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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/10-2

10:50 a.m., February 8, 2019

2. Nepal—2018 Article IV Consultation

Documents: SM/19/20 and Correction 1; and Supplement 1; and Supplement 2; and Supplement 2, Correction 1; SM/19/24; and Correction 1,

Staff: Almekinders, APD; Gonzalez Miranda, SPR

Length: 50 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	**Alternate Executive Directors**
	J. Garang (AE), Temporary
	R. Lopes Varela (AF), Temporary
	R. Morales (AG), Temporary
	J. Shin (AP), Temporary
	K. Hennings (BR), Temporary
	P. Sun (CC)
	M. Mulas (CE), Temporary
	A. McKiernan (CO)
R. Kaya (EC)	
	A. Castets (FF)
	K. Merk (GR)
	P. Dhillon (IN), Temporary
	P. Di Lorenzo (IT), Temporary
	Y. Saito (JA)
	M. Daïri (MD)
	M. Choueiri (MI), Temporary
	V. Rashkovan (NE)
	J. Sigurgeirsson (NO)
	Z. Smirnova (RU), Temporary
	W. Al Hafedh (SA), Temporary
J. Agung (ST)	
	A. Tola (SZ), Temporary
	D. Ronicle (UK)
	A. Grohovsky (US), Temporary

S. Bhatia, Acting Secretary
S. Maxwell, Summing Up Officer
J. Acheson, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: G. Almekinders, K. Kang, K. Min, C. Rhee, R. Salgado, N. Singh, P. Sodsriwiboon. Communications Department: P. Sherpa. Legal Department: J. Purcell, N. Rendak. Strategy, Policy, and Review Department: M. Gonzalez Miranda. World Bank Group: E. Blanco Armas. Alternate Executive Director: K.Tan (ST). Senior Advisors to Executive Directors: A. Muslimin (ST), H. Etkes (NE), S. Evjen (NO),

G. Vasishtha (CO). Advisors to Executive Directors: S. Buetzer (GR), U. Latu (ST), P. Mooney (CO), K. Osei-Yeboah (MD), R. Pandit (ST), A. Srisongkram (ST), K. Lok (CC).

2. NEPAL—2018 ARTICLE IV CONSULTATION

Mr. Agung and Ms. Pandit submitted the following statement:

On behalf of the Nepalese authorities, we would like to express our appreciation to the International Monetary Fund mission team for the constructive discussion and policy dialogue during the 2018 Article IV consultation. The authorities acknowledge the staff's constructive report and broadly concur with the policy recommendations.

Recent Economic Developments and Outlook

Nepal has recently transitioned into the federal government system with successful completion of 3 tiers of election and established federal, state and local level governments. With a strong political mandate, the present government has been creating conducive environment, advancing its reform agenda and boosting investment activities to foster high, sustainable and inclusive growth, while at the same time maintaining socio-economic stability.

Following an extended period of repressed growth, economic activity has now rebounded. Real GDP growth stood at 6.3 percent in fiscal year 2017/18 and is projected to remain at around 8 percent in current fiscal year 2018/19. Our authorities are more optimistic regarding the near and medium-term growth outlook targeting to reach double digit growth, underpinned by acceleration in reconstruction activities, substantial structural changes, initiatives to improve the investment climate, and accommodative fiscal and monetary policy. They underscored that stronger growth is critical to alleviate poverty and achieve the sustainable development goals (SDGs) and graduate to the middle-income country status by 2030.

Inflation has remained subdued in the last two years. Average annual inflation moderated to 4.2 percent in fiscal year 2017/18, down from 4.5 percent a year earlier. The average overall inflation rate stood at 4.1 percent as of mid-December 2018 with food and non-food inflation remaining at 0.5 percent and 6.3 percent respectively. Subdued inflation is largely due to low inflation in India, ease in the supply of goods and rise in agriculture output.

On external sector front, the overall BOP recorded a deficit of 1.1 million dollars at the end of fiscal year 2017/18 and widened to 750 million dollars in mid-December of 2018. The widening deficit was mainly driven by imports of construction materials and capital goods for post-earthquake reconstruction activities and is expected to decline when reconstruction is completed. The authorities have undertaken measures to curtail non-priority imports to ease the pressure in the external sector. The authorities highlighted that the level of foreign exchange reserves remains comfortable and is adequate to cover imports of merchandise goods and services for 7.8 months. In addition, remittance inflows are expected to remain strong due mainly to government efforts to control informal trade and financial transactions as well as other effective measures including improved customs management.

Fiscal Policy and Management

The authorities welcome the joint World Bank/IMF Debt Sustainability Analysis, which assesses that the risk of debt distress in Nepal remains low. This is supported by prudent fiscal policies and debt management over the years. The authorities are very much aware of the growing fiscal deficit, but stress that the transition to fiscal federalism and the pickup of reconstruction activities necessitated an increase in government spending. Our authorities expect that the fiscal deficits will normalize and will not be expanded excessively once resources and responsibilities to local and state government are fixed.

The authorities highlight that the fiscal federalism is working smoothly even within the first 6 month of the first federal budget in Nepal. There is a rule-based and transparent fiscal transfer and revenue sharing mechanism in place. The authorities emphasize that the setting up of the local consolidated funds would help monitor financial transactions of sub-national governments. Medium-term expenditure framework which would provide for a more transparent and comprehensive fiscal policy framework will be set up at all levels of governments.

Government revenue collection remains encouraging as the growth of revenue exceeded 26 percent in the first six months of this fiscal year compared to an average growth of 20 percent in the last decade. Our authorities highlight the important efforts that have been made to reform revenue administration. These include measures to increase revenue collection such as improvement of the tax system, a strategic plan for inland revenue management, reforms to customs valuation and customs control through customs risk management, adoption of e-payment system, set up of a revenue board, and further strengthening of revenue administration, zero tolerance in revenue leakage activities, among others.

A Public Expenditure Review Commission has been established to review public financial management. Currently, the Commission is reviewing the ongoing development projects and their evaluation, investment procedure, program budgeting framework and integrated social security system as well as the fiscal rule.

Monetary, Exchange Rate and Financial Sector

The authorities are of the view that the current monetary policy stance is appropriate, with the objective of maintaining price and external sector stability while facilitating high and sustainable economic growth. The real interest rate on deposits is positive as the average deposit rate has consistently remained above 6 percent while inflation has been averaging about 4 percent in recent times. The authorities concur with staff's assessment that the peg to the Indian rupee continues to serve as a transparent nominal anchor.

As staff raised concerns about recent credit growth and its possible impact for stability, the authorities underscore that they continue to ensure that credit growth will remain conducive for supporting growth while at the same time it is not excessive and is sound. The authorities also continue to closely monitor the expansion of credit at the sectoral level, to ensure it is predominantly concentrated in productive and priority sectors.

The financial sector remains sound and transparent, with adequate capital and low non-performing loans (1.6 percent in mid-July 2018). Various macro prudential measures such as CCD ratio, limits on real estate exposures, CRR as well as Loan to Value (LTV) ratio on car loan have been put in place to maintain financial soundness. Risk based supervision practices have been revised into risk profile of full scope and targeted supervision modality to examine the different risk categories to make the financial sector safer.

The authorities largely agree with staff for the necessary reform to financial sector oversight and stress that the implementation of recommendations from the 2017 Article IV consultation, the 2014 FSAP reform efforts along with safeguarding recommendations from the 2016 assessment will continue.

On the financial inclusion front, Nepal Rastra Bank (NRB) has launched the Financial Inclusion Action Plan and introduced various directives and guidelines to the micro finance institutions working in the rural areas. Substantial progress has been made by the bank in financial inclusion complimented by mobile banking, internet banking. Provision has been made to reach at least one commercial bank branch in each local administrative unit, currently 703 bank's branches have been established out of 753 local levels as of mid-January 2018. Our authorities acknowledge the staff's suggestion on directed credit provision; however, they confirm that the provision of directed credit and priority sector lending is quite small in size and serves to avail bank credit to the ultra-poor segment of the society, inaccessible people and critically important areas.

Structural Reform and Sustainable Growth

Transformation of the agricultural sector from manual to technological and equipment based, hydro power generation, boosting tourism sector, performance of SMEs and revive of construction sector are key areas of priority to promote high and sustainable economic growth. Under the political stability, our authorities are now concentrating on creating more employment opportunities, accelerating economic reforms, and promoting inclusive growth while enhancing the business environment for investment.

Our authorities note staffs' concern on corruption and lack of governance which can be one of the most problematic factors for doing business, after having infrastructure development and political stability. They are committed to zero tolerance on corruption. For the governance issues, a code of conduct for staff and close monitoring system has been established. The authorities also want to highlight that the government has emphasized the transparency, accountability and rule-based decision making procedure. The authorities are also working on revising the public procurement law to make it more transparent and competitive through the better use of IT on public procurement process.

International Investment Summit in March 2019 and Celebrating Visit Nepal Year 2020

Our authorities highlight that the effort of continuous improvement in investment climate in Nepal has been initiated through revisions of investment related laws and regulations, procedural simplification of FDI and reform in governance. They have already amended the labor law to make it business friendly. They are now targeting to complete the amendment of more than three dozen of investment-related laws including Foreign Investment Technology and Transfer Act (FITTA), Public Private Partnership (PPP) Act, Procurement Act and Investment Board of Nepal Act by next month. With this development, our authorities plan to hold an International Investment Summit in March 2019. This will be an excellent avenue for them to share the long awaited political stability that Nepal has gained for encouraging business environment and explore investment prospects in Nepal. Likewise, the government has announced the year 2020 as the Visit Nepal Year with targeting two million tourists.

AML/CFT

Our authorities put a top priority to implement the AML/CFT measures by internalizing it as a part of good governance and bringing them in line with international standards. With the successful implementation of the first AML/CFT National Strategy and Action Plan, the authorities have completed the AML/CFT self-assessment and are in the process of finalizing the second AML/CFT National Strategy and Action Plan for 2019 to 2024.

Capacity Development

Our authorities express their appreciation to the Fund for the continued support to enhance their technical capacity in various areas including fiscal, monetary, legal and financial statistics. However, technical capacity enhancement remains critical during the changed environment. The authorities urge technical support for strengthening fiscal and financial information system at the sub-national level. They also highlight the need for enhancing technical capacity to revisit and rebase the national GDP and disaggregate it up to sub national level.

Final Remarks

Finally, our authorities would like to thank the Fund for the successful conclusion of the Article IV consultation in Nepal. The authorities express their gratitude to the Fund for the continued support in terms of policy advice and technical assistance as well as to the donor community for their continued assistance and support to Nepal. The authorities look forward to continuing discussions with the Fund on macroeconomic and financial sector policies including structural reforms.

Ms. Pollard and Mr. Grohovsky submitted the following statement:

Nepal’s economy has recovered, but now appears to be growing faster than its potential due to expansionary fiscal and credit policies. While the outlook remains strong, fiscal and external positions have deteriorated and financial sector vulnerabilities have increased to a concerning degree. We agree with staff’s analysis and concur with the major recommendations, including front-loading fiscal consolidation to contain domestic demand, improving spending composition over the medium term, tightening monetary policy to correct imbalances and support the exchange rate peg, strengthening oversight of the financial sector, and improving the investment climate through well-designed amendments to existing laws to fight corruption and increase foreign direct investment. We urge the authorities to take heed of staff's advice in order to avoid worsening imbalances and further deterioration of fiscal and external buffers. Additionally, we would like to emphasize the following:

Debt Transparency: We note that the authorities have revived the hydroelectric power plant project with Gezhouba Group Corporation that was judged infeasible under the previous government. Given the potential for this deal to create fiscal distress if it is not properly undertaken, we encourage the authorities to be fully transparent about the terms and conditions of this deal and its potential effect on public debt sustainability under different scenarios including, among other things, underperformance of the asset, increased interest rates, construction delays, and poor offtake outcomes.

