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Nepal Development Update



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Table of Contents

.....	1
Summary	4
Review of Recent Economic Developments	7
Review of policies and short to medium term development challenges	24
Short and medium term economic projections.....	32
Bank support and activities.....	33
Excess liquidity – A “Fortunate Problem” ... if well managed.....	35
PART I : MANAGING EXCESS LIQUIDITY IN THE SHORT RUN	37
PART II: EXPANDING THE REACH AND THE EFFICIENCY OF CREDIT MARKETS	48

Table of Figures

Figure 1: Mid-year budget execution (nominal)	8
Figure 2: Mid-year budget execution (relative to plan).....	9
Figure 3: Recurrent expenditures at mid-year.....	10
Figure 4: Revenue mobilization at mid-year	12
Figure 5: Revenue composition (mid-year) reflecting a shift in drivers.....	13
Figure 6: Inflation in Nepal and India (y-o-y percentages)	14
Figure 7: Food and beverages inflation (by subcomponents)	14
Figure 8: Growth in foreign trade (mid-year)	16
Figure 9: Exports, Imports and Trade Balance FY 2001-14 (In US \$ Million)	16
Figure 10: Monthly Remittances Inflows and Movement of Migrant Workers.....	17
Figure 11: Import capacity of reserves against monthly remittance inflow.....	18
Figure 12: Evolution of monetary aggregates, credit and interest rates.....	19
Figure 13: Credit-Deposit Ratio of Commercial Banks.....	20
Figure 14: Total Credit and Deposit of Commercial Banks	20
Figure 15: Real estate exposure as a share of total loan portfolio	21
Figure 16: Non performing loans of commercial banks.....	22
Figure 17: Quarterly NEPSE Index FY06 - FY14	23
Figure 18: The proposed fast track alternative.....	28
Figure 19: Despite high access Nepal has the lowest per capita consumption of electricity in South Asia.....	31
Figure 20: Commercial banks biased toward liquid assets	38

Figure 21: Liquid funds of commercial banks	38
Figure 22: Structure of interest rates.....	39
Figure 23: Monetary policy objectives.....	42
Figure 24: Access to finance indicators.....	48
Figure 25: Household savings behavior	49
Figure 26: Percentage of firms reporting access to finance as a major constraint	50
Figure 27: Access to credit is low in Nepal.....	51

List of Tables

Table 1: NRB's interventions to mop up liquidity in FY14	43
Table 2: Loan origins	50

List of Boxes

Box 1: "National Pride Projects" progressing at slow pace.....	11
Box 2: Definitions: credit slowdown and credit crunch	40
Box 3: Reverse repo and open market operations: Basic definitions.....	43
Box 4: Ever-greening: lipstick on a pig?	45
Box 5: The Use of Sterilization Bonds in Asia.....	47
Box 6: Licensing, market structure and financial development	52

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Summary

The enabling environment for development has improved but opportunities need to be effectively leveraged through focused policy action. The successful election of a new parliament and subsequent formation of a popularly mandated government provide a more conducive environment for private sector activity and economic policy. The uncertainties brought about by Nepal's prolonged political transition and electoral period have acted as a break on private sector investment and diverted attention of the bureaucracy away from difficult and important reforms. Going forward, it will be important for the government to signal, from the start, that increased political stability will be put to profit to tackle the country's formidable challenges. This will involve a balancing act to ensure that the arduous process of constitutional drafting can be carried-out in tandem with regular and improved government operations.

Nepal has significant resources in the form of remittances from abroad, but the economy cannot use these resources in a productive manner to enhance the overall welfare of all citizens. The budget process does not work -funds cannot be used to build decent infrastructure that would bring in the private sector- and inefficiencies in the financial sector hinder the optimal allocation of resources to private agents. In view of these challenges, the GoN should set a new course for policy and tackle emerging risks. The appointment of a new Finance Minister with deep experience and reformist credentials is a positive sign and initial declarations of Minister Mahat committing to "take forward the second round of reforms [...] in partnership with the private sector" are also encouraging.

Specific priorities include:

1. Developing a growth promotion vision / agenda: because the numerous challenges facing Nepal make achieving clarity over policy goals and priorities particularly difficult. The Nepalese authorities have formulated the aspiration of graduating to "developing country" status by 2022, but have not articulated the vision for development that would underpin it and identify those policies and reforms that are the most urgent. In the absence of such clear prioritization, the process of development planning is likely to remain un-strategic.
2. Resolving Nepal's 'fiscal paradox': Nepal, today, is in a paradoxical situation. It is the only country in South Asia to record a budget surplus (helped by buoyant revenue growth), its level of indebtedness is modest, it is flush with liquidity (thanks to large remittance inflows) and yet it struggles to maintain investment at already low levels. Fiscal discipline is a means to an end, but in Nepal it appears to be pursued as an end in itself, with the government unable to plan and implement the budget. This bottleneck needs to be addressed urgently.
3. Boosting investment: Faster and sustained economic growth will not be possible without higher levels of investment but Nepal's model of growth appears premised on remittance financed consumption. The public sector has a key role to play to unlock investment by: (i) providing a friendlier environment for the private sector –domestic and foreign- to find it attractive to bid for projects in Nepal, and (ii) developing the essential public infrastructure needed for firms to thrive and private funds to be crowded-in. The fate of Nepal's "National Pride Projects" demonstrates that such synergies are not currently taking place.

4. Tackling enduring financial sector risks and managing excess liquidity: Uncertainty over the true health of the financial sector remains the single most important macroeconomic risk for Nepal. First, although unlikely, a financial sector crisis would have devastating effects on public finances and economic growth. Second, the ability of the financial sector to provide adequate credit to deserving borrowers is currently hampered by *inter alia* (i) distortionary policies (ii) low levels of effective access to finance, (iii) poor risk management practices by monetary authorities and banks amplified by deficient information, and (iv) limited recourses of banks vis-à-vis delinquent borrowers. As a result the financial sector is operating at sub-optimum and the current excess liquidity in the system is largely a reflection of this state of affairs.

After a difficult year in FY13, the economy is poised to recover, albeit modestly. In FY13, Nepal achieved only modest growth of 3.6%. This was due largely to poor performance of the agricultural sector as well as very modest levels of industrial activity. The only source of relief came from the services sector. The main difference in FY14 is expected to come from the agricultural sector with expanded production on the back of a good harvest, while strong remittance inflows will continue to drive services sector expansion.

Nepal's internal and external balances are sound but not for the right reasons.

- **The combination of low expenditure and robust revenue growth accounted for a large budget surplus and declining debt.** With a significant increase in foreign grants the overall government surplus ballooned to NRs 56.0 billion. Reflecting this comfortable fiscal position the GoN did not issue any fresh T-Bills in FY14 and domestic debt fell to NRs 217.61 billion. While much of the blame for low rates of budget execution and important bunching had been blamed, hitherto, on delayed budget approval, this was not the case in FY14 when a full budget was unveiled on day one of the fiscal year. In other words Nepal is yet to come to grips with deep structural inefficiencies in the process of budget planning, formulation and execution.
- **Nepal's external position is comfortable thanks to large remittance inflows.** On the external side Nepal has benefited from the depreciation of the rupee but also –and much more significantly- from a sharp further increase in inward remittances which are expected to amount to over 30% of GDP in FY14.

Monetary policy has sought to achieve a delicate equilibrium between controlling inflation and supporting economic activity but the optimal balance may evolve and call for corrections. Significant inflation, close to double digits, appears to have become a feature of the Nepali economy. While expanded agricultural output may contribute to dampen inflationary pressure, the significant growth in the money supply may eventually generate inflationary expectations and second round effects as well as translate into lower reserves. From that view point, the evolution of the quantity and quality of credit to the private sector will be important to monitor.

For FY14, the outlook is cautiously optimistic. The previous assessment estimated that growth would reach 4-4.5% in FY14 essentially driven by increased agricultural output and improved execution of the budget. While the pace of capital expenditure may be below initial

expectations, inward remittance inflows have been significantly above projected levels and should provide an additional boost to the services sector. On balance therefore, growth is projected to reach 4.5%, especially if capital spending picks up in the second half of the year.

As remittances have become a defining feature of the Nepali economy the country must learn to manage excess liquidity. The significant buildup of liquidity in the financial sector reflects both strong push factors (remittance inflows translating into a build-up of net foreign assets) and weak pull factors (slowing credit growth and loose monetary policy). In the short term, the NRB will need to strike a delicate balance between encouraging sound credit growth –so as to not compromise economic activity objectives- and containing inflation. At present this balance is particularly difficult to achieve because of uncertainties over the true health of the banking sector, weak risk management systems and market failures. In the short run, the NRB may also need to expand its toolset to deal with excess liquidity. In the medium run, resolving structural bottlenecks to efficient credit market functioning is a precondition for monetary policy to operate more smoothly and efficiently and for ample available resources to be allocated to grow Nepal's productive potential.

Review of Recent Economic Developments

Economic growth is expected to recover in FY14, albeit from a low point. Agricultural potential has expanded in the first half of the year on the back of a good monsoon and the sharp increase in remittance inflows should support services sector growth as well. The structural bias toward consumption led growth – as opposed to investment- is expected to continue with relatively low levels of both public and private investment.

Nepal, for the second year in a row, should achieve a twin surplus reflecting healthy developments (particularly domestic revenue mobilization) but also deep absorptive bottlenecks, which are really missed opportunities for growth. First, the slow pace of budget execution has translated into a sizeable budget surplus that is not leveraged to build the country's infrastructure. Second the sharp increase in remittances has more than made up for Nepal's chronic trade gap but it has also resulted in a buildup of liquidity in the financial system that may be in excess of the private sector's ability to translate it into sound credit.

Economic growth has slowed in FY13 and remains contingent mostly on exogenous factors.

Economic growth slowed in FY13 mainly on account of low agricultural production and depressed investment. The economy grew by 3.6% in FY13 compared to 4.9% in FY12. Owing to a weak monsoon and inadequate supply of agricultural inputs during the peak plantation season, agricultural sector performance was disappointing with growth of 1.3% in FY13 compared to 5% growth in FY12. Industrial sector growth slowed from 3% in FY12 to 1.6% in FY13 as private sector players held back investments due to political uncertainty. The only source of relief came from significant growth of the services sector (6% in FY13 compared to 4.5% in FY12) mostly aided by continuous growth in remittance transfers (15% growth from FY12 in dollar terms).

Agriculture output is expected to recover in FY14 and services growth to continue at a healthy rate. With a good monsoon, the production of Nepal's two staple crops has expanded significantly. Paddy production grew by 12% whereas maize production grew by 10% as compared to the level at the same time in FY13. Sharp and higher than anticipated inward remittance flows are expected to drive services sector growth, particularly wholesale and retail trade and social services. By contrast industrial activity is likely to remain lackluster owing to structural constraints –including irregular access to energy and difficult labor relations- and to modest levels of public capital spending.

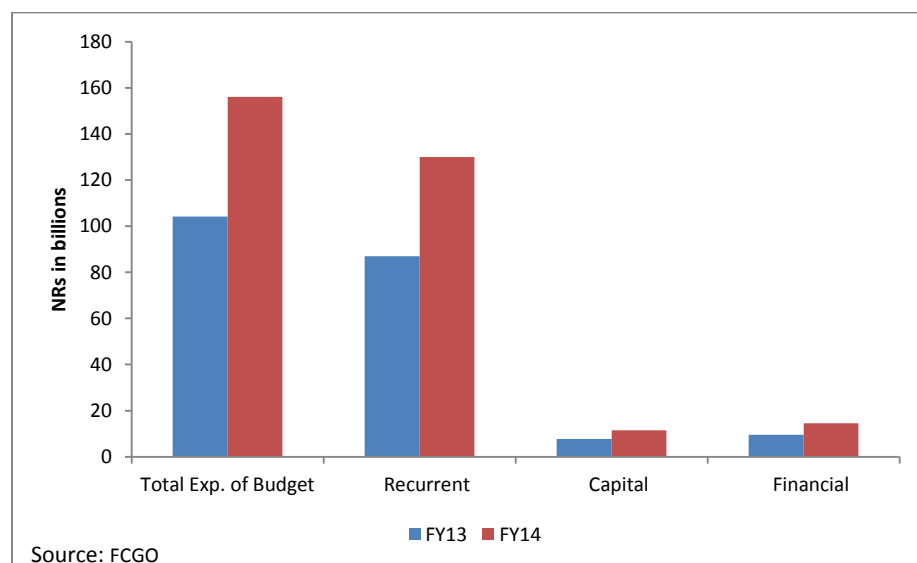
Economic activity has remained driven by consumption and weak investment continues to hold back the economy's growth potential. While record levels of remittance inflows and a significant increase in recurrent spending commitments of the government are expected to translate into consumption growth, both public and private investment have been depressed in the first half of FY14. First, the timely adoption of the budget has not translated into faster utilization of the capital budget and key priority projects remain at a standstill. Second, despite ample liquidity in the system and an accommodative monetary stance, private sector credit growth has slowed as a result of both weak demand (despite improving political stability) and reluctance of banks to lend. Finally, FDI inflows have been low even compared to FY13.

There is a significant discrepancy between investment commitments and realizations indicating the potential for improvements in the second half of the year. Total domestic capital investment commitments increased significantly in the first half of the year (by almost 400% relative to the same time in FY13) to reach NRs 183 billion. Likewise FDI commitments also increased relative to the same time in FY13 by 50%. In both cases the commitments have been overwhelmingly in the energy sector (95% and 70% of domestic and international commitments respectively). However, these additional commitments have not been reflected to date in either credit growth or FDI inflows. Total credit of Bank and Financial Institutions (BFIs) to the private sector grew by 9% in the first half of the year, compared with 12.3% at the same time in FY13. Likewise FDI inflows fell by 65.6% relative to the first half of FY13 amounting to a paltry NRs 1.3 billion (or just above USD 13 million).

The Government of Nepal has not managed to tackle structural absorption problems and has accumulated a large treasury surplus.

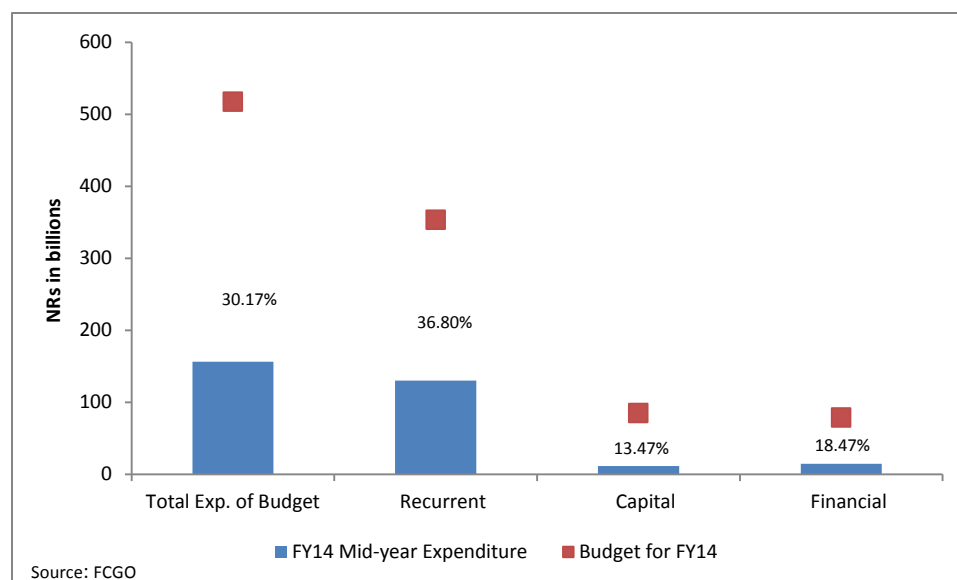
While a full budget was adopted on day 1 of the fiscal year, public capital expenditure has continued to lag significantly, relative to plan. The low level of expenditure in FY13 was widely blamed on political instability and the GoN's inability, as a result, to adopt a full budget before the last quarter of the fiscal year (on the 9th April, 2013). As a full budget was adopted on time in FY14, the expectation was that both capital and recurrent expenditures would grow significantly given pent-up demand and the freedom given to implementing agency to use their allocated budgets. This expectation has materialized to the extent that spending has grown significantly in the first six months of the year relative to the same time in FY13 (NRs 156 billion vs. NRs 104 billion or a 50% increase). While this improvement was for recurrent and capital spending alike (Figure 1), it is however relative to very different bases. As investment spending had lagged dramatically in FY13 the nominal increase in FY14 (NRs 11.46 billion compared to NRs 7.66 billion in FY13) is no cause for celebration and remains small in absolute terms and relative to budgeted amounts.

Figure 1: Mid-year budget execution (nominal)



The budget, at mid-year is under-executed, particularly for capital. At mid-year, only 13.5% of the capital budget and 36.8 % of the recurrent budget have been used (Figure 2). As a result underspending of the budget is likely as is important bunching of expenditure in the last quarter and especially in the last month of the fiscal year, calling into question both the realism of the budget and the quality of the expenses that are actually / eventually realized.

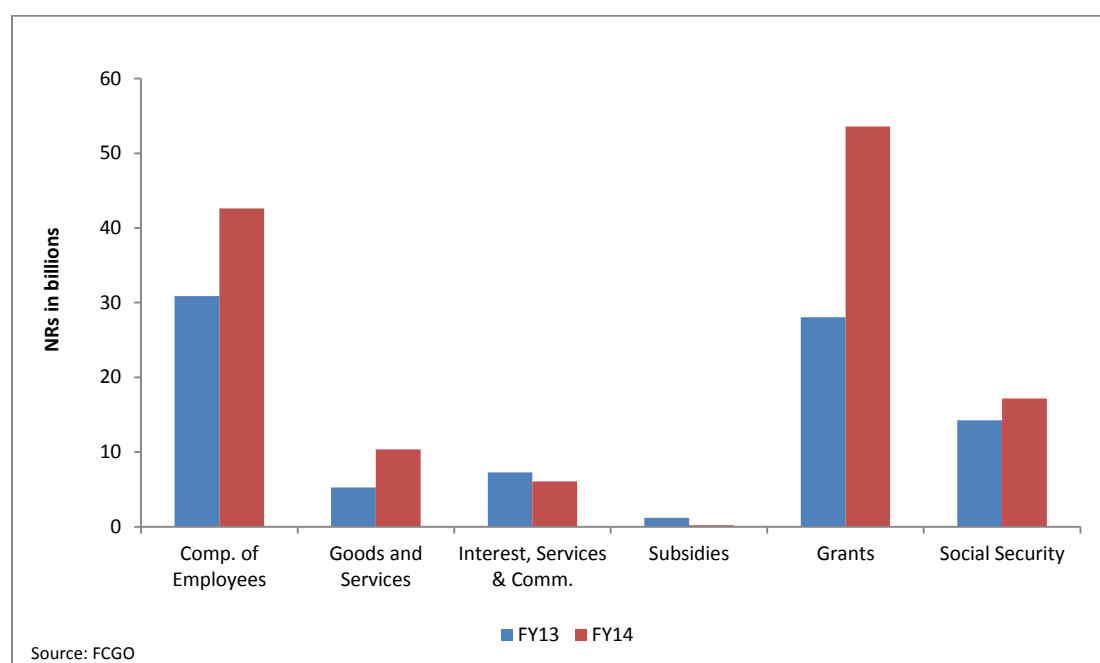
Figure 2: Mid-year budget execution (relative to plan)



In view of the low budget outturn, the government has revised and lowered its spending targets. Total expenditure is now expected to reach NRs 479.132 billion which is 92.6% of the total budgeted amount, with capital expenditure targets revised downwards by 13.4 billion (a 16% decrease) and recurrent spending by NRs 21.8 billion (a 6% decrease).

