LAPSE OF TIME

SM/17/46

March 13, 2017

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Nepal—Staff Report for the 2017 Article IV Consultation**

Board Action:	Executive Directors' **consideration** on a lapse of time basis as management has determined it meets the established criteria.
Deadline to Request Board meeting:	**Thursday, March 23, 2017** **12:00 (noon)**
Proposed Decision Deemed Approved:	Monday, March 27, 2017
Provisional Board Meeting Date: (if requested)	Monday, March 27, 2017
Proposed Decision:	Page 20
Publication:	Not yet decided* Press Release will be based on the staff appraisal if there is no request for a Board discussion, as attached.
Questions:	Mr. Almekinders, APD (ext. 34281) Ms. Wong, APD (ext. 34153) Ms. Sodsriwiboon, APD (ext. 35737)
Document Transmittal in the Absence of an Objection and in accordance with Board policy:	Tuesday, March 21, 2017—WTO After Board Consideration—Asian Development Bank

***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 2017 ARTICLE IV CONSULTATION

March 13, 2017

KEY ISSUES

Context. Nepal's economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions at the southern border. The upswing has been supported by the new government's efforts to revitalize the reform agenda. The key challenge is to put policies in place that will extend the cyclical recovery into a sustained period of high and inclusive growth.

Outlook and Risks. Staff expects growth to reach 5.5 percent in 2016/17, supported by a good monsoon, accommodative monetary policy, and rising government spending. Inflation is at a multi-year low as prices normalize following last year's disruptions. In the absence of strong policies and sustained reforms, growth would likely revert to the average of the past decade and fall short of substantially improving living standards and social indicators. Risks to the baseline are broadly balanced with the main downside risks pertaining to domestic political stability and the financial sector.

Key policy recommendations. Sustaining and deepening the nascent reform momentum observed in recent months would help boost growth and allow more progress in achieving the sustainable development goals (SDGs). Efforts should focus on strengthening key institutions and administrative capacity to overcome the chronic under-implementation of the budget and boost private investment and growth.

- **Fiscal policy** should focus on facilitating post-earthquake reconstruction and medium-term growth through higher and better-quality public investment.
- **Monetary policy** needs to be tightened to support the exchange rate peg and competitiveness by closing the inflation wedge with India on a sustained basis. Monetary management should be strengthened further building on recent steps to adopt an interest rate corridor.
- The buildup of risks related to the rapid credit growth underscores the importance of accelerating **financial sector reforms,** through stronger supervision, building on the recent amendments to the regulatory framework, and more stringent loan classification and provisioning and upgrading of banks' risk management, in line with FSAP recommendations.
- **Structural reform** will be essential to unlock growth. Key priorities include strengthening policy implementation capacity, upgrading transportation infrastructure, improving the business climate, and developing the hydropower sector.

Approved By
Kenneth Kang (APD) and Zeine Zeidane (SPR)

Discussions took place in Kathmandu during January 11–23, 2017. The staff team comprised Mr. Almekinders (head), Ms. Wong, Ms. Sodsriwiboon (all APD), Mr. O'Mahony (STA) and Mr. Chida (OAP), and was assisted by Mr. Bauer (Senior Resident Representative for Bhutan/India/Nepal). Mr. Marcelo and Mr. Nguyen (both OED) also participated in the mission. Ms. Inoue and Ms. Le (both APD) assisted in the preparation of this report.

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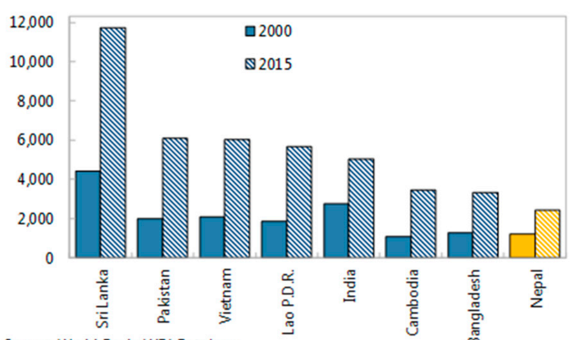
APPENDIX

INTRODUCTION

1. **Macroeconomic performance has been broadly satisfactory, with low public debt and moderate inflation, but growth averaged only 4 percent over the last decade, among the lowest in the region.** The government's vision is to graduate from least-developed country status by 2022 and achieve middle income country status by 2030. The government recently endorsed the 14th Development Plan (2016/17–2018/19) which targets annual average growth of 7.2 percent and a reduction in the share of the population living in poverty by 4.6 percent to 17 percent by 2018/19. However, frequent changes in government have held back progress in addressing infrastructure gaps, weak institutional capacity, and the difficult business climate.

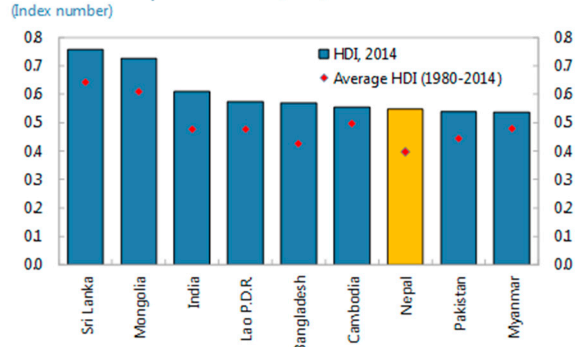
2. **With the country trapped in a low investment, low growth equilibrium, large numbers of Nepalese have sought employment overseas.** Nepal is now one of the largest recipients of remittances in the world. At 30 percent of GDP in FY2015/16, remittances help to reduce poverty, support the balance of payments, and boost the fiscal accounts through higher import-related revenues. But they have also contributed to an appreciation of the real exchange rate, rapid wage growth, stagnant exports and a widening trade deficit.

Per Capita GDP (PPP)
(In current international dollars)



Source: World Bank, *WDI Database*.

Human Development Index (HDI)
(Index number)



Source: UNDP, *Human Development Report 2015*.

3. **Political uncertainty is likely to persist with several elections to be held in the coming months.** Following the 2015 earthquakes, the main political parties reached agreement on a new constitution, which includes the transition to a federal system. However, after a change in government and unrest among ethnic groups in the south of the country, Nepal suffered from a 4½ month blockade of its terrestrial trade routes. In August 2016, a new coalition—the ninth government in nine years—assumed power. Under a power-sharing deal, PM Dahal from the *Communist Party of Nepal Maoist Center* is to oversee the first local elections in almost two decades, set for mid-May, and then hand the reins to a PM of the *Nepali Congress* who will oversee federal and provincial polls. The government has promised to address outstanding grievances related to the new constitution but no agreement has been reached so far.

4. **The authorities' policies are broadly in line with past Fund advice but policy implementation remains weak.** The new government has increased recurrent spending to facilitate post-earthquake reconstruction but inefficiencies in capital budget management and

implementation are holding back a scaling up of public investment to support medium-term growth. The introduction in mid-2016 of an interest rate corridor has been a positive step to strengthen the monetary policy framework and transmission which in turn supports the exchange rate peg by reducing the inflation wedge with India. Recent amendments to the legal and regulatory frameworks governing the central bank and the financial sector should help strengthen supervision and bank governance, and ultimately reduce financial sector vulnerabilities.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

5. Economic activity in 2015/16 suffered from the earthquakes and border blockades, while policy support was stymied by the continued under-execution of the budget.

- *Growth and inflation*. Real GDP growth slowed to 0.6 percent in 2015/16 (mid-July to mid-July). Shortages of fuel and other essential goods drove up inflation to 12 percent (y/y) in January 2016. Inflation subsequently eased on lower food prices (Figure 1).

- *Fiscal*. Budget under-implementation worsened in 2015/16, particularly for capital spending. At the same time, revenues exceeded the budget due to one-off telecom sector collections (1 percent of GDP). As a result, the budget was in surplus for the fourth year in a row and net public debt (gross public debt net of government deposits held at the central bank) fell to 22 percent of GDP, down from 34 percent of GDP in 2012 (Figure 2).

- *External*. The current account surplus reached 6.3 percent of GDP as the trade disruption lowered imports. Exports also fell, led by primary commodities and manufactured products. The growth rate of remittances slowed sharply, to 1 percent in 2015/16, from an annual average of 15 percent during the previous 5 years, due to weak growth in oil-producing host countries. Gross reserves of the central bank reached a record US$8.7 billion (10 months of imports) in December 2016 (Figure 3).

6. More recently, the economy is showing signs of a broad-based recovery.

- *Cyclical rebound*. The normalization of economic activity, a favorable monsoon season, improved power supply, accommodative monetary policy and rising government spending—in part due to the disbursement of housing grants to earthquake-affected households and a hike in government wages and pensions—are spurring a cyclical rebound, as evidenced in recent months by rising imports and tax revenues. Staff expects growth to reach 5.5 percent in 2016/17, somewhat less than the government's aspirations in view of softer remittances and delays in implementing the capital budget.

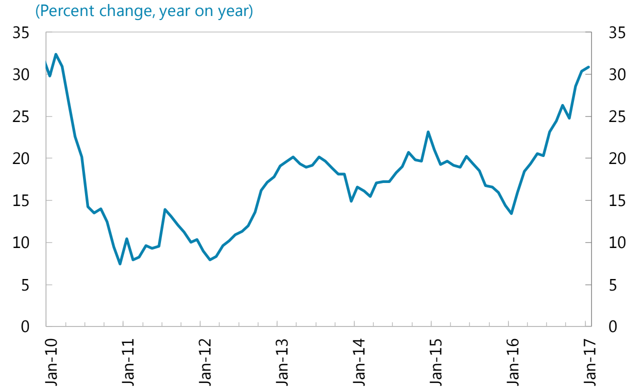
- *Inflation deceleration.* Base effects related to last year's trade disruption have pushed down inflation in Nepal to 3.2 percent (y/y) in January 2017. Nevertheless, inflation is expected to remain above India's this year and next.

- *India shock*. India's sudden withdrawal of legal tender of high-denomination banknotes is expected to have a limited economic impact overall on Nepal. Banks' holdings of Indian rupee notes are small but some corporates and households—of migrant workers and in the border area—are likely to hold such notes, affecting their purchasing power.

7. Macro-financial risks are on the rise.

- *Rapid credit growth.* Nepal maintains a peg to the Indian rupee and a *de jure* closed capital account. Insufficient sterilization of large BOP inflows loosened monetary conditions in recent years. This, along with the fourfold increase in paid-up capital required by the Nepal Rastra Bank (NRB), pushed private sector credit growth to a 7-year high of 31 percent (y/y) in January 2017. The increase in credit was concentrated in overdrafts, which can be diverted to risky activities such as purchases of land, real estate, and stocks (Figure 4).

Nepal: Private sector credit growth
(Percent change, year on year)



Sources: Nepali authorities.

- *Liquidity tightening.* High credit growth has now pushed banks' loan to deposit ratio close to the regulatory maximum of 80 percent. Temporary regulatory relief granted by the central bank in February (see ¶26) would allow for continued rapid credit growth, raising macro-financial risks. Softening remittances—which have been a key funding source for Nepal's predominantly bank-based financial sector—and rising imports contributed to a tightening of liquidity, pushing up interbank interest rates and leading to a correction in stock prices.

8. The medium-term outlook critically depends on progress in reforms. To illustrate this, staff prepared two scenarios (see text table):

- *Baseline.* The baseline scenario takes into account the experience in other fragile countries where disruptions such as the recent earthquakes and trade blockades had permanent effects on potential growth. Persistent political uncertainty and slow progress in strengthening key institutions and the bureaucracy would make it hard to overcome the chronic under-performance of the budget and improve the business climate to boost private investment which remains at around 25 percent of GDP over the medium term. Thus, growth settles somewhat below the 4 percent average of the past decade, delivering only modest improvements in living standards and social indicators. The current account is projected to swing to a deficit of about 2 percent of GDP in the medium term on higher imports amid slowing remittances.

- *Reform scenario*. The reform scenario illustrates the impact of sustaining and deepening the nascent reform momentum, including by (i) strengthening the government's policymaking and implementation capacity with regard to capital budget implementation and the central bank's monetary policy framework to effect a sustained tightening of monetary policy; (ii) bolstering regulation and supervision of the financial sector to improve the quality of credit; and (iii) creating a conducive environment for domestic and foreign investment, as well as accelerated implementation of donor-supported projects. In this scenario, growth accelerates gradually to close to 6 percent in the medium term, underpinned by public capital spending which is 1½ percent of GDP higher than in the baseline. The additional capital spending is assumed to be financed from concessional loans and grants from multilateral and bilateral development partners, including those pledged in the aftermath of the earthquakes. FDI-financed hydropower projects are an additional driver of growth. Sustained revenue efforts would create fiscal space to raise government current spending by close to 2 percent of GDP (see ¶15), allowing more progress in achieving the SDGs. Remittances growth is expected to be more moderate, in

Nepal: Macroeconomic Framework--Baseline and Reform Scenarios, 2015/16-2020/21 [1/]

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2017/18	2018/19	2019/20	2020/21
	Est.	Proj.	Baseline scenario projections				Reform scenario projections			
Output and prices (annual percent change)										
Real GDP	0.6	5.5	4.5	3.8	3.8	3.8	4.8	5.0	5.5	5.8
CPI (period average)	9.9	6.7	7.6	7.3	6.7	6.5	6.7	6.7	6.0	5.2
CPI (end of period)	10.4	6.5	7.5	7.0	6.5	6.5	7.0	6.5	5.5	5.0
Fiscal Indicators (in percent of GDP)										
Total revenue and grants	23.3	24.2	24.1	24.1	24.1	24.0	24.9	25.1	25.4	25.7
of which: tax revenue	18.7	20.0	20.1	20.0	20.0	20.0	20.8	21.0	21.3	21.7
Expenditure	22.0	25.3	25.3	25.0	24.6	24.5	26.6	26.8	27.2	27.8
Expenses	16.5	19.3	19.3	19.0	19.1	19.0	20.2	20.3	20.2	20.8
Net acquisition of nonfinancial assets	5.5	6.0	6.0	6.0	5.5	5.5	6.5	6.5	7.0	7.0
Statistical discrepancy	-1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing	1.4	-1.1	-1.2	-1.0	-0.5	-0.4	-1.8	-1.7	-1.8	-2.0
Net financial transactions	-2.4	1.1	1.2	1.0	0.5	0.4	1.8	1.7	1.8	2.0
Net acquisition of financial assets	5.2	-1.3	-1.2	1.2	1.2	1.2	-1.3	1.2	1.2	1.2
Net incurrence of liabilities	2.8	-0.2	-0.1	2.1	1.6	1.6	0.5	2.9	3.0	3.2
Foreign	1.1	0.8	0.7	1.2	1.1	1.4	1.4	2.6	3.1	3.1
Domestic	1.7	-1.0	-0.8	0.9	0.6	0.2	-0.9	0.2	-0.1	0.1
Balance of Payments										
Current account (in millions of U.S. dollars)	1,339	-73	-338	-450	-543	-648	-645	-956	-1,238	-1,552
In percent of GDP	6.3	-0.3	-1.3	-1.6	-1.8	-2.0	-2.5	-3.5	-4.1	-4.7
Trade balance (in millions of U.S. dollars)	-6,389	-8,079	-8,856	-9,486	-10,162	-10,892	-8,948	-9,719	-10,521	-11,284
In percent of GDP	-30.2	-34.7	-34.7	-34.3	-33.9	-33.6	-35.3	-35.1	-34.7	-34.2
Exports value growth (y/y percent change)	-28.8	18.8	3.9	4.0	4.1	4.2	4.0	4.1	4.5	5.0
Imports value growth (y/y percent change)	-7.4	25.7	9.1	6.8	6.9	6.9	10.1	8.2	7.9	7.1
Workers' remittances (in millions of U.S. dollars)	6,253	6,467	6,787	7,151	7,564	8,018	6,586	6,881	7,209	7,584
In percent of GDP	29.6	27.7	26.6	25.8	25.2	24.7	26.0	24.9	23.8	23.0
FDI (in millions of U.S. dollars)	55.5	72.8	79.6	86.4	93.6	117.4	279.1	366.4	374.6	399.5
In percent of GDP	0.3	0.3	0.3	0.3	0.3	0.4	1.1	1.3	1.2	1.2
Gross official reserves (in millions of U.S. dollars)	8,574	8,690	8,494	8,381	8,443	8,451	8,304	8,001	8,155	8,062
In months of prospective GNFS imports	10.1	9.4	8.6	7.9	7.5	7.0	8.2	7.3	7.0	6.5
Memorandum items										
Public debt (in percent of GDP)	27.3	25.7	23.2	22.8	22.5	22.3	23.9	24.1	24.8	25.9
GDP at market prices (in billions of U.S. dollars)	21.2	23.3	25.5	27.7	30.0	32.4	25.3	27.7	30.3	33.0

Sources: Nepalese authorities; and IMF staff estimates and projections.
1/ Fiscal year ends in mid-July.

part owing to improved employment opportunities in the domestic economy as growth accelerates. Imports increase more rapidly than in the baseline scenario reflecting higher capital spending and FDI-financed hydropower projects.

