Nepal—Assessment Letter for the Asian Development Bank
August 8, 2019

This note provides the IMF staff's assessment of Nepal's recent economic developments and outlook, and economic policies. The assessment was requested in relation to a proposed policy-based loan to Nepal to be considered by the Asian Development Bank.

Recent Developments and Outlook

Growth remained robust but macroeconomic stability risks have risen. Nepal's Central Bureau of Statistics estimates growth at 7.1 percent in FY2018/19 (mid-July 2018 to mid-July 2019). The pickup reflects cyclical factors—including the ongoing reconstruction from the 2015 earthquake, a rebound in agricultural production, and strong tourism-related activity—as well as structural improvements such as improved electricity supply and greater political stability. With output above potential, headline inflation rose to 5.3 percent (y/y) in May 2019, from 4.6 percent in FY2017/18, due to higher food prices and strong domestic demand. In the first ten months of FY2018/19, the current account deficit amounted to about 8 percent of GDP, on account of buoyant imports and softening remittances growth. International reserves fell to US$ 8.4 billion in May 2019, though remain adequate at 6 months of prospective imports. Nepal's external position in FY2017/18 was moderately weaker than the level consistent with medium-term fundamentals and desirable policy settings. Weak implementation capacity for capital expenditure and lower than expected transfers to subnational governments (due to their weak execution capacity) will bring the central government deficit to around 4.3 percent of GDP in FY2018/19, well below the revised budget target of 7.3 percent of GDP. Private sector credit continues to grow strongly, at 21.3 percent in May (y/y), rising to about 85 percent of GDP. Against the backdrop of weak financial sector oversight, the rapid credit expansion raises concerns about the quality of lending.

While the near-term outlook for growth is favorable, macroeconomic and financial vulnerabilities are expected to continue to build. In FY2019/20, growth is projected to moderate to 6.3 percent as strong activity in recent years has run up against the economy's productive capacity. Meanwhile, inflation is expected to rise further to 6.1 percent, due to both food and non-food inflation. The current account deficit is expected to widen to 10 percent of GDP, in part reflecting higher oil imports, bringing the reserve coverage to about 5 months of prospective imports. The fiscal deficit is expected to remain at 4.3 percent of GDP, due to ongoing capacity constraints to fully execute spending plans.

Under current policies, growth is expected to fall back to its potential of about 5 percent over the medium term. The economy's potential is weighed down by structural weaknesses, including inadequate levels of private investment, weak public infrastructure, and corruption. Although the current account deficits would narrow somewhat, reserve coverage is expected to decline further to 3 months of prospective imports, although less sharply than envisaged in the last Article IV Staff Report.

The joint World Bank/IMF Debt Sustainability Analysis indicates that Nepal's risk of debt distress remains low. Nepal's public debt remains moderate at about 30 percent of GDP in mid-2018. External public debt remains low at 17 percent of GDP, with a high degree of concessionality. Stress tests suggest that debt burden indicators are vulnerable to growth/exports shocks and natural disasters. This underscores the importance of improving the business climate and competitiveness through high-quality public investment and structural reforms to support growth and expand foreign exchange income streams.

Economic risks are tilted to the downside. Rising government spending related to fiscal federalism and capital spending could provide a stimulus to growth in the near-term. However, this would also be associated with more pronounced balance of payments pressures, leading to greater pressure on the exchange-rate peg and build up of financial sector risks. Downside risks to growth derive from subnational government weak implementation capacity, financial sector vulnerability, and slowing remittances impacting financial sector liquidity.

Economic Policies

Prudent implementation of fiscal federalism is needed to keep public debt and the external current account on a sustainable path. Although capacity constraints have implied a tighter fiscal policy than envisaged in the budget, fiscal policy can make a larger contribution toward containing domestic demand pressures and shoring up external stability. This entails a more front-loaded fiscal consolidation and the rationalization of the central government budget, as expenditure responsibilities are devolved. For sub-national governments, a medium-term plan which aligns spending needs with available funding is vital. More needs to be done to make spending more efficient and continue to build implementation capacity at all levels of government.