Recurrent expenditure growth accounted for 83% of the total increase in total expenditure, relative to FY13. In the first six months of FY14, recurrent spending reached NRs 130.1 billion (vs. NRs 86.9 billion in the corresponding period of FY13), driven inter alia by the public sector wage bill (following a 18% increase in the salaries of public employees as well as an additional NRs 1000 in monthly allowances) and significant growth in conditional and unconditional recurrent grants to government agencies, committees and boards (

Figure 3: Recurrent expenditures at mid-year



The fate of so called ‘National Pride Projects’ illustrates deep absorptive bottlenecks especially for capital projects. Of the 21 projects that have received allocations in the government budget under this category, three projects (Bhairahawa International Airport, Second International Airport, and West Seti Hydropower Project) have not spent anything at all in the first half of the year, while a further two projects (Bheri-Babai Diversion Multipurpose Project and the Kathamandu-Terai Fast-track project) have spent less than 1% of their respective allocations. In this respect they exemplify shortcomings in preparations and implementation that affect the broader capital project portfolio of the government. Their fate underscores the need to thoroughly re-evaluate the entire budget process from planning to formulation and execution (see the “review of policies and short to medium term development challenges” section for a fuller discussion) as well as to potentially review the basis upon which the prioritization process is carried-out.

Box 1: "National Pride Projects" progressing at slow pace

The Government of Nepal has accorded 21 infrastructure projects the status of 'National Pride Projects' to reflect their importance for Nepal's Development. The budget allocations for these projects represent 4.22% and 25.67% of the total and the capital budget respectively. However, the rate of utilization of budgets by these projects has been dismal. At mid-year, only 12.9% of the NPR 21.8 billion total allocation has been spent. Only two projects have exceeded the 50% utilization mark.

Some projects have run into difficulties even before they could begin, while with most projects progress has been very slow. A feasibility study is still missing for the West Seti Hydropower project and work has not started on the Nijgar International Airport - while a detailed feasibility has already been prepared, the BOOT (Build-Own-Operate-Transfer) Committee has not been able to decide on the BOOT modality to implement the project.

The Kathmandu-Terai Fast Track link has stalled for lack of investors. The government had begun construction and opened the track with the expectation that the remainder of the work (like tarmacking) would be contracted out to the private sector. However, no private party has shown interest. On the other hand, Bhairahawa International Airport has nearly completed its land acquisition and an international tender has been released. A detailed design for irrigation from the Bheri-Babai Diversion Multipurpose project is being developed but the rate of progress suggests it will not use up its allocated budget for FY14. The vast majority of the funds utilized by the Bhudhigandaki Hydropower project have been spent on the engineering company preparing a detailed project report.

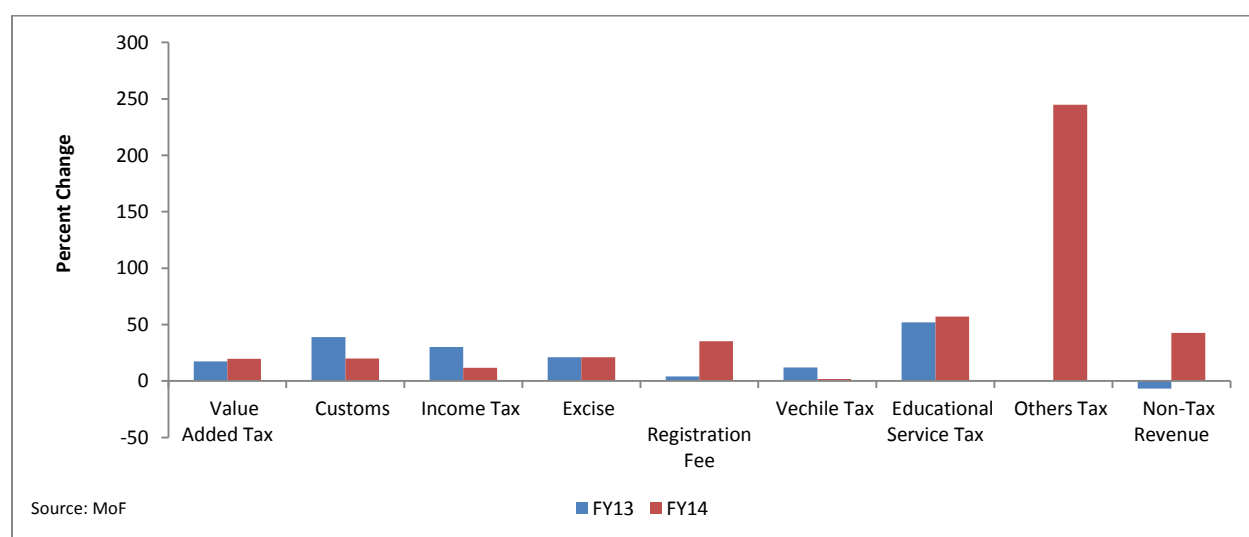
The Upper Tamakoshi Hydropower project is expected to come online in 2016 after problems while digging the main tunnel delayed it by a year. Melamchi Drinking Water has restarted tunneling work again after a new company was awarded the contract through rebidding. The original company contracted to dig the tunnel was dismissed in September 2012 due to its inability to fulfill contractual obligations. The Sikta Irrigation project was expected to be completed in FY14 but due to problems with land acquisition and contract management it has also been delayed.

Project*	FY14 Budget Allocation (NRP)	Burn rate after six months
Melamchi Drinking Water	5241300000	12.2%
Hulaki Highway	2213417000	6.9%
Upper Tamakoshi Hydropower	2000000000	0.0%
Bhairahawa International Airport	1991565000	0.0%
Mid Hill Highway	1922716000	22.5%
East-West Railway	1403871000	23.0%
Ranijamara Kulria Irrigation	1251919000	19.8%
Sikta Irrigation	1142069000	25.9%
Bheri Babai Diversion Multipurpose	1010080000	0.3%
Pokhara International Airport	1000000000	20.0%
North-South Highway (Karnali, Kaligandaki & Koshi Corridors)	510761000	26.8%
Kathmandu Terai Fast Track	500309000	0.8%
President's Chure Conservation Program	500000000	2.1%
Babai Irrigation	451000000	3.8%
Bhudhigandaki Hydropower	261000000	62.3%
Pashupati Area Development	250000000	59.0%
Lumbini Area Development	198500000	27.2%
West Seti	0	0.0%
Nijgar International Airport	0	0.0%
Total	21848507000	12.90%

*19 projects are listed because North-South Highway comprises of 3 different projects: Karnali Corridor, Kaligandaki Corridor and Koshi Corridor.

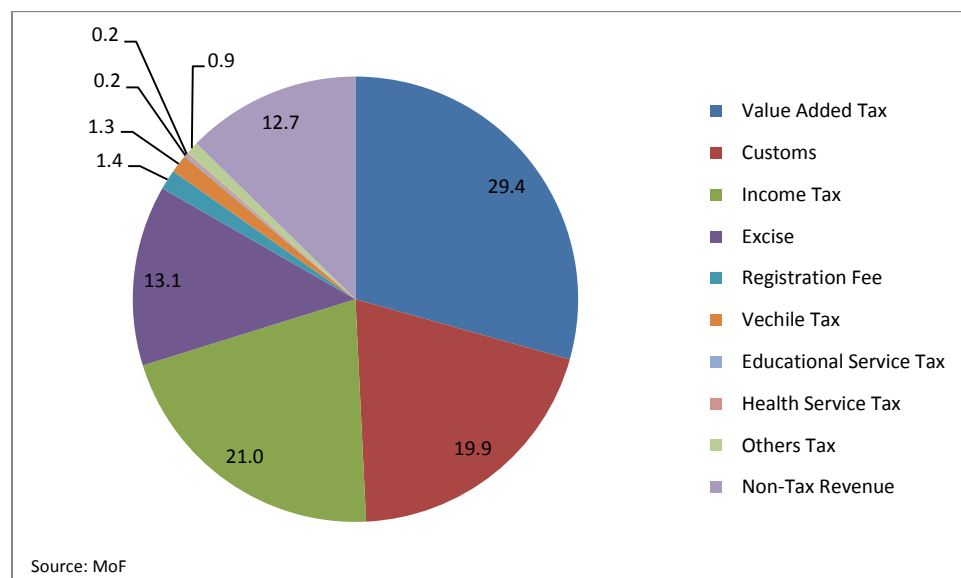
Revenue growth has continued at a sustained pace, from a high base in FY13, albeit with a shift in drivers. Six months into the fiscal year, domestic revenue mobilization stood at NRs 163.4 billion or 39% of the ambitious target set for FY14 (NRs 424 billion). Sharp revenue growth continued in FY14 (21.5% in the first half of the fiscal year compared to 21.2% at the same time in FY13) albeit driven relatively less by customs and personal income tax and more by other taxes and non-tax revenues (Figure 4). The growth rate of customs revenue slowed to 20% in FY14 as compared to 39.1% in the same period in FY13, although the reasons are unclear. Indeed, while import growth has slowed, the deceleration was in fact modest (1.3 percentage points). Likewise mid-year growth in income tax receipts was only 11.8% as compared to 30.3% at the same time in the previous fiscal year. A possibility is that tax administration of customs and the PIT may have been relaxed somewhat in the run-up to the election. The gap was made up to some extent by VAT which grew at 19.6% as compared to 17.4% in the same period in FY13 -mainly due to the positive impact of leakages control initiatives in VAT administration. A significant boost also came from non-tax revenues which grew by a whopping 42.6% in FY14 as compared to a -6.6% decline in FY13, mostly on account of increases in dividends paid by public enterprises and added royalties from telecom companies. It appears likely that the revenue target for FY14 will be met especially if customs and PIT revenues pick up in the second half of the year.

Figure 4: Revenue mobilization at mid-year



The shift in drivers is reflected to some extent in the composition of revenue streams. VAT and customs taxes still accounted for almost half (49.3%) of the revenue mobilization by mid-year in FY14. Even though there was a slowdown in the collection of income tax, it still made up 21% of the total revenue collected by mid-year in FY14 (as compared to 22.8% of the total revenue collected in the same period in the previous year). The share contributed by excise duty remained at 13.1% whereas the share of non-tax revenue grew from 10.8% at the end of six months in FY13 to 12.7% in the same period in FY14.

Figure 5: Revenue composition (mid-year) reflecting a shift in drivers



The combination of low expenditure and robust revenue growth accounted for a significant budget surplus and declining debt. With a significant increase in foreign grants (which more than doubled in the first six months of the year compared to the previous) the overall government surplus ballooned to NRs 56.0 billion. Reflecting this comfortable fiscal position the GoN did not issue any fresh T-Bills in FY14 and domestic debt fell to NRs 217.61 billion.

Inflationary pressures have not subsided with the risk of second round effects.

Inflation stood at 9.7% (y-o-y) in January 2014, driven by rising food prices. This is in contrast with FY13 when non-food items were pushing inflation up (Figure 6). At the end of the second quarter of FY14, the index for food and beverage prices had registered a 12.9% increase (y-o-y) while that of non-food item had grown only by 6.9%. In particular, within the food and beverage category, cereal grains and its products, vegetables, and meat and fish had seen sharp price rises (12.7%, 19% and 24.5% respectively).

A multiplicity of factors affected food prices during the review period. The price of meat was driven upwards by avian-flu fears leading authorities to impose a quarantine on imports and to destroy vast numbers of animals. Recorded increases in the prices of cereal grains, however are counterintuitive given that agricultural output is believed to have improved significantly. Among the possible reasons for persistently high prices: (i) high demand in the run up to the election in November 2013 (reflecting both campaign-related expenditures and 'stock piling' by households in anticipation of strikes); (ii) high food prices in India, allowing (iii) hoarding of supply to the market by middle-men (as indicated by the differential between CPI and WPI). In parallel, the decline in non-food prices growth is partly attributable to petroleum products whose administered prices were left unchanged during the first half of the year after the increases in FY13 (Figure 7).

Figure 6: Inflation in Nepal and India (y-o-y percentages)

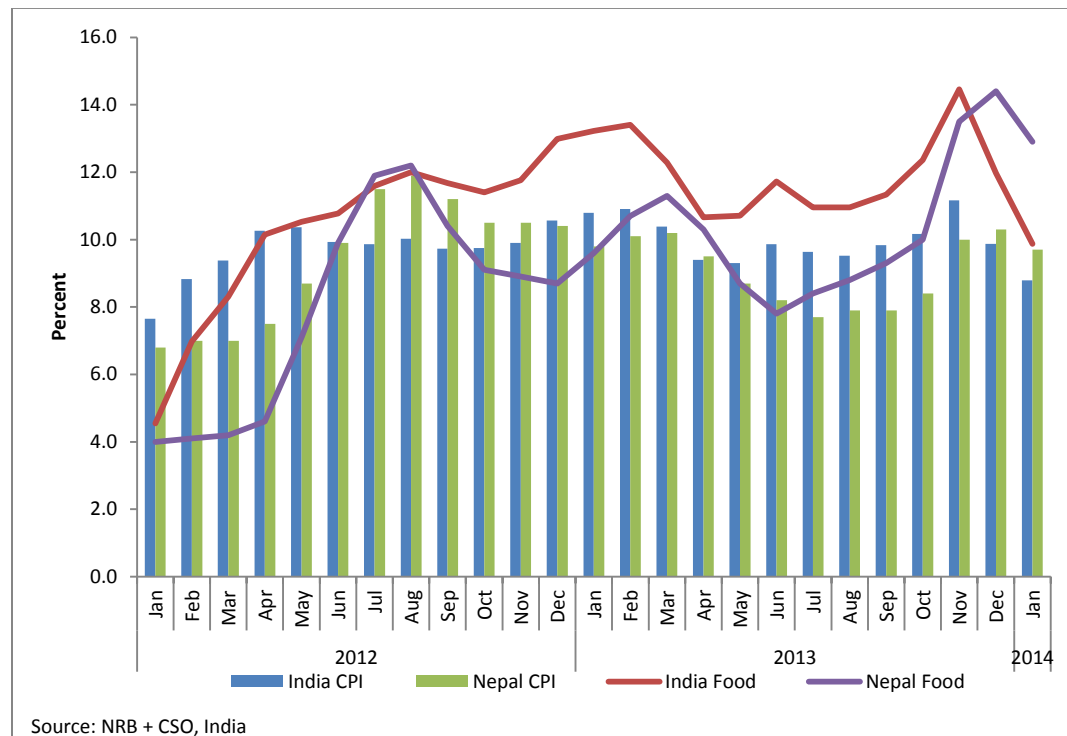
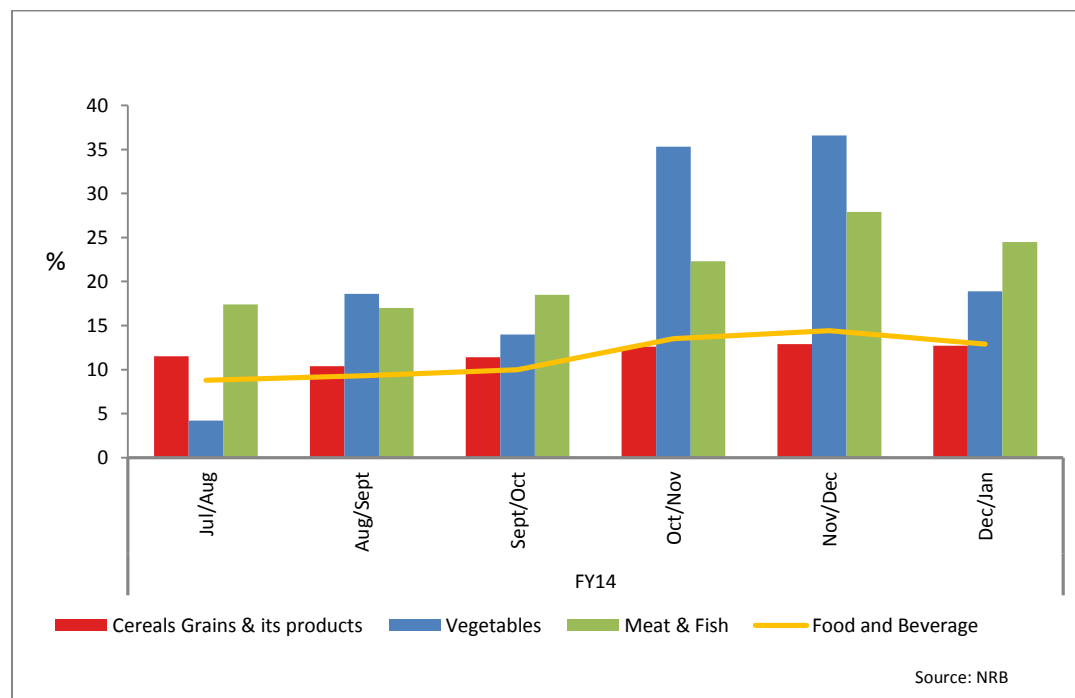


Figure 7: Food and beverages inflation (by subcomponents)



Higher food prices could generate second round effects. There is some evidence – logically given the share of food items in Nepal's CPI basket- that food prices are transmitted to non-food price inflation probably through changes in expectations and wages. Therefore, the speed at which food prices decline will need to be monitored closely. To reflect higher than expected inflation outcomes during the first half of the year the NRB has revised its annual inflation target to 8.5% (from 8%).

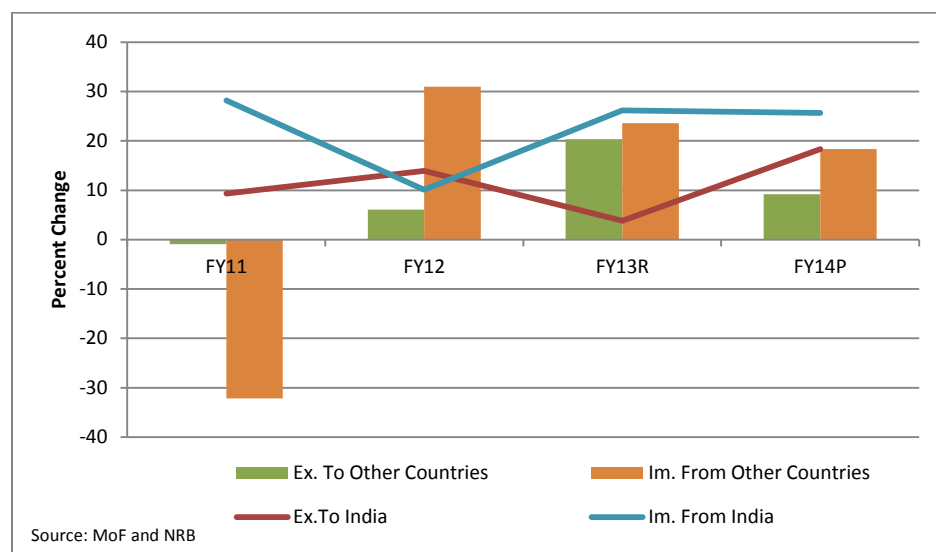
Sharp remittance growth and a slower deterioration of the trade balance leading to a record BOP surplus.

