

MACROECONOMIC UPDATE NEPAL

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The views expressed in the *Macroeconomic Update* are those of the authors and do not necessarily reflect the views of the ADB, or its Board of Directors, or its member governments.

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ABBREVIATIONS

BFI	—	banks and financial institutions
CAR	—	capital adequacy ratio
CPI	—	consumer price index
FDI	—	foreign direct investment
FY	—	fiscal year
GDP	—	gross domestic product
MDG	—	Millennium Development Goals
NEA	—	Nepal Electricity Authority
NOC	—	Nepal Oil Corporation
NPC	—	National Planning Commission
NRA	—	National Reconstruction Authority
NRB	—	Nepal Rastra Bank
NRs	—	Nepalese Rupees
PDNA	—	post disaster needs assessment
PE	—	public enterprise
PRC	—	People's Republic of China
VAT	—	Value Added Tax

NOTE

- (i) The fiscal year (FY) of the Government ends on 15 July. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY 2016 ends on 15 July 2016.
- (ii) In this report, "\$" refers to US dollars.

Executive Summary

1. The catastrophic 7.8 magnitude earthquake on 25 April 2015 and subsequent multiple aftershocks, and the subnormal monsoon in the first half of the year slowed down economic activities in FY2015, resulting in gross domestic product (GDP) growth of 3.0%, down from the pre-earthquake growth estimate of 4.6%. The earthquake affected industrial and services sectors the most even though it hit in the tenth month of FY2015. Agricultural output growth dropped to an estimated 1.9% from the pre-earthquake estimate of 2.3%. The industry sector, which comprises a mere 15% of GDP, grew by an estimated 2.6% compared to the estimated pre-earthquake growth of 4.6%. Meanwhile, the earthquake-induced disruptions to main services activities lowered its growth rate by 2.1 percentage points from the estimated pre-earthquake growth of 6.0%. Looking forward, the outlook for FY2016 is cautiously optimistic and is largely contingent upon the scope and pace of post-earthquake reconstruction works. Considering the weak and subnormal monsoon so far, modest to fast pick up in actual implementation of reconstruction projects, political uncertainties, and modest recovery of key services activities, GDP growth is projected to be between 4.5% and 5.5%.

2. The sluggish expenditure in the first three quarters and damages caused by the earthquake in the last quarter of FY2015 significantly affected public expenditure performance. The budget execution delays, and long-running procedural as well as procurement hassles constrained absorptive capacities, resulting in slower capital spending than in the previous years. The estimated actual capital spending was 69.9% of planned capital expenditure in FY2015, lower than the 78.4% achieved in FY2014. Meanwhile, actual recurrent spending was 84.4% of planned recurrent expenditure, marginally lower than the 85.9% in FY2014. Overall expenditure grew by 13.0%, with recurrent and capital spending growth at 11.0% and 22.3%, respectively.

3. Total revenue grew by 13.8%, much lower than 20.5% growth in FY2014, reaching NRs405.8 billion

(19.1% of GDP). It is lower than the budget target of NRs422.9 billion as the slowdown in economic activities and imports following the earthquake in April hit revenue mobilization. As a share of GDP, tax revenue mobilization has improved significantly, reaching 16.8% in FY2015, up from 9.8% of GDP in FY2007. The continuous reforms in revenue administration, broadening of the tax base, and the higher import bill (mostly financed by remittance income) resulted in robust revenue performance over the last decade.

4. The lower than expected revenue mobilization along with the disappointing expenditure performance resulted in a fiscal deficit equivalent to about 0.2% of GDP in FY2015. Though this is better than the fiscal surplus equivalent to 0.7% of GDP in FY2013 and 0.6% of GDP FY2014, it is still lower than the medium-term average fiscal deficit of about 2.2% of GDP. For a low-income country with a large financing need to bridge the infrastructure deficit, particularly in hydropower and transport, running a modest fiscal deficit without jeopardizing fiscal sustainability is desirable. Nepal has been running a primary surplus since FY2012, meaning that fiscal balance before interest payment on public debt is positive. Nepal's overall outstanding public debt (external and domestic) has been steadily declining, reaching an estimated 25.6% of GDP in FY2015. The fiscal sustainability analysis shows that the government has ample fiscal space for now to increase productivity-enhancing public capital investment, including for reconstruction projects, without jeopardizing fiscal soundness.

5. Inflation (year-on-year [y-o-y] average CPI) sharply declined to 7.2% in FY2015, the lowest since FY2008 as both food and non-food prices cooled down. Food and non-food prices increased by 9.6% and 5.2%, respectively, in FY2015. They increased by 11.6% and 6.8%, respectively, in FY2014. Overall, while food prices contributed 5.3 percentage points to overall inflation, non-food prices contributed 2.7 percentage points in FY2015. Looking forward, the expected low agricultural harvest due to subnormal monsoon,

slightly higher price pressures in India, higher demand for reconstruction materials and workers, blockage of major trading routes with the PRC, and supply disruptions, including in distribution networks, as a result of the political strikes in various parts of the country will likely push up general prices of goods and services to between 8.5% and 9.5% in FY2016. Even after accounting for the high probability of subdued fuel prices throughout FY2016, if supply disruptions persist for long, then there is a high likelihood of even higher inflation, probably around 10%.

6. Money supply (M2) grew by 19.9%, reaching NRs311.8 billion, on the back of a robust growth of net foreign assets and net domestic assets. Deposit mobilization of bank and financial institutions (BFIs) increased by 20.1%, higher than 18.4% growth in FY2014. Total credit (loans and advances) of BFIs increased by 17.5% (NRs229.3 billion) in FY2015, up from 14.4% growth in FY2014 (NRs165.5 billion). The central bank mopped up excess liquidity throughout the year deploying a variety of instruments such as reverse repo and deposit auction. However, the frequent use of recurring short-term liquidity management tools amidst fluctuating interest rates throughout the year indicates that the existing liquidity management strategy is a temporary measure and for long term solution the investment climate has to be improved. The persistence of excess liquidity throughout the year pushed short-term interest rates mostly below 1.0%, although the rates were higher starting February 2015 compared to the corresponding period in FY2014. The commercial banks' have comfortably satisfied the capital adequacy ratio (CAR) and net liquidity requirements. CAR of commercial banks stood at 11.69%, which is 0.69 percentage points higher than the minimum 10% CAR and 1% buffer requirement.

7. The country's external situation strengthened in FY2014 with the balance of payment surplus reaching \$1.5 billion (6.8% of GDP). The large merchandise trade deficit, which reached 31.2% of GDP, was partially offset by workers' remittances, which reached a record 29.1% of GDP, and export (4.6% of GDP), resulting in a current account surplus

of \$1.1 billion (5.1% of GDP), up from 4.6% of GDP in FY2014. Gross foreign exchange reserves increased from \$6.8 billion in FY2014 to \$8.3 billion in FY2015, sufficient to cover 11.2 months of imports of goods and non-factor services. Overall, the Nepalese rupee depreciated by 19.9% between 15 July 2011 and 15 July 2012 and a further 6.7% between 15 July 2012 and 15 July 2013. It depreciated by 0.9% between 15 July 2013 and 15 July 2014, and a further 5.4% depreciation between 15 July 2014 and 15 July 2015.

8. This edition of *Macroeconomic Update's* issue focus discusses the importance and ways to accelerate post-earthquake reconstruction for faster recovery. The earthquake caused tremendous loss of lives and properties. It lowered economic growth rate, pushed about a million people below the poverty line, slowed progress on achieving some of the Millennium Development Goals (MDG), and sapped investors and consumer confidence. The cumulative pledges during the international reconstruction conference exceeded the expected public sector needs for reconstruction. Now, the National Reconstruction Authority and line ministries' ability to swiftly prepare and implement viable projects will underpin the scope and pace of reconstruction and ultimately a better, faster and smarter recovery. The authority needs to be operationalized without delay and it has to chart out a coherent five-year reconstruction strategy by aligning it with the long-term economic development vision.

9. Accelerated reconstruction would require hiring of competent human resources, preparing a time-bound investment action plan, a strong pipeline of viable projects, outsourcing of design, monitoring and evaluation, political buy-in of proposed actions, and engaging youth, specialized institutions, and civil society at various stages of the project cycle. This would then 'crowd in' private investment as well, leading to a higher, sustainable, and inclusive economic growth. Overall, rehabilitation and reconstruction should primarily aim at increasing productivity-enhancing public capital investment, which is a key to ensuring structural transformation whereby high value-added and high-productivity sectors are more dominant than low value-added and low-productivity sectors in the medium term.

MACROECONOMIC UPDATE

A. Real Sector

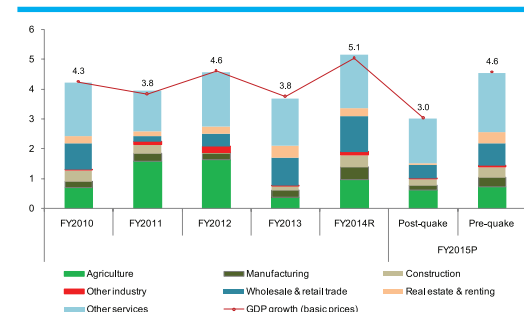
I. Performance in FY2015

1. Gross domestic product (GDP) is projected to grow by 3.0% in FY2015 as late and subnormal monsoon in the first half of the year, and the catastrophic 7.8 magnitude earthquake on 25 April 2015 and subsequent multiple aftershocks slowed down economic activities. The pre-earthquake GDP growth was projected to be 4.6%, down from 5.1% in FY2014 (Figure 1). The earthquake affected industrial and services sectors the most even though it hit in the tenth month of FY2015. The services sector contributed about seven-tenths of the GDP growth, largely coming from wholesale; retail trade, transport, storage and communication; and educational activities. The agriculture sector's contribution to the GDP growth stood at two-tenths and the industry sector contributed about one-tenth.

2. In the agricultural sector, which comprises almost 32% of GDP and provides livelihood to about 76% of households, growth dropped to an estimated 1.9%. As a result of the subnormal monsoon and flooding in the first half of FY2015, the pre-earthquake agricultural output was projected to be 2.3%, down from 2.9% a year before. However, the earthquake and aftershocks, followed by numerous landslides, destroyed livestock (leading to slowdown in dairy and meat output), and potato, barley and wheat output in the earthquake-hit districts, further chopping 0.4 percentage points off the projected growth rate. Consequently, agricultural output growth was 1.9%. In the absence of year round irrigation facilities and sporadic shortage of chemical fertilizers, unfavorable monsoon has been continuously sapping agricultural output since FY2013 (Figure 2). The earthquake-induced total gross value added loss in FY2015 was \$23.7 million in the agricultural sector. However, the total recovery needs is around \$156 million (0.7% of GDP).

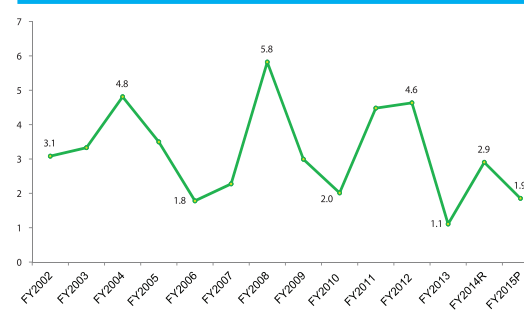
3. The industry sector, which comprises a mere 15% of GDP, grew by an estimated 2.6% compared to the estimated pre-earthquake growth forecast of 4.6%. Mining and quarrying growth declined by 3.4 percentage points from the pre-earthquake estimate of 4.5% because of the sharp drop in quarrying of stones, aggregates, sand and soil. Mining, which accounts for about 6% of mining and quarrying subsector, was not significantly affected by the earthquake. Meanwhile, manufacturing activities were also hit hard by the earthquake, chopping 2.2 percentage points off the estimated pre-

Figure 1: Supply-side contributions to growth, FY2010-FY2015¹



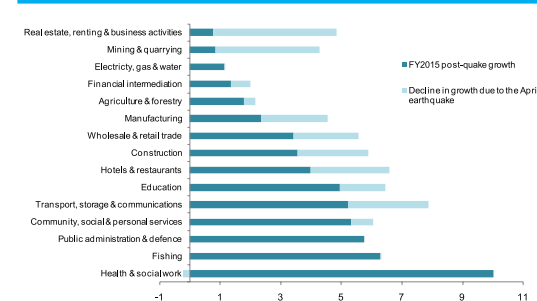
Source: Central Bureau of Statistics; NRM staff estimates

Figure 2: Agricultural output growth (% change)



Source: Central Bureau of Statistics

Figure 3: Sub-sectoral growth (% change)



Source: Central Bureau of Statistics

¹ R and P denote revised estimate and provisional estimate, respectively. Any reference to GDP for FY2014 and FY2015 in this *Macroeconomic Update* refers to revised and provisional estimates, respectively.

earthquake growth rate of 3.9% (Figure 3). Manufacturing activities, which accounts for a mere 6.8% of GDP, have been crippled by supply-side constraints (notably the lack of adequate electricity, adverse industrial relations, lack of capable human resources, and policy bottlenecks). The earthquake inflicted physical damage to industrial buildings, created labor shortage in industrial areas as workers left to their hometowns to take care of immediate family needs, and slowed down aggregate demand. Meanwhile, there was no significant damage to electricity, gas and water subsector. Construction activities were severely affected by the government's policy to temporarily halt construction of new buildings after the earthquake, and the decrease in production of construction materials. Consequently, this sub-sector grew by an estimated 3.6%, almost 2.3 percentage points lower than the pre-earthquake growth estimate. Overall, industrial output growth stood at 2.6% in FY2014, down from pre-earthquake estimate of 6.2% in FY2014 (underpinned by robust manufacturing and construction activities). Industrial output growth averaged 2.8% over FY2004-FY2013. The average capacity utilization of key industries remained at 51.3% in the first half of FY2015, slightly higher than the 49.9% capacity utilization recorded in the first half of FY2013². The earthquake-induced total gross value added loss in FY2015 was \$62.9 million in the industrial sector. However, the total needs for recovery is around \$641 million (3.0% of GDP).

4. The earthquake severely impacted services sector, which accounts for about 52% of GDP. It is a key driver of GDP growth and is propelled by remittance-induced consumption demand. Its growth rate has averaged 5.5% in the last decade. The earthquake-induced disruptions to main services activities lowered its growth rate by 2.1 percentage points from the estimated pre-earthquake growth of 6.0%. The deceleration of remittance inflows in the first three quarters of FY2015 had already cooled off service growth below 6.3% achieved in FY2014. The earthquake and subsequent aftershocks in the last quarter of FY2015 further dampened its growth to 3.9%. Real estate, renting and business activities saw the steepest decline in growth, by 4.1 percentage points to 0.8%, due to the substantially lower land and rent related transaction, particularly buying and selling, renting

Table 1: Sub-sectoral growth and share of GDP

Sub-sector	Growth		Share of GDP	
	FY2014R	FY2015P	FY2014R	FY2015P
Agriculture & forestry	2.8	1.8	32.9	32.5
Fishing	4.9	6.3	0.6	0.6
Mining & quarrying	5.4	0.9	0.4	0.4
Manufacturing	6.3	2.4	6.9	6.8
Electricity, gas & water	3.5	1.2	2.2	2.1
Construction	7.1	3.6	5.8	5.9
Wholesale & retail trade	9.0	3.4	13.2	13.3
Hotels and restaurants	6.8	4.0	1.8	1.8
Transport, storage & communications	8.3	5.2	10.4	10.6
Financial intermediation	3.7	1.4	4.0	3.9
Real estate, renting & business activities	3.6	0.8	7.9	7.7
Public administration & defence	5.0	5.8	1.8	1.8
Education	4.8	5.0	6.7	6.8
Health & social work	4.5	10.0	1.5	1.6
Community, social & personal services	4.8	5.3	4.1	4.2

Source: Central Bureau of Statistics

² Capacity utilization of key industries in FY2013 was 57.8%, the same as in FY2012. In FY2014, it averaged 59.3%.

and operation of self-owned or leased real estate; and renting of machinery, equipment and personal and household goods.

5. The sharp drop in tourist arrivals and the frequency of domestic and international flights led to a slowdown in air and land transport services, adversely impacting transport related value added transactions. Similarly, mechanized as well as non-mechanized transportation activities decreased due to the exodus of drivers and passengers from the main demand centers, including Kathmandu valley and district headquarters. Cumulatively, these factors decreased growth of transport, storage and communication activities by 2.7 percentage points to 5.2%. Meanwhile, the slowdown in tourism activities (both domestic and foreign) led to decline in hotel and restaurant business growth by 2.8 percentage points to 4%. Foreign visitor arrivals drastically slowed down, domestic tourism receded, and some hotels and restaurants partially to fully shut down operation due to the physical damage inflicted by the earthquake and subsequent aftershocks. The suspension of mountain climbing during its peak season for two consecutive years (deadly Everest avalanche in FY2014 and the earthquake-induced avalanche on April 2015) also hit its growth.

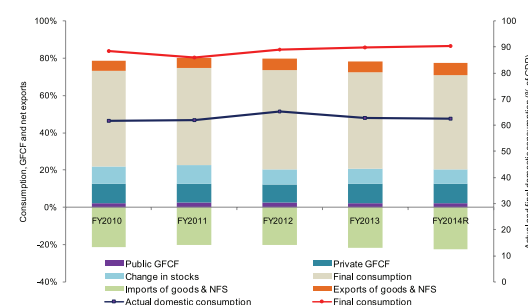
6. Wholesale and retail trade growth, which is the largest sub-sector save agriculture and forestry, decreased by 2.2 percentage points to 3.4% as agricultural and manufacturing output declined, and import growth slowed down immediately after the earthquake. Meanwhile, the disruptions to educational services provided by government, corporations and non-profit institutions, damage to physical assets likely lowered education sub-sector growth by 1.5 percentage points to 5%. Furthermore, the disruptions to banking and insurance related transactions in the earthquake-affected districts are estimated to lower financial intermediation growth by 0.6 percentage points to 1.4%. Community, social and personal services were marginally affected and its growth is estimated to drop to 5.3% in FY2015 from the no-earthquake growth estimate of 6.1%. Meantime, the scaling up of health services by public, private and non-profit institutions immediately after the earthquake resulted in health and social work sub-sector's growth of 10%, which is 0.2 percentage points higher than the growth rate projected in a no-earthquake scenario. The earthquake-induced total gross value added loss in FY2015 was \$230.5 million in the services sector. However, the total needs for recovery is around \$1.6 billion (excluding housing), which is about 7.5% of GDP.

7. The Central Bureau of Statistics (CBS) has not yet released GDP by expenditure³ estimates for FY2015. In FY2014, consumption accounted for an estimated 90.5% of GDP, up from 89.8% of GDP in FY2013 (Figure 4), indicating the increasing consumption demand stimulated by growing remittance income.⁴ Gross capital formation (alternatively gross investment) stood at an estimated 36.8% of GDP, contributed mostly by the increase in gross fixed capital formation (GFCF) from 22.5% of GDP in FY2013 to 23.0% of GDP in FY2014 despite a decrease in stocks from 14.3% of GDP in FY2013 to 13.9% of GDP in FY2014. Public and private GFCF were an estimated 4.7% and 18.3% of GDP⁵, respectively.

8. The public gross capital formation is rather low relative to the large investment needed to close the infrastructure financing gap (estimated to be between 8% and 12% of GDP annually until 2020). In the case of Nepal, private investment is initially contingent upon public capital investment in physical and social infrastructure, which ultimately spurs private sector investment by increasing returns. Furthermore, higher public spending is needed to boost economic growth by accelerating recovery, establish more sustainable growth patterns, generate aggregate demand quickly, and encourage technological innovation.⁶ Nepal needs both higher quantum (to close the infrastructure deficit) and higher quality of public investment (in productivity-enhancing activities such as infrastructure and human capital). Currently, Nepal's level of fixed capital investment is lower than the least developed country average (Figure 5). Short-term stabilization measures to accelerate growth by boosting public capital investment and long-term structural reforms to sustain the fundamentals required for higher and inclusive economic growth are needed.

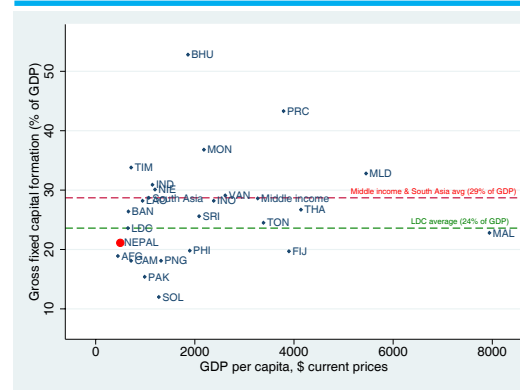
9. Despite an increase in exports, the high import demand—backed by high remittance income in the absence of domestically produced alternatives—further widened net exports, reaching an estimated negative 28.0% of GDP in FY2014 from 26.8% of GDP in FY2013. The increase in price competitiveness as a result of the weak currency pushed exports of goods and non-factor services to an estimated 12.1% of GDP, up from 10.7% of GDP in FY2013. Meanwhile, imports of goods and non-factor services increased to 40.0% of GDP in FY2014 from 37.5% of GDP in FY2013. The major factors affecting supply capacity and cost competitiveness of

Figure 4: Share of GDP by expenditure



Source: Central Bureau of Statistics

Figure 5: Investment and GDP per capita



Source: NRM staff estimates

³ The GDP by expenditure data are prone to measurement errors as change in stocks is computed residually, which also includes statistical discrepancy/errors. Change in stocks was estimated to be 13.9% of GDP in FY2014. A large residual indicates that a significant portion of the GDP is either unexplained or could not be directly attributed to its components, i.e. consumption, capital formation and net exports.

⁴ It may be noted that even though final consumption with respect to GDP is very high, the actual domestic consumption expenditure made up an estimated 62.5% of GDP in FY2014, down from 63.0% of GDP in FY2013 and 65.5% of GDP in FY2012. This is due to the surge in net exports (or export minus import) in FY2014, i.e. the consumption expenditure on imports of goods and non-factor services.

⁵ Even with these levels of investment, the impact on growth and employment is pretty nominal, most probably due to the inefficiency of investment management arising from the lack of efficiency-enhancing prerequisites related to physical and social infrastructures, and the inability to unwind expenditures in underperforming and unfeasible projects.

⁶ Also see: Spence, Michael. Why Public Investment? Project Syndicate. 20 February 2014.

exports sectors are: (i) lack of adequate and quality infrastructure; (ii) political instability and strikes; (iii) recurring labor disputes and low productivity; (iv) lack of skilled human resources; (v) deficient research and development investment and innovation in the private sector; and (vi) policy inconsistencies and implementation paralysis.⁷

10. Gross domestic savings declined to an estimated 9.5% of GDP from 10.2% of GDP in FY2013 and 14.0% of GDP in FY2011, indicating that a majority of the residents' income is spent on consumption, which is mostly fulfilled by imported goods. Meanwhile, the substantial increase in gross national savings—from 40.2% of GDP in FY2013 to an estimated 46.1% of GDP in FY2014—reflects the record high remittance inflows, which reached 28.0% of GDP in FY2014 (Figure 6). It has also contributed to a positive savings-investment gap⁸ (an estimated 9.4% of GDP in FY2014) in the last three consecutive years. Furthermore, reflecting the high per capita remittance inflows, nominal per capita gross national disposable income reached an estimated \$981.6 from \$923.7 in FY2013. Per capita gross national income (GNI) stood at \$727.9 in FY2014. The CBS estimated that per capita GDP decreased by \$23 in FY2015 (reaching \$762) due to the economic disruptions caused by the earthquake. The size of Nepal's economy expanded to an estimated \$21.2 billion in FY2015, up from \$19.7 billion in FY2014.

