Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 29-Nov-2018| Report No: PIDC26180

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Nepal	P169920	Nepal Maximizing Finance for Development (P169920)	
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
SOUTH ASIA	Mar 19, 2019	Finance, Competitiveness and Innovation	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Ministry of Finance	Ministry of Finance		

Proposed Development Objective(s)

The MFD Development Policy Credit series supports the government in its efforts to: (i) Improve the investment climate for domestic and foreign investors; and (ii) Strengthen the framework for investment financing.

Financing (in US$, Millions)

SUMMARY

Total Financing	150.00

DETAILS

Total World Bank Group Financing	150.00
World Bank Lending	150.00

Decision

The review did authorize the preparation to continue

B. Introduction and Context

Country Context

While Nepal remains one of the poorest countries in the South Asia region with large development needs, the prospects of undertaking a strong reform agenda to improve sustainable investment have improved. Nepal's growth averaged only 4.72 percent during FY2008-18, largely driven by remittance fueled private consumption. This low growth performance was primarily attributable to political and policy instability, and vulnerability to external shocks. In addition, the country has a significant infrastructure deficit and the government recognizes the need and urgency of addressing it through public and private sector investment. Investment needs are estimated at 10-15 percent of GDP annually for the next 10 years. Despite low debt levels at 30 percent of GDP, this is a challenging goal. However, the opportunity for reforms around sustainable investment have significantly improved. A new constitution was approved in 2015 that restructured Nepal into a federal republic and, in 2018, a majority government was elected with a strong mandate for reform to spur sustainable investment, growth and jobs.

To meet the country’s aspirations of reaching middle-income status by 2030, it will be critical to crowd in the private sector that is currently subject to several acute constraints. Foreign direct investment (FDI) inflows have been close to half a percent of GDP, depriving the economy of an important source of financing, technology transfer, and access to new markets. Poor infrastructure and governance, including a weak regulatory environment, have been serious constraints to private sector investment. Nepal’s land market is highly inefficient with constraints to access, ownership, use and service delivery inter alia. Foreign currency and other risks discourage foreign investors and lenders from investing. The ability of banks, which dominate the financial sector, to intermediate efficiently and provide long-term finance is constrained by weak financial infrastructure and maturity mismatches. Capital markets, on the other hand, do not yet play any significant role, while local institutional investors are underdeveloped and mostly invest in short-term instruments.

Nepal’s macroeconomic policy framework is adequate for development policy financing. Despite several severe shocks in the past, Nepal’s macroeconomic fundamentals have been sound: high growth in revenue, low debt to GDP ratio, a stable financial sector and comfortable reserves. Going forward, the government remains committed to macro-fiscal prudence, as evident in its decision to undertake a spending review and continued maintenance of the peg with the Indian Rupee. After more than a decade, the country now has political and policy stability that will support growth. The key risks are on the fiscal and external front. The transition to a federal structure will increase government spending and keep the fiscal deficit high. Risks are mitigated, to an extent, by the fact that there is considerable donor support for this transition, both in terms of technical assistance and concessional financing. The external deficit is also likely to remain elevated. Reforms supported by the current DPC series will help improve the investment climate and competitiveness, which will support export growth and help maintain reserve adequacy. Nepal is also vulnerable to climatic shocks that could disrupt growth.

Relationship to CPF

The proposed programmatic series is anchored in the Country Partnership Framework (CPF) for FY2019-23 and supports, in particular, the second pillar on ‘Private Sector Led Jobs and Growth’. The reforms are also consistent with the government’s three-year periodic plan and the 2030 Strategy. The DPC series will support the government in its efforts to maximize finance for development by improving the climate for sustainable investment and strengthening the framework for investment financing. These objectives will be achieved through reforms in the areas of investment facilitation, land, procurement, capital markets development and strengthening of the financial infrastructure. This programmatic series is underpinned by the joint IFC and World Bank Country Private Sector Diagnostics (CPSD), the forthcoming Infrastructure Sector Assessment (InfraSAP), as well as other analytical reports and advisory services by the World Bank and IFC. It also builds on and complements the recently completed programmatic series of Development Policy Credits (DPCs) on financial sector stability, the energy sector, fiscal and public financial management.

C. Proposed Development Objective(s)

The MFD Development Policy Credit series supports the government in its efforts to: (i) Improve the investment climate for domestic and foreign investors; and (ii) Strengthen the framework for investment financing.