In the first 6 months of FY14, Nepal accumulated a significant current account surplus driven in part by a slower deterioration of the trade balance and a significant increase in the rate of growth of workers' remittance transfers. In the first six months of the fiscal year, exports of goods increased by 16% (against 10.2% at the same time last FY) while import growth was 23.3% (vs. 24.6% in FY13). As a result the trade gap continued to grow, by just under 25%, albeit at a slower pace than in the corresponding period of FY13 (28%). Moreover, in parallel, workers' remittances grew by a whopping 34.4% since the beginning of the fiscal year, much in excess of the already impressive 22% growth registered in the first half of FY13 (a difference of NRs 68 billion). As a result, compared to the same time in FY13, the overall current account surplus increased by a 1150% (a difference of NRs 50.6 billion).

The rupee's depreciation and possible substitution by Indian importers resulted in significant export and moderate import growth. (Figure 8)

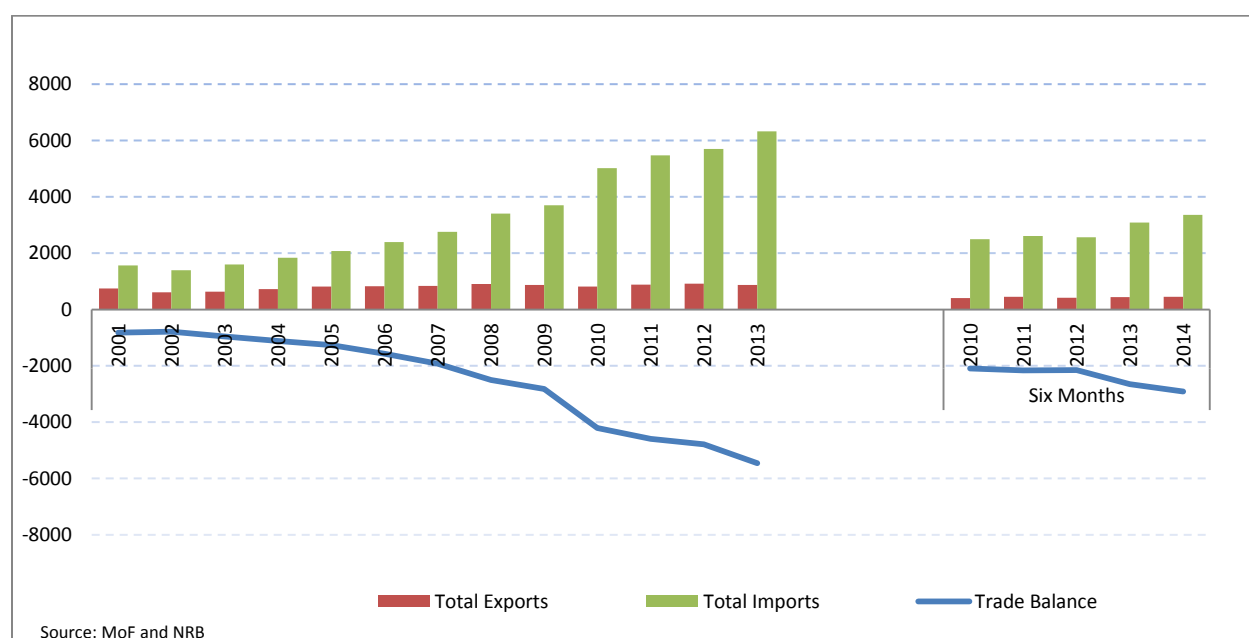
In the first 6 months of FY14, exports to India grew significantly (by 18.45%) compared to the corresponding period in FY13 (3.8%) driving the growth in total export to 16% at the end of six months in FY14. Since the INR is pegged to the NPR, the depreciation of the Indian currency vis-à-vis other currencies made Nepali products comparatively more attractive. The depreciation of NPR should have boosted exports to other countries as well but the product base of Nepal's exports to other countries is very narrow and further it is mainly in niche products like handicrafts, carpets and pashmina which have relatively low price elasticity of demand. In contrast, Nepal's exports to India are more varied. Of the top 10 highest value exports to India, 4 grew at a rate above 25% (Zinc Sheet 62.5%; Cardamom 38.6%; Juice 25.8%; Shoes and Sandals 43.9%), while exports declined only in 2 products. Likewise the depreciation of the rupee is likely to have caused the modest decline in the growth rate of imports, which slowed to 23.1% from 25.2% in the same period in FY13 (a predictably modest decline since the bulk of imports is from India for which there were no price effects at play).

Figure 8: Growth in foreign trade (mid-year)



The trade balance continued to deteriorate in FY14, albeit at a slower pace. While exports grew significantly in the first half of the year, their overall small size relative to imports (11.9% of total trade) meant that the trade deficit continued to grow by 24.4% at the end of first half of FY14, compared to 28.4% in the first half of FY13 (Figure 9).

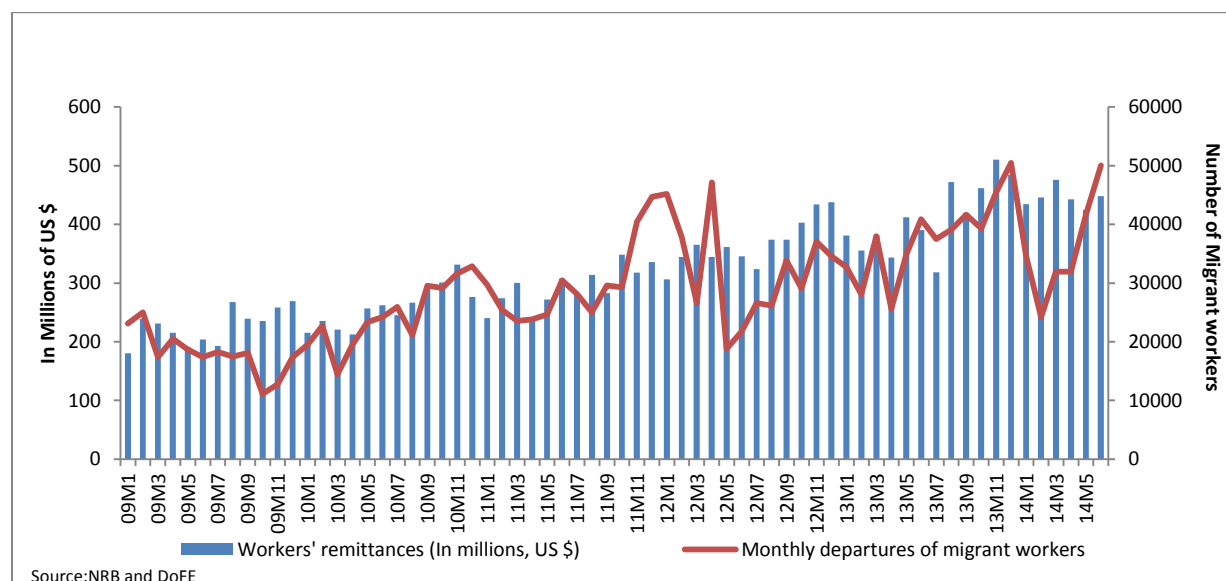
Figure 9: Exports, Imports and Trade Balance FY 2001-14 (In US \$ Million)



Record levels of remittance inflows are keeping the current account in surplus, by a wide margin. Remittance increased by 34.4% as of January 2014 compared to 21.8% over the same period in the previous year (Figure 10). The growth in the number of migrant workers

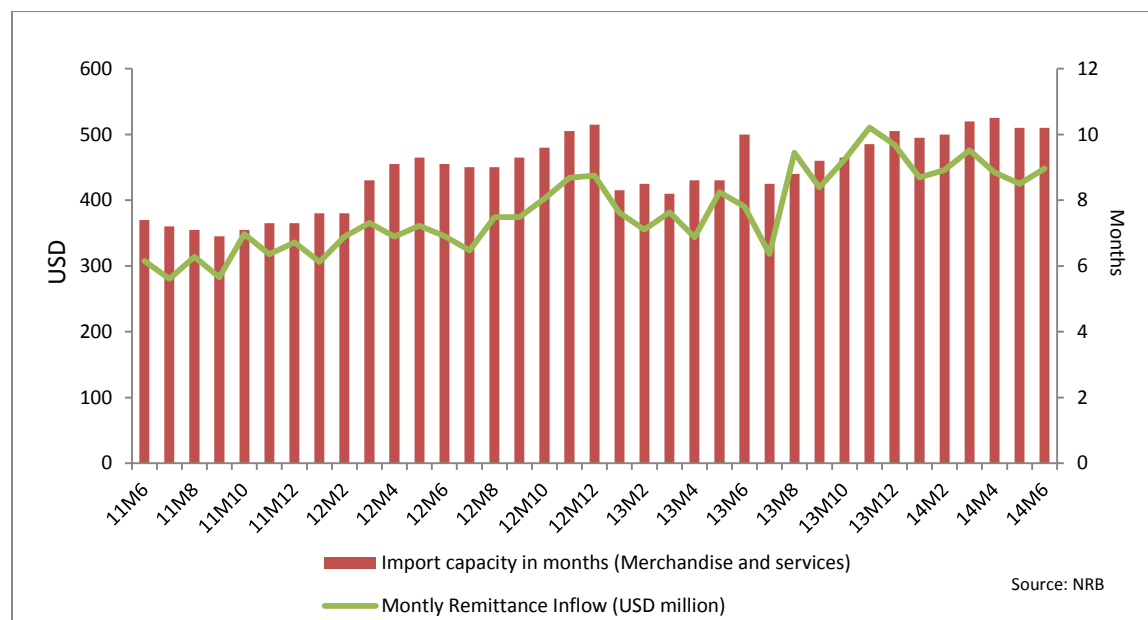
departing Nepal together with favorable policy changes in destination countries may have contributed. First, important destination countries revised upwards the minimum compensation entitlements for migrant workers. Second, the decision by Saudi authorities to grant amnesty for illegal workers may have promoted a significant number of illegal Nepali workers to return to Nepal with their life savings. Finally, the depreciation of NPR has provided additional incentives for migrant workers to send a larger proportion of their income (and possibly some savings) in foreign currencies back to Nepal.

Figure 10: Monthly Remittances Inflows and Movement of Migrant Workers



Reflecting the large balance of payment surplus, reserve assets grew significantly (Figure 11). As of January 2014, foreign exchange reserves were sufficient to cover the equivalent of 10.2 months of goods and services imports.

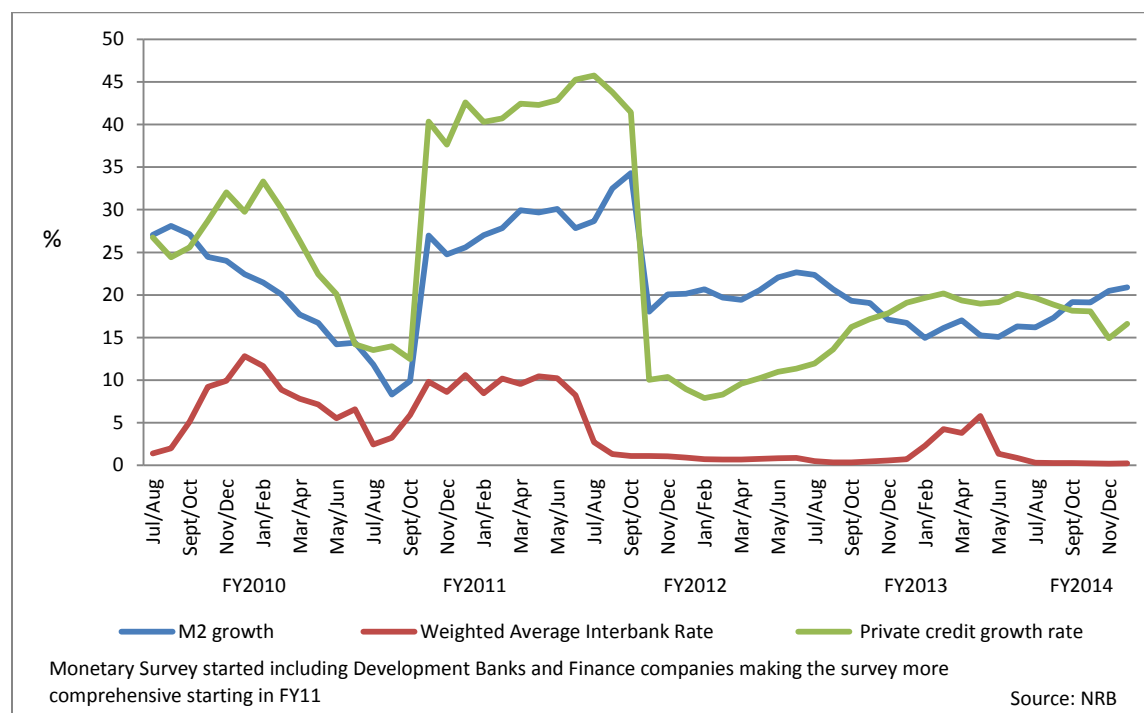
Figure 11: Import capacity of reserves against monthly remittance inflow



Monetary policy has remained accommodative in the face of sharp remittances growth.

The massive increase in remittance inflows was only partly sterilized and resulted in a significant increase of the money supply. In the first half of FY14, broad money (M2) grew nearly twice as fast during the first six months of FY14 (9%) compared to the same period in FY13 (4.8%). Somewhat lower growth in net domestic assets (4.8% in the first six months of FY14 compared to 6.2% at the same time in FY13) was largely made up by a rapid build-up of net foreign assets, which grew at a fast rate of 16.5% (compared to 2% in the first half of FY13). Likewise money supply grew significantly in the first half of the year both on account of currency and demand deposit growth (jointly by just under 9% during the first six months of the year vs. -0.5% at the same time in FY13) and saving and call deposits (jointly 11.2% vs. 9.6%).

Figure 12: Evolution of monetary aggregates, credit and interest rates



The financial system is characterized by excess liquidity with systemic weaknesses and uncertainty remaining.

Deposit growth has outpaced credit over the past 12 months with excess liquidity building up in the system (Figure 13 and Figure 14). In the last 12 months to Q2 of FY14, banks' deposit grew by 20.7% (NPR 174 billion) compared to credit growth of only 18.2% (NPR 126 billion). This is a reversal from the trend observed at the same time in FY13 when deposit and credit increased by 19.2% (NPR 135 bn) and 24.8% (NPR 137 bn) respectively. As a result the market is in surplus, by around NPR 50 billion, above and beyond the 20% mandatory liquidity requirement.

Figure 13: Credit-Deposit Ratio of Commercial Banks

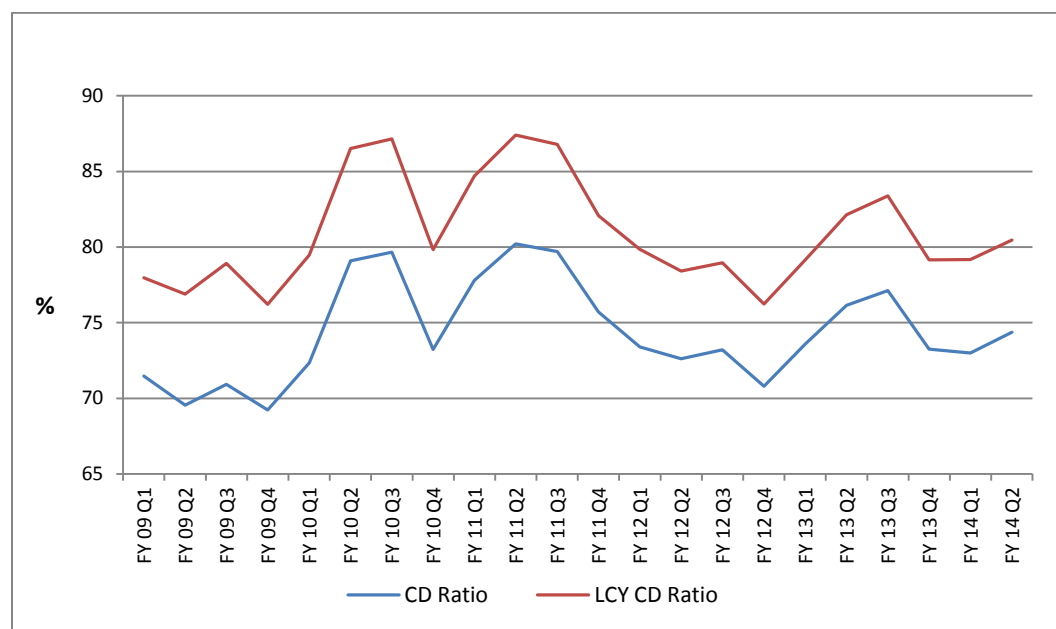
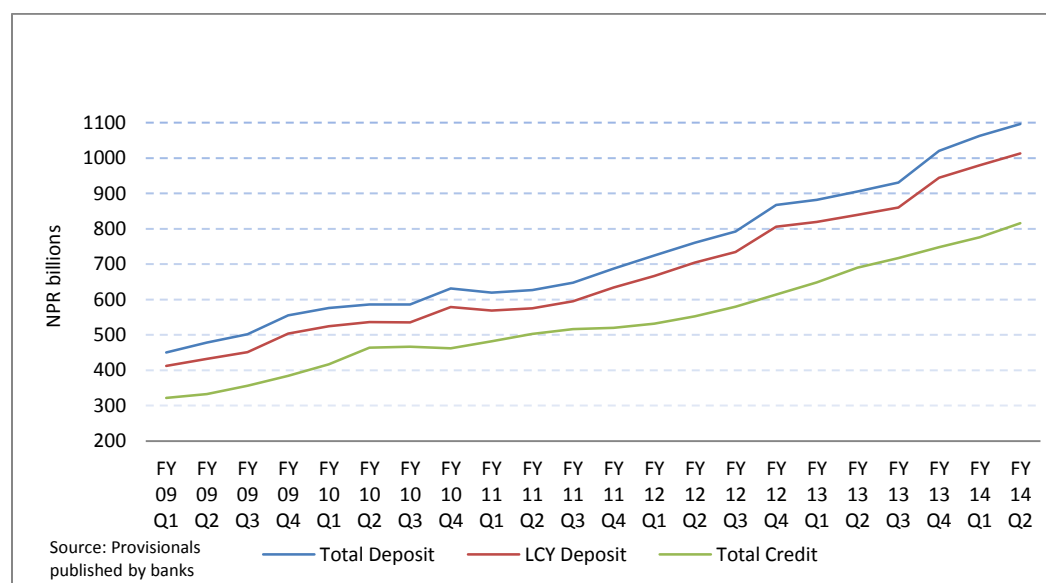


Figure 14: Total Credit and Deposit of Commercial Banks



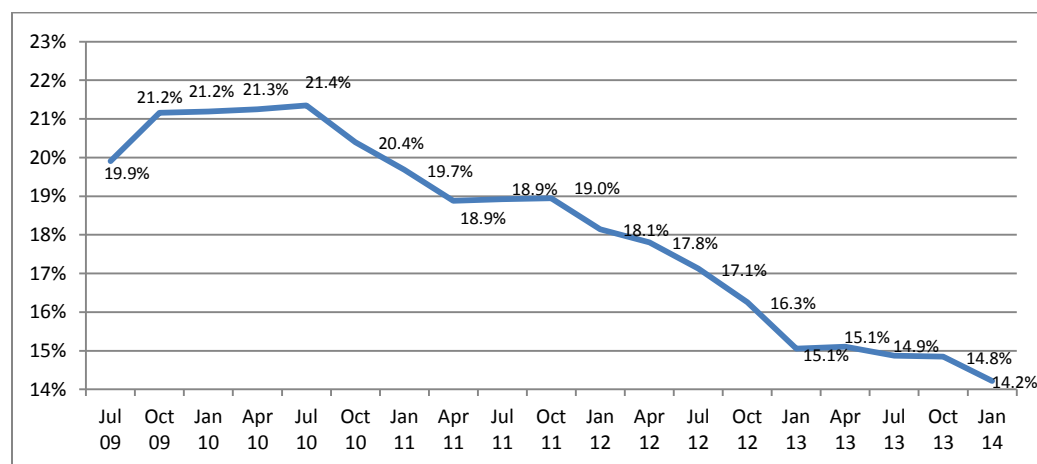
The NRB has acted to mop up liquidity albeit at levels significantly below market demand. In the first half of the year, the NRB has undertaken reverse repos worth NPR 118.5 billion and issued outright sale auction for securities worth NPR 8.5 billion and development bonds worth NPR 10 billion to address short and long-term liquidity issues. The last round was subscribed

by almost double the offered amount of NPR 19.5 billion with 25 banks bidding (total of NPR 38.9 billion) at an average rate of 0.23%.