9. **Risks to the baseline scenario are broadly balanced (Annex 1).** The rebound in economic activity could be more pronounced and persistent, particularly if (i) higher-than-expected capital spending and accelerated payment of housing grants add to the recent surge in government spending; (ii) the momentum in policy and structural reforms created in recent months is sustained and deepened; (iii) a breakthrough is achieved with regard to reaching financial closure for one or more large foreign-financed hydropower projects; and/or (iv) a faster recovery in international oil prices causes oil-exporting countries to increase hiring of Nepali workers. Key downside risks pertain to domestic political instability, the failure to increase implementation capacity, financial sector vulnerabilities, and slowing remittances impacting financial sector liquidity. Hasty implementation of a new framework for federal fiscal relations as mandated under the constitution could strain the government and its finances given prevailing weaknesses in public financial management (PFM) and institutional capacity.

Authorities' Views

10. **The authorities were somewhat more optimistic regarding the near-term growth outlook.** They were hopeful that the pickup in reconstruction activity, notable improvement in power supply, and strong agricultural output would allow the government's 6.5 percent growth target to be achieved. With regard to staff's reform scenario, the authorities concurred that structural reforms and increased policy implementation capacity would be key to sustaining higher growth in the medium term. They expected higher growth dividends from the reforms.

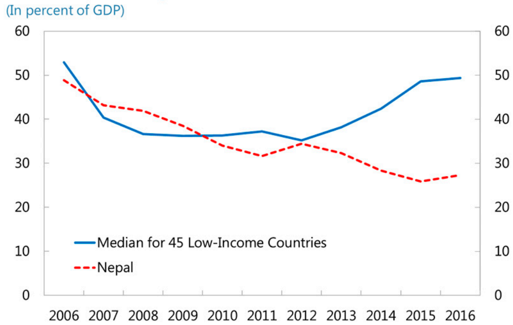
POLICY DISCUSSIONS

Discussions focused on policies to build on the cyclical rebound and create conditions for sustained high and inclusive growth, while safeguarding financial sector stability.

A. Fiscal Policy to Meet Public Spending Needs

11. **Fiscal policy was tighter than envisaged in recent years due to bottlenecks in budget implementation.** As a result, Nepal's public debt-to-GDP ratio continued to decline to 22 percent of GDP in 2015/16 (net of government deposits), unlike in many other low-income countries. The joint IMF/World Bank Debt Sustainability Analysis concludes that Nepal's risk of debt distress remains low.

Public Debt in Nepal and other LICs
(In percent of GDP)



Sources: IMF, LIC DSF database, and IMF staff estimates.

12. The 2016/17 budget envelope is very large and unlikely to be implemented in full, given limited budget execution capacity (¶16). Compared to the 2015/16 outturn, it aims for a near doubling of total spending, including a 150 percent increase in capital spending. The budget targets an overall fiscal deficit of 10 percent of GDP, compared to a surplus of 2.4 percent of GDP (based on financing data) in 2015/16. The mid-year budget review, released in February, marked down capital spending by one-sixth thereby reducing the fiscal deficit target to 6.7 percent of GDP.

13. Taking into account likely underspending of the budget, staff projects a fiscal deficit of 1.1 percent of GDP and a fiscal impulse of about 1½ percent of GDP in 2016/17. Spending is projected to increase by 3.2 percent of GDP, consisting of the disbursement of housing grants to earthquake-affected households (1.9 percent of GDP), higher salaries and allowances (0.8 percent of GDP), and capital spending (0.5 percent of GDP). Corrected for one-off receipts, underlying revenue is projected to rise by 1.9 percent of GDP.

Nepal: Expenditure by Economic Classification

	2013/14	2014/15	2015/16		2016/17	
			Budget	Actual	Budget	Actual 1/
	(In percent of GDP)					
Expenditure	18.8	20.2	30.8	22.0	36.7	8.4
Expenses	15.5	16.0	21.5	16.5	24.4	7.4
Compensation of employees	4.3	4.2	4.6	4.0	5.2	1.9
Use of goods and services	1.5	1.5	3.5	2.0	3.9	0.5
Interest and Services	0.6	0.4	1.0	0.4	0.9	0.2
Subsidies	0.1	0.0	0.1	0.0	0.1	0.0
Grants	6.9	7.4	9.2	7.6	10.4	3.4
Social Security	2.1	2.4	3.1	2.5	3.8	1.4
Net acquisition of non-financial assets	3.4	4.2	9.3	5.5	12.3	1.1

Sources: FCGO; and IMF staff estimates.
1/ Up to Janaury 1, 2017.

Policy Recommendations

14. The authorities' plans and efforts to scale up government spending to rebuild after the earthquakes and address infrastructure gaps are welcome. Nonetheless, in scaling up public spending, care should be taken not to exceed the economy's aggregate absorptive capacity and to safeguard expenditure quality. Throughout, close policy coordination and information sharing with the central bank will be important to ensure that the fiscal expansion does not lead to overheating and leaves room for adequate private sector credit growth.

- In the current and next fiscal years, the macroeconomic framework could accommodate the use of the government's accumulated cash balances. Total net domestic financing (NDF: net incurrence of domestic liabilities minus the change in government deposits at the central bank) could amount to about 1½ percent of GDP per annum.
- In subsequent years, Nepal also has some fiscal space. Concessional external financing can finance the bulk of the 1½ percent of GDP increase in government capital spending over the medium term. High-quality capital spending financed by concessional donor inflows can be accommodated since it keeps the debt burden in check while allowing for the needed infrastructure push. Given staff's projections for foreign financing, this will translate to overall fiscal deficits of up to 2 percent of GDP per annum in the medium term. To prevent crowding out credit to the private sector, shortfalls in donor financing should not be replaced by additional domestic financing of the budget and NDF should not exceed 1 percent of GDP per annum.

15. Continued improvements in revenue performance will be important to support adequate levels of development spending. The authorities' ongoing efforts to prepare a unified tax code and draw up a medium-term strategic plan to strengthen customs administration, could be instrumental in this, along with their plans to set up a Revenue Board (Annex II). If fully implemented, they could raise revenue by 1¾ percent of GDP over the medium term.

Nepal: Government Revenue 1/

	2013/14	2014/15	2015/16		2016/17	
			Budget	Actual	Budget	Proj.
	(In percent of GDP)					
Total revenue	18.2	19.1	21.1	21.4	22.3	22.3
Total tax revenue	15.9	16.8	19.0	18.7	20.2	20.1
Taxes on income, profits, and capital gains	3.8	4.1	4.7	5.1	4.9	...
Taxes on property	0.3	0.4	0.5	0.6	0.6	...
Taxes on goods and services	8.0	8.5	9.8	9.1	10.6	...
VAT	5.1	5.3	6.3	5.4	6.5	...
Excises	2.3	2.5	2.9	2.9	3.2	...
Taxes on international trade and transactions	3.5	3.5	3.7	3.7	3.8	...
Customs and other import duties	3.3	3.3	3.5	3.5	3.6	...
Non-tax revenue	2.2	2.4	2.1	2.7	2.2	2.2

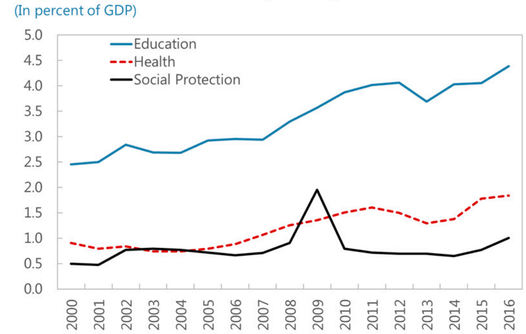
Sources: FCGO; and IMF staff estimates.
1/ Fiscal year is mid-August to mid-July
2/ Mid-year budget review released in late February 2017.

16. Budget preparation and implementation capacity should be strengthened further. This is critically important to break out of Nepal's low-investment-low-growth equilibrium.

- *Budget*. Budgets should be more realistic and capital spending should be spread more evenly over the year. Ambitious budgets and back-loaded implementation increase the risk of low-quality spending.

- *Projects*. Only well-prepared and prioritized projects should be included in the budget and the expansion of government spending should be anchored in a medium-term expenditure framework (MTEF) to ensure fiscal sustainability. In particular, projects should only be included in the budget after completion of a feasibility study, necessary environmental assessments, and land acquisition requirements. In this regard, the authorities' plans to focus on project readiness and preparation of a "bank" of projects that have gone through the various preparatory stages would be welcome. For such projects, government bodies should be able to start the tendering process immediately after the adoption of the budget and should no longer be required to obtain authorizations, including from the National Planning Commission, once the fiscal year has started.

Nepal: Government Social Spending
(In percent of GDP)



Sources: *Government Finance Statistics*: and data from the authorities.

- *PFM*. In addition to immediate steps to increase budget implementation capacity in the short term, there is a broader need to integrate the disparate PFM systems that currently exist across ministries and to strengthen budget coordination under the leadership of the Ministry of Finance.

- *SDGs*. Building on Nepal's early adoption of the SDGs, social spending priorities need to be costed, included in the MTEF, and translated into realistic annual budget allocations (Annex III).

17. To contain fiscal risks, and create additional fiscal space to address social and infrastructure gaps, financial support to state-owned enterprises (SOEs) should be phased out. In recent years, some 1¾ percent of GDP was spent per annum on equity injections and loans to SOEs, including banks:

- *Oil*. The repayment of Nepal Oil Company (NOC)'s debt over the course of the past two fiscal years is welcome. Full application of the automatic oil price adjustment mechanism should continue to prevent a recurrence of NOC losses as international oil prices rise.

- *Electricity*. The reduction in electricity load shedding achieved in recent months is encouraging. This reflects improvements in the management of demand and supply, which should continue. The welcome reform of electricity tariffs at the start of the fiscal year should be the impetus for a further strengthening of the finances of the Nepal Electricity Authority.

18. The impending fiscal decentralization has the potential to improve the quality and delivery of government services, provided that it is based on robust and sustainable inter-governmental fiscal arrangements. Developing these arrangements in the coming months will be a major policy challenge and should be a top priority on the authorities' policy agenda. Ideally, an enabling legal framework for fiscal decentralization should be put in place prior to the first subnational elections under the new constitution. The authorities have requested technical assistance from the IMF to develop such a framework. To make fiscal decentralization work, it would be important to build policy implementation capacity at the sub-national level which will require sustained efforts.

Authorities' Views

19. The authorities generally concurred with the staff's assessment and fiscal policy advice and expressed confidence in their ability to speed up budget execution and advance structural reforms. The implementation rate of the budget in the first half of the current fiscal year was lower than expected even though the budget was introduced earlier than in previous years. The delays were related to the transition to the new government and lack of project preparedness. The authorities highlighted recent measures such as the 10-point directive issued by the Ministry of Finance in November 2016 which emphasizes pro-active steps by line ministries, and intensified monitoring of capital budget implementation. They expected these to show results in the second half of the fiscal year.

B. Strengthening the Monetary Policy Framework

20. The peg to the Indian rupee serves as a transparent anchor for monetary policy. The peg continues to benefit Nepal in view of its close economic relationship with India and need to build policy implementation capacity. However, Nepal's real effective exchange rate (REER) is now about 13 percent more appreciated than the average for 2010-14. Staff assesses that with a continuation of current trends, the exchange rate would become somewhat overvalued (Box 1)

21. Overly accommodative monetary policy has put pressure on the exchange rate peg by keeping credit growth and inflation too high. For most of the last two fiscal years, the NRB's sterilization of remittances has been insufficient to stabilize money market conditions. To curb the risk-taking behavior caused by the low real interest rates—on the basis of the authorities' inflation target of 7.5 percent, real lending rates are about 1 percent—the NRB appropriately tightened loan-to-value ratios for real estate and margin lending in July 2016 and introduced a 50 percent loan-to-value ratio for automobile loans in February 2017.

22. A new operational framework for monetary policy based on an interest rate corridor was announced in July 2016. It was supported by the introduction of new instruments (two-week repos, two-week deposit auctions, as well as the issuance of NRB bonds), needed to stabilize money market rates within the corridor. However, volatility of interbank rates has remained high

Policy Recommendations

23. Monetary policy needs to be tightened. With remittances set to slow, fiscal policy turning expansionary, the current account turning to a deficit, and inflation continuing to run 2–3 percent higher than in India, a tightening of monetary policy is needed to sustain the peg. This should be done by the NRB adopting a medium-term inflation objective consistent with eliminating the inflation wedge with India. As it stands, the 14th Development Plan targets average inflation of 7.5 percent per annum. This is not ambitious enough to maintain the peg considering that India has set itself an inflation target of 4 percent with a tolerance band of plus/minus 2 percent for the next five years. In line with good international practice, the authorities should build a broad-based consensus for a more ambitious inflation target (Annex IV). This would call for providing more monetary policy autonomy to the central bank. However, provisions in the NRB Act Amendment (NRBAA) Bill, approved by Parliament in September 2016, indicate that the government of Nepal may issue directives to the central bank on money, banking and finance and that it shall be the duty of the central bank to abide by such directives.

