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From: The Secretary

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***At the time of circulation of this paper to the Board, the authorities have indicated that they need more time to consider whether they will consent to the Fund's publication of this paper. Publication will only proceed upon the receipt by the Fund of the member's explicit consent.**



NEPAL

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

October 30, 2015

KEY ISSUES

Context: Nepal has been trapped in a low-investment, low-growth equilibrium. The authorities' aim is to graduate from least-developed country status within 7 years.

Macroeconomic situation and outlook: The earthquakes in April and May have held back growth. Together with the recent unrest and disruptions to trade routes, they also pushed up inflation. Growth is expected to gradually rebound as economic activity recovers and reconstruction gains momentum. High remittance inflows are supporting a strong external position, as well as high broad money growth. The outlook is subject to considerable downside risk, involving continued political and economic instability and slower-than-expected growth of government capital spending.

Medium-term prospects: While remittances are expected to continue to support the external position, the outlook for growth depends importantly on the authorities' reform efforts. Experience in other fragile states shows that natural disasters can have permanent effects on potential growth. This underscores the importance of a decisive boost to public capital spending and reforms to strengthen the business climate.

Key policy recommendations: Fiscal policy needs to support post-earthquake reconstruction and medium-term growth through higher public investment. Stronger public financial management (PFM) will be key to the swift and efficient implementation of higher capital spending. Along with efforts to improve the business climate, this should support private investment needed to generate sustained higher economic growth and employment opportunities. The exchange rate peg to the Indian rupee provides a useful nominal anchor to the economy, and the real exchange rate is broadly in line with fundamentals. Money growth should be contained to a level consistent with supporting the peg. The monetary operations framework needs to be strengthened to put the central bank in a position to better control the growth of broad money in the face of strong inflows of remittances and aid. Financial sector reforms should continue to focus on bolstering regulation and supervision, and improving financial infrastructure, to reduce risk and increase access to finance.

Approved By
**Kalpana Kochhar and
Steven Barnett**

Discussions took place in Kathmandu during Sep. 20–Oct. 1, 2015. The staff team comprised Mr. Almekinders (head), Ms. Wong (APD), Ms. Mendoza (MCM), Ms. Marinkov (FAD), and Mr. Chida (OAP), and was assisted by Mr. Richardson (Senior Resident Representative for Bhutan/India/Nepal) and Ms. Das (APD). Ms. Tangcharoenmonkong and Mr. Marcelo (both OED) also participated. Ms. Inoue and Mr. Dalesio (both APD) assisted in the preparation of this report.

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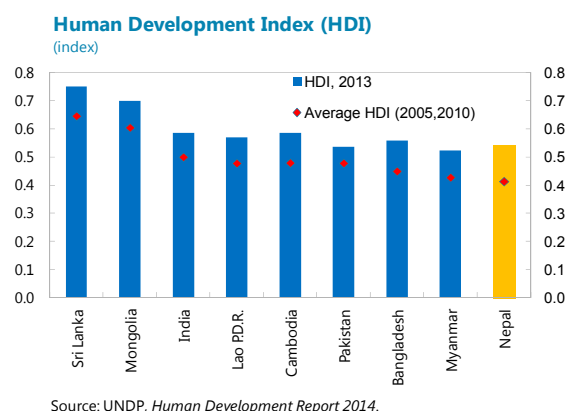
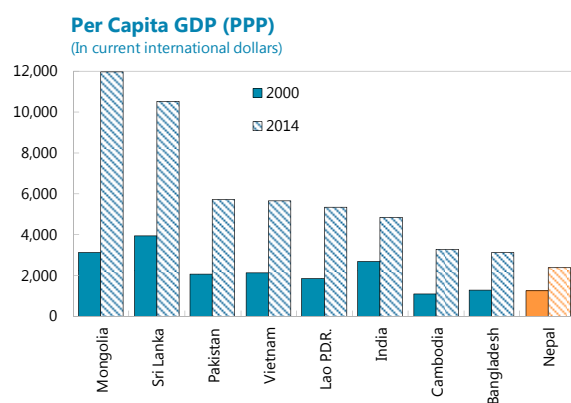
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INTRODUCTION

1. Nepal has been trapped in a low-investment, low-growth equilibrium and remains Asia's poorest country, despite progress with poverty reduction:

- After a decade-long civil war and the subsequent abolition of the monarchy in 2008, the country has been undergoing a gradual transition to a federal democratic state. Macroeconomic management has been broadly satisfactory. However, partly because of successive governments' preoccupation with internal power rivalries, infrastructure investment has been inadequate and the business climate unsupportive of growth. Due to lack of opportunities at home, Nepalis have been moving abroad in large numbers, mostly to Persian Gulf countries and Malaysia.
- Poverty has been declining, from over 50 percent of the population in 2003/04 to just under 25 percent in 2010/11, thanks in part to rising remittances, which currently amount to about 29 percent of GDP. Nevertheless, output per capita remains the lowest in the region, and further efforts are needed to improve human development indicators (Table 9).



2. Nepal was hit by two massive earthquakes, in April and May. Over 8,800 lives were lost and damages and losses are estimated at US\$7 billion or nearly one third of GDP. In the context of a June 25 international donor conference, multilateral and bilateral donors pledged more than US\$4 billion worth of grants and concessional loans to be disbursed over five years. The Nepalese authorities requested the equivalent of SDR35.65 million (50 percent of quota) under the Fund's Rapid Credit Facility. The funds were disbursed as direct budget support.

3. The September 20 promulgation of the constitution triggered unrest, a fuel crisis, and a change in government. After the earthquakes, the main political parties settled on a federal model of parliamentary government with seven provinces. However, fearing that the proposed federal structure will perpetuate their disenfranchisement, ethnic-minority groups in the south of the country mounted protests. The resulting disruptions to economic activity and transportation and trade routes to and from the southern border caused shortages of fuel and other imported goods. Parliament voted out the Prime Minister. His party moved to the opposition and a new Prime Minister and Cabinet were inaugurated in mid-October.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

4. The earthquakes exacerbated the macroeconomic policy challenge of boosting growth by raising public capital spending and private investment, while containing inflation:

- Real GDP growth is estimated to have decelerated to 3.4 percent in 2014/15, compared to a pre-earthquake baseline forecast of 5 percent. Growth had accelerated to 5.5 percent in 2013/14 owing largely to a favorable monsoon. Average growth of 4 percent in the three previous years lagged neighboring countries.
- Inflation had been moderating from a high base, in line with developments in India. However, the recent acceleration, to 6.9 percent in August (y/y), widens the wedge over Indian CPI, thereby undermining Nepal's competitiveness.
- Preliminary data on government spending suggests a 28 percent increase in capital spending in 2014/15. However, the financing data indicates that the budget was in surplus for the third year in a row, even as revenues fell short of the budget for the first time in several years. As a result, public debt remained on a declining path, falling to 26 percent of GDP in 2014/15, from 32 percent of GDP in 2012/13.
- The external position has remained strong. The current account surplus reached 5.0 percent of GDP in 2014/15, aided by a surge in remittances following the earthquake and lower oil import prices. Reserves rose to US\$7.2 billion, or 33 percent of GDP, covering almost eight months of prospective imports.
- The effect of the earthquakes on the financial system has yet to become clear. As of July 2015, commercial and development banks had capital adequacy ratios comfortably in excess of the required minima (6 percent) and reported low non-performing loans (Table 8).

5. Growth is expected to gradually rebound to around 5½ percent by 2016/17, as economic activity recovers from the earthquake and reconstruction gains momentum. Inflation is projected to rise to about 8½ percent over the next 12 months. Losses in agricultural production and damage to transport systems represent a large shock to the supply of agricultural products, which account for some 40 percent of the CPI basket. However, over time, as agricultural production recovers and transportation infrastructure improves, inflation pressure should ease. Stepped-up foreign aid and higher inflows of remittances will further boost liquidity pressures in the financial system, necessitating active liquidity management to avoid excess inflation relative to India.

6. The medium-term outlook depends importantly on the authorities' reform efforts.

Experience in other fragile countries shows that natural disasters can have permanent effects on potential growth. For instance, the June 2015 IMF policy paper on *IMF Engagement with Countries in Post-Conflict and Fragile Situations—Stocktaking* notes that fragile states tend to experience larger growth downturns in the face of shocks. This highlights the need for ambitious macroeconomic and structural policies. To illustrate this and the importance of ramping up public infrastructure spending and attracting FDI-financed mega-projects to boost medium-term growth, staff prepared two scenarios (see Table 1):

- The baseline scenario is an updated version of the medium-term scenario presented in the context of Nepal's request for a disbursement under the RCF. In this scenario, following the

Table 1. Nepal: Macroeconomic Framework—Baseline and Reform Scenarios, 2012/13–2019/20 1/

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2015/16	2016/17	2017/18	2018/19	2019/20
			Est.	Baseline scenario projections					Reform scenario projections				
Output and prices (annual percent change)													
Real GDP	4.1	5.4	3.4	4.4	5.4	3.9	3.8	3.8	4.4	5.6	5.3	5.5	5.8
CPI (period average)	9.9	9.0	7.2	8.0	8.3	7.7	7.0	6.1	8.0	7.7	6.5	5.5	5.0
CPI (end of period)	7.7	8.1	7.6	8.5	8.0	7.5	6.5	5.7	8.5	7.0	6.0	5.0	5.0
Fiscal Indicators (in percent of GDP)													
Total revenue and grants	19.3	20.6	20.8	21.9	22.0	22.2	22.4	22.5	22.0	22.3	23.0	23.2	23.2
of which: tax revenue	15.3	16.1	16.8	16.8	17.1	17.4	17.6	17.6	16.9	17.3	18.2	18.3	18.4
Expenditure	17.2	19.1	19.9	24.2	24.2	23.7	22.3	22.6	24.0	24.4	24.4	24.2	23.9
Expenses	14.2	15.6	15.8	17.7	17.8	18.0	17.9	17.8	17.4	17.7	17.7	17.7	17.7
Net acquisition of nonfinancial assets	3.0	3.4	4.1	6.5	6.4	5.7	4.4	4.7	6.6	6.7	6.6	6.5	6.3
Statistical discrepancy	0.2	0.9	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing	2.2	2.4	1.6	-2.3	-2.2	-1.5	0.1	-0.1	-2.0	-2.1	-1.4	-1.0	-0.7
Net financial transactions	-2.2	-2.4	-1.6	2.3	2.2	1.5	-0.1	0.1	2.0	2.1	1.4	1.0	0.7
Net acquisition of financial assets	1.1	1.2	1.4	1.5	1.2	1.3	1.2	1.1	1.5	0.9	0.8	0.7	0.6
Net incurrence of liabilities	-1.2	-1.2	-0.3	3.8	3.4	2.7	1.1	1.2	3.5	3.0	2.2	1.7	1.3
Foreign	-0.3	-0.1	0.8	2.9	1.9	1.8	1.4	1.1	3.0	2.1	2.0	1.6	1.0
Domestic	-0.8	-1.1	-1.0	0.9	1.5	0.9	-0.4	0.1	0.5	0.9	0.2	0.1	0.3
Balance of Payments													
Current account (in millions of U.S. dollars)	635	908	1,067	-570	-426	-452	-352	-234	-623	-555	-1,174	-1,440	-1,356
In percent of GDP	3.3	4.6	5.0	-2.5	-1.7	-1.7	-1.2	-0.8	-2.7	-2.2	-4.3	-4.9	-4.3
Trade balance (in millions of U.S. dollars)	-5,247	-6,082	-6,670	-8,453	-9,106	-9,867	-10,450	-11,080	-8,503	-9,227	-10,565	-11,372	-12,207
In percent of GDP	-27.2	-30.8	-31.2	-36.9	-36.2	-36.2	-36.2	-36.2	-37.1	-36.8	-38.8	-38.8	-38.5
Exports value growth (y/y percent change)	-3.1	5.4	-4.0	2.0	5.4	6.0	6.0	6.0	2.0	5.4	6.0	6.0	6.0
Imports value growth (y/y percent change)	10.9	14.3	7.7	23.5	7.5	8.1	5.9	6.0	24.2	8.2	13.6	7.5	7.2
Workers' remittances (in millions of U.S. dollars)	4,931	5,543	6,192	6,631	7,131	7,698	8,308	8,964	6,631	7,131	7,698	8,346	9,056
In percent of GDP	25.6	28.1	29.0	28.9	28.3	28.3	28.8	29.3	28.9	28.4	28.3	28.5	28.6
Gross official reserves (in millions of U.S. dollars)	4,972	6,172	7,162	7,320	7,594	8,003	8,548	9,138	7,325	7,558	7,978	8,448	8,979
In months of prospective GNFS imports	7.3	8.3	7.9	7.6	7.3	7.3	7.3	7.3	7.5	6.9	6.7	6.7	6.6
Excl. reconstruction- and FDI-related imports			9.0	8.3	7.8	7.5	7.3	7.3	8.3	7.4	7.4	7.4	7.4
Memorandum items													
Public debt (in percent of GDP)	32.3	28.3	25.7	28.9	29.4	29.6	28.7	28.0	28.6	28.8	28.5	28.0	27.0
GDP at market prices (in billions of U.S. dollars)	19.3	19.8	21.4	22.9	25.2	27.2	28.9	30.6	22.9	25.1	27.2	29.3	31.7

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

¹ Fiscal year ends in mid-July.

initial reconstruction-related, partially donor-funded rebound in activity, growth decelerates to around 4 percent over the medium term (Tables 3–7). Continued under-implementation of the budget and under-investment hold back imports thereby supporting reserves. A debt sustainability analysis conducted on the basis of this scenario in the RCF staff report (IMF Country Report 15/224) concluded that Nepal's risk of debt distress would remain low.