The rise in market liquidity and sluggish credit growth has impacted weighted T-bill (91 days) and average inter-bank rates considerably. T-bill (91 days) rates ranged between 0.515% to 0.016% and inter-bank from 0.24% to 0.15% in Q2 of FY14. In comparison, the T-bill was 1.6% and inter-bank 0.95% as of end of Q2 FY13.

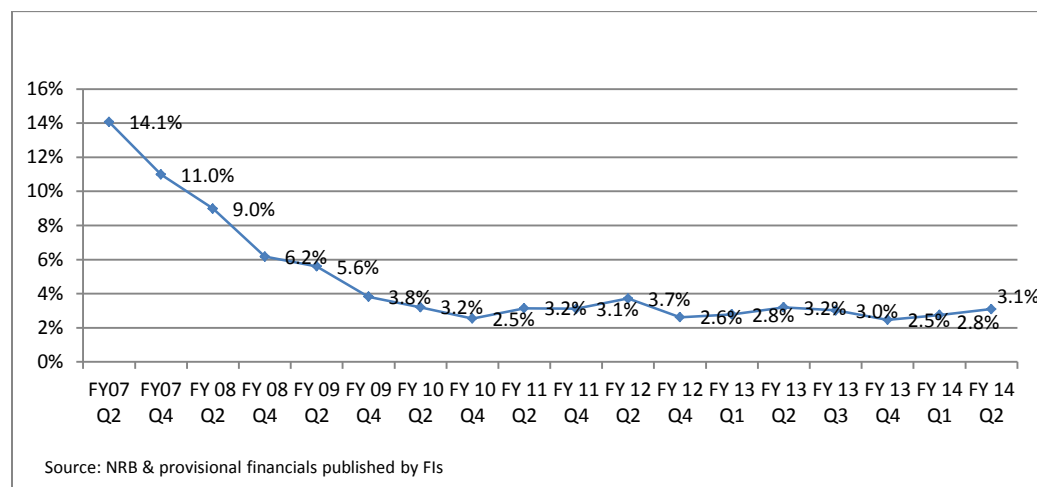
Bank balance sheets are still vulnerable to real estate exposure as well as NPLs and reported figures may understate the extent of such vulnerabilities (Figure 15). As per reported figures, the total exposure to real estate (including home loans) declined y-o-y from 15.1% of the total loan portfolio in Q2FY13 to 14.2% as of Q2FY14, with the share of home (mortgages) loans – considered relatively safer- growing to make up 47% of the total real estate exposure compared to 36% one year ago. None of the banks have real estate exposure in excess of the NRB cap of 25%.

Figure 15: Real estate exposure as a share of total loan portfolio



The share of NPLs increased marginally albeit from a small -reported- base and with adequate coverage (Figure 16). The share of NPLs was 3.1% of the total loan portfolio as of Q2FY14, a marginal deterioration relative to Q1 (2.8%) but similar to that of the same period in FY13 (3.2%). Only three banks (14% of the system) have NPLs in excess of 5% including two state controlled banks (ADBL and RBB). Total loan loss provision coverage vis-à-vis total NPLs is 113% for the commercial banking industry, including 9 banks with coverage of less than 100% and five banks with less than 90%.

Figure 16: Non performing loans of commercial banks



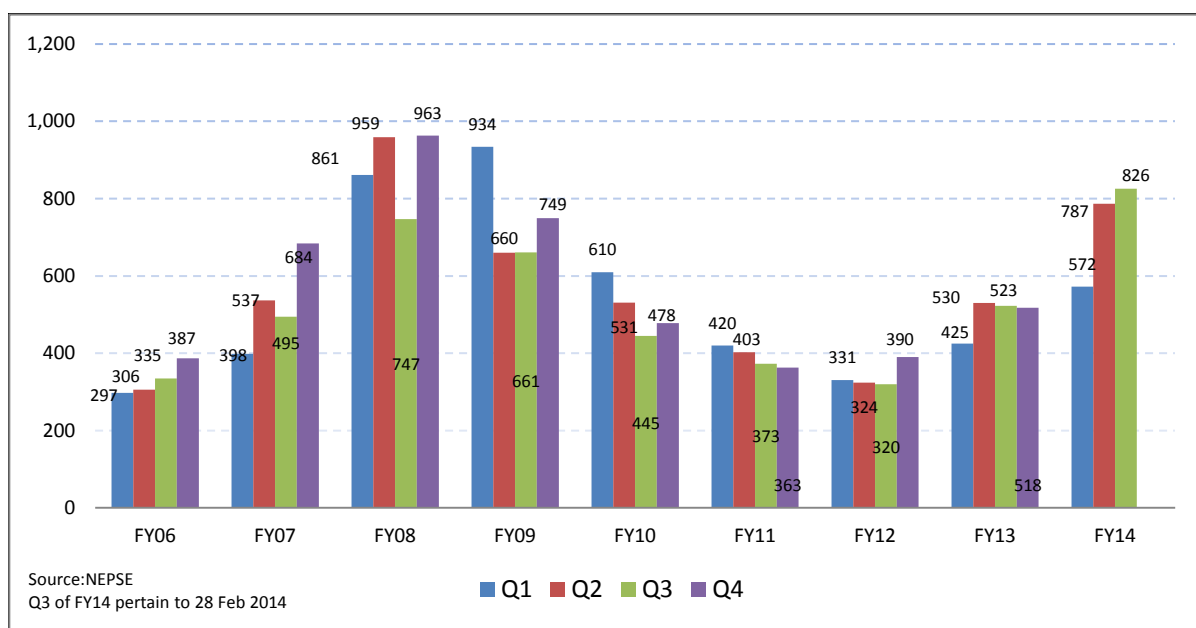
The overall capital position of the commercial banking industry remains sound. The average Capital Adequacy Ratio (CAR) is estimated to be 11.8% compared to 11.7% at the same time in FY13, albeit down from 14.2 % recorded at the end of last fiscal year (mainly due to dividend payouts and a significant increase in risk weighted assets - from NPR 785 bn to NPR 981 bn). All banks meet the minimum CAR of 10 % except two state controlled banks (representing 14.5 % of the banking system). These banks – NBL and RBB – have improved their CAR y-o-y from -5.4 % to 0.84% and -2.4 % to 4.3 % respectively as a result of equity injection from the government and retained earnings as per their recapitalization plan.

Banks remain profitable but the NRB’s proposed policy to limit interest spreads could put pressure on returns. The commercial banking industry posted a record net profit of NPR 9.4 billion in Q2 of FY14 compared to NPR 7.9 billion recorded in the same period last FY – a y-o-y growth of 18 %. Based on data of 23 (out of 31) banks, the average yield (from loans and investment) declined to 9.88 % (compared to 10.1 % in Q2FY13 and 10.3 % in Q4FY13) resulting from a decline in interest spread to 4.3 % (from 4.41 % in Q2FY13 and 4.6 % in Q4FY13) while there was no change in average (industry) cost of funds at 5.5 %. However, in terms of return on equity, there has been a gradual decline for the last three quarters (shareholders of 27 private commercial banks received an average return of 13.8% as of the first six months of the current fiscal year) due to low yielding investments made by banks resulting from lack of investible opportunities to extend loans and advances. The NRB’s move to cap the rates spread - BFIs have been told to reduce the spread rate to 5 percentage points by the end of the current fiscal year- and service charges will imply greater challenges for BFIs to increase or even maintain their returns. As of the first six months of the current fiscal year, 13 commercial banks had spread rates of above 5pp.

The stock market has climbed to a historic high reflecting improved investor sentiment and easy access to financing but decreasing incentives for needed reforms.

The securities market moved up on the expectation of healthy quarterly reports of the listed companies and improved prospects for political stability. The NEPSE posted a double-digit growth of 21.41% to reach a 63 months high of 831 points (Figure 17), reflecting increased investor confidence following the formation of the new government. According to stockbrokers, this bullish sentiment is explained by increased confidence of both old and new investors holding new positions, availability of funds from the banking system at reasonable interest rates, the formation of a new government and the majority of listed companies reporting good financial results.

Figure 17: Quarterly NEPSE Index FY06 - FY14



The master plan to reform capital markets has remained on the backburner. After more than two years since the five-year master plan on capital market was devised (2011), nothing substantial has materialized. The master plan was supposed to address most of the shortcomings of the Nepali securities market and to bring it at par with international standards by July 2016. SEBON had sought international support to address structural problems troubling the overall market as the stock index had crashed. However, as the stock prices have become bullish again, implementing the plan seems to have remained on SEBON's backburner.

Review of policies and short to medium term development challenges

The new government will have to focus resolutely on removing constraints to public and private investment without which growth will not accelerate significantly in the near future. This review of policies and short to medium term challenges focuses on those areas where the major bottlenecks to unlocking investment-supported growth currently reside, namely public financial management (PFM) and infrastructure development. Specifically it seeks to highlight feasible reforms that the new government could initiate.

Improving PFM systems to unlock more and better investment

Public investment is not per se constrained by lack of funds but rather hindered by weak PFM systems and practices. The key question is what explain the state's under-investment relative to potential. The answer lies in PFM systems that are well defined on paper but dysfunctional in practice, with critical gaps at all stages of the budget planning, formulation and execution as well as deficient oversight capacity and systems.

Address systemic weaknesses in the budget preparation and execution process

While a budget was adopted on time in for FY14 public investment has continued to underperform indicating fundamental flaws in the incentives and systems for the government to efficiently use the funds set aside for capital expenditure. What the experience of FY14 suggests is that budget timeliness and added MoF scrutiny may be a necessary but still insufficient condition for capital expenditure to proceed at the level and pace required. Poor execution of the capital budget in FY13 was blamed on the numerous delays with which the full budget was eventually adopted (in the fourth quarter of the fiscal year). The GoN made commendable efforts to adopt a full budget on day one of FY14 and has also set up ad hoc mechanisms for regular progress reviews but this has yielded only modest progress in the pace of spending.

To address structural absorptive bottlenecks, the GoN should carry out an in depth review of the entire budget chain from planning to budgeting and execution. Below are insights from a recently conducted WB-ODI report that could serve as a basis for such review. The basic finding is that, while formal budgetary guidelines and procedures exist, the budget process is practically in disarray:

1. Budget planning and preparation entails numerous and inefficient review steps. The budget ceilings approved by the MoF in January and presented to line ministries and agencies constitute, in theory, the basis for each ministry to submit their budgets by the end of March. Not only does this typically not happen until May but the ceilings are often not adhered to (by wide margins). This in turn requires a round of evaluations by the MoF and NPC that stretches up to the beginning of the fiscal year (although the budget circular specifies March-April). Program and sector discussions on the budget estimates are held between MoF, NPC and the concerned ministry or agency to reconcile the proposals (submitted in hard copies and inputted manually into the budget management information system) within the constraints imposed by the aggregate ceiling for the central government.

The negotiated budget requests are compiled by the MoF at the end of June when a draft annual budget is prepared. At the same time the Resources Committee decides the final set of macroeconomic forecasts and corresponding adjustments are made to the overall revenues and expenditures estimates (and ministries' allocations).

To accelerate the pace of budget approval and ensure a closer alignment between policy priorities and budgetary allocations, the GoN should consider enforcing adherence to budget ceilings, which may in turn require revising the bottom up process through which ministries prepare their budget proposals.

2. The approved budget is *de facto* renegotiated throughout the year. The approved budget is not a predictor of actual spending but, in some ways, the beginning of a new set of budget negotiations (with new projects included throughout the fiscal year) and a constant stream of reallocations and virements. While the ceilings outlined in the Red Book are binding, the inclusion / exclusion of activities within these limits are subject to ongoing discussion and there is no hard deadline for inclusion of new capital projects. Line ministries, departments and local bodies complain that the NPC and the MoF change the budget at the last minute by including projects and programs not previously planned for – possibly in response to political pressure. The concerned departments, division offices and local bodies must then re-adjust their work programs, re-write project implementation plans and develop new procurement plans, which must be sent afresh to the respective ministries and the NPC for approval. Moreover reallocations within budget headings are frequent during the fiscal year. Virement rules are extremely flexible, allowing line ministries to reallocate up to 25% of any particular line item within each budget heading, and there is no monitoring mechanism to track changes thus made to the budget.

To enhance the credibility of the budget as a tool for policy implementation and provide implementing agencies with clear marching orders at the beginning of the fiscal year, the GoN should consider ways to limit the inclusion of new projects after submission of the budget and curbing virements powers of implementing agencies.

3. The authorization process for development projects remains highly centralized and bureaucratic, causing major delays in project implementation. While the execution of salary payments may start on issue of the authorization letter by MoF, line ministries and the NPC must further assess other expenditures – notably from the development budget – before project implementation can start. Specifically, the approval of P1 projects (with so called priority projects accounting for 90% of the total) requires the adoption and vetting of feasibility studies, work plans and procurement plans by the NPC, following approval of the annual budget rather than *ex ante*. This approval process can take an additional 3 to 4 months and sometimes rolls into the last semester.

To expedite capital spending, the GoN should consider including in the budget only projects for which the full set of feasibility studies, work plans and procurement plans has been prepared and approved by the NPC ex ante.

4. Weak fiduciary capacity at the level of implementing agencies as well as deliberate manipulation further slow-down capital projects' implementation. While cumbersome approval processes and budget release procedures are partly to blame, delays are also the result of poor preparedness on the part of implementing agencies, with insufficient attention devoted to feasibility studies and other elements of project preparation. Moreover the process can also be manipulated. As unspent balances increase at the end of the fiscal year, budget holders gain additional freedom to expedite spending including by diverting it to lower priority projects and causing fragmentation of the capital budget into multiple small projects (with weaker procurement and oversight constraints). Approved projects are often unfinished, resulting in wastage of resources and ineffective development outcomes.
5. Budget process bottlenecks are compounded by implementation and procurement weaknesses, particularly for investment and at the local level. Significant local-level discretion by user committees over contractor selection and the financial terms of contract awards has frequently been associated with leakage and inefficient use of expenditure. There are reports of loss and leakage of funds through the inflation of user costs of construction as well as over-charging by user-committees which then subcontract. Procurement and contracting are weak in terms of both competition among contractors and technical capacity for proper procurement planning.

To improve procedures and capacities for procurement planning and management, the GoN could consider developing national norms and rates for project costing to replace the current district-by-district regime and establishing minimum technical standards for contracted works and enforcing them through technical monitoring.

Amplify good governance initiatives begun under the technocratic government.

To boost growth and service delivery, the GoN must focus on improving both the quantity and the quality of public spending. Important steps in the right direction were taken by the previous technocratic government, which ought to be leveraged and amplified. This is important not only for moral reasons (spending people's money well) but also for efficiency as poor public financial management distorts allocative decisions resulting in poor value for money. Interestingly, the ministries with the highest amount of reported irregularities (as per OAG) are also those in charge of delivering the infrastructure that the country critically needs. Specifically, low hanging fruits for reform include:

- Strengthening internal audit by separating, within FCGO, the audit and treasury functions. Internal control systems remain inadequate. In FY13, the cumulative backlog of unsettled irregular expenses incurred by government offices, committees and district development committees (DDCs) increased to NRs 204 billion (or 12% of GDP).

Separating the treasury and internal audit functions and the creation of a distinct internal audit cadre would strengthen the audit function and reduce the risk of both erroneous and inappropriate actions - by creating additional layers of review and by ensuring that authorization to spend and the review of such authorization are not carried out by the same service or person.

- Strengthening the Office of the Auditor General. The OAG has prepared and submitted proposed improvements to the audit legislation governing its operations. The proposed legislation would give the OAG the level of independence called for by the International Organization of Supreme Audit Institutions (INTOSAI). The OAG would for example be able to hire, promote and fire staff without going through government, and have financial and administrative independence. This is a pre-requisite to effective audit, as the auditor currently depends (for its budget) on those same people it is responsible for auditing.

As next step the GoN should review the proposed legislative improvements and submit an Audit Bill to Parliament for its consideration.

- Restore and resource key parliamentary committees. In the absence of an elected Parliament since April 2012, the key functions of the Finance and Public Accounts Committees of Parliament have not been exercised. In particular the Annual Reports of the Auditor General have not been tabled for review. In FY12, irregularities of government offices and organized entities, committees and DDCs amounted to NRs 35.1 billion or 19% of total audited expenditures. The Ministry of Physical Infrastructure and Transport (MoPIT) and the Ministry of Federal Affairs and Local Development (MoFALD) were found to have the highest amounts of reported irregularities (respectively 20% and 13% of the total).

With the new assembly in place, it is now imperative to restore the functions of the PAC and its ability to address reported irregularities.

Developing strategic infrastructure

Infrastructure is central to any development vision for Nepal. Not only is it at the core of the challenge to unleash private investment but it is also a fundamental pillar in building the bridge from economic growth to inclusion and shared prosperity – with a direct impact on the lives of the poor and the marginalized. Necessary actions would need to address both a quantity and quality deficiency, particularly in the two big and critical infrastructure sectors: transport and energy. Given limited resources the focus should be on maximizing the impact of every rupee spent and on creating the conditions for private finance to complement and leverage public resources.