24. The NRB's adoption of an interest rate corridor is welcome. The operation of the corridor should be enhanced by introducing standing overnight credit and deposit facilities. The existing Standing Liquidity Facility (SLF, currently at 7 percent) could act as the corridor's ceiling. This would need to be complemented by a binding interest rate floor (provided by an overnight deposit standing facility), which could be set at a level close to current market conditions. Moreover, the NRB would periodically review the level of the floor to keep short-term interest rates in line with fundamentals, and could gradually narrow the width of the corridor to contain interbank rate volatility.

25. Consideration should be given to phase out NRB requirements for directed lending by commercial banks. Sectoral lending targets may result in lower credit standards and asset quality, and contribute to financial instability by encouraging mispricing of risk. Phasing them out, while promoting financial inclusion through strengthening the regulation and supervision of microfinance institutions and cooperatives, would help strengthen monetary policy transmission and risk management practices, and allow the central bank to focus on its core functions.

26. Risks related to the rapid growth of credit should be addressed. The regulatory and macro-prudential measures introduced in the aftermath of the 2010–11 episode of financial sector pressures should be maintained to contain the buildup of financial sector risks. In the context of the mid-term review of monetary policy, announced in February, the central bank provided relief to banks with regard to the 80 percent loan-to-deposit (LTD) ratio ceiling. This relief should be withdrawn promptly when it lapses in mid-July, in order to moderate credit growth, normalize interest rates, discourage excessive risk taking, and reduce the impetus to capital outflows.

Authorities' Views

27. The authorities were pleased with the initial experience with the interest rate corridor. They were confident that the interest rate corridor would help improve monetary management. The framework will be gradually upgraded, in line with international practice, as policymakers and market participants gain more experience with it.

28. The authorities reiterated that the peg to the Indian Rupee has served Nepal well. While they broadly concurred with the staff's exchange rate assessment, they did not see the inflation divergence between Nepal and India becoming a threat to the peg and expected India's gains in disinflation to help hold down inflation in Nepal. The authorities noted that the directed lending policy aims to stimulate growth in productive sectors and boost financial inclusion, particularly in the rural area, and felt that risks to financial stability were minor given the limited scope of the policy.

C. Addressing Vulnerabilities to Safeguard Financial Stability

29. The 2014 FSAP highlighted a number of weaknesses in the legal and supervisory framework governing financial institutions. The authorities have begun to address these weaknesses in the context of four World Bank Development Policy Credits (DPCs), in collaboration with the UK's Department for International Development and the IMF. In September 2016, parliament approved the NRB Act Amendment (NRBAA) Bill and the new Deposit and Credit Guarantee Fund Act (DCGF). The former aims to strengthen and clarify the bank resolution powers of the NRB, while the latter enhances the legal framework for the deposit insurance scheme. Amendments to the Bank and Financial Institutions Act (BAFIA), which aim to strengthen the governance of commercial banks were passed in January 2017. The NRBAA shows improvements in some areas, including raising the central bank's capital and aligning the accounting standards with international practice. However, it curtails the autonomy of the central bank (see ¶23) and does not address two key FSAP recommendations (Annex V), regarding granting explicit consolidated supervision powers and clarifying emergency liquidity assistance provisions. Staff is still in the process of clarifying the extent and modalities of the central bank's special resolution regime powers under the amended law, a third FSAP recommendation.

30. Financial soundness indicators (FSIs) reported by the banks have improved (Table 5). All 28 Class A banks now meet the minimum 10 percent capital adequacy ratio (CAR). The three state-owned banks, which represent about a fifth of system assets and were undercapitalized until 2014, have retained earnings and received capital injections. Banks have made progress increasing their paid-up capital with a view to meeting the new requirement for mid-July 2017. Bank profits were at a record high in 2015/16 and non-performing loans (NPLs) and loan-loss provisions at a record low.

31. While these developments are positive, several weaknesses and vulnerabilities remain and the FSIs may therefore not be accurate. Loan classification and bank supervision are still in need of strengthening, and connected lending, ever-greening, and poor risk management practices, compounded by directed lending, suggest that the underlying asset quality in the banking system is weaker than indicated by the financial soundness indicators reported by the banks. Regulatory forbearance measures allowed banks to freeze the loan classification of borrowers impacted by the earthquakes and trade disruptions, while for loans that were rescheduled or restructured by April 2016, no additional loan-loss provisioning was required. However, preliminary data on capitalized interest suggests that only a small amount of loans (about ½ percent of GDP) benefitted from these forbearance measures which are set to run out from April 2017.

Policy Recommendations

32. Financial sector reforms, including recommended by the FSAP (Annex V), need to be accelerated and macro-financial risks need careful monitoring:

- *Supervision*. The NRB should accelerate the strengthening of the bank supervision function. Ongoing efforts to put in place a supervisory information system and to strengthen other credit assessment tools and agencies should be accelerated. To emphasize risk management requirements, the Risk Management Guideline should be converted to a Directive. The NRB's stress testing capabilities need to be upgraded. The NRB should carefully review the quality of the reported increase in banks' capital ahead of the mid-2017 deadline to quadruple paid-up capital from the mid-2015 regulatory minimum.

- *Staffing*. Supervisory capacity should be strengthened by increasing continuity in job assignments. Accordingly, a program to hire, train and retain supervisory staff should be developed, possibly in the context of a dedicated career stream that would be exempted from the existing staff rotation policy.

- *Regulation*. Secondary legislation for the NRBAA, the DCGF, and BAFIA needs to be upgraded. In addition to strengthening banks' risk management practices and disclosure standards, a clean-up period for overdraft loans needs to be introduced. The urgency of this move, which would bring Nepal more into line with the Basel Core Principles, is highlighted by the surge in overdraft loans in recent months. A bank resolution operational framework also needs to be developed urgently.

- *Financial inclusion and financial cooperatives*. The large number of financial cooperatives account for more than 15 percent of financial system assets and have linkages to the banks. However, the absence of meaningful regulation and supervision of the cooperatives sector needs to be remedied, for example through the creation of a designated second-tier institution as well as resolution tools. This would complement and support the government's welcome financial inclusion goals.

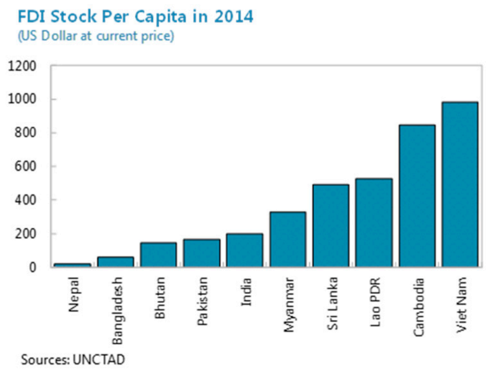
- *Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT).* Welcome developments include the completion of the national risk assessment, the recent issuance of rules which operationalize the Asset (Money) Laundering Prevention (Second Amendment) Ordinance 2013 and the start of preparations for the Mutual Evaluation scheduled for 2019/20. The central bank should continue to roll out the application of risk-based offsite and onsite AML/CFT tools, including decisive and prompt enforcement action and sanctions for non-compliance with AML/CFT requirements. Strengthened implementation of the AML/CFT framework is encouraged, notably by cooperatives, insurance companies and securities firms.

Authorities' Views

33. The authorities underscored their commitment to accelerate and strengthen financial sector reforms. They considered the BAFIA and NRBAA amendments to be instrumental in helping to address key regulatory gaps in line with FSAP recommendations. The NRB planned to convert the guideline for risk management practices into a directive in due course, and concurred that the stress testing capacity needed to be enhanced. To advance reforms and address financial sector vulnerabilities, the authorities emphasized the need for strong coordination among relevant counterparts, including the central bank, the Ministry of Finance, and the regulators of the stock market (SEBON), and the insurance sector (Insurance Board).

D. Structural Reforms to Unlock Nepal's Growth Potential

34. Nepal needs to improve its business environment and address structural bottlenecks to stimulate private sector activity and job creation. More than 500,000 persons enter the labor force each year but employment opportunities are limited. FDI flows to Nepal are lower than in peer countries and policies to stimulate private sector-led growth need urgent strengthening. Nepal's overall ranking in the World Bank's *Doing Business* report fell to 107th in 2017 (from 99th in 2016). Getting credit and construction permits, and enforcing contracts remains difficult (Figure 5). And national priority projects continue to experience extensive delays.



35. Efforts are underway to boost investment. Transmission lines have been readied to import more power from India. After long delays, the Melamchi drinking water project is nearing completion. Preparatory work continues for the Upper Karnali and Arun III hydropower projects, even as the two groups of foreign investors, which signed Project Development Agreements in 2014 for US$1 billion each, were recently granted extensions to their deadlines to reach financial closure. Following a Power Summit in December 2016, arrangements are being made for an Infrastructure Summit in February and an Investment Summit in March, all to lure potential investors. Several laws are being drafted to streamline the business environment.

Policy Recommendations

36. Priority structural reforms pertain to the power sector, infrastructure investment and the regulatory framework for the corporate sector:

- Drawing up and agreeing on an ambitious medium-term program of power sector reforms, possibly with assistance from multilateral and bilateral donors, could add to the recent reform momentum in the sector.

- Deregulation of product and factor markets can help reduce operating costs and spur productivity growth through greater contestability of markets and competition (e.g. in goods and passenger transport). Also, a one-stop shop should not only be offered for large investments, but to any investor.

- Modernization of labor relations to enhance labor market flexibility and streamlining of the regulatory environment are urgently needed. In light of this, the extensive stakeholder consultations that have informed the ongoing deliberations on the draft Labor Bill and Foreign Investment and Technology Transfer (FITT) Bill should be brought to fruition.

Authorities' Views

37. The authorities were encouraged by the results of recent power sector reforms. They expressed optimism about the impact of the Specialized Economic Zones Act, the draft Labor Bill and FITT Bill, as well as the development of the hydropower sector. In particular, they expected that structural reforms in these areas would enhance the business climate and encourage new investment and job creation.

E. Strengthening Capacity Development and Statistics

38. The Fund's capacity building efforts have had mixed results. Progress is hampered by frequent rotation of staff in the central bank, ministries, and government agencies.

39. The upcoming launch of the South Asia Regional Training and Technical Assistance Center (SARTTAC) in New Delhi allows for more, better-tailored, and better-integrated TA and training. The government of Nepal has pledged an important financial contribution to the operation of the Center and is represented on its Governing Board.

Policy recommendations

40. There are several steps that can be taken to strengthen capacity building:

- It is critically important for the authorities to review existing rotation policies, train specialized officials (e.g. bank supervisors, tax inspectors, statisticians, etc.) early in their tenure, and retain them in their positions for much longer than is the current practice.

- The Nepali authorities should participate actively in drawing up SARTTAC's training and TA program, carefully select officials for the various training courses, and work with the providers of TA to act on their recommendations.

- The central bank should follow up on the 2015 Safeguards Assessment recommendations. The NRB publishes its audited financial statements, but the assessment's key recommendations to enhance the quality of the external audit and to modernize the central bank law remain outstanding. The internal audit function should also be improved, including through technical assistance.

41. Efforts to strengthen statistics should be continued. Work on updating the base year of the national accounts and compiling and disseminating quarterly GDP statistics should be accelerated and data gaps identified in the SDG status report should be addressed. There is also scope to enhance cooperation between the Financial Comptroller General Office and the NRB in the publication of more complete and comprehensive Government Finance Statistics.

Authorities' Views

42. The authorities agreed that capacity building was important but there were no plans to change the rotation policies.

STAFF APPRAISAL

43. Nepal's economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions. The normalization of economic activity is supported by a good monsoon, accommodative monetary policy, and rising government spending. Inflation has been decelerating due to base effects related to last year's trade disruption but is expected to remain above India's inflation. More recently, the authorities have also been able to advance reforms in a number of areas.

44. The medium-term outlook critically depends on efforts to sustain and deepen the nascent reform momentum. Stronger policies are needed to enhance confidence amid ongoing political uncertainty. They are also needed to strengthen key institutions and administrative capacity, which are critical for overcoming poor service delivery and chronic under-implementation of the budget, and for boosting private investment and growth. Accordingly, in the absence of stronger policies, and taking into account the lower projected growth of remittances and the effects of the earthquakes and trade disruption, growth would likely fall below the average of the past decade and fall short of what is needed to substantially improve living standards and social indicators.

45. Risks to the outlook are broadly balanced. The rebound in economic activity could be more pronounced and persistent than set out in the baseline, particularly if the momentum in policy and structural reforms is sustained and deepened. Key downside risks pertain to domestic political instability, the weak financial sector, slowing remittances impacting financial sector liquidity, and lower growth in India due to the demonetization shock.

46. To support Nepal's recovery while maintaining macroeconomic and financial stability, the macroeconomic policy mix should be rebalanced toward a more accommodative fiscal position and a tighter monetary stance. Staff welcomes the authorities' plans and efforts to scale up government spending to rebuild after the earthquakes and address infrastructure gaps to boost medium-term growth. In view of the limited implementation capacity, it will be essential to have a realistic budget that effectively prioritizes spending to maximize growth dividends, including in social spending areas most important for inclusive growth. The scaling up of government spending should not exceed the economy's aggregate absorptive capacity and should be anchored in a medium-term expenditure framework to ensure quality and fiscal sustainability.

47. The monetary policy framework needs further strengthening. Staff welcomes the introduction of an interest rate corridor. Next steps would involve refining the framework by fixing the floor of the interest rate corridor to reduce the volatility of interbank interest rates and adopting a medium-term inflation objective consistent with eliminating the inflation wedge with India on a sustained basis. With remittances set to slow, fiscal policy turning expansionary, and the current account turning to a deficit, a tightening of monetary policy is needed to prevent the exchange rate from becoming somewhat overvalued.

48. Financial sector reforms should be accelerated in line with FSAP recommendations to mitigate macro-financial risks, including related to the rapid growth of credit. Financial sector supervision should be strengthened, building on the recent amendments to several aspects of the regulatory framework. Macro-prudential measures introduced in the aftermath of the 2010-11 episode of financial sector pressures to contain credit growth have served Nepal well and should be maintained after the temporary relief granted in February lapses in July.

49. Raising Nepal's potential growth requires sustained efforts to build policy implementation capacity, improve the business climate, and develop the hydropower sector. Structural reforms to deregulate product and factor markets should complement prioritized investment to upgrade transportation infrastructure and improve power supply.

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

Proposed Decision

The Executive Board endorses the thrust of the staff appraisal in the report for the 2017 Article IV consultation with Nepal a SM/17/46, 3/13/17.

It is expected that the next Article IV consultation with Nepal will take place on the standard 12-month cycle.