- The reform scenario illustrates the implications of adopting staff's policy advice. These reforms would aim to sustain the growth momentum, with an acceleration to about 6 percent by 2019/20, on sustained efforts to strengthen the government's capital budget implementation capacity, while bringing inflation down to the neighborhood of that in India. A persistent push to develop large FDI-financed hydropower projects would lay the basis for stronger, sustained, private-sector led growth in the next decade. Construction on the large hydropower projects is projected to start in 2017/18. Insofar as these projects are highly import intensive, and FDI and donor financing do not completely cover higher import spending, the current account balance would turn to modest deficits in the medium term due to higher imports and reserves would be lower than in the baseline. External debt would remain manageable and continue to be contracted largely on highly concessional terms.

7. Recent developments have heightened the downside risks to the baseline scenario (Table 2). Continued political instability and a continuation of the recent disruptions to economic activity and transportation and trade routes to and from the country's southern border and the related fuel crisis could severely affect growth and inflation in this fiscal year. Another important downside risk relates to the government's capacity to boost capital spending. The baseline scenario assumes a considerable degree of under-execution of the ambitious 2015/16 budget. Nevertheless, owing also to delays in setting up the National Reconstruction Authority (NRA) which remain to be resolved, the 40 percent increase in expenditure relative to the 2014/15 budget outturn that is projected in the baseline scenario, and expected to persist through 2015/16, may not be achieved. Other downside risks pertain to remittances, and the financial sector.

Authorities' Views

8. The authorities were more optimistic on the outlook for growth. The unrest and disturbances to trade routes were deemed to be temporary phenomena. Once stability would return, there would be confidence effects from the new constitution. The authorities were also hopeful that the measures taken to streamline procedures for government spending would pay off. Together with progress in operationalizing the NRA this was expected to underlie an important pick up in government capital and reconstruction spending following the October/November festival season. In conjunction with base effects from low growth in 2014/15, this was expected to raise growth above 5 percent in 2015/16.

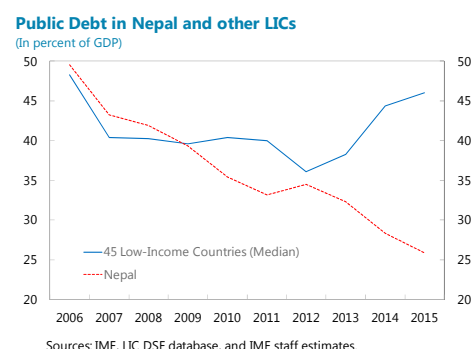
POLICY DISCUSSIONS

Nepal's long-term vision is to graduate from least-developed country status by 2022 and to achieve middle income country status by 2030. Accordingly, key objectives of Nepal's 13th Development Plan (2013-16) are to achieve an annual growth rate of 6 percent and bring down the percentage of the population living below the poverty line to 18 percent by 2016. These objectives are echoed in the Budget for 2015/16 (mid-July 2015/mid-July 2016) and Monetary Policy for 2015/16. Experience in other low-income countries has shown that the recovery and reconstruction after a natural disaster such as the recent earthquakes takes considerable time. In light of this, discussions focused on the macroeconomic policy mix needed to support Nepal's recovery while maintaining macroeconomic and financial stability.

A. Fiscal Policy

9. Fiscal policy was tighter than planned in recent years due to budget implementation bottlenecks.

Spending under-implementation left the large infrastructure gap mostly unaddressed. In conjunction with relatively strong revenue collection, it kept the public debt to GDP ratio on a declining path, unlike in other low-income countries.



10. Going forward, fiscal policy needs to support post-earthquake reconstruction and medium-term growth through higher public investment. This should be financed through a combination of higher tax revenues (see ¶14), external grants and loans, and domestic financing.

11. The 2015/16 budget targets a large increase in spending. Compared to the estimated outturns for 2014/15, it aims for a 44 percent increase in current spending and a 168 percent increase in capital spending. In the IMF's presentation of the fiscal data, the 2015/16 budget targets an overall fiscal deficit—measured by the net incurrence of liabilities—of 4.9 percent of GDP, compared to a surplus of 0.3 percent of GDP in 2014/15. If implemented, this fiscal impulse would have important implications for the conduct of monetary policy.

12. It is unlikely that the budget can be implemented in full. The Budget Speech labeled 2015/16 as the "Year of Implementation". While this is welcome, persistent implementation challenges and delays in operationalizing the NRA will make full budget implementation highly unlikely. For the next fiscal year, staff recommends that the budget targets a substantial but realistic spending increase. Reforms recommended to strengthen budget implementation are discussed in ¶16.

13. Fiscal policy should be anchored by a ceiling on net domestic financing of the budget (NDF). Concessional external financing can finance the bulk of the projected increase in

infrastructure spending. On this basis, and taking into account the exchange rate peg and the need to protect international reserves as well as the need to ensure adequate space for continued growth in private sector credit, NDF should not exceed 1 percent of GDP per annum. High-quality capital spending financed by concessional donor inflows should be accommodated since it keeps debt in check while allowing for the needed infrastructure push. Given staff's projections for concessional foreign financing, this will translate to an overall fiscal deficit of 3¾ percent of GDP per annum in the short term, and 2½ percent of GDP per annum in the medium term (reform scenario in the text table). In case of capital spending shortfalls, the deficit should be reduced one for one with shortfalls in donor-financed spending (with a corresponding reduction in NDF and a rise in NFA for any donor financing received but not spent). As discussed below, this fiscal performance would need to be underpinned by decisive structural fiscal reforms.

14. Continued improvements in revenue performance will be important to maintain a strong fiscal position and meet the increasing need for capital expenditure. Revenue has been growing in recent years, albeit at a decreasing rate, on the back of rising consumption and imports. However, revenue fell short of the FY2014/15 budget and the ambitious target set for this year implies a strong possibility of another shortfall in the current fiscal year. To ensure that the tax revenue to GDP ratio remains on a rising trend, staff recommended the following:

- The Inland Revenue Department (IRD) needs to ensure that taxpayer compliance is not adversely affected by the earthquake and the current unrest in the country.
- Staff welcomed the recently completed review of the tax policy framework and the intent to commence with the implementation of various policy reforms from FY2015/16. Staff encouraged the authorities to work closely with FAD in the drafting of a unified tax code.
- The findings and recommendations of a VAT-GAP analysis, conducted by a recent FAD mission, should be used for an action plan to improve tax administration and compliance.

15. Stronger public financial management (PFM) will be key to the swift and efficient implementation of post-earthquake reconstruction as well as the “regular” capital budget. Budget execution in Nepal suffers from persistent problems related to structural weaknesses such as poor project management and bureaucratic hindrances. The earthquake has added urgency to the need to improve capital budget execution and the authorities recently announced steps to expedite expenditure and simplify approval processes.¹

16. Capital budget implementation remained slow in the first two months of the fiscal year. A coordinated effort by the Ministry of Finance (MOF), the National Planning Commission (NPC), and key line ministries to address bottlenecks is needed. Staff welcomed the MOF's ongoing efforts to draft a Fiscal Responsibility and Budget Management Act (FRBM). This could provide

¹ For spending items included in the approved budget, government bodies are no longer required to obtain authorization from the District Development Committee, the line ministry and the NPC, a process that could take up to six months. Similarly, multi-year projects included in the approved budget in one year no longer need to be re-authorized at the start of each fiscal year. Projects with minimal implementation will henceforth need to surrender budget resources. And a revised employee performance evaluation system will incentivize project completion.

important guidance to the budget implementation process and should be put in place in time for the start of the next fiscal year. Staff welcomed the preparation of the PFM Reform Action Plan (following the publication of the Public Expenditure and Financial Accountability (PEFA) Assessment in May) and encouraged the authorities to focus the Plan on key priorities for each agency and implement it as soon as possible. Finally, staff reiterated past FAD PFM technical assistance advice to enhance upstream project preparation, appraisal and selection, including: (i) establishing proper and transparent planning, selection and implementation for major capital projects; and (ii) developing better targeted selection and prioritization criteria based on cost-benefit analyses, project life cycle and future recurrent costs, project implementation readiness, as well as associated risks (see also Box 3 in the staff report for Nepal's request for disbursement under the RCF).

17. Debt management needs to be strengthened in view of the increasingly complex debt instruments and larger borrowing envisaged in the future, particularly related to the development of Nepal's hydropower potential. The joint IMF/World Bank Debt Sustainability Analysis conducted in the context of Nepal's request for disbursement under the RCF concluded that Nepal's risk of debt distress remains low. However, a Debt Management Performance Assessment (DeMPA) conducted by the World Bank in August 2014 called for improving the effectiveness of managerial oversight on the debt management functions. It also recommended to task one entity with the preparation of a comprehensive debt management strategy, analyze the costs and risks of the debt portfolio, and make debt service forecasts more robust.

18. Protecting priority social spending and improving the effectiveness of safety nets are important. The growth of spending on health and education has stagnated in the last few years. Staff encouraged the authorities to reverse this trend and noted that the macro framework in the reform scenario can accommodate an increase in current spending by almost 2 percent of GDP per annum. Once earthquake-related spending is phased out, a rising share of this increase should be allocated to social spending.

19. Large state-owned enterprises (SOEs) in the energy sector need to be put on a sound financial footing. This is needed to reduce contingent liabilities and encourage private and foreign energy sector investment. In recent years, the combined losses of the Nepal Electricity Authority (NEA) and Nepal Oil Corporation (NOC) averaged about 1½ percent of GDP per year. To prevent future accumulation of losses, the automatic bi-weekly oil price adjustment mechanism introduced in 2014 should be adhered to and electricity tariffs should be reviewed more regularly. The NEA's operations should be scrutinized more closely and remaining losses should be covered by transparent budget transfers.

Authorities' Views

20. The authorities were confident that capital budget implementation would pick up from mid-November, after the festival season, and would end higher relative to the last fiscal year in part due to the simplification of administrative procedures. Nevertheless, they acknowledged scope to improve implementation capacity and that while there had been improvements in

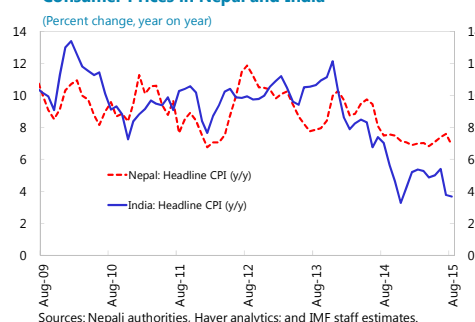
procurement, more needed to be done, including to strengthen capacity of the public and private construction sectors. The authorities viewed the 1 percent of GDP ceiling on NDF as too restrictive in view also of the abundance of liquidity in the financial system.

21. The authorities pointed out that social spending had been rising steadily in absolute terms and that much of the reconstruction spending would be on schools and health facilities. Moreover, local governments also carry out social spending but tracking this is difficult. On retail fuel prices, the authorities noted the importance of broadly maintaining parity with prices across the border to prevent distortions.

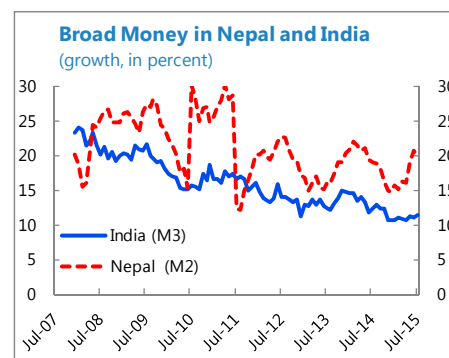
B. Monetary and Exchange Rate Policy

22. The peg to the Indian rupee serves as a transparent anchor. It continues to benefit Nepal in view of its close economic relationship with India. The level of the exchange rate remains broadly in line with fundamentals (Box 1). However, remittances skew domestic activity to non-tradables and contribute to reducing the competitiveness of agriculture and industry. Accordingly, in the staff's view, the authorities' focus should be on competitiveness-enhancing structural reforms to support the peg. Stepped-up efforts to install enough hydropower capacity to eliminate load shedding could give a big boost to the investment climate.