II. Investment

11. *Domestic investment commitment:* Following the remarkable 142% increase in total domestic capital investment (fixed plus working capital) commitment in FY2014, domestic investment commitment decreased by 54.1% in FY2015 as the earthquake dampened investors' confidence in construction and energy sectors. In previous years, steadily increasing domestic investment commitment was driven by the high investment in energy sector. Domestic investment commitment in energy sector increased by 158.5% in FY2014, but decreased by 62.9% in FY2015. Similarly, investment commitment for new construction projects decreased by 96.5%. Overall, of the total investment commitment of NRs132.9 billion in FY2015, 62.5% was in the energy sector, followed by tourism (16.1%), manufacturing (13.1%), and service (6.1%) (Figure 7). As a share of GDP, investment commitment in the energy sector went down from 11.5% in FY2014 to 3.9% in FY2015, indicating the impact of the earthquake on investors'

Figure 6: Nominal per capita GDP

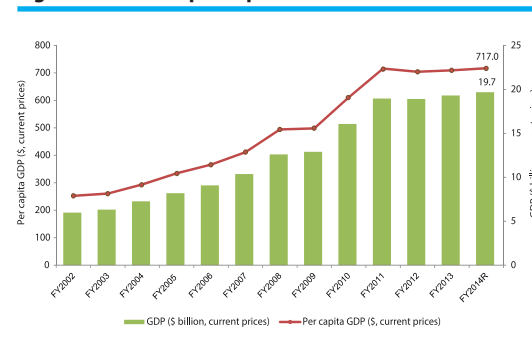
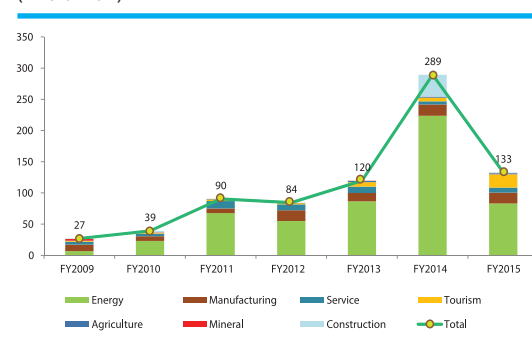


Figure 7: Domestic capital investment commitment (NRs billion)



Source: Department of Industry

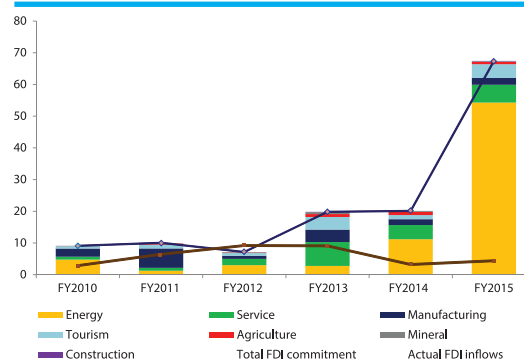
⁷ For more on Nepal's export competitiveness, see the issue focus section of *Macroeconomic Update*, Vol.2, No.1, February 2014.

⁸ Computed as the difference between gross national savings and gross capital formation.

confidence, especially with respect to detailed seismic study of the topography. Furthermore, the uncertainty over the promulgation of the constitution after the failure to do so by the earlier deadline (22 January) prompted investors to be in a wait-and-watch mood.

12. *Foreign direct investment (FDI) commitment:* FDI commitment, approved by the Department of Industry, reached NRs67.4 billion in FY2015, sharply up from NRs20.1 billion in FY2014 (Figure 8). It translates into a growth of 235.3% compared to 1.5% in the previous year. Consequently, as a share of GDP, it stood at 3.2%, up from 1.0% of GDP in FY2014. Except for 27.4% and 32.5% decrease in FDI commitment in agriculture and mineral sectors, respectively, all other sectors registered an increase by over 15%. Notably, energy sector FDI commitment soared by 385.3% and consisted of about 80.5% of all FDI commitment, mostly coming from India and the People's Republic of China (PRC). These together accounted for 99.0% of the total energy sector FDI commitment. Country-wise FDI commitment shows that the largest investment commitment came from India (51.5% of the total FDI commitment), followed by the PRC (36%), British Virgin Islands, the UK, Turkey, the USA, South Korea, Finland, and Japan. It may be noted that despite the increase in FDI commitment, actual FDI inflow, as per the balance of payments, remains low at NRs43.8 billion (0.21% of GDP), up from NRs31.9 billion (0.16% of GDP) in FY2014.

Figure 8: FDI commitment and actual inflow (NRs billion)



Source: Department of Industry; Nepal Rastra Bank

III. FY2016 Growth Outlook

13. The outlook for FY2016 is cautiously optimistic and is largely contingent upon the scope and pace of post-earthquake reconstruction works. The weak and subnormal monsoon so far has already affected agricultural plantation, particularly paddy in the eastern and central administrative regions. The loss of agricultural land to earthquake-triggered landslides will also lower potential agricultural output. Although the overall monsoon rains are expected to be better than last year's, it is still projected to be below the long-term average as weak El Nino continues to prevail over the Pacific⁹. Furthermore, monsoon rains were late by around two weeks. Normally monsoon rains enter on June 10 from the eastern region, and gradually cover the entire country within a week. Approximately, 80% of total rainfall occurs between June and September. Industrial and services sectors are expected to register modest to robust performance depending on the political

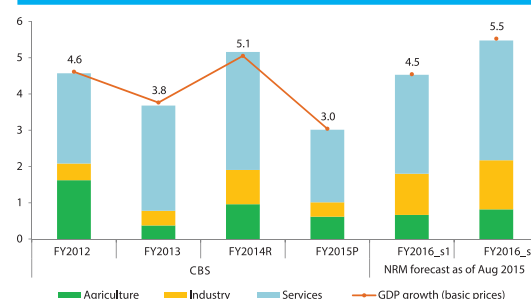
⁹ Indian Meteorological Department's assessment as of 3 August 2015. The monsoon seasonal rainfall is projected to be about 84% (August to September), 90% (August) and 88% (June to September) of the long period average. Long period average refers to the 50 year average. See: http://imd.gov.in/section/nhac/dynamic/LRF_second.pdf

development, reconstruction efforts, recovery of earthquake-hit factor and product markets, and remittance inflows. The promulgation of a new constitution within FY2016 by settling most of the contentious issues may boost investor confidence. Furthermore, the scope and pace of acceleration of reconstruction projects will affect performance of quarrying, manufacturing and construction activities, which in turn will then determine industrial sector growth. Timely and judicious execution of the FY2016 budget remains at the core the recovery process. The rate of net migration to overseas employment destinations and the subsequent levels of remittance inflows, and the pace of full restoration and resumption of services activities such as hotels and restaurants, transport and communications, education and real estate and renting will influence services sector growth.

14. Considering these developments, this edition of *Macroeconomic Update* forecasts FY2016 GDP growth (at basic prices) under two scenarios (Figure 9). Under the first scenario, assuming a marginally better monsoon rainfall, modest pickup in actual implementation of reconstruction projects through the National Reconstruction Authority (NRA), gradual normalization of political scenario, continuation of previous trend in spending capital budget, modest recovery of tourism related activities and slightly better services sector growth, GDP growth is forecast at 4.5%. Under the second scenario, a slightly better rainfall (average over the last five years) and adequate paddy plantation in the main paddy plantation belts, robust pickup in manufacturing and construction activities propelled by accelerated spending by the NRA and improved capital budget execution by line ministries, normalization of political scenario, and robust services sector performance (including robust remittance inflows and quick recovery of tourism related activities), GDP growth is forecast at 5.5%. The adverse political situation and the slow capital budget execution are the two major downside risks that could drastically lower growth forecast.

15. These estimates are lower than the government's target of 6% as announced in FY2016 budget speech. In order to attain a 6% growth rate, assuming agricultural output growth of 2.5% considering the subnormal monsoon in the first half of FY2016, the non-agricultural output has to growth by at least 7.7%, which is 4.1 percentage points higher than in FY2015. Furthermore, assuming agricultural output equal to the average over the last five years and services output growth of 6% (which is higher than the average over the last five years), industrial output has to growth by at least 13.6% to attain GDP growth of 6%. This may be challenging given

Figure 9: Sectoral contributions to growth (percentage points)



Source: Central Bureau of Statistics; NRM staff estimates.

that industrial production is yet to recover fully to pre-earthquake levels due to production and supply disruptions caused by the earthquake and the political unrest in various parts of the country. Furthermore, the NRA is yet to be fully operation and it will take few months for the authority to firm up reconstruction project, and the line ministries have not proactively prepared investment plan and project strategy to execute the \$170 million allocated to them for reconstruction related projects.

B. Fiscal Sector

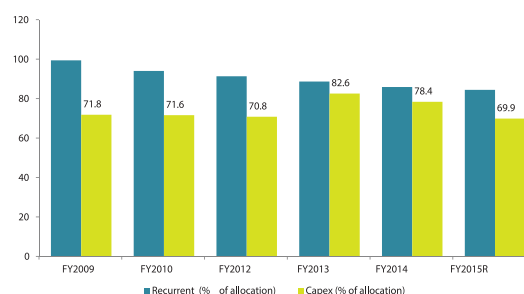
I. Expenditure Performance

16. The sluggish expenditure in the first three quarters and damages caused by the earthquake in the last quarter of FY2015 significantly affected public expenditure. The budget execution delays, and long-running procedural as well as procurement hassles constrained absorptive capacities,¹⁰ resulting in slower capital spending than previous years. The earthquake derailed the government operations for a few weeks before resuming a singular focus on rescue and relief operations. This virtually stalled the capital spending related procedural approval, procurement execution, and implementation not only in the earthquake-affected areas, but throughout the country. The estimated actual capital spending was 69.9% of planned capital expenditure in FY2015, lower than the 78.4% achieved in FY2014. Meanwhile, actual recurrent spending was 84.4% of planned recurrent expenditure, marginally lower than the 85.9% in FY2014 (Figure 10). Overall expenditure grew by 13.0%, with recurrent and capital spending growth at 11.0% and 22.3%, respectively— lower than the growth rates in FY2014 (Figure 11).

17. Within recurrent expenditures, compensation of employees increased by 4.1%, grants to local bodies and subsidies¹¹ by 10.4%, use of goods and services¹² by 8.2% and social security by 48.6%. Overall, recurrent expenditures are estimated to be 15.9% of GDP, marginally higher than 15.6% of GDP in FY2014 (Figure 12).

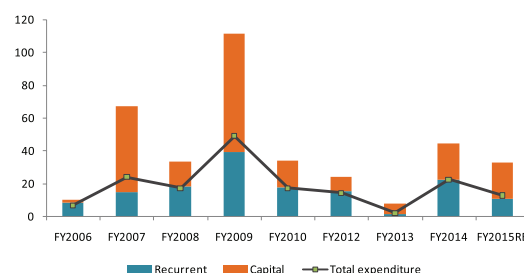
18. Capital spending continued to be sluggish, reaching just 3.8% of GDP against 5.5% of GDP planned for FY2015 (Figure 13). Apart from the slowdown caused by the earthquake in the last quarter, the time when most of the capital spending happens, of FY2015, other persistent

Figure 10: Absorption capacity (% of planned expenditure)



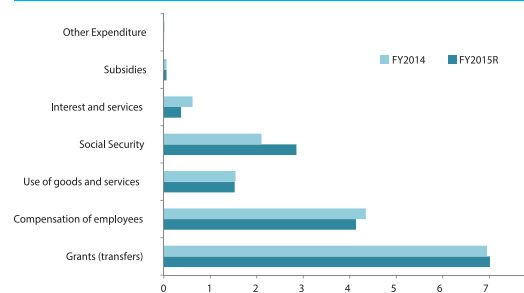
Source: FCGO; NRM staff estimates

Figure 11: Growth rate of total, recurrent and capital expenditures (% change)



Source: FCGO; NRM staff estimates.

Figure 12: Recurrent expenditures (% of GDP)



Source: Budget Speech FY2015

¹⁰ Absorptive capacity generally refers to the skills mastered by bureaucracy, state of infrastructure, and quality of institutions.

¹¹ Subsidies include direct subsidies to non-financial public corporations and private enterprises only. Actual direct and indirect subsidies are much higher. This does not include subsidies for chemical and organic fertilizer, micro-hydropower projects, transportation subsidy for seed and fertilizer supply, and interest subsidies to farmers groups and cooperatives, among others.

¹² Use of goods and services consists of (i) rent & services; (ii) operation and maintenance of capital assets; (iii) office materials and services; (iv) consultancy and other services fee; (v) program expenses; (vi) monitoring, evaluation and travel expenses; (vii) recurrent contingencies; and (viii) miscellaneous.

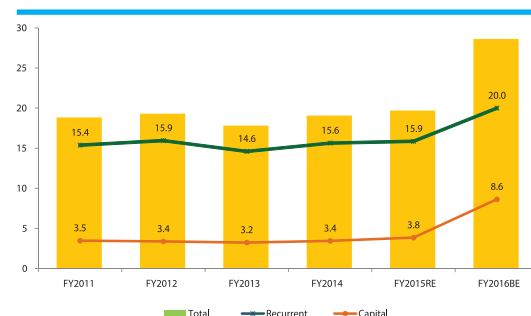
factors impeding capital spending are: (i) lack of project readiness, in terms of timely preparatory activities such as detailed project design, land acquisition, establishment of project management offices and required personnel, and procurement plans; (ii) delays in project approval and budget release; (iii) delays in procurement related processes; and (iv) overall weak project planning and implementation capacity.¹³ The damage caused by the earthquake in addition to the large investment needed to close the infrastructure deficit has meant that Nepal needs to drastically enhance its capital budget execution performance. Else, the foundations for graduation from Least Developed Country (LDC) category to a developing country status by 2022¹⁴ and the overarching goal to become a middle income country by 2030 will continue to remain weak.

19. Within capital expenditure although vehicle purchase declined by 31.8%, all other components grew higher than last year. But still actual capital spending fell far short of the planned capital spending. Spending on building construction, plant and machinery, and research and consultancy grew by over 90%. Building related capital spending grew by a whopping 286.8%, which could partly be attributed to the low base effect. The expenditure for civil works increased by 113.5%, reflecting slightly better performance than previous years but still requiring further enhancement. Except for civil works—which was 2.3% of GDP, the same as in FY2012 and FY2013—none of the eight sub-categories within capital expenditures was above 1.0% of GDP (Figure 14).

20. As in the previous years, FY2015 saw bunching of spending, especially capital spending, towards the last quarter. Almost one-fourth of actual total public expenditure was done in the last month and 44.8% in the last three months. Of the actual capital spending, 44.0% was spent in the last month and 63.0% in the last three months (Figure 15). This pattern of spending is not much different from previous years, irrespective of the timeliness of issuance of budget. It raises concerns about not only the absorptive capacity, but also the structural issues concerning budget execution.

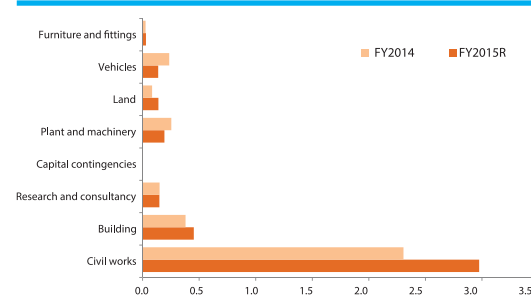
21. The ballooning recurrent expenditure needs to be rationalized by cutting down subsidies; improving the quality of spending, including operations and maintenance of assets created; weeding out unproductive projects; and reducing the number of priority projects so that more focus is accorded to the strategically important ones. Planning, allocation, delivery, monitoring and evaluation of public sector expenditure must be efficient and productivity-oriented. The urgency also comes from the fact that tax

Figure 13: Total, recurrent and capital expenditures (% of GDP)



Source: FCGO; NRM staff estimates.

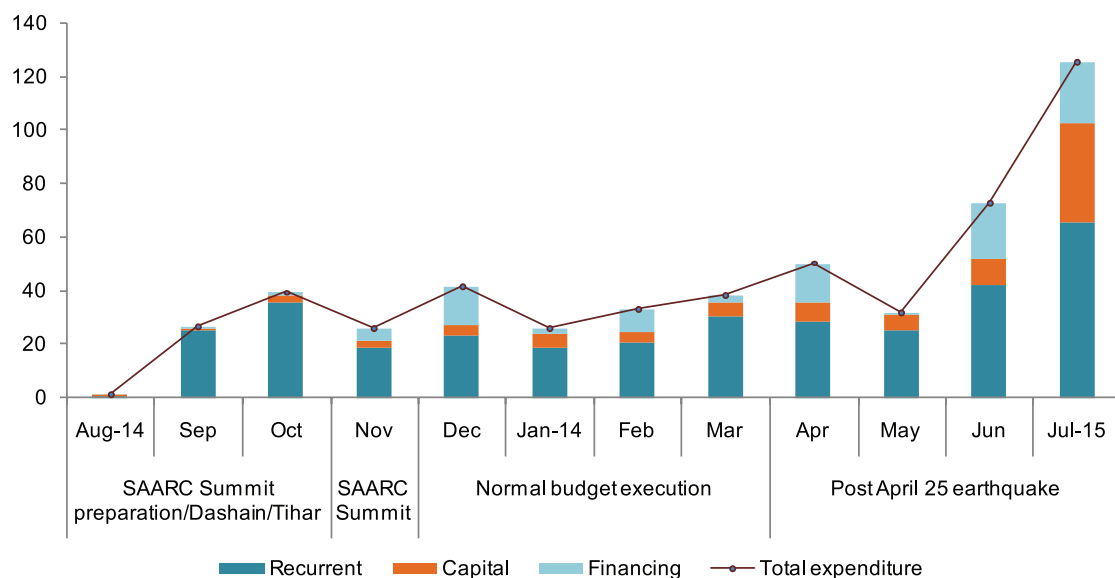
Figure 14: Capital expenditures (% of GDP)



Source: Budget Speech FY2015

¹³ The Commission for Investigation of Abuse of Authority's (CIAA) pro-active monitoring of corruption in bureaucracy has also delayed decision making, especially those related to procurement.

¹⁴ For a detailed analysis on prospects for Nepal's graduation to a developing country status by 2022, see: ADB. August 2013. *Macroeconomic Update*. Vol.1, No.2, Manila: Asian Development Bank.

Figure 15: Monthly spending in FY2015 (NRs billion)

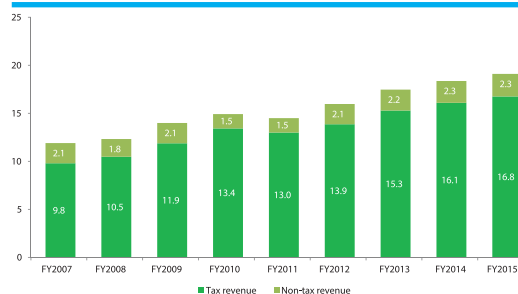
Source: FCGO; NRM staff estimates.

revenue mobilization and its growth rate are marginally higher than recurrent expenditure and its growth rate. Rationalization of recurrent spending will create more fiscal space to boost allocations for capital spending, which needs to be drastically ramped up to create the physical and social infrastructure foundations to accelerate short-term growth and to sustain long-term growth, resulting in an accelerated, high and inclusive growth process.

II. Revenue Performance

22. Total revenue grew by 13.8%, much lower than 20.5% growth in FY2014, reaching NRs405.8 billion (19.1% of GDP). It is lower than the budget target of NRs422.9 billion as the slowdown in economic activities and imports following the earthquake in April hit revenue mobilization. While non-tax revenue grew by 13.0% as opposed to an increase by 20.1% in FY2015, tax revenue growth slowed down to 13.9% from 20.5% in FY2014. Tax revenue and total revenue growth rates have been continuously decreasing since FY2013. As a share of GDP, tax revenue mobilization has improved significantly, reaching 16.8% in FY2015, up from 9.8% of GDP in FY2007 (Figure 16).

23. The continuous reforms in revenue administration, broadening of the tax base, and the higher import bill (mostly financed by remittance income) resulted in robust revenue performance over the last decade. Some of the notable reforms undertaken in recent years include: (i) information and communication technology based tax

Figure 16: Tax and non-tax revenue (% of GDP)

Source: Ministry of Finance, NRM staff estimates

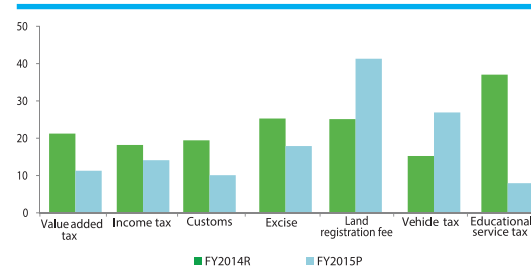
returns filing and payments systems; (ii) establishment of a data link with the Company Registrar's Office to enhance tax compliance;¹⁵ (iii) measures to reduce tax compliance costs; (iv) strengthening of tax monitoring and audit systems; (v) measures to widen the tax net for various tax categories; and (vi) implementation of the Any Branch Banking System (ABBS) for large tax payers.

24. Revenue mobilization from major sources decelerated in FY2015. The growth rates of value added tax (VAT), income tax, customs and excise duty were lower than in FY2014. They grew by 11.3%, 14.1%, 10.1% and 17.9%, respectively. Meanwhile, land registration fee, vehicle tax and health service tax grew by 41.3%, 26.9% and 31.7%, respectively—higher than the growth rates in the previous year (Figure 17). The deceleration in the major sources of revenue is attributed to the economic and imports slowdown following the earthquake. The acceleration in vehicle tax and land registration fee mobilization is due to the higher import of vehicles and land transactions, respectively, in the first three quarters of FY2015. The slower non-tax revenue growth is attributed to the decrease in interest and dividend paid by some public enterprises. Overall, VAT contributed the largest (27.7%) to total revenue mobilization, followed by income tax (22.0%), customs (18.4%), and excise duty (13.2%) (Figure 18). Taxes on consumption and imported goods, which are largely financed by remittance income, constitute a lion's share of total tax revenue mobilization—around 70%. Furthermore, import-based revenues (custom duties, VAT, and excise on imports only) account for about 45% of total revenue.

III. Fiscal Balance

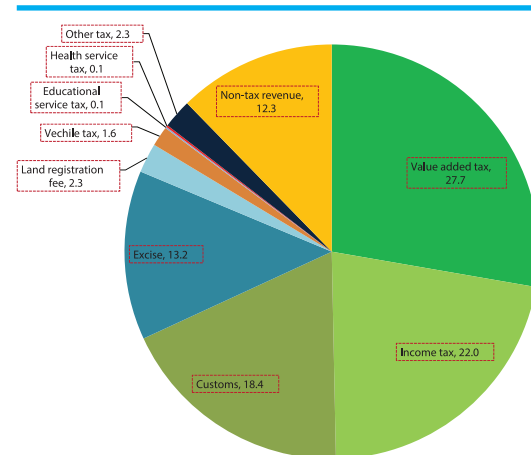
25. The lower than expected revenue mobilization along with the disappointing expenditure performance resulted in a fiscal deficit¹⁶ equivalent to about 0.2% of GDP in FY2015 (Figure 19). Though this is better than the fiscal surplus equivalent to 0.7% of GDP in FY2013 and 0.6% of GDP FY2014, it is still lower than the medium-term average fiscal deficit of about 2.2% of GDP. For a low-income country with a large financing need to bridge the infrastructure deficit, particularly in hydropower and transport, running a modest fiscal deficit without jeopardizing fiscal sustainability is desirable. Nepal faces an estimated infrastructure financing gap of between 8-12% of GDP until 2020. The damage wrought by the earthquake and subsequent aftershocks has necessitated the need to ramp up even more productivity-enhancing public spending in physical and social infrastructures.

Figure 17: Revenue growth (% change)



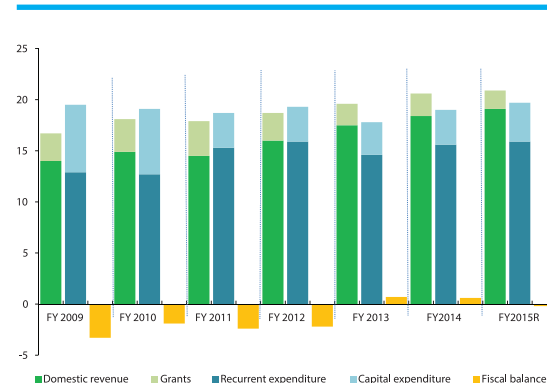
Source: Nepal Rastra Bank

Figure 18: Composition of total revenue in FY2015



Source: Nepal Rastra Bank

Figure 19: Fiscal indicators (% of GDP)



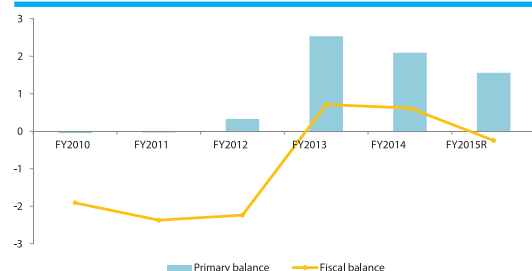
Source: Budget Speech various years; NRM staff estimates

¹⁵ The cost of collection per NRs1,000 decreased from NRs16.4 in FY2007 to NRs12.7 in FY2011.

¹⁶ Fiscal balance is computed as expenditures (including net lending) minus revenue (including grants). However, normal fiscal balance (revenue minus expenditure and net financing) was a surplus equivalent to 1.3% of GDP.