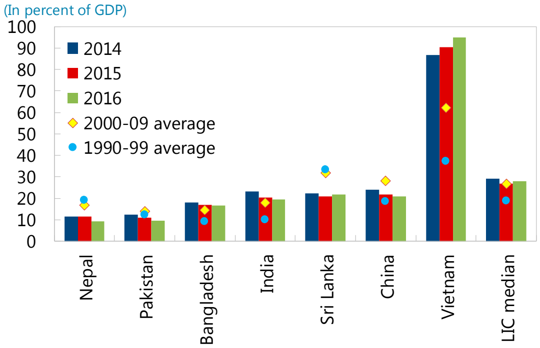
Box 1. Nepal: External Sector Assessment and Reserve Adequacy

Reserves are more than adequate but with a continuation of current trends, the exchange rate would become somewhat overvalued

Nepal's balance of payments has been in surplus in recent years with rising remittances more than offsetting declining exports of goods and services and expanding imports:

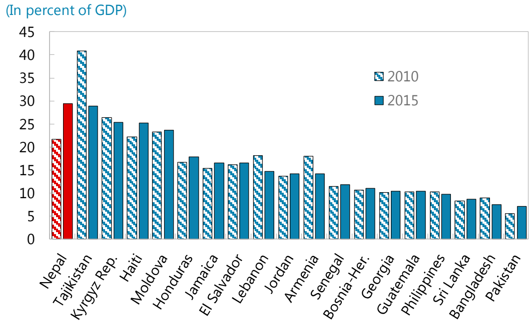
- **Nepal's export performance has been weak, lagging that of peers.** The exports of goods and services to GDP ratio declined from 16 percent in the early 2000s to 11.7 percent in 2014/15. The earthquakes and disruptions to trade pushed the ratio down to 9.3 percent of GDP in 2015/16. Reflecting also the inflation differential with India, Nepal's REER is now about 13 percent more appreciated than the average for 2010-14. However, concerns about the competitiveness of Nepal's exports go beyond the level of the real exchange rate. The infrastructure gap, power shortages, and restrictive labor regulations make for a difficult business environment.
- **Nepal stands out because of the large remittances it receives**. At almost 30 percent of GDP in 2015/16, Nepal's remittances are among the highest in the world. The bulk of remittances comes from migrant workers in Persian Gulf countries and Malaysia.

Exports of Goods and Services
(In percent of GDP)



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

Inflows of Remittances, Selected Countries, 2015
(In percent of GDP)



Sources: World Bank, *Remittances Data*; IMF, *World Economic Outlook*.
Note: Observation for Nepal is for fiscal year 2015/16.

Gross international reserves (of which about a quarter is held in Indian rupees) have risen to US$8.8 billion, equal to more than 9 months of imports. Taking into account the peg to the Indian rupee, the need to be able to absorb external shocks, and the low opportunity cost of holding reserves, 7 months of imports would be adequate (see also Box 2 in EBS/15/83).

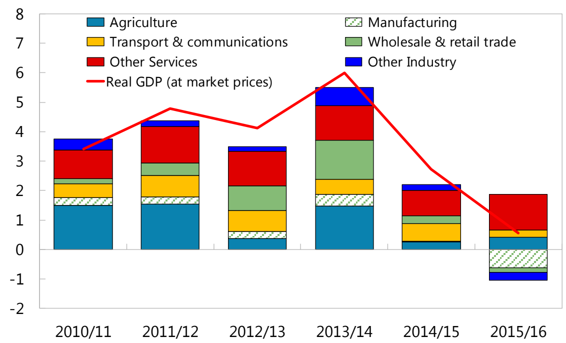
Under current policies and with a continuation of recent trends, the exchange rate would become somewhat overvalued. Slowing remittances and a projected shift in fiscal policy are expected to cause the BOP to swing to a deficit. In conjunction with the ongoing appreciation of the REER, with inflation continuing to run 2-3 percent higher than in India, the exchange rate would become overvalued**.** Various econometric approaches to assess the exchange rate do not give uniform results. However, in view of the REER appreciation and the weak export performance, it seems opportune to assign more weight to the finding of the equilibrium REER approach:

- The current account (CA) panel regression approach takes fundamentals, policy variables, and cyclical factors into account in estimating the current account "norm". The CA norm for Nepal is estimated at -2.8 percent of GDP, while the underlying CA in 2015/16 was 4.1 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 21 percent. However, the CA is projected to converge to the norm over the medium term.
- The equilibrium real 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 17 percent overvalued as of mid-2016.
- Reflecting persistent underinvestment in the domestic economy, Nepal's net international investment position (IIP) is strong for a low-income country: +15 percent of GDP in 2015. Nepal could afford to run a current account deficit of about 2 percent of GDP, as currently projected in the medium term, and still stabilize its IIP at -15 percent of GDP, thus suggesting that the REER is in line with fundamentals.

Figure 1. Nepal: Macroeconomic Developments

The trade disruption compounded the effects of the earth-quakes, reducing growth to 0.6 percent in 2015/16.

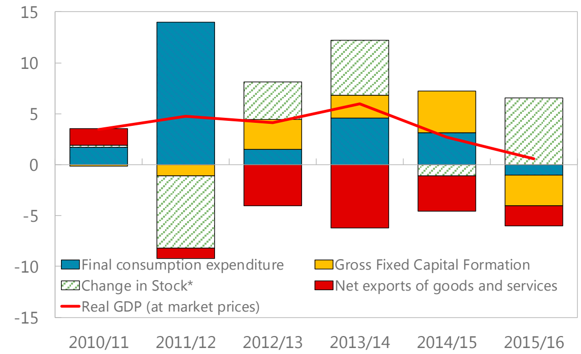
Real GDP Growth by Sector
(In percent)



Source: Nepal Central Bureau of Statistics.

Growth has been underpinned by consumption but the statisical discrepany in the national accounts has been significant.

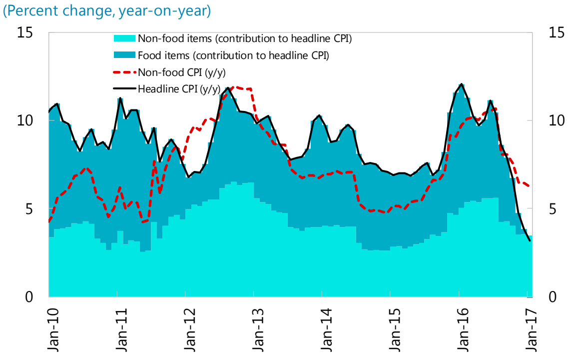
Real GDP Growth by Expenditure
(In percent)



Sources: Nepal Central Bureau of Statistics.
*Includes statistical discrepancy.

Inflation decelerated rapidly, to 3.2 percent (y/y) in January 2017, as food prices normalized…

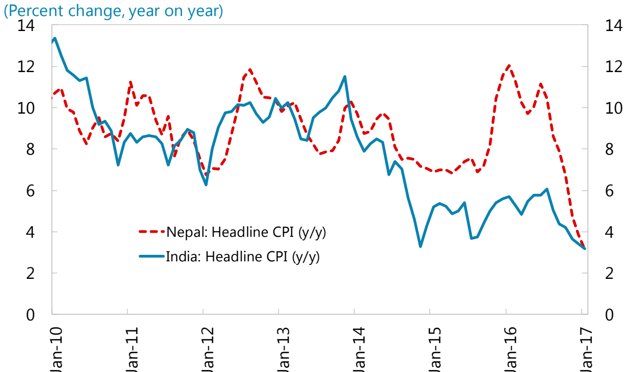
Consumer Price Inflation
(Percent change, year-on-year)



Sources: Nepali authorities; and IMF staff estimates.

…causing the inflation gap with India to narrow.

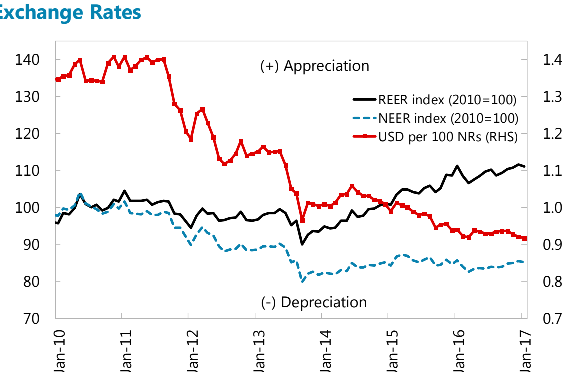
Consumer Prices in Nepal and India
(Percent change, year on year)



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

In combination with the peg to the Indian rupee, this has put the REER 13 percent above the 2010-14 average.

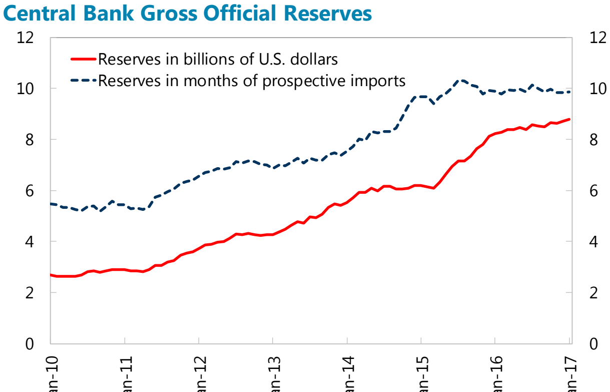
Exchange Rates



Sources: Nepali authorities; and IMF staff estimates.

Reserves increased to US$8.8 billion supported by stong remittance inflows.

Central Bank Gross Official Reserves



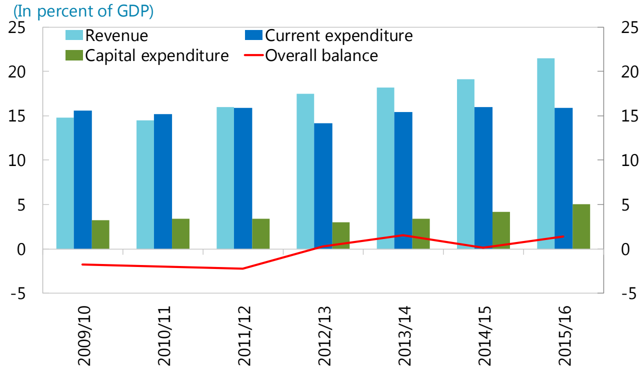
Sources: Nepali authorities; and IMF staff estimates.

Figure 2. Nepal: Fiscal Developments

Strong revenue growth and subdued capital spending kept the budget in surplus for the past four years.

Fiscal Performance

(In percent of GDP)

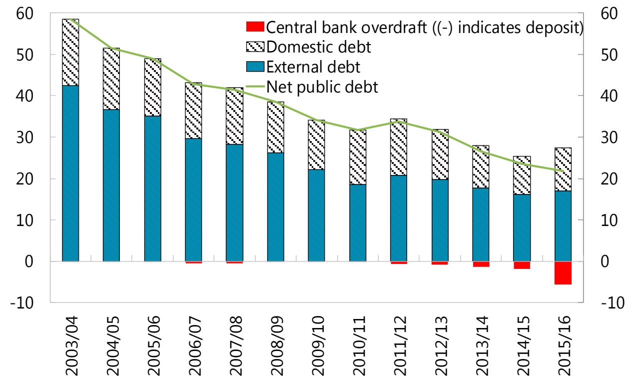


Sources: Nepali authorities; and IMF staff estimates.
Note: Overall balance: incurrence of net liabilities (incl. government deposits at NRB).

As a result, public debt declined steadily and the government accumulated large cash balances at the central bank.

Public Debt

(In percent of GDP)

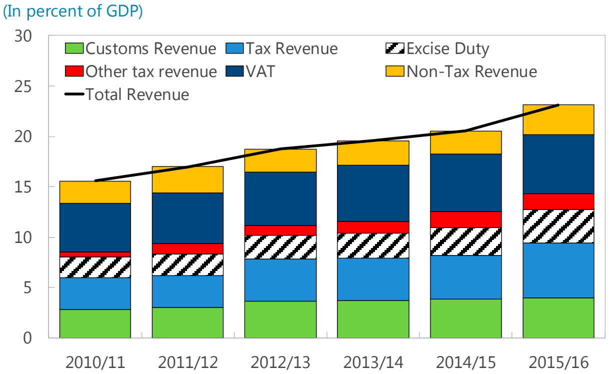


Sources: Nepali authorities; and IMF staff estimates

Revenue mobilization is supported by increases in VAT and customs thanks to higher imports.

Fiscal Revenue

(In percent of GDP)

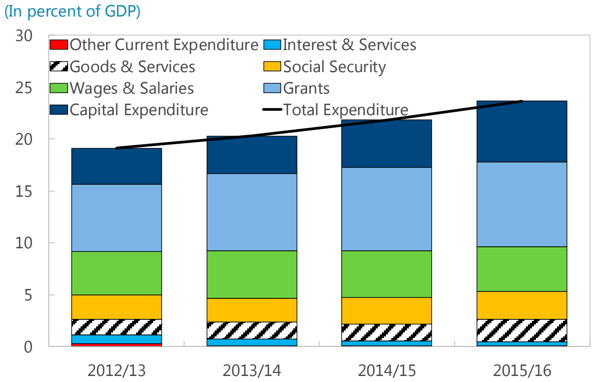


Sources: Nepali Authorities, and IMF staff estimates.

Recurrent expenditure has been edging up.

Fiscal Expenditure

(In percent of GDP)

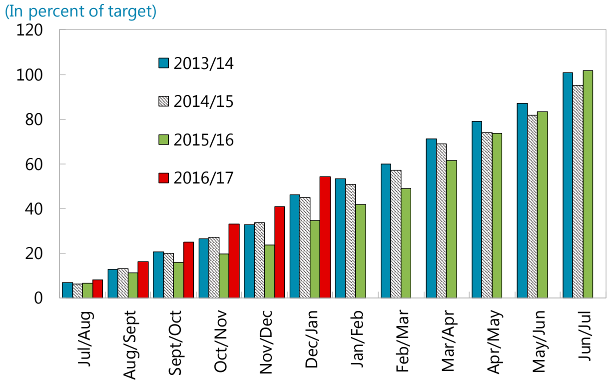


Sources: Nepali Authorities, and IMF staff estimates.

Revenues exceeded the collection target in 2015/16…

Revenue Collection Rate

(In percent of target)

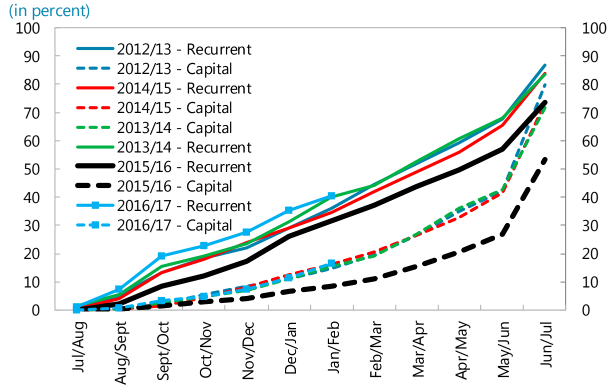


Sources: Nepali Authorities, and IMF staff estimates.

…whereas budget execution rates declined. And capital spending has been bunching toward the end of the fiscal year.

Budget Execution Rate

(in percent)

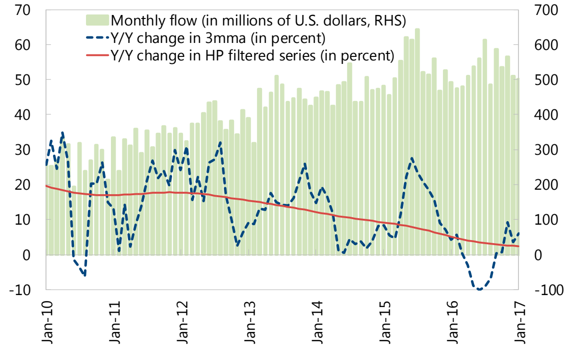


Source: Nepali authorities.

