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Nepal—Assessment Letter for the Asian Development Bank September 21, 2022

This letter provides the IMF staff's assessment of Nepal's recent economic developments, outlook, and economic policies based on available information as of August 31, 2022. The assessment was requested by the Asian Development Bank (ADB) for a policy based loan (PBL) to be considered by the ADB's Executive Board. This letter may be published by the ADB if the authorities consent.

Recent Developments

- 1. Economic activity strengthened and inflation increased in FY2021/22.** Nepal's post-COVID economic recovery continues notwithstanding ongoing global supply and commodity price shocks. Real GDP growth is estimated at 4.2 percent in FY2021/22 (same as FY2020/21). This recovery is supported by a successful vaccination campaign and the reopening of the economy, strong domestic demand, accommodative policies, a gradual recovery in tourism and sustained remittances. However, the increase in domestic demand and the impact of the war in Ukraine on commodity prices (especially oil) has driven a sharp increase in inflation from 4.2 percent in FY2020/21 to 8.1 percent in July 2022.
- 2. Imports have been strong, and the current account weakened substantially.** As demand recovered and imports surged in FY2021/22, the current account improvement in the previous year—due to strong remittances and a collapse of imports during the pandemic—reversed. More recently, commodity price shocks due to the war in Ukraine are impacting Nepal's import reliant economy and exacerbating external imbalances. While exports have also increased, they remain an order of magnitude smaller than imports. Tourism flows have remained well below pre-pandemic levels, and remittances have provided less support than in previous years. The authorities introduced import bans on vehicles and selected luxury goods in April 2022 to stem external pressures. Overall, the current account deficit is estimated at 12.1 percent of GDP in FY2021/22 from 7.9 percent of GDP in FY2020/21. Although they remain adequate, international reserves have declined at a faster pace than anticipated when the ECF was approved in January 2022.
- 3. Fiscal outturns were less expansionary than expected.** The FY2021/22 fiscal deficit is estimated at 3.7 percent of GDP from 4.0 percent in the previous year. While the growth of fiscal revenues continues to be strong 14.2 percent (y-o-y)—driven by import-related taxes—expenditure outturns have been mixed, with capital expenditure underperforming as uncertainty from the political stalemate in the beginning of the fiscal year and the third wave of the pandemic impacted budget execution. At the same time, recurrent expenditure increased by 14.3 percent (y-o-y) mainly driven by social security expenditures. Public debt is estimated at 49 percent of GDP for FY2021/22. The most recent DSA (January 2022) assessed both external and overall debt in Nepal at low risk of debt distress.
- 4. Banks reported non-performing loans (NPLs) are low, capital adequacy ratios are above regulatory minima, but downside risks are high.** Loose monetary conditions fueled excessive credit growth in the first half of FY2021/22 with credit growth reaching 32.5 percent (y-o-y)

in September 2021. As a result, banking sector liquidity tightened resulting in large liquidity injections by the Nepal Rastra Bank (NRB). Credit growth has since moderated to 11.8 percent (y-o-y) in August 2022 reflecting monetary tightening (350 bps increase in policy rates so far in 2022), and the gradual unwinding of COVID-19 support measures to the banking system. Reported NPLs are low and are likely understated, reflecting the high level of evergreening and forbearance in the system. Further, Nepal's strong credit cycles raise concerns about risks to financial sector and asset quality. Nepal's banking system has no direct exposure to Russia or Ukraine.

Outlook, Policies and Risks

5. Nepal's medium-term outlook is broadly favorable, predicated on the continued implementation of a decisive macroeconomic policy response to preserve macroeconomic and financial stability. Protracted shocks on commodity prices, weaker global activity, a further slowdown in China's growth, higher and more volatile commodity prices, and the intensification of export bans from India could trigger a new round of external pressures, necessitate additional policy tightening and impact near term growth. However, Nepal's recent macroeconomic outturns, recent policy actions, sustained implementation of commitments under the ECF, and the availability of fiscal space to counteract shocks, support the medium term projections in table 1. Specifically:

- **Growth and inflation.** Real GDP growth is forecast to rise to 5 percent in FY2022/23 and 5.3 percent in the medium term. The broad-based recovery is driven by public infrastructure and development spending, hydropower, a gradual recovery in tourism and the wider service sector that was impacted by the pandemic. High global commodity prices will cause headline inflation to remain elevated through FY2022/23 (due to higher prices of cereals, fuels, and chemical products) and gradually fall within the NRB's target in the medium term as improved monetary policy implementation, in line with the NRBs FY2022/23 monetary policy framework, continues to anchor price expectations.
- **Current account.** The current account deficit is expected to fall to 6.3 percent of GDP in FY2022/23 and steadily decline thereafter supported by dissipating global price shocks, less volatile remittance flows, higher electricity exports and the recovery in tourism. Global price shocks will keep imports elevated through FY2022/23 while a tight monetary stance will help moderate aggregate demand and external pressures. Reserve coverage is expected to remain above adequacy levels through the medium term. Import bans introduced in April 2022 remains a concern as they may frustrate the orderly adjustment of the balance of payments in the medium term. The authorities should adhere to their plan to remove import bans and develop a plan to phase out foreign exchange measures implemented for balance of payment purposes. Finally, ECF financing and budget support by development partners should help replenish FX reserves.
- **Fiscal policy.** The overall fiscal deficit is expected to increase to 5.1 percent of GDP in FY2022/23 to accommodate higher expenditures to mitigate against rising food and energy prices, enhance social safety nets, and accommodate election related spending. Fiscal support and risks related to some public enterprises, such as the National Oil Corporation, will contribute to higher expenditure in FY2022/23. However, the deficit is expected to gradually decline in the medium

term underpinned by enhanced revenue mobilization, lower expenditures from gradual unwinding COVID response measures, less duplication of spending responsibilities across levels of governments, and better targeted social security spending. Further, the continued implementation of the structural fiscal reform agenda envisaged under the ECF in the areas of domestic revenue mobilization, strengthening fiscal risk management, and public investment will help sustain fiscal consolidation in the medium term. These efforts will help the public debt stabilize at around 50 percent of GDP in the medium term.

- **Monetary and financial sector policies.** The NRB needs to maintain a tight monetary policy stance to decisively address inflation and external demand pressures, limit the buildup of financial stability risks, and maintain adequate levels of foreign exchange reserves to support the peg as envisaged in its FY2022/23 monetary policy framework. The 350 bps increase in policy rates implemented in February and August is therefore a welcome first step towards this objective. However, while interest rate increases have primarily borne the brunt of policy tightening in FY2021/22, there is scope to further tighten monetary and financial sector policies through: the continued gradual withdrawal of covid related liquidity and borrower support measures including the refinance facility; the strict enforcement of macroprudential measures to limit the buildup of financial sector risks; and the unwinding of the remaining COVID related relaxations in asset classification and provisioning rules and loan interest and principal payment deferrals. In addition, the NRBs commitment to enhance the monetary policy framework, specifically the interest rate corridor (IRC) will help provide a clear and predictable framework for conducting monetary operations. Finally, it is important to keep the momentum on the financial sector reform agenda under the ECF such as the modernization of the NRB law, the full implementation of the supervisory information system (SIS), and the amendments to regulations on asset classification, which will support financial stability.
- **Other structural reforms.** The authorities have taken important steps towards implementing the structural reform agenda set out in the ECF. The Office of the Auditor General (OAG) has commissioned an external audit of the NRB financial statements for FY2021/22. Going forward, the authorities should continue to make progress on reforms that supports the stability of the financial sector such as the Financial Sector Stability Review (FSSR) scheduled for FY2022/23. Further, reforms that improve fiscal transparency, enhance the efficiency of public investment spending, and strengthen climate resilience drawing on recommendations of the Public Investment Management Assessment (PIMA) will help support fiscal consolidation efforts and sustainable growth. Maintaining momentum on governance, anti-corruption and AML/CFT issues will be critical to cement the gains from reforms.

6. The outlook remains highly uncertain and subject to downside risks. Intensifying spillovers from Russia's war in Ukraine and global commodity price shocks could slow down recovery in energy-intensive sectors, de-anchor inflation expectations, aggravate food insecurity, impose high fiscal costs, cause recurrent commodity price volatility and social and economic instability. At the same time, Nepal's limited direct trade and financial linkages with Russia, Ukraine and global financial markets could buffer against spillovers from some global shocks. A deeper-than expected

slowdown in China could add to strains. Further, the pandemic is not yet behind us, and the emergence of more contagious vaccine-resistant variants could force new lockdowns in Nepal and its key trading partners disrupting remittances, tourism, and economic activity and result in a larger and protracted balance of payments and fiscal financing needs. Domestic risks also weigh on the outlook from Nepal's vulnerability to climate related shocks and natural disasters (flooding, landslides, earthquakes) and upcoming elections in November 2022. In addition, macro-financial risks, likely to have accumulated during the extended period of monetary accommodation, rapid credit growth and regulatory forbearance, can be exacerbated by monetary tightening or a sharp slowdown in remittances.

