

**FOR
AGENDA**

SM/14/165
Correction 1

June 30, 2014

To: Members of the Executive Board

From: The Secretary

Subject: **Nepal—Staff Report for the 2014 Article IV Consultation**

The attached correction to SM/14/165 (6/18/14) has been provided by the staff:

Mischaracterization of the Views of the Authorities

Page 12, paragraph 29, line 3: for “indicated that they had begun the process of closing a number of development banks.” read “indicated that the number of financial institutions has come down due to mergers of a number of development banks and finance companies.”

Questions may be referred to Mr. Pitt (ext. 38841), Mr. Ojima (ext. 35944), and Mr. Mohommad (ext. 36332) in APD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

Box 4: Key FSAP Recommendations

Financial Stability

Significant further consolidation of the financial sector is needed. To avoid creating large, weak banks out of small, weak banks, and strengthen the financial system overall, the NRB should:

- Undertake a thorough asset quality review to identify problem loans in banks' balance sheets.
- Actively guide the bank consolidation process to ensure stronger banks emerge.
- Strengthen bank licensing regulations and policy to include adequate fit-and-proper criteria, a requirement for satisfactory risk management systems, and tighter standards for related parties and intra-group exposures.
- Be given special resolution powers to close insolvent banks, and those banks that do not meet tightened licensing standards after an adequate transition period.
- Be granted explicit consolidated supervision powers and amend the legal framework to incorporate a comprehensive definition of related parties and controlling interests.

Financial Sector Oversight and Crisis Management

Supervision, despite some recent improvements, requires significant further strengthening. Key actions are:

- Expedite implementation of a more risk-based approach to supervision and the integration of off- and on-site supervision (though capacity constraints will need to be taken into account).
- Supervisors should not hesitate to exercise judgment, and follow up more thoroughly on implementation of their recommendations.
- Exercise the NRB's corrective and sanctioning powers proactively, and amend the prompt corrective action framework to trigger stronger corrective action at an earlier stage.
- Increase staffing and analytical capacity, limit staff rotation, develop IT and management systems, and streamline the NRB Board's participation in operational decisions.
- Bring the Employment Provident Fund (EPF) and Citizens Investment Trust (CIT), two state-owned insurance providers, under joint supervision of the NRB and the Insurance Board,
- Significantly strengthen supervision of cooperatives by the Department of Cooperatives.
- Develop and coordinate agency-specific contingency plans, and carry out crisis simulations under the umbrella of the Interagency Coordination Committee, which should meet on a regular basis.

Financial Development and Infrastructure

Enhanced financial access and deepening could be promoted by the following steps:

- Clarify the mandate and reduce the number of state-owned banks.
- Accelerate the modernization of the payments system.
- Create a collateral registry, and eliminate the reporting threshold to the Credit Information Bureau.
- Improve and implement the debt enforcement and insolvency systems.

Authorities' Views

29. The authorities broadly agreed with staff recommendations. However, they pointed to resource constraints as well as the difficulty of closing financial institutions, though they indicated that the number of financial institutions has come down due to mergers of a number of development banks and finance companies. They also considered that re-licensing now would be disruptive and should be carried out gradually. With regard to joint supervision of the EPF and CIT, they noted that legal and institutional arrangements needed to be amended, and were being reviewed.

D. Fiscal Policy

Background

30. The fiscal position is solid, with public debt projected to decline to 30½ percent of GDP in 2013/14, but execution of the capital budget is sluggish. Revenue growth remained strong due to high import growth and ongoing administrative reforms in the Inland Revenue and Customs Departments. Grant inflows strengthened, mainly related to election spending. High revenue growth has financed large increases in current spending, including on salaries, wages and pensions. The authorities significantly raised the capital budget in 2013/14, even though execution remains difficult and the overall level remains low. However, capital spending is underrecorded as some transfers to local governments, accounted as expense, are used for capital formation.

Staff Views

31. Fiscal policy needs to support growth through higher public investment. Key areas with a large impact on potential growth are power generation and distribution, and transport. Investments in these areas would also likely crowd in private sector investment, as they would provide essential infrastructure for agriculture and industry. Spending on health and education has increased significantly in recent years, including with donor support. This should be continued. Care needs to be taken to monitor expenditures executed through local bodies.

32. There is ample fiscal space to finance additional investment and social spending. There is room for further growth in revenues, even if at decreasing rates. At the same time, with public debt low, a modest expansion of fiscal deficits is affordable without endangering debt sustainability. Further space should be created by reducing or eliminating implicit subsidies to the NOC. At the same time, the sustainability of current spending will need to be ensured. This applies in particular to civil service remuneration and pensions, which, though still low, could rise substantially over the longer run.

33. NOC losses need to be addressed to avoid the build-up of further liabilities.³ Prices should be adjusted as needed to avoid recurrent losses and interruptions in supply, ideally

³ The NOC currently has Nrs 34 billion in debt (1¾ percent of GDP).