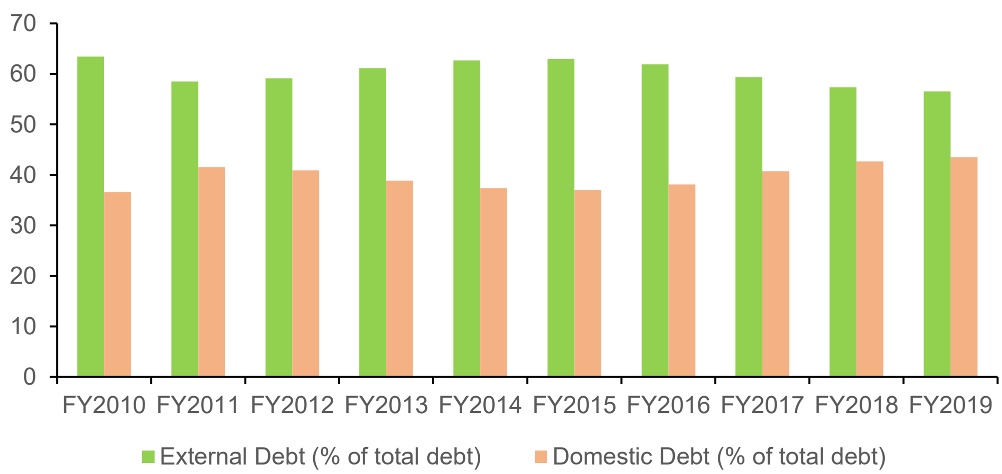
DEBT SUSTAINABILITY ANALYSIS

1. **In fiscal year 2020 (ended on 15 July 2020), Nepal's total public debt was estimated to be 41.3% of gross domestic product as the country was hit by the pandemic in the last 4 months of FY2020.**[1] Between fiscal year (FY) 2010 and FY2019, the total public debt averaged 26.7% of gross domestic product (GDP).[2] During this period, the shares of external and domestic debt in total debt were on average 60% and 40%, respectively (Figure 1). In its 2020 Article IV report published in February 2020,[3] the International Monetary Fund (IMF) projects the share of external debt to decline, while domestic debt will rise over the long-term. It also reports that Nepal's public debt remains low compared to other low-income countries, and Nepal remains a net external creditor.

Figure 1: Shares of External and Domestic Public Debt (%)

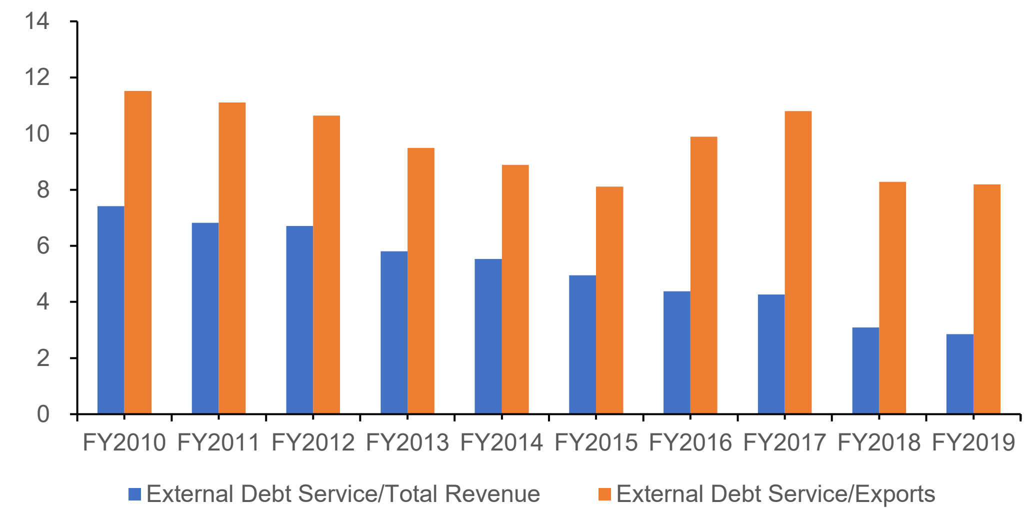


FY = fiscal year.
Source: Financial Comptroller General Office, Ministry of Finance, Government of Nepal; and Nepal Rastra Bank.