Figure 3. Nepal: External Sector Developments

Remittances remain resilient but their growth is slowing…

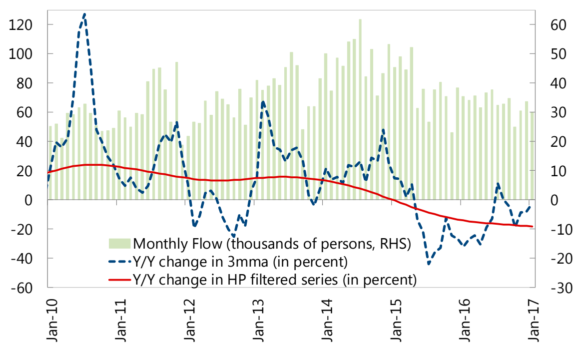
Remittances



Sources: Nepali authorities; and IMF staff estimates.

… due to a slowdown in the outflow of migrant workers.

Foreign Employment

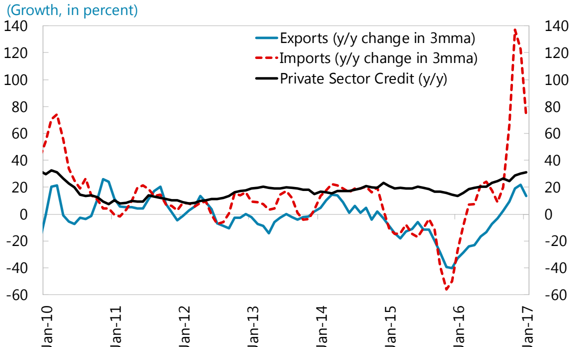


Sources: Nepali authorities; and IMF staff estimates.

Imports have rebounded strongly from the trade disruption.

Trade and Private Sector Credit

(Growth, in percent)

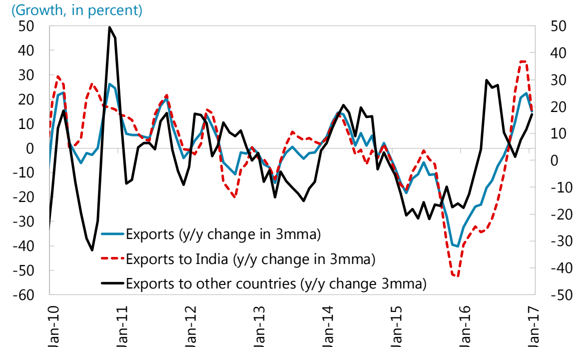


Sources: Nepali authorities; and IMF staff estimates.

Exports have recovered, driven by exports to India.

Exports

(Growth, in percent)

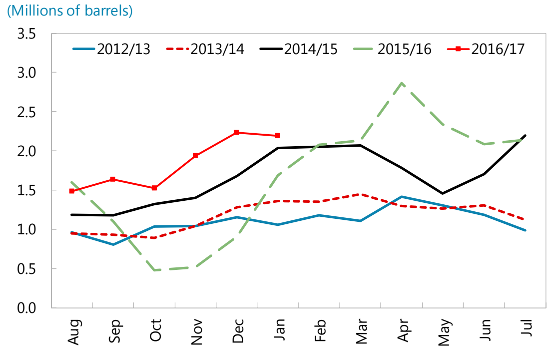


Sources: Nepali authorities; and IMF staff calculations.

Oil import volumes are also on the rise.

Oil Import Volume

(Millions of barrels)



Sources: Nepali authorities; and IMF staff estimates.

But strong remittances kept the current account in surplus

Current Account

(in percent of GDP)

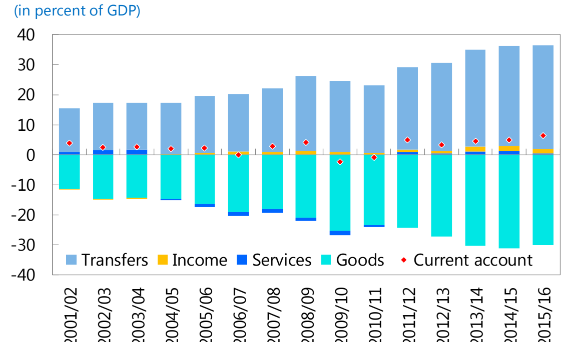
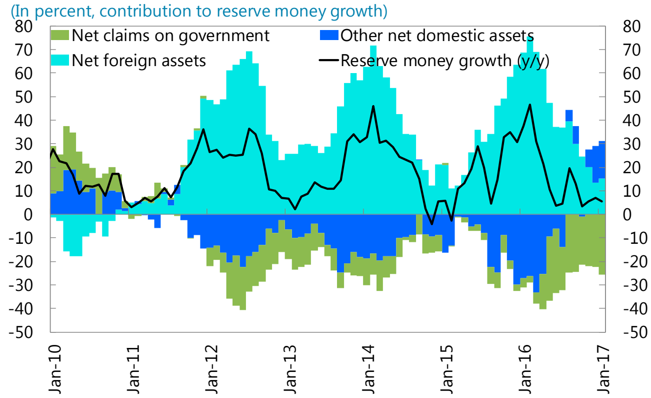


Figure 4. Nepal: Monetary Developments

Reserve money has slowed on moderating growth of central bank NFA.

Central Bank Balance Sheet

(In percent, contribution to reserve money growth)

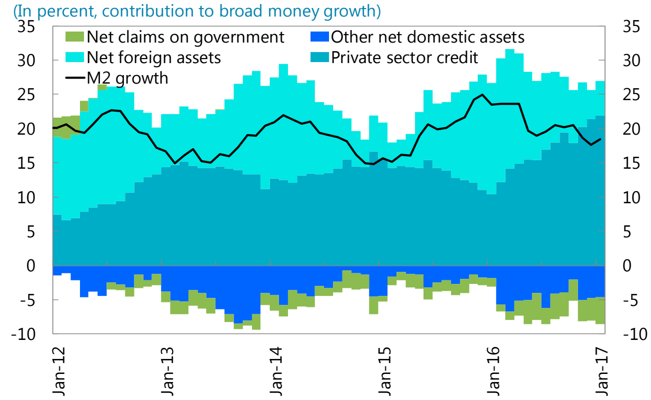


Sources: Nepali authorities; and IMF staff estimates.

Credit to the private sector is the key driver of the 19 percent (y/y) increase in broad money (M2) in January 2017.

Broad Money Growth

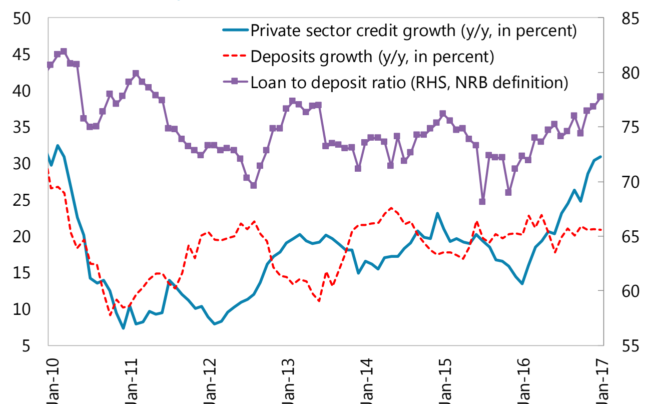
(In percent, contribution to broad money growth)



Sources: Nepali authorities; and IMF staff estimates.

Credit growth hit a 7-year high in January 2017, surpassing the growth of bank deposits and pushing up the loan to deposit ratio.

Nepal: Monetary Developments

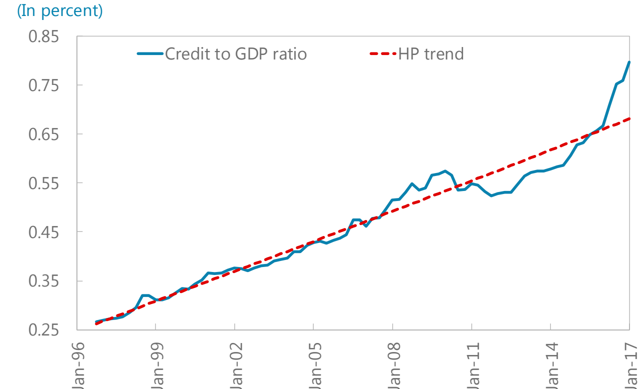


Sources: Nepali authorities.

Credit has been expanding above trend.

Credit Gap Analysis, 1996-2016

(In percent)

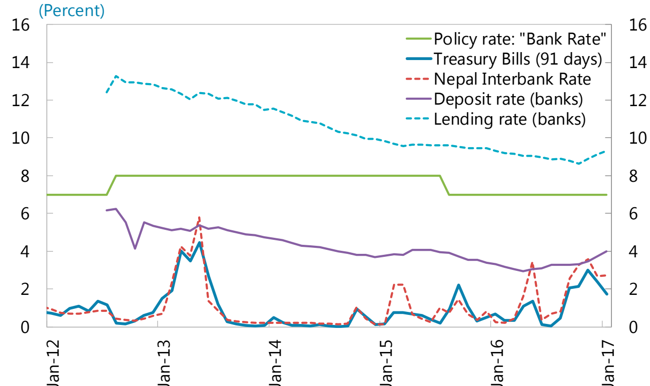


Sources: Nepali authorities and IMF staff calculations.

Loose monetary conditions pushed interest rates down. But rates have been edging up in recent months.

Nepal: Interest Rates

(Percent)

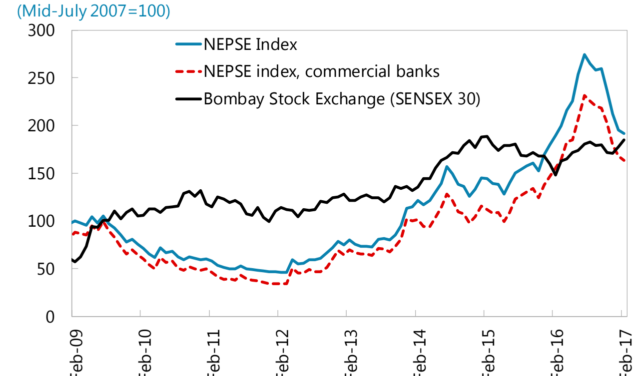


Sources: Nepali authorities.

Tightening liquidity conditions have turned the momentum in Nepal's stock market.

Stock Market Performance in Nepal and India

(Mid-July 2007=100)

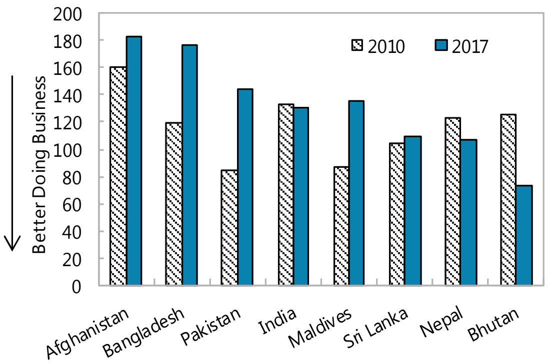


Sources: Nepali authorities; and IMF staff estimates

Figure 5. Nepal: Business Environment and Governance

Nepal's overall ranking has improved somewhat compared to 2010. But it slipped compared to 2016...

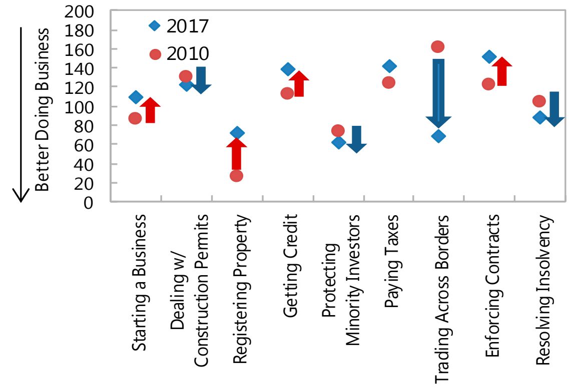
Ease of Doing Business Ranking: South Asia



Sources: World Bank, Doing Business Report (2017 and 2010)

...and deteriorated in some areas important to business.

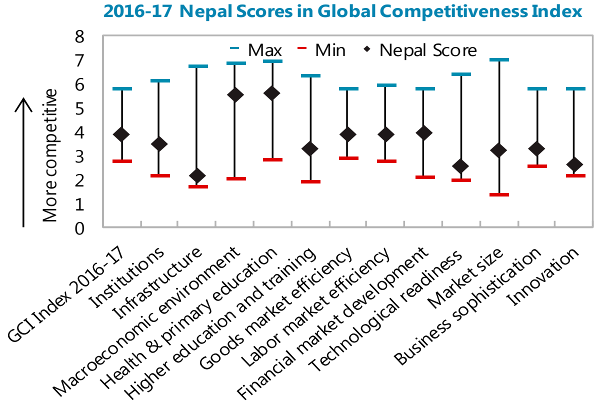
Ease of Doing Business Ranking: Nepal



Source: World Bank, Doing Business Report (2017 and 2010).

Competitiveness is hampered by inadequate infrastructure.

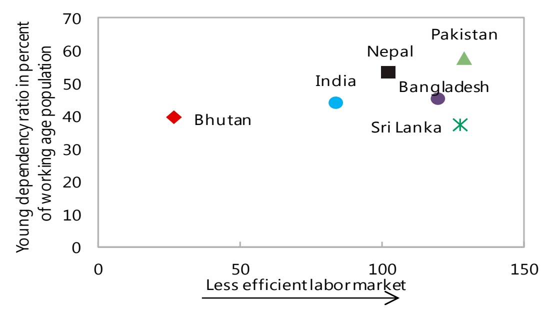
2016-17 Nepal Scores in Global Competitiveness Index



Source: World Economic Forum Global Competitiveness Report (16/17)

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

Labor Market Efficiency Ranking and Young Population Ratio: South Asia



Sources: World Development Indicators (2015) and World Economic Forum Global Competitiveness Report (2016)
Note: Young, defined as people younger than 15; working-age population as 15-64.

