INTERNATIONAL MONETARY FUND ASSESSMENT LETTER

INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 17/100
FOR IMMEDIATE RELEASE
March 27, 2017

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with Nepal

The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Nepal on March 27, 2017, and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

Nepal's economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions at the southern border. The growth of real GDP at market prices slowed to 0.6 percent in 2015/16 (mid-July 2015 to mid-July 2016). Shortages of fuel and other essential goods due to the trade disruption drove up inflation to 12 percent (y/y) in January 2016, but eased subsequently to 3.2 percent in January 2017, mainly on account of lower food prices.

Budget under-spending worsened in 2015/16. At the same time, revenues exceeded the budget due to one-off telecom sector collections. As a result, the budget was in surplus for the fourth year in a row and net public debt declined further to 22 percent of GDP, down from 34 percent of GDP in 2011/12.

Private sector credit growth surged to a 7-year high of 31 percent (y/y) in January 2017.

The current account surplus reached 6.3 percent of GDP in 2015/16 on account of lower imports from the trade disruption. Exports also suffered. The growth rate of remittances slowed sharply, to 1 percent in 2015/16, from an annual average of 15 percent during the previous 5 years, due to weak growth in oil-producing host countries. Gross reserves of the central bank reached a record US$8.7 billion, covering more than nine months of imports, in January 2017.

Growth is projected to reach 5.5 percent in 2016/17 and inflation is expected to undershoot the central bank's mid-2017 target of 7.5 percent.

Executive Board Assessment

In concluding the 2017 Article IV consultation with Nepal, Executive Directors endorsed the staff's appraisal, as follows:

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Nepal's economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions. The normalization of economic activity is supported by a good monsoon, accommodative monetary policy, and rising government spending. Inflation has been decelerating due to base effects related to last year's trade disruption but is expected to remain above India's inflation. More recently, the authorities have also been able to advance reforms in a number of areas.

The medium-term outlook critically depends on efforts to sustain and deepen the nascent reform momentum. Stronger policies are needed to enhance confidence amid ongoing political uncertainty. They are also needed to strengthen key institutions and administrative capacity, which are critical for overcoming poor service delivery and chronic under-implementation of the budget, and for boosting private investment and growth. Accordingly, in the absence of stronger policies, and taking into account the lower projected growth of remittances and the effects of the earthquakes and trade disruption, growth would likely fall below the average of the past decade and fall short of what is needed to substantially improve living standards and social indicators.

Risks to the outlook are broadly balanced. The rebound in economic activity could be more pronounced and persistent than set out in the baseline, particularly if the momentum in policy and structural reforms is sustained and deepened. Key downside risks pertain to domestic political instability, the weak financial sector, slowing remittances impacting financial sector liquidity, and lower growth in India due to the demonetization shock.

To support Nepal's recovery while maintaining macroeconomic and financial stability, the macroeconomic policy mix should be rebalanced toward a more accommodative fiscal position and a tighter monetary stance. Staff welcomes the authorities' plans and efforts to scale up government spending to rebuild after the earthquakes and address infrastructure gaps to boost medium-term growth. In view of the limited implementation capacity, it will be essential to have a realistic budget that effectively prioritizes spending to maximize growth dividends, including in social spending areas most important for inclusive growth. The scaling up of government spending should not exceed the economy's aggregate absorptive capacity and should be anchored in a medium-term expenditure framework to ensure quality and fiscal sustainability.

The monetary policy framework needs further strengthening. Staff welcomes the introduction of an interest rate corridor. Next steps would involve refining the framework by fixing the floor of the interest rate corridor to reduce the volatility of interbank interest rates and adopting a medium-term inflation objective consistent with eliminating the inflation wedge with India on a sustained basis. With remittances set to slow, fiscal policy turning expansionary, and the current account turning to a deficit, a tightening of monetary policy is needed to prevent the exchange rate from becoming somewhat overvalued.

Financial sector reforms should be accelerated in line with FSAP recommendations to mitigate macro-financial risks, including related to the rapid growth of credit. Financial sector supervision should be strengthened, building on the recent amendments to several aspects of the regulatory framework. Macro-prudential measures introduced in the aftermath of the 2010-11 episode of financial sector pressures to contain credit growth have served Nepal well and should be maintained after the temporary relief granted in February lapses in July.

Raising Nepal's potential growth requires sustained efforts to build policy implementation capacity, improve the business climate, and develop the hydropower sector. Structural reforms to deregulate product and factor markets should complement prioritized investment to upgrade transportation infrastructure and improve power supply.