Consumer Prices in Nepal and India

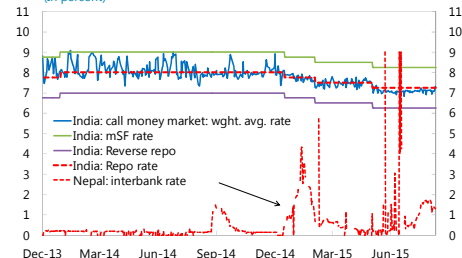


23. Money growth should be contained to a level consistent with supporting the peg. By mid-2014, Nepal's inflation began to decouple from that in India, reflecting the Reserve Bank of India's increased emphasis on bringing consumer price inflation down in the context of their planned transition to flexible inflation targeting. The earthquake has exacerbated the decoupling of inflation in the two countries. Given the economic disruption caused by the earthquake and the recent unrest, some temporary increase in inflation in Nepal is inevitable and should be accommodated. However, as the economy recovers, the Nepal Rastra Bank (NRB) should aim to keep Nepalese inflation close to that in India to maintain competitiveness. Accordingly, efforts should be made to contain the growth of broad money in 2015/16 (Table 5).



24. The monetary operations framework needs to be strengthened to put the NRB in a position to better control the growth of broad money. A positive first step in this respect is the creation, since the FSAP, of separate open

Nepal and India: Policy and Call Market Interest Rates (In percent)



market committees for public debt management and monetary management. Staff also welcomed the introduction of deposit auctions in August 2014. Over the past year, deposit auctions have at times contributed to the mopping up of excess liquidity. The next step would be to hold regular pre-announced deposit auctions with a view to effectively mop up excess liquidity and systematically raising short-term interest rates from current low levels, closing the gap with interbank interest rates in India. This should be supported by the NRB refining its liquidity forecasting framework building on suggestions made in the context of the FSAP and earlier MCM technical assistance missions. A key recommendation has been for the NRB to adopt an interest rate corridor to provide more systematic guidance to short-term interest rates with a view to strengthening the monetary transmission mechanism. In addition, treasury sterilization bonds could be introduced for the purpose of addressing structural excess liquidity with NRB instruments (repo/reverse repo) used for fine-tuning. The introduction of treasury sterilization bonds would also foster capital market development and make the cost of monetary tightening transparent in the budget. Consideration should also be given to phase out the NRB's directed lending facilities as they complicate the conduct of monetary policy and are not core central bank functions; they should be gradually transferred to the budget.

Authorities' Views

25. The authorities favored a looser monetary policy stance to promote growth. They broadly concurred with the staff's exchange rate assessment. By virtue of the peg to the Indian rupee, India's gains in disinflation were expected to spill over to lower inflation in Nepal. Broad money should expand by at least 15 percent to support growth. In view of market imperfections, the NRB's directed lending facilities are needed to achieve the government's inclusive growth objectives. They expected interest rates to rise once government spending would pick up. To regulate liquidity, the authorities were also looking at monetary operations frameworks other than the interest rate corridor. They questioned the relevance of treasury sterilization bonds in the context of a separation of public debt management and monetary management.

C. Financial Sector Reforms

26. Steps have been taken to begin to address weaknesses in the legal and supervisory framework governing financial institutions highlighted by the 2014 FSAP. The 2014 FSAP stress tests suggest banking system strains if asset quality deteriorates moderately. The attached matrix (Appendix I) summarizes the limited progress made so far in implementing high-priority FSAP recommendations. Staff recommended follow through on existing policy initiatives along with additional reforms to support the stability and resilience of the financial sector:

- **Strengthen the taskforces set up to follow up on the FSAP recommendations.** Staff welcomed the various taskforces in the NRB and the GON established to follow up on FSAP recommendations. Given the large number of recommendations as well as the need for collaboration across institutions, an apex committee may be useful. That committee should be provided a mandate, technical support, suitable resources and a firm timetable.

- **Continue to strengthen the bank supervision function.** The NRB is working to complete the first cycle of risk-based supervision (RBS) on-site inspections. Off-site supervision needs significant strengthening to complement the on-site component. As the supervisory information system (SIS) is put in place, plans to integrate the off-site and on-site functions should be developed. A program to hire, train and retain supervisory staff should be developed to provide for continuity in supervisory activities. In this regard, staff urges the NRB to revisit the staff rotation policy, which has undermined its ability to effectively supervise the financial system.
- **Limit further forbearance.** Staff welcomed the NRB's statement that post-earthquake forbearance on asset classification and loan loss provisioning would remain limited in scope and time-bound.
- **Extend legal upgrades to secondary legislation.** While the primary legislation (BAFIA, NRB Act Amendments, Deposit and Credit Guarantee Fund Act) has benefitted from considerable TA and is pending enactment, the secondary legislation and regulations require attention. The NRB is encouraged to identify the priorities in the prudential regulations that need upgrading and begin the upgrade process.
- **The NRB Risk Management guideline should be converted to a directive, officially introducing risk management requirements to the banking industry.** The directive's issuance will help level the playing field by officially informing the industry of the shift to risk-based supervision. Additionally, guidance should be provided as the industry transitions to IFRS.
- **Use the results of the Special Inspections Program to prepare a diagnostic of the impact of the earthquakes on the banks.** This diagnostic could be based on the results of the ongoing special inspection of 54 BFIs (representing 64 percent of the banking system) by DFID, in coordination with the World Bank and the Fund, and by performing additional diagnostics of financial institutions to determine their resilience. On this basis, a strategy should be developed to resolve unviable BFIs and address possible capital shortfalls in others.
- **Develop an operational framework for bank resolution.** Building on the relevant laws that have been submitted to Parliament, the next step in the development of an operational framework for bank resolution is to draw up implementing regulations.
- **Formalize a system to monitor banks' capital-raising plans.** The two-year phase in period to increase the paid up capital demands diligent NRB oversight. A formal review process should be established to ensure that each BFI has internalized the obligation to increase the capital and adheres to the capital plan. Also included in this process should be a robust review of the accounting techniques used by BFIs, to minimize the potential for overstated earnings. And the NRB should establish a contingency plan that would include corrective action and administrative sanctions in the event of failure to meet required capital levels.

27. Efforts to strengthen the Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) framework should continue. Staff welcomed the enactment of the AML/CFT ordinances and Nepal's exit from FATF's enhanced scrutiny in June 2014. The implementation of the AML/CFT regime should be further strengthened, including through the issuance of implementing rules and the application of risk-based supervisory tools, supported by ongoing IMF TA.

28. The ongoing safeguards assessment of the NRB will call for a strengthening of the quality of the NRB's external audit and legal framework. A safeguards assessment mission in September 2015 found that limited progress has been made in following up on recommendations made in the context of a similar evaluation in 2011. Notable positive developments include the successful implementation of a new accounting system and improved financial reporting practices. However, several key functions lag behind and strong commitment from the NRB Board and senior management will be needed to modernize them; in particular internal audit and currency and vault operations. Priority should be given to the following:

- The quality of the external audit should be brought in compliance with international standards. The NRB should engage an auditor with requisite global experience and expertise in the audit of large financial institutions.
- The NRB's legal framework should be enhanced to further support central bank autonomy and governance.

Authorities' Views

29. The authorities broadly agreed with the recommendations and requested technical assistance and training to support implementation. The Special Inspections Program would be completed by October and the NRB had asked DFID to go ahead with the preparation of the "fast diagnostic" of the impact of the earthquake on banks and insurance companies. The NRB would consider the modalities for monitoring banks' implementation of their capital plans. It would aim to issue the Risk Management directive by February 2016.

D. Enabling Sustainable and Inclusive Growth

30. Efforts to improve the business climate should be intensified. There is considerable scope to simplify trading across borders, enforcing contracts, paying taxes and getting credit. Staff welcomed the steps taken to extend the one-stop-shop to facilitate registration of new companies beyond large investors, to any investor. As a next step, the one-stop-shop should be further improved for instance by strengthening the investment facilitation coordination committee. In addition, labor market reforms including streamlining the complex labor code, streamlining procedures (e.g. environmental impact assessments) and strengthening policy frameworks to boost private-sector-led investment are critical.

31. Unlocking Nepal's hydropower generation potential would relieve power shortages and enable the exports of power to help diversify foreign exchange earnings (Box 2). In this regard, staff welcomed the Power Trade Agreement signed with India and the Project Development Agreements signed for the development of two large hydropower projects with foreign investors. Large hydropower projects are complex and take long to develop. In view also of earlier failed attempts to develop Nepal's hydropower potential, staff encouraged the authorities to consider setting up a special high-qualified project committee that could help to establish realistic project timetables to spearhead progress in developing the large hydroelectric power projects in the pipeline.

KEY OBJECTIVES OF A POSSIBLE ECF ARRANGEMENT

32. A possible ECF arrangement would focus on supporting the government's efforts to recover from the earthquakes. The authorities first expressed interest in longer-term Fund engagement in the context of the discussions on their request for a disbursement under the RCF. Program discussions could take place later this year, depending on the new government's interest. The arrangement's aim would be to boost public and private investment, social spending and financial inclusion, and address financial system weaknesses, with a view to improving growth prospects and poverty reduction efforts, and all while preserving overall macroeconomic stability. Accordingly, the program would focus on strengthening policies in four key areas: (i) public capital budget management; (ii) monetary policy operations; (iii) financial sector reforms; and (iv) the business climate. In transition to a higher growth trajectory, the government's medium-term reform efforts will create additional external financing needs, over and above those created by the earthquake-related reconstruction effort. Access to IMF financial resources—which like in the RCF would be disbursed to the MOF's account at the NRB—would depend on program strength, as a more robust reform agenda over the near- to medium term would come with a greater BOP and fiscal financing need—currently suppressed by budget under-execution and under-investment.

STAFF APPRAISAL

33. Macroeconomic performance has been held back by the earthquakes and the ongoing political instability. Growth has been dampened by the disruption caused by the natural disaster and the recent unrest and the under implementation of the budget. The supply shocks related to the earthquake and trade disruption have caused Nepal's inflation to rise, exacerbating its decoupling from the declining path of inflation in India. Meanwhile, remittances have continued to support consumption, poverty reduction, and high international reserves.

34. Growth is expected to gradually rebound as reconstruction gains momentum but inflation is projected to rise over the next 12 months. Losses in agricultural production and damage to transport systems along with the recent disruption to trade routes represent a large shock to the supply of agricultural products and other goods. However, over time, as agricultural production recovers and transportation infrastructure improves, inflation pressure should ease.

35. The medium-term outlook depends importantly on the authorities' reform efforts.

Experience in other fragile countries shows that natural disasters can have permanent effects on potential growth, thus highlighting the need for ambitious macroeconomic and structural policies. In a "reform scenario," the growth momentum from post-earthquake reconstruction would be sustained through determined efforts to strengthen the government's capital budget implementation capacity and a persistent push to develop large FDI-financed hydropower projects. Given that hydropower projects are highly import intensive, the current account balance would turn to modest deficits in the medium term due to higher imports and reserves would be lower than in the baseline. External debt would remain manageable and continue to be contracted largely on highly concessional terms.

36. Recent developments have heightened the downside risks to the baseline scenario.

Continued political instability and disruptions to trade to and from the southern border could severely affect growth and inflation in this fiscal year. Another important downside risk relates to the government's capacity to boost capital spending. Owing also to the delay in setting up the National Reconstruction Authority (NRA), the increase in expenditure may be more limited than expected.

37. Fiscal policy needs to support post-earthquake reconstruction spending and medium-term growth through higher public investment. Establishing proper and transparent planning, selection, and implementation for major capital projects remains a priority. Continued improvements in revenue performance will be important to maintain a strong fiscal position. Concessional external financing can finance the bulk of the sustained increase in government capital spending needed to address infrastructure gaps. On this basis, and taking into account the exchange rate peg and the need to protect international reserves as well as the need to ensure adequate space for continued growth in private sector credit, fiscal policy should be anchored by a ceiling on net domestic financing of the budget (NDF).

38. Monetary policy should be geared toward supporting the exchange rate peg, containing inflation, and safeguarding reserves. As the economy recovers, the central bank would need to closely monitor price developments. In light of the exchange rate peg, monetary policy would need to be oriented to keep Nepalese inflation close to that in India. Higher inflows of foreign aid and remittances will further boost liquidity pressures in the financial system, necessitating active liquidity management.

39. Efforts to enhance the stability and resilience of the financial sector should be intensified. In particular, implementation of the high-priority FSAP recommendations should be accelerated. Financial sector risks may have been amplified by the earthquakes, thus underscoring the importance of conducting a diagnostic of their impact on the banks, continuing to strengthen the bank supervision function, and developing an operational framework for bank resolution. The two-year phase in period to increase banks' paid up capital requires diligent NRB oversight. The quality of the NRB's external audit should be brought in compliance with international standards and its legal framework should be enhanced to further support central bank autonomy and governance.