Excessive Credit Growth: We note that the authorities were less concerned than staff about rapid credit growth. The sharp credit expansion, combined with its connection to real estate and weak oversight and risk management, poses a substantial downside risk to the economy. We strongly endorse staff's recommendation to tighten the existing macroprudential measures and strengthen capital buffers and risk management.

Financial Sector Surveillance: In line with the above point, we thought that staff's analysis of financial sector stability, the macro-financial linkages, the Selected Issues chapter on sustainable finance, and the connection to the previous FSAP and Article IV were well-done and are a good example of the integration of financial surveillance into broader bilateral surveillance.

CFMs: We look forward to a timely update from staff on the recent foreign exchange measures and how they fit into the Institutional View, the macroprudential policy framework, and Article VIII, noting that there is also an existing Article VIII restriction on the limit on the conversion and transfer to foreign currency of salaries of some non-residents. Given that one of the measures is simply a change to an existing facility, could staff offer up their initial views?

Mr. Psalidopoulos, Mr. Rashkovan, Mr. Etkes, and Mr. Persico submitted the following joint statement:

We thank staff for their comprehensive report and valuable SIPs as well as Mr. Agung and Ms. Pandit for an instructive buff statement. The last staff report on Nepal was circulated in March 2017, and was approved on lapse of time. The last Board discussion dates back from November 2015. We hope that future reports will be discussed within the normal yearly cycle.

Nepal's economy is recovering from the 2015 earthquake with high growth based on an accommodative fiscal policy -inter alia to support the reconstruction- and loose credit policy. While the current policies are expected to support growth in the short run, the resulted growing fiscal and current account deficits are expected to increase and undermine future stability and growth. We therefore concur with staff's main advice to tighten the fiscal and financial policies to avoid a looming abrupt slowdown.

Fiscal Policy

Nepal's fiscal deficit increased following the necessary expenditures for investment and reconstruction after the earthquake, as well as the transition to a fiscal federal system. While Nepal's commendable low levels of debt and the ensuing low risk of debt distress allow for some fiscal accommodative policy, we agree with staff that a fiscal consolidation is needed. Specifically, there is a need to strengthen the regional government and the tax revenue administration. We are somewhat surprised to observe that income and profit taxes declined in 2017/18 (Figure 2) despite the robust growth during that year.

Monetary Policy

The Nepalese Rupee is pegged to the Indian Rupee and serves as a nominal anchor. Nevertheless, we agree with staff that the optimal monetary policies in these economies are different and note the weakening co-movement of the core inflation in India and Nepal, particularly since 2015 (SIP p. 4). We presume that, in the long run, Nepal could benefit from a flexible exchange rate regime. Such a monetary regime requires an adequate institutional set up including an independent and full-fledged central bank. Meanwhile, the Nepalese authorities could consider simpler changes such as a peg to a currency basket that reflects Nepal's current composition of external trade and remittances. Can staff assess the share of transactions denominated in Indian Rupees, USD and other currencies in Nepal's external transactions including remittances? Would a peg to a basket of currencies serve the Nepalese economy better?

External Position

Staff's analysis indicates that Nepal's external position was moderately weaker than medium term fundamentals. We take confidence from the virtually identical estimates of the REER gap in the two EBA methods (p. 33). Nepal's external position crucially depends on labor remittances, which are 9 time larger than the country's exports and equivalent to more than a quarter of its GDP. In the case of Nepal and in similar cases, we believe that the GNI could be a more useful statistic for analysis of growth and debt than GDP, which excludes labor remittances. At any rate, we note that labor remittances increased in 2017/18 after three years of stagnation in nominal value (World Bank data), and that both the authorities and staff expect a strong growth of labor remittances growth in the near future. This expectation is at odds with a plausible adverse impact of the recent decline in oil prices on important host countries of Nepalese migrant workers. We would appreciate if staff could explain the assumptions supporting these optimistic projections for this crucial source of external reserves, and hope that future reports will elaborate more on this important issue for the Nepalese economy.

Mr. Saito and Mr. Naruse submitted the following statement:

We thank staff for the comprehensive reports and Mr. Agung and Ms. Pandit for their informative statement. It is encouraging that economic activity in Nepal has picked up, amid greater political stability and enhanced supply of electricity. We welcome the staff's estimate that growth is expected to continue, supported by ongoing reconstruction, investment in hydro-power projects, and strong tourism-related activity. On the other hand, the country faces important challenges, such as the implementation of fiscal federalism, rapid credit growth, and low FDI. In this context, we encourage the authorities to continue prudent policies to maintain macroeconomic and financial stability as well as implement actions to make Nepal's economy more competitive and attractive to investment. As we broadly agree with the staff's appraisal, we would like to make a few comments as follows:

Fiscal Policy

It is welcoming that progress has been made in the transition to fiscal federalism. We are encouraged by the staff's assessment that the risk of debt distress in Nepal remains low. Also, we welcome the authorities' efforts to reform revenue administration, such as the adoption of the e-payment system and zero tolerance in revenue leakage activities. However, we are concerned about the uneven spending capacity of local and provincial governments. We therefore agree with the staff's appraisal that efforts should focus on building policy implementation capacity and instituting a sound public financial management framework at the subnational level. In addition, we welcome the authorities' intention that medium-term expenditure frameworks would be set up at all levels of governments. We agree with the authorities' view that this would provide for a more transparent and comprehensive fiscal policy framework.

Monetary Policy

We note the staff's assessment that the peg to the Indian rupee continues to serve as a transparent nominal anchor. At the same time, the staff's report shows that a large difference in interest rates between India and Nepal put pressure on the pegged regime. Also, we take note of the staff's analysis in the Selected Issues that although food-inflation co-movement between India and Nepal is relatively strong, non-food inflation in Nepal is largely determined by domestic factors, suggesting monetary policy can play a role in guiding domestic inflation rates. This finding and policy advice seem to be contradictory to the staff's appraisal that the peg regime should be maintained. We would like to hear from staff on the merit and demerit for Nepal to maintain the exchange rate peg to the Indian rupee. What is the motivation for sustaining the peg to Indian rupee, while core inflation co-movement between India and Nepal is limited?

We would like to emphasize the importance of ensuring the central bank's operational autonomy. In this light, we note with concern that the 2016 amendment to the NRB Act allows the government to issue directives regarding currency, banking and finance, which weakens the NRB's autonomy. Could staff elaborate more on the motivations behind this government's directive? Also, while interest rates remain low in Nepal, do staff think that pressure exists from the government to maintain low interest rates?

Financial Sector Policy

We encourage the authorities to continue closely monitoring rapid credit growth. We note with concern that sustained private sector credit growth has pushed the credit-to-GDP ratio above trend. We agree with the staff's view that the rapid credit growth might build up credit and liquidity risks in the banking system. In this light, we welcome the authorities' efforts to strengthen financial sector oversight, such as implementing the risk-based supervision and putting various macroprudential measures in place. Last but not least, on the central bank's lender of last resort policy, we take note of the staff's recommendation that this needs to be further clarified and aligned with standard central bank practices. Could staff elaborate more on what challenges the current policy has and what actions the authorities should take?

Structural Policy

We commend the authorities' efforts to improve the investment climate. We welcome the Prime Minister's zero-tolerance policy on corruption. We also welcome the authorities' commitment to overhaul the existing investment-related laws. We encourage the authorities to continue their efforts to revise the public procurement law. We expect that such an overhaul and revisions would improve the investment projects' choice and quality. Also, we encourage the authorities' continued efforts to promote foreign direct investment, including through easing the complexity of the current approval system. Lastly, we wish the authorities' success in the International Investment Summit in March 2019 and the Visit Nepal Year 2020.

Mr. Sigurgeirsson and Mr. Evjen submitted the following statement:

We thank staff for the report and Mr. Agung. and Ms. Pandit for their informative BUFF statement. We broadly share staff's appraisal. Nepal's economic outlook has improved amid greater political stability and a more reliable electricity supply. Going forward, fiscal and monetary policies should be orientated towards containing spending pressures and limiting the buildup of financial imbalances. Enhancing efficiency of public spending will also be key. We would like to offer the following points on fiscal policy, monetary policy, financial stability, and policies to promote inclusive growth for emphasis.

We agree with staff's assessment that fiscal policy should make a larger contribution toward containing domestic demand pressures. Withdrawing policy stimulus will limit domestic demand pressures, contain current account deficits and dampen the risk of rising financial imbalances, thus lowering the possibilities of an abrupt slowdown later. In addition, we strongly support the efforts to strengthen public financial management at all levels of government to mitigate risks to fiscal sustainability and improve allocative efficiency gains.

We note however that the authorities are more optimistic than staff on the near-term outlook and more complacent regarding the need for tighter policies. For example, authorities think that potential growth has risen more than estimated by staff, thus indicating that the need for tighter macroeconomic policies may be exaggerated. This underlines the importance of analysis on potential growth, as this seems to be an important precondition for the Fund's advice on fiscal and monetary policy.

We agree that monetary policy should be less accommodative in the near term to support the exchange rate peg, rein in imbalances and safeguard credibility. The NRB should bring interbank rates back into the corridor which will improve the transmission mechanism of monetary policy. In addition to hampering financial market developments, volatile interbank rates outside the corridor may undermine monetary policy credibility. We concur with staff's proposals to develop a framework for reviewing the appropriateness of the policy stance and prioritize ensuring the central bank's operational autonomy through amendments of the central bank act. We believe these measures will help strengthen transparency, accountability, and credibility of Nepal's monetary policy.

A tightening of monetary policy will also contain inflation pressures, curb credit growth and contain the buildup of financial imbalances and risks to the financial sector. Macroprudential policies and banking oversight should however play the major roles in containing financial vulnerabilities. While we welcome the steps taken by authorities to address weaknesses in the financial sector since the 2014 FSAP, the warning signs related to the current developments in the financial sector are clear as described in chapter 3 of the selected issues paper and need to be addressed.

The positive near-term outlook provides a window of opportunity for focusing on a swift implementation of structural reforms which can increase potential growth and lift more people out of poverty. We note that financial inclusion has improved over the past several years, but there are still large gaps between Nepal and other countries and within groups inside the country. We encourage the authorities to continue and strengthen their efforts in enhancing financial inclusion targeting the underserved. We believe this initiative could help facilitate inclusive growth.

We commend the authorities' efforts to reduce corruption and to prioritize implementing AML/CFT-measures. Staff indicates that the Nepalese authorities are treating corruption as a serious issue and we welcome the prime minister's zero-tolerance policy statements. However, indicators suggest that corruption is still a significant problem and remains an impediment to investment and growth. We take note from the BUFF statement that authorities are working on revising the public procurement law to make it more transparent and competitive, and that implementing AML/CFT measures by bringing them in line with international standards is a top priority.

Mr. Sun and Ms. Lok submitted the following statement:

We thank staff for the useful set of reports and Mr. Agung and Ms. Pandit for their insightful buff statement. Factors including a more stable political environment and increased reliability of electricity supply have supported a rebound in economic activity in Nepal following extended tepid growth, and the near-term outlook is favorable. That said, careful macroeconomic policy management is necessary to tackle the various challenges faced by the economy and ensure growth is sustainable in the longer term. We broadly agree with the thrust of staff's appraisal and limit ourselves to the following comments.

Robust public financial management is critical for the smooth functioning of the new federal system while maintaining sufficient support for the economy. As a result of the sizeable transfers to subnational governments and reconstruction spending, Nepal's fiscal deficit has widened sharply and is expected to increase further. To better preserve fiscal sustainability, we encourage the authorities to continue to exercise fiscal prudence and see some merit in staff's suggestion to reduce recurrent spending in the central government budget, particularly as more spending responsibilities are being reassigned to subnational governments. Meanwhile, we take positive note of the efforts by the authorities to mobilize domestic revenue and the establishment of a Public Expenditure Review Commission which could help strengthen public financial management.

