LAPSE OF TIME

SM/20/53
Supplement 3

March 16, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Nepal—Staff Report for the 2020 Article IV Consultation—Draft Press Release**

Board Action:	Executive Directors' **consideration** on a lapse of time basis
Deadline to Request Board meeting:	**Tuesday, March 17, 2020 5:30 p.m.**
Publication:	Yes*
Questions:	Ms. Jaramillo Mayor, APD (ext. 39946)

***Unless an objection from the authorities is received prior to the conclusion of the Board's consideration, the press release will be published.**

IMF Executive Board Concludes 2020 Article IV Consultation with Nepal

FOR IMMEDIATE RELEASE

- Recent strong growth in Nepal has been supported by greater political stability, improved electricity supply, and reconstruction activity following the devastating earthquakes in 2015.
- GDP growth is expected to moderate amid slower growth in India, sluggish remittances, and weaker agricultural production. In this context, there has been a welcome narrowing of the current account deficit, stabilization of gross official reserves, and slower credit growth.
- Additional policies are needed to continue to support inclusive growth, while safeguarding macroeconomic and financial stability. Fiscal policy should remain prudent, and the transition to fiscal federalism carefully managed. Macroprudential measures should remain in place to limit the buildup of financial sector risk. Recent reforms to boost foreign investment need a supportive implementation environment.

Washington, DC – [May 17, 2020]

On March 17, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Nepal and considered and endorsed the staff appraisal without a meeting.[2]

Recent strong growth in Nepal has been supported by greater political stability, an electricity supply that is more reliable and with broader access, and reconstruction activity following the devastating earthquakes in 2015. Nepal has seen significant poverty reduction, though vulnerabilities remain, exacerbated by climate related shocks.

Growth performed well in FY2018/19. Growth increased to 7.1 percent, reflecting a rebound in agriculture, earthquake reconstruction, and buoyant tourism. Higher food prices prompted a rise in headline inflation to 6.5 percent in December 2019. The current account deficit was 7.7 percent of GDP in FY2018/19, with remittances helping to finance the large trade deficit. The central government deficit narrowed to 4.6 percent of GDP, due to improvements in revenue collection and underspending with respect to the budget. Provinces and local governments also saw spending under-execution.

There are signs of moderation in economic activity in FY2019/20. Remittance inflows have recently decelerated because of a slowdown in major remittance-sending economies,

---

[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.

700 19th Street NW
Washington, DC 20431
USA

including India. Agricultural sector performance has been weaker this year. During the first months of FY2019/20, the current account deficit narrowed considerably, due to lower imports of fuel and construction material, reflecting both slowing reconstruction activities and greater domestic electricity and cement production. Gross official reserves were at US$8.7 billion in December 2019, remaining adequate at 6.9 months of prospective imports. Credit growth tapered to 14.8 percent (y/y) in December 2019 compared to 25.4 percent (y/y) a year earlier, reflecting regulatory tightening and slowing deposit growth due to sluggish remittances.

Executive Board Assessment

In concluding the 2020 Article IV Consultation with Nepal, Executive Directors endorsed staff's appraisal as follows:

Growth is expected to moderate, helping to contain macroeconomic stability risks. Nepal's recent strong growth performance has been supported by a stable political environment, a more reliable electricity supply, and post-earthquake reconstruction spending. For FY2019/20, growth is expected to ease to 6 percent including because of slower growth in India, sluggish remittance inflows, and weaker agricultural production. Inflation is expected at 6 percent due to high food inflation. In the context of moderating growth, there has been a welcome narrowing of the current account deficit and stabilization of gross official reserves. Credit growth has moderated from very high levels, though credit as a share of GDP remains elevated relative to peers. Nonetheless, downside risks remain, including renewed balance of payments pressures and increase in financial-sector risks if credit growth were to increase sharply or remittances slowdown abruptly. Nepal's external position in FY2018/19 is assessed as weaker than the level consistent with fundamentals and desirable policy settings.