40. The peg to the Indian rupee continues to serve as a transparent anchor and the level of the exchange rate remains broadly in line with fundamentals. To the extent that remittances skew domestic activity to non-tradables and contribute to reducing the competitiveness of agriculture and industry, the authorities' focus should be on competitiveness-enhancing structural reforms. Stepped-up efforts to install enough hydropower capacity to eliminate load shedding could give a big boost to the investment climate and inclusive growth.

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

Table 2. Nepal: Risk Assessment Matrix 1/

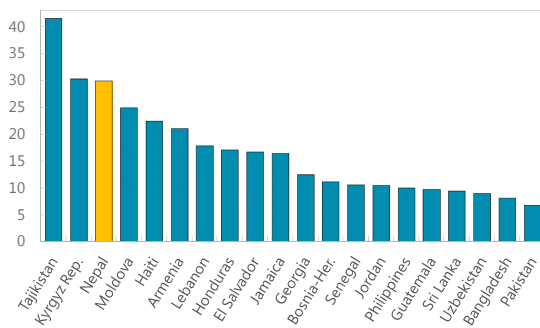
Source	Likelihood	Impact	Policy Response to Minimize Impact
DOMESTIC RISKS			
Post-earthquake reconstruction is slow Under-execution of the ambitious 2015/16 budget and delays in reconstruction work in the aftermath of the earthquake, could depress confidence and hold back private investment and growth.	High	High	Boost the government's ability to manage capital expenditure as well as complex reconstruction projects, underpinned by effective coordination mechanisms that will enhance the ability of line ministries to execute their capital and reconstruction budgets.
Political instability Political instability, even in the aftermath of the promulgation of the constitution, could undermine confidence and delay economic reforms.	High	Medium/High	Preserve fiscal and external policy space.
Financial sector distress The damages and economic disruption caused by the earthquake could exacerbate existing weaknesses in the loan portfolio of banks and financial institutions.	Medium	Medium/High	Move to pro-active and risk-based supervision and exercise corrective and sanctioning powers more forcefully, and earlier. Increase resources for supervision.
Natural disaster Natural disasters similar to the recent earthquake could take a significant toll on Nepal, including by damaging infrastructure, housing and the production base.	Low	Medium/High	Prepare for future disasters by: (i) adhering to disaster-proof building codes, (ii) accelerating structural reforms to diversify the economy; (iii) building fiscal space and reserves buffers; and (iv) enhancing financial safety nets.
EXTERNAL RISKS			
Persistently low energy prices A slowdown in countries hosting Nepali migrant workers (Persian Gulf countries, Malaysia) could weaken remittance inflows. This would reduce demand and growth; tighten liquidity and expose weaknesses in the financial system; and reduce government revenues due to slower import growth.	Medium	Medium/High	Strengthen the financial sector and preserve fiscal and external policy space to cope with adverse shocks in the short term. In the longer term, boost public investment, and pursue structural reforms to improve the investment climate to reduce dependency on remittances.
Slower-than-projected growth in India Prolonged slow growth in India could reduce FDI and, to some extent, exports and remittances.	Medium	Medium	Accelerate structural reforms to improve the investment climate and boost public investment.

¹The 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 is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Box 1. Nepal – Exchange Rate Assessment

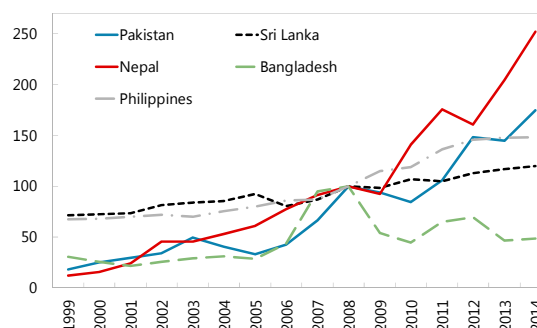
Nepal stands out through the large remittances it receives and their effect on the economy. At almost 30 percent of GDP in 2014, Nepal's remittances are its most important source of foreign exchange, amounting to 2½ times exports of goods and services and over ⅔ of imports. The bulk of remittances come from migrant workers in Persian Gulf countries and Malaysia. In recent years, the outflow of workers from Nepal has outpaced that of Pakistan, Bangladesh, Sri Lanka and the Philippines—larger countries with migrant workers heading to similar destinations as Nepal. The number of registered migrant workers leaving Nepal hit a record high of almost 600,000 in 2014—very large relative to its population of about 28 million. Correspondingly, the growth of remittances has averaged 15 percent since 2009/10.

Inflows of Remittances, Selected Countries, 2014
(In percent of GDP)



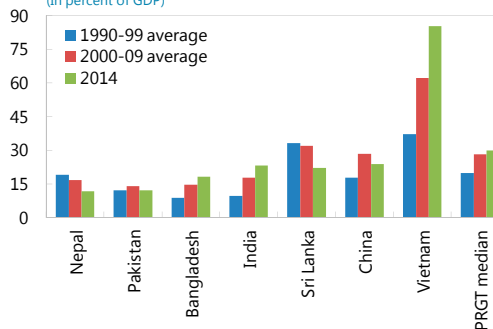
Sources: World Bank, Remittances Data; IMF, *World Economic Outlook*.

Gross Outflow of Migrant Workers
(Index, 2008=100)



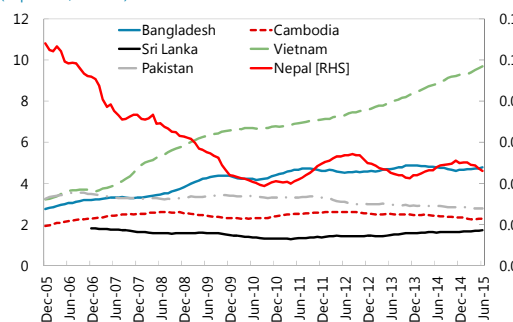
Nepal's export performance has been weak, lagging that of peers. The exports of goods and services to GDP ratio declined from 16 percent in the early 2000s to 11½ percent in 2014/15. In the garment's sector, for example, Nepal's market share in exports to the US has halved since 2005, and its share in the EU market has also declined. Weak exports along with the remittances-fueled increase in imports have caused the trade deficit as a share of output to increase steadily over the years, reaching 31 percent of GDP in 2013/14.

Exports of Goods and Services
(In percent of GDP)



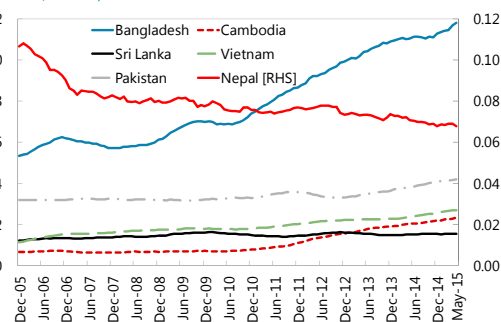
Sources: *World Economic Outlook*, and IMF staff estimates.

Shares in U.S. Garments Market
(In percent, 12mma)



Source: U.S. Department of Commerce.

Shares in E.U. Garments Market
(In percent, 12mma)



Source: Eurostat.

Box 1. Nepal – Exchange Rate Assessment (Concluded)

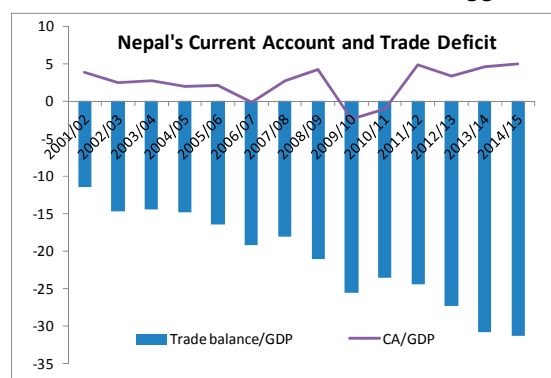
Gross international reserves (including the central bank's holdings of Indian rupees) reached US\$7.2 billion at the end of 2014/15, equal to 7.9 months of prospective imports. Reserves have risen on the strength of remittances and notwithstanding lackluster export performance. As laid out in the recent RCF staff report, Nepal's reserves should be maintained at about 7 months of imports of goods and services not related to FDI-financed projects, in view of the peg to the Indian rupee, the need to be able to absorb external shocks and the low opportunity cost of holding reserves.

The application of several econometric approaches¹ suggests that the exchange rate is broadly in line with macro-economic fundamentals. Last year's Article IV consultation concluded that the exchange rate was broadly in line with fundamentals. Reflecting also the inflation differential with India, Nepal's REER appreciated by about 8 percent over the past year. Nevertheless, and in part because Nepal's large trade deficits are sustained by even larger remittances, various econometric approaches to assess the exchange rate produce a relatively wide range of estimates:

i) The current account panel regression approach takes fundamentals, policy variables, and cyclical factors into account in estimating the current account "norm".² The current account norm for Nepal is estimated at 1.8 percent of GDP, while the underlying current account in 2014/15 is 5.0 percent of GDP. Assuming an elasticity of the trade balance with respect to the REER of -0.33, the difference between the two suggests an undervaluation of the REER 9.7 percent.

ii) The index equilibrium exchange rate approach compares the current value of the REER with an estimate of its medium-term equilibrium value. The gap between the two indicates that the REER is approximately 23 percent overvalued as of end-June 2015.

iii) The external sustainability approach determines that the current account that is consistent with stabilizing Nepal's net international investment position (IIP) at the 2013 level of 9.8 percent of GDP is estimated at -0.4 of GDP. Taken together with the current account projected in the medium term (-1.1 percent of GDP), this suggests the REER is overvalued by 2.1 percent.



¹ These are based on the EBA methodology. See "The External Balance Assessment (EBA) Methodology, IMF 2013, IMF WP/13/272.

² The current account norm is based on a reduced form panel regression of the current account on policy variables, non-policy fundamentals, and cyclical factors. The difference between the current account norm and the actual underlying current account is then combined with an elasticity of the trade balance to the REER to arrive at an estimate of the REER that is consistent with fundamentals and desirable policies.

Box 2. Nepal—Developing the Hydropower Potential

Nepal's per capita use of electricity is among the lowest in the world. The inadequate electricity supply results in persistent load shedding, representing a major constraint to growth. Developing the country's vast hydropower potential should be a top priority to boost growth and diversify foreign exchange earnings.

At present, less than one percent of Nepal's vast hydropower potential is being exploited. Nepal's commercially viable hydropower generation potential is estimated at 43,000 MW. Earlier attempts to develop this vast potential on a large scale have failed.

Over the past year some promising steps were made, notwithstanding the earthquake-related damage to the Upper Tamakoshi project which pushed back its date of completion to late-2017:

- Nepal signed a power trade agreement with India in September 2014.
- Project development agreements were signed for two large projects (Upper Karnali (900MW) and Arun-3 (900MW)).
- Nepal's Investment Board cleared a proposal by a Chinese investor to develop the West Seti (750MW) project.
- The capacity of government agencies involved in the regulation and development of the hydropower sector is being strengthened through technical assistance from various development partners (e.g. the World Bank, Japan, and the United States).

Table 1. Nepal: Planned Large Hydropower Projects

Project	Capacity (MW)	Cost (US\$m)	Expected completion	Developer	Status
Upper Tamakoshi	456	441	2017	Upper Tamakoshi Hydro Power Ltd, Subsidiary of NEA (Nepal)	Slated for completion by late-2017.
West Seti	750	1,000	2022	Three Gorges, China	Cleared by Investment Board in April 2015. Special Purpose Vehicle is being formed and on-site investigation is underway.
Upper Karnali	900	1,050	2021	GMR, India	Project development agreement signed in Sept. 2014. Financial closure expected in Sept. 2016.
Arun-3	900	1,009	2020	SJVNL, India	Project development agreement signed in November 2014.
Total	3,006	3,500			
Memorandum items:					
Current power production (MW)			800		
Current power demand (MW)			1,400		

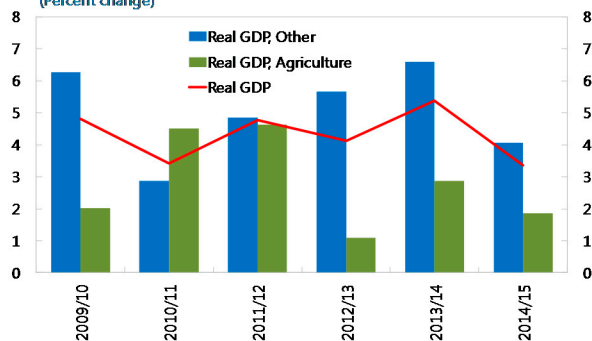
Sources: Nepalese authorities, World Bank and news reports.

Figure 1. Nepal: Recent Macroeconomic Developments

Growth averaged 4.5 percent in recent years but it slowed to 3.4 percent in 2014/15 due to the earthquake.