Tackle issues in the transport sector

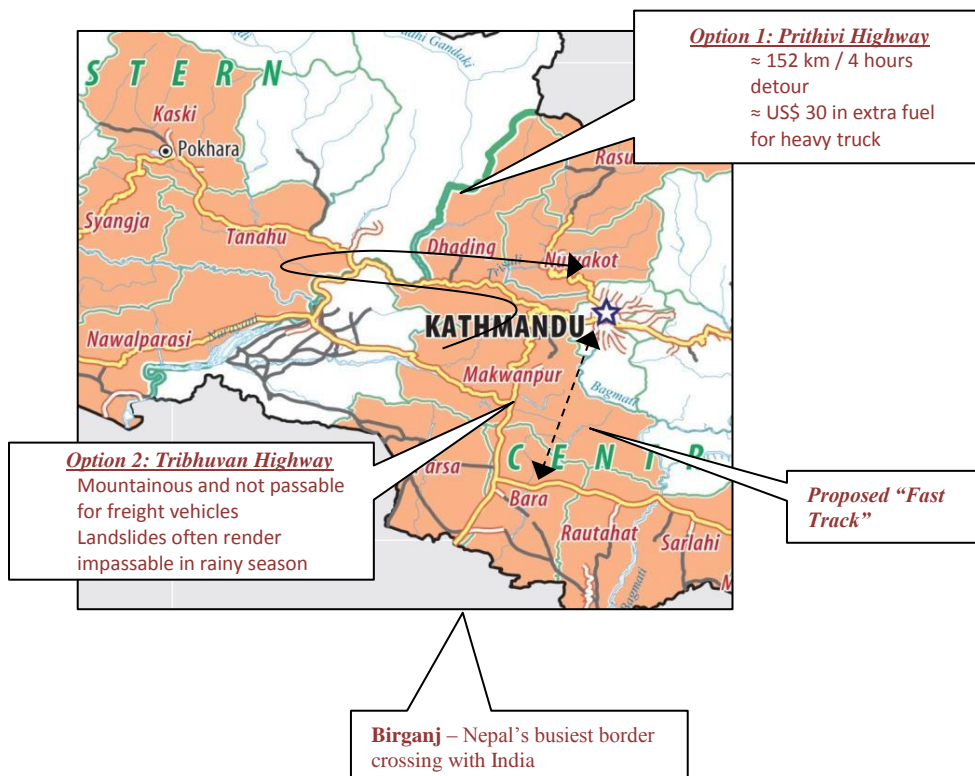
The quality of Nepal's road infrastructure is particularly poor relative to other low income countries. Some 80% of respondents to the WB's 2010 Logistic Performance Index survey ranked Nepal's roads as low or very low quality and 100% ranked the cost of road transport as high or very high. Improving connectivity throughout Nepal is not only important for growth but also for inclusiveness in order to ensure physical access for all to social and economic services and facilities including markets, educational institutions or health centers. In the short- to medium-term the GoN could consider the following policy priorities:

- Reviving the proposed fast track linkage between Kathmandu and the Tarai plains project. Although it is of vital economic significance the project appears to have stalled. At present goods and passenger transport vehicles make a 250km detour to avoid the Tribhuvan

highway (between Hetuada and Kathmandu) that has steep gradients and unfavorable alignment for larger vehicles. The initial feasibility study for a 'fast track' alternative estimated potential time savings of 4-5 hours, fuel savings of US\$30 per one way trip for a heavy truck and some 32 million liters of fuel saved in the first year of operation alone. At a more macro level the project would greatly facilitate trade with India and the transit of goods to and from Kolkata and reduce the cost of imports and exports (inland transport and transshipment costs account for over 60% of export costs in Nepal). Rough cost estimates suggest that building the fast track will require approximately US\$ 1 billion. Given the project's importance and complexity it is clear that much preparatory work will be needed which should begin now.

In particular the GoN could consider (i) enacting new legislation to manage the unique institutional, regulatory and operational challenges that the fast track entails, and setting up a separate authority to manage the project – with a clear business and procurement plan; (ii) preparing the technical ground including : a detailed alignment survey, basic design of structures and tunnels, social and environmental safeguards, (iii) making a plan for financing such a huge investment including recosting the project, carrying out a fiscal assessment and identifying external partners.

Figure 18: The proposed fast track alternative



- Resolving overlapping institutional roles and mandates in the transport sector is key to unlock and improve public infrastructure spending. Institutional limitations and overlapping roles and responsibilities severely hamper Nepal's ability to make sound capital investments in the transport sector. According to the World Bank's 2011 Roads Sector Public Expenditure Review, roughly 70% of spending in the transport sector occurs in the last trimester of each fiscal year. This fact evidences that the budgeting, planning, procurement, and contract management processes applied throughout the transport sector need to work more smoothly. The capacity of local government entities and the accountability framework that applies to their transport sector investment activities also require significant improvement. Roughly 30 paisa of every rupee that the GoN transferred to support local government-led transport sector investment triggered some form of audit observation from the Office of Auditor General. Throughout the transport sector, there are instances of overlapping institutional roles and mandates. For instance, the department responsible for strategic road network and bridges takes-up local road network and bridges and vice versa. This is particularly challenging for urban transport interventions that simultaneously aim at improving physical infrastructure, traffic management, and policies that fall under different ministries or departments. At present, four different line ministries and roughly 23 different departments, divisions, or local government bodies have jurisdiction over issues relating to urban transportation in the Kathmandu valley. Reducing this complexity can help make meaningful urban transport interventions less unwieldy.

In order to reduce such complexity and streamline the process of investment project implementation the GoN should consider (i) placing urban transport in Kathmandu under one single institution (new or rebooted), (ii) taking measures to ensure that departments under MoPIT and MoFALD stick to investments only along roads under their official remits, (iii) making local government bodies more accountable regarding investment decisions and implementation.

- Addressing Kathmandu's growing urban transport challenges. Although improving urban transport may not appear to be a short term priority given Nepal's overall low levels of urbanization, the pace at which Nepal's cities are growing (particularly in the Kathmandu valley) is the highest of any South Asia country. Addressing this medium- to long-term challenge will therefore require resolute action now. Managing rapid motorization more effectively is critical for improving transport and the urban environment in the Kathmandu valley. The number of vehicles registered annually in the valley grew by 14% each year between 2001 and 2010, especially personal motorcycles and at the same time public transportation has increased dramatically with close to a million trips made every day via bus services.

In order to meet the challenge of urban transportation on time, before it is too late, the GoN should develop a plan to (i) provide more appropriate pedestrian infrastructure as walking accounts for nearly 40% of all trips in the valley and Kathmandu was identified as one of the least 'walkable' cities in Asia; and (ii) improve public transport facilities and bus services for those relying on public transportation.

Initiate reform in the power sector

Unreliable and poor power supply is probably the single greatest obstacle to development and growth in Nepal. All political parties have recognized that, pledging in their electoral manifestos to reduce load shedding hours within 3 years. The task however is huge and it should begin now. Below are a few areas that the new government could consider addressing as a matter of priority.

- Launching a process for electricity tariff reform: the Nepal Electricity Authority (NEA) a vertically integrated government owned utility suffers from severe financial losses and cannot, therefore, generate financing for investment in critical power generation, transmission and distribution infrastructure. Since 2002, almost no transmission line has been built and only 92MW have been added to the system. NEA owns 66% of the generation capacity in the country and has the monopoly of power transmission and distribution (therefore it is a single buyer for privately generated power). While private investment is no doubt needed to increase generation, lack of transmission capacity, exposure to foreign exchange risk and risks of NEA payment default (in addition to other country risks) are major bottlenecks for such sizeable private investments. The current tariff charges to consumers are about 25% below the cost of supply by NEA which accumulated net losses of 8.55 billion in FY12 alone. With such dismal financial performance, it would be difficult to provide comfort to the private developer for which NEA is the off-taker of power generation. Tariff reform is therefore imperative, but it must be combined with actions to reduce T&D operating losses and structured in a way that minimizes public resistance (legitimate to the extent that service is poor) and does not generate unwanted redistributive effects.

The tariff reform would need to consider a stepped approach to deal with social impacts and allow tariff adjustment, with indexation to inflation and foreign exchange rates, and tariff categories restructure and allow cross-subsidies among consumer categories to address impacts on the poor.

- **Introducing compensation policies for transmission lines right of way (ROW)**: On-going transmission line projects have suffered extensive delays in construction due to disputes on compensation payments for land under the ROW. One World Bank-funded transmission line project has been under implementation for 10 years but still could not be completed due to the dispute for a 3.8 km ROW stretch. While government laws and regulations allow full compensation for acquiring land for tower foundation under the transmission projects, NEA does not have a clear corporate policy for the compensation for land under the ROW. As is common practice in many countries, NEA provides full compensation for losses of properties, trees and crops for ROW clearance. In addition, NEA also provides 10 % of the land value as compensation for the restricted use of the ROW. This practice has worked well in remote rural areas where the land is used predominantly for cultivation. However, ROW compensation has become a serious issue in urban and peri-urban areas, where land has significant value appreciation potential due to the growing

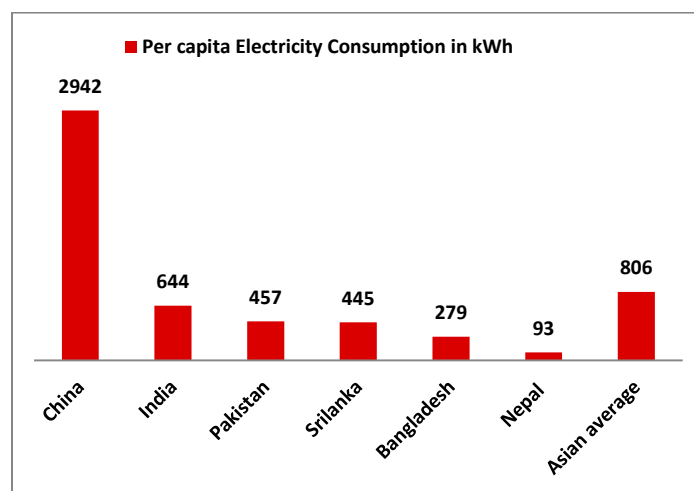
real-estate market in Nepal. In the absence of a clear corporate policy for compensation, the process of making decisions for compensation above 10%, such as in urban and peri-urban areas, has been unduly long and difficult.

As a matter of priority the GoN / NEA should formulate a transmission line ROW compensation policy that provides justifiable compensation for restricted land use within the legal framework of Nepal taking into account land location and use.

- Producing a road map on power sector development:** Hydropower and transmission projects have long lead times in preparation, financing and construction; so a strategic vision is needed for power sector development to guide policy and regulation efforts and investments. The strategic vision or the road map should clearly indicate the GoN's objectives of power sector development and how these objectives could be achieved. The rich hydropower resources available in Nepal make it possible to provide reliable, affordable and sustainable electricity supply and to generate huge export revenues (which in turn can be invested in infrastructure development and service delivery). While public investments are needed, such as in transmission lines, it is impossible to achieve these objectives in Nepal without private sector hydropower participation and policy reforms are needed to create an enabling environment for such private investments. As the Nepalese hydropower generation has strong seasonality, there is also a need to balance the seasonal generation through a development of seasonal storage hydropower plants and effective power trading with India, Bangladesh or China. The power trading would allow to export surplus generation during the wet season to make large sized hydropower projects financial viable, and import of electricity to meet domestic demand during the dry season when hydro-generation is low. Power trading would help to reduce the trade deficit and enhance regional integration.

The GON should produce a power sector road map with full cabinet endorsement.

Figure 19: Despite high access Nepal has the lowest per capita consumption of electricity in South Asia



Short and medium term economic projections

Growth is expected to recover to 4.5% in FY14, mostly on account of favorable exogenous developments, and despite lackluster public spending. Overall economic growth is expected to recover from the slow-down experienced in FY13 and to reach 4.5% in FY14, above the initial forecast made at the end of FY13 but below the GoN's own projection of 5.5%. Agriculture output is expected to grow significantly reflecting more clement weather patterns (a timely and adequate monsoon) as well as improved supply of agricultural inputs, particularly fertilizers. Likewise and more importantly given the sector's contribution to overall value added, growth in the services sector is expected to be boosted by much higher than anticipated remittance inflows growth, particularly education services and retail trade.

Much uncertainty remains on the extent to which investment may pick up in the second half of the fiscal year. The slow pace of budget execution, particularly for capital projects reflects a combination of structural factors (weaknesses in budget preparation and implementation) but also circumstantial elements. Focus on policy implementation was overshadowed by the elections (which took place in November) for which a significant number of key civil service personnel (including technical staff from line ministries) were deployed to prepare and supervise the ballot. With the electoral period now over and a government in place, the pace of project execution is expected to pick up. Likewise, it is also likely that private players have been withholding planned investments until a clearer picture of the political environment could be formed. Indeed, during the first half of the fiscal year there has been a sharp discrepancy between domestic and external investment commitments and actual realization. The length of the lag between the improved political outlook and its translation into fresh domestic and external investments will determine whether the growth dividends from increased political stability will materialize mostly at the tail end of the fiscal year or into FY15.

External developments are unlikely to affect the outlook significantly, other than via their possible effect on remittance inflows. While higher growth in India and expansion in developing-country markets may boost exports, their small base means that the overall impact will be modest. With limited exposure to foreign capital, Nepal will not be affected meaningfully by tighter financial conditions. Despite their importance in Nepal, the drivers of remittance inflows remain largely unknown: much in the same way as the sharp increase observed in the first half of the year was unexpected one cannot assume that such growth can be sustained over time.

Given the trend observed during the first half of the year, it is likely that the budget will end the year in surplus. With robust revenue growth, the increase in total expenditure is expected to translate into a smaller overall surplus (equivalent to 0.3% of GDP against 2% in FY13).

Inflation in Nepal tends to follow India's but inflationary pressure could build up if record remittance inflows observed in the first 6 months continue and if monetary policy does not adapt. Overall inflation for FY14 is expected to remain significant – at 9.8%. Although the impact of this year's good harvest will be to drive down food prices, the expected accelerated pace of public spending in the latter part of the year combined with relatively loose monetary policy is likely to translate into inflationary pressures. Moreover, this assumes that the NRB stands ready to act decisively, should the large build-up of liquidity in the system translate into asset bubbles and

expectations. The Special Focus section of this Economic Update looks precisely at the policy implications of excess liquidity.

Bank support and activities

A new Country Partnership Strategy (CPS) for fiscal years 2014-17 is under preparation. The last Country Assistance Strategy (CAS) covered FY04-07, and was followed by three Interim Strategy Notes (in 2007, 2009, and 2011). The new strategy proposes a major shift in World Bank Group (WBG) support away from short-term post-conflict assistance towards establishing the foundations for increased and inclusive growth. Based on Nepal's progress to date, there is a compelling case to provide assistance under a longer-term partnership strategy, while maintaining the flexibility needed to accommodate a fragile country environment. To do this, the strategy aims to consolidate the WBG's current engagement in basic services while shifting focus on the binding constraints to growth: inadequate infrastructure (especially energy and transportation), a poor investment climate, a fragile financial sector and a poorly skilled workforce. Given the reality of the Nepali economy, it will also focus on agriculture, which accounts for over one third of GDP and employs three-quarters of the population (including the bulk of the poor). It also aims to shift the Bank's engagement in the social sectors from providing financing for access to services to providing knowledge and solutions for improving quality, governance and providing equal opportunities.

The new CPS will focus on two pillars—(i) increasing economic growth and competitiveness; and (ii) increasing inclusive growth and providing opportunities to increase prosperity—while also seeking, in a crosscutting manner, to enhance governance, accountability and citizens' empowerment. Given Nepal's fluid political situation, the CPS has been developed through extensive consultations with key stakeholders, including political parties, and is aligned around Nepal's development priorities.

The current portfolio consists of 17 projects with net commitments of US\$1.5 billion, and three regional projects with net commitments of about \$240 million. The average project size is \$86 million, near the Bank-wide IDA average of about US\$87 million. Under IDA16 (FY12-14), Nepal's total IDA allocation is about \$630 million, and similar indicative financing levels are expected for IDA17 (FY15-17). Cumulative disbursements as of January 31, 2014, were \$633 million (about 46 % of net commitments) for the national and about \$15million (about 6 % of net commitments) for the regional projects. The portfolio also includes three active trust fund projects with commitments above \$5 million each. The total commitment of these three projects is \$87.5 million of which \$15.06 million (about 17.2 % of net commitments) have been disbursed.

Pipeline Program: The FY14 lending pipeline includes a total of \$221 million in new commitments across three projects of which two (\$150 million) have already been approved by the Board on December 23, 2013. They include the Strengthening of the National Rural Transport Program Project (\$100 million) and Additional Financing for the Irrigation and Water Resources Management Project (\$50 million). The Rural Water Supply Project of about \$71 million is planned for Board submission in May 2014. This would provide for the full commitment of the entire IDA16 allocation to Nepal. Several strategic pieces of analytical support have been completed or are

nearing completion, including Policy Notes for the New Government, Competitive Industries Diagnostic, Mapping of Local Service Delivery, Medium Term Expenditure Framework and TA for Hydropower Scale-up.

Data sheet

Nepal: Selected Economic Indicators – 2010-2014					
	2010	2011	2012	2013	2014
				Estimates	Projected
<i>Annual percent change</i>					
GDP	4.8	3.4	4.9	3.6	4.5
CPI (period average)	9.5	9.6	8.3	9.9	9.8
Broad Money	14.1	12.3	22.7	16.3	19.7
Private sector credit		13.1	11.3	20.2	19.7
Workers' remittances (USD)		13.8	39.6	15.4	14.2
<i>In percent of GDP</i>					
Total Revenue and Grants	18	17.6	18.6	19.2	20.9
Expenditure	18.8	18.5	19.2	17.2	20.7
Net incurrence of Liabilities	1.8	2	2.2	-0.9	1.3
Foreign	0	-0.3	-0.2	-0.3	0.5
Domestic (above the line)	1.7	2.3	2.4	-0.6	0.9
Current Account	-2.4	-0.9	4.8	3.3	2.4
Trade Balance	-25.5	-23.4	-24.3	-27.1	-33.3
Workers' remittances (USD)		18.5	23.3	25.5	30.9
Gross official reserves (in months of goods and services)	5.4	5.8	7.2	7.6	7.8
Public Debt	35.4	33	34.1	31	30
Source: WB / IMF/ NRB					

Excess liquidity – A “Fortunate Problem” ... if well managed.

Since the turn of the decade Nepal has experienced a liquidity squeeze, which almost brought about a financial crisis, followed by a build-up of excess liquidity. In a recent review of monetary policy the NRB Governor characterized such excess liquidity as a “fortunate problem”. However, the volatility -from scarcity to abundance- is problematic for the private sector and symptomatic of inefficiencies in the financial sector. This note looks at short and medium term challenges it poses for policy

The buildup of liquidity in Nepal’s financial system reflects strong push and weak pull factors. The steady and impressive growth of remittance inflows - in FY14 as in previous years - has translated in a significant buildup of liquidity in the financial system as banks appear reluctant to extend credit to the productive sector, despite cheap access to funds and policy encouragements. The NRB’s response so far has been muted and geared toward striking a delicate balance between supporting credit growth on one hand and controlling inflationary pressures on the other.