We welcome the actions taken by the authorities to enhance financial sector regulation and supervision, including the introduction of macroprudential measures and moving towards risk-based banking supervision. Nevertheless, staff have highlighted a number of risks and vulnerabilities in the financial system, notably rapid credit growth, that warrant greater attention. While noting that strong credit expansion is needed to support growth and alleviate poverty, it is important that the expansion is underpinned by robust underwriting standards and strong risk-management. We encourage the authorities to continue to strengthen financial sector oversight and enhance data quality to facilitate better monitoring, drawing from relevant Fund recommendations and seeking technical assistance where appropriate.

Finally, the current favorable economic environment provides an opportunity for the authorities to undertake further structural informs to achieve long-term inclusive growth. We welcome the authorities' commitment to tackling corruption and improving governance and look forward to further progress in this regard. Steps to further improve the business and investment environment are also encouraged. While staff noted that the new labor law is well-intended, they also noted that it may disproportionately impact smaller businesses. In staff's view, what possible measures can the authorities adopt to mitigate possible unintended adverse impacts and avoid a shift to the informal sector?

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. de Villeroché, Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their document and for Mr. Agung and Ms. Pandit for their insightful buff Statement. Nepal ongoing transition to a federal government system is an historical transformation that could provide the impetus for a rise in the level of social and economic development. However, this reform process is not without risks and the authorities should remain committed to prudent macroeconomic policies while pursuing their efforts to promote private sector led growth. While we broadly agree with staff's analysis and recommendations, we would like to highlight the following point for emphasis:

We agree with staff that Nepal fiscal space should be used to finance quality and sustainable public investment as well as public spending targeted to reach the sustainable development goals. We agree that the short term fiscal stance should be tighten compared to current forecasts and that public expenditures management needs to remain rigorous notably to avoid unnecessary duplications that could come from the decentralization process. Enhanced public financial management at the sub-national level will be key in this regard. As highlighted by staff in one annex, we commend the authorities for their achievements in term of domestic revenue mobilization which have been supported by well-designed policies and ambitious revenue administration reforms. Is there any lesson to be drawn from this success for the benefit of other low income countries?

The implementation of the new LIC DSF framework points to some weaknesses in the data gathering system. Given the relatively poor coverage of public finance data, we encourage the authorities to improve their data collection and reporting practices, notably on the risks of contingent liabilities from public-private partnerships and external private sector debt. We would be interested to have staff feedbacks on how the new debt sustainability framework has been applied, whether it helped the dialogue with the authorities, notably regarding data coverage issues. We would also be interested to know how staff plans to support the authorities in improving data collection and reporting.

Given the elevated risks related to natural disasters occurrence, we encourage the authorities to strengthen natural disaster prevention and preparedness both through public investment and improvement of the fiscal framework. As highlighted by staff this challenge calls for an adoption of disaster-proof building codes, the building of fiscal space and reserve buffers as well as the enhancement of financial safety nets.

The monetary framework needs to be strengthened to ensure adequate liquidity levels as well as exchange rate stability. Mopping up excess liquidity, as recommended by staff, would help to tighten a monetary stance which is excessively expansionary. This tightening should be complemented by a strengthening of financial regulation and supervision to tame the current credit boom. Concerning the exchange rate regime, could staff elaborate on the adequacy of the current peg to the Indian rupee and whether a transition to a more flexible regime is desirable in the medium term.

Regarding structural reforms, we agree with staff that Nepal has the potential to improve its medium-term growth prospects by designing a legal and technical environment more conducive for investment. This means improving the public procurement process, tackling corruption and governance problems, as well as reinforcing the business climate, notably for FDI. We notably support staff effort to measure governance challenges in Nepal and we welcome the recent measures taken by the authorities to fight corruption. Given the poor performance of Nepal in terms of human capital compared to peers, and the constraint this could induce on private sector led growth, we would encourage staff to increase its analysis of this dimension in future article IV consultation.

Mr. Raghani, Mr. Sylla and Mr. Lopes Varela submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. Agung and Ms. Pandit for their informative buff statement.

We welcome the sustained economic recovery of Nepal in the wake of the 2015 earthquakes, with growth driven by reconstruction activity, investment projects, and tourism sector. The country's economic outlook remains broadly favorable as the current reconstruction efforts continue. However, the expansionary fiscal and monetary policies implemented in recent years have begun to create macroeconomic imbalances with a significant increase in fiscal and current account deficits, a decrease in reserves, and buildup of financial sector risks. In this context, we agree that going forward policy actions should address the balance-of-payments pressures, reinforce financial resilience, and promote a business environment conducive to robust sustainable and inclusive growth.

On the fiscal front, we encourage consolidation to address the growing macroeconomic imbalances. While expansionary fiscal policy has supported economic activity and led to robust growth in recent years, we concur that a more front-loaded consolidation path is warranted to reduce the fiscal deficit and help attain a strong external position. In this regard, we encourage the authorities to give due consideration to measures aimed at lowering transfers and revenue sharing with subnational governments, addressing their capacity constraints to promote fiscal discipline and efficiency, and better prioritizing projects based on net economic returns. In parallel, the efforts made by the authorities to increase tax revenue by strengthening the tax and customs administrations are commendable. Furthermore, we take note that fiscal federalism is working well in its first six months, as indicated in Mr. Agung and Ms. Pandit's buff statement, and we also welcome the efforts aimed at enhancing its implementation with the view to attaining budgetary targets. To that end, we support the recommendations to set robust PFM systems at the subnational level, adopt a fiscal responsibility and budget management bill, and put in place a medium-term budget framework.

Regarding the monetary sector, while we agree that the current policy stance has supported economic growth, the authorities should remain attentive to inflationary pressures as the economy is growing above potential. We would appreciate staff comments on the differences of views with the authorities regarding the monetary stance. We take note that the 2016 amendment to the NRB Act affects the autonomy of the Central Bank, and we encourage the authorities to address this issue in line with the 2014 FSAP recommendation.

In the financial sector, we encourage further efforts to improve its stability and resilience. While the measures to contain banking sector risks are welcome, the authorities should also strengthen macroprudential measures to curb credit growth. Measures to limit risks to the sector include the adhesion to an 80-percent limit on the credit-to-core capital cum deposit (CCD) ratio, terminating current carve-outs to the CCD as well as raising reserve requirement ratio to tighten liquidity in the banking system. We commend the progress made so far in implementing the recommendations of the 2017 Article IV consultation and the 2014 FSAP and encourage the authorities to speed up strengthening the supervisory and regulatory frameworks. We very much appreciate the Selected Issues paper on “Financial Inclusion in Nepal: Bridging the Gaps” and broadly agree with the findings. We encourage the authorities to step up their efforts to improve financial inclusion along their action plan and reduce the gaps between urban and rural areas and across genders.

On the structural front, it will be necessary to press ahead with reforms that would strengthen resilience and address the impediments to sustainable and inclusive growth. We welcome the authorities’ reform agenda aimed at enhancing competitiveness and enabling a more favorable business environment. In this regard, further strengthening of the procurement process, enhancement of the PPPs’ policy, and effective labor market policies to increase flexibility will be paramount. The ongoing legal reforms to attract more FDI and the authorities’ commitment to improve governance and tackle corruption also go in the right direction. Finally, we encourage the authorities to pursue their efforts to reinforce the country’s AML/CFT regime in line with international standards and welcome their new strategy and action plan to this effect.

With these comments, we wish the Nepalese authorities success in their future endeavors.

Mr. Di Tata and Mr. Morales submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Agung and Ms. Pandit for their informative buff statement.

Nepal’s economic activity is picking up within a context of political stability. Real GDP growth is expected to reach 6.5 percent in FY2018/19 (the second year of steady growth after a period of declining growth rates), helped by reconstruction investment, hydro-power projects, and tourism. Reliable electricity supply has contributed to productivity gains that could be sustained if complemented by consistent macroeconomic policies and decisive action in addressing emerging vulnerabilities and implementing key structural reforms. The transition to a federal government system and the establishment of three levels of government have been successful so far, as indicated by Mr. Agung and Ms. Pandit in their buff statement.

Macroeconomic policies should aim at preserving Nepal's comfortable international reserves position and low risk of debt distress. Rising non-food inflation and the recent loss of international reserves reflect emerging macroeconomic imbalances, with expansionary monetary and fiscal policies explaining a widening of the fiscal and external current account deficits. In this regard, we concur with the staff's recommendation to tighten monetary policy and contain non-priority government spending to strengthen the external current account and support the peg to the Indian rupee. Although the external imbalance remains moderate according to the EBA exercise, delays in addressing it run the risk of eroding policy space that could be needed in the event of unexpected shocks.

A fiscal consolidation effort based on further enhancing revenue mobilization and containing non-priority spending would support a smooth transition to fiscal federalism. Based on preliminary information on budget execution, staff projects a fiscal deficit of 5 percent of GDP in FY 2018/19, which would imply a partial reversal of last year's fiscal impulse. However, the revenue projections are subject to downside risks because of heavy reliance on import taxes. Thus, we concur on the need to lower government spending relative to the baseline projections.

Looking ahead, we encourage the authorities to make further efforts to strengthen revenue mobilization by broadening the tax base and modernizing tax administration. Regarding expenditure, proper planning, selection and implementation of major capital projects require decisive steps to improve PFM systems at the central government level. Could staff elaborate on the expected impact on revenues of the envisaged introduction of the unified tax code, as well as of the measures envisaged in the recently released Inland Revenue Management Second Strategic Plan?

International experience shows that fiscal decentralization may pose several institutional challenges, including slow absorption of new responsibilities by decentralized units, revenue-sharing tensions, and coordination issues. Ensuring a prudent management of fiscal resources at all levels of government would require addressing capacity issues, implementing sound PFM systems at the subnational level, and adopting the planned Fiscal Responsibility and Budget Management bill. An appropriate monitoring of financial transactions by decentralized units should aim at identifying slippages on time to introduce corrective actions. In this regard, we commend the authorities for their intention to use a medium-term expenditure framework to enhance transparency and comprehensiveness. Such framework should be sufficiently robust to ensure fiscal sustainability while contemplating adequate service delivery by local governments.

We agree with staff that the current stance of monetary policy is too accommodative and encourage the NRB to bring up interest rates within the interest rate corridor by mopping up excess liquidity. This would help reverse the recent increase in non-food inflation while containing pressures on the exchange rate. The recently-initiated review of the NBR Act provides an excellent opportunity to strengthen the operational autonomy of the central bank.

Rapid credit growth may increase financial vulnerabilities in the face of unreliable loan classification by banks and possible evergreening. Financial intermediation has doubled in the last ten years to about 80 percent of GDP, a development that, according to the selected issues paper, is only partially explained by progress in financial inclusion. In this regard, we welcome the authorities' recent efforts to strengthen financial regulation and supervision with technical assistance from the Fund and other development partners, focusing on risk-based supervision and the tightening of some macroprudential policies, including the loan -to-value ratio on car and residential real estate loans. Although the authorities intend to adhere to the credit-to-core-capital cum deposit ratio, carve-outs that have been introduced over the years conspire against the abovementioned efforts to curb excessive credit growth. On a related matter, we would appreciate if staff could provide the rationale behind the increase in the limit on commercial banks' foreign exchange borrowing from foreign banks referred to in paragraph 7 of the report.

We note the authorities' intention to encourage financial intermediation to support growth. However, appropriate safeguards should be put in place to avoid exposing the economy to high volatility and eventual shocks. Therefore, consideration should be given to introducing cyclical capital buffers, upgrading risk management guidelines, and limiting short-term and revolving loans used for evergreening. These measures could be accompanied by an upgrade of the crisis management framework, including by streamlining emergency liquidity assistance provisions.

We welcome the authorities' intention to accelerate structural reforms, as well as their commitment to zero-tolerance on corruption, which is reiterated in Mr. Agung and Ms. Pandit's buff statement. Significant improvements in the perception of corruption would go a long way towards enhancing the business environment, attracting foreign investment, and helping sustain high growth rates. This commitment should be supported by institutional reform in key areas, including procurement, governance, and financial sector oversight. The planned overhaul of a large number of investment-related laws is an important reform, which should also contribute to improving the investment climate. We also encourage the authorities to expedite measures to strengthen safeguards at the NRB and to promptly bring AML/CFT provisions in line with international standards by implementing the second AML/CFT National Strategy and Action Plan for 2019-2024.