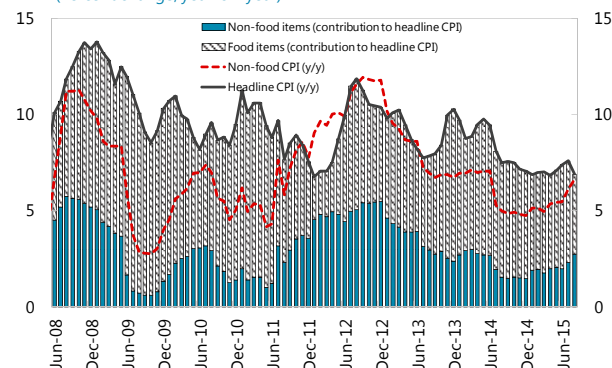
Inflation stood at 6.9 percent (y/y) in August...

Real GDP Growth (Percent change)



Sources: Nepali authorities; and IMF staff estimates.

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

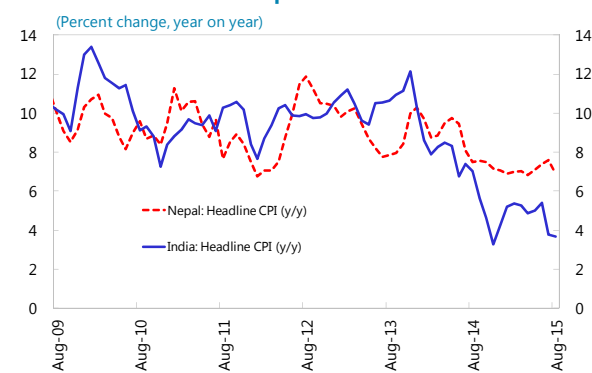


Sources: Nepali authorities; and IMF staff estimates.

...substantially higher than in India.

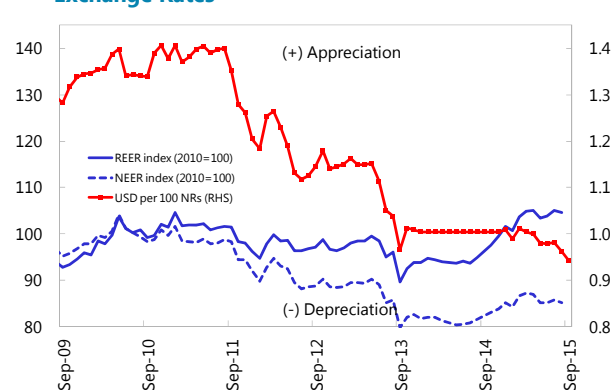
In combination with the stable nominal exchange rate, this has put the REER 12 percent above the 2013/14 average.

Consumer Prices in Nepal and India



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

Exchange Rates

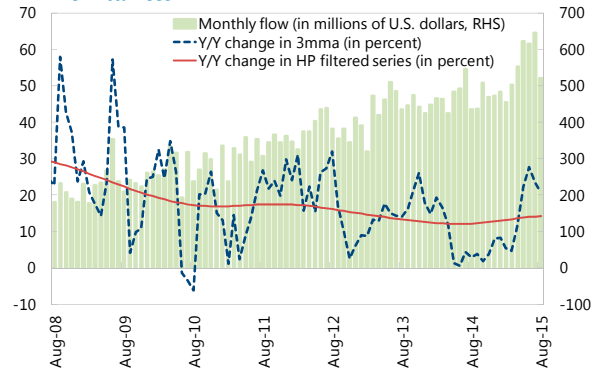


Sources: Nepali authorities; and IMF staff estimates.

Remittances have picked up after the earthquake...

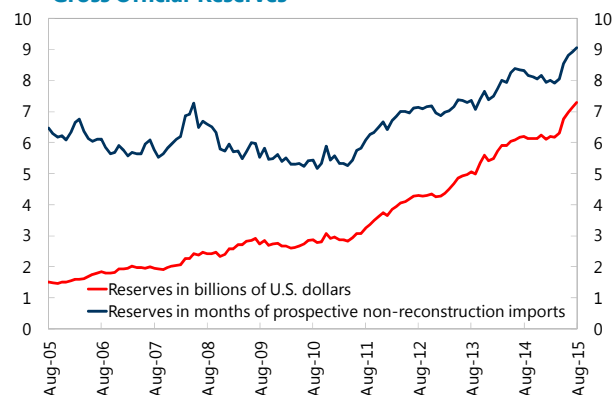
...pushing reserves to a record of US\$7.3 billion

Remittances



Sources: Nepali authorities; and IMF staff estimates.

Gross Official Reserves



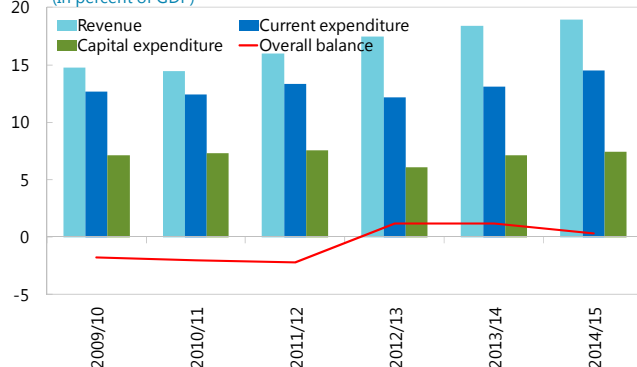
Sources: Nepali authorities; and IMF staff estimates.

Figure 2. Nepal: Recent Fiscal and Monetary Developments

Strong revenue growth combined with subdued capital spending kept the budget in surplus for the third year in a row.

Fiscal Performance

(In percent of GDP)

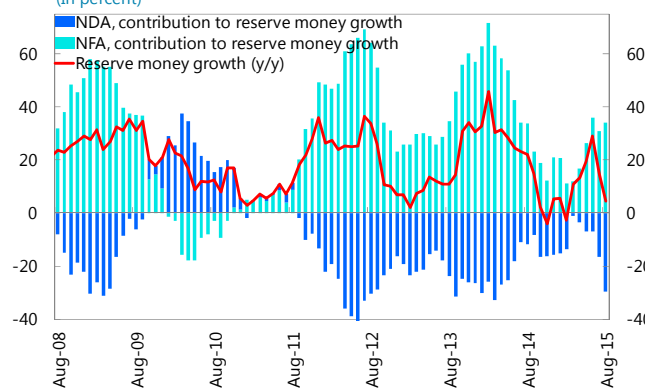


Sources: Nepali authorities; and IMF staff estimates.

Rising government deposits at the central bank and more activist central bank operations are keeping reserve money in check

Central Bank Balance Sheet

(In percent)

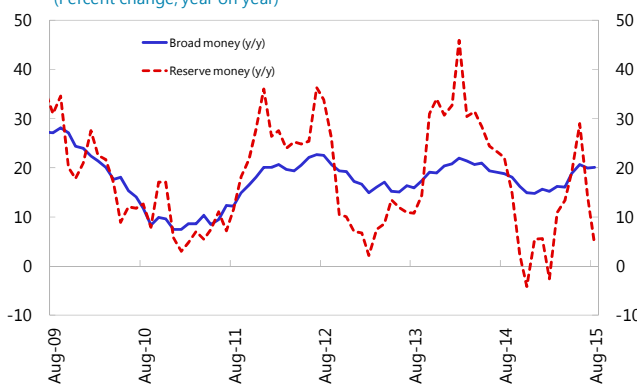


Sources: Nepali authorities; and IMF staff estimates.

Broad money growth rose to 20 percent in August (y/y)...

Nepal: Monetary aggregates

(Percent change, year on year)

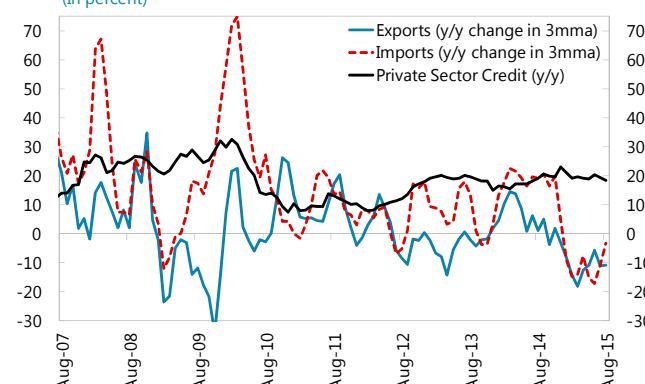


Sources: Nepali authorities; and IMF staff estimates.

...about equal to the rate of private credit growth.

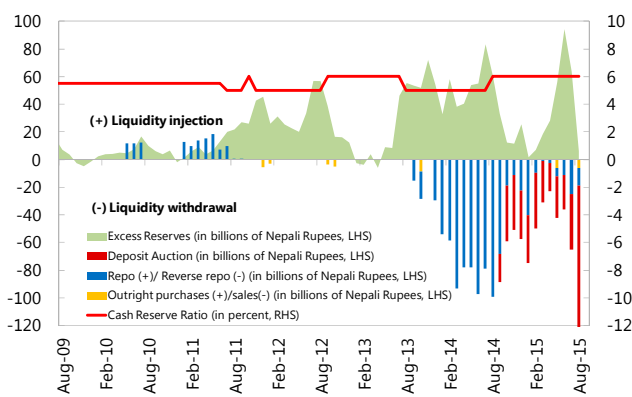
Private Sector Credit and Trade

(In percent)



Sources: Nepali authorities; and IMF staff estimates.

Banks' excess reserves increased in recent months until the NRB mopped up NR107 billion through a deposit auction in August

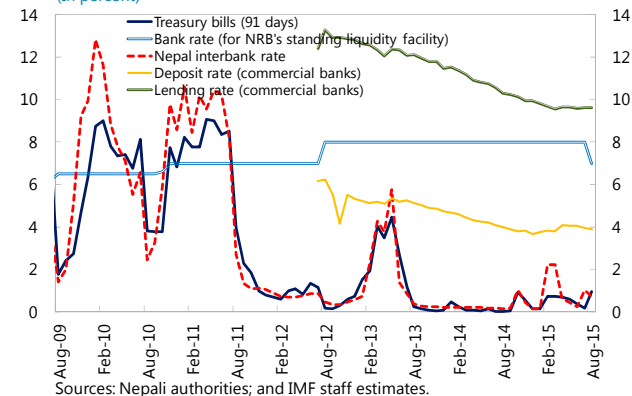
Excess Reserves and Open Market Operations

Sources: Nepali authorities; and IMF staff estimates.

As a result, the interbank interest rate has ticked up and deposit and lending rates have bottomed out.

Interest Rates

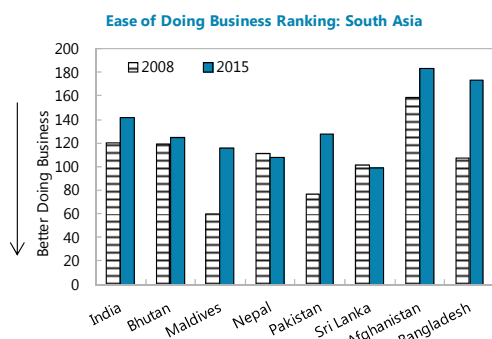
(In percent)



Sources: Nepali authorities; and IMF staff estimates.

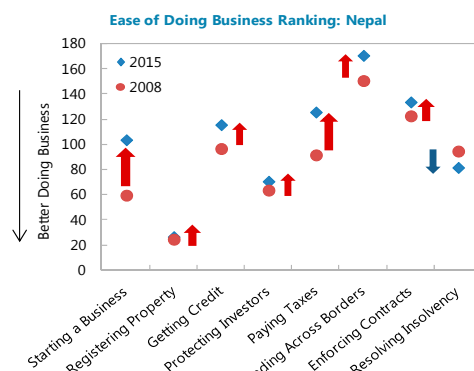
Figure 3. Nepal: Business Environment and Governance

Nepal's overall ranking improved marginally...



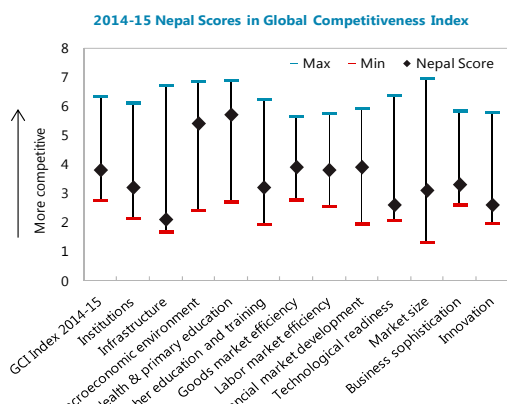
Sources: World Bank, Doing Business Report (2015 and 2008)

...but deteriorated in most areas important to business.