Relations With the Fund

7. Program Developments. Nepal is currently under a 38-month Fund-supported Extended Credit Facility (ECF) approved in January 2022 for 180 percent of quota (about US \$ 395.9 million). The ECF's objectives are to: mitigate the COVID-19 impact on health and economic activity and protect vulnerable groups; preserve macroeconomic and financial stability; and implement reforms to support sustained growth and poverty reduction. The ECF program aims to address the macroeconomic and structural policy priorities mentioned in Section II. It is also expected to help catalyze additional financing from development partners. Overall program implementation has continued in a difficult environment including local and parliamentary elections in May and November 2022. The first review, scheduled for June 2022, has however not yet concluded because of earlier delays in commissioning of the external audit of the NRB (now completed) and to allow for more time to discuss the policy framework underpinning the program. The external audit of the NRB is one of the structural benchmarks under the ECF to enhance transparency and governance. Staff remain in close consultation with the authorities as they seek to make further progress towards reaching a staff level agreement that would pave the way for an IMF Executive Board's approval of the First Review.

8. Surveillance and capacity development. The 2020 Article IV consultation was concluded on March 17, 2020, based on policy discussions in Kathmandu from January 5-17, 2020. The next Article IV mission is expected in 2023Q1. The Fund provides technical assistance and training from headquarters, SARTTAC, and the Singapore Training Institute including in priority areas for the ECF such as the NRB Act, revenue mobilization, fiscal risk reporting, and the FSSR.