26. The total net borrowing amounted to just NRs2.9 billion in FY2015 (0.1% of GDP). Net external borrowing was NRs8 billion, but net internal borrowing was a negative NRs5 billion. The amount of foreign grants is continuously declining since FY2011, when it was 3.4% of GDP against 1.8% of GDP in FY2015, indicating the slow disbursement in projects funded with foreign assistance. This is not ideal given the large investment required not only in infrastructure, education and health sectors, but also in capacity building of public institutions. Furthermore, Nepal has been running a primary surplus since FY2012, meaning that fiscal balance before interest payment on public debt is positive (Figure 20). Combined with the low and declining outstanding public debt, it indicates that the government has ample fiscal space for now to expand productivity-enhancing public capital investment without jeopardizing fiscal sustainability. Box 3 includes further analysis on fiscal sustainability.

Figure 20: Primary and fiscal balances (% of GDP)

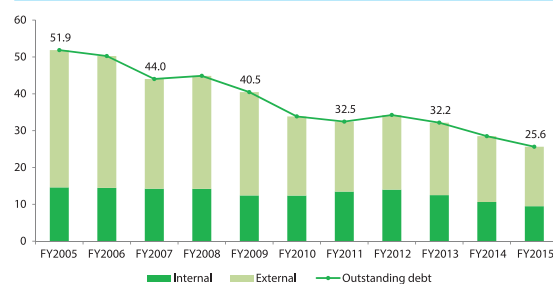


Source: Budget Speech various years; NRM staff estimates

IV. Public Debt

27. Nepal's overall outstanding public debt (external and domestic) has been steadily declining, reaching an estimated 25.6% of GDP in FY2015 (Figure 21). Total external debt decreased to 16.1% of GDP in FY2015 from 17.9% of GDP in FY2014. Similarly, total domestic debt declined to 9.5% of GDP from 10.6% of GDP in FY2014, reflecting the lower than targeted domestic borrowing as a result of the wide gap between actual and planned expenditure. External debt service payments stands at around 8.1% of exports of goods and non-factor services. The declining stock of public debt and debt service payments generally indicate sound public debt management in addition to the early repayment of principle (contributed by large treasury surplus due to high revenue growth but low expenditure). Nepal's external debt is mostly on concessional terms and faces low debt distress as per the latest debt sustainability analysis. Box 1 provides further insight on the composition of Nepal's outstanding public debt.

Figure 21: Public debt (% of GDP)



Source: FCGO

V. Public Enterprises

28. The overall performance of public enterprises (PEs) worsened in FY2014 as a result of large losses incurred by Nepal Oil Corporation (NOC) and Nepal Electricity Authority (NEA). The continued mismatch between international price of oil and domestic retail price led to the huge losses of NOC. Similarly, the mismatch between per unit production cost of electricity and per unit selling price resulted in large loss of NEA. However, in FY2015 the net profit of public enterprises is expected to increase drastically, largely due to the huge profit earned by NOC and stable profit of Nepal Telecom (Figure 22). Of the 37 PEs, 15 are expected to make losses in FY2015. As a result of the automatic price adjustment mechanism followed

by NOC and continued low international oil prices, including that of LPG cooking gas, NOC is expected to post net profit of NRs18.0 billion (0.85% of GDP) after five years of continued losses. NEA's losses are expected to increase by twofold to NRs8.5 billion (0.4% of GDP) as the wedge between production and retail price widens.¹⁷ Nepal Telecom is expected to post a marginal increase in profit, reaching NRs11.9 billion (0.6% of GDP).

29. The cumulative liabilities of PEs decreased from 2.5% of GDP in FY2013 to 1.8% of GDP in FY2014 as a result of the decline in both unfunded and contingent liabilities. The unfunded liabilities (salary, pension, social security contribution, health care, and recurrent costs, among others, that the PEs cannot finance themselves) had increased steadily from 1.0% of GDP in FY2009 to 1.6% of GDP in FY2013 and marginally declined to 1.4% of GDP in FY2014. A major contributor to the rise in unfunded liabilities is the hike in salary and allowances in the public sector. Meanwhile, contingent liabilities (state guarantees of loans, defaults of PEs, and clean-up liabilities of privatized PEs, among others) increased in FY2013 after a steady decline in the past four years, but again declined in FY2014. It declined from 0.9% of GDP in FY2013 to 0.5% of GDP in FY2014 (Figure 23).

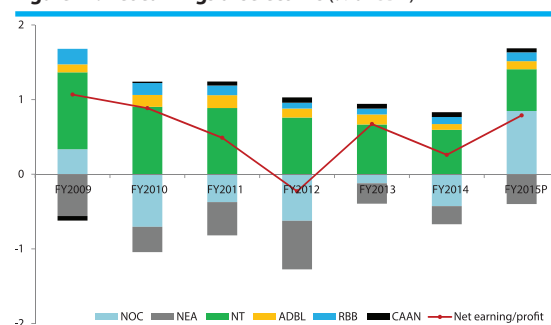
30. Either privatization or liquidation of loss making PEs needs to be accelerated to reduce the budget drain. The weak financial position of PEs has led to large unfunded liabilities, especially for pension and other related retirement benefits, which could ultimately become the government's liabilities. It may be noted that due to the lack of accurate and updated data, the contingent liability of PEs presented here are at best conservative estimates. It is likely that the government is exposed to much higher level of liabilities. In this regard, fiscal and macroeconomic stability could potentially be subject to significant risks. Continuing the adjustment of electricity tariffs to reflect the cost of production and automatic adjustment of fuel prices to reflect the international prices will help to lower the losses and liabilities.

C. Monetary Sector

I. Inflation

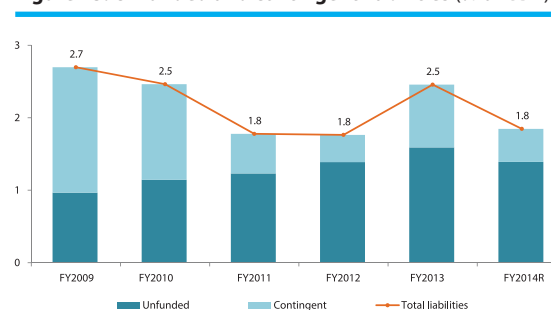
31. Inflation (year-on-year [y-o-y] average consumer price index [CPI]) sharply declined to 7.2% in FY2015, the lowest since FY2008 as both food and non-food prices decreased. Particularly, non-food prices, which has 53% weight in the CPI basket, growth dropped

Figure 22: Net earnings of select PEs (% of GDP)



Source: Ministry of Finance; NRM staff estimates

Figure 23: Unfunded and contingent liabilities (% of GDP)



Source: Ministry of Finance; NRM staff estimates.

¹⁷ The high losses of NEA are also attributed to the rising electricity import, which is sold at suppressed rates, from India, and the still large provisioning for pension and gratuity of employees. The average electricity import price is NRs8.4 per unit, but the retail price is NRs8.04 per unit. Nepal imports around 250 MW of electricity during the dry season.

Box 1: Nepal's Public Debt

Nepal's public debt stock has been continuously decreasing, reaching 25.6% of GDP in FY2015 from 51.9% of GDP in FY2005. In FY2015, internal and external debt stock amounted 9.5% and 16.1% of GDP, respectively. Much of Nepal's external debt is on concessional terms. Hence, debt distress is considered to be at low risk.

External debt

Nepal's debt servicing has marginally increased, reaching 3.5% of GDP in FY2015 from 2.7% of GDP in FY2009. Total internal and external principal repayments were 2.2% and 0.8% of GDP, respectively, in FY2015. Similarly, total internal and external interest payments were 0.3% and 0.1% of GDP in FY2015.

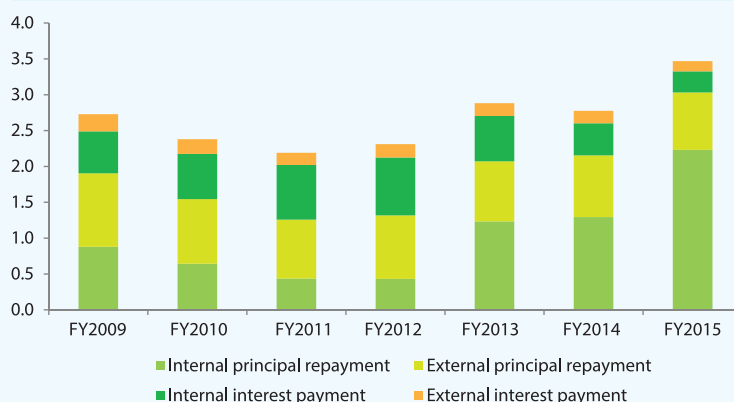
Of the total outstanding external debt (NRs343 billion), ADB's and WB's share is 41% and 45.3%, respectively. It translates into 6.6% and 7.3% of GDP, respectively, in FY2015. Total debt owed to multilateral and bilateral donors was equivalent to 14.5% and 1.6% of GDP, respectively, in FY2015. It was 19.2% and 3.8% of GDP, respectively, in FY2010. Among bilateral donors, the outstanding debt owed to Japan amounts to 0.5% of GDP, 0.4% for PRC, and 0.3% of GDP for India and South Korea.

Of the total loan commitment in FY2015, only 58.5% was disbursed (amounting to about 1.4% of GDP). ADB committed loan amounting to 0.8% of GDP, but only 0.4% of GDP was disbursed. Similarly World Bank (IDA window) committed loan amounting to 1.0% of GDP, but only 0.6% of GDP was disbursed in FY2015. Total disbursement has lagged behind total loan commitment, reflecting the government's low capital expenditure absorption capacity.

Internal debt

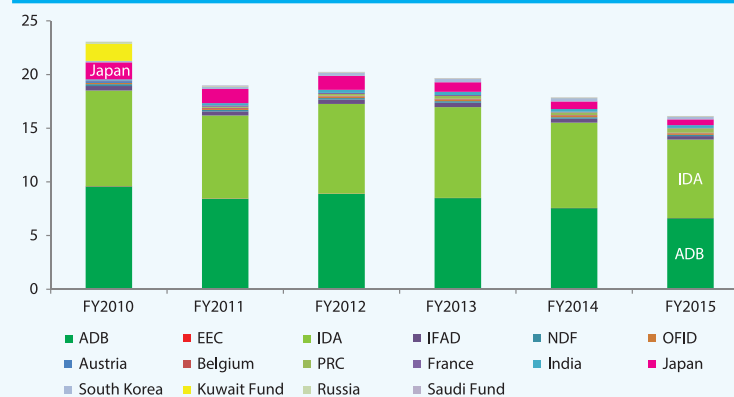
The outstanding internal debt increased to NRs201.7 billion in FY2015 (12.4% of GDP) from NRs122.8 billion in FY2009 (9.5% of GDP). Treasury bills

Figure 1.1: Gross debt servicing (% of GDP)

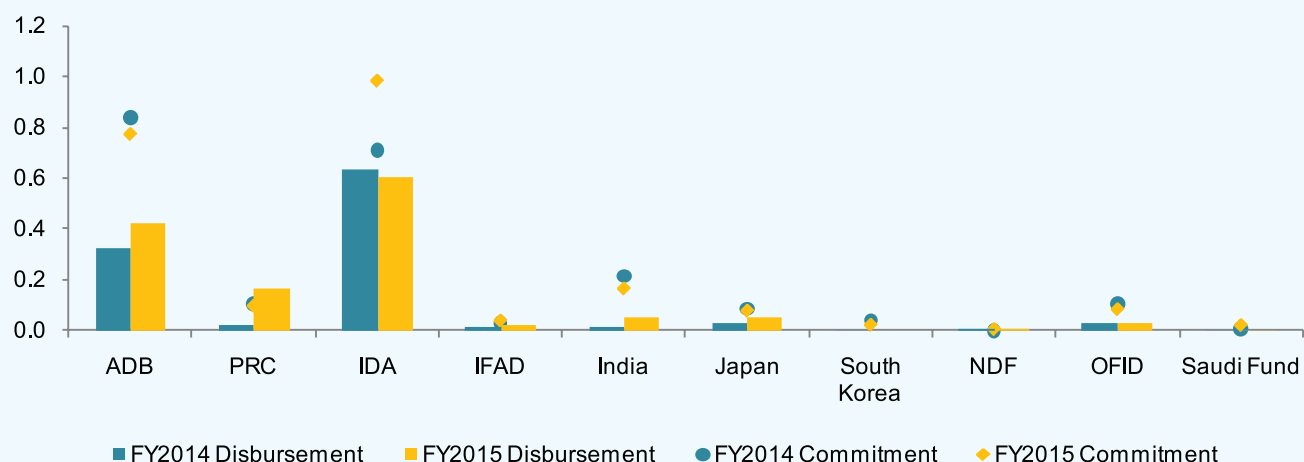


Source: FCGO; NRM staff estimates

Figure 1.2: Gross outstanding external debt (% of GDP)



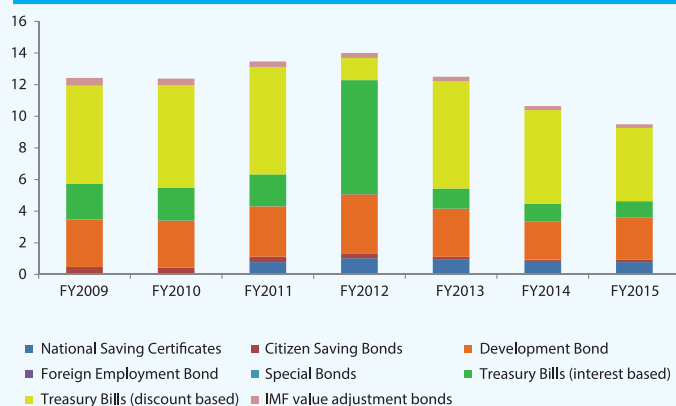
Source: FCGO; NRM staff estimates

Figure 1.3: Total loan commitment and disbursement (% of GDP)

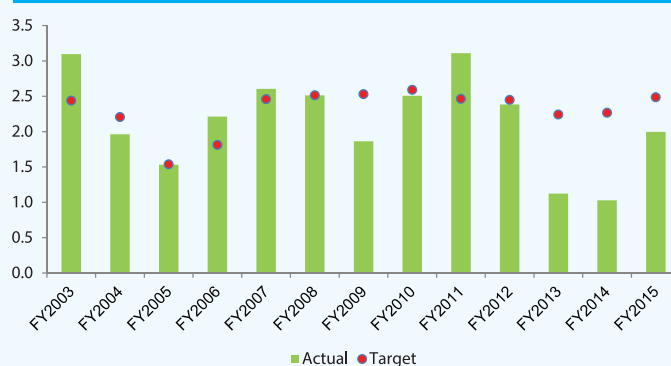
Source: FCGO; MOF; NRM staff estimates

accounted for 5.6% of GDP and development bonds 2.7% of GDP. Most of the internal debt is short-term treasury bills (60% of total internal debt) and such funds are used to finance long-term development projects. Ideally, increasing the share of long-term bonds in total internal debt to finance medium to long term investment is desirable. The medium to long term bonds are in the form of national savings certificate, development bonds, citizen saving bonds and foreign employment bonds.

The gap between internal borrowing target and actual borrowing is widening recently. For instance, in FY2003 the government had a target of borrowing 2.4% of GDP internally, but ended up borrowing 3.1% of GDP. However, in FY2014, the government had a target of 2.3% of GDP, but actual borrowing was just 1.0% of GDP. In FY2015, there was a slight improvement with actual borrowing of 2.0% of GDP against the target of 2.5% of GDP. It again indicates the low expenditure absorption capacity of the government despite having comfortable fiscal space, which could be utilized in financing critically needed physical and social infrastructure that would create the foundation for a high, employment-centric and sustainable inclusive growth, and to strengthen economic fundamentals.

Figure 1.4: Outstanding internal debt (% of GDP)

Source: FCGO; NRM staff estimates

Figure 1.5: Internal target and actual borrowing (% of GDP)

Source: FCGO; NRM staff estimates

by almost half from 10.1% in FY2013 (Table 2). Food and non-food prices increased by 9.6% and 5.2%, respectively, in FY2015. They increased by 11.6% and 6.8%, respectively, in FY2014. Overall, while food prices contributed 5.3 percentage points to overall inflation, non-food prices contributed 2.7 percentage points in FY2015. Food prices remained at elevated levels as subnormal monsoon lowered agricultural production in the first three quarters and the disruptions caused by landslides following the earthquake disrupted transportation and distribution services. Prices of all major sub-products in the CPI's food basket increased by over 10% except for that of vegetables, meat and fish, ghee and oil, sugar and sweets, and soft drinks. Cereals and grains, legumes, vegetables, meat and fish, and fruits contributed 2.9 percentage points to the overall inflation, and almost 63% of food inflation. The subsiding of non-food prices largely reflects the impact of the substantial drop in international fuel prices (Figure 28), which lowered import price of goods, and the lower inflation rate in India.

32. Inflation has remained elevated since FY2008 due to a combination of structural bottlenecks, domestic supply-side factors, high inflationary expectations, and exogenous pressures such as the ongoing depreciation of Nepalese rupee despite some appreciation in the latter part of the year. Structural bottlenecks include weak backward and forward linkages, fragmented value chain and distribution systems, low productivity and policy inconsistencies. Supply-side constraints include the lack of adequate supply of electricity, transport bottlenecks, lack of raw materials leading to high import content of processed and light manufactured goods, and the inadequate supply of key inputs to boost productivity. Credible strategies to tame elevated inflation would help dampen inflationary expectations.

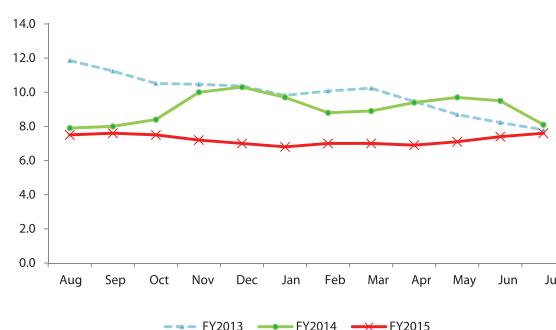
33. Inflation gradually moderated from 7.5% in mid-August 2015 to 6.9% in mid-April, but then the supply disruptions caused by the earthquake slowly increased inflation to 7.6% in the last month of FY2015. Compared to the prices in the corresponding months in FY2014, inflation was lower in all months (Figure 24). Similarly, compared to prices in FY2014, food and beverage prices remained lower in all months except between mid-August and mid-September 2014 (Figure 25). Non-food and services prices moderated in all the months compared to the level in corresponding months in FY2014 except for the last month of FY2015 (Figure 26). Both food and non-food prices were declining till mid-April 2015, but then they started to rise for the remaining months.

Table 2: Annual y-o-y inflation (% change)

Year	Average	Food	Non-food
FY2010	9.6	15.3	4.9
FY2011	9.6	14.6	5.3
FY2012	8.3	7.7	9.0
FY2013	9.9	9.7	10.1
FY2014	9.1	11.6	6.8
FY2015	7.2	9.6	5.2

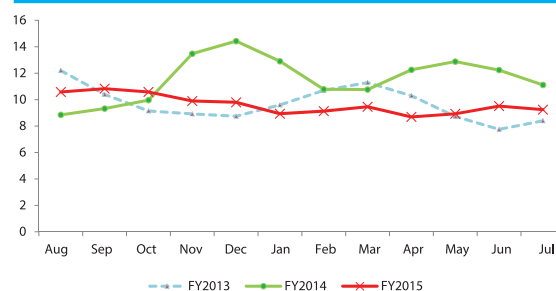
Source: Nepal Rastra Bank

Figure 24: Overall inflation



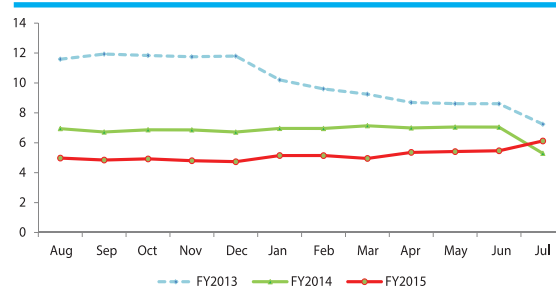
Source: Nepal Rastra Bank

Figure 25: Food inflation



Source: Nepal Rastra Bank

Figure 26: Non-food inflation



Source: Nepal Rastra Bank

II. FY2015 Outlook

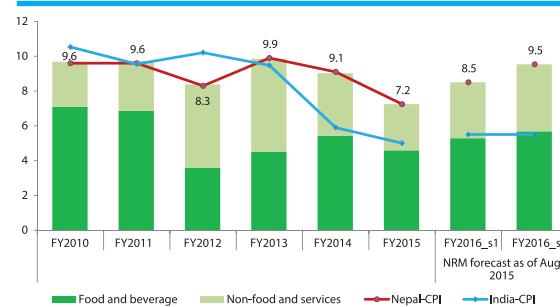
34. The expected low agriculture harvest due to subnormal monsoon, slightly higher price pressures in India, higher demand for reconstruction materials and workers, blockage of major trading routes with the PRC, and supply disruptions, including in distribution networks, as a result of the political strikes in various parts of the country will likely push up general prices of goods and services in FY2016 (Figure 27). Depending on the intensity of these factors, inflation is forecast considering two scenarios. Under the first scenario, although non-food prices are expected to remain low as a result of continued lower fuel prices and stable price pressures in India, food inflation is projected to remain in double digit, resulting in overall inflation of 8.5%.

35. Under the second scenario, moderate price pressures in India, and higher intensity of supply disruptions caused by political strikes and blocking of major trading and distribution networks would push up food prices even higher than the one considered under the first scenario, especially that of cereals, legumes, vegetables and fruits. Similarly, non-food prices will likely escalate, particularly that of clothing and footwear, and furnishing and household equipment. These factors will likely push up inflation to about 9.5% in FY2016. Even after accounting for the high probability of subdued fuel prices throughout FY2016, if supply disruptions persist for long, then there is a high likelihood of even higher inflation, probably around 10%. Continued depreciation of Nepalese rupee against the US dollar will likely fuel inflationary pressures.

III. Money Supply

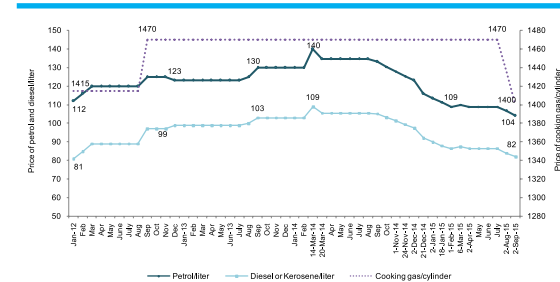
36. Money supply¹⁸ (M2) grew by 19.9%, reaching NRs311.8 billion, on the back of a robust growth of net foreign assets¹⁹ and net domestic assets (Figure 29). M2 growth was 19.1% in FY2014 (NRs250.6 billion). The large net foreign asset holdings— registering a 24.2% growth (NRs144.8 billion) in FY2015, down from 27.2% growth rate in FY2014 (NRs127.1 billion)— were supported by high remittance inflows and foreign assistance, especially in the last quarter of FY2015. The increase in money supply was reflected in the 19.7% growth of narrow money (M1) and 15.1% growth of time deposits. As a share of GDP, money supply, net foreign assets and net domestic assets stood at 88.4%, 35.2%, and 53.2%, respectively, in FY2015— all higher than the levels in FY2014.

Figure 27: Contributions to inflation (percentage points)



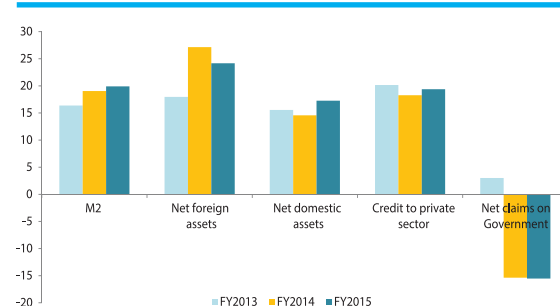
Source: Nepal Rastra Bank; ADOS July 2015; NRM staff estimates

Figure 28: Price of petrol, diesel and LPG cooking gas (NRs)



Source: Nepal Oil Corporation

Figure 29: Monetary sector (% change)



Source: Nepal Rastra Bank

¹⁸ Money supply (M2) is the sum of net foreign assets and net domestic assets. Also called broad money, M2 is equal to narrow money (M1,) and saving and time deposits. M1 is equal to currency in circulation and demand deposits.

¹⁹ The balance sheet of monetary authorities is composed of assets and liabilities. Assets consist of net foreign assets and net domestic assets (net claims on government and claims on the private sector). Liabilities consist of currency issued and deposits. Both net foreign assets and net claims on government affect reserve money and hence the money supply. A decline in net foreign assets, denominated in local currency in the monetary survey, and the banking sector's net credit to government reduces the money supply. Net foreign assets are associated with the fluctuations in foreign exchange reserves (in the balance of payments account).