Efforts to prevent excessive credit growth and contain financial-sector risks should continue. The NRB has appropriately implemented macroprudential measures to limit the buildup of systemic risk in the financial sector. It has also taken actions to further strengthen bank supervision and regulation, including the introduction of a supervisory information system and implementation of selected elements of the Basel III capital framework. The recent regulatory requirement for banks to cross-check corporate borrowers' financial information against the ITS is expected to facilitate more prudent risk assessment by banks. Activation of the countercyclical capital buffer that will require banks to increase their level of capital by July 2020 is appropriate. The NRB should continue to closely monitor asset quality of banks and improve monitoring of concentration risk.

Fiscal policy should be geared towards containing external pressures and protecting fiscal sustainability. In this regard, a fiscal deficit of 4.5 percent of GDP, similar to the outcome in FY2018/19, would be prudent. Recent upgrades to tax administration are commendable. Staff underscores that a top-down budget process and MTFF based on conservative revenue and expenditure assumptions would instill greater prioritization and would avoid creating unrealistic revenue expectations among SNGs. While important steps have been taken to improve public financial management, further efforts are needed to ensure that spending is of high quality and executed in a timely manner.

The transition to fiscal federalism is a monumental challenge and needs to be carefully managed. To protect fiscal sustainability, the overall expenditure envelope of SNGs needs to be aligned with available funding, with tight limits on any subnational borrowing. A robust reporting and monitoring system for SNGs is urgently needed. There also needs to be a clear delineation of roles and responsibilities across levels of government to ensure adequate delivery of services and investments.

Strengthening the implementation of monetary policy requires a well-functioning interest rate framework that reduces volatility in short-term interest rates. Less short-term interest rate volatility would support financial market development and improve policy signaling and transmission. Staff emphasizes the need to introduce a standing deposit facility as a first step towards establishing a reliable implementation track record for the interest rate corridor.

Achieving the central bank's mandated price and financial stability objectives calls for modernizing the NRB governance framework to improve its autonomy and accountability, Reforms are needed to strengthen independent oversight, safeguard institutional and personal autonomy, and enhance internal controls and quality of external audit, all underpinned by supportive human resource management.

To boost growth prospects, structural reforms that encourage high-quality investment projects, in particular FDI, are critical. As post-earthquake reconstruction spending draws to a close in coming years, maintaining the recent growth momentum will require an enabling implementation environment for infrastructure projects and FDI. To ensure that high-quality projects move forward in a clear and timely manner, staff encourages authorities to focus on adequate staffing, better skills matching, and aligning incentives across and within government ministries responsible for project approvals, implementation, and subsequent monitoring.