Table 1. Nepal: Selected Economic Indicators, 2019/20-2026/27^{1/}

	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
			Est.	Projections				
Output and Prices (annual percent change)								
Real GDP	-2.4	4.2	4.2	5.0	5.1	5.2	5.2	5.3
Headline CPI (period average)	6.1	3.6	6.3	7.7	7.0	6.1	5.3	5.4
Headline CPI (end of period)	4.8	4.2	8.1	7.2	6.8	5.3	5.4	5.4
Fiscal Indicators: Central Government (in percent of GDP)								
Total revenue and grants	22.2	23.7	24.0	24.9	25.7	26.4	26.3	26.3
of which: Tax revenue	18.0	20.3	20.8	21.5	22.3	23.0	23.0	22.9
Expenditure	27.6	27.7	27.6	30.0	29.8	29.5	29.2	29.2
Expenses	22.7	22.4	23.1	23.7	23.7	23.6	23.6	23.5
Net acquisition of nonfinancial assets	4.9	5.4	4.5	6.2	6.0	5.8	5.6	5.6
Operating balance	-0.5	1.3	0.9	1.2	2.0	2.8	2.8	2.8
Net lending/borrowing	-5.4	-4.0	-3.7	-5.1	-4.1	-3.1	-2.9	-2.9
Statistical discrepancy	-0.8	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	4.6	4.2	3.7	5.1	4.1	3.1	2.9	2.9
Net acquisition of financial assets	1.9	3.7	1.6	1.6	1.6	1.6	1.6	1.6
Net incurrence of liabilities	6.5	7.9	5.3	6.7	5.7	4.7	4.5	4.5
Foreign	2.4	3.5	4.4	3.7	3.2	3.2	2.9	2.6
Domestic	4.1	4.4	0.9	3.0	2.5	1.5	1.6	1.9
Money and Credit (annual percent change)								
Broad money	18.1	21.8	6.8	10.6	12.5	12.9	12.8	12.9
Domestic credit	14.6	26.8	17.9	10.7	13.7	12.2	11.7	11.2
Private sector credit	12.6	26.3	13.3	12.4	13.3	12.7	12.1	12.9
Saving and Investment (in percent of nominal GDP)								
Gross investment	30.4	35.8	42.3	37.8	36.4	36.1	35.1	34.3
Gross fixed investment	30.5	29.9	36.8	32.8	31.6	31.3	30.5	29.7
Private	25.6	24.5	32.2	26.6	25.5	25.5	24.8	24.1
Central government	4.9	5.4	4.5	6.2	6.0	5.8	5.6	5.6
Change in Stock	0.0	5.9	5.6	5.0	4.8	4.8	4.6	4.5
Gross national saving	29.4	27.8	30.2	31.5	32.0	32.2	31.3	30.8
Private	30.5	27.4	30.8	31.2	30.7	29.9	28.8	28.3
Central government	-1.1	0.4	-0.5	0.3	1.2	2.3	2.5	2.5
Balance of Payments								
Current account (in millions of U.S. dollars)	-339	-2,844	-4,729	-2,659	-2,043	-1,971	-2,057	-2,070
In percent of GDP	-1.0	-7.9	-12.1	-6.3	-4.4	-3.9	-3.7	-3.2
Trade balance (in millions of U.S. dollars)	-9,186	-11,510	-13,475	-13,166	-13,498	-13,992	-14,593	-15,374
In percent of GDP	-27.2	-32.1	-34.5	-31.3	-29.1	-27.6	-26.6	-24.1
Exports of goods (y/y percent change)	-6.4	30.0	43.5	10.1	7.5	6.9	6.6	6.4
Imports of goods (y/y percent change)	-18.2	25.7	19.6	-0.9	3.2	4.1	4.6	5.5
Workers' remittances (in millions of U.S. dollars)	7,533	8,150	8,216	8,752	9,241	9,641	10,011	10,370
In percent of GDP	22.3	22.7	21.1	20.8	19.9	19.0	18.2	16.3
Gross official reserves (in millions of U.S. dollars)	10,559	10,884	8,800	8,547	8,861	9,601	10,624	11,471
In months of prospective imports	9.0	7.7	6.3	5.9	5.9	6.0	6.2	6.4
Memorandum Items								
Public debt (in percent of GDP)	42.4	45.8	49.1	50.5	50.8	50.7	50.3	50.0
Nominal GDP (in billions of U.S. dollars)	33.8	35.8	39.0	42.1	46.4	50.6	55.0	63.7
Nominal GDP (in billions of Nepalese Rupees)	3,889	4,277	4,737	5,358	6,026	6,724	7,456	8,273
Net International Reserves (in millions of U.S. dollars)	10,687	10,893	9,121	8,547	8,861	9,600	9,662	
Primary Deficit (in billions of Nepali Rupees)	183	138	129	219	182	135	131	141
Primary Deficit (in percent of GDP)	4.7	3.2	2.7	4.1	3.0	2.0	1.8	1.7
Tax Revenue (in billions of Nepalese Rupees)	700	870	984	1,154	1,343	1,546	1,712	1,897
Tax Revenue (in percent of GDP)	18.0	20.3	20.8	21.5	22.3	23.0	23.0	22.9
UN Human Development Index 2/	...	...	...	...	...	...	...	...
Health Expenditure (in percent of GDP)	1.0	1.5	2.4	1.8	2.1	1.8	1.8	1.8
Social Protection/Assistance (in percent of GDP)	1.7	1.6	3.9	2.9	3.4	2.9	2.9	2.9
CCRT debt relief (in millions of SDR) 3/	2.9	7.1	3.6	...	...	...	...	...
Private sector credit (in percent of GDP)	84.3	96.8	99.0	98.4	99.1	100.0	101.2	102.9
Exchange rate (NPR/US\$; period average)	115.2	119.3	141.7	...	...	...	...	...
Real effective exchange rate (average, y/y percent change)	1.8	-3.7	0.3	...	...	...	...	...

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

1/ Fiscal year ends mid-July.

2/ The UN Human Development Index is a composite index measuring average achievement in three basic dimensions of human development—a long and healthy life, knowledge and a decent standard of living.

3/ CCRT debt relief is included in grants and net incurrence of liabilities (foreign). The first tranche of CCRT debt relief covering the period April 14, 2020 to October 13, 2020 for SDR 2.9 million in FY 2019/20 was approved on April 13, 2020. The second tranche of CCRT debt relief covering the period October 14, 2020 to April 13, 2021 for SDR 3.6 million was approved on October 2, 2020. The third tranche of CCRT debt relief covering the period April 14, 2021 to October 15, 2021 for SDR 3.6 million was approved on April 1, 2021. The fourth and fifth (final) tranche of CCRT debt service relief covering the period from October 16, 2021 to January 10, 2022 and January 11 to April 13, 2022 was approved on October 6, 2021 and December 15, 2021 respectively for SDR 3.6 million.

Note: Current baseline forecast is as of August 31, 2022