Monetary policy is too accommodative given the cyclical position of the economy, calling for a tighter stance to support the exchange rate peg to the Indian rupee, which has served Nepal well. In recent months, the Nepal Rastra Bank's actions have been insufficient to mop up excess liquidity. The recent pickup in interbank rates stems from earlier relaxation of the authorities' loan-to-deposit ratio, which now counts interbank borrowing as deposits. A tighter monetary policy stance will help reduce the upward inflationary pressure and contain the build-up of imbalances.

An acceleration of financial sector reforms and tightening of macro-prudential measures will help temper excessive credit growth. The ongoing sharp credit expansion raises concerns about the buildup of financial stability risks given the weak underwriting standards, poor risk management practices, and weak financial sector oversight. This underscores the importance of encouraging banks to build additional capital and provisioning buffers against potential losses, and strengthening financial sector oversight and regulations. A tightening of macroprudential policies will slow credit growth and limit the buildup of financial sector risks.

To promote sustained high and inclusive growth, the economy's productive capacity can be enhanced through higher private investment and greater competition. Structural reforms are needed to improve the business climate, strengthen governance and institutions, and enhance access to finance to the underserved population. These steps will help encourage private investment, including foreign direct investment, which will generate sustained higher economic growth and employment opportunities.

IMF Relations

Financial support. In the aftermath of the 2015 earthquakes, the IMF's Executive Board approved the disbursement, as direct budget support, of the equivalent of SDR 35.65 million (22.7 percent of quota) under the Fund's Rapid Credit Facility on July 31, 2015.

Surveillance. The 2018 Article IV Consultation was concluded by the IMF's Executive Board on February 8, 2019. The next Article IV mission is planned for January 2020. The joint IMF-World Bank FSAP was completed in mid-2014.

Capacity development. In recent years, the Fund has been providing technical assistance in the areas of tax administration, tax policy, public expenditure management, monetary policy operations, and macroeconomic statistics. A long-term resident advisor is supporting the NRB's efforts to strengthen banking supervision. Nepal is a member of the South Asia Regional Training and Technical Assistance Center (SARTTAC) in New Delhi.

Nepal: Selected Economic Indicators, 2015/16-2020/21 1/

Population (2017, est. million): 29.3
Quota: 156.9 million SDR
Main exports (2017): Textiles and other manufactured goods, food items
Key export markets (2017): India, U.S., Turkey

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
				Est.	Projections	
Output						
Real GDP growth (percent)	0.6	8.2	6.7	7.1	6.3	5.8
Prices						
Inflation (period average, percent)	9.9	4.5	4.2	4.5	6.1	6.0
Inflation (end-year, percent)	10.4	2.7	4.6	6.2	6.0	5.9
General government finances (percent of GDP)						
Total revenue and grants	23.3	24.1	25.3	26.2	26.2	26.4
of which: tax revenue	18.7	20.7	21.1	22.5	22.5	22.6
Expenditure	21.9	27.2	31.9	30.6	30.6	30.3
of which: current expenditure 2/	16.5	19.4	23.0	24.6	24.6	23.6
capital expeniture	5.5	7.8	8.9	6.0	6.0	6.7
Fiscal balance	1.4	-3.1	-6.7	-4.3	-4.3	-3.8
Public debt	27.9	26.1	30.2	32.6	34.9	36.2
Money and credit						
Broad money (percent change)	19.5	15.5	19.4	17.8	8.2	7.8
Domestic credit (percent change)	17.4	20.2	26.1	24.3	18.3	13.5
Credit to private sector (percent change)	23.2	18.0	22.3	21.4	17.6	12.1
Balance of payments						
Current account (percent of GDP)	6.3	-0.4	-8.1	-8.3	-10.0	-8.3
Trade balance (percent of GDP)	-30.2	-33.5	-37.4	-39.7	-40.7	-38.3
Remittances (percent of GDP)	29.5	26.0	24.9	26.5	24.8	24.0
Reserves (months of prospective imports)	9.6	8.3	7.6	6.0	5.0	4.1
Public external debt (percent of GDP)	17.3	15.5	17.3	18.7	20.1	20.5
Exchange rate						
Exchange rate (Nepali rupees/US$; period average)	106.4	106.2	104.4	...	...	...
Real effective exchange rate (period avg., y/y percent change) 3/	5.7	3.6	0.2	-1.8	...	...

1/ Fiscal year ends mid-July.

2/ Current expenditure includes transfers to subnational governments which can be used for capital expenditure.

3/ For 2018/19, year-to-date as of June 2019.