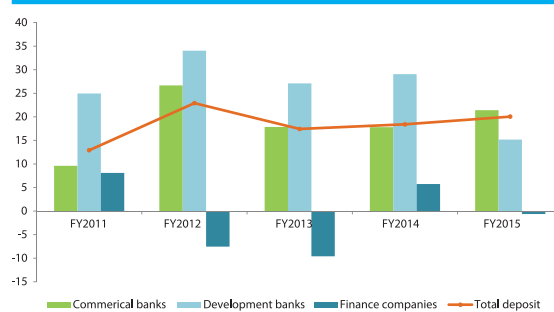
37. Net claims on government²⁰ — direct loans and government securities held by the central bank— decreased by 15.5% (NRs22.0 billion) from a decrease of 15.4% in FY2014, reflecting the still large government deposits compared to the BFIs claims on the government. The overall credit to the private sector picked up pace, registering a growth of 19.4% compared to 18.3% growth in the previous year. It indicates a gradual pick up in credit demand by the private sector and the BFIs willingness to lend at a time when excess liquidity persisted for over two years. As a share of GDP, total credit to the private sector stood at 64.7% of GDP in FY2015, up from 72.5% of GDP in FY2014.

IV. Deposit and Credit

38. The BFIs mobilized NRs282.1 billion (reaching a total of NRs1688.8 billion) in deposits in FY2015, higher than the NRs218.7billion mobilized in FY2014, as higher remittance inflows through the formal channel in the last quarter boosted deposits. This translates into a growth of 20.1%, higher than 18.4% growth in FY2014. Deposit mobilization of commercial banks and development banks by 21.4% and 15.2% respectively. But, the deposit mobilization by finance companies declined by 0.6% (Figure 30). The cumulative deposit mobilization reached 72.6% of GDP in FY2015, up from 67.6% of GDP in FY2014.

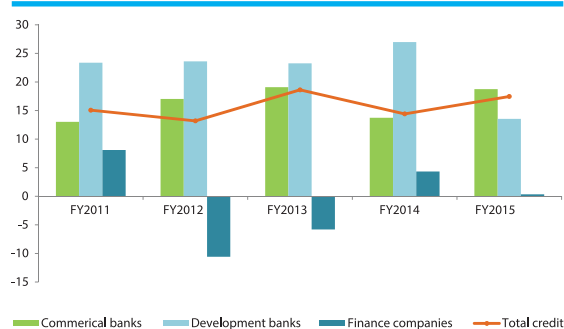
39. Total credit (loans and advances) of BFIs increased by 17.5% (NRs229.3 billion) in FY2015, up from 14.4% growth in FY2014 (NRs165.5 billion). Credits of commercial banks grew by 18.8% (NRs200.0 billion), up from a rate of 13.7% in FY2014. Similarly, credits of development banks and finance companies grew by 13.5% (NRs30.2 billion) and 0.3% (NRs323 million), respectively (Figure 31). Credit to the private sector (by category A, B and C BFIs) increased by 19.8% (NRs221.6 billion), up from 18.7% growth rate (NRs176.1 billion) in FY2014, with commercial banks and development banks registering growth of 22.0% and 16.0%, respectively. Credit to private sector by finance companies declined by 0.4%. The normal political outlook and low lending rates led to higher credit growth to private sector, especially construction, finance and insurance, and transportation sectors. However, the credit flow still appears restrained, given the continued excess liquidity and low lending rates, due to the lack of immediate bankable investment projects. Cumulatively, 21.8% of the total lending went to wholesale and retail traders, followed

Figure 30: Growth of deposits (% change)



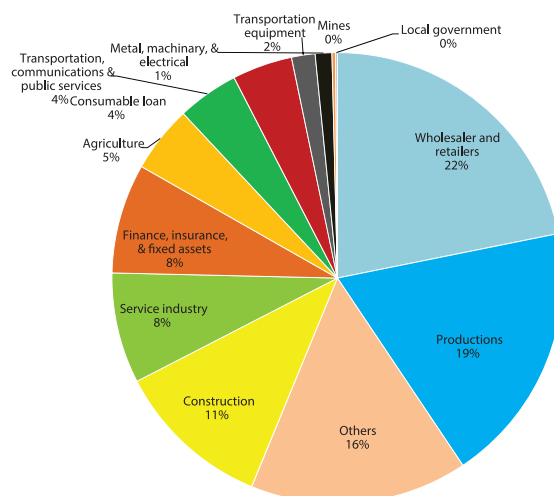
Source: Nepal Rastra Bank

Figure 31: Growth of credits (% change)



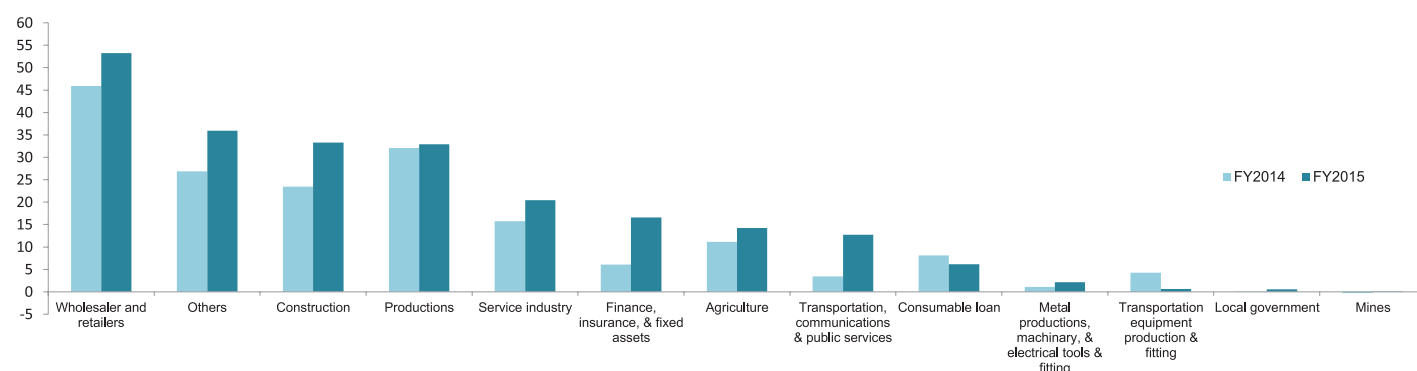
Source: Nepal Rastra Bank

Figure 32: Sectoral distribution of total lending



Source: Nepal Rastra Bank

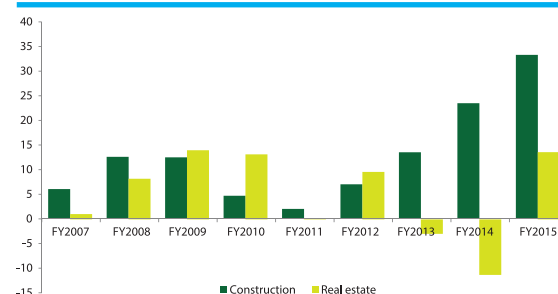
²⁰ To facilitate the analysis of the central bank's financing of government operations, claims on the government are recorded in net basis. The net credit to the government means creation of high-powered money, i.e. monetary base (currency in circulation plus reserves of banks in the central bank).

Figure 33: Annual change in lending (NRs billion)

Source: Nepal Rastra Bank

18.8% to industry, 11.2% to construction and 7.9% to services activities (Figure 32). The total credit of BFIs reached 72.6% of GDP in FY2015, up from 67.6% of GDP in FY2014.

40. On a sectoral basis, 23.3% of the increase in credit by BFIs was absorbed by wholesale and retail trade (NRs53.2 billion), followed by construction (NRs33.3 billion), industry (NRs32.9 billion), and services (NRs20.4 billion) (Figure 33). While lending to construction sector is continuously recovering after it hit a low in FY2011, lending to real estate declined for two consecutive years and rebounded with NRs13.6 billion credit flows in FY2015 (Figure 34) – reflecting the pickup in residential housing and infrastructure related activities as well as real estate market, especially during the first three quarters of FY2015.

Figure 34: Annual change in lending to construction and real estate (NRs billion)

Source: Nepal Rastra Bank

V. Liquidity Management

41. Responding to the persistent excess liquidity in the banking sector, in FY2015, the Nepal Rastra Bank (NRB) mopped up a net liquidity equivalent to NRs315.8 billion through reverse repo auctions— one of the short-term tools used by the central bank to manage liquidity— at a weighted average interest rate of 0.05%, and NRs6.00 billion through outright sale auctions at a weighted interest rate of 0.78%. Similarly, NRs155.0 billion was mopped up through deposit auction at a weighted interest rate of 0.45%. In FY2014, the NRB had mopped up a net liquidity equivalent to NRs602.5 billion through reverse repo auctions at a weighted average interest rate of 0.16%, and NRs8.50 billion through outright sale auctions at a weighted interest rate of 0.05%. The central bank did not use reverse repo auctions in FY2012 and FY2013. The repeated use of short-term liquidity management tools amidst fluctuating interest rates throughout the year indicates that the existing liquidity management

strategy is a temporary measure and for long term solution the investment climate has to be improved. It may then result in higher credit growth relative to deposit growth. Furthermore, the repeated bouts of reverse repo auctions, the nearly zero bound interest rates, and the slow pick up in credit growth also indicates the persistence of structural issues constraining innovation in the banking sector.

42. To finance burgeoning imports from India, the NRB sold \$3.5 billion in the Indian money market and purchased Indian currency equivalent to NRs348.1 billion. In FY2014, the NRB sold \$3.14 billion to purchase Indian currency equivalent to NRs308 billion. The central bank also injected NRs396.7 billion into the banking sector by purchasing \$4.03 from the commercial banks.

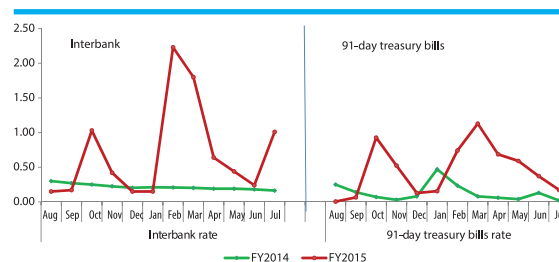
VI. Interest Rates

43. The persistence of excess liquidity throughout the year pushed short-term interest rates mostly below 1.0%, although the rates were higher after starting February 2015 compared to the corresponding period in FY2014 (Figure 35). The 91-day treasury bills weighted average rate was 0.0004% in mid-August 2014, which jumped to 0.17% in mid-July 2015 and averaged 0.43% in FY2015, higher than 0.13% in FY2014. Similarly, inter-bank rate increased from 0.15% in mid-August 2014 to 1.01% in mid-July 2015, and averaged 1.06% in FY2015, much higher than 0.22% in FY2014. It indicates that the short-term liquidity management measures deployed by the NRB worked in lowering down excess liquidity. However, the persistent and recurring excess liquidity has to be sustainably resolved by address overall investment climate and structural issues in the banking sector.

44. The weighted average deposit and lending rates fell as the BFIs struggled to boost lending amidst persistence of excess liquidity (Figure 36). The weighted average deposit rate of commercial banks dropped to 3.94% in mid-July 2015 from 3.99% in mid-August 2014. It has fallen consistently from a high of 6.17% in mid-July 2012. Similarly, the weighted average lending rate fell to 9.62% in mid-July 2015 from 10.3% in mid-August 2014. The weighted average interest rate spread stood at 5.7% by mid-July 2015. Base rate continued to decline as well, reaching 7.88% in mid-July 2015.

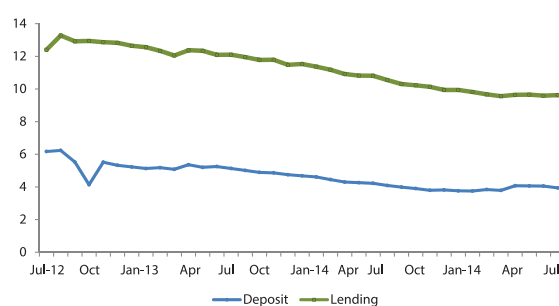
45. The cash reserve ratio (CRR), which is the minimum mandatory deposits that BFIs needs to hold as reserves either in cash or as deposits with the central bank and is usually used as one of the tools to achieve monetary policy goals, has remained unchanged since mid-August 2014. The present CRR for commercial banks,

Figure 35: Weighted average Interbank and 91-day treasury bills rate (%)



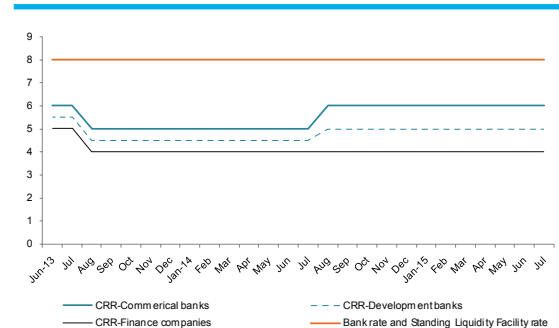
Source: Nepal Rastra Bank

Figure 36: Weighted average interest rates of commercial banks



Source: Nepal Rastra Bank

Figure 37: Policy rate (%)



Source: Nepal Rastra Bank

development banks and finance companies is 6.0%, 5.0% and 4.0%, respectively (Figure 37). The bank rate and standing liquidity facility have been kept unchanged at 8%.

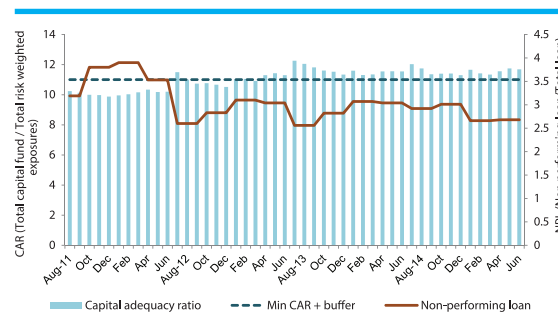
46. Meanwhile, the commercial banks' have comfortably satisfied the capital adequacy ratio (CAR) and net liquidity requirements. CAR of commercial banks stood at 11.69%, which is 0.69 percentage points higher than the minimum 10% CAR and 1% buffer requirement. Similarly, credit to deposit ratio stood at 77.8% against a maximum limit of 80% and net liquidity stood at 31.8% against the minimum 20% requirement, indicating that there is still room for commercial banks to expand credit and reduce their excess liquidity (Figure 38). Non-performing loans declined to 2.68% of total loan by mid-June 2015 from 3.01% in mid-October 2014. Average productivity sector lending (agriculture, energy, tourism, and cottage & small industries), was 21.88% of total credit by mid-June 2015. Credit to agriculture and energy sectors alone stood at 13.24% of total credit by mid-June 2015.

VII. Securities Market

47. The stock market index nosedived in FY2015 primarily due to over two weeks of closure of share trading following the April earthquake. Investor confidence on the stock market continued to remain low despite low deposit rates and excess liquidity in the banking sector. Consequently, stock market turnover declined to NRs65.3 billion by mid-July 2015 from NRs77.3 billion in mid-July 2014 (Figure 39). The commercial bank's share in total turnover was 45.7% (NRs29.9 billion). A higher share turnover indicates more liquid shares of a listed company. Note that Nepal's share market is still developing and it does not always respond meaningfully to policy change and political developments.

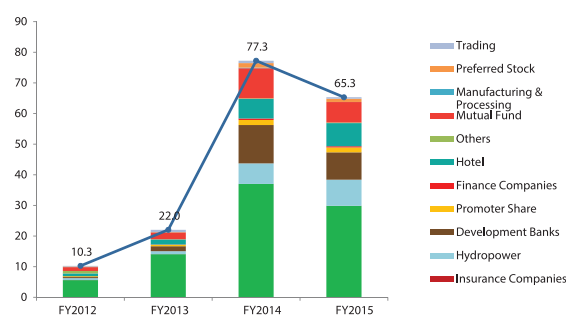
48. The Nepal Stock Exchange (NEPSE) index dropped to 961.2 in mid-July 2015, down from 1036.1 in mid-July 2014. Stock market capitalization sharply decreased to 46.6% of GDP in FY2015 (NRs989.4 billion) from 54.4% of GDP in FY2014 (NRs1057.2 billion). The total number of listed companies decreased to 232 from 237 in FY2014, primarily due to the merger of some BFIs (Figure 40). The NEPSE index remained bullish on August 2015 following the NRB's directive to BFIs to increase paid-up capital by around fourfold,

Figure 38: CAR and NPL (%)



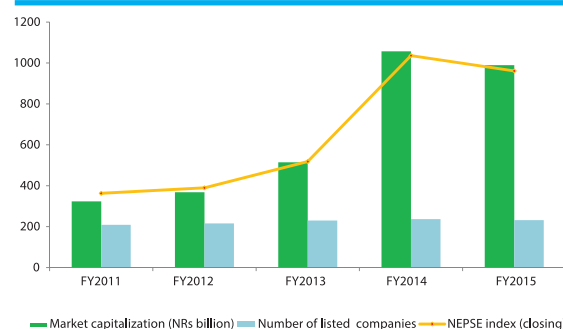
Source: Nepal Rastra Bank

Figure 39: Stock market turnover (NRs billion)



Source: Nepal Stock Exchange Ltd.

Figure 40: Stock market performance



Source: Nepal Stock Exchange Ltd.

forcing capital strained BFIs to merge and/or issue bonus share. The initial euphoria was also driven by favorable political direction, especially the agreement among major political parties to promulgate a constitution. This, however, remains uncertain.

D. External Sector

I. Exports

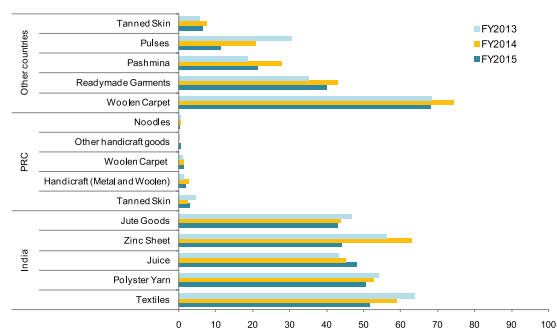
49. Despite the weak currency, which improved relative price competitiveness, exports failed to pick up in the first three quarters and then plunged drastically as production got severely affected by the April earthquake and its aftershocks. Merchandise exports (free on board [fob]), in US dollar terms, decreased by 3.9%~ a sharp fall from 5.1% growth in FY2014. The country exported merchandise goods worth \$990.8 million, down from \$1.03 billion in FY2014. Overall, merchandise exports decreased to 4.6% of GDP in FY2015 from 5.2% of GDP in FY2014. Exports to India, PRC, and other countries accounted for 65.5%, 2.6% and 31.9%, respectively, of total exports in FY2015.

50. The top five exports to India were textiles (\$51.7 million), polyester yarn (\$50.6 million), juice (\$48.1 million), zinc sheet (\$44.2 million), and jute goods (\$43.1 million). Meanwhile, the top five exports to PRC were tanned skin (\$3.1 million), handicraft (\$2.0 million), woolen carpet (\$1.5 million), other handicraft goods (\$0.6 million), and noodles (\$0.5 million). The top five exports to other countries were woolen carpet (\$68.2 million), readymade garments (\$39.9 million), pashmina (\$21.3 million), pulses (\$1.4 million), and tanned skin (\$6.5 million) (Figure 41).

II. Imports

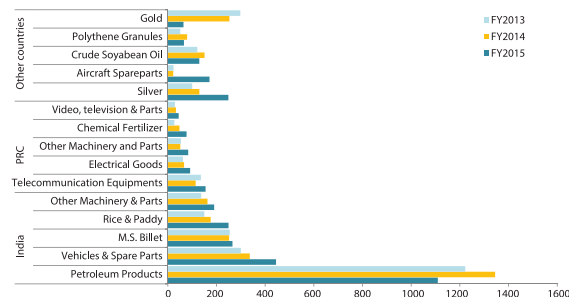
51. Merchandise imports growth (cost, insurance freight [cif]) in dollar terms slowed down to 8.0% from 13.9% growth in FY2014 as it got hit due to the severe disruption in economic activities and a slump in import demand following the earthquake. Of the total imports of \$7.6 billion, 14.7% was oil imports. In US dollar terms, this is equivalent to \$1.1 billion, higher than the value of the country's total merchandise exports but lower than the oil import bill in FY2014. This is primarily due to the low international oil prices and the weakening of aggregate demand in the last quarter of FY2015. Overall, merchandise imports stayed unchanged at 35.9% of GDP in FY2015

Figure 41: Top five exports to India, PRC and other countries (\$ million)



Source: Nepal Rastra Bank

Figure 42: Top five imports from India, PRC and other countries (\$ million)



Source: Nepal Rastra Bank

and FY2014. Imports from India, PRC, and other countries accounted for 63.5%, 12.9% and 23.6%, respectively, of total imports in FY2015.

52. The five top imports from India were petroleum products (\$1,109.6 million), vehicle and spare parts (\$444.9 million), steel billets (\$265.5 million), rice and paddy (\$249.6 million), and other machinery and parts (\$190.5 million). The top imports from PRC were telecommunication equipment (\$155.2 million), electrical goods (\$91.7 million), other machinery and parts (\$83.9 million), chemical fertilizer (\$76.0 million), and video, television and parts (\$44.8 million). The top imports from other countries were silver (\$249 million), aircraft spare parts (\$171.2 million), crude soybean oil (\$129.5 million), polythene granules (\$66.3 million), and gold (\$64.4 million) (Figure 42).

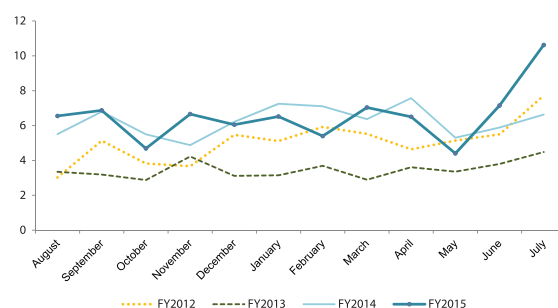
53. As a share of GDP, Nepal's merchandise trade deficit with India, PRC and other countries stood at 20.5%, 4.6% and 7.3%, respectively, in FY2015. It translates into \$4.4 billion, \$0.9 billion, and \$1.6 billion, respectively. Similarly, as a share of GDP, Nepal's total trade with India, PRC and other countries stood at 25.8%, 4.8% and 9.9%, respectively. Trade with India accounted for about 63.7% of total trade in FY2015. Apart from import from India against payment of Indian rupee, the NRB has allowed traders to import industrial raw materials and intermediate goods against payment of US dollars. This mode of payment has also been steadily increasing, reaching import equivalent to NRs78.5 billion that was paid in US dollars in FY2015 to Indian suppliers. Such import drastically increased in the two months following the earthquake (Figure 43).

III. Remittances

54. Despite the deceleration of remittance inflows till the third quarter of FY2015, the earthquake in the last quarter prompted migrant workers to drastically increase the amount of income remitted to Nepal. Consequently, workers' remittance inflows reached a record 29.1% of GDP in FY2015, equivalent to \$6.2 billion (Figure 44). In US dollar terms, remittance inflows grew by 12.2%, marginally up from 11.9% growth in FY2014.²¹ This follows a 16.4% growth of migrant workers (those who obtained permits from the Department of Foreign Employment).