With these comments, we wish the Nepalese authorities every success in their future endeavors.

Mr. Fachada and Ms. Hennings submitted the following statement:

We thank staff for the reports and Mr. Agung and Ms. Pandit for their insightful statement. Real GDP growth in Nepal accelerated in the last two fiscal years, supported by infrastructure investment, stable energy supply and favorable international conditions. While this strong growth momentum has contributed to alleviate poverty and to advance towards achieving the sustainable development goals (SDG), its sustainability can be derailed by financial stability vulnerabilities, large external imbalances and inflation pressures. We therefore agree with staff in recommending some policy tightening to the authorities.

The transfer of resources and responsibilities to regional governments can pose risks to fiscal sustainability. We comment the authorities for the smooth transition into a federal system of government. At the same time, we highlight the importance of monitoring its impact on the evolution of the consolidated fiscal deficit, and on the capacity of the sub-national governments to perform their new responsibilities efficiently. We agree with staff that continued improvement in revenue performance will be fundamental to maintain a strong fiscal position and meet capital and social spending needs. In this context, we encourage the authorities to advance their tax reform plans. We take note that, according to the Debt Sustainability Analysis, Nepal’s risk of debt distress remains low.

Headline inflation is subdued amid accommodative monetary policy. Nonetheless, the relatively well-behaved headline inflation mainly reflects favorable food price developments. We concur with staff that the monetary authorities should tighten policy in response to mounting price pressures, to support the exchange rate peg, and to contain credit growth. We note that the ongoing strong credit growth has increased financial sector vulnerabilities. Against this background, we fully agree with staff’s recommendation to tighten macroprudential measures, and to reinforce banking regulation and supervision, in line with the 2014 FSAP.

Good governance, combined with political stability and reliable electricity supply, can improve the business environment and pave the way for more inclusive and sustainable growth. We welcome the key priority areas to promote growth described by Mr. Agung and Ms. Pandit in their statement, as well as the authorities’ commitment to zero tolerance on corruption.

Mr. Inderbinen and Mr. Tola submitted the following statement:

We thank staff for the comprehensive report and broadly share their policy recommendations. In particular, we underscore the need to withdraw policy stimulus to avoid an abrupt slowdown further down the road. We encourage the authorities to work toward the consolidation of federalism and strengthen the implementation capacity of subnational governments.

The consolidation of the federal system is necessary to create conditions conducive to sustained medium-term growth. The newly found political stability has created a favorable environment for investment and the implementation of structural reforms that will lift medium-term growth prospects. While we appreciate staff’s focus on fiscal federalism in the Select Issues, we think that it cannot be treated in isolation from the political and administrative federalization of the country. The successful implementation of these processes will require that the newly elected political representatives have the necessary means to fulfil their responsibilities. A shift of resources from the central to subnational governments would facilitate this transition without unduly increasing overall spending.

Successful implementation of fiscal federalism hinges on the strengthening of PFM across all levels of government. Staff rightly points out the need to further clarify the roles and responsibilities across the three tiers of government. Success will largely depend on robust PFM systems at all levels. Hence, efforts should concentrate on building capacity. As a first step, the ongoing evaluation of needs at the subnational level will provide information to the National Natural Resource and Fiscal Commission that is necessary to its functions.

The implementation of comprehensive structural reforms will be key to achieve the SDG targets. We agree with staff on the necessity to address bottlenecks on the supply side. We encourage the authorities to tackle corruption, eliminate entry barriers for firms and improve the quality of public services. At the same time, we note that staff has not included the impact of labor force migration and remittances in their analysis of potential growth drivers. A considerable portion of the Nepalese labor force is currently abroad. This could have a direct consequence, not only for the country's productivity, but also its competitiveness. Staff's comments would be welcome.

We echo staff's call for tighter macro-prudential measures and enhanced financial oversight. Enhanced supervision will be critical reign in excess credit growth and reduce vulnerabilities in the banking sector. This is especially relevant given the excess liquidity due to subnational governments depositing funds in commercial banks. Risks from excess liquidity could be compounded by risk management deficiencies in banks. The latter should be in the focus of financial sector supervision.

Mr. Kaya and Mr. Hagara submitted the following statement:

We thank staff for the candid report on Nepal, and Mr. Agung and Ms. Pandit for their informative buff statement. Three years after the earthquake, the Nepalese economy continues to see strong growth, driven by a supportive policy stance and some structural improvements, particularly the enhanced electricity supply. While the accommodative policy mix supports growth in the near term, there are also growing signs of increasing macroeconomic imbalances and vulnerabilities, including rising twin deficits, higher inflation, and excessive credit growth. We encourage the authorities to withdraw the policy stimulus and address vulnerabilities to avoid the risk of a disruptive adjustment further down the road, while focusing on structural policies to strengthen the Nepalese economy's growth potential. We broadly agree with staff's appraisal and would like to add the following comments.

A front-loaded fiscal consolidation is needed to ensure external stability. While public debt in Nepal remains low, the expansionary fiscal policy fuels domestic demand, feeds into the widening current account deficit, and adds to external pressure risks. Efforts to support growth and meet capital spending needs are understandable. Nevertheless, the authorities need to reduce the fiscal deficit to a level that would ensure external stability, while investment plans should be aligned with Nepal's absorption capacity. In this vein, while the ongoing transition to fiscal federalism can bring benefits in the form of improved public services, the authorities need to ensure that the shift is effective, aligned with the capacity building at the subnational level, and guided by strong public financial management and budgetary frameworks. We welcome staff's extended coverage of the topic in the accompanying Selected Issues Paper.

Tighter monetary policy is needed at the current stage of the business cycle, also to support the exchange rate peg. While headline inflation remained moderate owing to benign food prices, the non-food component accelerated to above 6 percent at the end of 2018. Furthermore, the interest rates in Nepal currently seem too low compared to India, putting pressure on the exchange rate peg. Aside from monetary policy tightening, we support staff's call on the authorities to strengthen the Central Bank of Nepal's (NRP) autonomy. Since concerns about the NRP's autonomy were already raised in the 2014 Financial Sector Assessment Program (FSAP), we would welcome more detailed information from staff about the authorities' efforts and progress thus far.

Credit boom risks and oversight in the banking sector should be addressed. Excessive credit growth largely directed to real estate has fueled asset price increases and represents a key financial sector risk that requires the authorities to tighten macroprudential measures. While improving financial inclusion can also help promote a more inclusive growth, it should be set within robust financial sector oversight with adequate enforcement powers. We strongly encourage the authorities to expedite the implementation of the 2014 FSAP recommendations. Since Annex IV shows that many high-priority FSAP recommendations have not yet been implemented, staff's more detailed elaboration on the reasons behind slow progress would be welcome, in particular, taking into account that the authorities seem less concerned about the financial sector risks.

Mr. Ronicle and Mr. Cowie submitted the following statement:

We thank staff for their assessment of the Nepal economy and thank Mr. Agung and Ms. Pandit for their informative buff statement.

We support the broad findings and policy actions in the focused Article IV report and read the the detailed selected issues paper with interest. We would like to highlight the following issues.

Nepal has been through difficult times, most recently the devastating earthquake, and before that the period of conflict. This is an important moment of transition as constitutional reforms are implemented and a new federal system of government is adopted. In that context, it is imperative the authorities maintain key policy strengths, such as the effective currency peg, low debt levels, and strong growth, or else risk a deterioration in the macro environment jeopardize important progress.

We agree with staff's key recommendation on containing fiscal spending in light of recent sharp increases in the Government of Nepal's budget (44 percent of GDP in FY2019) and likely future pressures from fiscal federalism. Additional fiscal obligations without concurrent reduction in fiscal spending by the federal government could lead to higher debt and deteriorating fiscal conditions. Effective civil service restructuring and reductions at the federal level against significant devolution to local government will be important for reducing government spending. The introduction of robust financial management systems and planning at the newly formed provincial and local levels are necessary to improve the efficiency of spending. While Nepal has very low debt, there is potential for significant public spending on large infrastructure projects that may have low economic return. What is the staff assessment of this issue? Can staff comment on the authorities' approach to ensuring such projects are value for money?

We also welcome the Government's plans to improve the investment climate ahead of the upcoming Investment Summit. We agree that reforming the Foreign Investment and Technology Transfer Act (FITTA) to streamline investment approvals is essential, as well as strengthening the IBN Act. Two additional priorities to support investment are to revise the visa rules for foreign firms, and to take stronger action on corruption. On visas, we appreciate that the new labour regulations were designed to create more jobs for Nepalis, but unfortunately it is having the opposite effect, since there are already cases of investors shifting new investments to other countries because of the difficulty of bringing in foreign workers. We welcome coverage in the staff report of corruption and governance, and note that strong action should be taken against those responsible for the alleged corruption in the procurement of wide-bodied airplanes for Nepal Airlines, otherwise it risks undermining the Government's credibility with both investors and the public.

While we agree on the need to slow credit expansion, we are concerned about reports of high interest rates on bank lending. High borrowing costs have implications for infrastructure projects and the competitiveness of Nepali products. This may make it politically difficult for the authorities to raise base rates as advocated by staff. What assessment have staff made of borrowing costs in Nepal: are borrowing costs high? If so, what is driving high costs? Does this reflect high financing costs for banks, or other issues such as low competition?

The large inflows of remittances and the large credit expansion are correctly linked in the report to the unsustainable rise in land and real estate prices. Are staff able to comment on any macroeconomic or financial stability implications from these price rises, including any policy recommendations for addressing the issue?

Mr. Gokarn and Ms. Dhillon submitted the following statement:

We thank staff for the excellent set of reports and Mr. Agung and Ms. Pandit for their candid buff statement.

Amidst political stability, the transition to a federal framework, post-earthquake reconstruction and expansionary macroeconomic policies have contributed to a rebound in economic activity. Growth is expected to accelerate, to 6.5 percent in FY2018/19, well above its historical average. We note that staff has assessed the outlook as vulnerable to weak implementation capacity of subnational governments, financial sector vulnerabilities, slowing remittances and expansionary policies. However, the authorities are more optimistic regarding the near and medium-term growth outlook targeting to reach double digit growth. Could staff comment on this difference in assessment?

Fiscal Sector

The authorities should carefully calibrate fiscal policy for consolidation while protecting pro-poor spending and developing capacities at the subnational level. It is reassuring that public debt remains low and we commend the initiatives to strengthen tax administration and increase domestic revenue mobilization. We recognize that an increase in government spending may be inevitable in the face of the transition to fiscal federalism and the pickup of reconstruction activities. However, the authorities must remain mindful of the expansionary policy and its consequences on inflation, reserves and related exposures. Fiscal policy should be well matched with robust capacity building and a sound public financial management framework. It would be useful to have a comprehensive list of TAs, ongoing and proposed, from the Fund to Nepal and the status of the authorities request for enhancing technical capacity to revisit and rebase the national GDP and disaggregate it to sub national level. Have staff held substantive discussions on capacity gaps and how they can be addressed?

Monetary, Exchange Rate and Financial Sector

We agree with the staff assessment that the peg to the Indian rupee continues to serve as a transparent nominal anchor and should be supported by a tighter monetary policy stance. We see merit in staff advise for the NRB to resume using its IRC, by actively mopping up excess liquidity when needed and bringing interbank rates back towards the mid-point of the target range. Staff comments are welcome on whether there are any overarching factors which hinder its swift implementation. In the same vein, we share with staff the concerns about recent credit growth and its possible impact on stability. We would urge the authorities to take staff suggested measures, strengthen data and supervision, and remain vigilant with an eye on inflation and financial stability. Beyond this, we would stress the implementation of recommendations of the 2014 FSAP reforms. We welcome the recently launched Financial Inclusion Action Plan and the priority accorded for implementation of the AML/CFT measures and its alignment to international standards.