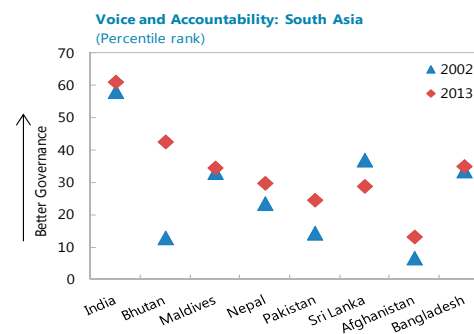
Sources: World Bank, Doing Business Report (2015 and 2008)

Competitiveness is hampered by inadequate infrastructure.



Sources: World Economic Forum Global Competitiveness Report (2014-15)

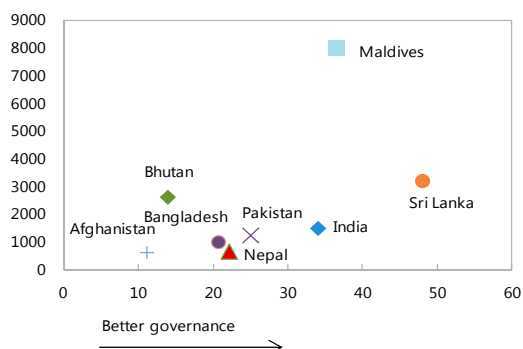
Voice and accountability have improved but lagged behind peers.



Sources: Worldwide Governance Indicators 2014
Note: Voice and Accountability reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom.

There is room for further improvement in regulatory quality ...

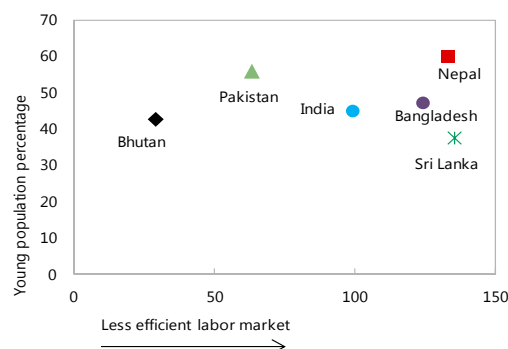
Regulatory Quality and GDP Per Capita: South Asia 2013
(Percentile rank; in US Dollars)



Sources: Worldwide Governance Indicators 2014; IMF
Note: Regulatory quality reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector.

...labor markets are less efficient than regional peers despite the advantage of a young population.

Labor Market Efficiency Ranking and Young Population Ratio: South Asia



Sources: World Development Indicators (2012) and World Economic Forum Global Competitiveness Report (2013)
Note: Young population ratio: people younger than 15 as percentage of population aged 15-64.

Table 3. Nepal: Selected Economic Indicators, 2012/13–2019/20 1/

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
				Est.	Projections			
Output and prices (annual percent change)								
Real GDP	4.1	5.4	3.4	4.4	5.4	3.9	3.8	3.8
CPI (period average)	9.9	9.0	7.2	8.0	8.3	7.7	7.0	6.1
CPI (end of period)	7.7	8.1	7.6	8.5	8.0	7.5	6.5	5.7
Fiscal Indicators (in percent of GDP)								
Total revenue and grants	19.3	20.6	20.8	21.9	22.0	22.2	22.4	22.5
of which: tax revenue	15.3	16.1	16.8	16.8	17.1	17.4	17.6	17.6
Expenditure	17.2	19.1	19.9	24.2	24.2	23.7	22.3	22.6
Expenses	14.2	15.6	15.8	17.7	17.8	18.0	17.9	17.8
Net acquisition of nonfinancial assets	3.0	3.4	4.1	6.5	6.4	5.7	4.4	4.7
Statistical discrepancy	0.2	0.9	0.7	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing	2.2	2.4	1.6	-2.3	-2.2	-1.5	0.1	-0.1
Net financial transactions	-2.2	-2.4	-1.6	2.3	2.2	1.5	-0.1	0.1
Net acquisition of financial assets	1.1	1.2	1.4	1.5	1.2	1.3	1.2	1.1
Net incurrence of liabilities	-1.2	-1.2	-0.3	3.8	3.4	2.7	1.1	1.2
Foreign	-0.3	-0.1	0.8	2.9	1.9	1.8	1.4	1.1
Domestic	-0.8	-1.1	-1.0	0.9	1.5	0.9	-0.4	0.1
Money and credit (annual percent change)								
Broad money	16.3	19.1	19.9	12.8	15.1	...	...	...
Domestic credit	16.9	13.9	15.7	15.8	18.3	...	...	...
Private sector credit	20.2	18.3	19.4	16.5	18.0	...	...	...
Velocity	1.3	1.2	1.1	1.1	1.1	...	...	...
Balance of Payments								
Current account (in millions of U.S. dollars)	635	908	1,067	-570	-426	-452	-352	-234
In percent of GDP	3.3	4.6	5.0	-2.5	-1.7	-1.7	-1.2	-0.8
Trade balance (in millions of U.S. dollars)	-5,247	-6,082	-6,670	-8,453	-9,106	-9,867	-10,450	-11,080
In percent of GDP	-27.2	-30.8	-31.2	-36.9	-36.2	-36.2	-36.2	-36.2
Exports value growth (y/y percent change)	-3.1	5.4	-4.0	2.0	5.4	6.0	6.0	6.0
Imports value growth (y/y percent change)	10.9	14.3	7.7	23.5	7.5	8.1	5.9	6.0
Workers' remittances (in millions of U.S. dollars)	4,931	5,543	6,192	6,631	7,131	7,698	8,308	8,964
In percent of GDP	25.6	28.1	29.0	28.9	28.3	28.3	28.8	29.3
Gross official reserves (in millions of U.S. dollars)	4,972	6,172	7,162	7,320	7,594	8,003	8,548	9,138
In months of prospective GNFS imports	7.3	8.3	7.9	7.6	7.3	7.3	7.3	7.3
Excl. reconstruction- and FDI-related imports	...	...	9.0	8.3	7.8	7.5	7.3	7.3
Memorandum items								
Public debt (in percent of GDP)	32.3	28.3	25.7	28.9	29.4	29.6	28.7	28.0
GDP at market prices (in billions of Nepalese rupees)	1,695	1,942	2,125	2,396	2,733	3,060	3,351	3,651
GDP at market prices (in billions of U.S. dollars)	19.3	19.8	21.4	22.9	25.2	27.2	28.9	30.6
Exchange rate (NRs/US\$; period average)	88.0	98.3	99.5	...	...	...	...	...
Real effective exchange rate (average, y/y percent change)	-0.6	-4.0	8.2	...	...	...	...	...
Sources: Nepalese authorities; and IMF staff estimates and projections.								
¹ Fiscal year ends in mid-July.								

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

¹ Fiscal year ends in mid-July.

Table 4. Nepal: Summary of Government Operations, 2012/13–2019/20 1/

	2012/13	2013/14	2014/15		2015/16		2016/17	2017/18	2018/19	2019/20
			Budget ^{2/}	Est.	Budget ^{2/}	Proj.	Projections			
(In billions of Nepalese rupees)										
Total revenue and grants	327	399	496	443	586	525	601	681	751	820
Total revenue	296	357	423	403	475	458	529	604	667	729
Tax revenue	260	312	375	358	427	403	466	534	589	644
Non-tax revenue	36	45	48	45	48	55	63	70	77	85
Grants	31	42	73	40	111	67	72	77	84	91
Expenditure	292	370	511	422	693	579	661	725	747	823
Expenses	240	303	394	336	484	425	486	550	601	651
<i>Of which</i> : Interest payments	14	12	23	9	21	14	16	19	23	23
Salaries and allowances	51	68	90	74	104	96	119	140	157	173
Net acquisition of nonfinancial assets	52	67	117	86	209	155	175	175	146	172
Operating balance	86	96	102	107	102	100	115	130	150	168
Statistical discrepancy	3	17	0	14	0	0	0	0	0	0
Net lending/borrowing	38	46	-14	34	-59	-54	-60	-45	3	-4
Net financial transactions	-38	-46	14	-34	59	54	60	45	-3	4
Net acquisition of financial assets	18	23	50	29	-61	36	33	38	39	40
Net incurrence of liabilities	-20	-23	64	-6	119	91	93	83	35	44
Foreign	-5	-1	29	17	73	69	52	55	48	38
Domestic	-14	-22	35	-22	47	21	41	28	-13	5
(In percent of GDP, unless otherwise indicated)										
Total revenue and grants	19.3	20.6	23.4	20.8	24.0	21.9	22.0	22.2	22.4	22.5
Total revenue	17.5	18.4	19.9	19.0	19.5	19.1	19.4	19.7	19.9	20.0
Tax revenue	15.3	16.1	17.6	16.8	17.5	16.8	17.1	17.4	17.6	17.6
Non-tax revenue	2.1	2.3	2.3	2.1	2.0	2.3	2.3	2.3	2.3	2.3
Grants	1.8	2.2	3.5	1.9	4.5	2.8	2.6	2.5	2.5	2.5
Expenditure	17.2	19.1	24.0	19.9	28.4	24.2	24.2	23.7	22.3	22.6
Expenses	14.2	15.6	18.5	15.8	19.9	17.7	17.8	18.0	17.9	17.8
<i>Of which</i> : Interest payments	0.8	0.6	1.1	0.4	0.9	0.6	0.6	0.6	0.7	0.6
Salaries and allowances	3.0	3.5	4.2	3.5	4.3	4.0	4.3	4.6	4.7	4.7
Net acquisition of nonfinancial assets	3.0	3.4	5.5	4.1	8.6	6.5	6.4	5.7	4.4	4.7
Operating balance	5.1	4.9	4.8	5.0	4.2	4.2	4.2	4.3	4.5	4.6
Statistical discrepancy	0.2	0.9	0.0	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing	2.2	2.4	-0.7	1.6	-2.4	-2.3	-2.2	-1.5	0.1	-0.1
Net financial transactions	-2.2	-2.4	0.7	-1.6	2.4	2.3	2.2	1.5	-0.1	0.1
Net acquisition of financial assets	1.1	1.2	2.3	1.4	-2.5	1.5	1.2	1.3	1.2	1.1
Net incurrence of liabilities	-1.2	-1.2	3.0	-0.3	4.9	3.8	3.4	2.7	1.1	1.2
Foreign	-0.3	-0.1	1.4	0.8	3.0	2.9	1.9	1.8	1.4	1.1
Domestic	-0.8	-1.1	1.6	-1.0	1.9	0.9	1.5	0.9	-0.4	0.1
Memorandum items										
Primary balance	3.0	3.0	0.4	2.1	-3.5	-1.7	-1.6	-0.8	0.8	0.5
Public debt	32.3	28.3	...	25.7	...	28.9	29.4	29.6	28.7	28.0
Domestic	12.2	10.4	...	9.3	...	9.1	9.5	9.4	8.2	7.7
External	20.0	17.9	...	16.5	...	19.8	19.9	20.2	20.5	20.3
GDP (in billion of Nepalese rupees)	1,695	1,942	2,125	2,125	2,439	2,396	2,733	3,060	3,351	3,651

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

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

2/ Based on the authorities' data and Fund staff assumptions.

Table 5. Nepal: Monetary Indicators, 2012/13–2016/17

	2012/13	2013/14	2014/15	2015/16	2016/17
				Projections	
Nepal Rastra Bank					
	(In billions of Nepalese rupees, end-period)				
Reserve money	354	437	499	563	646
Net domestic assets	-111	-150	-221	-203	-181
Claims on public sector	2	-1	-21	15	15
Claims on private sector	5	4	5	5	6
Claims on banks & financial institutions	3	2	3	-19	-32
Other items (net)	-121	-154	-208	-204	-170
Net foreign assets	465	586	721	766	827
Monetary Survey					
Broad money	1,315	1,566	1,878	2,118	2,437
Narrow money	302	355	425	645	741
Quasi-money	1,014	1,211	1,453	1,473	1,696
Net domestic assets	847	967	1,131	1,322	1,578
Domestic credit	1,153	1,313	1,519	1,760	2,082
Credit to public sector	179	162	145	159	193
<i>of which</i> : Credit to central government	154	140	120	132	162
Credit to private sector	973	1,151	1,374	1,601	1,889
Other items(net)	-305	-346	-388	-438	-504
Net foreign assets	468	599	747	796	859
	(Twelve-month percent change)				
Reserve money	10.9	23.3	14.3	12.8	14.8
Broad money	16.3	19.1	19.9	12.8	15.1
Net domestic assets	12.0	14.1	17.0	16.9	19.4
Domestic credit	16.9	13.9	15.7	15.8	18.3
Credit to public sector	1.9	-9.9	-10.3	9.3	21.4
Credit to private sector	20.2	18.3	19.4	16.5	18.0
Net foreign assets	25.0	28.0	24.7	6.6	7.9
Memorandum items					
Velocity	1.3	1.2	1.1	1.1	1.1
Multiplier	3.7	3.6	3.8	3.8	3.8
Private credit (in percent of GDP)	57.4	59.3	64.7	66.8	69.1
GDP at market prices (in billions of NR)	1,695	1,942	2,125	2,396	2,733
Source: Nepalese authorities; and IMF staff estimates and projections.					