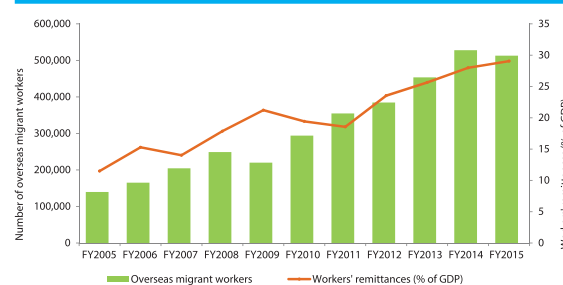
55. According to the Department of Foreign Employment, growth of migrant workers decreased by 2.8% against a growth of 16.4% in FY2014 as recruitment process got derailed for over a month and potential migrant workers deferred travel plans in view of the

Figure 43: Import from India against payment of US dollar (NRs billion)



Source: Nepal Rastra Bank

Figure 44: Number of migrants and remittance inflows

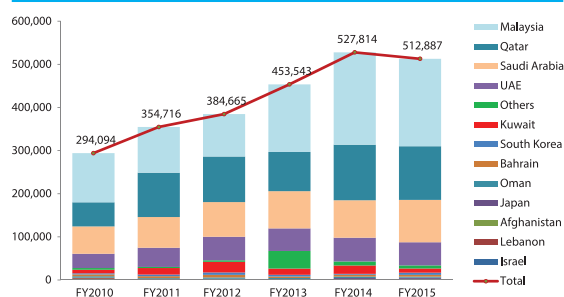


Source: Department of Foreign Employment; Nepal Rastra Bank

²¹ In local currency, the growth rate was 13.6% in FY2015, down 25.0% growth in FY2014.

immediate relief and temporary reconstruction works needed in the earthquake affected areas. A total of 512,887 migrants legally left to work overseas in FY2015 (daily average of 1,405), down from 527,814 in FY2014 (daily average of 1,466). Malaysia, Qatar, Saudi Arabia, and UAE have remained the top employment destinations for low and semi-skilled Nepalese migrant workers (Figure 45). They together accounted for 92% of total migrant workers in FY2015. As a share of total migrants, Malaysia's share increased from 34.6% in FY2013 to 40.6% in FY2014, but declined to 39.5% in FY2015. Meanwhile, Qatar's share also decreased from 24.4% in FY2014 to 24.2% in FY2015. Saudi Arabia, Japan and South Korea absorbed higher share of migrant workers when compared to the shares in FY2014.

Figure 45: Destination-wise distribution of labor migrants



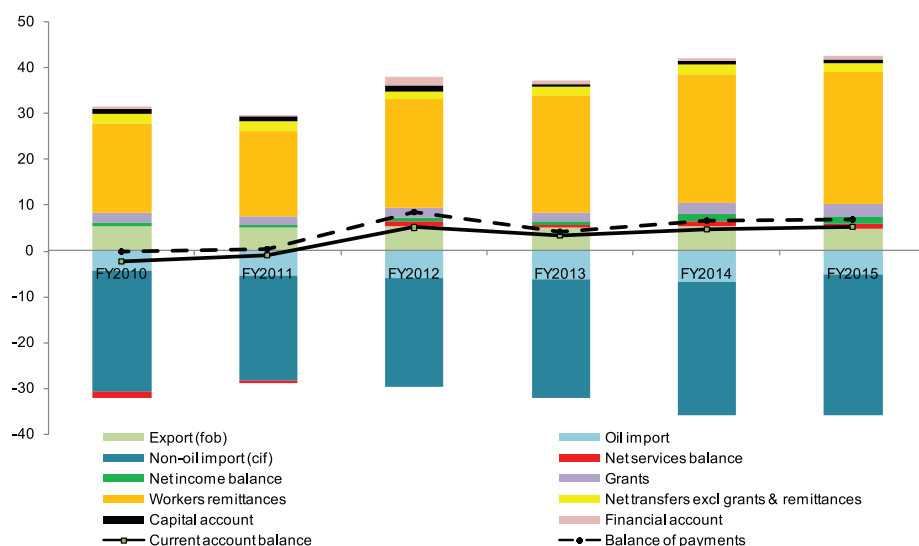
Note: Migrant worker to India are not included as they do not require employment permits.

Source: Department of Foreign Employment

IV. Balance of Payments

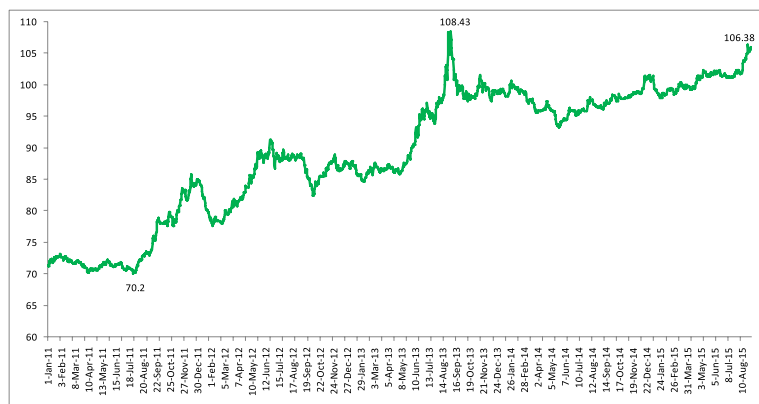
56. The country's external situation strengthened in FY2014 with the balance of payment surplus reaching \$1.5 billion (6.8% of GDP). Though this is an impressive increase from the \$1.3 billion (6.5% of GDP) surplus in FY2014, it is still lower than the \$1.6 billion (8.2% of GDP) surplus in FY2012 (Figure 46). The large merchandise trade deficit, which reached 31.2% of GDP, was partially²² offset by workers' remittances, which reached a record 29.1% of GDP, and export (4.6% of GDP), resulting in a current account surplus of \$1.1 billion (5.1% of GDP), up from 4.6% of GDP in FY2014. While capital transfers decreased by 14.3%, financial transfers increased by

Figure 46: Balance of payments (% of GDP)



Source: Nepal Rastra Bank; NRM staff estimates

²² Overall, the net goods, services and income balance was a negative 28.3% of GDP, which was offset by net transfers equivalent to 33.4% of GDP, resulting in current account surplus equivalent to 5.1% of GDP.

Figure 47: Daily nominal exchange rate (NRs per \$)

Source: Nepal Rastra Bank; NRM staff estimates

57.0% as a result of the 35.5% jump in foreign direct investment, amounted to \$44.2 million. Gross foreign exchange reserves increased from \$6.8 billion in FY2014 to \$8.3 billion FY2014, sufficient to cover 11.2 months of imports of goods and non-factor services.

V. Exchange Rate

57. The Nepalese rupee continues to remain weak against the US dollar, closely following the currency movement of the Indian rupee, to which the currency peg has remained unchanged since 1993 (Figure 47). Overall, the Nepalese rupee depreciated by 19.9% between 15 July 2011 and 15 July 2012 and a further 6.7% between 15 July 2012 and 15 July 2013. It depreciated by 0.9% between 15 July 2013 and 15 July 2014, and a further 5.4% depreciation between 15 July 2014 and 15 July 2015. The country is not able to benefit from the weak currency, which typically boosts relative price competitiveness, as external demand remains sluggish and domestic production is stymied by persistent structural as well as supply-side bottlenecks.

58. The volatility of the Chinese yuan following the depreciation (as a part of the market oriented reforms) in the third week of August and possibility of a rise in US interest rates may put further downward pressures on Indian rupee. This ultimately will get transmitted to Nepalese rupee's exchange rate with convertible currencies. Between mid-July and 23 August, Nepalese currency further depreciated by 3.5% against the US dollar. A weak currency boosts exports (provided there is adequate productive capacity and strong external demand) and remittance inflows. However, weak currency also increases import bill and fuels inflationary pressures.

ISSUE FOCUS

Accelerating Post-earthquake Reconstruction for Faster Recovery

I. Introduction

1. A catastrophic 7.8 magnitude earthquake struck Barpak of Gorkha district on 25 April at 11:56 AM. In between numerous aftershocks of below 5 magnitude, two powerful 6.7 magnitude (26 April) and 7.3 magnitude (12 May) aftershocks shook a large part of the country, particularly central and western administrative regions. It caused further damage to the already weakened houses and physical infrastructure, and also triggered numerous landslides in the rural areas. The calamity has added a new challenge to Nepal's short-to-medium term economic growth and development prospects.

2. The completion of post disaster needs assessment (PDNA), establishment of a National Reconstruction Authority (NRA) the reconstruction-focused budget and monetary policy for FY2016, and the gradual improvement in political environment have put in place the key prerequisites for the execution of reconstruction programs. Now, effectively operationalizing the NRA along with immediate planning and strategizing of reconstruction projects is critical for ensuring a fast and inclusive recovery. The NRA's and sector ministries' ability to swiftly prepare and implement the viable reconstruction projects will be a key determinant for speedy restoration of livelihoods and economic recovery.

3. The estimated 700,000-982,000 additional people pushed below the poverty line by the earthquake-induced income shock need to be pulled back above the line by providing them with jobs, skills and social protection as appropriate. The post-reconstruction programs need to be well coordinated, ensure 'building back better', and be an integral part of the larger goal of meaningful structural transformation of the economy.

II. Damages to Lives and Property

4. Over 8,800 were confirmed dead and 22,309 injured. Furthermore, 602,257 and 285,099 private houses were fully and partially damaged, respectively, forcing thousands of people to seek temporary shelter under tents and tarpaulin sheets. Furthermore, 2,673 and 3,757 public buildings were fully and partially damaged, respectively. To prioritize rescue and relief operations, the government declared 14 districts as severely affected (mostly in the central and western regions) although the earthquake has affected 31 of Nepal's 75 districts.

III. Post Disaster Needs Assessment

5. According to PDNA estimates, the cumulative damage and loss amount to 33.3% of GDP (\$7.1 billion) and the cumulative need for recovery is estimated at \$6.7 billion (31.5% of GDP). PDNA was spearheaded by the National Planning Commission with the support of various government agencies, development partners and civil society. It included 21 sectoral and thematic assessments.

6. Of the total estimated recovery needs, about 50% is for rebuilding private housing and settlement. Productive and infrastructure clusters need 17.3% and 11.1%, respectively. These amount to about 5.5% and 3.5% of GDP, respectively. The recovery needs requirement for agriculture, education, electricity, and transport is estimated at \$156 million, \$397 million, \$186 million, and \$282 million, respectively. Furthermore, recovery of the tourism sector and restoration of cultural heritage are estimated to require \$387 million and \$206 million, respectively.

IV. Impact on Economy

7. On 8 June 2015, the Central Bureau of Statistics estimated the macroeconomic impact of the earthquake. GDP growth (basic prices) is estimated to decline by over 1.5 percentage points to 3.0% in FY2015. Pre-earthquake growth estimate for FY2015 was 4.6% (Figure 48). Although the earthquake struck Nepal only in the tenth month of FY2015, the impact on GDP growth is sizable, especially on the services sector.

8. Agricultural sector is expected to grow by 1.9%, industry by 2.7%, and services by 3.9%, down from earlier no-earthquake scenario forecasts of 3%, 3.5%, and 5.8%, respectively. The sharp drop in agricultural output is primarily due to the negative impact of delayed and weak monsoon in the first half of FY2015, and later the loss of livestock due to the earthquake.

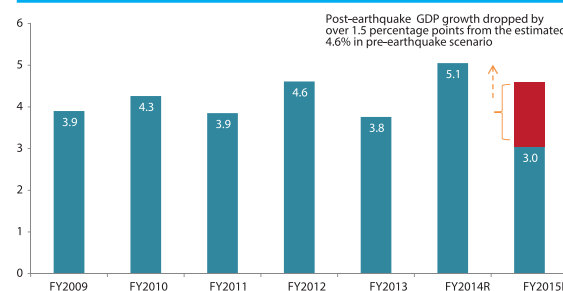
9. The slowdown in the industry sector is due to the drastic drop in quarrying (stones, aggregates, sand and soil extraction slowing down in the affected districts, and the government's policy to temporarily halt construction activities till mid-July 2015); manufacturing (physical damage, labor shortage, and weak demand); and

Table 3: Damages, losses and needs (\$ billion)

Sector themes	Included sectors	Damages	Losses	Total needs
Social	Cultural heritage; education; health; housing and human settlements; nutrition	3.6	0.5	4.1
Productive	Agriculture; finance; industry; commerce; irrigation; tourism	0.6	1.2	1.2
Infrastructure	Communications; community infrastructure; electricity; transport; water and sanitation	0.5	0.1	0.7
Cross-Cutting	Gender; social protection; employment & livelihoods; disaster risk reduction; environment and forestry; governance	0.5	0.0	0.7
Total		5.2	1.9	6.7

Source: National Planning Commission

Figure 48: GDP growth (at basic prices), %



Source: Central Bureau of Statistics

construction (policy to temporarily halt construction activities, and low production of construction materials, among others).

10. The disruptions caused by the earthquake have been the most severe in the services sector. Overall, services growth is estimated to decline by about 2.1 percentage points to 3.9% in FY 2015. It grew by 6.4% in FY2014. Wholesale and retail trade; tourism activities (affects air transport, and hotel and restaurant businesses); real estate, renting and business activities; and education sub-sectors are the most affected.

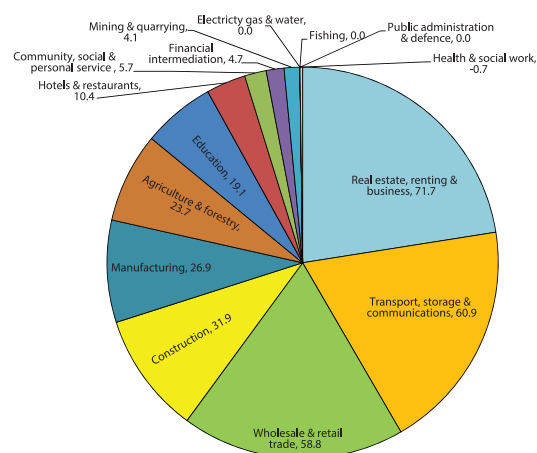
11. Wholesale and retail trade grew by 9% in FY2014, but dropped to 3.4% after the earthquake (against the pre-earthquake forecast of 5.6%) in FY2015. This is primarily due to the slowdown in agricultural production and import of goods immediately after the earthquake. Hotels and restaurants suffered due to slowdown in tourist arrivals, physical damage to hotels and restaurants, and decline in domestic tourism. Furthermore, real estate activities were in line with the substantially lower land-related transactions (including buying and selling, renting, and operation of self-owned or leased real estate; and renting of machinery, equipment and personal and household goods). There was also a substantial slowdown in property renting business due to the physical damage to buildings.

12. Overall, agricultural, industry, and services sectors will contribute 0.6, 0.4, and 2.1 percentage points to GDP growth of 3% (at basic prices) in FY2015, respectively. Nepal's GDP is estimated at \$21.6 billion in FY2015 (\$371 million less than what would have been in a no-earthquake scenario). The loss is equivalent to 1.5% of GDP, and about 62% of the total gross value added¹ (GVA) loss is accounted for by the services sector (Figure 49).

13. Per capita income is estimated to decrease by \$23 compared to the no-earthquake scenario (in which case per capita income would have been \$785) (Figure 50). Accordingly, real per capita income increased by just 0.6% against 3.6% in a no-earthquake scenario.

14. Inflation was moderating till mid-April 2015, but it started edging up as a result of the supply-side disruptions caused by the earthquake. Prices of both food and non-food items increased in the last three months of FY2015, resulting in an average inflation of 7.2%.

Figure 49: Value added output loss by sub-sector in FY2015 (\$ million)

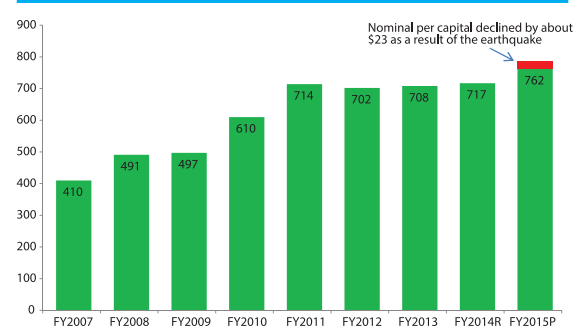


Source: Central Bureau of Statistics

¹ Gross output is the total value of all goods and services produced during the accountancy period (at basic prices). Intermediate consumption is the total value of goods and services consumed as inputs by production processes (at purchasers' prices). Gross value added is the difference between gross output and intermediate consumption. Finally, GDP is equal to gross value added plus taxes minus subsidies.

15. External sector stability remained robust as net transfers increased sharply than the rise in trade deficit, resulting in a current account surplus of 5.1% of GDP and a record foreign exchange reserves (\$8.3 billion, which is sufficient to cover 11.2 months of import of goods and nonfactor services). However, this may not be sustained for long as import of construction items is expected to increase drastically in the next few years for the post-earthquake reconstruction programs. Consequently, growth of net transfers may stabilize as migrant workers deplete their present and anticipated savings by remitting early to help households meet immediate needs. Furthermore, remittance inflows may also slowdown if there is less demand for workers in the Gulf countries and Malaysia following the cost-free migration policy² implemented by the on July 2015. Hence, the current account balance may slip into the negative territory over the medium term and foreign exchange reserves may deplete to an equivalent of around 7 months of imports, which is also the recommended level of reserve adequacy to ensure external sector stability.³

Figure 50: Nominal per capita GDP (US\$)



Source: Central Bureau of Statistics

Box 2: Highlight of ADB's Commitment for Reconstruction

\$600 million aid pledged

- **Emergency Assistance Project (\$200 million)**
- **Accompanying packages (\$50 million)**
 - \$30 million budget support
 - \$15 million from Japan Fund for Poverty Reduction
 - \$3 million from the Asia Pacific Disaster Response Fund
 - Remaining technical & other assistance
- **\$350 million from restructuring of ongoing project portfolio, subject to satisfactory progress of assistance already committed.**

EMERGENCY Assistance Project

- **Rebuilding schools**
 - At least 700 schools (7,000 classrooms)
 - Disaster-resilient standard
- **Rural roads and bridges**
 - Rehabilitate about 135 kms of strategic roads
 - 450 kms of district road
- **Public buildings**
 - Rebuilding or retrofitting of about 300 district-level government buildings
- **Capacity building**
 - Disaster preparedness & risk management skills

² The Ministry of Labor and Employment directed overseas recruitment agencies to facilitate migration without financially burdening the migrant workers. This essentially means cost-free migration for workers seeking employment in Saudi Arabia, Qatar, Kuwait, the United Arab Emirates, Bahrain, Oman and Malaysia.

³ IMF. 2015. Nepal: Request for Disbursement Under the Rapid Credit Facility. IMF Country Report No.15/224. Washington, DC. See: <http://www.imf.org/external/pubs/ft/scr/2015/cr15224.pdf>

V. Impact on Poverty and MDGs

16. The severely earthquake-affected 14 districts account for about 13.6% of the total number of people living below the poverty line in Nepal. Among them, Dolakha, Makwanpur, Ramechhap, Rasuwa, Sindhuli, and Sindhupalchowk have higher poverty rate than the national average of 25.2% in 2011. Similarly, nine have human development index (HDI) score lower than the national average.

17. Preliminary estimates show that the income shock as a result of the earthquake will likely push an additional 700,000-982,000 people below the poverty line. This translates into an additional 2.5%-3.5% of the estimated population in 2015 pushed into poverty compared to the no-earthquake baseline scenario of about 21%. About 50%-70% will come from rural Central hills and mountains, where the vulnerability prior to the earthquake was already high. The income shock is largely felt through the loss of livelihoods (including death and injuries to primary wage earners) and the loss of housing, productive assets (seeds, livestock, and farm equipment), and durable assets (assorted household items).

Table 4: Damages to education, health and electricity sectors

Education sector					
	ECD	School	TVET	Higher edu	NEF/LLL
No. of classrooms/rooms fully destroyed	784	26,090	356	1,292	40
Number of classrooms/rooms partially destroyed		26,080	184	3,040	7
Number of toilets and WASH facilities		4,416			
Number of compound walls		1,791		6	
Equipment (NRs million)		140.4	90	155.5	
Furniture (NRs million)		1,867.60	4.5	5.6	0.6
Other assets (NRs million)	10	2,087	1	17	0.4
Total damages and losses (NRs million)	413.5	27,832.80	494	2,472.60	23.4
Health sector					
	Hospital	PHCC	HP	Others	Private facilities
No. completely damaged	5	12	417	12	16
No. partially damaged	39	54	598	10	56
	Infrastructure	Medical equipment	Office equipment	Medicines & supplies	Other logistics + losses
Total damages and losses (NRs million)	6,357	284	41	13	1065
Electricity sector					
	Generation	Transmission	Distribution	Civil structures	Contingencies
Public (NRs million)	1,400.00	347	1,315.00	514	2,000.00
Private (NRs million)	10,737.00		1,497.00		
Total damages (NRs million)	12,134.00	347	2,812.00	514	2,000.00
Total reconstruction needs (NRs million)	12,573.00	417	3,118.00	514	2,000.00

Source: National Planning Commission

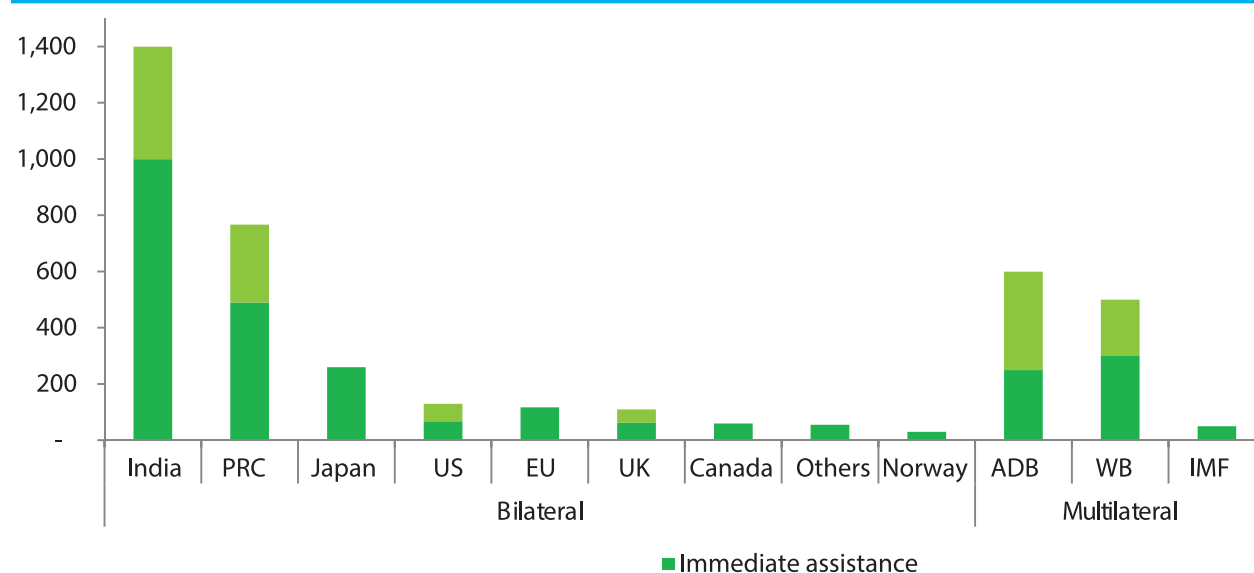
18. Beyond this monetary-based poverty estimates, a larger impact can be expected when factoring in multidimensional poverty, which includes additional factors such as water and sanitation services, disruption of schools and health services, and the possibility of an uptick in food insecurity. The poor and vulnerable are particularly dependent on local infrastructure (roads, bridges, health posts, and schools) for access to labor and commodity markets, and for accumulation of human capital (especially those of children). Reviving local economic activities and resumption of basic public services along with an accelerated implementation of reconstruction projects will be critical to make up for the setback on poverty reduction caused by the earthquake.

19. Furthermore, the progress towards achieving the Millennium Development Goals (MDGs), on which Nepal was mostly on track prior to the earthquake, is likely to be adversely affected, given the widespread damages to houses, classrooms, and health posts. It will also likely affect the country's overarching goal to graduate from the Least Developed Country (LDC) category by 2022.

VI. International Conference on Nepal's Reconstruction

20. On 25 June 2015, the government organized an international conference on Nepal's reconstruction. High level representatives from over 50 countries and multilateral agencies participated in the conference.

Figure 51: Total aid pledged for reconstruction (\$ million)



Source: Ministry of Finance; ADB staff estimates

21. ADB, represented by its President, Takehiko Nakao, pledged \$600 million—including \$200 million emergency assistance approved by its Board of Directors on 24 June—to support rebuilding of schools, roads, and public buildings. The government estimated the total pledge of assistance at \$4.0 billion (equally split in grants and concessional loans). Of the total pledge, about 67% is new commitment (\$2.7 billion). Cumulatively, India and the Peoples' Republic of China committed \$1.4 billion and \$767 million, respectively. World Bank, Japan, the US and the EU pledged \$500 million, \$260 million, \$130 million, and \$117 million, respectively (Figure 51).

22. According to the PDNA, total public sector losses and damages amount to \$1.7 billion, which excludes housing. The National Planning Commission (NPC) estimated that about 57% of the recovery needs (\$3.8 billion), including housing, will have to be shouldered by the government. In this respect, the total pledged amount was higher than the public sector recovery needs till the medium-term. However, a much higher amount of investment may be needed in the long-term to build better and earthquake-resilient public infrastructure throughout the country.

