

**EXECUTIVE
BOARD
MEETING**

EBS/20/84
Correction 1

May 4, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Nepal—Request for Disbursement Under the Rapid Credit Facility**

Board Action: The attached corrections to EBS/20/84 (4/30/20) have been provided by the staff:

Evident Ambiguity **Pages 5 and 7**

Additional Information: Corrected to remove duplicate paragraphs.

Questions: Ms. Jaramillo Mayor, APD (ext. 39946)

- *Trade services.* Lock down measures implemented by neighboring countries and the nationwide restrictions on movement have significantly disrupted international and domestic trade.

5. Growth would fall sharply in FY2019/20, with a deterioration in the fiscal and external accounts (Text Table 1):

- Growth in FY2019/20 (July 16, 2019 to July 15, 2020) would fall to 1 percent (5 percentage points below the pre-pandemic baseline) and 3.5 percent in FY2020/21 (compared to 5.7 percent in the pre-pandemic baseline), as the COVID-19 shock in recent months derailed the growth momentum observed in the earlier part of the FY.
- Inflation is expected to reach 7.5 percent by July 2020 (end-FY2019/2020), as the pressure on food prices continues due to disruptions to imports and food production.
- An increase in health spending, economic support measures, and revenue shortfalls would widen the overall fiscal deficit by 2.7 percent of GDP to 7.2 percent of GDP in FY2019/20. Revenue losses are estimated at 1.8 percent of GDP, of which 0.3 percent of GDP is due to active COVID-response measures. Higher healthcare costs and economic support measures would increase spending by 2 percent of GDP, but delays and reprioritization of capital expenditures would provide some offset (about 1.2 percent of GDP) (Text Table 2).
- The current account deficit is expected at 7.6 percent of GDP (compared to 5.2 percent in the pre-pandemic baseline) due to the sharp drop in remittance inflows and tourism receipts, even as imports decline.³

6. Based on the above, an urgent external financing need of 3.0 percent of GDP in FY2019/20 has emerged (Text Table 2). In parallel, the fiscal financing need is 2.6 percent of GDP. The external gap results from a worsened current account deficit of 7.6 percent of GDP and weaker capital and financial account surplus of only 4.5 percent of GDP (due to lower direct investments and bilateral loans), compared to the recent Article IV consultation. The wider fiscal deficit of 7.2 percent of GDP would be financed by 2.1 percent of GDP of previously identified (pre-COVID) external financing and 4.1 percent of GDP of domestic financing, leaving a 2.6 percent of GDP financing gap.⁴

~~**7. Based on the above, an urgent external financing need of 3.0 percent of GDP in FY2019/20 has emerged (Text Table 2).** In parallel, the fiscal financing need is 2.6 percent of GDP. The external gap results from a worsened current account deficit of 7.6 percent of GDP and weaker capital and financial account surplus of only 4.5 percent of GDP (due to lower direct investments and bilateral loans), compared to the recent Article IV consultation. The wider fiscal deficit of 7.2 percent~~

³ Lower global oil prices provide some offset to external pressures by lowering Nepal's import bill, but negatively impact remittances received from workers in oil-producing countries.

⁴ Financing gap takes into account net acquisition of financial assets (-1.6 percent of GDP).

of GDP would be financed by 2.1 percent of GDP of previously identified (pre-COVID) external financing and 4.1 percent of GDP of domestic financing, leaving a 2.6 percent of GDP financing gap.⁵

8.——Based on the above, an urgent external financing need of 3.0 percent of GDP in FY2019/20 has emerged (Text Table 2). In parallel, the fiscal financing need is 2.6 percent of GDP. The external gap results from a worsened current account deficit of 7.6 percent of GDP and weaker capital and financial account surplus of only 4.5 percent of GDP (due to lower direct investments and bilateral loans), compared to the recent Article IV consultation. The wider fiscal deficit of 7.2 percent of GDP would be financed by 2.1 percent of GDP of previously identified (pre-COVID) external financing and 4.1 percent of GDP of domestic financing, leaving a 2.6 percent of GDP financing gap.⁶

9.—7. Fund financing under the RCF will make a substantial contribution to filling the immediate balance of payments needs. Direct disbursement to the Treasury will allow the authorities to address 26 percent of the fiscal financing needs and 22 percent of the external financing gap in FY2019/20. IMF debt relief provided under the Catastrophe Containment and Relief Trust (CCRT) (SDR2.85 million; US\$3.85 million) will also help to close the financing gap. The authorities are actively seeking additional budget support from development partners and the RCF is expected to play a catalytic role in this effort. So far, the World Bank has approved a \$29 million COVID-19 Emergency Response and Health Systems Preparedness Project and the Asian Development Bank is processing a pandemic response loan under the Countercyclical Support Facility for up to US\$250 million.⁷ As part of the G-20 debt relief initiative, the authorities also intend to request debt service reprofiling from official bilateral creditors (including export-import banks) over the period May 1 and December 31, 2020 to address immediate needs, which would free-up resources of up to US\$31 million for social, health or economic spending to respond to the COVID-19 pandemic. 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. As a result of the projected weakening in imports, reserve coverage would remain at about 7 months of prospective imports.⁸ Nonetheless, given the uncertainty about the duration and intensity of the Covid-19 shock, there is an urgent need for Nepal to preserve its foreign reserves 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).

⁵ Financing gap takes into account net acquisition of financial assets (-1.6 percent of GDP).

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⁷ In addition, the World Bank is reviewing its existing project portfolio to identify funds that can flexibly be allocated toward COVID19 response. The World Bank is: (1) re-aligning project design toward COVID19 relief and recovery activities through a Contingent Emergency Response Component embedded in projects as well as funds from partial project cancellations that go toward a stimulus or recovery package, overall estimated to be 15 to 18 percent of uncommitted project funds (or close to US\$300 million); and (2) aligning a series of upcoming Development Policy Credits (including on financial and fiscal policy reforms) to support COVID19 relief, recovery and resilience (US\$200 million).

⁸ The IMF's tool for assessing reserve adequacy in credit-constrained economies (ARA-CC) suggests that 4.2 months of prospective imports of goods and services is an adequate level of reserves (see IMF Country Report No. 20/96).