Table 1. Nepal: Macroeconomic Framework, 2013/14-2021/22 1/

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
				Projections					
Output and prices (annual percent change)									
Real GDP	6.0	2.7	0.6	5.5	4.5	3.8	3.8	3.8	3.8
CPI (period average)	9.0	7.2	9.9	6.7	7.6	7.3	6.7	6.5	6.5
CPI (end of period)	8.1	7.6	10.4	6.5	7.5	7.0	6.5	6.5	6.5
Fiscal Indicators (in percent of GDP)									
Total revenue and grants	20.4	20.9	23.3	24.2	24.1	24.1	24.1	24.0	24.0
of which: tax revenue	15.9	16.8	18.7	20.0	20.1	20.0	20.0	20.0	20.0
Expenditure	18.8	20.2	22.0	25.3	25.3	25.0	24.6	24.5	24.4
Expenses	15.5	16.0	16.5	19.3	19.3	19.0	19.1	19.0	18.9
Net acquisition of nonfinancial assets	3.4	4.2	5.5	6.0	6.0	6.0	5.5	5.5	5.5
Operating balance	4.9	4.8	6.8	4.9	4.8	5.0	5.0	5.0	5.1
Net lending/borrowing	1.5	0.7	1.4	-1.1	-1.2	-1.0	-0.5	-0.4	-0.4
Statistical discrepancy	-0.9	-1.2	-1.1	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	-1.5	-0.7	-1.4	1.1	1.2	1.0	0.5	0.4	0.4
Net acquisition of financial assets	2.4	2.2	5.2	-1.3	-1.2	1.0	1.2	1.2	1.2
Net incurrence of liabilities	0.0	0.3	2.8	-0.2	-0.1	2.1	1.6	1.6	1.5
Foreign	0.2	0.6	1.1	0.8	0.7	1.2	1.1	1.4	1.3
Domestic	-0.3	-0.2	1.7	-1.0	-0.8	0.9	0.6	0.2	0.2
Money and credit (annual percent change)									
Broad money	19.1	19.9	19.5	15.9	13.6	12.5	10.8	10.6	10.6
Domestic credit	13.9	16.4	17.4	20.2	17.8	14.3	11.0	10.7	11.8
Private sector credit	18.3	19.4	23.2	19.0	16.7	14.3	11.1	11.2	12.3
Velocity	1.3	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Saving and Investment (in percent of nominal GDP)									
Gross investment	41.2	38.8	34.0	42.7	42.6	42.1	41.7	41.4	41.1
Gross fixed investment	23.5	27.7	25.0	31.4	31.4	31.0	30.7	30.5	30.3
Private	20.1	23.6	19.5	25.5	25.4	25.0	25.2	25.0	24.8
Central government	3.4	4.2	5.5	6.0	6.0	6.0	5.5	5.5	5.5
Change in stock	17.7	11.0	8.9	11.2	11.2	11.1	11.0	10.9	10.8
Gross national saving	45.7	43.8	40.3	42.4	41.2	40.5	39.9	39.4	38.9
Private	40.5	38.5	33.3	37.2	36.1	35.1	34.6	34.1	33.5
Central government	5.2	5.2	7.0	5.1	5.1	5.3	5.3	5.3	5.5
Balance of Payments									
Current account (in millions of U.S. dollars)	908	1,067	1,339	-73	-338	-450	-543	-648	-745
In percent of GDP	4.5	5.0	6.3	-0.3	-1.3	-1.6	-1.8	-2.0	-2.1
Trade balance (in millions of U.S. dollars)	-6,082	-6,670	-6,389	-8,079	-8,856	-9,486	-10,162	-10,892	-11,658
In percent of GDP	-30.4	-31.3	-30.2	-34.7	-34.7	-34.3	-33.9	-33.6	-33.3
Exports value growth (y/y percent change)	5.4	-4.0	-28.8	18.8	3.9	4.0	4.1	4.2	4.2
Imports value growth (y/y percent change)	14.3	7.7	-7.4	25.7	9.1	6.8	6.9	6.9	6.8
Workers' remittances (in millions of U.S. dollars)	5,543	6,192	6,253	6,467	6,787	7,151	7,564	8,018	8,500
In percent of GDP	27.7	29.1	29.6	27.7	26.6	25.8	25.2	24.7	24.3
Gross official reserves (in millions of U.S. dollars)	6,172	7,162	8,574	8,690	8,494	8,381	8,443	8,451	8,452
In months of prospective GNFS imports	8.3	10.4	10.1	9.4	8.6	7.9	7.5	7.0	6.7
Memorandum items									
Public debt (in percent of GDP)	28.3	25.2	27.3	25.7	23.2	22.8	22.5	22.3	22.0
GDP at market prices (in billions of Nepalese rupees)	1,965	2,120	2,249	2,532	2,848	3,171	3,513	3,885	4,297
GDP at market prices (in billions of U.S. dollars)	20.0	21.3	21.2	23.3	25.5	27.7	30.0	32.4	35.0
Exchange rate (NRs/US$; period average)	98.3	99.5	106.3	…	…	…	…	…	…
Real effective exchange rate (average, y/y percent ch	-2.8	7.7	5.9	…	…	…	…	…	…
India's CPI (period average)[2/]	9.4	5.9	4.9	5.1	4.7	5.2	5.2	5.0	4.9

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

1/ Fiscal year ends in mid-July.

2/ Fiscal year ends end-March.

Table 2. Nepal: Summary of Government Operations, 2013/14–2021/22 1/

	2013/14	2014/15	2015/16		2016/17			2017/18	2018/19	2019/20	2020/21	2021/22
			Budget 2/	Est.	Budget 2/	Revised Budget	Proj.	Projections				
						(In billions of Nepalese rupees)						
Total revenue and grants	400	442	586	525	673	654	612	687	763	846	934	1,033
Total revenue	357	406	475	482	566	579	565	635	706	782	864	957
Tax revenue	312	356	427	421	511	506	506	572	635	704	778	861
Non-tax revenue	44	50	48	61	55	74	60	63	70	78	87	96
Grants	44	36	111	43	107	75	47	51	57	63	70	76
Expenditure	370	428	693	495	929	824	639	720	793	863	951	1,048
Expenses	304	339	484	371	617	562	488	551	604	671	739	813
Net acquisition of nonfinancial assets	67	89	209	123	312	262	151	170	189	192	212	235
Operating balance	97	103	102	154	56	93	124	136	159	174	196	220
Net lending/borrowing	30	14	-107	30	-256	-170	-27	-34	-30	-18	-17	-15
Statistical discrepancy	-17	-26	-49	-24	0	44	0	0	0	0	0	0
Net financial transactions	-47	-40	59	-55	256	214	27	34	30	18	17	15
Net acquisition of financial assets	46	47	61	117	7	0	-33	-35	36	40	45	49
Foreign	0	0	0	0	0	0	0	0	0	0	0	0
Domestic (net)	46	47	61	117	7	0	-33	-35	36	40	45	49
Sale of equity	9	11	12	13	23	20	14	17	19	22	24	26
Lending minus repayment	13	26	49	11	44	39	13	15	17	19	21	23
Change in cash/deposit	23	10		94	-59	-59	-59	-68	0	0	0	0
Net incurrence of liabilities	-1	7	119	63	263	214	-5	-2	67	58	61	64
Foreign	4	12	73	25	170	121	21	21	39	37	53	54
Domestic	-5	-5	47	37	93	93	-26	-22	28	21	9	10
						(In percent of GDP, unless otherwise indicated)						
Total revenue and grants	20.4	20.9	26.1	23.3	26.6	25.8	24.2	24.1	24.1	24.1	24.0	24.0
Total revenue	18.2	19.1	21.1	21.4	22.3	22.9	22.3	22.3	22.3	22.3	22.2	22.3
Tax revenue	15.9	16.8	19.0	18.7	20.2	20.0	20.0	20.1	20.0	20.0	20.0	20.0
Non-tax revenue	2.2	2.4	2.1	2.7	2.2	2.9	2.4	2.2	2.2	2.2	2.2	2.2
Grants	2.2	1.7	4.9	1.9	4.2	3.0	1.8	1.8	1.8	1.8	1.8	1.8
Expenditure	18.8	20.2	30.8	22.0	36.7	32.5	25.3	25.3	25.0	24.6	24.5	24.4
Expenses	15.5	16.0	21.5	16.5	24.4	22.2	19.3	19.3	19.0	19.1	19.0	18.9
Net acquisition of nonfinancial assets	3.4	4.2	9.3	5.5	12.3	10.3	6.0	6.0	6.0	5.5	5.5	5.5
Operating balance	4.9	4.8	4.5	6.8	2.2	3.7	4.9	4.8	5.0	5.0	5.0	5.1
Net lending/borrowing	1.5	0.7	-4.8	1.4	-10.1	-6.7	-1.1	-1.2	-1.0	-0.5	-0.4	-0.4
Statistical discrepancy	-0.9	-1.2	-2.2	-1.1	0.0	1.8	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	-2.4	-1.9	2.6	-2.4	10.1	8.5	1.1	1.2	1.0	0.5	0.4	0.4
Net acquisition of financial assets	2.4	2.2	2.7	5.2	0.3	0.0	-1.3	-1.2	1.2	1.2	1.2	1.2
Foreign	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic (net)	2.4	2.2	2.7	5.2	0.3	0.0	-1.3	-1.2	1.2	1.2	1.2	1.2
Sale of equity	0.5	0.5	0.5	0.6	0.9	0.8	0.6	0.6	0.6	0.6	0.6	0.6
Lending minus repayment	0.7	1.2	2.2	0.5	1.7	1.6	0.5	0.5	0.5	0.5	0.5	0.5
Change in cash/deposit	1.2	0.5	0.0	4.2	-2.3	-2.3	-2.3	-2.4	0.0	0.0	0.0	0.0
Net incurrence of liabilities	0.0	0.3	5.3	2.8	10.4	8.5	-0.2	-0.1	2.1	1.6	1.6	1.5
Foreign	0.2	0.6	3.2	1.1	6.7	4.8	0.8	0.7	1.2	1.1	1.4	1.3
Domestic	-0.3	-0.2	2.1	1.7	3.7	3.7	-1.0	-0.8	0.9	0.6	0.2	0.2
Memorandum items												
Primary balance	2.1	1.1	-3.8	1.7	-9.2	...	-0.5	-0.7	-0.5	-0.1	0.0	0.1
Public debt	28.3	25.2	...	27.3	...	...	25.7	23.2	22.8	22.5	22.3	22.0
External	18.0	15.9	...	16.9	...	...	17.5	16.7	16.0	15.8	16.0	16.0
Domestic	10.3	9.3	...	10.4	...	...	8.2	6.5	6.8	6.7	6.3	5.9
GDP (in billion of Nepalese rupees)	1,965	2,120	2,249	2,249	2,532	2,532	2,532	2,848	3,171	3,513	3,885	4,297

Sources: Nepalese authorities; and IMF 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

Table 3. Nepal: Monetary Indicators, 2013/14–2021/22 1/

	2013/14	2014/15	2015/16	Jan-17	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
					Projections					
	(In billions of Nepalese rupees, end-period)									
Nepal Rastra Bank										
Reserve money	437	523	547	555	633	719	809	896	991	1,096
Net domestic assets	-150	-198	-366	-399	-321	-238	-162	-104	-34	47
Claims on public sector	-1	-13	-109	-198	-42	20	20	20	20	20
Claims on private sector	4	5	4	4	5	5	6	7	7	8
Claims on banks & financial institutions	2	3	7	10	6	6	6	6	6	6
Other items (net)	-154	-193	-269	-216	-290	-270	-194	-137	-67	13
Net foreign assets	586	721	913	954	954	957	971	1,001	1,025	1,049
Monetary Survey										
Broad money	1,566	1,878	2,245	2,426	2,602	2,957	3,327	3,687	4,077	4,509
Narrow money	355	425	503	529	791	897	1,009	1,119	1,239	1,370
Quasi-money	1,211	1,453	1,741	1,896	1,811	2,060	2,318	2,567	2,838	3,138
Net domestic assets	967	1,131	1,289	1,419	1,596	1,947	2,303	2,631	2,996	3,402
Domestic credit	1,313	1,527	1,793	1,915	2,156	2,539	2,902	3,221	3,566	3,988
Credit to public sector	162	153	101	10	142	188	215	235	245	257
of which : Credit to central government	140	127	75	-21	109	155	177	194	201	209
Credit to private sector	1,151	1,374	1,692	1,905	2,014	2,351	2,687	2,986	3,321	3,731
Other items(net)	-346	-397	-505	-496	-560	-591	-599	-590	-571	-586
Net foreign assets	599	747	956	1,006	1,006	1,010	1,024	1,056	1,081	1,107
	(Twelve-month percent change)									
Reserve money	23.3	19.8	4.6	5.4	15.7	13.6	12.5	10.8	10.6	10.6
Broad money	19.1	19.9	19.5	18.5	15.9	13.6	12.5	10.8	10.6	10.6
Net domestic assets	14.1	17.0	14.0	24.0	23.9	22.0	18.3	14.2	13.9	13.6
Domestic credit	13.9	16.4	17.4	24.0	20.2	17.8	14.3	11.0	10.7	11.8
Credit to public sector	-9.9	-5.2	-34.1	-88.7	40.1	32.9	14.1	9.5	4.3	4.8
Credit to private sector	18.3	19.4	23.2	30.9	19.0	16.7	14.3	11.1	11.2	12.3
Net foreign assets	28.0	24.7	28.0	11.5	5.2	0.4	1.4	3.1	2.4	2.4
Memorandum items										
Velocity	1.3	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Multiplier	3.6	3.6	4.1	4.4	4.1	4.1	4.1	4.1	4.1	4.1
Private credit (in percent of GDP)	58.6	64.8	75.3	82.1	79.6	82.5	84.7	85.0	85.5	86.8
GDP at market prices (in billions of NR)	1,965	2,120	2,249	2,320	2,532	2,848	3,171	3,513	3,885	4,297

Sources: Nepalese authorities; and IMF staff estimates and projections.
1/ Fiscal year ends in mid-July.