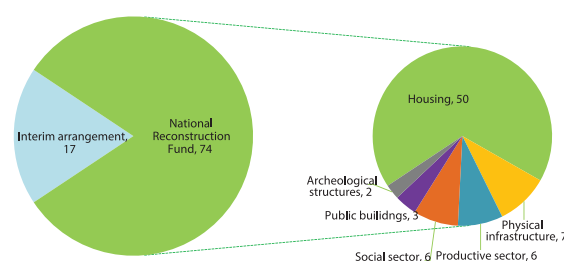
VII. FY2016 Budget and Monetary Policy

23. The FY2016 budget is primarily focused on rehabilitation and reconstruction of physical and social infrastructure, housing and livelihoods after the catastrophic earthquake.

24. Completing of reconstruction work within the next five years is the most prominent agenda. It commits to fully operationalize the NRA soon, with a special implementation authority, effective leadership, and adequate financial resources. A total of NRs91 billion (\$910 million or 3.8% of GDP) has been earmarked for reconstruction work, including \$740 million (3.1% of GDP) for the National Reconstruction Fund, which will initially prioritize reconstruction of housing, public buildings, archeological structures, physical infrastructure, and enhancement of productive capacity. About \$170 million is earmarked for sector ministries and agencies to carry out reconstruction works till the NRA is operational, i.e. an interim arrangement (Figure 52).

25. The budget also includes NRs200,000 (about \$2000) for each household that has lost its house due to the earthquake. To address the shortage of labor for reconstruction, skill training is planned for 50,000 people in the areas of masonry, plumbing, and electrical works.

Figure 52: Planned reconstruction budget for FY2016 and composition of National Reconstruction Fund (NRs billion)



Source: FY2016 Budget Speech

26. Meanwhile, to assist government, Banks and Financial Institutions (BFI), and the public in their efforts toward accelerated post-earthquake recovery, Nepal Rastra Bank (the central bank) introduced a number of measures in the monetary policy for FY2016, including:

- (i) Zero percent refinancing facility for BFIs willing to provide loans at 2% interest to those households affected by the earthquake, provided that such households meet the requirements set by the government. Accordingly, households within and outside Kathmandu Valley can access the subsidized loans of up to NRs2.5 million and NRs1.5 million, respectively.
- (ii) As announced in the FY2016 budget speech, the NRB will help assist in the establishment of an Economic Rehabilitation Fund, which will provide refinancing facility and interest subsidy to the business community affected by the earthquake

Table 5: Breakdown of reconstruction budget for FY2016

NRs billion	GON	Grant	Loan	Total	Share of aid
National Reconstruction Fund	16	36	22	74	78
Recurrent expenditure	8	15	12	35	77
Program expenses	2	0	0	2	0
Capital grants to institutions & individuals	6	15	12	33	82
Capital expenditure	8	21	10	39	79
Building construction	2	10	5	17	88
Civil works	6	11	5	22	73
Natural disaster relief & reconstruction	17	0	0	17	0
Recurrent expenditure	2	0	0	2	0
Capital expenditure	15	0	0	15	0
Civil works	5	0	0	5	0
Capital contingencies	5	0	0	5	0
Capital formation	5	0	0	5	0

Source: FY2016 Red Book; Budget Speech

VIII. Effective Reconstruction and Recovery

27. Recovery has to be faster, better and smarter given that the country lies on an active geological fault lines. Drawing from ADB's experience in post-disaster recovery in Asia and the Pacific region, ADB President Nakao highlighted, during the reconstruction conference, five principles for effective reconstruction that Nepal could follow:

- (i) Public as well as private buildings should be rebuilt to earthquake-resilient standards, fully applying the principle of "Build-Back-Better".

Box 3: Fiscal Sustainability and Post-earthquake Reconstruction

The cumulative damages and losses as result of the earthquake and the subsequent aftershocks were estimated at about \$7.1 billion. However, the cumulative need for recovery is estimated at \$6.7 billion. Excluding housing, total public sector damages and losses (excluding housing) amount to \$1.7 billion. The NPC's estimate of total public sector burden, including housing and human settlement, is about \$3.8 billion (or about 18% of FY2015 GDP) over the medium term. The total donor pledge during the reconstruction conference exceeds the total public sector needs for recovery. About 50% of the total pledge is on grant basis.

Given that Nepal needs to borrow a higher amount both internally and externally (cumulatively about 9% of GDP over the next five years) to finance reconstruction projects, and tax revenues being barely sufficient to finance recurrent spending, Nepal's fiscal policy will need to be more prudent yet expansionary in the coming years.

Nepal has a very low fiscal deficit to start with when compared to regional economies, and low and lower middle income economies. In FY2013 and FY2014, robust revenue growth (including grants) along with under-spending of the capital budget resulted in a fiscal surplus. This is not ideal for a low income country with huge infrastructure deficit that is constricting

overall economic potential. Nepal needs about 8% to 12% of GDP in annual investment in infrastructural till 2020 to close its infrastructure deficit, accelerate inclusive economic growth, and create adequate new jobs. Hence, increasing borrowing to a fiscally prudent level to financing productivity-enhancing capital investment will be of paramount importance.

The IMF's latest debt sustainability analysis¹ shows that Nepal's risk of debt distress continues to be low, mainly attributed to 'prudent fiscal policy and low capital budget execution'. Public external debt stock and servicing ratios are within the policy-dependent indicative thresholds as government borrowing has mostly been on concessional terms. The analysis shows that debt dynamics remain resilient to standard shocks (shocks to GDP growth, exports, non-debt creating flows [captures a remittance shock], a combination of these shocks, and

onetime 30% nominal depreciation shock).

Broadly, fiscal sustainability over the medium to long term can be assessed by looking at the real interest rate, exchange rate, inflation, GDP growth, and the debt stock.

At present, Nepal's debt stabilizing primary balance is about -1.2% (Table 3.1), which means that it is the primary deficit required to keep debt to GDP ratio constant at FY2015 level (25.6% of GDP). It assumes a 10% depreciation of the currency against the US dollar (which then increases outstanding debt payment), average real interest rate on total government debt stabilizing at FY2015 level (weighted average of real interest rate on domestic and foreign currency debts), and GDP deflator (proxy for inflation) and GDP growth averaging 7.5% and 5.0%², respectively, over the medium term. Alternatively, it indicates that if Nepal judiciously utilizes borrowed money on productivity-enhancing investment projects, it has ample fiscal space (mostly borrowing on concessional

Table 3.1: Debt stabilizing primary balance

Initial debt to GDP level	25.6%
Weighted real interest rate	-0.1%
GDP growth rate	5.0%
Required primary balance	-1.2%

Source: NRM staff estimates

¹ IMF, July 2015. Request for Disbursement Under The Rapid Credit Facility— Debt Sustainability Analysis. International Monetary Fund. Washington, DC

² Lower GDP growth necessitates higher levels of primary balance to stabilize debt to GDP ratio.

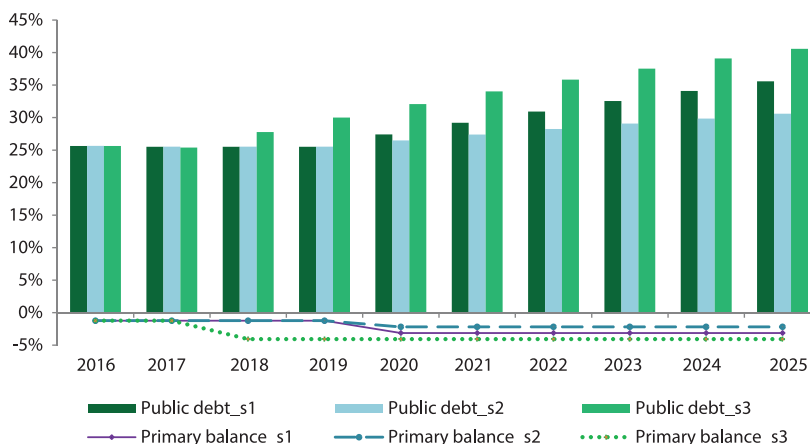
terms). In FY2015, primary balance amounted to 1.6% of GDP.

Furthermore, even after taking into account the need for higher borrowing to finance public sector investment needs (an additional 10% of GDP cumulatively over the next ten years), the country can still maintain overall fiscal sustainability. It translates into a targeted debt stock of about 35.6% of GDP by 2025 (Figure 3.1), which can be maintained by a combination of the following scenarios:

- **Scenario 1:** (i) primary deficit of 1.2% of GDP till 2019 (assuming that actual disbursement is higher than the previous years) and then 3.1% of GDP till 2025 (disbursement accelerates even higher); (ii) real interest rate of -0.1; and (iii) GDP growth of 4.8% in FY2016; 5.5% in FY2017 and 5.0% till 2025. It assumes GDP deflator of 7.5% and currency depreciation by 10%.
- **Scenario 2:** If the public debt target is increased by five percentage points of GDP only (increasing public debt stock to 30.6% of GDP by 2025 assuming a slower disbursement) then primary balance requirement after 2020 will decrease (maintaining other assumptions as they are in scenario 1).

In addition, if the government's spending capacity is drastically enhanced, an additional 5% of GDP could be spent in capital projects throughout the country (i.e. not restricted to earthquake-hit areas) to close the infrastructure gap.

Figure 3.1: Public debt and primary balance estimate (% of GDP)



Source: NRM staff estimates

Considering this scenario along with the following assumptions in Scenario 3 would still result in a manageable fiscal position (a larger primary deficit and cumulative public debt stock of 40.6% of GDP by 2025)

- **Scenario 3:** (i) primary deficit of 1.2% of GDP till FY2017 and then disbursement accelerates much faster than in scenario 1 (reconstruction expenditure amounting to an additional 10.0% of GDP and a further 5.0% of GDP equivalent of expenditure to close infrastructure gap in remaining areas of the country) leading to increase in primary deficit to 4.1% of GDP from FY2018 to FY2025; (ii) weighted average real interest rate of -0.1; and (iii) GDP growth of 4.8% in FY2016; 6.0% in FY2017 and 7.0% till 2025 (higher spending accelerates economic growth as well). It assumes

GDP deflator of 7.5% and currency depreciation by 10%. Traditionally, countries having public debt of around 40% of GDP are considered fiscally sustainable.

Overall, Nepal's average weighted real borrowing rate is much lower than the GDP growth rate, indicating that a small primary deficit would not jeopardize fiscal sustainability. It opens up more fiscal space, which needs to be exploited by the government by enhancing absorptive capacity with respect to productivity-enhancing capital investment, i.e. avoiding inefficient capital accumulation or using such borrowed money to finance recurrent expenditure. The availability of funds for reconstruction should not be an issue. Drastically enhancing absorptive capacity, however, remains an unresolved issue.

- (ii) Inclusiveness should be at the core of reconstruction effort. Special attention should be paid to the needs of the poor, rural residents, and other vulnerable social groups, who have suffered more from the earthquakes.
- (iii) A robust institutional setup for reconstruction is pivotal to successfully execute reconstruction projects within the given timeframe. A strong leadership and competent human resources are vital for the success of the NRA.
- (iv) Continuous enhancement of the institutional capacity of executing and implementing agencies along with the adoption of sound governance and fiduciary risk management systems for the reconstruction process are also important.
- (v) Effective donor coordination and strong government ownership of the entire process are also equally important for the success of the reconstruction projects.

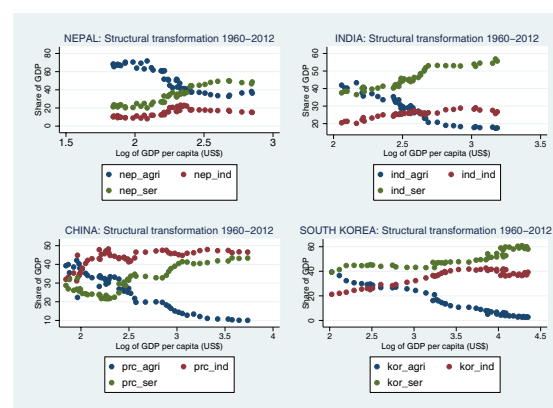
28. He also emphasized that reconstruction should go hand in hand with development programs already planned, without affecting the latter.

IX. Accelerated Recovery and Structural Transformation

29. The reconstruction authority's and sector ministries' ability to swiftly prepare and implement viable projects will underpin the scope and pace of reconstruction, and hence the recovery phase. A coherent reconstruction strategy has to be ideally aligned with the long-term economic development vision, which aims to increase per capita income to the level of a middle-income country before 2030. This is especially important because the PDNA covered earthquake-resilient reconstruction only in the affected areas, whereas this has to be implemented throughout the country. Adhering to the principle of Build-Back-Better, rebuilding damaged houses beyond the set size, retrofitting standing buildings in Kathmandu Valley and affected districts, and nationwide resilience (such as ensuring housing and school safety across the country) need to be kept in mind while planning and initiating rehabilitation and reconstruction projects.

30. Overall, rehabilitation and reconstruction should primarily aim at increasing productivity-enhancing public capital investment. This is a key to ensuring structural transformation whereby high value-added and high-productivity sectors are more dominant than low value-added and low-productivity sectors in the medium term. Promoting agribusiness, industrial capacity, innovation and high-productivity services need to be at the center of such a reconstruction and structural transformation strategy. In addition to higher

Figure 53: Structural transformation



Source: NRM staff estimates

investment, this will require reforms on institutional, legal, regulatory, and capacity enhancement fronts.

31. Private investment has been suppressed primarily due to the liberal product market (including imports), but an unreformed factor market (land, labor, and capital) after 1992 (the time when the first set of liberalization reforms were rolled out). This has led to stunted growth of the manufacturing sector and its declining share of GDP as imported-based activities expanded. Given this background, a higher quantum and quality⁴ of capital spending is vital to boost aggregate demand, expand the growth potential of the economy, and increase per capita income. Higher productivity-enhancing public capital investment would also increase returns on private investment, resulting in higher private investment due to the ‘crowding-in’ effect. Such public investment over the medium term in physical and social infrastructure enhances productivity growth, encourages technological innovation, accelerates recovery and establishes a faster, inclusive, and sustainable growth pattern. However, in the long term, structural changes, especially in factor markets (land, labor, and capital), are required to sustain the growth pattern established through stabilization measures over the medium term.

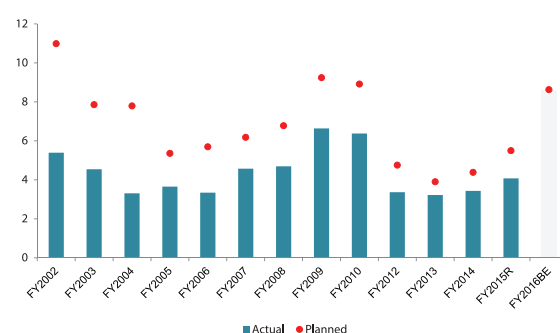
X. Concerns Over Effective Budget Execution

32. One of the biggest unknowns following the decision to establish the NRA is its ability to fully execute the planned reconstruction budget in well-planned productivity-enhancing projects. This concern arises from the persistent budget execution shortfalls even under normal circumstances, which has further weakened in the last decade (Figure 54). As such, actual capital spending averaged about 72% in the last decade and about 60% is bunched in the last quarter. Furthermore, the actual capital spending (about 3% to 4 % of GDP) is far less than the required spending (of 8-10% of GDP) to close the infrastructure gap.

33. Capital spending is marred mainly by:

- a. *Bureaucratic hassles*: project approval delays, and weak intra and inter-ministry coordination,
- b. *Structural weaknesses*: limited appraisal, planning, and implementation capacity of line ministries (including the lack of medium-term expenditure framework), lack of strong pipeline of projects ready for implementation, cumbersome laws and regulations (procurement and procedural clearances), and allocative inefficiency,

Figure 54: Planned and actual capital spending (% of GDP)



Note: Changed reporting system to Government Finance Statistics (GFS) 2001 in FY2012. In FY2011, actual reporting was done based on GFS 2001, but budget allocation was done based on earlier GFS.

Source: Ministry of Finance; NRM staff estimates

⁴ Low quality of capital spending escalates future recurrent costs associated with the project (such as operation and maintenance costs, staff required to monitor the project, etc)

- c. *Low project readiness*: lack of feasibility studies and detail designs in advance, lack of well-planned procurement plans, and delays in land acquisition,
- d. *Weak project management*: high staff turnover, lack of staff capacity, lengthy procurement process, weak contractor capacity, and weak contract management
- e. *High fiduciary risks in project implementation*, particularly in rural areas when programs are implemented through local government having limited human resources and capacity,
- f. *Political instability* and interference at operational level

34. The budget for FY2016 partially addresses this concern by giving the line ministries administering large projects the authority to spend the planned budget without getting prior approval from the NPC and the Ministry of Finance (MOF). Similarly, multi-year contracts are allowed for some projects and the government has committed to restrict transfer key project staff subject to satisfactory progress in implementation. Deployment of managers, accountants, and technical staff is envisaged in village development committees starting with earthquake affected areas. However, other issues outlined above impeding regular capital spending remain unchanged and it is likely that \$170 million allocated to various line ministries for reconstruction work may remain underspent at the end of FY2015.

35. With regard to spending by the NRA, the ordinance, which needs to be transformed into an Act without delay, governing its establishment gives it sweeping powers to do away with most of the hassles impeding accelerated capital spending. The authority is chaired by the Prime Minister and its Chief Executive Officer (CEO) will independently handle the operations. The CEO, whose performance will be critical to accelerated reconstruction within the given timeframe, was still not appointed two months after the ordinance for its establishment was introduced. This already delayed the pace of implementation, especially concerning hiring of human resources, preparing a quick pipeline of projects, an associated action plan for investment, and its overall synchronization with the long-term development vision being envisaged by the NPC. The faster the NRA comes into operation, the faster will be the capital spending and ultimately completion of the reconstruction programs.

36. The NRA will have a critical role in managing the following crucial issues for accelerated reconstruction and recovery:

- Hiring competent human resources that can bring in new and smarter ideas and foster innovation (including reassigning competent civil servants from across government departments)

- Preparing a credible time-bound action plan for investment in reconstruction projects, including a sizable pipeline of potential projects
- Managing political interference in normal operations and preparation of reconstruction projects and ensuring an inclusive development process
- Ensuring line ministries' full ownership of projects designed, approved and procured by the NRA
- Coordinating with development partners to ensure that the committed funds for reconstruction are realized within the given timeframe
- Engaging meaningfully youth, local communities, think tanks, specialized institutes, and civil society in reconstruction planning, design, implementation, monitoring, and evaluation
- Ensuring 'crowding-in' of private investment for reconstruction on public-private partnership (PPP) basis
- Outsourcing of managerial as well as non-managerial work (time and output-bound contractual arrangement for design, supervision, and management of reconstruction projects).

XI. Conclusion

37. The earthquake caused tremendous loss of lives and properties. It lowered economic growth rate, pushed about a million people below the poverty line, slowed progress on achieving some of the MDGs, and sapped investors and consumer confidence. The cumulative pledges during the international reconstruction conference exceeded the expected public sector needs for reconstruction. Now, the NRA and line ministries' ability to swiftly prepare and implement viable projects will underpin the scope and pace of reconstruction and ultimately a better, faster and smarter recovery. The authority needs to be operationalized without delay and it has to chart out a coherent five-year reconstruction strategy by aligning it with the long-term economic development vision.

38. Accelerated reconstruction would require hiring of competent human resources, preparing a time-bound investment action plan, a strong pipeline of viable projects, outsourcing of design, monitoring and evaluation, political buy-in of proposed actions, and engaging youth, specialized institutions, and civil society at various stages of the project cycle. This would then 'crowd in' private investment as well, leading to a higher, sustainable, and inclusive economic growth. Overall, rehabilitation and reconstruction should primarily aim at increasing productivity-enhancing public capital investment, which is a key to ensuring structural transformation whereby high value-added and high-productivity sectors are more dominant than low value-added and low-productivity sectors in the medium term.

Appendix 1: Review of FY2016 Budget

I. Introduction

1. On behalf of the new coalition government, headed by Prime Minister Sushil Koirala, formed after the second Constituent Assembly (CA) elections in November 2013, Finance Minister Dr. Ram Sharan Mahat presented a full and timely budget for FY2016 to the CA on 14 July 2015². The long-term vision is to graduate from least developed country category by 2022 and to achieve a middle income country status by 2030.

2. The budget is primarily focused on rehabilitation and reconstruction of physical and social infrastructure, housing and livelihoods after the catastrophic 7.8 magnitude earthquake on 25 April. Furthermore, the budget has also emphasized effective budget execution and service delivery. One important departure from previous budgets is that the line ministries administering large projects now have the authority to spend the allocated budget without getting prior approval from National Planning Commission and Ministry of Finance.

3. This note summarizes and analyzes the key macroeconomic features of the FY2016 budget, reform agenda, implications for the economy, and sector investment and policy reforms. It also compiles FY2016 budgetary allocations for some of the ADB-supported projects (Attachment 1).

Table A1.1: Budget and expenditure overview

	FY2016BE	FY2015BE	FY2015RE
GDP growth target (%)	6.0	6.0	3.0
Inflation target (%)	--	8.0	below 8
Budget allocation and expenditure (NRs billion)			
Budget allocation	819.0	618.1	522.7
Recurrent	484.3	399.0	339.2
Capital	208.9	116.8	86.6
Financial	126.3	102.4	96.9

Source: FY2016 Budget Speech

BE: budget estimate; RE: revised estimate; Further detail of income and expenditure is in Table 2

¹ This analysis was prepared by Chandan Sapkota, Economics Officer, and Neelina Nakarmi, Economics Analyst, under the overall of guidance of Raju Tuladhar, Senior Country Specialist and Kenichi Yokoyama, Country Director of Nepal Resident Mission, ADB. The views expressed are those of the authors and do not reflect the views of the ADB, or its Board of Directors, or its member governments.

² From mid-July 2014 to mid-July 2015.

4. The total expenditure outlay for FY2016 is NRs819 billion (an estimated 33.8% of GDP), which is 56.7% higher than the revised total expenditure in FY2015. The FY2016 outlay comprises NRs484 billion for recurrent expenditures (59.1% of the total outlay), NRs208.9 billion for capital expenditures (25.5%), and NRs126.3 billion for financial provision³ (15.4%).

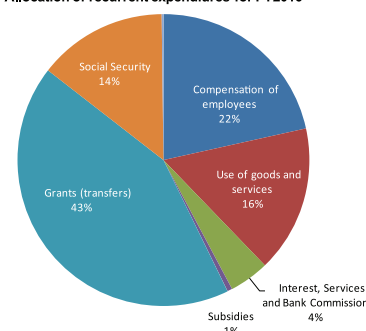
5. The substantially larger size of the budget is due the 141% increase in planned capital spending (compared to the FY2015 revised estimate), which will primarily be used for post-earthquake reconstruction of physical and social infrastructure. However, actual utilization of will mainly depend on (i) how the government improves its limited absorptive capacity (FY2016 is touted as the 'Year of Implementation'), and (ii) how quickly the new National Reconstruction Authority will be established and made fully and effectively operational. Budget utilization in FY2015 is estimated to be low at 85.0% of the budget amount for recurrent expenditure, and only 74.2% for capital expenditure, reflecting the persistent weaknesses in budget execution processes, lack of project readiness, and procurement-related delays, among others.

6. The outlay for recurrent expenditure (equivalent to 20.0% of GDP) is 42.8% higher than the revised estimated expenditure in FY2015. Recurrent expenditures have been rapidly increasing in recent years; they were just 12.7% of GDP in FY2010. This is largely contributed by the use of goods and services⁴, and grants (transfers) to local bodies. Meanwhile, the planned capital spending has been increased by a whopping 141.2% over the FY2015 revised estimate (equivalent to 8.6% of GDP compared with 4.1% of GDP in FY2015). About NRs91 billion is set aside for reconstruction activities. One of the major challenges would be to fully spend the planned capital budget so that reconstruction activities are not delayed as is the case with other infrastructure spending. Civil works account for about 65% of total planned capital spending.

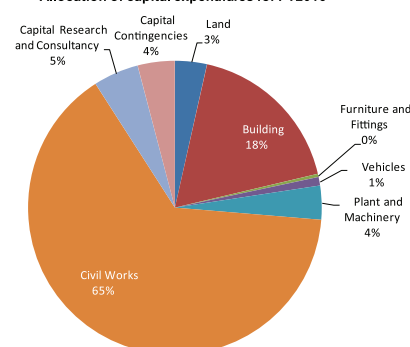
7. A total revenue target of NRs587.9 billion (24.3% of GDP) has been set for FY2016, including projected foreign grants of NRs110.9 billion (4.6% of GDP) and principal repayment of NRs2.0 billion. The revised estimate for revenue mobilization (including grants) in FY2015 was 20.3% of GDP. This government has increased the business transaction threshold for value added tax (VAT) to NRs5 million from NRs2 million and has also given tax concessions on

Figure A1.1: Planned recurrent and capital expenditures for FY2016

Allocation of recurrent expenditures for FY2016



Allocation of capital expenditures for FY2016



Source: FY2016 Budget Speech⁵

³ It includes internal loan investment, domestic share investment, and external and domestic debt repayments.