Structural Reform and Sustainable Growth

Finally, Nepal needs to build a conducive environment for the private sector and address governance weaknesses for inclusive growth. We welcome the authorities' efforts to make Nepal's economy more competitive and to enhance the investment environment through revisions of investment related laws and regulations, procedural simplification of FDI and reform in governance. Moving forward, strengthening governance and institutions should be prioritized.

With these comments, we wish the authorities the best in their endeavors.

Ms. Levonian, Ms. McKiernan and Mr. Mooney submitted the following statement:

We thank staff for their set of reports and Mr. Agung and Ms. Pandit for their informative buff statement. The economy of Nepal has recovered following the massive earthquakes in 2015 and a more stable political climate, coupled with expansionary macroeconomic policies, have led to a strong recovery. However, while the projections for near-term growth are favorable, risks remain including fiscal deficits, excessive credit growth and financial vulnerabilities. We broadly support staff's assessment and offer the following comments for emphasis.

We note the growing fiscal deficit and can support staff's recommendation for more front-loaded fiscal consolidation and an improved composition of expenditure in the medium term. We urge the authorities to implement staff's recommendation on fiscal policy. The transition to fiscal federalism in recent years has added complexity to macroeconomic management and, if not managed prudently, may limit the central government's ability to utilize fiscal policy levers. This transition has led to increased expenditure that has contributed to the wider fiscal deficit.

In terms of financial risks, we note the concentration of bank loan portfolios in the real estate and construction sectors, coupled with weak underwriting standards and risk management, accompanied by the sharp expansion in credit. In addition, we note the significant reliance on remittance inflows as the main funding for deposits. We agree with staff's assessment that banks should be encouraged to build additional capital and provisioning buffers along with increased financial oversight. The authorities need to build on their positive steps on banking reform to ensure sustainable development in the financial sector and to prevent the risks associated with credit growth from materializing.

Moves to improve the investment climate are welcomed, although we note staff's concerns regarding corruption and lack of governance and welcome the acknowledgement of these issues by the authorities. We note the ongoing work by the authorities to overhaul numerous investment-related laws in order to enhance transparency, oversight and governance on a sustained basis. In addition, we are supportive of increased efforts to ensure that safeguards at the NRB are strengthened. We support the conclusion in the Selected Issues Paper that Nepal's financial inclusion plan should target the rural population, low-income households, women, and geographically-remote communities.

Mr. Guerra and Ms. Arevalo Arroyo submitted the following statement:

We thank staff for the illustrative reports and Mr. Agung and Ms. Pandit for their helpful buff statement. We broadly agree with the staff's appraisal and would only like to comment on a few aspects below. Economic activity in Nepal continues to be strong. A favorable near-term outlook in hand with greater political stability and the establishment of a federal government provide a window of opportunity to boost growth and address structural weaknesses.

Laying the foundations for strong and sustainable growth in the medium-term will contribute to alleviate poverty and reach the sustainable development goals. We note the difference in views between the authorities and staff regarding the near-term growth outlook and the need to tighten macroeconomic policies. We concur with staff that the near-term outlook is favorable, but risks are tilted to the downside. The current ambitious growth targets, exceeding growth potential, could put substantial pressure on the domestic economy and worsen external and internal imbalances that could result in an abrupt correction in the medium-term.

Preserving fiscal sustainability, increasing revenue mobilization and instituting sound public financial management (PFM) are key policy actions. We agree with staff that fiscal policy should contribute to contain domestic demand pressures and shore up external stability. We welcome that public debt remains low and the efforts on revenue mobilization. We note that spending pressures due to reconstruction and the transfers related to the implementation of fiscal federalism have increased the fiscal deficit substantially. We welcome the introduction of the fiscal federal framework and we agree with staff that the central government budget should be rationalized. Building implementation capacity and establishing a robust public financial management system in both the subnational and central governments will contribute to ensure fiscal sustainability and effective functioning of the fiscal federal framework.

We agree with staff that the current monetary policy stance should be less accommodative in order to rein in imbalances and support the peg to the Indian rupee. We also agree that resuming the use of the Interest Rate Corridor (IRC) and mopping up excess liquidity when needed will contribute to greater stability on interbank rates and improve monetary policy transmission. Staff comments are welcome on the rationale and appropriateness of the current exchange rate peg to the Indian rupee.

Granting operational autonomy to the RNB should be a top priority in the amendment to the NRB Act. Can staff highlight which other aspects included in the 2014 FSAP should be given priority in order to boost central bank autonomy?

We note that existing macroprudential measures have helped contain credit growth, but further tightening of these measures as well as strengthening of financial regulation is needed in light of potential vulnerabilities arising from the credit boom. We welcome the macroprudential measures introduced by the authorities as well as the steps taken to strengthen regulation and supervision supported by the WB and the IMF. However, we agree with staff that additional capital buffers should be built and efforts to strengthen financial sector oversight should be deepened.

We commend the authorities' commitment and ongoing efforts on the implementation of a structural reform agenda that improves the investment environment, strengthens governance and institutions, and increases competitiveness.

Mr. Alkhareif and Mr. AlHafedh submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Agung and Ms. Pandit for their informative buff statement.

Nepal's economy is experiencing strong growth, but challenges remain. Growth is being promoted by large reconstruction efforts, following the 2015 earthquake, and by the expanded development in manufacturing and tourism industries. Nevertheless, ensuring sustainable macroeconomic environment represents a challenge in the context of the current expansionary fiscal measures and accommodative credit policies.

Against this background, we broadly concur with staff's appraisal and policy recommendations. Specifically, we agree on the need to contain the current account deficit, reinforce banking and credit oversight, and enhance the business environment. We encourage the authorities to take note of staff's recommendations, and we would limit our remarks to a few areas for emphasis.

The authorities' ambitious growth targets could put some pressure on the domestic economy and the growing current account deficit. The expansionary fiscal policy would likely raise external pressures and contribute to the build-up of financial sector vulnerabilities, potentially putting economic stability at risk. In this context, we encourage the authorities to take the necessary measures to reduce pressure on the current account and ensure macroeconomic stability. Could staff elaborate on the technical assistance being provided to Nepal to enhance the authorities' capacity to strengthen the implementation capacity of fiscal policies at the sub-national level?

We agree with staff that the pegged exchange rate to the Indian rupee has served Nepal well. We also see merit in staff's recommendation to improve monetary policy operations, through moving the corridor higher over time to better align short term nominal interest rates in Nepal with those in India. We also welcome the Central Bank's efforts to implement a risk-based banking supervisory framework and macroprudential policies to safeguard financial stability and enhance quality lending.

We welcome staff's SIP on Financial Inclusion and commend the authorities for the recently approved Financial Inclusion Plan. We agree with staff that financial inclusion can promote inclusive growth and reduce poverty. We also agree with staff's recommendation to focus on the underserved, particularly the rural population, low-income households, women, and geographically-remote communities. We note, however, that the report did not highlight the most recent changes in key socioeconomic indicators (i.e. unemployment and poverty rates), therefore could staff shed some light on those indicators especially in the aftermath of the 2015 earthquake?

Going forward, we welcome the authorities' commitment to improve the investment climate, including through revising the existing laws, strengthening governance, enhancing transparency, and implementing AML/CFT measures in line with the international standards.

With these remarks, we wish the authorities well in their reform efforts.

Mr. Mozhin and Ms. Smirnova submitted the following statement:

We thank staff for their succinct report and the informative Selected Issues analysis and Mr. Agung and Ms. Pandit for their helpful BUFF statement. Nepal continues to recover from the 2015 earthquake, with reconstruction activities supporting GDP growth. It is encouraging to read the staff estimate that growth is expected to continue on the back of reconstruction activity, development of hydro-power projects, recovery in agriculture and tourism-related activity. At the same time, the challenges remain, such as high credit growth, rising non-food inflation, widening current account deficit and falling foreign exchange reserves. The implementation of fiscal federalism is also an area which requires careful attention. We broadly concur with the staff appraisal and would like to limit our comments to the following points.

Fiscal Policy

Nepal has a low level of public debt and, thus, could afford fiscal expansion to support the recovery processes. Current dynamics of the economy and the main macroeconomic indicators show that it is time to slow fiscal expansion down. We agree with staff's advice that to ensure fiscal and external sustainability and to prepare a platform for the medium-term growth, the streamlining of the budget is needed, with front-loaded fiscal consolidation and improved composition of expenditure as the key actions to take. The authorities' revenue mobilization strategy, mentioned in the report, would also be very helpful.

We welcome the fiscal federalism implementation and believe that it would support fiscal consolidation efforts. Spending cuts on the recurring elements of the central government budget should be considered in the context of reassigning spending responsibilities across all levels of the federal fiscal framework, with clear definitions of the roles of the national and subnational authorities.

Monetary Policy

We agree that the peg to the Indian rupee remains an adequate nominal anchor. At the same time, we are worried that the authorities allowed interest rates to fall substantially below the interest rate corridor, drawing pressures on Nepal's exchange rate regime by widening interest rate differential with the Indian rupee. Could staff comment on why the authorities decided to allow interest rates to fall below the interest rate corridor instead of managing to hold the rates at a lower bound?

We note the staff estimate that the economy is operating above the potential and that non-food inflation is already at a 2-year high level of 6.3 percent and is expected to increase, and agree that the monetary policy stance should be more restrictive.

Financial Sector

We welcome the authorities' intention to support growth and alleviate poverty through the financial sector. We note that the authorities undertook efforts to control the buildup of excessive risks in the financial sector through loan-to-deposit and credit-to-core capital cum deposit ratios.

Nevertheless, current credit market dynamics, with credit to the private sector expanding by 24 percent in December (y/y), is quite endangering. We read in the report that the loan portfolios have a limited scope for diversification, and that risk management practices are weak, as are underwriting standards. Together, this could lead to increased financial vulnerability and, in case of adverse events, could negatively affect poverty rates.

We thus agree with staff that additional tightening measures should be implemented, including a possible increase of a reserve requirements ratio, and that the supervisory procedures in the financial sector should be strengthened.

The Acting Chair (Mr. Zhang) made the following statement:

In 2015, Nepal was hit by a large earthquake, and in the same year, a new constitution was adopted, and elections were completed successfully following that at the state, provincial, and local levels in 2017.

On the economic front, economic activity has picked up after a prolonged period of tepid growth. The near-term growth outlook is considered favorable. At the same time, the internal and external imbalances are growing. Directors' gray statements encouraged the authorities to pursue prudent policies and structural reforms to contain the macro and financial stability risks.

Mr. Daïri made the following statement:

At the outset, we express our sympathy to the authorities following the devastating earthquake. This is the first opportunity we have had to do that. I commend the authorities for their recent strong economic performance in the context of subdued inflation. The reserve position continues to be comfortable despite the higher imports, mainly for post-earthquake construction, while the risk of debt distress remains low. The outlook is for continued strong growth even though the staff points to outside risks from more expansionary macroeconomic and financial policies.

The authorities are more sanguine than the staff on the pace of future growth. We note that two of the main impediments to growth in Nepal, namely political instability and energy supply issues, have been addressed, which explains the rebound in potential growth. We encourage the authorities to continue addressing remaining impediments while closely monitoring the impact of their macroeconomic accommodation to preserve macroeconomic stability. We share the authorities' focus on the need to have stronger growth to reduce poverty further and reach the Sustainable Development Goals (SDGs) as well as middle-income status.

While the fiscal deficits are higher than two years ago, we welcome the recent improvement projected in the fiscal position this year, reflecting mainly the impressive revenue performance and the tight recurrent expenditure control if the new revenue transfers to subnational entities under the new federal system are excluded. We are comforted by Mr. Agung's and Ms. Pandit's indication that fiscal deficit should decline to more acceptable levels once the sharing of responsibilities among the government levels is completed.