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

Table 6. Nepal: Balance of Payments, 2012/13–2019/20

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Projections							
	(in million US dollars)							
Current account	635	908	1,067	-570	-426	-452	-352	-234
Current account (excluding official transfers)	378	547	774	-1,081	-893	-941	-841	-737
Trade balance	-5,247	-6,082	-6,670	-8,453	-9,106	-9,867	-10,450	-11,080
Exports, f.o.b.	977	1,030	988	1,008	1,062	1,125	1,193	1,264
Imports, f.o.b.	-6,224	-7,112	-7,658	-9,461	-10,168	-10,992	-11,642	-12,344
Services (net)	87	214	275	-177	77	138	147	156
Receipts	1,083	1,277	1,499	1,272	1,459	1,634	1,732	1,836
Of which : tourism	390	473	537	344	428	517	548	582
Payments	-995	-1,063	-1,224	-1,449	-1,382	-1,496	-1,585	-1,681
Income	146	334	342	355	390	422	447	474
Credit	263	403	428	447	491	531	563	597
Debit	-117	-69	-86	-92	-101	-109	-115	-122
Current transfers	5,648	6,442	7,120	7,703	8,213	8,855	9,503	10,216
Credit, of which:	5,732	6,477	7,146	7,804	8,323	8,974	9,629	10,350
General government	257	362	293	524	481	505	505	521
Workers' remittances	4,931	5,543	6,192	6,631	7,131	7,698	8,308	8,964
Debit	-84	-34	-26	-100	-110	-119	-126	-134
Capital account	117	173	148	290	194	192	207	202
Financial account	-50	-19	83	397	514	675	695	625
Direct investment	102	33	44	59	74	89	104	223
Portfolio investment	0	0	0	0	0	0	0	0
Other investment (net)	-152	-51	39	339	440	586	591	402
MT debt (net)	-13	45	460	662	550	599	524	425
Other (net)	-139	-96	-421	-323	-109	-13	67	-23
Errors and omissions	37	121	185	0	0	0	0	0
Overall balance	739	1,184	1,483	117	282	415	549	594
Financing	-739	-1,184	-1,483	-117	-282	-415	-549	-594
Change in reserve assets (- =increase)	-665	-1,200	-1,477	-158	-274	-409	-545	-590
Use of IMF resources (net)	-5	-6	-5	41	-8	-6	-4	-4
IMF Disbursements	0	0	0	50	0	0	0	0
IMF Repayment	5	6	5	9	8	6	4	4
Memorandum items								
Current account (in percent of GDP)	3.3	4.6	5.0	-2.5	-1.7	-1.7	-1.2	-0.8
Current account, excl. grants (in percent of GDP)	2.0	2.8	3.6	-4.7	-3.5	-3.5	-2.9	-2.4
Trade balance (in percent of GDP)	-27.2	-30.8	-31.2	-36.9	-36.2	-36.2	-36.2	-36.2
Exports (in percent of GDP)	5.1	5.2	4.6	4.4	4.2	4.1	4.1	4.1
Imports (in percent of GDP)	32.3	36.0	35.9	41.3	40.4	40.4	40.3	40.3
Exports (y/y percent change)	-3.1	5.4	-4.0	2.0	5.4	6.0	6.0	6.0
Imports (y/y percent change)	10.9	14.3	7.7	23.5	7.5	8.1	5.9	6.0
Remittances (in percent of GDP)	25.6	28.1	29.0	28.9	28.3	28.3	28.8	29.3
Remittances (y/y percent change)	11.7	12.4	11.7	7.1	7.5	8.0	7.9	7.9
Total external debt (in percent of GDP)	20.0	17.9	16.5	19.8	19.9	20.2	20.5	20.3
Debt service (in percent of current account receipt)	2.4	2.2	1.6	1.7	1.7	1.7	1.7	1.7
Gross official reserves (in millions of U.S. dollars)	4,972	6,172	7,162	7,320	7,594	8,003	8,548	9,138
In months of prospective GNFS imports	7.3	8.3	7.9	7.6	7.3	7.3	7.3	7.3
Excl. reconstruction- and FDI-related imports	...	...	9.0	8.3	7.8	7.5	7.3	7.3
As a share of broad money (in percent)	36.0	37.9	38.7	36.8	34.4	...	...	...
Nominal GDP (in millions of U.S. dollars)	19,270	19,761	21,356	22,927	25,160	27,233	28,868	30,607

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

Table 7. Nepal: Macroeconomic Framework, 2012/13–2019/20 1/

	2012/13	2013/14	2014/15	Baseline Scenario				
	2015/16	2016/17	2017/18	2018/19	2019/20			
Output and prices (annual percent change)								
Real GDP	4.1	5.4	3.4	4.4	5.4	3.9	3.8	3.8
CPI (period average)	9.9	9.0	7.2	8.0	8.3	7.7	7.0	6.1
CPI (end of period)	7.7	8.1	7.6	8.5	8.0	7.5	6.5	5.7
Fiscal Indicators (in percent of GDP)								
Total revenue and grants	19.3	20.6	20.8	21.9	22.0	22.2	22.4	22.5
of which: tax revenue	15.3	16.1	16.8	16.8	17.1	17.4	17.6	17.6
Expenditure	17.2	19.1	19.9	24.2	24.2	23.7	22.3	22.6
Expenses	14.2	15.6	15.8	17.7	17.8	18.0	17.9	17.8
Net acquisition of nonfinancial assets	3.0	3.4	4.1	6.5	6.4	5.7	4.4	4.7
Statistical discrepancy	0.2	0.9	0.7	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing	2.2	2.4	1.6	-2.3	-2.2	-1.5	0.1	-0.1
Net financial transactions	-2.2	-2.4	-1.6	2.3	2.2	1.5	-0.1	0.1
Net acquisition of financial assets	1.1	1.2	1.4	1.5	1.2	1.3	1.2	1.1
Net incurrence of liabilities	-1.2	-1.2	-0.3	3.8	3.4	2.7	1.1	1.2
Foreign	-0.3	-0.1	0.8	2.9	1.9	1.8	1.4	1.1
Domestic	-0.8	-1.1	-1.0	0.9	1.5	0.9	-0.4	0.1
Money and credit (annual percent change)								
Broad money	16.3	19.1	19.9	...	...	...	...	...
Domestic credit	16.9	13.9	15.7	...	...	...	...	...
Private sector credit	20.2	18.3	19.4	...	...	...	...	...
Velocity	1.3	1.2	1.1	...	...	...	...	...
Saving and Investment (in percent of nominal GDP)								
Gross investment	29.8	28.7	28.9	31.6	30.9	30.7	30.7	29.7
Private	26.7	25.2	24.9	25.2	24.5	25.0	26.3	25.0
Central government	3.0	3.4	4.1	6.5	6.4	5.7	4.4	4.7
Gross national saving	33.1	33.3	33.9	29.2	29.2	29.1	29.5	28.9
Private	27.8	28.0	28.9	25.6	25.4	25.0	25.1	24.4
Central government	5.3	5.3	5.0	3.5	3.8	4.1	4.4	4.6
Balance of Payments								
Current account (in millions of U.S. dollars)	635	908	1,067	-570	-426	-452	-352	-234
In percent of GDP	3.3	4.6	5.0	-2.5	-1.7	-1.7	-1.2	-0.8
Trade balance (in millions of U.S. dollars)	-5,247	-6,082	-6,670	-8,453	-9,106	-9,867	-10,450	-11,080
In percent of GDP	-27.2	-30.8	-31.2	-36.9	-36.2	-36.2	-36.2	-36.2
Exports value growth (y/y percent change)	-3.1	5.4	-4.0	2.0	5.4	6.0	6.0	6.0
Imports value growth (y/y percent change)	10.9	14.3	7.7	23.5	7.5	8.1	5.9	6.0
Workers' remittances (in millions of U.S. dollars)	4,931	5,543	6,192	6,631	7,131	7,698	8,308	8,964
In percent of GDP	25.6	28.1	29.0	28.9	28.3	28.3	28.8	29.3
Gross official reserves (in millions of U.S. dollars)	4,972	6,172	7,162	7,320	7,594	8,003	8,548	9,138
In months of prospective GNFS imports	7.3	8.3	7.9	7.6	7.3	7.3	7.3	7.3
Excl. reconstruction- and FDI-related imports			9.0	8.3	7.8	7.5	7.3	7.3
Memorandum items								
Reconstruction-related expenditure (in percent of GDP) ¹	...	...	...	3.0	2.7	1.8	...	...
Public debt (in percent of GDP)	32.3	28.3	25.7	28.9	29.4	29.6	28.7	28.0
GDP at market prices (in billions of U.S. dollars)	19.3	19.8	21.4	22.9	25.2	27.2	28.9	30.6

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

¹ Fiscal year ends in mid-July.

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

¹ Fiscal year ends in mid-July.

Table 8. Nepal: Commercial Banks' Financial Soundness Indicators, 2008–2015 1/

	2008	2009	2010	2011	2012	2013	2014	2015
	(in percent)							
Capital adequacy								
Capital fund to risk weighted assets	4.0	7.2	9.6	10.6	11.5	12.3	12.0	11.9
Tier 1 capital to risk weighted assets	1.8	5.2	7.9	9.1	10.0	10.7	10.4	10.3
Asset quality								
NPLs to total loans	6.1	3.6	2.5	3.2	2.6	2.6	2.9	2.6
Loan loss provision to total loans	8.2	5.9	4.6	4.0	3.5	3.4	3.5	3.2
Earnings and profitability								
Return on equity (ROE) 2/	35.2	34.7	33.9	25.3	22.5	28.2	24.5	28.0
Return on assets (ROA) 2/	2.0	4.9	1.9	1.7	1.5	1.7	1.5	1.5
Interest income to gross income	68.3	73.9	77.9	81.4	82.4	81.6	81.7	76.3
Non-interest expenditures to gross income	70.4	60.1	60.2	53.2	48.0	58.3	24.6	24.1
Employees expenses to non-interest expenditures	18.7	25.1	23.7	22.2	21.5	20.4	57.2	55.6
Liquidity								
Liquid assets to total assets	11.8	26.0	13.1	11.2	15.2	14.7	26.2	25.5
Liquid assets to demand and savings deposits	25.0	31.1	31.7	31.6	40.6	39.8	43.6	n.a.
Liquid assets to total deposits	15.9	18.3	16.0	14.3	18.6	32.4	31.7	29.2
Exposure to real estate								
Share of real estate and housing loans	...	19.4	20.7	18.5	16.9	14.6	13.9	13.8
Share of loans collateralized by land and buildings	...	71.7	58.4	68.4	55.9	55.2	54.9	55.8

Source: Nepalese authorities.

1/ End of fiscal year (mid-July). All 30 commercial banks unless noted otherwise.

2/ Excluding state-owned banks.

Table 9. Nepal: Millennium Development Goals

Targets	Indicators	1990/ Earliest	Most recent	2015 Target	Status of Progress
Goal 1: Eradicate extreme poverty and hunger					
Target: Halve between 1990 and 2015, the proportion of people living below the poverty line	Proportion of population below the national poverty line (percent) 1/	42(90)	23.8(13)	21	Likely
Target: Halve by 2015, the proportion of people who suffer from hunger	Proportion of population below minimum level of dietary energy consumption (percent)	49(90)	15.7 (13)	25	Achieved
Goal 2: Achieve universal primary education					
Target: Ensuring that by 2015, children everywhere will be able to complete a full course of primary schooling	Net primary enrollment ratio (percent)	64(90)	95.3 (13)	100	Likely
	Reaching last grade	38(90)	84.2 (13)	100	Possible
	Literacy rate of 14-24 age	49.6(90)	88.6 (13)	100	Possible
Goal 3: Promote gender equality and empower women					
Target: Eliminate gender disparity in primary and secondary education preferably by 2005, and to all levels of education by 2015	Ratio of girls to boys in primary education (percent)	56(90)	102(13)	100	Achieved
	Ratio of girls to boys in secondary education (percent)	43(90)	99(13)	100	Achieved
	Ratio of females to males in tertiary institutes (percent)	32(90)	73(13)	100	Unlikely
Goal 4: Reduce child mortality					
Target: Reduce by two-thirds between 1990 and 2015, the under-five mortality rate	Under-five mortality rate (per 1,000 births)	162(90)	54(11)	54	Achieved
	Infant mortality rate (per 1,000 live births)	108(90)	46(11)	36	Achieved
	Immunization, measles (percent of children under 12 months)	108(90)	88 (11)	>90	Likely
Goal 5: Improve maternal health					
Target: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio	Maternal mortality ratio (per 100,000 live births)	850(90)	170 (13)	213	Achieved
	Births attended by skilled health personnel (percent)	7(90)	50 (13)	60	Likely
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Target: Halt and begin to reverse the spread of HIV/AIDS	HIV prevalence among population aged 15-24 years (percent)	0.29(90)	0.12 (13)	Halt and reverse	Achieved
Target: Halt and begin to reverse the spread of malaria and other major diseases	Annual parasite incidence of malaria per 100,000 people	119(90)	0.08 (13)	0.06	Likely
	Prevalence rate of tuberculosis cases per 100,000 people	460(90)	238 (13)	Halt and reverse	Achieved
Goal 7: Ensure environmental sustainability					
Target: Halve between 1990 and 2015, sustainable access to safe drinking water and sanitation	Proportion of population with access to an improved drinking water source (percent)	46(90)	85 (13)	73	Achieved
	Proportion of population with access to improved sanitation (percent)	6(90)	62 (13)	80	Unlikely
Source: UNDP, Nepal Millennium Development Goals--Progress Report (September 2013).					