⁴ Use of goods and services consists of (i) rent & services; (ii) operation and maintenance of capital assets; (iii) office materials and services; (iv) consultancy and other services fee; (v) program expenses; (vi) monitoring, evaluation and travel expenses; (vii) recurrent contingencies; and (viii) miscellaneous.

⁵ Subsidies include direct subsidies (NRs 2.6 billion) to non-financial public corporations and private enterprises only. Actual direct and indirect subsidies are much higher. The chemical and organic fertilizer subsidy, losses of NOC and NEA (could be thought of as an indirect subsidy as the government pays for it ultimately), subsidies to micro-hydro-power projects, transportation subsidy, and interest subsidies to farmers groups and cooperatives, among others are not included.

import of construction materials (zinc sheet and pre-fabricated home), and agricultural machinery. The rates of excise duty on cigarette, beer and alcohol, and vehicle tax have been revised upward. Besides these, there isn't significant change in revenue policy. **Sustaining the large growth in revenue (about 20% per annum) may be challenging in the absence of an accelerated economic recovery in FY2016.** Furthermore, planned foreign aid may not be realized if there are delays in project implementation.

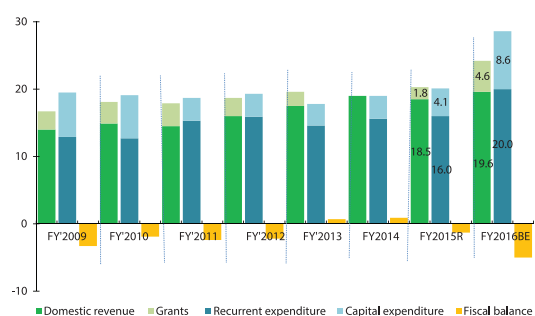
8. The deficit (against the total expenditure of NRs819.0 billion) is to be financed by foreign loans amounting to NRs95.0 billion, domestic borrowing of NRs88.0 billion, and FY2015 cash balance of NRs48.6 billion. Considering expenditure including net lending and revenue including grants plus previous year's cash carryover, **fiscal deficit is projected to be about 5.0% of GDP.** Net foreign loans and net domestic borrowings are projected to be 3.0% and 1.9% of GDP, respectively. Although the fiscal deficit appears large, particularly given the historically low fiscal deficit (and even surplus in FY2013 and FY2014), it may shrink by few percentage points by the end of the year if the government is unable to accelerate capital spending including reconstruction projects. Eventually, **the modest rise in fiscal deficit should be manageable** given the need to accelerate growth and economic recovery, and it is most fruitful if the spending is focused on productivity-enhancing investments.

II. Main Agenda: Post-earthquake Reconstruction and Reforms

9. The budget has given continuity to the reforms, mostly legislative, aimed at improving the investment climate, improving the efficiency and governance of the financial sector, and strengthening public sector management/governance. Some of the reform agenda committed in the FY2015 budget that are given continuity in FY2016 budget are in Attachment 2.

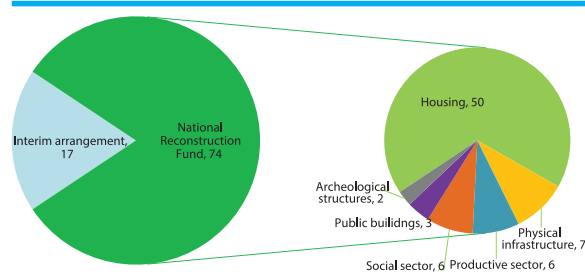
10. **The completion of reconstruction work within the next five years is the most prominent agenda.** It commits to fully operationalize the National Reconstruction Authority soonest, with special implementation authority, effective leadership, and adequate financial resources. A total of Rs91 billion (\$910 million) has been earmarked for reconstruction work, including \$740 million for National Reconstruction Fund, which will initially prioritize reconstruction of housing, public buildings, archeological structures, physical infrastructure and enhancement of productive capacity. About \$170 million is earmarked for sector ministries and agencies to carry out reconstruction works till the reconstruction authority is operational, i.e. an interim arrangement.

Figure A1.2: Fiscal indicators (% of GDP)



Source: FY2016 Budget Speech and NRM staff estimates.

Figure A1.3: Planned reconstruction in FY2016 and composition of National Reconstruction Fund (NRs billion)



Source: FY2016 Budget Speech

11. As committed before, the budget includes NRs200,000 (about \$2000) for each household that has lost its house due to the earthquake. Furthermore, the central bank will provide up to NRs2.5 million and NRs1.5 million concessional loans at 2% interest to reconstruct houses in Kathmandu Valley and outside of the valley, respectively. Similarly, favorable loan loss provisions and loan rescheduling are also proposed.

12. The government has committed to establish an Economic Rehabilitation Fund, which will provide refinancing facility and interest subsidy to the business community affected by the earthquake. To address the shortage of labor for reconstruction, skill training is planned for 50,000 people in the areas of masonry, plumbing and electricity.

13. The budget proposes organizing an ‘Investment Forum’ to promote investment in Nepal after the earthquake, with a particular focus on launching projects on a public-private partnership basis. The government’s earlier proposal of establishing an Infrastructure Development Bank has been revived. Also, Nepal Industrial Development Corporation (NIDC) Development Bank and Hydropower Investment and Development Company Limited (HIDCL) are to be restructured so that they are capable of increasing investment in infrastructure.

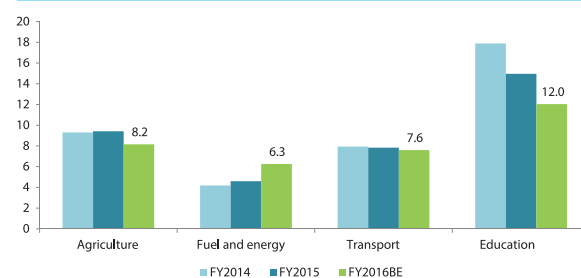
14. The budget earmarks 12.0% of total planned expenditure to education sector, lower than the 15.0% in FY2015.⁶ About 6.3% of the total budget is earmarked for energy sector (mostly for the construction of transmission lines, hydropower generation and project preparation), 7.6% for transport sector, and 8.2% for agriculture sector. Compared to FY2015, the allocation, as a share of total budget, is higher for the energy sector.

15. Within the above distribution of sectoral budgets, the budget proposes various priority investment projects, mostly in the infrastructure sectors (Attachment 3). Key sector reforms agenda are outlined in Attachment 4.

III. Key Implications for the Economy

16. The private sector has received the budget as business-friendly as many of its concerns have been addressed. These include the revision of the VAT threshold, duty concessions on import of

Figure A1.4: Key sectoral expenditure (% of total budget)⁷



Source: FY2016 Budget Speech.

⁶ In absolute terms, planned spending for education sector has been increased by \$204 million, reaching \$986 million in FY2016, an increase by 26.2%.

⁷ Actual data for FY2014, revised estimate for FY2015 and budget estimate for FY2016. It includes financing provision as well.

construction materials, subsidized loans for business recovery along with rescheduling of loan payments, added incentives for cement factories, and continuation of cash incentives for exports. Furthermore, the private sector has welcomed the government's commitment to organize an 'Investment Forum' to attract investments after the earthquake. However, there are concerns regarding the delays in preparing, updating, and enacting the various legislative reforms announced in the last budget statement. The private sector has appreciated the government's commitment to implement certain physical and social infrastructure related reconstruction projects on a PPP basis.

17. **Full execution of the budget, especially capital expenditure, will be challenging** given that the operationalization of the proposed reconstruction authority is taking more time than expected. For the interim period, the budget will be spent through the line ministries following the normal spending process, which means the pace of spending will be affected by persistent factors such as: (i) lack of project readiness, in terms of timely preparatory activities such as land acquisition, establishment of project management offices, and preparation of procurement plans; (ii) delays in procurement processes; (iii) overall weak project planning, implementation, and contract management capacity; and (iv) slow decision-making arising from the apprehension over the autonomous anti-corruption body's actions. Also, although the budget has dubbed FY2016 as 'Budget Implementation Year', it does not provide specifics on the ways and means to improve implementation. However, some measures such as performance-based retention of key project staff, waving off requirement for project approval from NPC and MOF after the introduction of budget, and multi-year contract of key roads projects may ease the bottlenecks to some extent.

18. A major push in project implementation— including project readiness, project administration, and further efficiency gains in budget approval and execution processes—is needed to accelerate capital spending. **The quality of spending—a key determinant of the sustainability of assets—is also a key concern** as there is a perennial problem of 'bunching' of expenditures towards year-end. Normally, about 60% of capital budget is spent in the last three months of a fiscal year. The budget includes a performance based provision whereby project directors, account chiefs and key staff won't be transferred until the project period if they achieve more than 80% of the targeted spending. Furthermore, projects not starting work till second quarter of FY2016 or achieving less than 50% progress against the target will see their budget surrendered to MOF for reallocation to performing projects. These partly address key concerns regarding frequent turnover of project staff and delayed contract awards, but need stronger enforcement to realize a tangible progress in implementation.

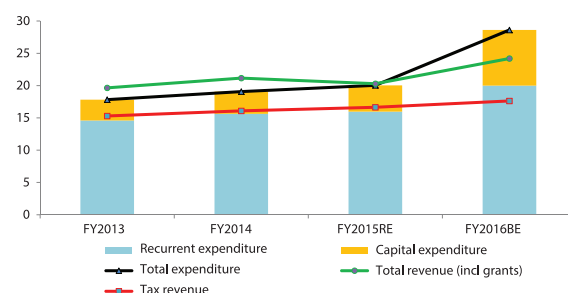
19. On the macroeconomic front, **the ballooning recurrent expenditure remains a concern.** Recurrent spending was about 96% of total tax revenue in FY2015 and its rate of growth continues to outpace the rate of tax revenue growth. In FY2016, planned recurrent spending is 20% of GDP, but projected tax revenue is about 17.6% of GDP. Rationalization of recurrent expenditures—a significant portion of these go to public sector salary, transfer to local bodies, and pension and social security payments—are required for creating increased fiscal space needed to boost capital spending. In this context, the budget proposes an austerity policy for government offices, public enterprises and all other public bodies to reduce administrative and production costs. Of the planned recurrent expenditure, about 43% is allocated as grants (or transfers) to local bodies to carry out local level development work, which needs to be synchronized with the national level plans. Similarly, about 22% is allocated for compensation of employees.

20. **The large planned domestic borrowing** (gross domestic borrowing of 3.6% of GDP, but net domestic borrowing of 1.9% of GDP) to cover a part of the huge budget deficit in FY2016 might crowd-out private borrowing (and hence investment) as it **will exert upward pressure on interest rate.** The reconstruction boom and the corresponding demand for credit by the private sector may lead to a rise in interest rates as liquidity landscape may drastically change in the case of too much government borrowing in a short span of time. However, if fiscal and monetary operations are conducted in the right way, then the modest rise in overall fiscal deficit should be manageable given the need to accelerate growth and economic recovery, and the persistence of excess liquidity, which is fueled by the surge in remittance inflows and the low credit demand by private sector immediately after the earthquake.

21. **On the revenue front, the ambitious target of 24.2% increase seems challenging** given that the budget lacks any substantive revenue measures except for the increase in duty on alcohol and vehicles. Furthermore, subdued economic activities in FY2016 may dampen revenue mobilization. It may be noted that the FY2015 revenue collection (tax and nontax) fell short of the target by 11 percentage points, largely from the impact of the earthquake. Similarly, the **194% increase in planned foreign grants seems unrealistic** given the expected delays in operationalization of the proposed reconstruction authority and the low absorptive capacity of the major sector ministries. The major multilateral donors (ABD and World Bank) are providing concessional loan.

22. The budget has set GDP growth target at 6%, which appears ambitious because of the subnormal monsoon being experienced, loss of agricultural land due to the landslides triggered by the earthquake

Figure A1.5: Expenditures and Revenues (% of GDP)



Source: FY2016 Budget Speech and NRM staff estimates.

and subsequent aftershocks, and the expected delay in getting reconstruction activities off the ground (at least in the first half of FY2016). Considering these factors and accounting for the low base effect, **GDP growth (at basic prices) of between 4.5% and 5.5%** seem more realistic. Despite accounting for the low non-food prices due to continued low fuel prices throughout 2015 and 2016, overall **inflation may remain between 8.5% and 9.5%** because of the food price pressures arising from low agricultural harvest and supply bottlenecks.

Table A1.2: Details of Income and Expenditure

FY2015 budget details	NRs billion		Share of GDP	
	FY2015RE	FY2016BE	FY2015RE	FY2016BE
GDP growth target (%)	3.0	6.0		
Inflation target (%)	7.2%	above 8%		
Details of Income and Expenditure				
Projected total expenditure	425.8	693.1	20.0	28.6
Recurrent	339.2	484.3	16.0	20.0
Capital	86.6	208.9	4.1	8.6
Projected total revenue	431.2	585.9	20.3	24.2
Revenue	393.5	475.0	18.5	19.6
Tax revenue	353.5	427.0	16.6	17.6
Foreign grants	37.7	110.9	1.8	4.6
Projected surplus (-)/deficit (+)	-5.5	107.2	-0.26	4.4
Projected financing	27.5	-58.4	1.3	-2.4
Net loan investment	20.2	48.9	1.0	2.0
Net share investment	10.2	11.9	0.5	0.5
Net foreign loans	-8.0	-72.6	-0.4	-3.0
Net domestic borrowing	5.0	-46.7	0.2	-1.9
Projected overall surplus (-)/deficit(+)	22.0	48.8	1.0	2.0

Source: FY2016 Budget Speech and NRM staff estimates.

Attachment 1:

Highlights of Key Reform Agenda (as outlined in FY2015 budget)

23. Reforms aimed at improving the investment climate include:

- Amendment of the Company, Competition Promotion and Market Protection, and Insolvency acts to simplify the processes for establishing, renewing and liquidating businesses.
- Various policies and legislations to attract foreign direct investments in viable sectors and large projects.—amendment of the Debt and Guarantee Act, new foreign investment and industrial intellectual property policies, and streamlining of business procedures.

- Policies and legislations to promote overall private sector investment, particularly in manufacturing—Special Economic Zone bill, a new Labor Act, and tax exemptions for establishing manufacturing industries.⁸
- Amendment to the Electricity Act and Regulations, and enactment of the Electricity Regulatory Commission Act to facilitate private sector investment in the sector.
- Enactment of laws relating to contract farming, to promote commercialization of agriculture.

24. Reforms to enhance the efficiency and regulation of the financial sector include:

- Tabling of bills in the parliament this year to amend the Nepal Rastra Bank Act 2002, Bank and Financial Institution Act 2007, and Banking Offence and Punishment Act 2008 to enhance sustainability of monetary and fiscal stability and regulation and supervision of banks and financial institutions. A new Deposit and Credit Security Bill will also be tabled.
- Amendment of the Foreign Exchange Regulation Act, Foreign Investment Restriction Act, and Insurance Act.
- Formulation of a separate Act for effective monitoring, supervision, and regulation of microcredit institutions, and savings and credit cooperatives.

25. Reforms to strengthen public sector management include the following. These are also aimed at facilitating improvement of project implementation and increasing capital expenditure absorption capacity.

- Formulation of a Budget Management and Fiscal Responsibility law to strengthen and make budget preparation, appropriation and execution more accountable.
- Amendment of the Public Procurement Act 2007 and Regulations 2007 to simplify public procurement procedures and streamline bidding processes.
- Formulation of an integrated law to resolve land acquisition issues.
- Amendment of the Environment Protection Act and Rules to simplify EIA process of projects.
- Enactment of laws in line with the United Nations Convention against Corruption, and capacity building and empowerment of CIAA and NVC for more effective anti-corruption and oversight functions.

⁸ Five-year income tax exemption for manufacturing firms with capital investment of over NRs 1 billion and tourism and civil aviation firms with over NRs 2 billion investment. The exemption will be reduced to 50% for three years subsequently. .

Attachment 2:**Highlights of Key Sector Investments**

26. The energy sector has received a central focus, with higher expenditure outlay for hydropower generation and transmission lines.

Reconstruction:

- NRs74 billion allocated to the National Reconstruction Fund. Out of this, NRs50 billion for housing, NRs3 billion for public buildings, NRs2 billion for archeological structures, NRs7 billion for other physical infrastructure, NRs6 billion for productive activities, and NRs6 billion for social sector needs.
- NRs17 billion additional money to be spent by sector ministries to kick-off the reconstruction work
- NRs200,000 grant to construct completely damaged houses
- Concessional loan at 2% interest to construct damaged houses in Kathmandu valley (maximum NRs2.5 million) and out of the valley (maximum NRs1.5 million).

Energy:

- Construction of East-West Transmission line to be initiated
- Implementation of Dhalkewar-Mujaffarpur, Kushwaha-Kataiya, Bardaghat-Gorakhpur, Birgunj-Parwanipur cross-border transmission lines to be expedited
- Dhalkewar-Mujaffarpur 400 KV transmission line project to be completed within FY2016
- Upper Tamakoshi Hydropower Project to be completed within two years
- Construction of Tanahu Hydropower Project to be initiated in FY2016
- Construction work of Budhigandaki Hydropower Project (1,200 MW) to be initiated
- Detail design of Nalsinghgarh Hydropower Project to be completed

Transport:

- Postal Road to be completed within five years
- Upgrading the East-West Highway to four lane
- 47 roads in Terai-Madhesh to be constructed through a multi-year tendering process
- Land acquisition and construction of railway track for Bardibas-Simara railway section
- Kathmandu-Terai-Madhesh fast track road construction to be initiated
- Gautam Buddha Airport in Bhairahawa to be completed within two years
- All weather roads to be constructed in headquarters of hilly districts
- Detail design of Mahakali bridge to be prepared
- 1,942 km of new track roads to be opened; 795 km road to be blacktopped; 170 bridges to be constructed

Urban development:

- 10 modern cities to be developed along the Mid-Hill Highway
- Driving license to be distributed through smart card from FY2016
- Under-ground and multi-story parking facilities in Kathmandu on PPP basis
- Sewerage construction from Sundarijal to Sundarighat in Bagmati river to be completed within two years
- 400 public toilets to be constructed in Kathmandu
- Expansion of Kathmandu ring road to be given high priority
- Expansion of Suryabiyak-Dhulikhel road to 6 lane
- Feasibility study for the construction of International Conference Center in Kathmandu.
- South Asia Conference Center to be constructed on PPP basis (government to convert Sajha Yatayat's NRs900 million previous loan into equity)
- Melamchi Water Supply Project to be completed within two years

Agriculture:

- Large irrigation projects to be operated to provide irrigation facilities to all agricultural land in Terai-Madhesh
- Installation of 48 deep tube wells. 7,100 shallow tube wells to be installed in pocket areas of vegetable farming
- Agricultural processing centers and industrial corridors to be established in Terai-Madhesh
- Medium size irrigation facilities to be expanded in each district to increase agricultural production.
- Network of agricultural and rural roads to be expanded to facilitate movement of agricultural inputs and harvest

Education:

- Technical and vocational institutes to be expanded to produce technical manpower
- Provide short-term training for skills development of 75,000 people required in education and industrial sector

Attachment 3:**Highlights of Key Sector Reforms**

27. The government has committed to formulate and enact new Acts and amend existing Acts to boost investments, and enhance efficiency in implementation and operation.

Reconstruction:

- Completion of reconstruction work within the next five years.
- National Reconstruction Authority to be fully operational soon with special authority, guaranteed financial resources, specific terms of reference, and efficient professional structure.
- National Reconstruction Fund to be established to carry out projects with internal and external resources. Furthermore, “Reconstruction Bond” to be issued to finance reconstruction projects.
- Economic Rehabilitation Fund to be established to provide refinancing facility and interest subsidy for the business activities damaged by the earthquake. Favorable loan loss provision and loan rescheduling to be allowed.
- Skill development trainings on areas such as masonry, plumbing and electricians to be provided to 50,000 youths.
- Investment Forum to be organized to attract private sector investment
- Some of the reconstruction projects to be initiated on public private partnership (PPP) basis.
- Integrated Resettlement Master Plan for the earthquake affected districts headquarters to be developed and implemented
- Distribution and selling of all fallen trees at various forest areas to be simplified to ease supplies for reconstruction work

Energy:

- HIDCL to be restructured to enable it to increase investment in hydropower projects.
- Preparatory work for the implementation of Pancheshwor Multipurpose projected to be commenced soon
- Construction of West Seti Hydropower Project to be initiated by attracting FDI
- Identification, study and development of multipurpose and reservoir-type hydropower projects to be prioritized
- Agreement to be sealed to construct 800 MW Tamakoshi III and 400 MW Marsyangdi hydropower projects (both export-oriented)
- “Remit Hydro” scheme to be launched to channel remittances to hydropower development

- Transmission line to be constructed on Build and Transfer (BT) model
- Electricity Trading Company to be established for national and international electricity trade

Transport:

- National Tourism Strategic Action Plan to be implemented
- Tribhuvan International Airport upgradation accorded high priority
- Master Plan for the development of Lumbini to be completed soon and preliminary work of Buddhist Circuit to be commenced

Urban development:

- Pokhara, Dharan and Lalitpur sub-metropolitan cities to be developed as green cities.
- Master plan to be prepared to develop Kathmandu, Lumbini and Nijgadh as smart cities.

Agriculture:

- Areas identified in the Agriculture Development Strategy to be implemented. These include agriculture extension service, research, irrigation, land reform, agricultural road, electrification, etc.
- Limit interest on agricultural loans to 6%.
- 100% interest grant in the first five years for those willing to build and operate cold and food storage houses
- Exemption of customs and VAT in the import of machineries such as tractor, power tiller, and thresher machine

Education:

- At least one school in each region to be developed into a residential school
- Vocational and Skill Development Training Center to be established to provide basic training for labor-intensive works.

Appendix 2: Review of Monetary Policy for FY2016

I. Introduction

1. About a week after Finance Minister Dr. Ram Sharan Mahat announced FY2016 budget, Dr. Chiranjivi Nepal, Governor of Nepal Rastra Bank (NRB, the central bank), presented the monetary policy for the year. It is the first monetary policy under the governorship of Dr. Nepal and also the first one after the catastrophic 7.8 magnitude earthquake on 25 April.

2. The monetary policy aims to help achieve the GDP growth and inflation targets, and to maintain balance of payments stability. It also aims to maintain overall financial sector stability, manage excess liquidity, channel credit to productive sectors, and make access to finance more inclusive, including subsidized housing credit to households who lost houses due to the earthquake.

II. Key Features

3. The overall targets of the monetary policy for FY2016 are to: (i) support attainment of a GDP growth of 6.0%; (ii) contain inflation within 8.5%; (iii) maintain foreign exchange reserves sufficient to cover 8 months of imports of goods and non-factor services; (iv) maintain money supply growth at 18%; and (v) maintain total credit growth at 23.4%, with growth of credit to government and private sector at 68.5% and 20%, respectively.

4. The NRB has maintained the cash reserve ratio (CRR) prevalent in FY2015. CRR for commercial banks, development banks and finance companies is 6%, 5%, and 4%, respectively. Capital adequacy ratio is also kept unchanged. However, the bank rate has been decreased by 100 basis points to 7%. These rates indicate a loose monetary policy despite the large excess liquidity in the banking system. The NRB is targeting M2 growth of 18%, which is higher than the 16% growth in FY2015.

5. The productive sector lending requirement is kept unchanged. In FY2015, the NRB mandated commercial banks to lend at least 20% of their loan portfolios to productive sectors². Of this at least 12% should go to agriculture and/or energy sectors. Starting

¹ This analysis was prepared by Chandan Sapkota, Economics Officer and Neelina Nakarmi, Economics Analyst, under the overall of guidance of Raju Tuladhar, Senior Country Specialist and Kenichi Yokoyama, Country Director of Nepal Resident Mission, ADB. The views expressed are those of the authors and do not reflect the views of the ADB, or its Board of Directors, or its member governments.

² Productive sectors constitute agriculture, energy, and industrial activities,

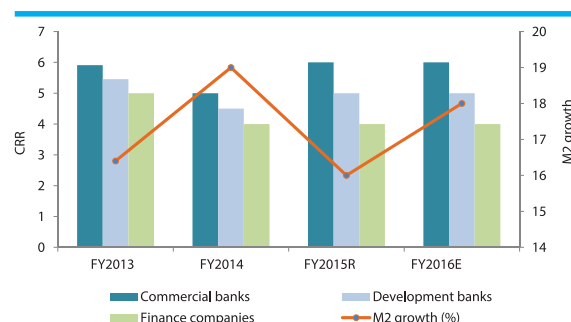
FY2015, the central bank had mandated development banks and finance companies as well to increase productive sector lending to 15% and 10%, respectively, of their loan portfolios.