We note that the rapid credit growth has not led to the deterioration of credit quality or the soundness of the banking sector, as reflected in the low NPL ratio and the more-than-adequate provisioning. We also note that the banks' exposure to the real estate sector, one of the concerns expressed by the staff, has been declining, and as Mr. Agung and Ms. Pandit have mentioned, the authorities have at their disposal a number of macroprudential tools that they can use to control credit expansion if they are considered excessive. We would like staff to clarify what they see as potential improvements and enhancements of the macroprudential toolkit. We wish the authorities further success.

Mr. Morales made the following statement:

Nepal's economic activity is growing thanks to structural factors, including reconstruction investment and a steady provision of electricity and supported by macroeconomic policies. At the same time, Nepal's impressive growth performance of recent years will introduce challenges in many areas. To name a few, first, the availability of skills in the public and private sector to make growth sustainable in an environment where many Nepalese workers still seek employment out of the country. Second, the need to ensure that public investment priorities are aligned with the demands arising from the sectors of the economy gaining more dynamism in recent times. This would require proper planning, selection, public procurement, and efficient implementation of projects, as highlighted by the staff. Three, the need to overcome oversight capacity limitations in several areas from debt management to financial supervision in a context of new challenges and in a changing global environment.

We agree with the staff that if the economy is operating above its productive capacity, in that situation maintaining an accommodating stance simultaneously on fiscal and financial and monetary policies would likely have a short-lived additional impact on growth while running the risk of building up macroeconomic imbalances that will be difficult to manage in the event of changes in the global environment. Therefore, we encourage the authorities to maintain prudence in macroeconomic policies, including by reversing the recent fiscal stimulus, bringing central bank interest rates within the policy corridor, and using macroprudential tools to contain financial risks.

This is particularly important in a period when fiscal devolution is introduced. In a previous incarnation when I was working for the Fund Kenya team, the Managing Director visited and rightly stated that these processes are never as smooth as originally planned, and maintaining prudent macroeconomic policies will be all the more important when such a reform is undertaken. In this regard, I would like to ask the staff two questions about this process.

First, are the new centralized units going to be able to borrow from financial institutions or markets at some point? Second, would management of the largest public investment projects remain under the control of the central government? With that I wish the authorities success in their endeavors.

Mr. Saito made the following statement:

We thank the staff for the comprehensive report and Mr. Agung and Ms. Pandit for their informative statement. I have issued a gray statement and would like to limit our remarks on the exchange rate regime.

We take note of the staff's assessment that the peg to the Indian rupee continues to serve as a transparent nominal anchor. At the same time, we note the staff's analysis in the selected issues paper that core inflation co-movement between India and Nepal is weak. The staff therefore sees an important role for domestic monetary policy to achieve stable inflation. This advice seems to contradict the staff's appraisal that the peg regime should be maintained. In responding to our questions, the staff answered that even if a move to a more flexible exchange rate regime was appropriate, the preconditions for moving away from the peg are not currently in place. While we agree that monetary policy transmission should be strengthened, it is not entirely clear whether staff believes that the flexible exchange rate regime is desirable as a medium-term policy option. The staff's comments are welcome.

In any case, as pointed out by other Directors in some of the other country cases, we encourage the staff to provide more granular explanation in the staff report about the background or the rationale for the staff's recommendations on the exchange rate regime.

Mr. Shin made the following statement:

We did not issue a gray statement since we mostly agree with the staff's assessment and key recommendations, but we would like to emphasize the importance of policy sustainability.

We share the concern about large current account deficits. Looking more closely at the current account flows, huge trade deficits, more than 40 percent of GDP, are offset by the large workers' remittances. Given that the remittances are mostly in dollars and might be linked to the domestic asset booms, the flows could become volatile once real currency value changes and the shocks to the asset quality materialize. Like some other chairs, we would like the staff's view on the persistence of this trend.

We would also like to highlight that large current account deficits often have implications for the capital flows, especially in tight global market conditions. Even with limited flows under capital control, persistent deficit could add pressure on the balance of payments and thereby the country's tax system. Therefore, we support the staff's recommendations of holding back policy stimulus to some extent for more stable and sustainable growth, and thus avoid an upward adjustment in the future. With this, we wish the authorities all the best.

Mr. Sigureirsson made the following statement:

We have issued a gray statement in which we broadly agree with the staff's appraisal but also offered some views which I will not repeat here.

There is one area I would like to ask the staff about. We have come across some articles in the media recently referring to a report on climate change and sustainability in the Himalayan range, and according to the report, the impact will be significant in the region, and the effects may start kicking in somewhat earlier than had been expected. This is not the first time this area has been pointed out, but the focus of the debate globally has been on different parts of the world. I realize that the focus has been on recent natural disasters, and rightly so, but we wonder whether the staff intends to consider this issue in upcoming surveillance.

The representative from the Asia and Pacific Department (Mr. Almekinders), in response to questions and comments from Executive Directors, made the following statement:[1]

I thank Directors for their interest in the staff report and the selected issues paper. We responded to most of the questions raised in the gray statements. In my intervention, I would like to highlight some key areas and common themes in the gray statements pertaining to the disagreements on potential growth in Nepal and also the policy recommendations on monetary policy, the exchange rate peg, and also the financial sector policy.

On growth, it is important to remember that Nepal's economy expanded at an average annual rate of about 4.25 percent in the decade before the earthquake in 2015. We believe that improvements in electricity supply and structural reforms already underway will help raise potential growth to 5.25 percent. We believe that it will take time to put in place the structural preconditions to support substantially stronger growth on a sustained basis. As evidenced by the rising non-food inflation and widening external imbalances, and also the high credit growth needed to sustain the current strong growth, those factors highlight that Nepal is currently growing above potential. Therefore, we believe it is not realistic to target 8 percent growth at this point, as the authorities currently do.

On fiscal policy, based on Nepal's low public debt and large development needs, there would seem to be a strong case for higher capital spending, as was pointed out in some gray statements. However, weak implementation capacity, particularly with regard to capital spending, has been a perennial issue in Nepal. To increase the economic return of higher government spending, more needs to be done to strengthen public financial management, including project selection, preparation, implementation, and

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

monitoring. The relatively low economic returns are another reason to go slower in scaling up government spending, especially if capital spending is now undertaken in part by state and local governments, which still need to build public financial sector management capacity. The public investment program will be also delegated down to the lower tiers of government, to the state governments and the local governments. That introduces an additional coordination challenge that needs to be overcome. In the short run, low spending efficiency and the need to put in place strong institutional agreements, could further dampen the economic return of capital spending.

This brings me to the broader issue of fiscal federalism. Fiscal federalism could bring improved delivery of service by the government. However, fiscal federalism in Nepal is implemented at an unprecedented pace. What takes other countries decades to phase in, Nepal tries to do in very short order, and at the moment, subnational governments have to start from scratch with setting up public financial management systems.

As some Directors may have heard from their capitals, Nepal’s development partners have been trying to adjust to the rapidly changing demands for capacity building, and also the Fund’s South Asia Regional Training and Technical Assistance Center (SARTTAC) in New Delhi has been adjusting to the demands, and we have scaled up our assistance in the area of fiscal reporting and government-financed statistics training to accommodate the increased demands in that area.

On the question of whether the decentralized units will also be allowed to borrow, the regulations for that are still being worked out, but there is a broad understanding that it is important to keep control over that. Nepal is a low-debt country. There is an overarching prudence in the government, but there will be some room for borrowing by subnational governments, but it has not been quantified yet, and everybody is aware that it should be properly curtailed.

Turning to monetary policy, this is also an area in which there were some differences of views. Excess liquidity in the banking system has long been an issue in Nepal. There was mention of the importance of strong inflows of remittances and also aid inflows. They inject liquidity into Nepal’s financial system, but the authorities have several instruments at their disposal to manage this liquidity. Building on sustained technical assistance from the Fund, the central bank successfully operated an interest rate corridor during the first half of 2018. However, starting with the new fiscal year in July, the authorities no longer want to tie their hands and limit policy discretion.

Instead, they want a more accommodative monetary policy to support credit and growth.

As far as we are concerned, and as far as the central bank is concerned at the technical level, there are no overarching concerns and factors that would hinder swift implementation of the interest rate corridor. It is hard not to see a link between the abandonment of the interest rate corridor and the lack of central bank autonomy. The government wants the economy to grow on all cylinders, and in the government's view, a high short-term interest rate is not conducive to that.

Several Directors have asked about the appropriateness of the peg to the Indian rupee. Several arguments can be put forward in support of the peg. It is a simple and transparent nominal anchor. It has worked well for several decades, and Nepal has close ties with India. About two-thirds of trade is with India. There are common weather shocks and also common economic shocks. On the other hand, India is an emerging market economy. It is exposed to portfolio flow volatility, which does not affect Nepal to the same extent. India has also been growing more rapidly, so there is a productivity differential between the two economies.

In light of this, eventually Nepal could benefit from more exchange rate flexibility, but to move to more flexibility in a gainful way, Nepal would first need to strengthen the transmission of monetary policy. This would include steps to adhere to the interest corridor that I just touched on and the strengthening of the functioning of money markets over time.

The Fund's technical and policy advice has been aiming to put this in place for several years now with the ultimate view of moving to more exchange rate flexibility. I could add, against the background of the discussion this morning, that the rapid rollout of fiscal federalism creates transitional uncertainty about macroeconomic policy implementation, so one could argue that this is another reason why this may not be the right time to move to more exchange rate flexibility and that the authorities should try to strengthen policies within the current monetary policy framework.

On financial sector stability, there was a question on why many high priority recommendations from the 2014 Financial Sector Assessment Program (FSAP) have not yet been implemented. A similar concern can also be added with regard to the implementation of recommendations made in the context of the 2015 safeguards assessment. A number of factors account for the slow progress in implementing these recommendations. Capacity issues continued to be a key obstacle. Ample technical assistance and training has been provided, and there may be scope on the part of the authorities to enhance the follow-up to development partners' capacity development efforts.

Another issue in Nepal is the frequent rotation of staff, which undermines the effectiveness of capacity development. Frequent staff rotation and limited central bank autonomy also undermine responsibility and accountability of officials involved in implementing financial sector reforms and reforms to strengthen central bank governance.

On the positive side, commercial banks' paid-up capital has been quadrupled in the last two years. The central bank also adopted a risk-management directive, and there is a work plan to strengthen bank regulations and supervision, which is being implemented by the authorities, that includes modernizing the lender-of-last-resort function.

The authorities have also been making good use of a resident long-term advisor that has been stationed in Kathmandu for the last two years. She is backstopped by our Monetary and Capital Markets Department (MCM), and she helps strengthen the implementation of risk-based bank supervision. That is going well.

On the question of how and whether the macroprudential toolkit should be strengthened what we write in the staff report is that the toolkit is broadly adequate. What we talked about is that the loan-to-deposit ratio, which we strongly support, which puts a lid on credit growth, is basically in an un-transparent way being undermined and becoming nonbinding by making adjustments and giving banks free passes on basically playing with the definition of the loan-to-deposit ratio, so in that way it is no longer a binding constraint. We are happy with the architecture. It is just that the implementation can be done more firmly, and then Nepal would benefit from the existing architecture.

A Director mentioned that the real estate exposure has been falling, according to the financial soundness indicators, but that pertains only to the direct lending to the real estate sector. There is a significant amount of lending that is collateralized by real estate and land, and in the context of the risk management guideline implementation, the commercial banks and the central bank should both take a look at whether there is too much overall exposure to the real estate sector, which exposes Nepal to shocks to that sector.

> On the question on climate change, this is an important long-term issue for Nepal. Unfortunately, Nepal has very large hydro power potential that it has not been able to use so far because of problems in getting the large hydropower project going. The reports that we have seen suggest that the melting of the Himalaya glaciers will speed up. In the next 20 to 30 years, there will be more water coming down, which could lead to flooding and therefore more negative shocks for Nepal. In the very long run, it could undermine the viability of the whole hydropower sector. This is an issue that needs to be looked at, and because several other countries have been climate change pilots, perhaps Nepal could be a good example to look at this issue in the future.