Key Results

Key results expected under Pillar 1 that aims to improve the investment climate for domestic and foreign investors are: (i) reduced time taken to get all clearances for private investment above NPR10 billion; (ii) increased number of FDI projects approved through the automatic route; (iii) increased number of projects that use the hedging facility; (iv) increased number of awarded bids that fully comply with the provision on bidding capacity; (v) increased number of women having land ownership/ tenure; and, (vi) availability of information on forest carbon stocks. Key results expected under Pillar 2 that aims to enhance the framework for investment financing are: (i) increased average term to maturity of government securities issued in the actual fiscal year; (ii) increased number of corporate bond issuances; (iii) increased number of insurance policy holders; (iv) increased number of individuals and firms enrolled with the Credit Information Bureau (CIB); (v) increased number of registrations of security interests in the secured transactions registry; (vi) identification of D-SIBs by NRB; and, (vii) increased number of cashless retail payment transactions per capita.

D. Concept Description

Pillar 1 seeks to relieve some of the key policy and regulatory challenges faced by domestic and foreign investors. The bulk of firms are small and do not grow significantly over their lifecycle. Productivity levels are remarkably low and FDI inflows have historically been below one percent of GDP. Nepal ranked 88 (out of 137 countries) in the 2018 Global Competitiveness Report and 110 (out of 190 countries) in the 2019 Doing Business Report. Infrastructure constraints are binding, alongside access to finance and inefficient land markets. Excessive barriers to foreign investment and foreign-exchange transactions constrain the financing of the private sector. Policies on land acquisition and the use of land as collateral deter foreign investors and lenders, restricting private sector access to long-term finance. Pillar 1 prior actions support the establishment of a framework for public-private partnerships (PPP) and the investment facilitation and coordination services for large investments; efforts aimed at easing the regulatory framework for foreign investments, the movement of foreign capital, and solutions to minimize foreign currency risks and attract foreign finance; the adoption of procurement regulations that will enable the government to efficiently undertake investments and honor PPP contracts; reforms in land ownership, access, use, valuation and service delivery, and the approval of the National Reducing Emission from Deforestation and Forest Degradation (REDD+) policy.

Pillar 2 seeks to unlock local and foreign capital in terms of quantity, quality and allocative efficiency, to support the private finance of investment. The ongoing Fourteenth Development Plan estimates that 55 percent of total investment required to implement the plan will be mobilized from the private sector. An efficient, diverse and stable financial sector will be necessary for the private sector to mobilize the needed resources. Building on the fourth Financial Sector Stability DPC series, the MFD DPC series broadens reform engagement into financial access and long-term finance. The Pillar entails reforms to support (i) the development of long-term and alternative finance, to overcome the constraints faced by the dominant banking sector and diversify the available forms of finance, and (ii) the strengthening of financial infrastructure, to provide an enabling environment for efficient financial intermediation and preserve financial stability that attracts and underpins private investment. Pillar 2 prior actions support the establishment of a Public Debt Management Office (PDMO) as a first step towards building a benchmark yield curve; regulations that will enable the development of alternative finance, such as venture capital, hedge funds and private equity investors; revised investment guidelines for insurance companies, enabling the emergence of the insurance sector as an institutional investor; improved financial infrastructure through enhanced availability and quality of information in the CIB.

E. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

Based on an initial assessment, the policy reforms supported by this operation can potentially have positive and negative effects on the poor if not adequately mitigated. Policy reforms supported by this operation will contribute to greater private sector investment, which can be expected to have an overall positive effect on the poor through the employment and wage channel, as well as through the lowering of prices and the delivery of better services due to increased competition. The substitution of public for private investment can generate saving, that may have a positive effect on the poor if channeled accordingly. Broader access to finance and financial inclusion can also potentially have a positive effect. Private sector investments in sectors prone to monopoly, however, may need to be regulated to ensure that the services are affordable and accessible to the poor. In addition, there are potentially negative effects if land valuation mechanisms are ineffective.

Environmental Impacts

Based on an initial assessment, increased investment can potentially have negative effects on the environment and on natural resources, if not adequately mitigated. Nepal has limited capacity for preparing environmental impact assessments, monitoring air and water pollution, and ensuring waste management. This may deteriorate during the transition to federalism and if reforms targeting increased investment are not implemented with adequate care. At the same time, procurement reforms that target improved performance of vendors, including adherence to environmental standards, could help lessen negative environmental impacts. Reforms that aim to ensure sustainable land/ natural resources management and avoid forest degradation and deforestation can potentially also have a positive effect. Mitigation measures will be further developed during preparation and over the course of the series to address the potential negative effects of reforms, including through World Bank Group advisory services and the exploration of complementarities with World Bank and development partner interventions.

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