Nepal: Selected Economic Indicators, 2013/14-2017/18 [1/]

	2013/14	2014/15	2015/16	2016/17	2017/18
				Projections	
Output and prices (annual percent change)					
Real GDP	6.0	2.7	0.6	5.5	4.5
CPI (period average)	9.0	7.2	9.9	6.7	7.6
CPI (end of period)	8.1	7.6	10.4	6.5	7.5
Fiscal Indicators (in percent of GDP)					
Total revenue and grants	20.4	20.9	23.3	24.2	24.1
of which: tax revenue	15.9	16.8	18.7	20.0	20.1
Expenditure	18.8	20.2	22.0	25.3	25.3
Expenses	15.5	16.0	16.5	19.3	19.3
Net acquisition of nonfinancial assets	3.4	4.2	5.5	6.0	6.0
Operating balance	4.9	4.8	6.8	4.9	4.8
Net lending/borrowing	1.5	0.7	1.4	-1.1	-1.2
Statistical discrepancy	-0.9	-1.2	-1.1	0.0	0.0
Net financial transactions	-1.5	-0.7	-1.4	1.1	1.2
Net acquisition of financial assets	2.4	2.2	5.2	-1.3	-1.2
Net incurrence of liabilities	0.0	0.3	2.8	-0.2	-0.1
Foreign	0.2	0.6	1.1	0.8	0.7
Domestic	-0.3	-0.2	1.7	-1.0	-0.8
Money and credit (annual percent change)					
Broad money	19.1	19.9	19.5	15.9	13.6
Domestic credit	13.9	16.4	17.4	20.2	17.8
Private sector credit	18.3	19.4	23.2	19.0	16.7
Velocity	1.3	1.1	1.0	1.0	1.0
Saving and Investment (in percent of nominal GDP)					
Gross investment	41.2	38.8	34.0	42.7	42.6
Gross fixed investment	23.5	27.7	25.0	31.4	31.4
Private	20.1	23.6	19.5	25.5	25.4
Central government	3.4	4.2	5.5	6.0	6.0
Change in stock	17.7	11.0	8.9	11.2	11.2
Gross national saving	45.7	43.8	40.3	42.4	41.2
Private	40.5	38.5	33.3	37.2	36.1
Central government	5.2	5.2	7.0	5.1	5.1
Balance of Payments					
Current account (in millions of U.S. dollars)	908	1,067	1,339	-73	-338
In percent of GDP	4.5	5.0	6.3	-0.3	-1.3
Trade balance (in millions of U.S. dollars)	-6,082	-6,670	-6,389	-8,079	-8,856
In percent of GDP	-30.4	-31.3	-30.2	-34.7	-34.7
Exports value growth (y/y percent change)	5.4	-4.0	-28.8	18.8	3.9
Imports value growth (y/y percent change)	14.3	7.7	-7.4	25.7	9.1
Workers' remittances (in millions of U.S. dollars)	5,543	6,192	6,253	6,467	6,787
In percent of GDP	27.7	29.1	29.6	27.7	26.6
Gross official reserves (in millions of U.S. dollars)	6,172	7,162	8,574	8,690	8,494
In months of prospective GNFS imports	8.3	10.4	10.1	9.4	8.6
Memorandum items					
Public debt (in percent of GDP)	28.3	25.2	27.3	25.7	23.2
GDP at market prices (in billions of Nepalese rupees)	1,965	2,120	2,249	2,532	2,848
GDP at market prices (in billions of U.S. dollars)	20.0	21.3	21.2	23.3	25.5
Exchange rate (NRs/US$; period average)	98.3	99.5	106.3	…	…
Real effective exchange rate (average, y/y percent change)	-2.8	7.7	5.9	…	…

Sources: Nepalese authorities; and IMF staff estimates and projections.

1/ Fiscal year ends in mid-July.

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STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

March 13, 2017

KEY ISSUES

Context. Nepal's economy is rebounding following a slowdown caused by the 2015 earthquakes and trade disruptions at the southern border. The upswing has been supported by the new government's efforts to revitalize the reform agenda. The key challenge is to put policies in place that will extend the cyclical recovery into a sustained period of high and inclusive growth.

Outlook and Risks. Staff expects growth to reach 5.5 percent in 2016/17, supported by a good monsoon, accommodative monetary policy, and rising government spending. Inflation is at a multi-year low as prices normalize following last year's disruptions. In the absence of strong policies and sustained reforms, growth would likely revert to the average of the past decade and fall short of substantially improving living standards and social indicators. Risks to the baseline are broadly balanced with the main downside risks pertaining to domestic political stability and the financial sector.

Key policy recommendations. Sustaining and deepening the nascent reform momentum observed in recent months would help boost growth and allow more progress in achieving the sustainable development goals (SDGs). Efforts should focus on strengthening key institutions and administrative capacity to overcome the chronic under-implementation of the budget and boost private investment and growth.

- **Fiscal policy** should focus on facilitating post-earthquake reconstruction and medium-term growth through higher and better-quality public investment.
- **Monetary policy** needs to be tightened to support the exchange rate peg and competitiveness by closing the inflation wedge with India on a sustained basis. Monetary management should be strengthened further building on recent steps to adopt an interest rate corridor.
- The buildup of risks related to the rapid credit growth underscores the importance of accelerating **financial sector reforms,** through stronger supervision, building on the recent amendments to the regulatory framework, and more stringent loan classification and provisioning and upgrading of banks' risk management, in line with FSAP recommendations.
- **Structural reform** will be essential to unlock growth. Key priorities include strengthening policy implementation capacity, upgrading transportation infrastructure, improving the business climate, and developing the hydropower sector.