2. **The IMF's latest staff report for the disbursement under the Rapid Credit Facility approved on 6 May 2020 confirmed that even under the coronavirus disease pandemic, Nepal's debt is assessed to remain at a low risk of external and overall debt distress.** The assessment remains unchanged from the Article IV report, and also notes that a composite indicator using real GDP growth, remittances, foreign exchange reserves, and world growth signals a strong rating.[4] Nepal's external debt-servicing ratios are low (Figure 2). None of the debt and debt service indicators breach the indicative threshold values. Between FY2009 and FY2019, average external debt services to revenue and external debt to exports were 5% and 10%, respectively.

[1] WEO. April 2021.
[2] Financial Comptroller General Office, Ministry of Finance.
[3] IMF. 2020. *2020 Article IV Consultation-Staff report.* IMF Country Report No. 20/96. Washington DC.
[4] IMF. 2020. *Nepal: Request for Disbursement Under the Rapid Credit Facility-Press Release; Staff Report.* Washington DC.

Figure 2: External Debt Service Ration (%)



FY = fiscal year.
Source: Financial Comptroller General Office, Ministry of Finance, Government of Nepal; and Nepal Rastra Bank.

3. **Nepal's external debt is dominated by concessional public-sector lending from multilateral institutions, such as the ADB, the IMF, and the World Bank**. Nepal's 2015 Constitution gives the federal government the power to raise domestic and external debt. The subnational governments can borrow from the domestic market; however, they need to seek prior confirmation from the federal government. About 83% of all external debt were owed mainly to multilateral lenders, with the rest from bilateral lenders at the end of FY2019. External debt includes borrowing by the federal government and that on-lent to the state-owned enterprises. Private external debt stock is estimated to be small (around 1% of GDP). This includes largely the borrowing by local commercial banks and project financing by international lenders.[5] Domestic public debt includes treasury bills with a varying maturity of up to 1 year, and medium- to long-term bonds. All domestic debt is held by residents.

4. **The National Natural Resources and Fiscal Commission recommends a limit on internal borrowing for all three tiers of government**. The federal government can raise domestic debt up to 5% of GDP, whereas the subnational governments can raise internal debt up to 10% of the sum of own-source revenues and the amount received from the federal government under revenue-sharing arrangements.[6] Nepal's 2015 Constitution gives the federal government the power to raise domestic and external debt. The subnational governments can borrow from the domestic market; however, they need to seek prior confirmation from the federal government.

5. **A Public Debt Management Office has been set up by the federal government for integrated public debt management.** A Public Debt Management Bill is under consideration in

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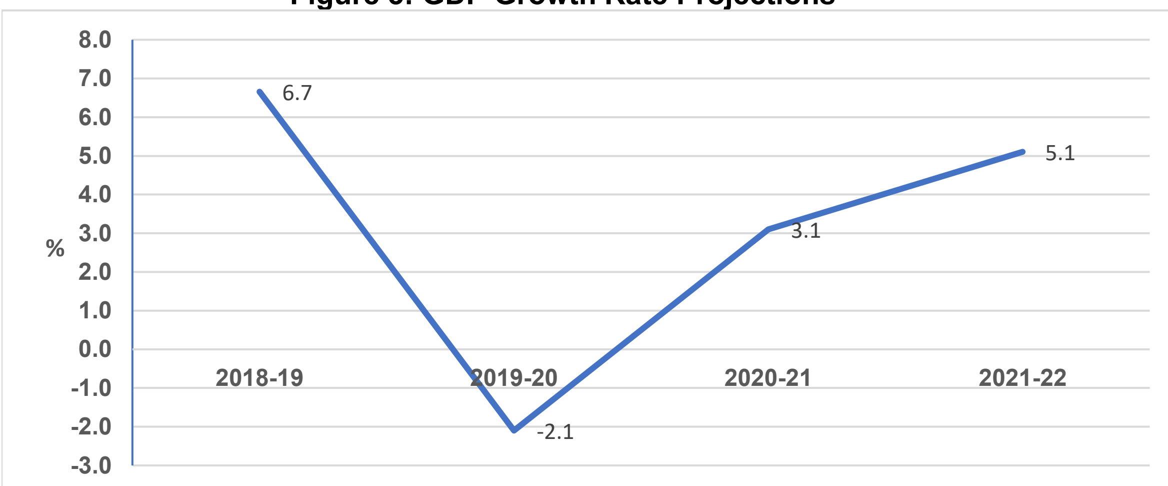
[5] In November 2019, nine development financial institutions committed financial resources of $450 million to one of the privately-owned hydropower projects (216 MW Upper Trishuli 1). ADB has committed $60 million to this project. However, it is believed that there has not been any significant loan disbursement yet.