Table 4. Nepal: Balance of Payments, 2013/14–2021/22 1/

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
				Projections					
				(in million US dollars)					
Current account	908	1,067	1,339	-73	-338	-450	-543	-648	-745
Current account (excluding official transfers)	547	774	947	-338	-628	-765	-894	-1,028	-1,160
Trade balance	-6,082	-6,670	-6,389	-8,079	-8,856	-9,486	-10,162	-10,892	-11,658
Exports, f.o.b.	1,030	988	704	836	869	903	940	980	1,020
Imports, f.o.b.	-7,112	-7,658	-7,092	-8,915	-9,725	-10,389	-11,103	-11,872	-12,678
Services (net)	214	275	92	228	297	328	360	393	428
Receipts	1,277	1,499	1,302	1,466	1,650	1,791	1,939	2,095	2,262
Of which : tourism	473	537	393	503	563	611	660	714	769
Payments	-1,063	-1,224	-1,210	-1,238	-1,353	-1,463	-1,579	-1,702	-1,835
Income	334	342	320	356	389	422	458	495	534
Credit	403	428	405	446	488	530	574	620	670
Debit	-69	-86	-85	-90	-99	-107	-116	-125	-136
Current transfers	6,442	7,120	7,316	7,423	7,831	8,285	8,802	9,356	9,950
Credit, of which:	6,477	7,146	7,351	7,525	7,943	8,406	8,933	9,498	10,103
General government	362	293	392	279	305	331	368	398	434
Workers' remittances	5,543	6,192	6,253	6,467	6,787	7,151	7,564	8,018	8,500
Debit	-34	-26	-36	-102	-112	-121	-131	-142	-153
Capital account	173	148	159	143	156	170	189	204	223
Financial account	-19	-102	-91	55	-8	172	420	462	534
Direct investment	33	44	55	73	80	86	94	117	144
Portfolio investment	0	0	0	0	0	0	0	0	0
Other investment (net)	-51	-145	-146	-18	-88	85	326	345	390
MT debt (net)	45	118	505	357	188	449	447	440	457
Other (net)	-96	-264	-651	-376	-275	-364	-121	-96	-68
Errors and omissions	121	185	175	0	0	0	0	0	0
Overall balance	1,184	1,298	1,583	125	-190	-108	66	18	12
Financing	-1,184	-1,298	-1,583	-125	190	108	-66	-18	-12
Change in reserve assets (- =increase)	-1,200	-1,293	-1,624	-116	196	113	-62	-8	-2
Use of IMF resources (net)	-6	-5	41	-8	-6	-4	-4	-10	-10
IMF Disbursements	0	0	50	0	0	0	0	0	0
IMF Repayment	6	5	9	8	6	4	4	10	10
Memorandum items									
Current account (in percent of GDP)	4.5	5.0	6.3	-0.3	-1.3	-1.6	-1.8	-2.0	-2.1
Current account, excl. grants (in percent of GDP)	2.7	3.6	4.5	-1.4	-2.5	-2.8	-3.0	-3.2	-3.3
Trade balance (in percent of GDP)	-30.4	-31.3	-30.2	-34.7	-34.7	-34.3	-33.9	-33.6	-33.3
Exports (in percent of GDP)	5.2	4.6	3.3	3.6	3.4	3.3	3.1	3.0	2.9
Imports (in percent of GDP)	35.6	35.9	33.5	38.2	38.1	37.5	37.0	36.6	36.2
Exports (y/y percent change)	5.4	-4.0	-28.8	18.8	3.9	4.0	4.1	4.2	4.2
Imports (y/y percent change)	14.3	7.7	-7.4	25.7	9.1	6.8	6.9	6.9	6.8
of which Oil imports (y/y percent change)	11.4	-17.0	-42.8	62.6	13.7	4.2	12.5	4.5	4.1
Remittances (in percent of GDP)	27.7	29.1	29.6	27.7	26.6	25.8	25.2	24.7	24.3
Remittances (y/y percent change)	12.4	11.7	1.0	3.4	4.9	5.4	5.8	6.0	6.0
FDI (in percent of GDP)	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.4	0.4
Total external debt (in percent of GDP)	18.0	15.9	16.9	17.5	16.7	16.0	15.8	16.0	16.0
Gross official reserves (in millions of U.S. dollars)	6,172	7,162	8,574	8,690	8,494	8,381	8,443	8,451	8,452
In months of prospective GNFS imports	8.3	10.4	10.1	9.4	8.6	7.9	7.5	7.0	6.7
As a share of broad money (in percent)	37.9	38.7	41.0	36.8	...	...	...	...	...
Nominal GDP (in millions of U.S. dollars)	19,995	21,314	21,154	23,316	25,501	27,678	29,986	32,403	35,013

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

1/ Fiscal year ends in mid-July.

Table 5. Nepal: Commercial Banks' Financial Soundness Indicators, 2013–2016 1/

	2013	2014	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3
					(in percent)				
Capital adequacy									
Capital fund to risk weighted assets	13.4	12.6	11.7	11.9	11.9	12.2	12.5	12.6	11.9
Tier 1 capital to risk weighted assets	11.8	11.0	10.1	10.2	10.2	10.4	10.9	11.1	10.4
Asset quality									
NPLs to total loans	1.9	2.5	2.7	2.3	2.3	2.1	1.8	1.4	1.3
Loan loss provision to total loans	2.4	2.9	2.9	2.7	2.7	2.7	1.2	2.2	2.1
Earnings and profitability									
Return on equity (ROE)	28.2	26.9	23.7	29.2	21.6	28.0	20.8	21.7	…
Return on assets (ROA)	1.7	1.5	1.3	1.7	1.6	1.5	1.7	1.8	…
Interest income to gross income	83.4	82.6	81.5	79.5	79.8	78.9	79.4	78.2	…
Non-interest expenditures to gross income	18.3	18.9	20.4	19.8	20.2	21.1	20.0	20.6	…
Employees expenses to non-interest expenditures	43.1	44.6	47.0	45.9	45.1	45.0	47.5	47.3	…
Liquidity									
Liquid assets to total assets	25.3	24.4	22.2	21.4	20.6	24.7	22.8	21.7	…
Liquid assets to total deposits	30.4	29.2	26.7	25.8	24.8	29.4	27.6	26.3	…
Exposure to real estate									
Share of real estate and housing loans	16.1	15.1	14.6	14.5	14.5	14.9	14.6	14.9	…
Share of loans collateralized by land and buildings	50.9	51.7	51.8	52.0	53.1	52.5	55.5	54.6	…

Source: Nepalese authorities.

1/ Data presented on a calendar year basis. "A" class banks excluding state owned banks.

Annex I. Risk Assessment Matrix[1]

Source	Likelihood	Time Horizon	Impact	Policy Response to Minimize Impact
DOMESTC RISKS				
Slow progress in post-earthquake reconstruction Under-execution of the ambitious 2016/17 budget and further delays in reconstruction work could depress confidence and hold back private investment and growth.	High	Short to Medium Term	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 under the power-sharing arrangement of the coalition government could undermine confidence and delay economic reforms.	High	Short to Medium Term	Medium/High	Preserve fiscal and external policy space. Ensure policy continuity.
Financial sector vulnerabilities Vulnerabilites arising from the earthquakes and trade disruption, and uncertainties associated with deposit growth could affect liquidity and exacerbate existing weaknesses in the loan portfolio of banks and financial institutions.	Medium	Medium Term	Medium/High	Regulatory forbearance to help deal with the aftermath of the earthquake and trade disruption should be completely phased out. Exercise corrective and sanctioning powers more forcefully. Move to pro-active and risk-based supervision. Increase resources and raise capacity for supervision.
Natural disaster Nepal with weak crisis prepareness and capacity is highly vulnerable to natural disasters similar to the recent earthquake, which could take a significant toll, including by damaging infrastructure, housing and the production base.	Low	Short to Medium Term	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				
Lower energy prices Production cuts by OPEC and other major producers may not materialize as agreed, keeping prices lower than the WEO baseline. A prolonged slowdown in countries hosting Nepali migrant workers (Persian Gulf countries, Malaysia) could further weaken remittance inflows. This would further reduce demand and growth; lower growth in private deposits would tighten liquidity and expose weaknesses in the financial system; and reduce government revenues due	Low	Short to Medium	Medium/High	Strengthen the financial sector and preserve fiscal and external policy space to cope with adverse shocks. In the longer term, boost public investment, and pursue structural reforms to improve the investment climate to attract higher private investment to reduce dependency on remittances.
Weaker-than expected global growth Retreat from cross-border intergration and policy uncertainty and divergence would weigh on global growth and exacerbate global financial market volatility.	High	Short to Medium	Low	Maintain sound policy frameworks and enhance financial stability.
Slower-than-projected growth in India Slower growth in India could reduce remittances and, to some extent, FDI and exports.	Medium	Short to Medium	High	Accelerate structural reforms to improve the investment climate and boost public investment.
Reduced financial services by global/regional banks ("derisking") Loss of corresponding banking services could affect the cost and inward transfer of remittances. However, as money tranfer operators are preferred option to banks in receving remittance in Nepal, together with the prevalence of informal remittance channel such as the *hawala* system, derisking has limited impact on remittance transfers to Nepal.	High	Short to Medium Term	Low	Enhance coordinated efforts by the public and private secors to mitigate risk and promote formal remittance tranfers. Continue strengthening regulatory and supervisory frameworks to meet relevant international standards, including on AML/CFT measures, and regulate informal remittance channels that are susceptible to illegal activities.

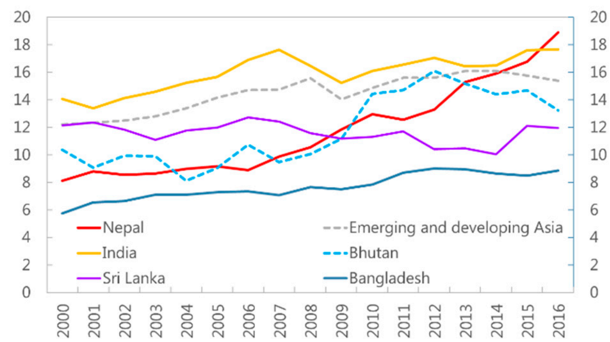
[1]The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability 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. "Short Term" and "Medium Term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex II. Domestic Revenue Mobilization[1]

Nepal has achieved strong growth in domestic revenue in recent years. This was facilitated by rapid growth of the tax base—with rising remittances propelling consumption and imports—alongside sustained efforts to strengthen tax administration, including at customs. There is considerable scope to raise revenue further.[2] This would be important to finance the current and capital spending needed to achieve the Sustainable Development Goals (SDGs) and address infrastructure bottlenecks to boost medium-term growth and raise living standards throughout Nepal. The authorities' ongoing efforts to modernize the tax system and strengthen core tax and customs administration have the potential to substantially raise collections. The recent establishment of the IMF's South Asia Regional Training and Technical Assistance Center (SARTTAC) in India, provides additional opportunities for relevant training and technical assistance (TA), to augment IMF assistance that has been provided in the past.

Following a review of the tax system, the government is currently drafting a new single tax code to implement tax policy improvements and to consolidate and harmonize the main domestic taxes under one piece of legislation. A High-Level Tax System Review Commission (HLTSRC) formed in 2014 conducted extensive consultation with a wide range of stakeholders. The Commission's recommendations, delivered in July 2015, envisage broadening the base for the value-added tax (VAT) base, simplification of the major taxes, and introduction of tax expenditures as supplementary information in the annual budget. The recommendations are mostly in line with those made by FAD tax policy missions in 2013 and 2015. A February 2017 mission advised the authorities on the preparation of the new single tax code. The new legislation, which the authorities aim to implement from 2018, would help reduce compliance costs and create a business-friendly environment.

General Government Tax Revenue
(In percent of GDP)



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

The Inland Revenue Department (IRD) has strengthened tax administration as it implemented the Strategic Plan (2012/13-2016/17) and the supporting Reform Plan (2012/13-2014/15). Administrative improvements included: (i) establishment of a segment-based organization in Kathmandu with Medium Taxpayer Offices focused on improving compliance of medium taxpayers and Taxpayer Service Offices bringing services and support closer to small taxpayers; (ii) reducing taxpayers' compliance costs through better use of information technology and expansion of e-services for registration and filing; (iii) enhancing taxpayer education offerings; (iv) expansion of payment options for taxpayers; and (v) establishment of an Internal Monitoring System to set annual targets for core functions.

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[1] Prepared with input from Ms. Adams, and Messrs. Nagy and Nakayama.

[2] It should be noted that Nepal's current relatively high revenue to GDP ratio compared to regional peers may reflect underestimation of Nepal's GDP due to the outdated national accounts base year (2000/01).

There is room to bring core tax compliance performance indicators more in line with modern tax administration standards building on the IRD's earlier gains.[3,4] Gains can be made with regard to making the register of taxpayers more accurate, increasing on-time filing, managing VAT refunds, using enforcement powers to prevent tax arrears and nonpayment, and strengthening the audit program, including by employing a range of audit types to bring more taxpayers under the audit program.

The Department of Customs (DOC) has a long history of formalized planning, which has enabled it to make significant strides in modernizing customs administration. FAD has provided detailed guidance to assist the DOC to develop its strategic, reform and operational planning processes. Under the first four Customs Reform and Modernization Action Plans (CRMAP), commencing in 2003, and with extensive TA from a wide range of donors,[5] the DOC has taken important steps in reforming its operations. These include the implementation of ASYCUDA++, and ongoing migration to ASYCUDA World; ongoing implementation of the Nepal National Single Window and Trade Portal and updated organization structure.

The DOC is continuing to work in areas which it needs to focus its reform efforts with donor assistance. These areas, drawn from the CRMAP 2013–2017, include simplifying and harmonizing customs procedures, strengthening customs valuation processes, strengthening Post Clearance Audit (PCA), controlling revenue leakage, and balancing trade facilitation and regulatory intervention.

FAD TA supported the completion of a VAT gap study in 2015 that highlighted VAT policy and compliance gaps. The findings of the study could be used to inform the development of the Ministry of Finance or IRD's VAT policy and administration future work programs.

The authorities' plans to establish a Revenue Board could provide for more continuity in staffing and reform policies. As it stands, the Nepal civil service policies on staff rotation inhibit the sustained buildup of expertise through experience and training. They may also result in institutional focus on short term results, rather than longer term reform planning.

[3] FAD has provided advice on strengthening the IRD's headquarters operations to better design, deliver and monitor national compliance strategies and programs.

[4] The Tax Administration Diagnostic Assessment Tool (TADAT) is a structured means by which tax administrations are assessing their performance outcomes. See www.TADAT.org for information on the tool.

[5] Agencies that have been working with DOC include ADB, JICA, KOICA, UNCTAD, UNESCAP, UNODC, USAID, and the World Bank.

Annex III. Sustainable Development Goals (SDGs)—Progress and Challenges

- **Nepal has made a strong start on the adoption of the SDGs.** Nepal was one of the first countries to publish a preliminary national report on *Sustainable Development Growth 2016-2030* in 2015. The early adoption of the SDGs follows on good progress made on most Millennium Development Goals (MDGs) by 2015 (Table), despite a decade-long armed conflict that ended only in 2006.

- **The next steps are to localize SDGs by setting national priorities.** This includes establishing institutional arrangements, enhancing capacity at the regional and local levels, arranging financial resources to achieve the SDGs, and developing indicators to measure and monitor progress. The government acknowledges the need for goal-specific and cross-cutting interventions in implementing and monitoring the SDGs. In particular, work has begun to mainstream and track the MDGs in the Nepali context to ensure that national goals are synchronized with international goals for sustainable development. The SDGs have also been incorporated into the 14th National 3-year Plan (2016/17-2018/19) that was recently endorsed by the government. To adequately track SDG indicators, there is a need to conduct additional surveys to fill data gaps, improve data collection, strengthen the Central Bureau of Statistics, and implement the National Strategy for the Development of Statistics.

- **The SDGs need to be costed and financial resources need to be mobilized**. It would be important to know how much it will cost Nepal to meet the SDGs. The government has noted that more grants and concessional loans need to be mobilized from development partners. However, this should be complemented by domestic revenue mobilization for which there is ample scope. In the context of the IMF's commitment to support the SDGs, Nepal is a "domestic revenue mobilization pilot". Accordingly, Annex II of this report highlights policy options to efficiently raise more revenue.

- **Development partners' support is crucial**. The government needs to work closely with development partners, the private sector and community organizations. The authorities have noted that development partners will play an important role in developing SDG-based periodic plans, as well as supporting and monitoring implementation.

- **Achieving the ambitious SDGs will pose key challenges**. Frequent government changes and rotation of officials have impeded policy planning, implementation, and reforms. Policy implementation capacity need to be strengthened to achieve 'economic diversification and transformation' (SDG 1,2,8, and 9) and 'economic, gender, and financial inclusion' (SDG 3,4,5, and 10). The latter will also require social change and important structural reforms. Nepal made impressive progress in achieving the MDG on halving absolute poverty. However, the government has recognized that ending absolute poverty by 2030 (SDG1) will be very challenging as this requires reducing the share of the population living below the poverty line from 23.8 percent (estimate for 2011) to 5 percent. Achieving resilient infrastructure (SDG 9) will require an important upgrade to capital budget implementation capacity.

