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Nepal—Assessment Letter for the World Bank

April 27, 2020

This note provides the IMF staff's assessment of Nepal's macroeconomic conditions, prospects, and policies, based on available information as of April 19, 2020. The assessment has been requested in relation to the Second Programmatic Energy Sector Development Policy Credit to Nepal to be considered by the World Bank in May 2020.

I. Recent Developments, Outlook and Risks

Nepal's near-term growth outlook is being negatively impacted by the COVID-19 pandemic and related containment policies. Nepal's strong growth performance in recent years (7.1 percent in FY2018/19) has been supported by a stable political environment, a more reliable electricity supply, and post-earthquake reconstruction spending. However, the COVID shock is expected to derail the high growth momentum and severely impact both the last quarter of FY2019/20 and the first quarter of FY2020/21 (fiscal year starts in July 16). Remittances (mainly from Gulf Cooperation Council countries, India, and Malaysia) have contracted, tourism has collapsed, and domestic activities have dropped due to containment measures that include a nationwide lockdown and border closures. Staff expects growth to be 1 percent in FY2019/20 (compared to 6 percent in the pre-pandemic baseline) and 3.5 percent in FY2020/21 (compared to 5.7 percent in the pre-pandemic baseline). Inflation is expected to reach 7.5 percent by July 2020, as the pressure on food prices continues due to disruptions to imports and food production. The current account deficit is expected to widen to 7.6 percent of GDP (compared to 5.2 percent of GDP in the pre-pandemic baseline). An increase in health spending, economic support measures, and revenue shortfalls would widen the overall fiscal deficit to 7.2 percent of GDP in FY2019/20.

The COVID-19 shock has given rise to an urgent external financing need of 3.0 percent of GDP and a fiscal financing need of 2.6 percent of GDP in FY2019/20. The authorities are actively seeking budget support from development partners to fill these gaps. In the absence of additional budget support in 2020, the remaining fiscal financing gap will be closed either with additional domestic financing or with rationalization of expenditures. Any remaining external financing gap will be closed with a drawdown of gross official reserves, entailing a loss of 6 percent of reserves. Reserve coverage would nonetheless remain adequate at about 7 months of prospective imports because of subdued import levels. Nepal must preserve its foreign reserves in these uncertain times to protect the credibility of the exchange rate peg, to prepare in case of further weakening of remittances, and to maintain buffers in case other possible risks materialize (including natural disasters).

Downside risks to the outlook are substantial. The depth and duration of the current external shock is highly uncertain. Current projections are based on a global scenario anticipating a sharp contraction in activity in CY2020Q2, and a modest recovery taking hold thereafter. However, there is a significant risk that containment measures could remain in place for longer in Nepal or abroad—for example, through early 2021—in which case disruptions to Nepal's domestic activity, remittances, and tourism would result in a larger and more protracted balance of payments and fiscal financing needs. In addition, if the external and fiscal financing gaps identified in this report cannot be filled, growth would be weaker than in the baseline, as there would be less support to the economy. An abrupt slowdown in deposit growth, emanating from the fall in remittances related to the COVID-19, could create liquidity strain in the banking system and expose loan portfolio weaknesses. The other risks identified in the 2020 Article IV consultation remain relevant, in particular natural disasters (flooding and landslides).

II. Policy Response and Settings

Fiscal policy

The government has taken actions to counter the effects of the pandemic. Health spending has increased, including to import additional medical supplies, provide additional incentive pay and insurance to front-line medical personnel, and set up quarantine centers and temporary hospitals. Social assistance is being strengthened by providing those most vulnerable with daily food rations, subsidizing utility bills for low-usage customers, and taking measures to partially compensate those who suffer job loss. In the current volatile and uncertain environment, the authorities have adequate focus on the immediate response measures and the need to prioritize the health sector and strengthening social assistance.

Nepal continues to be assessed at low risk of debt distress for both the external and overall public debt, unchanged from the assessment in the February 2020 Joint Bank-Fund Debt Sustainability Analysis (DSA). A preliminary staff update of the DSA—in response the authorities' request for financing under Rapid Credit Facility—assesses debt sustainability with the COVID-19 pandemic as the new baseline. Even under this new baseline and stress tests, all debt and debt service indicators are projected to be well below their indicative threshold values. Nonetheless, Nepal's public debt is projected to gradually increase over the medium-term owing to continuing fiscal and current account deficits. This underscores the importance of further efforts to improve domestic productivity and competitiveness and to enhance monitoring of risks related to contingent liabilities.

Going forward, the priority remains to protect fiscal sustainability while containing external and domestic pressures. It is also key to continue to make improvements in public financial management practices while carefully managing the transition to fiscal federalism. The authorities have indicated their commitment to maintaining fiscal discipline, managing expenditure closely to keep the deficit in check. Once the effects of the pandemic have subsided, an enhanced commitment to fiscal consolidation will be needed to protect fiscal sustainability, which would be facilitated by the expiry of the temporary support programs. Revenue collection will continue to be enhanced by upgrades to the tax system, especially tax administration. Efforts are underway to eliminate duplication of spending across levels of government, and to improve the public procurement process. Further measures would strengthen capital-spending execution rates and smooth its annual profile.