Table 1. Nepal: Selected Economic Indicators, 2016/17-2024/25 1/

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
			Est.	Projections					
Output and prices (annual percent change)									
Real GDP	8.2	6.7	7.1	6.0	5.7	5.5	5.4	5.3	5.3
Headline CPI (period average)	4.5	4.1	4.6	6.0	5.9	5.8	5.6	5.3	5.3
Headline CPI (end of period)	2.7	4.6	6.0	5.9	5.8	5.7	5.5	5.3	5.3
Fiscal Indicators: Central Government (in percent of GDP)									
Total revenue and grants	24.1	25.3	26.0	25.8	26.0	25.8	25.5	25.6	25.5
of which: Tax revenue	20.7	21.1	21.9	21.9	21.8	21.6	21.4	21.3	21.4
Expenditure	27.2	31.9	30.6	30.4	30.4	30.0	29.7	29.4	29.3
Expenses	19.4	23.0	23.6	23.1	23.1	22.9	22.7	22.7	22.8
Net acquisition of nonfinancial assets	7.8	8.9	7.0	7.3	7.3	7.1	7.0	6.7	6.5
Operating balance	4.7	2.3	2.4	2.8	2.9	2.9	2.9	2.8	2.8
Net lending/borrowing	-3.1	-6.7	-4.6	-4.5	-4.4	-4.2	-4.1	-3.9	-3.7
Statistical discrepancy	-1.3	-3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net financial transactions	1.8	3.6	4.6	4.5	4.4	4.2	4.1	3.9	3.7
Net acquisition of financial assets	1.4	-0.7	1.7	1.6	0.9	0.9	0.9	0.9	0.9
Net incurrence of liabilities	3.2	2.9	6.3	6.1	5.3	5.0	5.0	4.8	4.6
Foreign	1.3	2.4	2.1	2.4	1.9	1.6	1.6	1.5	1.3
Domestic	1.9	0.4	4.2	3.7	3.4	3.4	3.4	3.3	3.3
Money and credit (annual percent change)									
Broad money	15.5	19.4	15.8	13.2	11.9	11.6	11.1	10.9	10.7
Domestic credit	20.2	26.1	21.7	17.6	15.7	14.3	13.8	13.3	13.1
Private sector credit	18.0	22.3	19.1	15.0	13.8	12.5	12.2	12.0	12.0
Saving and Investment (in percent of nominal GDP)									
Gross investment	45.2	55.2	62.3	54.6	53.4	52.4	51.5	50.6	49.8
Private	23.6	25.8	30.0	25.1	24.4	24.0	23.5	23.3	23.0
Central government	7.8	8.9	7.0	7.3	7.3	7.1	7.0	6.7	6.5
Change in Stock	13.8	20.5	25.3	22.2	21.7	21.3	21.0	20.6	20.2
Gross national saving	44.8	47.1	54.6	49.4	48.5	47.6	46.8	46.0	45.3
Private	41.3	46.1	53.3	47.8	47.0	46.1	45.3	44.6	44.0
Central government	3.5	1.0	1.2	1.6	1.5	1.5	1.4	1.4	1.4
Balance of Payments									
Current account (in millions of U.S. dollars)	-93	-2,350	-2,369	-1,760	-1,832	-1,963	-2,104	-2,215	-2,323
In percent of GDP	-0.4	-8.1	-7.7	-5.2	-4.9	-4.8	-4.7	-4.6	-4.4
Trade balance (in millions of U.S. dollars)	-8,446	-10,849	-11,373	-11,658	-12,379	-13,140	-13,956	-14,770	-15,643
In percent of GDP	-33.5	-37.4	-37.1	-34.2	-33.1	-32.2	-31.4	-30.5	-29.6
Exports of goods (y/y percent change)	9.9	15.5	12.1	1.4	9.9	9.9	9.9	9.9	9.9
Imports of goods (y/y percent change)	30.0	27.4	5.4	2.4	6.5	6.5	6.5	6.2	6.3
Workers' remittances (in millions of U.S. dollars)	6,556	7,224	7,769	8,402	8,825	9,270	9,737	10,227	10,742
In percent of GDP	26.0	24.9	25.3	24.7	23.6	22.7	21.9	21.1	20.3
Gross official reserves (in millions of U.S. dollars)	9,264	9,304	8,545	8,536	8,419	8,233	8,045	7,850	7,673
In months of prospective imports	8.3	7.9	7.0	6.6	6.1	5.5	5.1	4.7	4.3
Memorandum items									
Public debt (in percent of GDP)	26.1	30.2	30.1	33.7	35.7	37.4	39.0	40.3	41.1
Nominal GDP (in billions of U.S. dollars)	25.2	29.0	30.7	34.1	37.4	40.8	44.5	48.4	52.9
Nominal GDP (in billions of Nepalese Rupees)	2,674	3,031	3,464	3,892	4,354	4,860	5,406	5,997	6,687
Private Sector Credit (in percent of GDP)	74.7	80.6	84.0	86.0	87.5	88.2	88.9	89.8	90.2
Exchange rate (NPR/US$; period average)	106.2	104.4	112.9	…	…	…	…	…	…
Real effective exchange rate (average, y/y percent change)	3.6	0.2	-1.4	…	…	…	…	…	…

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