[6] The amount of internal debt to be raised by sub-national governments is determined based on the projected own-source revenue mobilization and resources to be received through revenue sharing among the three tiers of governments for that fiscal year.

the Parliament. As per the bill, the Public Debt Management Office is expected to undertake debt issuance, management, and settlement functions of all tiers of the government.

6. **GDP is estimated to have contracted by 2.1% in FY2020 as the impact of the COVID-19 pandemic devastated the economy in the closing months of the year.**[7] GDP is expected to recover to 3.1% growth in FY2021 on a low base effect, the lifting of nationwide restrictions as coronavirus disease (COVID-19) ebbeds earlier in FY2021, and a forecast global economic recovery. GDP growth is forecast at 5.1% in FY2022 in anticipation of further global and domestic economic recovery as vaccination campaigns underpin economic impetus, approaching the GDP growth of 6.2% in FY2019 (Figure 3). [8]

Figure 3: GDP Growth Rate Projections



Source: Central Bureau of Statistics; and Asian Development Outlook (April 2021).

7. **Under an ADB baseline, the public debt-to-GDP ratio is projected to increase over the projection period and reach nearly 60% by FY2025 before starting to decline.** The ADB baseline (Table 1) further assumes that GDP growth will rebound to 6.0% in FY2023 and then moderate to 5.5% in the medium term, slightly higher than the IMF's latest projections. The ADB baseline assumes the primary deficit to be 8.3% of GDP in FY2021 and 6.5% in FY2022 to fight the pandemic and support economic recovery. With these assumptions, the public debt-to-GDP ratio will jump to 49.7% in FY2021 and 54.9% in FY2022 as the primary balance worsens (Figure 4). As growth picks up and the primary deficit falls, public debt will continue to rise at a slower pace and reach 59.5% in FY2025 before falling to 58.3% in FY2026. The debt path of ADB baseline is about 1.3 percentage point higher than that projected by the IMF, largely due to the higher primary deficit assumption in FY2022. Nepal's public debt-to-GDP ratio will stabilize when the primary deficit is at 3.3% of GDP.

[7] Central Bureau of Statistics. 2021. http://cbs.gov.np/. National Accounts of Nepal 2020-21.
[8] Asian Development Outlook 2021. Financing A Green And Inclusive Recovery. April 2021.

Table 1: Key Macroeconomic and Fiscal Assumptions

World Economic Outlook *(April 2021)*	**2019–2020**	**2020–2021**	**2021–2022**	**2022–2023**	**2023–2024**	**2024–2025**	**2025–2026**
Real GDP growth	(1.9)	2.9	4.2	6.0	5.4	5.2	5.2
GDP deflator	4.1	4.2	6.4	5.8	5.6	5.5	5.4
Effective interest rate	1.9	1.9	2.1	2.2	2.2	2.2	2.4
Primary balance % of GDP	(4.5)	(8.3)	(5.9)	(4.7)	(2.9)	(1.9)	(1.8)
Nominal GDP growth	2.2	7.2	10.8	12.2	11.3	10.9	10.8
ADB Baseline							
Real GDP growth	(2.1)	3.1	5.1	6.0	5.8	5.5	5.5
GDP deflator	3.6	4.4	5.2	5.5	5.5	5.5	5.5
Effective interest rates	1.9	1.9	2.1	2.2	2.2	2.2	2.4
Primary balance % of GDP	(4.5)	(8.3)	(6.5)	(5.2)	(3.9)	(2.7)	(1.5)
Nominal GDP growth	1.4	7.6	10.6	11.8	11.6	11.3	11.3

( ) = negative, ADB = Asian Development Bank, GDP = gross domestic product.
Source: World Economic Outlook (April 2021); Central Bureau of Statistics, and ADB estimates.