Excessive liquidity can potentially be of concern for both growth and inflation. Bank liquidity can be a source of concern for growth to the extent that it amounts, de facto, to a tightening of the money supply. Other things equal, excessive liquidity (money held by banks rather than extended as credit) means less lending to support non-government productive investment – for a given money base- and therefore slower overall economic growth. However, at the same time, it is also potentially a source of inflationary pressure. Abundant liquidity comes at a cost for commercial banks (in the form of deposit) who will only hold it if they need to improve their balance sheets and/or consider the risk profile of borrowers to be too high. But such liquidity can be rapidly mobilized for lending if these parameters change and can translate in asset bubbles fueling inflation.

The question is what characterizes ‘excess’ liquidity. It is not only an academic one but has important policy implications. At minimum it describes a situation where banks chose to hold liquid assets above and beyond statutory requirements. This may be purely rational if banks are worried about their balance sheets and anticipate a deterioration in borrower credit worthiness such that the holding of excess liquidity amounts to an additional self-imposed precautionary behavior. At maximum, however, it may be the case that banks in fact involuntarily hold excess liquidity because of information asymmetries (keeping rates sticky), poor alternatives (such as bonds or viable demand for credit), lack of competition, and/or missing safety nets (such as a well-developed interbank market and operational lender of last resort function by the NRB). It can also be that banks are irrationally conservative in their appetite for risk.

Achieving a sound diagnostic of Nepal’s situation is not easy and many of these features could be simultaneously at play. Given Nepal’s recent near financial crisis it is likely that psychological factors are making banks more risk averse than they otherwise might be. At the same time one should also recognize that much uncertainty remains as to the true state of the financial sector (including health of banks’ balance sheets) and quality of demand for loanable funds. Finally, it is clear that there are substantial market inefficiencies. Given such ambiguity, thoroughly diagnosing the patient’s condition should be a prerequisite to prescribing remedies and the first therapeutic imperative, in the meantime, should probably be to ‘do no harm’.

In the short term, monetary prudence may be the wisest course of action. Given persistently high inflation and the overall healthy growth rate of the economy, the most immediate risk is that inflationary expectations could build-up and become, eventually and increasingly, harder to control. Relative monetary restraint (such as through sterilization of inflows) may come with a price tag in terms of growth in the short term but would be unlikely to result in a vicious spiral. Monetary expansion is a riskier choice. If banks are indeed excessively conservative and the growth potential of the economy is solid, then monetary expansion could yield important dividends. However, if banks are correctly assessing the risk of further extending credit and the economy susceptible to asset bubbles (in the absence of productive avenues for credit expansion combined with weak safeguards) then loose monetary policy combined with additional policy directives to boost credit could spur inflation and possibly a return to financial sector stress.

The NRB, sooner rather than later, may need to clarify its overarching strategy to deal with persistently large private inflows. With remittance inflows showing no sign of abating - characterized by both large volumes and volatility- and liquidity building up in the system, the NRB has followed a course of action characterized by (i) an overall loose management of money growth – intended to keep interests low and encourage credit expansion, (ii) targeted policy measures to encourage banks to extend credit and access to finance, combined with (iii) ad hoc interventions to mop up liquidity in the system through open market and reverse repo operations. This course of action is equivalent to walking a fine line between pro-active support to economic growth and containing inflationary pressures, but it does not amount to a clear and predictable course of action. Moreover it has resulted in high interest rate volatility, which may have adversely affected the propensity of banks to extend lending and of private agents to borrow.

Ultimately, building the systems required for banks to safely and sustainably expand credit is a sine qua non condition to strike the best possible balance between economic growth and inflation control objectives. A patient has greater chance to recover from a temporary illness if she is in good health to start with. Building-up the ‘immune system’ of the financial sector should therefore be of paramount importance and there are many avenues to do so in Nepal. By contrast, policy measures intended to force banks to simultaneously strengthen their balance sheets and to expand credit (via interest rate caps) and direct it to underserved clients (via directed lending to priority sectors) may be inefficient and possibly counterproductive. Ultimately the key is to establish a strong enabling environment that creates opportunities for banks to lend for productive purposes.

This special focus section proposes a number of steps: to clarify the monetary policy stance in the face of high liquidity as well as to develop market alternatives to potentially distortionary policies to allow the credit market to work more efficiently.

PART I : MANAGING EXCESS LIQUIDITY IN THE SHORT RUN

Nepal's financial system is currently characterized by excess liquidity reflecting a combination of conjunctural and structural factors. On the one hand bank lending to the private sector has slowed – with lending rates adjusting sluggishly to available liquidity- possibly remaining below optimal levels. On the other hand, high external inflows of cash into the economy are creating significant pressure that could translate into prices if banks are unable to channel this liquidity to sound investments and if the monetary authorities do not act to effectively and predictably manage the overall level of liquidity in the system.

In the short run, therefore, it may make sense for the NRB to clarify its monetary stance by articulating a liquidity management strategy in relation to both growth (credit) and inflation goals as well as financial stability and development objectives. This may call for creating new instruments to manage excess liquidity, which has become a feature of the Nepali economy.

From symptoms to diagnostic: excess liquidity, credit slowdown or credit “crunch”.

In mid-2011, a financial sector crisis nearly unfolded in Nepal. Withdrawals of deposits from smaller financial institutions and severe liquidity constraints across the banking sector exposed the vulnerabilities of the financial system and required urgent intervention by Nepal's central bank and bank regulator, the Nepal Rastra Bank (NRB). The World Bank, together with the International Monetary Fund (IMF), was called on by the NRB and the Government of Nepal (GoN) to provide assistance, both technical and financial, to support efforts to contain the developing crisis and to provide longer-term support for institutional and regulatory changes that would contribute, over time, to a more robust system. Due to quick and effective intervention by the NRB – including large scale liquidity support through multiple lending windows and regulatory forbearance - and thanks to a favorable environment (notably continuing large flows of remittances which contributed liquidity to the system), a full-blown financial crisis was averted.

Over FY13 and FY14, excess liquidity has been building up in Nepal's financial system. Nepal's banking sector appears to be increasingly biased toward holding liquid assets rather than supporting productive investment through lending. Deposit mobilization increased by 8% in the first half of the year vs. 5.3% at the same time in FY13; by contrast domestic credit growth slowed to 7.3% over the first 6 months of the fiscal year under the influence of both lower levels of government borrowing and slower growth of claims on the private sector (9% in the review period vs. 12.3% in the first half of FY13). As a result, the loans-to-deposits ratio has been declining over time. Three commercial banks (8.8% market share) recorded Credit to Deposit Ratio (in LCY) in excess of 90% in the second quarter of FY14 compared to five commercial banks (9% market share) in the previous quarter and eleven banks (30percent of the market) in the previous year. At the same time, treasury bills accounts of commercial banks increased significantly, almost doubling between FY11 and FY13. Reflecting these trends the interest rate spread between risky assets (private sector loans) and low risk assets (T-Bills) widened significantly.

Figure 20: Commercial banks biased toward liquid assets

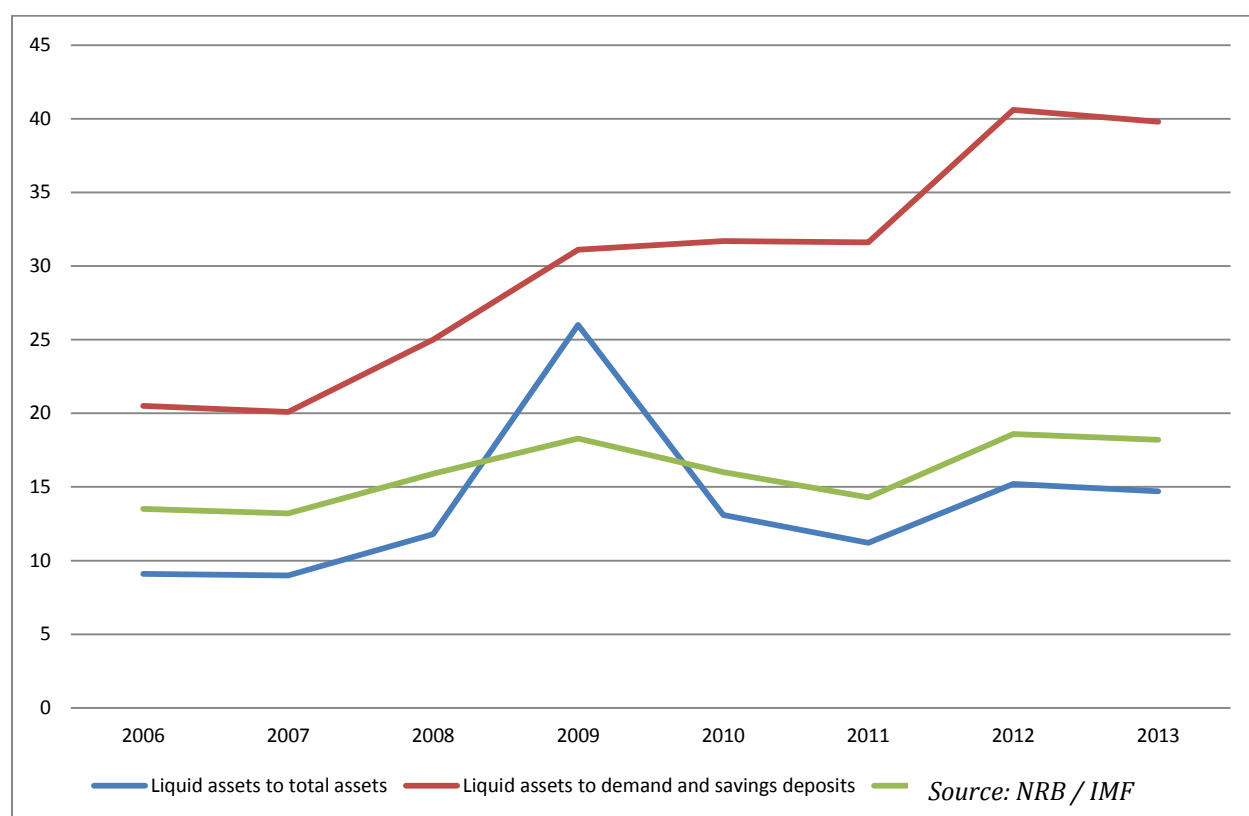
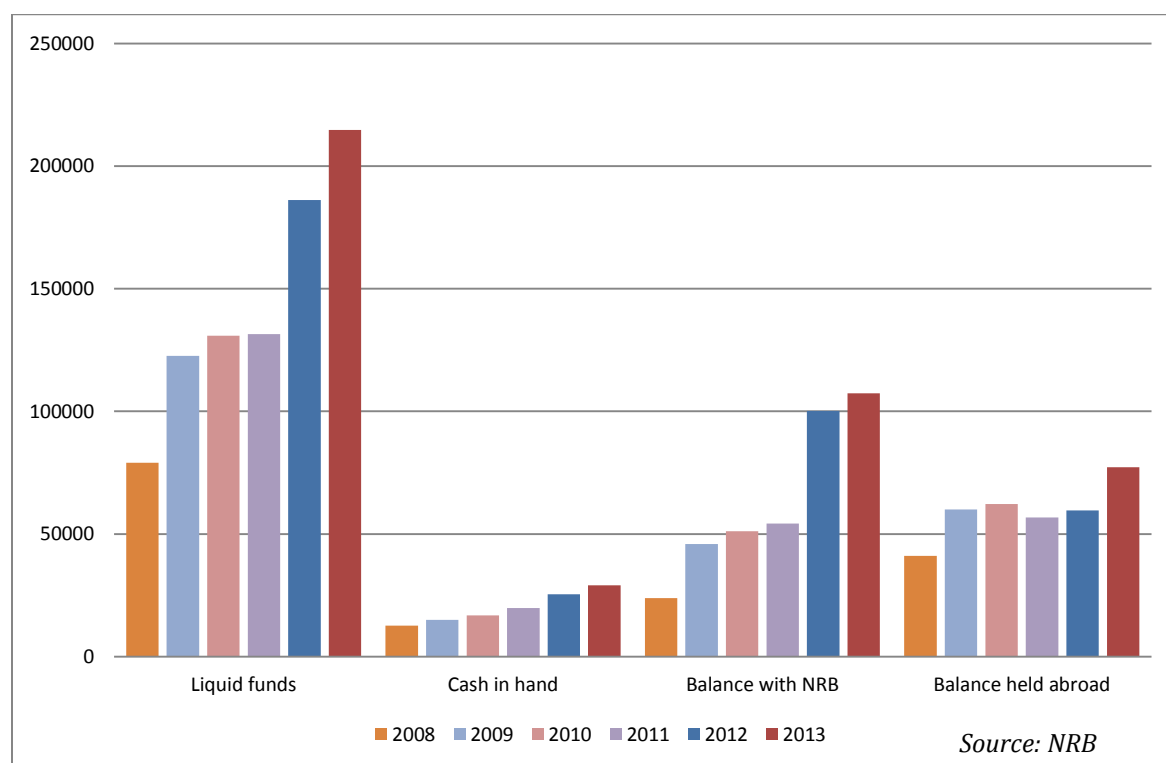
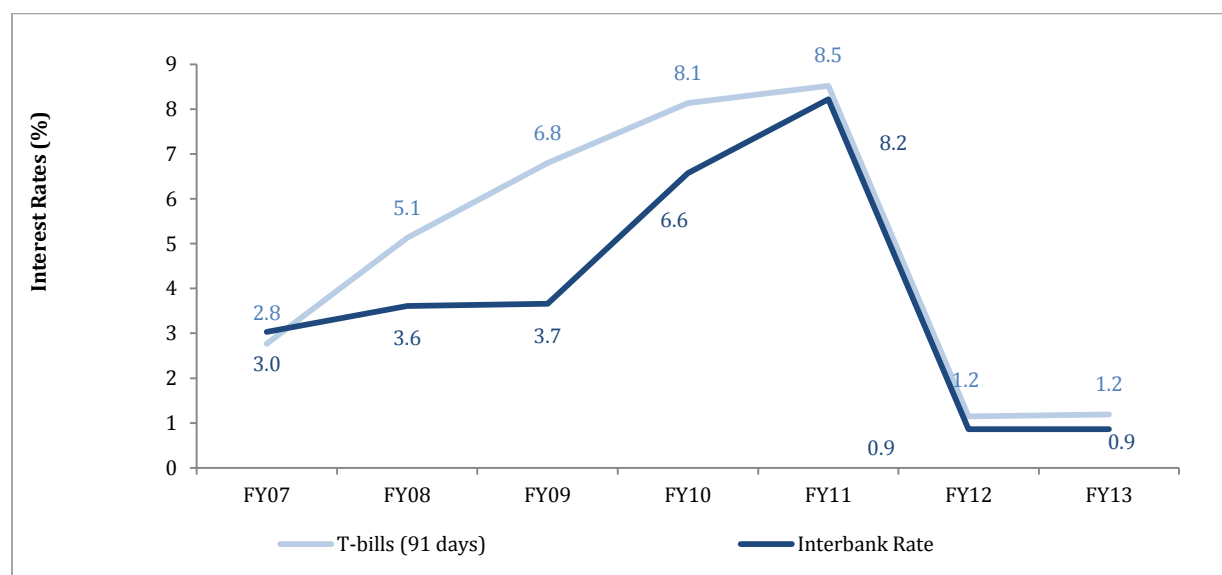


Figure 21: Liquid funds of commercial banks



Banks appear to be withholding credit by maintaining high lending rates despite slower credit growth. Indeed, while credit to the private sector remains high, the rate of credit growth has decreased significantly from FY13. Also, the large interest spread between risky assets (credit to the private sector) and low risk assets (T-bills, deposits at NRB) is significant, indicating reluctance from banks to use the price mechanisms to attract greater demand for loanable funds. That is not because of involuntary rationing (although the NRB has imposed some limits to real estate related lending) but rather appears to be a voluntary behavior, possibly linked to psychological factors, a reassessment by banks of default risk and balance sheet weaknesses, and/or absence of competition in the sector.

Figure 22: Structure of interest rates



Understanding the drivers of the credit slowdown – and whether Nepal’s situation can in fact be characterized as a mild credit crunch¹- is not straightforward as both demand and supply factors may be at work. On the one hand political uncertainty, especially since the dissolution of the first Constituent Assembly and in the run-up to the elections, may have led private operators to postpone investment decisions; likewise the depreciation of the Nepali rupee may have led importers to reduce their demand for letters of credit. On the other hand however, the supply of credit may also have fallen (for any given level of interest rate –i.e. leftward shift of the supply curve) due to balance sheet weaknesses of banks and/or heightened perception of default risk. The banks’ continued exposure to real estate – whose valuation is particularly hard and where the market remains subdued– adds to the constraints that banks face in assessing the true extent of their exposure and need for additional protection beyond those imposed by regulation. Perceptions could also be playing a part including the experience of crisis (an impaired loan portfolio) and/or heightened uncertainty (leading to regard previously normal loans as having now excessive risk).

¹ Arguably Nepal is not in a full credit crunch scenario as the term usually refers to situations in which a drastic reduction of credit (against the backdrop of deleveraging) precipitates a sharp contraction in real economic activity. By comparison, Nepal’s slowdown is relatively mild.

These two dynamics maybe re-enforcing each other since the most typical form of collateral is real-estate.

Box 2: Definitions: credit slowdown and credit crunch

A *credit slowdown* can be defined as a general decline in credit growth that may have been generated by either demand or supply factors, or both. Broad changes in the demand for credit may be cyclical (varying with the pace of economic activity) or structural (induced by changes in the tax code etc.). Credit supply can be influenced by changes in financial regulations, structures, and institutions. Monetary policy and autonomous shifts in lender and borrower psychology will have an impact on both credit supply and demand.

Unlike *credit slowdown*, which is a fairly general term, *credit crunch* specifically refers to a reduction in the available supply of credit. During a period of credit crunch, lenders become reluctant to lend either because of funding problems stemming from disintermediation, or because regulators have urged credit restraint. The reluctance to lend may also stem from the lenders' own balance sheet weaknesses (capital constraints) and their reassessment of borrowers' average credit quality. Although credit crunches are often deemed as primarily supply phenomena, it is difficult to disentangle supply from demand effects since some of the same factors that reduce the willingness to lend may also restrain the desire to borrow.

A *credit crunch* implies changes in the relationship between credit availability and interest rates: (i) less credit may be available over a wide range of interest rates -- a condition consistent with a leftward shift in a credit supply schedule, or (ii) the reduction in credit availability may bear little relation to the level of rates -- a condition that takes place when allocation occurs via non-price mechanisms. Since credit is normally allocated across potential borrowers by the interest rate, the term credit rationing is commonly used for situations in which the supply of credit is allocated through non-price mechanisms. In general, credit rationing episodes are considered to be a subset of credit crunches in which the interest rate is not the price underlining the credit allocation mechanism. Credit crunches that are characterized by credit rationing may be difficult to alleviate through monetary policy alone.