Monetary and Financial Policy

In response to the pandemic, the Nepal Rastra Bank (NRB) is taking actions to support financial sector stability and access to credit. To ensure adequate liquidity in the financial system, reserve requirements and the interest rate on the standing liquidity facility have been lowered. To support borrowers, the size of the refinancing facility has been increased to provide subsidized interest rates to banks willing to lend to priority sectors, including small and mid-size enterprises affected by the pandemic. The NRB is no longer requiring banks to build up the 2 percent countercyclical capital buffer that was due in July 2020 and financial institutions will not be penalized for their non-compliance with regulatory and supervisory requirements in April. To minimize moral hazard issues, the NRB should clearly communicate that banks are expected to continue to comply with regulatory requirements and, in case of a breach, banks should restore compliance in a timely manner.

Over the medium-term, the NRB needs to continue to strengthen the monetary policy framework. Reducing volatility in short-term interest rates will support financial market development and improve policy signaling and transmission. Steps need to be taken to improve the autonomy and accountability of the central bank, including by updating human resource management to facilitate staff capacity development. On the financial sector, the NRB needs to continue to implement macroprudential measures to limit the buildup of systemic risk in the financial sector while taking actions to further strengthen bank supervision and regulation, including close monitoring of the asset quality of banks.

Macrostructural Issues

To raise growth prospects over the medium-term, there is an ongoing need to strengthen the investment climate in Nepal. This includes implementing structural reforms that encourage high-quality public- and private-sector investment projects, in particular FDI. New legislation and regulations need to be supported by an enabling implementation environment. Moving high-quality projects forward in a timely manner will require adequate staffing, better skills matching, and aligning incentives across and within Ministries. Regarding public procurement, recent reforms—including a reduction in the up-front project mobilization grant size, more stringent scrutiny of bidding contractors' capacity to deliver, and the introduction of a project pipeline—go in the right direction. However, the ultimate enforcement of these regulations, and project monitoring more generally, lies with the Public Procurement Monitoring Office, which requires more staff with expertise in procurement and contract monitoring.

III. IMF Relations

Surveillance. The 2020 Article IV consultation was concluded on March 17, 2020, based on policy discussions in Kathmandu from January 5-17, 2020, before the COVID-19 shock.

Financial support. Nepal has requested financing under the Rapid Credit Facility to support its COVID-19 response. Nepal received grants for relief on IMF debt service under the Catastrophe Containment window of the Catastrophe Containment and Relief Trust for US$3.9 million.

Capacity development. The Fund provides technical assistance and training from headquarters, SARTTAC, and the Singapore Training Institute, as well as a MCM long-term financial sector expert based in Kathmandu.

Table 1. Nepal: Selected Economic Indicators, 2016/17-2021/22 1/

Population (2018, est. million): 28.1
Quota: 156.9 million SDR
Main exports (2017): Textiles and other manufactured goods, food items
Key export markets (2017): India, U.S., Turkey

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
			Est.		Projections	
Output						
Real GDP growth (percent)	8.2	6.7	7.1	1.0	3.5	6.5
Prices						
Inflation (period average, percent)	4.5	4.1	4.6	6.7	6.5	5.8
Inflation (end-year, percent)	2.7	4.6	6.0	7.5	6.0	5.6
General government finances (percent of GDP)						
Total revenue and grants	24.1	25.3	26.0	24.0	25.2	25.2
of which: tax revenue	20.7	21.1	21.9	20.0	21.0	21.0
Expenditure	27.2	31.9	30.6	31.2	31.8	29.9
of which: current expenditure 2/	19.4	23.0	23.6	25.1	24.8	23.1
capital expeniture	7.8	8.9	7.0	6.1	7.0	6.8
Fiscal balance	-3.1	-6.7	-4.6	-7.2	-6.6	-4.7
Public debt	26.1	30.2	30.1	38.0	42.4	43.8
Money and credit						
Broad money (percent change)	15.5	19.4	15.8	8.6	11.4	12.7
Domestic credit (percent change)	20.2	26.1	21.7	16.0	17.5	14.6
Credit to private sector (percent change)	18.0	22.3	19.1	11.5	13.3	12.8
Balance of payments						
Current account (percent of GDP)	-0.4	-8.1	-7.7	-7.6	-7.1	-5.7
Trade balance (percent of GDP)	-33.5	-37.4	-37.1	-30.2	-30.3	-29.0
Remittances (percent of GDP)	26.0	24.9	25.3	18.7	19.1	18.5
Reserves (months of prospective imports)	8.3	7.9	8.2	7.2	6.0	5.2
Public external debt (percent of GDP)	15.5	17.3	17.0	20.6	20.8	20.7
Exchange rate						
Exchange rate (Nepali rupees/US$; period average)	106.2	104.4	112.9	…	…	…
Real effective exchange rate (period avg., y/y percent change)	3.6	0.2	-1.4	…	…	…

1/ Fiscal year ends mid-July.
2/ Current expenditure includes transfers to subnational governments which can be used for capital expenditure.

Note: Forecast as of April 15, 2020