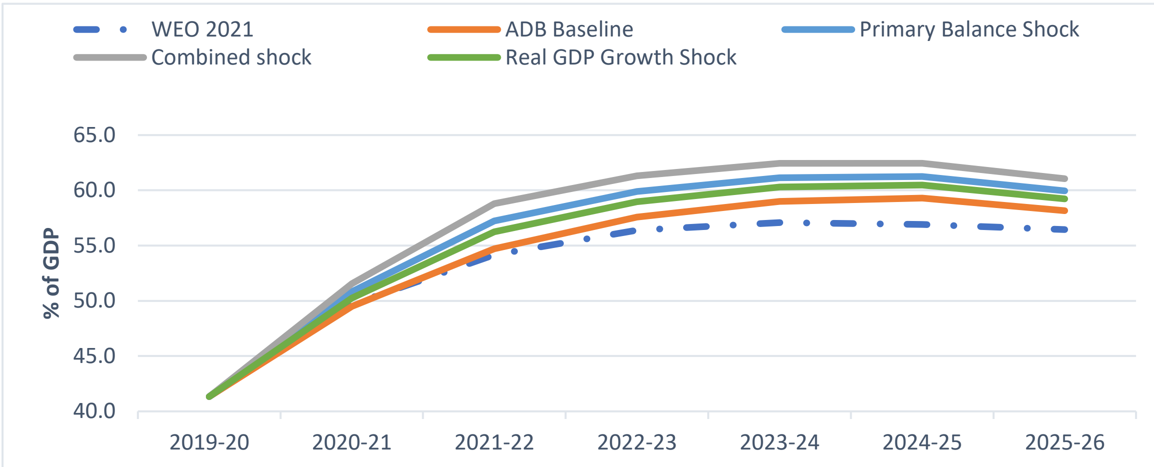
8. **Risks to Nepal's debt sustainability remain contained.** Main risks include low growth and high primary deficits. A resurgence of a second wave in India and Nepal in April 2021and sluggish remittances are likely to slow Nepal's growth. A negative growth shock, with GDP growth one-half standard deviation (1.2 percentage points) below the baseline in the first two years along with corresponding falls in nominal growth (Table 2), is likely to increase debt-to-GDP at a faster pace reaching a peak of 60.7% in FY2025 (Figure 4). A primary balance shock, where the primary deficit as a percent of GDP is one-half standard deviation (1.3 percentage points) above the baseline in the first two years of projection, will elevate debt levels to 61.4% in FY2025. The two shocks combined will push the debt-to-GDP ratio further higher to 62.6% in FY2025.

Table 2: Underlying Assumptions for Stress Tests

	2020–2021	**2021–2022**	**2022–2023**	**2023–2024**	**2024–2025**	**2025–2026**
Real GDP growth shock						
Real GDP growth	1.9	3.9	6.0	5.8	5.5	5.5
GDP deflator	3.7	4.5	5.5	5.5	5.5	5.5
Primary balance shock						
Primary balance % of GDP	(9.6)	(7.8)	(5.2)	(3.9)	(2.7)	(1.5)
Combined shock						
Real GDP growth	1.9	3.9	6.0	5.8	5.5	5.5
GDP deflator	3.7	4.5	5.5	5.5	5.5	5.5
Primary balance % of GDP	(9.6)	(7.8)	(5.2)	(3.9)	(2.7)	(1.5)

( ) = negative, GDP = gross domestic product.
Source. Asian Development Bank estimates.

Figure 4: Public Debt Sustainability Analysis



ADB = Asian Development Bank, GDP = gross domestic product, WEO = World Economic Outlook.
Source: WEO (April 2021) and ADB estimates.

9. **Approved and proposed COVID-19 response assistance from international financial institutions are $786.3 million in FY2020 and FY2021**. These borrowings are used to finance vaccine procurement, medical supplies, and other expenditure, and are part of external financing for the estimated fiscal deficit over the span of FY2020–FY2021. Therefore, these borrowings from international financial institutions are already reflected in the baseline debt path. The assistance for vaccine procurement includes from ADB (proposed $165 million) and World Bank ($67.5 million for vaccines and additional $7.5 million to support health systems strengthening, monitoring and evaluation). These two multilateral loans are about 0.7% of GDP in FY2021.