Source : "Is there a credit crunch in East Asia", W. Ding, I. Domac, G. Ferri, WB Policy Research Working Paper, August 1998

Understanding the reasons behind the recent credit growth slowdown and/or the stickiness of lending rates at which banks extend credit is imperative in order to assess the most appropriate monetary policy response. In very schematic terms, the monetary policy dilemma can be expressed as follows. On the one hand, if sound demand for credit exists in the economy which is not materialized either because investors are postponing investment and /or banks are excessively risk averse, then maintaining a relatively loose monetary policy may be justified. On the other hand, if banks are worried about balance sheet weaknesses and assess the existing demand for credit as too risky (given such balance sheet weaknesses) then loose money combined with policy directives to expand lending could exacerbate financial sector woes and feed asset bubbles and inflation.

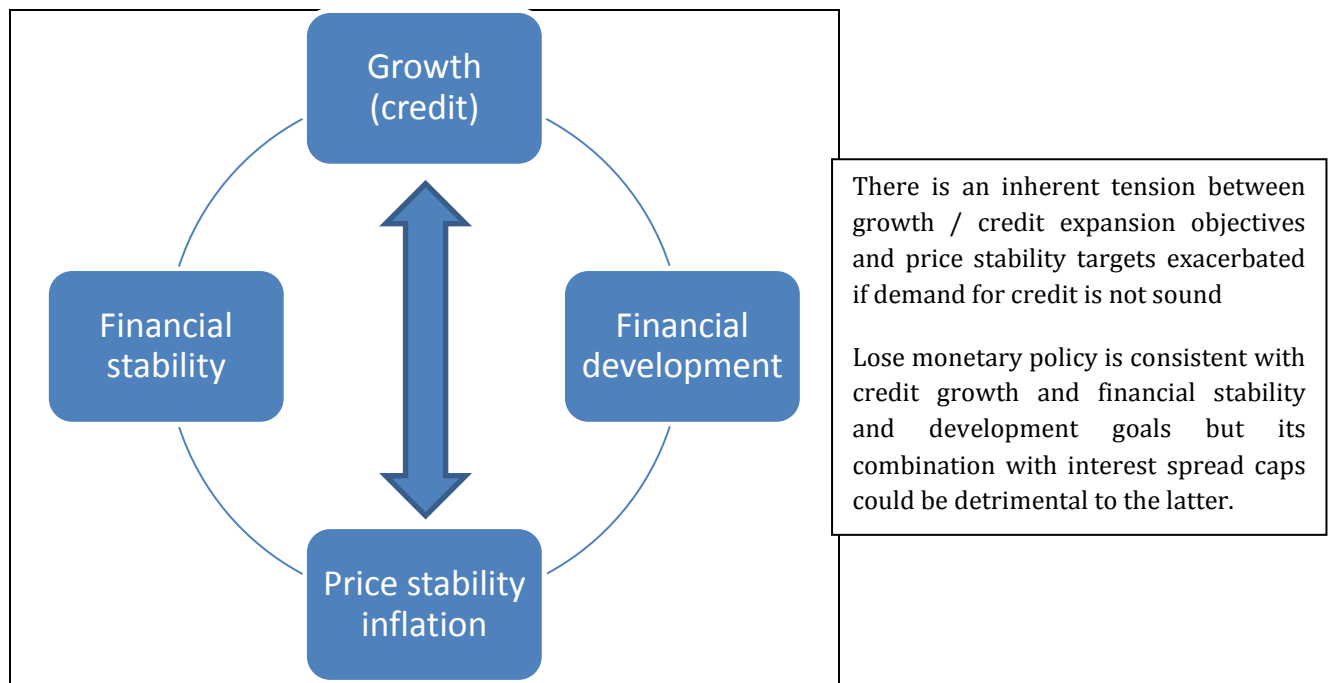
Monetary policy choices

From a policy standpoint determining what constitutes 'excessive' liquidity is particularly difficult and the outcome of the diagnostic has important implications. In theory, the buildup of liquidity, in excess of regulatory requirements, can have at least four sets of adverse consequences albeit with different implications for policy:

- On growth: as the bias toward liquidity implies a higher cost of borrowing (or credit rationing) leading businesses and households to defer investments or current expenditure and possibly to sectoral shifts in the composition of lending at the expense of smaller and less well established clients (flight to quality)
- On inflation: since it increases the capacity of the banking sector to boost credit in response to demand shocks, inflationary pressures could quickly become difficult to contain
- On financial sector stability: the effect is ambiguous: to the extent that banks can have access to cheap money, high levels of liquidity provide a boon to the banks' ability to rebuild their balance sheets; at the same time, if adequate safeguards are not in place banks could be tempted to engage in overly risky lending practices
- On monetary policy effectiveness: by affecting the ability of monetary authorities to stimulate demand and stabilize the economy during downturns: with banks already highly liquid (i) further attempts by the monetary authorities to stimulate demand would likely prove futile and (ii) the ability to regulate the money supply via reserve requirements and the money multiplier are also proportionately weaker.

The monetary policy stance, therefore, involves a tradeoff between the objectives of avoiding an unnecessary slowdown in growth on one hand and controlling inflation on the other hand. Maintaining a relatively loose monetary policy and allowing the excess liquidity to remain is consistent with emphasis on the first objective. Draining off excess liquidity is consistent with a priority on the second objective. In addition, in Nepal, the NRB has identified two additional objectives namely, financial development and stability. Loose monetary policy is consistent with both, however its combination with policy directives to fix the spread that banks can maintain between deposit and lending rates is not and even possibly counterproductive.

Figure 23: Monetary policy objectives



Striking the right balance implies understanding the drivers of banks' unwillingness to extend credit and bias toward holding more liquid assets. On the one hand, banks may be purely rational in their choice, holding excess reserves as a precautionary measure. On the other hand, banks may be acting irrationally if their bias for liquid assets is above and beyond what statutory requirements and what precautionary measures would call for. The extent to which banks are acting 'rationally' has important implications for monetary policy.

- If banks are irrationally restricting credit, despite sound balance sheets and worthy demand for loans, then loose monetary policy may in fact be required. In fact excess liquidity could call for monetary base expansion: to support the same nominal aggregate demand, a higher base is needed the less inclined bankers are to lend.
- However, if banks are adequately assessing risks of expanding lending, then loose monetary policy would be risky. If borrowers have weak solvency –if at all- or there are few sector with viable investment opportunities, then banks are being rational in denying them credit, hence expanding the money supply may run the risk of increasing the fragility of the financial sector, creating speculative bubbles and driving up inflation especially when combined with policy directives to boost credit.
- Lastly, if banks are involuntarily holding excess liquidity (potentially because of asymmetric information or an underdeveloped bond market), then the most appropriate response is to tackle these inefficiencies directly to allow the credit market to function more smoothly.

Mapping Nepal neatly within this typology is hard because these factors are likely to be simultaneously at play. Little is known about the true health of the financial sector and credit growth, though slower, has far from collapsed.

What to do in the short term?

The response of the monetary authorities to date has been muted. In the face of large remittance inflows and persistent inflationary pressures the NRB has adopted a muted response, clearly displaying reluctance to face the cost of sterilization in terms of credit and economic growth. Massive inward remittances are sustaining a large current account surplus, reflected in the buildup of net foreign assets. At the same time, food prices have remained high despite an improved agricultural production outlook. The NRB's response to date has involved a delicate balancing act between maintaining a relatively loose monetary policy to support credit growth while preventing the buildup of 'excessive' liquidity through ad hoc interventions.

- On the one hand the NRB has deliberately not fully sterilized the reserves build-up leading to low interest rates and a widening spread vis-à-vis Indian rates.
- On the other hand it has acted – with increased frequency- to drain off the excess via reverse repo and open market operation, to contain inflationary pressures in the face of weak credit growth.

Box 3: Reverse repo and open market operations: Basic definitions

Both instruments are used to decrease the money supply in the economy

Reverse repo: The Central Bank agrees to borrow money from commercial given them a vehicle to park their funds with the NRB, thereby decreasing the supply of money in the market. However this is only a temporary absorption of money (i.e. for the duration of the loan)

Outright sales auctions: The Central Bank sells government securities and thus withdraws money over the longer term.

Table 1: NRB's interventions to mop up liquidity in FY14

Reverse Repo Auction	Amount (NRs million)	Rate (%)
September 2013	15,000	0.07
October 2013	20,000	0.05
December 2013	29,500	0.06
January 2014	54,000	0.68

The NRB appears to have adopted a wait and see position, to gauge whether demand for credit will pick up. The decision of the NRB to maintain loose monetary policy is presumably premised on the belief that:

- Inflationary pressures are in fact manageable because driven mainly by food prices, energy prices and the value of the rupee (i.e. all largely exogenous) and much less so by domestic credit growth, while
- Sound pent up demand for credit exists which either (i) requires more time to materialize and/or (ii) has been prevented by excessive conservatism on behalf of banks.

This strategy, however, has the potential to be risky, on at least two counts:

- **First, much is still unknown about the true health of Nepal's financial sector and a better diagnostic is needed.** While officially reported/recorded problem loans represent a modest 3.8% of the total, ever-greening is believed to be widespread, partly as a result of policy. Currently, the quality of outstanding loans is assessed essentially on the basis of “past due days”, which is particularly prone to missing (and perhaps encouraging) ever-greening of bad loans². Moreover, the decision to suspend dividend payments in institutions reporting NPLs over 5% may have prompted bank managers to underreport and constituted in fact a disincentive to adequate and transparent risk assessment – possibly driving a wedge between the NRB's assessment of BFI health and the institutions' own understanding of their risks.

Therefore, in the short term the NRB should carry out an in depth review of weaknesses of BFIs and build its capacity to provide effective supervision. With support from DfID and in preparation for the Second Financial Sector Stability Development Policy Credit, the NRB has started carrying out an in depth review of BFI balance sheets, which will shed light on the extent of these problems. Over time banks and the NRB should also move increasingly toward carrying out Asset Quality Reviews so that the assessment of overall portfolio health and decisions on new loans should be made on the basis of detailed analysis of the borrower's repayment capacity (rather than history).

- **Second, additional policy measure to fix the spread between deposit and lending rates and direct lending toward deprived and “priority” sectors may compromise both the objective of restoring balance sheet health and allowing sound demand for credit to be met.** Of specific concern are (i) the establishment of a margin cap (of 5 percentage points between deposit and lending rates) designed to protect customers, and (ii) requirements for banks to lend to deprived sectors. The margin cap, affects both the ability of banks to rebuild balance sheet strength and to use price mechanisms to discriminate between good and bad demand for loans. The requirement to lend to deprived sectors has translated in commercial banks' lending to class D and cooperatives, which are poorly regulated and often unable themselves to find appropriate destinations for their funds.

Therefore, in the short term the NRB may want to reconsider such policy initiatives that affect the ability of the market to allocate credit efficiently through price signals

² In principle the number of overdue days provides a simple, objective benchmark for asset quality but in the case of Nepal there is some evidence that banks do not ‘play by the rules’ and, in the absence of strong supervision, trade each other's bad loans booking them as fresh credit.

Box 4: Ever-greening: lipstick on a pig?

It is quite common, and in fact appropriate, for banks to revisit the original terms of a loan when corporate clients that are in fact solvent are faced with a temporary liquidity shortage. In Nepal however this practice has been largely indiscriminate and unrelated to an assessment of borrowers' ultimate repayment capacity.

Ever-greening refers to such practices whereby banks extend new loans to customers to allow them to remain current on obligations from previous (bad loans), motivated solely by the objective to avoid provisioning charges (that would be deducted from capital). As a result bank balance sheets appear healthier than they really are (because the quality of loans is essentially measured in relation to default on payments due but artificially so).

In a recent statement, warning banks against engaging in such practices, Reserve Bank of India Governor Raghuram Rajan said that one 'can put lipstick on a pig but it doesn't become a princess'.

Source: Business Today "Raghuram Rajan warns bankers on ever-greening of bad loans" 16/11/13

In the short run, therefore, it might make sense for the NRB to

- **Closely monitor the evolution of bank balance sheets and new loans and stand ready to tighten monetary conditions.** Given the relatively favorable macroeconomic outlook (and particularly the absence of recessionary risks), Nepal is in a fortunate position that it can afford to be relatively conservative in its monetary policy stance. In other words, tighter monetary policy is unlikely to feed into a vicious recessionary circle (where lower credit depresses output, which leads banks to be even more cautious, which depresses output further). In coming months the NRB should pay close attention to both the volume of private sector credit growth and its quality. The impact of credit expansion on inflation and financial sector health will depend a lot on the quality of underlying projects. Of particular importance will be the evolution of the housing market. So far growth of credit in this sector has been biased toward home loans relative to developments indicating that banks remain cautious. However any indication that credit remains constrained over time or that it may be feeding speculative ventures would call for tighter monetary conditions.
- **Reconsider the proposed cap on interest rate margins.** The proposed cap on interest spreads is consistent with growth objectives but possibly detrimental to stability goals as well as to the objective of extending access to finance (which is was ostensibly meant to promote).

In the medium run, the NRB may want to consider developing (and/or making explicit) a clear strategy for action with adequate tools to manage excess liquidity. The NRB should develop its toolkit to deal with excess liquidity in a way that provides clarity and stability with respect to goals (inflation and growth) and adopt corresponding targets for bank liquidity and interest rates.

Clarify monetary policy objectives and expand the available monetary policy tool kit in the face of structural excess liquidity

In Nepal, the large buildup of liquidity in the system reflects to a large extent structural push factors. While excess liquidity can result from temporary shocks, in Nepal this is increasingly a structural feature of the economy. The phenomenal and sustained rise in inward remittances and corresponding buildup of net foreign assets –other things equal- is steadily growing the money base. At the same time this overall steady rise is combined with short term fluctuations driven by remittances and asset bubbles (and their bursting), which discourage investors from making long term investments (due to the un-predictability of funding) and bank lending (due to the unpredictability of supply of credit).

The instruments deployed so far by the NRB are well suited for handling such inflows in the short term but not for strategically managing them over time. The NRB has acted with increasing frequency in FY14 to absorb excess liquidity in the system via reverse repo and open market operations (outright sale auctions) but these are short term fixes, in fact more typically used for fine tuning purposes -to smooth the interest rate fluctuations caused by temporary variations in liquidity- than for long term management. As such they are different from so called structural operations that are used to adjust a central bank's long term position vis-à-vis the financial sector.

In order to manage liquidity predictably and efficiently over the long run, the use of dedicated instruments may become necessary. While open market and reverse repo operations may be suited to fine tune liquidity management they are ill adapted to manage liquidity in the face of persistent and large pressures stemming from the inflow of remittances. The result is high interest rate volatility and lack of clarity –on the side of market players- on medium to long term prospects (possibly fueling excessive holding of liquidity).

- The NRB may consider formulating an explicit strategy for managing excess liquidity: that strategy should make explicit how credit growth and inflation control objectives are traded off against one another and reflect that position in targets for overall bank liquidity
- The NRB should develop new instruments to effectively and strategically manage excess liquidity. Given the sustained nature of inward remittances and the GoN's commitment to the peg (when a flexible exchange rate would automatically act to correct external imbalances) ad hoc mopping up of liquidity may (i) not be sufficient to absorb the very large inflows, nor (ii) provide the level of predictability that is needed for the market to function effectively.
 - This would involve developing longer term treasury bonds explicitly issued to absorb excess liquidity. The proposed 'sterilization bonds' would have longer maturities although at the cost of higher interest rates. In fact this has been the path followed by India when, in 2003, it introduced a new scheme known as the Market Stabilization Scheme to sterilize liquidity absorption spurred by large external capital inflows via issuance of additional T-Bills and securities. (Box 5). An additional benefit would be the development of capital markets with greater ability for market players to develop a yield curve.
 - In parallel, the NRB could consider introducing an interest rate corridor to limit volatility above or below a desired / targeted level. This would be done by setting a floor rate (through a deposit facility) as well as a ceiling rate (lending facility).

Box 5: The Use of Sterilization Bonds in Asia

In the wake of the Asian Crisis, a number of Asian economies have accumulated large FX reserves to sustain exchange rate regimes, leading to large increases in their balance sheets. In order to maintain monetary stability central banks have resorted to sterilization through non-market and market based approaches. Among the latter sterilization bonds – mostly the sale of own securities by CBs- have been increasingly popular and seen as a way to deepen local bond markets and develop a yield curve while avoiding the negative impact of non-market measures on financial intermediation.

In Korea, “Monetary stabilization bills” were issued for the first time in 1961 and used as the primary method to remove excess liquidity, reaching an amount equivalent to 20% of GDP in 2005.

China issued central bank bills, alongside other instruments (including reserve requirements, open market operations, etc.) beginning in 2003. In China market based issuance has also been combined with targeted issuance to specific commercial banks experiencing abundant liquidity and fast credit growth.

While the Reserve Bank of India is not allowed to issue its own securities a new instrument was created in 2004, namely the “Market Stabilization Scheme” – or government treasury bonds and medium-term dated securities used solely for sterilization purposes (with the proceeds from the auction placed on a separate cash account).

Adapted from: Aaron Mehrotra “On the Use of Sterilization Bonds in Emerging Asia” BIS paper No66

In the medium run, given the cost of sterilization, the best option is to tackle the inefficiencies that are at the source of involuntary or ‘excessive’ of liquidity. While developing the toolset needed for effective liquidity management, the GoN should carry out structural reforms to improve the overall credit environment and the investment climate to make sure that banks can expand lending in a sustainable and safe manner to viable investments.

PART II: EXPANDING THE REACH AND THE EFFICIENCY OF CREDIT MARKETS

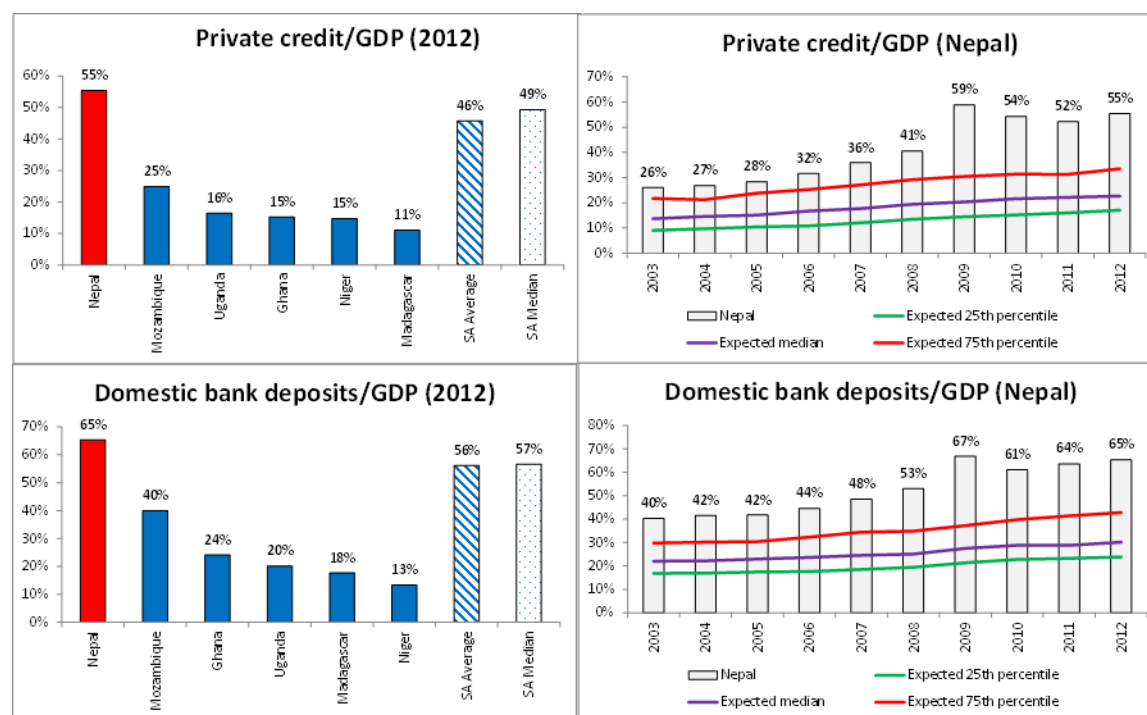
The Central Bank's policy stance is consistent with the interpretation that commercial banks are excessively cautious in their credit allocation decisions and thus simultaneously restricting the economy's growth potential and hurting customers by maintaining high spreads between deposit and lending rates. Specific policy measures, such as the proposed cap on interest rate spreads and directed lending to deprived sectors and priority sectors are meant to correct such market inefficiencies. However they run the risk of introducing additional distortions and should be evaluated carefully. Moreover such interventions are at best 'second best' while a more sustainable option would be to improve the ability of the market to function efficiently.

