by mobile banking, internet banking. Provision has been made to reach at least one commercial bank branch in each local administrative unit, currently 703 bank's branches have been established out of 753 local levels as of mid-January 2018. Our authorities acknowledge the staff's suggestion on directed credit provision; however, they confirm that the provision of directed credit and priority sector lending is quite small in size and serves to avail bank credit to the ultra-poor segment of the society, inaccessible people and critically important areas.

Structural Reform and Sustainable Growth

Transformation of the agricultural sector from manual to technological and equipment based, hydro power generation, boosting tourism sector, performance of SMEs and revive of construction sector are key areas of priority to promote high and sustainable economic growth. Under the political stability, our authorities are now concentrating on creating more employment opportunities, accelerating economic reforms, and promoting inclusive growth while enhancing the business environment for investment.

Our authorities note staffs' concern on corruption and lack of governance which can be one of the most problematic factors for doing business, after having infrastructure development and political stability. They are committed to zero tolerance on corruption. For the governance issues, a code of conduct for staff and close monitoring system has been established. The authorities also want to highlight that the government has emphasized the transparency, accountability and rule-based decision making procedure. The authorities are also working on revising the public procurement law to make it more transparent and competitive through the better use of IT on public procurement process.

International Investment Summit in March 2019 and Celebrating Visit Nepal Year 2020

Our authorities highlight that the effort of continuous improvement in investment climate in Nepal has been initiated through revisions of investment related laws and regulations, procedural simplification of FDI and reform in governance. They have already amended the labor law to make it business friendly. They are now targeting to complete the amendment of more than three dozen of investment-related laws including Foreign Investment Technology and Transfer Act (FITTA), Public Private Partnership (PPP) Act, Procurement Act and Investment Board of Nepal Act by next month. With this development, our authorities plan to hold an **International Investment Summit in March 2019**. This will be an excellent avenue for them to share the long awaited political stability that Nepal has gained for encouraging business environment and explore investment prospects in Nepal. Likewise, the government has announced the year **2020 as the Visit Nepal Year** with targeting two million tourists.

AML/CFT

Our authorities put a top priority to implement the AML/CFT measures by internalizing it as a part of good governance and bringing them in line with international standards. With the successful implementation of the first AML/CFT National Strategy and Action Plan, the authorities have completed the AML/CFT self-assessment and are in the process of finalizing the second AML/CFT National Strategy and Action Plan for 2019 to 2024.

Capacity Development

Our authorities express their appreciation to the Fund for the continued support to enhance their technical capacity in various areas including fiscal, monetary, legal and financial statistics. However, technical capacity enhancement remains critical during the changed environment. The authorities urge technical support for strengthening fiscal and financial information system at the sub-national level. They also highlight the need for enhancing technical capacity to revisit and rebase the national GDP and disaggregate it up to sub national level.

Final Remarks

Finally, our authorities would like to thank the Fund for the successful conclusion of the Article IV consultation in Nepal. The authorities express their gratitude to the Fund for the continued support in terms of policy advice and technical assistance as well as to the donor community for their continued assistance and support to Nepal. The authorities look forward to continuing discussions with the Fund on macroeconomic and financial sector policies including structural reforms.