Appendix I. Progress in Implementing High-Priority FSAP Recommendations

Recommendations		Responsible Authority	Time Line*	Progress to date
Financial Stability				
1.	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	ST	In process The NRB has been holding deposit auctions intermittently since August 2014 to reduce banks' excess liquidity. The introduction of Treasury sterilization bonds is under discussion
2.	Undertake a thorough Asset Quality Review (AQR) to identify the extent of problem loans in banks' balance sheets (with TA support).	NRB	ST	Not done Lack of AQR is largely offset by the special investigations conducted by KPMG (Portugal) in conjunction with NRB supervisors. Reviews conducted in BFIs holding about 64% of total assets.
3.	Conduct an in-depth review and financial analysis of loan portfolios during bank examinations.	NRB	ST/MT	In process Loan portfolio reviews are performed on-site; the reviews are guided by the outmoded asset classification and loss provisioning guidance. As the supervisors gain experience, it is expected the reviews will be more in-depth.
4.	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 NRB established a payment and settlement system department, which will also oversee some of the new products such as mobile banking and branchless banking. Reforms have been identified to strengthen the credit information bureau, the collateral registry and debt recovery areas but action has not yet been taken.
Financial Sector Oversight				
A. Banking Sector				
5.	Redefine supervisory approach by: <ul style="list-style-type: none"> • 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 / not done Supported by FIRST-funded TA (FIRST) risk-based supervision (RBS) is being implemented for Class A institutions; and is in preliminary stage for on-site supervision. A complementary off-site RBS component is yet to be developed. A donor is assisting in procurement of MIS, and FIRST aims to support off-site RBS practices. A critical need remains for a dedicated HR policy to hire, train and retain qualified supervisors. No action taken on streamlining the NRB Board's participation in operational decisions.
6.	Ensure effective compliance with supervisory directives and guidelines by: <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	Not done Corrective and supervisory actions remain largely informal; with PCA having a formal framework. The FIRST project supports the development of programs to ensure compliance.

7.	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	Under review NRB has indicated its intent to review the licensing framework; this is supported by the FIRST project. The consolidation of the sector may – in the long run have an impact on the various classes of FI.
8.	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 Although amended BAFIA and NRB Acts have been submitted to Parliament, it is uncertain if the listed items were addressed.* Introduction of consolidated supervision will be sequenced as appropriate.
B. Non-banking Sector				
9.	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	In preparation MOF is preparing a concept report (based on a study trip to India)
10.	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 Regulatory and supervisory options are being explored.
11.	Strengthen the operational independence of the IB and SEBON.	SEBON/IB/MOF	ST	Not done The government is first looking to strengthen the capacity of the IB and the SEBON.
Crisis Management				
12.	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	Under consideration NRB considering including liquidity as a trigger for PCA program. No changes made regarding the designation of problematic status.
13.	Develop and implement a banking financial institution (BFI) Supervision Enforcement policy that presumes certain enforcement action based on CAMELS ratings.	NRB	MT	Not done As the supervisory reforms are implemented, such an enforcement policy may emerge.
14.	Revise NRB Act to clarify ELA provisions.	NRB/MOF	ST	In preparation NRB Act Amendments tabled in Parliament.*
15.	Revise NRB Act to grant it special resolution regime powers.	NRB/MOF	ST	In preparation NRB Act Amendments tabled in Parliament.*
16.	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	Not done A high-level interagency coordination committee meets on an <i>ad hoc</i> basis. It would be important to formalize the mandate of this committee to include the development of a national crisis contingency plan.
17.	Crisis simulations should be conducted periodically.	MOF/NRB/IB/SEBON	MT	Not done A simulation has not yet been conducted; the authorities are encouraged to conduct crisis simulations after passage of the relevant Acts.

* English versions of the BAFIA and the NRB Acts that have been tabled in Parliament are not available; therefore there is no clarity regarding the efficacy of the proposed text.

Appendix II. Key Policy Recommendations from the 2014 Article IV Consultation

Policy advice	Implementation status
Fiscal policy	
<i>Objective: To increase capital spending to provide infrastructure that supports private investment, which will help generate sustained economic growth and employment opportunities.</i>	
Support growth through higher public expenditure	Capital spending increased by 0.7 percent of GDP in 2014/15 but the budget remains under-executed
Continue spending increase on health and education	In progress
Monitor expenditures executed through local bodies	In progress. A Line Ministry Budget Information System (LIMBS) has been rolled out
Ensure sustainability of current spending	Revenue has been growing but fell short of the 2014/15 budget
Reduce or eliminate implicit subsidies to the NOC	Implemented. An automatic bi-weekly oil price adjustment mechanism was introduced in 2014. Since the NOC did not fully pass through the decline in international oil prices to its customers, it made a profit in 2014/15 and was able to repay part of its debts
Reforms on budget planning and execution process	In progress. MOF has drafted a Fiscal Responsibility and Budget Management Act
Enhance cash management, and improve revenue and expenditure forecasts	In progress
Monetary and exchange rate policies	
<i>Objective: To control the volatility and level of excess reserves in the financial system.</i>	
Step up sterilization and/or raising reserve requirement	Progress made through the introduction of deposit auctions; more effective liquidity management needed
Additional issuance of government debt securities for OMOs	Under consideration but challenges remain
Enhance cooperation between the NRB and the MOF to improve liquidity forecasts	Problem recognized but challenges remain
Separate monetary policy from debt management considerations	Implemented via the creation of separate OMO committees for public debt management and monetary management
Introduce interest rate corridor to strengthen monetary framework	Under consideration for implementation over the longer-term
Phase out direct lending and cap on interest rate spreads	Will consider if banks begin to lend sufficiently to specific sectors/regions
The peg to the Indian rupee provides a useful nominal anchor	Closing the inflation differential with India remains a challenge.
Financial sector	
<i>Objective: Bolster regulation and supervision and improve financial infrastructure to reduce risk and increase access to finance.</i>	
<i>See Appendix I for progress in implementing high-priority FSAP recommendations.</i>	
Source: IMF Country Report No. 14/214.	



INTERNATIONAL MONETARY FUND



Appendix III. Draft Press Release

Press Release No. 15/xx
FOR IMMEDIATE RELEASE
[November, 16, 2015]

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

IMF Executive Board Concludes 2015 Article IV Consultation with Nepal

On [November, 16, 2015], the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Nepal.

The earthquakes in April and May and protests and trade disruptions following the promulgation of a new constitution in September have exacerbated the macroeconomic policy challenges facing the Nepalese economy. Real GDP growth is estimated to have decelerated to 3.4 percent in 2014/15 (mid-July 2014 to mid-July 2015) from 5.5 percent in 2013/14. Inflation had been moderating from a high base but the recent acceleration to 6.9 percent in August (y/y) widens the wedge over Indian CPI, thereby undermining Nepal's competitiveness given the exchange rate peg to the Indian rupee. The financing data indicates that the budget was in surplus for the third year in a row, even as revenues fell short of the budget for the first time in several years. As a result, public debt remained on a declining path, falling to 26 percent of GDP in 2014/15, from 32 percent of GDP in 2012/13. The external current account surplus reached 5.0 percent of GDP in 2014/15, aided by a surge in remittances following the earthquake and lower oil import prices. Reserves rose to US\$7.2 billion, or 33 percent of GDP, covering almost eight months of prospective imports.

Growth is expected to gradually rebound to around 5½ percent by 2016/17, as economic activity recovers from the earthquake and reconstruction gains momentum. Inflation is projected to rise to about 8½ percent over the next 12 months as losses in agricultural production and damage to transport systems represent a large shock to the supply of agricultural products. However, over time, inflation pressures should decline as supply bottlenecks ease. Stepped-up foreign aid and higher inflows of remittances will further boost liquidity pressures in the financial system,

¹Under 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.

necessitating active liquidity management to avoid excess inflation relative to India. The medium-term outlook depends importantly on the authorities' reform efforts. Experiences in other fragile countries show that natural disasters can have permanent effects on potential growth, thus highlighting the need for ambitious macroeconomic and structural policies. This underscores the importance of a decisive boost to public capital spending and reforms to strengthen the business climate.

Recent developments have heightened the downside risks to the staff's baseline scenario. Continued political instability and a continuation of the recent disruptions to economic activity and transportation and trade routes to and from the country's southern border and the related fuel crisis could severely affect growth and inflation in this fiscal year. Another important downside risk relates to the government's capacity to boost capital spending owing in part to the delay in setting up the National Reconstruction Authority (NRA).

Executive Board Assessment²

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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>.

Nepal: Selected Economic Indicators, 2012/13–2016/17 1/

	2012/13	2013/14	2014/15	2015/16	2016/17
				Projections	
Output and prices (annual percent change)					
Real GDP	4.1	5.4	3.4	4.4	5.4
CPI (period average)	9.9	9.0	7.2	8.0	8.3
CPI (end of period)	7.7	8.1	7.6	8.5	8.0
Fiscal indicators (in percent of GDP)					
Total revenue and grants	19.3	20.6	20.8	21.9	22.0
Expenditure	17.2	19.1	19.9	24.2	24.2
Expenses	14.2	15.6	15.8	17.7	17.8
Net acquisition of nonfinancial assets	3.0	3.4	4.1	6.5	6.4
Statistical discrepancy	0.2	0.9	0.7	0.0	0.0
Net lending/borrowing	2.2	2.4	1.6	-2.3	-2.2
Net acquisition of financial assets	1.1	1.2	1.4	1.5	1.2
Net incurrence of liabilities	-1.2	-1.2	-0.3	3.8	3.4
Foreign	-0.3	-0.1	0.8	2.9	1.9
Domestic	-0.8	-1.1	-1.0	0.9	1.5
Money and credit (annual percent change)					
Broad money	16.4	19.1	19.9	12.8	15.1
Domestic credit	12.2	13.9	15.7	15.8	18.3
Private sector credit	11.3	18.3	19.4	16.5	18.0
Velocity	2.0	1.2	1.1	1.1	1.1
Saving and Investment (in percent of nominal GDP)					
Gross investment	29.8	28.7	28.9	31.6	30.9
Private	26.7	25.2	24.9	25.2	24.5
Central government	3.0	3.4	4.1	6.5	6.4
Gross national saving	33.1	33.3	33.9	29.2	29.2
Private	27.8	28.0	28.9	25.6	25.4
Central government	5.3	5.3	5.0	3.5	3.8
Balance of payments					
Current account (in millions of U.S. dollars)	635	908	1,067	-570	-426
In percent of GDP	3.3	4.6	5.0	-2.5	-1.7
Trade balance (in millions of U.S. dollars)	-5,247	-6,082	-6,670	-8,453	-9,106
In percent of GDP	-27.2	-30.8	-31.2	-36.9	-36.2
Exports value growth (y/y percent change)	-3.1	5.4	-4.0	2.0	5.4
Imports value growth (y/y percent change)	10.9	14.3	7.7	23.5	7.5
Workers' remittances (in millions of U.S. dollars)	4,931	5,543	6,192	6,631	7,131
In percent of GDP	25.6	28.1	29.0	28.9	28.3
Gross official reserves (in millions of U.S. dollars)	4,972	6,172	7,162	7,320	7,594
In months of imports of goods and services	7.3	8.3	7.9	7.6	7.3
Memorandum items					
Public debt (percent of GDP)	32.3	28.3	25.7	28.9	29.4
GDP at market prices (in billions of Nepalese rupees)	1,695	1,942	2,125	2,396	2,733
GDP at market prices (in billions of U.S. dollars)	19.3	19.8	21.4	22.9	25.2
Exchange rate (Nrs/US\$; period average)	88.0	98.3	99.5	...	...
Real effective exchange rate (eop, y/y percent change)	-0.6	-4.0	8.2	...	...

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

¹ Fiscal year ends mid-July.