Mr. Daïri noted that on the issue of revenue transfer, for the current fiscal year, the staff projected 4.6 percent of GDP in transfers to the lower tiers of the government. He asked if the staff knew whether the money would be spent. If it was not spent for capacity intermediation, it meant that the real underlying deficit would be lower than in the staff report. He also asked whether the staff considered moving to a definition of fiscal operations that covered all tiers of the government and not only the central government.

The representative from the Asia and Pacific Department (Mr. Almekinders), in response to further questions and comments from Executive Directors, made the following additional statement:

> Indeed, the transfers to lower tiers have been going from very low to substantial amounts, which is macroeconomically relevant to track. I have to say that given the speed with which the fiscal federalism is being rolled out, the reporting mechanisms and the reporting frameworks have not been able to keep pace with that, and we cannot confirm to what extent this 4.5 percent of GDP has been spent. The central bank and the office of the accountant general are trying to set up the monitoring because this is a critical issue. But on the other hand, we know that there are strong spending needs, and because the whole infrastructure has to be built up, a good amount of this has been spent.
>
> Along with the authorities putting in place reporting frameworks, we will also adjust our reporting in future staff reports to make sure that good fiscal indicators, the relevant fiscal indicators, are all available both to the team and to the Board.

Mr. Agung made the following concluding statement:

On behalf of my Nepalese authorities, I thank Directors for their thoughtful gray statements and useful comments, which I will certainly convey to my authorities.

Nepal's economic performance remains robust with strong growth and low inflation. Externally, the deficit has widened due to higher imports from the earthquake-related reconstruction and recovery activity. However, the external position remains comfortable with inflows from remittances serving to maintain an adequate level of reserves.

The authorities acknowledge concern regarding the growing fiscal deficit. Nonetheless, they stress that the training period and reconstruction activities necessitated an increase in government spending. The risk of debt distress remains low while revenue mobilization will contribute to fiscal rebalancing.

On the monetary and exchange rate front, the peg to Indian rupee continues to serve Nepal well. India accounts for more than two-thirds of Nepal's external trade, and the Nepalese and Indian price levels are closely correlated. The authorities believe that this regime will remain appropriate for some years until Nepal's trade is diversified.

We thank Directors for their helpful comments on the monetary policy stance. The authorities remain confident that the central bank will be able to maintain price and external sector stability while also facilitating high and sustainable economic growth. The authorities would like to assure Directors that the central bank stands ready to adjust its policy stance if the current accommodative stance challenges economic and financial stability.

On the financial sector front, Nepal's banking sector remains profitable. Capital is adequate, and nonperforming loans are low. The authorities feel credit growth in the current circumstances remain at reasonable levels, although they are cautious about further increases in credit growth. Preliminary data for the past six months suggest that the credit growth has slowed down.

My authorities are well aware that there is no room for complacency and will remain steadfast in undertaking necessary reform to make Nepal's economy more resilient. They have recently initiated various efforts to improve the investment climate, including for FDI, and to enhance governance. Before concluding, I want to express that my authorities urge the Fund to provide technical support for strengthening the fiscal and financial information system at the subnational level as well as to rebase the national GDP and disaggregate it into the subnational level.

Finally, I would like to convey my authorities' appreciation to the Fund for the constructive engagement through policy advice and technical assistance, which have helped Nepal achieve macroeconomic stability and reduce poverty. The authorities look forward to continued support from the Fund as they seek to promote sustainable and inclusive growth.

I thank the mission chief, Mr. Almekinders, and his team as well as management and Directors for constructive recognition and discussion. Thank you very much.

The Acting Chair (Mr. Zhang) noted that Nepal is an Article VIII member but maintained an exchange restriction subject to Fund approval under Article VIII. The staff was not recommending approval of those exchange restrictions, and therefore no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities on the pick-up in economic activity in Nepal, supported by greater political stability, more reliable electricity supply, and reconstruction activity. Directors considered that the improved near-term outlook provides an opportunity to address macroeconomic and financial vulnerabilities and deep-seated structural weaknesses and boost prospects for long-term inclusive growth and the attainment of the Sustainable Development Goals.

Directors noted that expansionary fiscal and credit policies are putting pressure on the domestic economy, through higher non-food inflation and a buildup of financial sector risks, and a wider current account deficit. They recommended a policy tightening in the near term, including through fiscal consolidation, to avoid an abrupt slowdown, and promote a more durable economic expansion.

Directors welcomed the progress made in putting in place a fiscal federalism framework. They noted that public debt remains low and encouraged continued efforts to strengthen tax administration and increase domestic revenue mobilization. Directors observed that more needs to be done to ensure fiscal sustainability, make budgets more realistic and spending more efficient, and build implementation capacity. They agreed that with the devolution of responsibilities and resources to local and provincial levels, efforts should be focused on building policy implementation capacity and instituting a sound public financial management framework at the subnational level.

Directors considered that monetary policy should be tightened, including to support the exchange rate peg to the Indian rupee. They noted that the recently initiated review of the central bank act provides an important opportunity to strengthen the central bank's operational autonomy and accountability. While Nepal's external position in FY2017/18 was moderately weaker than that consistent with medium-term fundamentals and desirable policies, Directors expected that the proposed tightening of policies would help strengthen the external position.

To temper excessive credit growth, Directors encouraged a strengthening of macro-prudential policies alongside an acceleration of financial sector reforms. They concurred that banks should be encouraged to build additional capital and provisioning buffers against potential losses, and financial sector oversight and regulations should be further strengthened. Directors encouraged the authorities to continue implementing the 2014 FSAP recommendations, and strengthening the AML/CFT regime in line with international best practices.

Directors welcomed the authorities' efforts to strengthen competition, generate a more conducive environment for investment, and reduce corruption. They called for swift implementation of the structural reform agenda, including revising public procurement laws and easing obstacles to firm entry and operations. Directors emphasized that increasing foreign direct investment, strengthening governance and institutions, and enhancing access to finance, particularly for the underserved population outside major cities, remain top priorities.

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

APPROVAL: April 7, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. ***The authorities are more optimistic regarding the near and medium-term growth outlook targeting to reach double digit growth. Could staff comment on this difference in assessment?***

- As highlighted in Box 1 of the staff report, Nepal's economy is poised to benefit from a persistent growth acceleration under the baseline scenario, supported by improvements in electricity supply and structural changes already underway—this is a relatively rare and noteworthy feat. However, the analysis in the Box also demonstrates that sustained growth at even 8 percent would put Nepal among exceedingly rare company, featuring a growth acceleration similar to that of China in the 2000s. In staff's view, it will take time to establish the structural preconditions to support substantially stronger growth on a sustained basis.

2. ***A considerable portion of the Nepalese labor force is currently abroad. This could have a direct consequence, not only for the country's productivity, but also its competitiveness. Staff's comments would be welcome.***

- The decision by many Nepali workers to seek employment outside of the country reflects a relative scarcity of employment opportunities at home. While this is an optimal response for these individuals, and one which serves to support the trade deficit through an inflow of remittances, it does carry a productivity cost.

- Inflows of remittances are typically associated with an appreciation of the real effective exchange rate. Implementation of the recommended structural reforms should create more employment opportunities at home, including by raising Nepal's productivity and thereby its competitiveness.

Fiscal Policy

3. ***We commend the authorities for their achievements in term of domestic revenue mobilization which have been supported by well-designed policies and ambitious revenue administration reforms. Is there any lesson to be drawn from this success for the benefit of other low income countries?***

- As highlighted in the context of the Domestic Revenue Mobilization Pilot in Annex II of the 2017 Article IV staff report, tax policy improvements and sustained efforts to strengthen tax administration and enforcement, including with support from technical assistance, have been important drivers of rising tax revenue in recent years. The strong growth of revenue has also been facilitated by rapid growth of the tax base, including rising imports financed from remittances.

4. ***Could staff elaborate on the expected impact on revenues of the envisaged introduction of the unified tax code, as well as of the measures envisaged in the recently released Inland Revenue Management Second Strategic Plan?***

- The unified tax code is expected to help consolidate and harmonize the main domestic taxes under one piece of legislation, which should help reduce compliance costs and create a more business-friendly environment.

- The Inland Revenue Management 2nd Strategic Plan (2018/19-2022/23) lays out the framework for reform of tax policies, as well as to enhance taxpayer services and education, improve enforcement mechanism, and strengthen institutional capacity and governance. The plan establishes the key performance indicators as the following.

Performance indicators	Target of 1st Strategic Plan (2012/13-2016/17)	Performance in 2016/17	Target of 2nd Strategic Plan (2018/19-2022/23)
Tax revenue/GDP	18 percent	21 percent	25 percent
Income tax/GDP	5.5 percent	5.7 percent	7 percent
VAT/GDP	5.6 percent	6.2 percent	9 percent
Excise tax/GDP	3.2 percent	3.3 percent	5 percent
Numbers of taxpayer			3 million

- All-in-all, staff projects tax revenue to rise by about 1 percent of GDP over the medium term.

5. ***While Nepal has very low debt, there is potential for significant public spending on large infrastructure projects that may have low economic return. What is the staff assessment of this issue? Can staff comment on the authorities' approach to ensuring such projects are value for money?***

- In staff's view, infrastructure development is key for Nepal's sustainable growth. To improve the efficiency of infrastructure investment, infrastructure development projects should be prioritized. Immediate actions should focus on establishing proper planning, selection, public procurement and implementation of major capital projects. Overall public financial management at both center and subnational levels should also be strengthened.

6. ***Have staff held substantive discussions on capacity gaps and how they can be addressed?***

- The Fund has supported significant capacity development in Nepal. The recently established South Asia Regional Training and Technical Assistance Center (SARTTAC) provides additional capacity for technical assistance and training to Nepali officials. However, training outcomes, as proxied by learning gains and absolute post-training test scores, have been weaker for Nepali officials than for peers.

- In the context of the mission, staff discussed ways in which the authorities could make better use of the available technical assistance and training. Allowing specialized officials (e.g. bank supervisors, tax inspectors, statisticians, etc.) to stay in their positions for more extended periods would help sustain capacity-development efforts. In addition, authorities could do more to select officials for various training courses on the basis of matching job responsibilities with course offerings. And TA recommendations should be implemented expeditiously.

7. ***Could staff elaborate on the technical assistance being provided to Nepal to enhance the authorities' capacity to strengthen the implementation capacity of fiscal policies at the sub-national level?***

- The Fund alongside other development partners have provided significant support to strengthen the implementation capacity of fiscal policies at the sub-national level. In 2018, SARTTAC provided technical assistance related to strengthening fiscal reporting, budget formulation, and government statistics training, where these TAs were tailored to the new fiscal federalism structure. In addition, development partners are heavily involved in providing support for the transition to fiscal federalism, for instance, World Bank's DPCs to support fiscal federalism and PFM, DFID program to support capacity building and strengthen institutions for new local governments, UNDP program to support capacity building of provincial governments, ADB program to support policy and institutional reforms to operationalize fiscal federalism.

8. ***We would be interested to have staff feedback on how the new debt sustainability framework has been applied, whether it helped the dialogue with the authorities, notably regarding data coverage issues. We would also be interested to know how staff plans to support the authorities in improving data collection and reporting***

- Debt management capacity remains weak. The authorities are in the process of establishing a designated Debt Management Office, with assistance from the ADB and World Bank. This should allow for more focused capacity building, including technical assistance in the application of the new DSA framework.

Monetary Policy

On central bank independence

9. ***Since concerns about the NRB's autonomy were already raised in the 2014 Financial Sector Assessment Program (FSAP), we would welcome more detailed information from staff about the authorities' efforts and progress thus far.***

10. ***Can staff highlight which other aspects included in the 2014 FSAP should be given priority in order to boost central bank autonomy?***

- 2014 FSAP highlighted NRB independence is compromised and its accountability limited by the fact that almost all NRB board members are directly appointed by the government of Nepal without parliamentary approval, as well as a representative from the ministry of finance which by itself does not favor the independence and governance of the NRB.