6. The refinancing interest rate on loans to agriculture, hydropower, poultry, livestock, and fishery has been fixed at 5%, the same as in FY2015. Banks and financial institutions (BFIs) can on-lend at a maximum interest rate of 9%. The refinancing interest rate on loans to sick industries, cottage and small industries, export businesses, and women-operated businesses has also been left unchanged at 1%. The on-lending rate is fixed at a maximum of 4.5%. Meanwhile, the minimum deprived sector lending³ by commercial banks, development banks and finance companies has been increased by 50 basis points to 5%, 4.5% and 4%, respectively, of their loan portfolios.

7. A key feature of the monetary policy is its attempt to consolidate the banking sector by encouraging the merger of BFIs. The policy mandates commercial banks to increase their paid-up capital four-fold to \$80 million by end-FY2017. Similarly, national level development banks will have to increase their paid-up capital by nearly three-fold to \$25 million. For other development banks and finance companies, the mandatory increase in paid-up capital is as per their operational coverage in the country, but is still substantial. This is expected lower the number of BFIs in the country as many comparatively weak BFIs will have to merge with stronger BFIs (or raise additional capital through initial public offerings) to satisfy the mandatory requirement within two years. In FY2015, one commercial bank, 10 development banks and 4 finance companies merged into one commercial bank, four development banks and one finance company. In FY2015, there were 195 BFIs⁴, down from 204 in FY2014 and 213 in FY2012. The total number of branches of BFIs stands at 3,824, up from 3,430 in FY2014.

8. To strengthen its supervision and monitoring of BFIs, the NRB has continued most of the initiatives outlined in the last year's monetary policy. This includes the adoption of Basel III liquidity management framework for commercial banks and the launching of prompt corrective action as and when required. It has also mandated the BFIs to allocate at least one percent of their total profits for the purpose of human resource development. Credit rating is now

Figure A2.1: CRR and M2 growth



Source: Monetary Policy 2016, Nepal Rastra Bank; FY2015 provisional and FY2016 targeted

³ Though there is a need to channel more credit to productive sectors and increase access to finance in rural areas, principally, the mandatory lending targets limit the BFIs' ability to allocate resources efficiently in terms of maintaining sound portfolios and ensuring reliable income sources. Since the state-owned banks (ADBL, RBB and NBL) hold almost 30% of total banking sector assets, it might result in deterioration of their portfolio performance. Furthermore, a majority of the BFIs lack adequate knowledge and skills in lending to agriculture sector. The absorption capacity of the deprived sector is relatively low and more mandatory lending to them might increase banking risk and their indebtedness. The mandatory directed lending policy might be addressing symptoms rather than the root causes of the problem.

⁴ 30 commercial banks (category A), 79 development banks (category B), 50 finance companies (category C), and 36 microfinance institutions (category D)

⁵ Typically, large banks with significant deposit and credit portfolios. Its rapid fluctuation could induce high volatility in the financial market.

mandatory on joint loan financing above a certain limit. Systemically Important Banks⁵ are to be identified and closely monitored.

9. Other highlights of the monetary policy are: (i) the decision to review the moratorium imposed on opening new BFIs and (iii) establishment of an Infrastructure Development Bank⁶ (domestic as well as foreign investment) with a minimum paid-up capital of \$200 million. Liquidity management measures introduced in the previous years will be continued in FY2016.

10. Regarding the investment of BFIs in local currency bonds issued by international financial institutions, it has committed to introduce necessary directives to allow BFIs to trade such shares in the open market. The government has already approved ADB and IFC to issue NRs50 billion worth of local currency bonds, primarily for infrastructure investment.

11. Earthquake-related provisions: To assist government, BFIs and the public for accelerated post-earthquake recovery, NRB has introduced a number of measures:

- Zero percent refinancing facility for BFIs willing to provide loans at 2% interest to those households affected by the earthquake, provided that such households meet the requirements set by the government. Accordingly, households within and outside Kathmandu Valley can access the subsidized loans of up to NRs2.5 million and NRs1.5 million, respectively.
- As announced in the FY2016 budget speech, the NRB will help assist in the establishment of an Economic Rehabilitation Fund, which will provide refinancing facility and interest subsidy to the business community affected by the earthquake.

III. Key Implications for the Economy

12. The banking associations—Nepal Bankers' Association, Development Bankers Association, and Nepal Finance Companies Association—have largely welcomed the loose and accommodative monetary policy at a time when the banking industry is flush with excess liquidity, which is not only lowering deposit and lending interest rates, but also forcing the BFIs to invest in negligible interest-bearing government securities in the absence of immediate bankable investment projects. They also appreciated the unchanged cash-reserve ratio and mandatory lending to productive sectors. However, there

⁶ This concept was floated by some prominent bankers around FY2010. It remains to be seen how this new bank will be operationalized.

are concerns over the drastic increase in mandatory paid-up capital, especially the provision to satisfy the requirement within two years. This is an important policy initiative aimed at (i) easing NRB's monitoring and supervision burden, and (ii) promoting the financial health of the BFIs and healthy competition in the sector. However, the banking community views the two-year timeframe as too stringent and unrealistic, which could force unsuccessful mergers

13. The continued emphasis on the consolidation of the BFIs and higher paid-up capital requirement will help further consolidate the banking sector and enhance supervision and regulation capacities of NRB. However, the review of the moratorium on the establishment of new BFIs should be done cautiously keeping in mind the efficacy and soundness of financial sector. As such, except in certain unbanked section of the country, loosening the moratorium on opening new banks might not be fruitful given the financial sector vulnerabilities exposed after the decline in remittance growth rate in FY2011, subsequent tumbling down of real estate and housing markets, and the vulnerable health of the financial sector. To reduce financial sector vulnerabilities, more mergers and acquisitions should be encouraged by providing appropriate incentives. In fact, the decision to review the moratorium on establishing new BFIs may run counter to the efforts to compel consolidation by increasing paid-up capital.

14. The continued high mandatory productive sector lending may be discouraging and may be counterproductive in the medium to long term if such policy is pursued without concrete measures to improve the overall investment climate. Given acceptable level of risks and a conducive investment climate, BFIs should automatically increase lending to sectors such as energy, transport, and agriculture, among others. Key constraints to increased lending by BFIs to the productive sectors are the long-standing policy, institutional and legal weaknesses and complexities plaguing these sectors. Furthermore, not all BFIs have sufficient capacities right now to lend to these sectors by evaluating all the aspects of an investment proposal, including risk premiums. Energy sector loans are usually of medium to long-term in nature, but the bank deposits are short term in nature— thus increasing further possibilities of asset-liabilities/maturity mismatches. Monetary policy alone cannot address the lack of infrastructure and structural bottlenecks in the economy.

15. The focus on liquidity management and the commitment to channel remittances to productive investments is timely. The NRB has given continuity to longer term repo/reverse repo (three to six months), buying of certain deposits of BFIs through auction, and commitment

to issue NRB bonds if required to manage liquidity. Furthermore, the emphasis on establishing a robust infrastructure development bank may help increase long-term financing in critical infrastructure projects. This was also proposed by the FY2016 budget speech.

16. Given the subnormal monsoon being experienced, loss of agricultural land due to the landslides triggered by the earthquake and subsequent aftershocks, and the expected delay in getting reconstruction activities off the ground (at least in the first half of FY2016), the GDP growth target of 6% appears ambitious and the 8.5% inflation target conservative. Considering these factors and accounting for the low base effect, GDP growth (at basic prices) of between 4.5% and 5.5% seem more realistic. Furthermore, despite accounting for the low non-food prices due to continued low fuel prices throughout 2015 and 2016, overall inflation may increase to 8.5%-9.5% in FY2016 because of the food price pressures arising from low agricultural harvest, supply bottlenecks, and increased demand as a result of cash transfer to earthquake affected households.

Table A2.1: Overview of Monetary Policy

Indicators	FY2012	FY2013	FY2014	FY2015R	FY2016E
GDP growth (%)	4.5	3.6	5.1	3.0	6.0
Inflation (%)	8.3	9.9	9.0	7.5	8.5
Imports of goods and nonfactor services (months)	9.4	9.3	10.5	11.3	8.0
M2 growth (%)	22.7	16.4	19.0	16.0	18.0
Total credit growth (%)	13.2	17.2	12.7	18.7	23.4
Growth of credit to government	-0.3	3	-16.4	-22	68.5
Growth of credit to private sector	11.6	20.2	7.3	18.0	20
Cash Reserve Ratio (%)					
Commercial banks	5.0	5.9	5.0	6.0	6.0
Development banks	5.0	5.5	4.5	5.0	5.0
Finance companies	5.0	5.0	4.0	4.0	4.0
Bank rate (%)	7.0	8.0	8.0	8.0	7.0
Productive sector mandatory lending (% of total loans)					
Commercial banks			20.0	20.0	20.0
Agriculture and energy		10.0	12.0	12.0	12.0
Development banks				15.0	15.0
Finance companies				10.0	10.0
Refinancing rates (%)					
Agriculture, hydro, poultry, livestock, fishery		6.0	5.0	4.0	4.0
re-lending max		9.0	9.0	9.0	9.0
Sick industries	1.5	1.5	1.0	1.0	1.0
re-lending max	4.5	4.5	4.5	4.5	4.5

Source: Monetary Policy 2016, Nepal Rastra Bank; FY2015 provisional and FY2016 targeted

Appendix 3: ADB Assisted Projects

Sl. No.	Loan/Grant No.	Project Name	Milestone Dates			
			Approved	Signed	Effective	Closing (Org/Rev)
1.	2587	Energy Access and Efficiency Improvement	27 Nov 09	11 Mar 10	04 Jun 10	31 Dec 15
2.	215	Detailed Engineering Study for Upper Seti	02 Sep 10	23 Dec 10	23 Mar 11	30 Sep 15
3.	0270/2808	Electricity Transmission Expansion & Supply Impr	15 Nov 11	23 Mar 12	21 Jun 12	31 Dec 17
4.	2990/2991	Tanahu Hydropower Project	21 Feb 13	22 Apr 13	29 Aug 14	30 Jun 21
5.	361	Project Preparatory Facility for Energy	24 Sep 13	29 Nov 13	14 Mar 14	30 Jun 19
6.	3139	SASEC Power System Expansion	04 Jul 14	11 Jul 14	15 Jan 15	30 Jun 22
7.	2581, 0181	Air Transport Capacity Enhancement	23 Nov 09	25 May 10	06 Dec 10	30 Jun 16
	227	Transport Project Preparatory Facility	29 Oct 10	04 Mar 11	25 Apr 11	30 Jun 20
8.	2579,0179/3117	South Aisa Tourism Infrastructure Development	16 Nov 09	25 May 10	03 Sep 10	15 Mar 15
9.	219	Community Irrigation Project		08 Feb 11	05 May 11	31 Aug 17
10.	2796/0267	Decentralized Rural Infra & Livelihood Project-AF	31 Oct 11	01 Feb 12	23 Apr 12	30 Jun 17
11.	305	Strengthening Public Management Program	26 Sep 12	27 Dec 12	26 Aug 13	31 Oct 15
12.	51	Road Connectivity Sector	10 Aug 06	11 Sep 06	20 Nov 06	31 Jul 14
13.	150	Emergency Flood Damage Rehabilitaion	21 Apr 09	03 Aug 09	25 Aug 09	30 Jun 15
14.	2658,G0225	Subregional Transport Facilitation Project	27 Oct 10	04 Mar 11	26 Apr 11	30 Jun 17
15.	2656,G0212	Kathmandu Sustainable Urban Transport Project	22 Jul 10	26 Oct 10	05 Jan 11	30 Jun 17
16.	227	Transport Project Preparatory Facility - Civil Aviation	29 Oct 10	04 Mar 11	25 Apr 11	30 Jun 20
17.	3012	SASEC Road Connectivity	30 Jul 13	20 Oct 13	31 Jan 14	30 Jun 19
18.	1820/3110	Melamchi Water Supply	21 Dec 00	24 Jan 01	28 Nov 01	31 Dec 16
19.	2059	Kathmandu Valley Water Services Sector Development	18 Dec 03	08 Apr 04	07 Dec 04	31 Dec 14
20.	157	Second Small Towns Water Supply & Sanitation Sector	17 Sep 09	27 Nov 09	14 Jan 10	31 Mar 16
21.	2650	Secondary Towns Integrated Urban Environmental Improvement	06 Jul 10	26 Oct 10	18 Jan 11	30 Jun 16
22.	2776/3255	Kathmandu Valley Water Supply Improvement Project	15 Sep 11	10 Nov 11	07 Feb 12	30 Jun 17
23.	0284/2851	Integrated Urban Development Project	14 Feb 12	08 May 12	04 Jul 12	31 Dec 17
24.	3000	Kathmandu Valley Wastewater Management	26 Apr 13	08 May 12	08 Oct 13	31 Dec 17
25.	3157	Third Small Towns Water Supply and Sanitation Sector	19 Sep 14	25 Nov 14	23 Feb 15	30 Jun 19
26.	0367/3057	Bagmati River Basin Improvement	31 Oct 13	06 Mar 14	08 Apr 14	25 Feb 20
27.	99	SASEC Information Highway Project	17 Dec 07	09 Feb 09	02 Jul 09	15 Jul 15
28.	106	ICT Development	28 Jan 08	23 May 08	25 Jul 08	31 Mar 16
29.	233	Raising Income of Small and Medium Farmers	24 Nov 10	24 Nov 10	14 Jun 11	30 Jun 18
30.	248	Highland Mountain Agribusiness and Livelihood	25 Mar 11	25 Mar 11	26 Sep 11	31 Oct 17
31.	2102/3124	Community Managed Irrigated Agriculture Sector	17 Nov 04	23 Dec 05	13 Jan 06	30 Sep 4/31 Jan 21
32.	299	Water Resources Project Preparatory Facility	27 Jul 12	02 Nov 12	13 Dec 12	30 Jun 19
		Building Climate Resilience of Watershed in Mountain Eco Regions				
33.	0252	Capital Market and Infrastructure Capacity Support	19 Apr 11	09 Aug 11	09 Aug 11	30 Nov 15
	0345	Skills Development project				
		Local Governance and Community Dev. Program				
		Hydropower Strengthening Project				
		Urban and Environmental Improvement Project				

ADB's share of expenditure in FY2016 (NRs million)	FY2016 budget	ADB's commitment	Share of budget (%)	Share of GDP (%)
Recurrent	484266	7154	1.5	0.3
Capital	208877	30432	14.6	1.3
Total	693144	37586	5.4	1.6

Excluding financing

\$ million	FY2016 budget allocation (NRs million)							
	Net amount	GON's commitment			ADB's commitment			Total
		Recurrent	Capital	Sub-total	Recurrent	Capital	Sub-total	
56.2								
2.5								
69.2			4025.0	4025.0		5376.6	5376.6	9401.6
137.3			200.0	200.0		2000.0	2000.0	2200.0
21.0								
164.0								
74.1			1750.0	1750.0	0.0	2939.8	2939.8	4689.8
			13.7	13.7	374.9	94.6	469.5	483.2
51.8	39.6		1000.0	1039.6	293.9	2858.7	3152.6	4192.2
26.4	20.1		147.1	167.1	64.0	654.2	718.3	885.4
23.5	81.4		425.4	506.8	22.8	813.1	835.9	1342.7
21.0								
53.2								
25.6								
39.5			168.3	168.3		331.7	331.7	500.0
19.8	9.3		209.3	218.5	300.8	682.2	983.0	1201.6
12.0								
70.6			577.8	577.8		1745.6	1745.6	2323.4
160.5	66.0		1573.1	1639.1	5.0	1834.2	1839.2	3478.3
10.1								
45.1	27.9		173.3	201.1	14.7	326.1	340.8	541.9
58.7	384.8		2.7	387.5	985.9	17.5	1003.4	1390.9
72.9			549.0	549.0		5442.0	5442.0	5991.0
52.0	197.9		9.6	207.5	1081.8	35.5	1117.2	1324.7
75.2			250.0	250.0		1750.0	1750.0	2000.0
54.8	30.6		222.6	253.2	22.5	875.6	898.1	1151.3
28.1	26.8		73.1	99.9	21.1	377.4	398.4	498.4
5.0	19.0		47.0	66.0	16.1	217.7	233.8	299.8
25.0	5.6		138.4	144.0	40.0	640.0	680.0	824.0
20.1	118.3		2.2	120.6	425.9	4.7	430.6	551.2
20.0	89.9		31.7	121.5	577.2	53.2	630.4	751.9
46.1	13.2		215.7	228.8	8.7	653.8	662.5	891.3
11.0	13.3		17.7	31.0	27.1	129.4	156.5	187.5
			21.2	48.1	92.9	290.5	383.4	431.5
5.0	46.1			46.1	183.0		183.0	229.1
	145.7			145.7	521.1	0.2	521.3	667.0
	106.7			106.7	1089.1		1089.1	1195.9
	0.0		220.0	220.0		270.0	270.0	490.0
	384.8		2.7	387.5	985.9	17.5	1003.4	1390.9

Appendix 4: Country Economic Indicators

Item	Fiscal Year				
	2011	2012	2013	2014	2015 ^P
A. Income and Growth					
1. GDP per Capita (\$, current)	716	704	709	717	764 ^a
2. GDP Growth (% in basic prices)	3.8	4.6	3.8	5.1	3.0 ^a
a. Agriculture	4.5	4.6	1.1	2.9	1.9 ^a
b. Industry	4.3	3.0	2.7	6.2	2.6 ^a
c. Services	3.4	5.0	5.7	6.3	3.9 ^a
B. Saving and Investment (current and market prices, % of GDP)					
1. Gross Domestic Investment	38.0	34.5	36.9	36.8	...
2. Gross National Saving	37.0	39.5	40.3	46.1	...
C. Money and Inflation					
1. Consumer Price Index (average annual % change)	9.6	8.3	9.9	9.1	7.2 ^b
2. Total Liquidity (M2) (annual % change)	12.3	22.6	16.4	19.1	19.9 ^b
D. Government Finance (% of GDP)					
1. Revenue and Grants	17.9	18.6	19.5	20.8	20.2 ^c
2. Expenditure and Onlending	20.2	20.9	18.9	20.2	21.5 ^c
3. Overall Fiscal Surplus (Deficit)	(2.4)	(2.2)	0.7	0.6	(0.2) ^c
E. Balance of Payments					
1. Merchandise Trade Balance (% of GDP)	(23.3)	(24.4)	(27.3)	(30.7)	(31.2) ^b
2. Current Account Balance (% of GDP)	(0.9)	5.0	3.4	4.6	5.1 ^b
3. Merchandise Export (\$) Growth (annual % change)	11.7	5.7	(2.9)	5.1	(3.9) ^b
4. Merchandise Import (\$) Growth (annual % change)	8.9	4.7	10.9	13.9	8.0 ^b
5. Remittances (% of GDP)	18.5	23.5	25.7	28.2	29.1 ^b
F. External Payments Indicators					
1. Gross Official Reserves (\$ million)	3,835.8	4,960.0	5,613.7	6,793.1	8,306.1 ^b
Months of current year's imports of goods)	7.4	9.4	9.3	10.2	11.2 ^b
2. External Debt Service (% of exports of goods and services)	11.1	10.6	9.5	8.9	8.1 ^d
3. Total External Debt (% of GDP)	19.0	20.2	19.7	17.9	16.1 ^d
G. Memorandum Items					
1. GDP (current prices, NRs billion)	1,367.0	1,527.3	1,692.6	1,942.0	2,125.0 ^a
2. Exchange Rate (NRs/\$, average)	72.1	80.7	87.7	98.0	99.2 ^b
3. Population (million)	26.5	26.9	27.3	27.6	28.0

Note: FY2015 started on 16 July 2014 and ended on 15 July 2015.

GDP = gross domestic product; P = provisional; ... = not available

^a Based on FY2015 and FY2016 National Accounts Statistics. Central Bureau of Statistics

^b Based on FY2015 annual data. Nepal Rastra Bank

^c Based on FY2015 Budget Speech. Ministry of Finance

^d Based on FY2015 annual data. Financial Comptroller General Office

Sources: Ministry of Finance. FY2015 Budget Speech. Kathmandu; Nepal Rastra Bank. 2015. Macroeconomic Situation. Kathmandu; Central Bureau of Statistics. April 2015. FY2015 National Accounts Statistics. Kathmandu; Financial Comptroller General Office Annual Data.

Appendix 5: Country Poverty and Social Indicators

Item	Period					
	1990s		2000s		Latest Year	
A. POPULATION INDICATORS						
1. Population (million)	18.5	(1991)	23.2	(2001)	26.5	(2011)
2. Population growth (annual % change)	2.1		2.2		1.4	(2011)
B. Social Indicators						
1. Fertility rate (births/woman)	5.1	(1996)	3.6	(2004)	3.4	(2011)
2. Maternal mortality ratio (per 100,000 live births)	539.0	(1996)	281	(2006)	170.0	(2013)
3. Infant mortality rate (below 1 year/1,000 live births)	82.0	(1991)	48.0	(2006)	46.0	(2011)
4. Life expectancy at birth (years)	55.0	(1991)	62.0	(2001)	68.8	(2011)
a. Female	54.0	(1991)	63.0	(2001)	70.0	(2011)
b. Male	55.0	(1991)	62.0	(2001)	68.0	(2011)
5. Adult literacy (%)	35.6	(1996)	48.0	(2004)	56.5	(2011)
a. Female	19.4	(1996)	33.8	(2004)	44.5	(2011)
b. Male	53.5	(1996)	64.5	(2004)	71.6	(2011)
6. Primary school gross enrollment (%)	57.0	(1996)	72.0	(2004)	134.4	(2014)
7. Secondary school gross enrollment (%)	43.8	(2001)	54.4	(2004)	51.6	(2014)
8. Child malnutrition (% below 5 years old)	57.0				36.4	(2010)
9. Population below poverty line (international, %)	68.0	(1996)	53.1	(2003)	24.8	(2011)
10. Population with access to safe water (%)	45.9		82.5	(2006)	85.0	(2013)
11. Population with access to sanitation (%)	22.0	(1995)	24.5	(2006)	62.0	(2013)
12. Public education expenditure (% of GDP)	2.0		2.9	(2005)	3.7	(2015)
13. Human development index	0.341		0.429	(2005)	0.540	(2013)
14. Rank/total number of countries	152/173		136/177	(2003)	145/187	(2013)
15. Gender-related development index	0.33	(1995)	0.511	(2003)	0.912	(2013)
16. Rank/total number of countries	148/163	(1995)	106/140	(2003)	102/187	(2013)
C. Poverty Indicators						
1. Poverty incidence	42	(1996)	31	(2004)	25.2	(2011)
2. Proportion of poor to total population						
a. Urban	23.0	(1996)	9.6	(2004)	15.5	(2011)
b. Rural	44.0	(1996)	34.6	(2004)	27.4	(2011)
c. Mountain	57.0	(1996)	32.6	(2004)	42.8	(2011)
d. Hills	40.7	(1996)	34.5	(2004)	24.3	(2011)
e. Terai	40.3	(1996)	27.6	(2004)	23.4	(2011)
3. Poverty gap	11.8	(1996)	7.6	(2004)	5.4	(2011)
4. Poverty severity index	4.7	(1996)	2.7	(2004)	1.8	(2011)
5. Inequality (Theil Index)	
6. Multidimensional poverty index ¹		0.197	(2011)

... = not available, GDP = gross domestic product,

Sources: Central Bureau of Statistics. 2012. *National Population and Housing Census 2011*. Kathmandu; Central Bureau of Statistics. 2011. *Nepal Living Standards Survey 2010/11*. Kathmandu; Ministry of Health and Population. 2012. *Nepal Demographic and Health Survey 2011*. Kathmandu; United Nations Development Programme. 2014. *Human Development Report*. New York; Central Bureau of Statistics. 2011. *Poverty in Nepal (2010/11)*. Kathmandu; World Health Organization, United Nations Children's Fund, United Nations Population Fund, and World Bank. 2012. *Trends in maternal mortality 1990 to 2010*, Kathmandu; Ministry of Education. 2015. *Flash I Report 2014-2015*. Kathmandu; Ministry of Finance. FY2016 Budget Speech. Kathmandu

¹ UNDP replaced Human Poverty Index with Multidimensional Poverty Index from Human Development Report 2011.



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