Table 1. 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)	96.2 (14)	100	Likely
	Reaching last grade	38(90)	98.9 (14)	100	Likely
	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)	103 14)	100	Achieved
	Ratio of girls to boys in secondary education (percent)	43(90)	103 (14)	100	Achieved
	Ratio of females to males in tertiary institutes (percent)	32(90)	105 (14)	100	Achieved
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)	38 (14)	54	Achieved
	Infant mortality rate (per 1,000 live births)	108(90)	33 (14)	36	Achieved
	Immunization, measles (percent of children under 12 months)	108(90)	92.6 (14)	>90	Achieved
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)	258 (14)	213	Likely
	Births attended by skilled health personnel (percent)	7(90)	55.6 (14)	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)	0.03 (14)	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)	0.11 (14)	0.06	Likely
	Prevalence rate of tuberculosis cases per 100,000 people	460(90)	211 (14)	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

Sources: UNDP, Nepal Millennium Development Goals--Progress Report (September 2013); NPC Sustainable Development Goals 2016-30--National (Preliminary) Report.

Annex IV. Strengthening the Monetary Policy Framework and its Implementation

1. A broad consensus has emerged on key features of effective policy frameworks in countries with scope for independent monetary policy, such as Nepal with its pegged exchange rate and *de jure* closed capital account. An October 2015 IMF staff study on *Evolving Monetary Policy Frameworks in Low-Income and Other Developing Countries* draws on cross-country experiences to derive "principles" that encapsulate the key characteristics of sound forward-looking monetary policy frameworks (Annex Table 1).

Annex Table 1. Principles and Key Stakeholders

Principles for Monetary Policy	Stakeholders
I. The CB has a clear mandate in terms of its goals, and operational independence to pursue its goals	Requires consensus in society. Government/Ministry of Finance
II. Price stability is the primary overriding objective of monetary policy	Government. Requires consensus in society.
III. CB has a medium-term inflation objective	Central bank and government
IV. Policy actions take into account implications for macroeconomic activity and financial stability	Central bank, statistics office
V. The CB has a clear and effective operational framework	Central bank, financial regulator
VI. The CB has a transparent forward-looking strategy	Central bank, statistics office
VII. CB communication is transparent and timely	Central bank

2. Nepal's relatively low conformity with the principles appears to be driven by the multiple objectives assigned to the NRB and monetary policy, leading to the deployment of instruments and operational objectives not always geared at achieving the price stability mandate, and to the following:

- *Greater susceptibility of monetary policy to short-term considerations and pressures*, e.g., boosting the money supply and/or driving interest down (including below a level aligned with fundamentals), which can in turn result in inflationary pressures that can place a strain on the peg regime (Principles I and II).

- *Greater difficulties in anchoring the private sector's inflation expectations*, which can make it difficult for the NRB to use a medium-term numerical inflation objective for its internal deliberations, and even more to use it in its communication (Principle III).

- A *complex operational framework,* characterized by a multiplicity of instruments aimed at supporting structural policies, which can make it more difficult for the NRB to align market conditions with its announced policy stance (Principle V).

- *Difficulties for adopting a transparent forward-looking strategy,* as short-term considerations may take priority (Principle VI).

- *Communication becomes even more challenging,* as the multiplicity of objectives and instruments makes it difficult for the NRB to communicate consistently and in a clear and transparent fashion (Principle VII).

3. Addressing the gaps with the Principles requires building a broad-based consensus with stakeholders so that they all share a common view on the NRB's mandate and its monetary policy. While the NRB should play a catalytic role, the process should build on long-term commitment from all relevant authorities. That will facilitate understanding and acceptance of the Principles, and their impact on the country's economic structures.

4. There is ample scope for enhancing conformity with the Principles immediately, in particular in areas under the direct control of the NRB. They include: short-term liquidity forecasting and management (and related actions to support market development, including financial market infrastructures); effective internal organizational structures; analytical capacity to support the monetary policy decision making process (including inflation forecasts, analysis of the transmission channels); and communication strategy. The current benign fiscal and balance of payments position provides a favorable window of opportunity to commit to the modernization of the monetary policy framework, building on the recent adoption of an interest rate corridor.

Annex V. Progress in Implementing High-Priority FSAP Recommendations

Recommendations	Responsible Authority	Time Line*	Progress to date
Financial Stability			
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** An interest rate corridor was introduced in mid-2016. There is scope to strengthen the new framework further in line with IMF TA recommendations. NRB bonds were issued.
Undertake a thorough Asset Quality Review (AQR) to identify the extent of problem loans in banks' balance sheets (with TA support).	NRB	ST	**In process** NRB supervisors are following-up on the special inspections that were done to review asset quality. Prompt corrective action was taken in some cases.
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 that the review will increasingly focus on asset quality and borrowers' financials.
Reinforce efforts to address financial infrastructure shortcomings in the Payments System, clearing, credit information, collateral registry, and debt recovery areas.	NRB/MOF	ST/MT	**In process** • NRB established a payment and settlement system department in July 2015, which will also oversee some of the new products such as mobile banking and branchless banking. The NRB has requested Fund TA to strengthen its payment systems oversight function. • Setting up of Real-time gross settlement (RTGS) is being initiated. • Nepal Financial Reporting Standard (NFRS) was drafted. Class A banks are required to adopt NFRS-compliant financial statements by [2016/17]. Other financial institutions are required to adopt NFRS by [2017/18]. • 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			
Redefine supervisory approach by: integrating risk-based off-site and on-site supervision; • increasing analytical capacity through training; • introducing supervisory management information systems (MIS); • developing a dedicated human resources (HR) rotation policy; and • streamlining the NRB board participation in operational decisions.	NRB	ST/MT	**In process / not done** Supported by FIRST-funded TA (FIRST) risk-based supervision (RBS) is being implemented for Class A institutions; and is in the 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.
Ensure effective compliance with supervisory directives and guidelines by: • performing a thorough follow up of the implementation of supervisory recommendations; • proactive, earlier, and stronger corrective actions.	NRB	MT	**In process/not done** Corrective and supervisory actions remain largely informal; with PCA having a formal framework. Some existing provisions are being revised. The FIRST project supports the development of programs to ensure compliance.
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** The NRB has indicated its intent to review the licensing framework in due course. The consolidation of the sector may in the long run have an impact on the various classes of FI.
Granting the NRB explicit consolidated supervision powers, amending the legal framework to incorporate a comprehensive definition of related parties and controlling interests.	NRB	MT	**In process/Not done** The amendments of the NRB Act and the BAFIA Act have been endorsed by the Parliament. However, the NRB's consolidated supervision powers were not specified in the NRB Act. Staff has not yet been able to review the BAFIA Act.
B. Non-banking Sector			
Divide the CIT into two separate legal entities, segregating the capital market business, to be placed under the supervision of the Securities Board of Nepal (SEBON), from the pension fund business.	MOF/SEBON	ST	**In preparation** MOF is preparing a concept report.
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.

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
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 is considering including liquidity as a PCA trigger. No changes have been made on the designation of problematic status.
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.
Revise NRB Act to clarify emergency liquidity assistance (ELA) provisions.	NRB/MOF	ST	**Not done** NRB Amendment Act passed by the Parliament does not clarify ELA provisions.
Revise NRB Act to grant it special resolution regime powers.	NRB/MOF	ST	**Mostly done** Special resolution regime powers have been granted but need further clarification, strengthening, and operationalization (Pending further assessment by Fund staff).
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 *ad hoc* basis. It would be important to formalize the mandate of this committee to include the development of a national crisis contingency plan.
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.

INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

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

Appendix I. Draft Press Release

IMF Executive Board Concludes 2017 Article IV Consultation with Nepal

The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Nepal on March 27, 2017, and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

Nepal's economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions at the southern border. The growth of real GDP at market prices slowed to 0.6 percent in 2015/16 (mid-July 2015 to mid-July 2016). Shortages of fuel and other essential goods due to the trade disruption drove up inflation to 12 percent (y/y) in January 2016, but eased subsequently to 3.2 percent in January 2017, mainly on account of lower food prices.

Budget under-spending worsened in 2015/16. At the same time, revenues exceeded the budget due to one-off telecom sector collections. As a result, the budget was in surplus for the fourth year in a row and net public debt declined further to 22 percent of GDP, down from 34 percent of GDP in 2011/12.

Private sector credit growth surged to a 7-year high of 31 percent (y/y) in January 2017.

The current account surplus reached 6.3 percent of GDP in 2015/16 on account of lower imports from the trade disruption. Exports also suffered. The growth rate of remittances slowed sharply, to 1 percent in 2015/16, from an annual average of 15 percent during the previous 5 years, due to weak growth in oil-producing host countries. Gross reserves of the central bank reached a record US$8.7 billion, covering more than nine months of imports, in January 2017.

Growth is projected to reach 5.5 percent in 2016/17 and inflation is expected to undershoot the central bank's mid-2017 target of 7.5 percent.

Executive Board Assessment

Nepal's economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions. The normalization of economic activity is supported by a good monsoon,

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

accommodative monetary policy, and rising government spending. Inflation has been decelerating due to base effects related to last year's trade disruption but is expected to remain above India's inflation. More recently, the authorities have also been able to advance reforms in a number of areas.

The medium-term outlook critically depends on efforts to sustain and deepen the nascent reform momentum. Stronger policies are needed to enhance confidence amid ongoing political uncertainty. They are also needed to strengthen key institutions and administrative capacity, which are critical for overcoming poor service delivery and chronic under-implementation of the budget, and for boosting private investment and growth. Accordingly, in the absence of stronger policies, and taking into account the lower projected growth of remittances and the effects of the earthquakes and trade disruption, growth would likely fall below the average of the past decade and fall short of what is needed to substantially improve living standards and social indicators.

Risks to the outlook are broadly balanced. The rebound in economic activity could be more pronounced and persistent than set out in the baseline, particularly if the momentum in policy and structural reforms is sustained and deepened. Key downside risks pertain to domestic political instability, the weak financial sector, slowing remittances impacting financial sector liquidity, and lower growth in India due to the demonetization shock.

To support Nepal's recovery while maintaining macroeconomic and financial stability, the macroeconomic policy mix should be rebalanced toward a more accommodative fiscal position and a tighter monetary stance. Staff welcomes the authorities' plans and efforts to scale up government spending to rebuild after the earthquakes and address infrastructure gaps to boost medium-term growth. In view of the limited implementation capacity, it will be essential to have a realistic budget that effectively prioritizes spending to maximize growth dividends, including in social spending areas most important for inclusive growth. The scaling up of government spending should not exceed the economy's aggregate absorptive capacity and should be anchored in a medium-term expenditure framework to ensure quality and fiscal sustainability.

The monetary policy framework needs further strengthening. Staff welcomes the introduction of an interest rate corridor. Next steps would involve refining the framework by fixing the floor of the interest rate corridor to reduce the volatility of interbank interest rates and adopting a medium-term inflation objective consistent with eliminating the inflation wedge with India on a sustained basis. With remittances set to slow, fiscal policy turning expansionary, and the current account turning to a deficit, a tightening of monetary policy is needed to prevent the exchange rate from becoming somewhat overvalued.

Financial sector reforms should be accelerated in line with FSAP recommendations to mitigate macro-financial risks, including related to the rapid growth of credit. Financial sector supervision should be strengthened, building on the recent amendments to several aspects of the regulatory framework. Macro-prudential measures introduced in the aftermath of the 2010-11 episode of financial sector pressures to contain credit growth have served Nepal well and should be maintained after the temporary relief granted in February lapses in July.

Raising Nepal's potential growth requires sustained efforts to build policy implementation capacity, improve the business climate, and develop the hydropower sector. Structural reforms to deregulate product and factor markets should complement prioritized investment to upgrade transportation infrastructure and improve power supply.

Nepal: Selected Economic Indicators, 2013/14–2017/18 1/

	2013/14	2014/15	2015/16	2016/17	2017/18
				Projections	
Output and prices (annual percent change)					
Real GDP	6.0	2.7	0.6	5.5	4.5
CPI (period average)	9.0	7.2	9.9	6.7	7.6
CPI (end of period)	8.1	7.6	10.4	6.5	7.5
Fiscal Indicators (in percent of GDP)					
Total revenue and grants	20.4	20.9	23.3	24.2	24.1
of which: tax revenue	15.9	16.8	18.7	20.0	20.1
Expenditure	18.8	20.2	22.0	25.3	25.3
Expenses	15.5	16.0	16.5	19.3	19.3
Net acquisition of nonfinancial assets	3.4	4.2	5.5	6.0	6.0
Operating balance	4.9	4.8	6.8	4.9	4.8
Net lending/borrowing	1.5	0.7	1.4	-1.1	-1.2
Statistical discrepancy	-0.9	-1.2	-1.1	0.0	0.0
Net financial transactions	-1.5	-0.7	-1.4	1.1	1.2
Net acquisition of financial assets	2.4	2.2	5.2	-1.3	-1.2
Net incurrence of liabilities	0.0	0.3	2.8	-0.2	-0.1
Foreign	0.2	0.6	1.1	0.8	0.7
Domestic	-0.3	-0.2	1.7	-1.0	-0.8
Money and credit (annual percent change)					
Broad money	19.1	19.9	19.5	15.9	13.6
Domestic credit	13.9	16.4	17.4	20.2	17.8
Private sector credit	18.3	19.4	23.2	19.0	16.7
Velocity	1.3	1.1	1.0	1.0	1.0
Saving and Investment (in percent of nominal GDP)					
Gross investment	41.2	38.8	34.0	42.7	42.6
Gross fixed investment	23.5	27.7	25.0	31.4	31.4
Private	20.1	23.6	19.5	25.5	25.4
Central government	3.4	4.2	5.5	6.0	6.0
Change in stock	17.7	11.0	8.9	11.2	11.2
Gross national saving	45.7	43.8	40.3	42.4	41.2
Private	40.5	38.5	33.3	37.2	36.1
Central government	5.2	5.2	7.0	5.1	5.1
Balance of Payments					
Current account (in millions of U.S. dollars)	908	1,067	1,339	-73	-338
In percent of GDP	4.5	5.0	6.3	-0.3	-1.3
Trade balance (in millions of U.S. dollars)	-6,082	-6,670	-6,389	-8,079	-8,856
In percent of GDP	-30.4	-31.3	-30.2	-34.7	-34.7
Exports value growth (y/y percent change)	5.4	-4.0	-28.8	18.8	3.9
Imports value growth (y/y percent change)	14.3	7.7	-7.4	25.7	9.1
Workers' remittances (in millions of U.S. dollars)	5,543	6,192	6,253	6,467	6,787
In percent of GDP	27.7	29.1	29.6	27.7	26.6
Gross official reserves (in millions of U.S. dollars)	6,172	7,162	8,574	8,690	8,494
In months of prospective GNFS imports	8.3	10.4	10.1	9.4	8.6
Memorandum items					
Public debt (in percent of GDP)	28.3	25.2	27.3	25.7	23.2
GDP at market prices (in billions of Nepalese rupees)	1,965	2,120	2,249	2,532	2,848
GDP at market prices (in billions of U.S. dollars)	20.0	21.3	21.2	23.3	25.5
Exchange rate (NRs/US$; period average)	98.3	99.5	106.3	…	…
Real effective exchange rate (average, y/y percent change)	-2.8	7.7	5.9	…	…

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

1/ Fiscal year ends in mid-July.