- The staff report for the 2017 Article IV consultation highlighted that amendments to the NRB Act in 2016 have further weakened the bank's autonomy. The amendments now oblige the NRB to follow "government directives regarding currency, banking and finance". The legal framework also needs to be modernized in other areas, such as governance and accountability.

- In staff's view, amending the NRB Act should be a top priority. The objective should be to ensure operational autonomy.

11. ***We would appreciate staff comments on the differences of views with the authorities regarding the monetary stance.***

- Staff views the stance of monetary policy as too accommodative for the current cyclical position of the economy (operating above its productive capacity), inconsistent with the medium-term sustainability of the exchange-rate peg vis-à-vis India (where, for example, the interbank rate is currently 6.25 percent). The accommodative stance is contributing to the buildup of macroeconomic imbalances, jeopardizing medium-term prospects. The authorities emphasized the need for accommodative monetary policy to boost growth, while maintaining financial stability.

12. ***Could staff comment on why the authorities decided to allow interest rates to fall below the interest rate corridor instead of managing to hold the rates at a lower bound?***

- Strong growth is needed to lift Nepal out of poverty—this is a clearly stated policy priority by authorities, and one policy lever being invoked to pursue strong growth is accommodative monetary policy. While low interest rates can deliver strong growth in the short term, staff have flagged that growth driven by low-cost credit leads to a buildup of risks and macroeconomic imbalances, jeopardizing medium-term prospects.

13. ***On the central bank's lender of last resort policy, we take note of the staff's recommendation that this needs to be further clarified and aligned with standard central bank practices. Could staff elaborate more on what challenges the current policy has and what actions the authorities should take?***

- The 2014 FSAP highlighted weaknesses to Nepal's crisis management framework, particularly with respect to the emergency liquidity assistance (ELA). Specifically, the legal framework for ELA is not clear about its modalities and does not include statutory safeguards for the Nepal Rastra Bank (NRB). Therefore, the ELA provisions in the NRB Act should clarify its exceptional nature and provide the NRB with adequate safeguards, that address eligible institutions, a solvency requirement, collateral, maturity, and provide for enhanced supervision. To date, the NRB Act Amendment extended the tenure for refinancing and lender of last report facilities from 6 months to 1 year. The modernization of the ELA framework is under consideration in the NRB's workplan with expected completion by end-FY2018/19 (Annex IV of staff report).

On interest rates

14. ***We see merit in staff advise for the NRB to resume using its IRC, by actively mopping up excess liquidity when needed and bringing interbank rates back towards the mid-point of the target range. Staff comments are welcome on whether there are any overarching factors which hinder its swift implementation.***

15. ***Could staff elaborate more on the motivations behind this government's directive? Also, while interest rates remain low in Nepal, do staff think that pressure exists from the government to maintain low interest rates?***

- Building on extensive technical assistance from MCM and SARTTAC, the interest rate corridor (IRC) was implemented quite successfully on a sustained basis from approximately mid-November of 2017 through mid-July of 2018. As such, staff have no reason to believe that there are any technical or capacity-related impediments at the Nepal Rastra Bank which would prevent the swift resumption of adherence to the IRC.

On the exchange rate regime

16. ***We would like to hear from staff on the merit and demerit for Nepal to maintain the exchange rate peg to the Indian rupee. What is the motivation for sustaining the peg to Indian rupee, while core inflation co-movement between India and Nepal is limited?***

17. ***Concerning the exchange rate regime, could staff elaborate on the adequacy of the current peg to the Indian rupee and whether a transition to a more flexible regime is desirable in the medium term.***

18. ***Staff comments are welcome on the rationale and appropriateness of the current exchange rate peg to the Indian rupee***

- Nepal is well served by the existing exchange-rate peg vis-à-vis India, a country with which Nepal is highly economically integrated (e.g. about 2/3 of total imports come from India and there is a substantial presence of Nepali migrant workers in India)—the peg is well-understood and relatively easy to administer.

- Even if a move to a more flexible exchange rate regime were appropriate, the pre-conditions for moving away from the peg are not currently in place. As partly discussed in a recent MCM TA report (August 2014), before considering moving towards a flexible exchange-rate regime, Nepal would first need to strengthen the transmission of monetary policy. This would include steps to adhere to the interest-rate corridor, and strengthen this mechanism over time.

19. ***Can staff assess the share of transactions nominated in Indian Rupees, USD and other currencies in Nepal's external transactions including remittances? Would a peg to a basket of currencies serve the Nepalese economy better?***

- Nepal's external transactions mainly comprise trade and remittances flows. Trade transactions are largely nominated in Indian Rupees, given trade with India accounts for about two-third of total trade flows. Remittances inflows are mainly from the Gulf countries (Qatar, Saudi Arabia, UAE, Kuwait), where most of these transactions may be nominated in US dollars among others.

Data as of 2017/18	Trade (Share of total)	Remittances 1/ (Share of total)	Trade and Remittances (USD million)	Trade and Remittances (Share of total)
India	65	15	9,267	47
Others	35	85	10,639	53
Total	100	100	19,906	100
Flows (USD million)	12,682	7224	19,906	

Sources: NRB, World Bank's Migration and Remittances Data

1/ Bilateral Remittance Estimates for 2017 using Migrant Stocks, Host Country Incomes, and Origin Country Incomes (millions of US$)

- As noted above, Nepal is well served by the existing peg to the Indian rupee because of the strong economic ties. As highlighted in an MCM TA report (August 2014), a basket peg would be just as rigid (from an economic stabilization perspective) as the current bilateral peg to the Indian rupee, but would be more opaque.

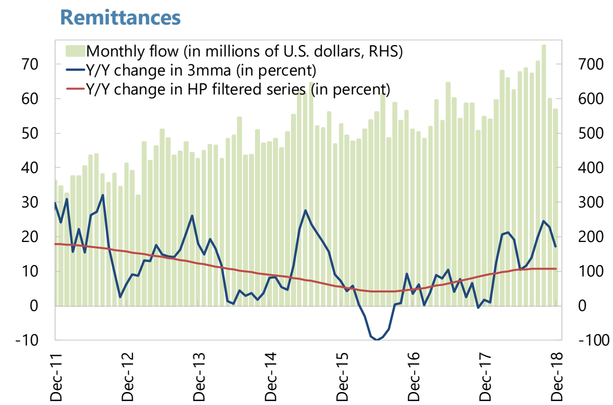
20. ***We look forward to a timely update from staff on the recent foreign exchange measures and how they fit into the Institutional View, the macroprudential policy framework, and Article VIII, noting that there is also an existing Article VIII restriction on the limit on the conversion and transfer to foreign currency of salaries of some non-residents. Given that one of the measures is simply a change to an existing facility, could staff offer up their initial views?***

- While Staff is assessing the recent measures, our preliminary view is that the steps taken are consistent with Nepal's obligations under Article VIII and the *Institutional View on Liberalization and Management of Capital Flows*. The higher limit on bank borrowing from abroad is considered a step in the direction of liberalizing capital inflows. Overall, these measures will likely have a small impact and can be seen mostly as signaling efforts to curtail the balance of payment pressures.

External sector

21. ***We would appreciate if staff could explain the assumptions supporting these optimistic projections for this crucial source (remittances) of external reserves?***

- The projections for the growth of remittances take into account the latest available information, WEO assumptions related to oil prices, and growth projections for GCC countries. In particular, for the first five months of FY2018/19, remittances inflows surged by 19 percent (see chart), and despite a decline in number of Nepali workers going for foreign employment. This strong growth of remittances inflows was mainly due to (i) government efforts to control informal trade and financial transactions as well as other effective measures including improved customs management as mentioned in the authorities' BUFF and Annex III of the staff report, and (ii) Nepalis living abroad sending more money as the US dollar appreciated. The growth of remittances is projected The US$-value of remittances is projected to expand by 17.6 percent in FY2018/19, and by about 6 percent per annum over the medium term, which is below the average annual growth seen in recent years.



Sources: Nepali authorities; and IMF staff estimates.

Financial sector

22. ***Since Annex IV shows that many high-priority FSAP recommendations have not yet been implemented, staff's more detailed elaboration on the reasons behind slow progress would be welcome, in particular, taking into account that the authorities seem less concerned about the financial sector risks.***

- A number of factors accounts for the slow progress in implementing the high-priority FSAP recommendations. Capacity issues, including frequent staff rotation in the government and central bank, continue to be a key obstacle. However, the authorities have been making good use of the services of the resident advisor for banking supervision who is backstopped by MCM. She is assisting the authorities with the implementation of risk-based banking supervision. With assistance from DfID, the central bank is also in the process of putting in place a Supervisory Information System. Increased central bank autonomy could help with strengthening banking supervision and enforcement with a view to improve financial stability and make financial sector oversight more effective.

23. ***What assessment have staff made of borrowing costs in Nepal: are borrowing costs high? If so, what is driving high costs? Does this reflect high financing costs for banks, or other issues such as low competition?***

- With private sector credit growing by 24 percent in December (y/y), borrowing costs are likely not prohibitively high. Further, we note that surveys indicate that Nepal's business climate is relatively challenging, and that factors other than borrowing costs are considered more problematic obstacles for private-sector activity. These include substantial tax-compliance administrative burden, weak contract enforcement, and getting electricity—however, with the recent elimination of load shedding, the latter should become less problematic in coming years.

24. ***The large inflows of remittances and the large credit expansion are correctly linked in the report to the unsustainable rise in land and real estate prices. Are staff able to comment on any macroeconomic or financial stability implications from these price rises, including any policy recommendations for addressing the issue?***

- An important share of bank lending is channeled to the real estate sector. Overdrafts and working capital loans collateralized by land and real estate represent another important category of bank loans. Anecdotal evidence points to rapidly rising land and real estate prices. This raises concerns about the quality of lending and underlying risks in the banking system. As described in the staff report and SIP, a negative shock to real estate prices and a broader economic slowdown could cause a deterioration of asset quality. This underscores the importance of tightening macroprudential policies, build up buffers against potential losses, strengthen financial sector oversight and banks' risk management practice, and upgrade the crisis management framework and financial infrastructure.

25. ***We would appreciate if staff could provide the rationale behind the increase in the limit on commercial banks' foreign exchange borrowing from foreign banks referred to in paragraph 7 of the report.***

- An increase in the limit on commercial banks' foreign exchange borrowing is considered a step in liberalizing capital inflows. The authorities noted during the mission that the increase in the limit was partly driven by the request from banks and an international financial institution to be able to channel foreign funds for developmental projects.

Structural reforms

26. ***While staff noted that the new labor law is well-intended, they also noted that it may disproportionately impact smaller businesses. In staff's view, what possible measures can the authorities adopt to mitigate possible unintended adverse impacts and avoid a shift to the informal sector?***

- The authorities could implement policies that reduce the cost of doing business for smaller businesses. As noted in the World Bank's recent report '*Doing Business 2019: Training for Reform*,' tax compliance is costly for businesses in Nepal—this is likely especially the case for smaller businesses, where expertise may be more limited and tax administration takes up a greater share of work time. The implementation of an e-filing platform, currently under consideration by Nepal's tax authorities, could facilitate compliance for businesses, and thereby lessen the shift towards informality.

27. ***We note, however, that the (SIP) report did not highlight the most recent changes in key socioeconomic indicators (i.e. unemployment and poverty rates), therefore could staff shed some light on those indicators especially in the aftermath of the 2015 earthquake?***

- As shown in in the United Nations' most recent Human Development Report (2018), Nepal's Human Development Index has improved (albeit very gradually) in recent years, even following the 2015 earthquake. For example, the share of Nepal's working poor (defined by the report as the proportion of employed people who live on less than $3.10 per day, in PPP terms) stood at 32.6 percent in 2017, slightly improved from the 2015 estimate of 34.4 percent.