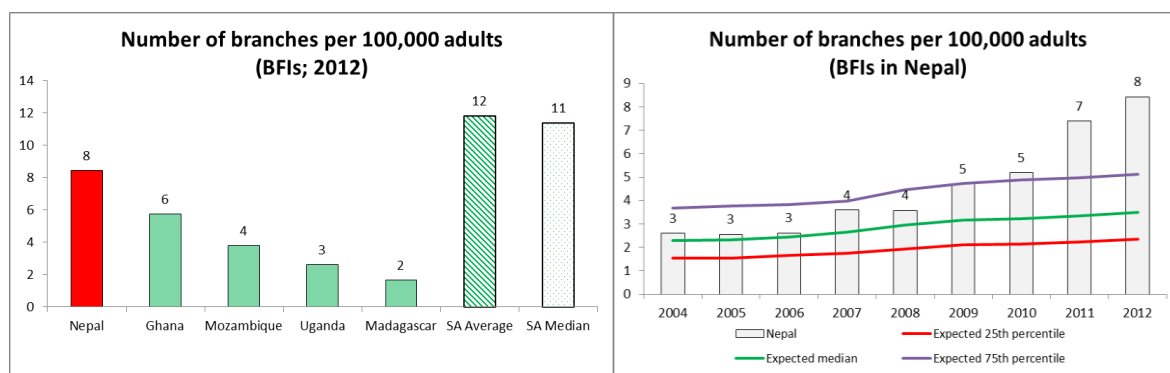
The section below contains recommendations on how such an agenda could be pursued to improve access to finance, release under-exploited economic potential and help banks diversify their risk.

Access to finance is broad by some measures but limited in fact for specific categories of clients (households and firms) and in practice under-exploited.

Nepal's financial sector has been growing rapidly, and in most respect access to financial services compares favorably to other low income country peers. The aggregate amount of deposits, credit and number of branches and ATMs has been increasing steadily over the past few years. Deposits and credit are 65% and 55% of GDP respectively, somewhat higher than the South Asia averages and exceeding the predicted value for a country of Nepal's GDP per capita and population, by a significant margin. Accessibility in general has improved: the number of BFI branches per 100,000 adults in Nepal has doubled from 3 in 2004 to 8 in 2012.

Figure 24: Access to finance indicators

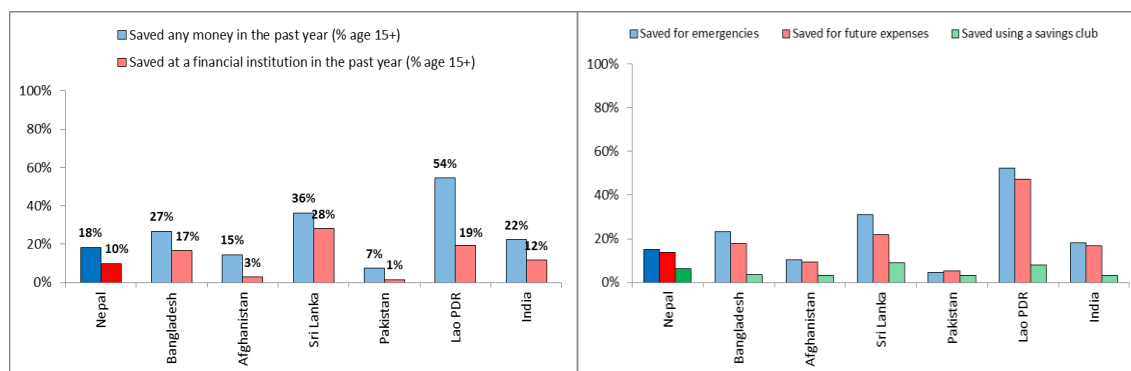




Source: Finstats, accessed February 2014.

Nonetheless significant gaps remain in the coverage of financial services, both in terms of access and effective use. Access gaps are most acute in the more remote and geographically isolated parts of the country, which as of yet remain underserved by formal financial institutions. Despite the relatively large deposit base, financial services are concentrated among the urban and male population. Of the urban population, 51% has a bank account, compared to 22% of the rural adult population. Similarly, a persistent gender gap exists: while about 30% of Nepali adult males have a bank account, only 21% of females do. Moreover, access to deposit accounts does not necessarily mean that they are used for savings. An average of 18% of adults in Nepal save money, but only 10% do so at a formal financial institution, and most of the savings are intended for emergencies (Figure 25).

Figure 25: Household savings behavior



Source: Findex, accessed January 2014

A large fraction of household borrowing occurs outside of the formal sector. Some 11% of loans come from a formal financial institution (Table 2) – a proportion higher than the South Asia average (9%) but still low. Most of household borrowing comes from informal sources such as friends and family (33%) or other private lenders (19%), well above the South Asia average.

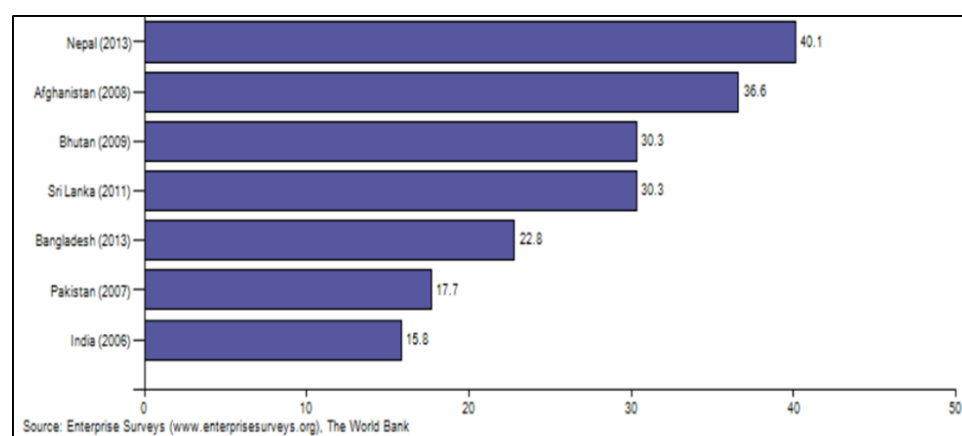
Table 2: Loan origins

	Nepal	Bangladesh	Afghanistan	Sri Lanka	Pakistan	Lao PDR	India
Loan from a financial institution in the past year	11%	23%	7%	18%	2%	18%	8%
Loan from a private lender in the past year	19%	7%	6%	3%	2%	5%	7%
Loan from an employer in the past year	2%	1%	8%	3%	6%	2%	5%
Loan from family or friends in the past year	33%	11%	30%	13%	23%	16%	20%

Source: Findex

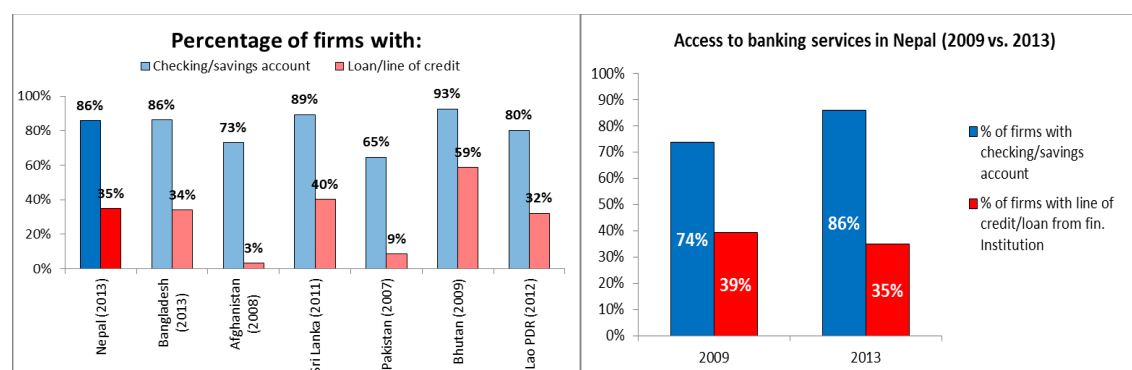
Access to finance is a major and worsening constraint for firms, particularly small and medium enterprises (SMEs). Some 40% of firms recently surveyed in the World Bank's Enterprise Survey 2013 considered access to finance to be a major or severe obstacle to their operations, significantly higher than the 5% reported in 2009. This proportion is also higher than reported by firms in regional peer countries (Figure 26). While the percentage of firms with a checking or savings account has increased from 2009 to 2013, the share of firms with a line of credit or loan has fallen in the same time period. Compared to their regional peers, large Nepali firms have very favorable access to credit – in large part due to the close affiliations between industrial groups and banks. All the large firms surveyed in Nepal's Enterprise Survey had a checking or savings account, and 84% had a loan or line of credit. However, although 85% of SMEs have a savings or checking account, only around 35% had a loan or line of credit from a financial institution in 2013 due to the higher collateral requirements for SMEs (mostly in the form of fixed assets of the owner of the enterprise).

Figure 26: Percentage of firms reporting access to finance as a major constraint



Source: Enterprise Surveys, World Bank

Figure 27: Access to credit is low in Nepal



Source: Enterprise Surveys, World Bank

Retail electronic payments and innovative delivery channels such as e-banking and mobile banking are only slowly gaining traction. As of yet, Nepali customers rely primarily on conventional delivery channels. Over 75% of adult Nepali withdraw their money through conventional branch tellers, while over 81% deposit their money by the same way. The use of ATMs is low – only 1% of adults in Nepal deposit money through ATM, while almost 12% withdraw money through ATMs, a proportion lower compared to Pakistan (32%) or Sri Lanka (15%). Banks in Nepal are taking various initiatives for retail electronic payments in the spheres of internet and mobile banking, cross-border inward remittances and cards.

The authorities have actively promoted improved access to finance but there are shortcomings to the current approach

The Government of Nepal (GoN) and the Nepal Rastra Bank (NRB) strongly recognize the importance of the financial sector in advancing economic growth and poverty reduction. The authorities have taken an active interest in promoting access to finance and financial inclusion. Over time, the strategic direction of the policy package has undergone marked changes. In recent years, the Nepali authorities have moved away from a strategy centered on liberal licensing policies (Box 6) toward more interventionist administrative measures.

In the past, the NRB has pursued a liberal bank licensing policy, which set the stage for the entry of a large number of new financial institutions. The liberal licensing policy has promoted entry of many smaller financial institutions - attracted by the prospect of high dividend pay-outs-, particularly in the B and C categories. The banking system now comprises 31 class A banks (i.e. regular commercial banks), 86 class B banks (i.e. development banks) and 59 class C banks (i.e. finance companies). Although there are differences in permissible activities and prudential requirements, particularly minimum required capital, all categories are allowed to accept deposits from the public.

The common perception is that the liberal bank licensing policy has fallen short of expectations in terms of financial deepening and access to finance. The entry of new players has had only limited impact in terms of motivating banks to venture out of the narrow readily bankable sector of the economy. As a consequence, the upper end of the market (i.e. the large corporates) has become more crowded, while a significant portion of the economy remains seriously underserved by the financial system. Liberal licensing has also contributed to the emergence of a fragmented banking structure, with many banks, particularly in the B and C classes, that appear too small to be professionally run and remain commercially viable. A moratorium for new licenses has been in effect for class A, B and C banks since 2011.

There are indications that the fragmented market structure of Nepal's banking system may be inefficient from a financial development point of view. When viewed in comparison with peer countries, the lending-deposit spread appears to be below the averages for regional and income group peers. The picture that emerges from a detailed decomposition of the lending-deposit spread for class A banks is that there is considerable variety in terms of deposit rates (i.e. funding costs), but that lending rates are fairly uniform across the board. It appears that size is associated with lower funding costs and higher efficiency, as is illustrated by the lower overheads of the larger private banks. These efficiency gains are however not or only partially channeled through to the end users as larger banks also have higher profit shares. The state-controlled class A banks are a notable exception to this pattern. Their funding costs are among the lowest in the sector, but their overheads and provisions are among the highest in the sector. The low funding costs plausibly reflect widespread expectations among depositors and other liability holders of implicit state support. The high overhead costs reflect large and unionized workforce, lack of automation and an ongoing restructuring agenda while the high provisions reflect a diminishing but still high exposure to non-performing assets. As a consequence, the state-controlled class A banks have the highest lending-deposit spreads in the sector in large part due to their inefficiencies.

The liberal licensing policy remains in force for the so-called class D financial institutions. Class D financial institutions comprise entities engaged in microfinance activities, covering a diverse set of financial NGOs (FINGOs), a limited number of cooperatives, microfinance development banks and regional rural development banks (MFIs) that are regulated by the NRB. In fact, the NRB is encouraging Class D institutions to set-up in under-served areas by fast-tracking licensing for Class D institutions in 22 districts. Currently, there are 35 MFIs, 33 FINGOs and 15 cooperatives licensed by NRB. While the NRB supervises a limited number of cooperatives, the vast majority of cooperatives fall under the auspices of the Department of Cooperatives (DoC).

The Nepali authorities have been actively promoting access to financial services through a wide range of (i) institutions, (ii) policies and (iii) funds and subsidized credit schemes.

The Nepali authorities have pushed the access to finance agenda by directly assuming ownership in a variety of financial institutions:

- **Regional Rural Development Banks (Grameen Bank replicators³):** Purbanchal, Sudur Pashchimanchal, Pashchimanchal, Madhya Pashchimanchal and Madhyamanchal Grameen Bikas Banks were established in 1992 to bring the rural population into the formal financial channel and to channel micro-credit to micro-industries, agro business and trading among others in the rural area. In October 2012, it was decided to merge the five banks and form a national level development bank, although the merger has not yet taken place. Four Grameen replicator banks are insolvent, have high NPLs (unlike the rest of the sector), high operating costs, low productivity and unionized labor.
- **National Cooperative Bank Limited (NCBL):** The NCBL was established in 2003, as the only umbrella bank in the cooperative movement of Nepal to provide banking and financial services to all cooperatives. It was established under the Cooperative Act, 1992 (first amendment, 2000) and received a banking permit from NRB. The GoN has a small equity ownership of NPR10 million. The bank works with 6,309 member cooperatives in 72 out of 75 districts.
- **The Small Farmers' Development Bank** is a government-owned apex institution that channels funds to farmer cooperatives to be on-lent to small farmers. It is categorized as a "D" class bank. Besides providing funds to cooperatives and MFIs, it also supervises its client cooperatives' and MFIs' activities to ascertain adherence to prudential regulations and provides technical and capacity building assistance to its client institution.
- **State-controlled banks:** The three class A state-controlled banks – Rastriya Banijya Bank (RBB), Agriculture Development Bank Limited (ADBL), Nepal Bank Limited (NBL) – account for 22% of class A banks total assets, 20% of deposits, and 18% of lending. The state also owns NIDC Development Bank, a class B bank. These state-controlled banks do not have a specific developmental mandate but do provide certain public services⁴, and as a consequence have been competing with each other and against private banks.

The NRB has introduced several new policies aimed at reallocating banking credit towards underserved productive sectors, and lowering the cost of credit, in addition to pre-existing deprived sector lending targets:

- **Deprived Sector Lending:** The policy has been in place since the 1990s, whereby NRB mandates that a percentage of the total loan portfolio of banks and financial institutions (BFIs) be lent to the "deprived sector", defined as "low income and especially socially backward women, tribes, lower caste, blind, hearing impaired and physically handicapped persons, marginal and small farmers, craft-men, labor and landless families". Currently,

³ These are microfinance institutions (MFIs) modelled after the Grameen Bank model of uncollateralized group lending. There is one bank for each region of the country. The five banks fall in the class D category.

⁴ RBB and NBL are the main agents of the government for expenditure disbursements and revenue collection. They also claim to be promoters of access to finance in remote areas. ADBL and NIDC were originally established to focus on agriculture and manufacturing respectively.

4.5%, 4%, and 3.5% of Class, A, B and C banks' loan portfolios respectively have to be lent to this sector.

- **Productive Sector Lending:** the NRB has issued new regulation requiring class A institutions to lend 20% of their portfolio to agriculture, energy, tourism, cottage and small industries (of which 12% has to be lent to agriculture and energy) by mid-July 2015.⁵ The NRB has also directed development banks and finance companies to raise the level of their lending to the productive sector to 15% and 10% respectively by mid-2016.
- **Cap on the deposit-lending spread:** The NRB has issued directives instituting a cap of 5 percentage points of the interest rate spread of class A banks. The NRB has directed all class A banks to reduce their interest rate spread to 5pp to curb the increasing gap in the interest rate the borrowers have to pay and the interest rate depositors get.
- **Cap on fees and commissions:** The NRB is also drafting a regulation to restrict the ability of BFIs to charge fees and commissions, in order to lower the cost of financial services. This is considered a pre-emptive move so that BFIs don't start charging more fees and commissions to compensate for loss in the income from reducing the interest rate spread. NRB is preparing to instruct the banks to reduce fees for cards, collateral evaluation and insurance, and stop charging fees on inactive accounts and is seen as move towards seeking more transparency from the banks.
- **Branch Expansion Policy:** NRB has instituted a branch expansion policy where a bank or financial institution must establish three branches outside the Kathmandu valley to open a branch inside Kathmandu valley (an increase from two branches outside the valley in the previous policy). These three branches should include at least one branch in one of the 14 under-served districts designated by the NRB⁶, one branch outside any district headquarters or municipality, and one branch as per the bank's own interest outside the Kathmandu valley. NRB accords a priority to open branches outside the ring-road or in the VDCs inside Kathmandu valley.
- **Branch Expansion Loan:** the NRB is offering a 6-month interest free loan to BFIs to open branches in 22 remote districts, and no prior approval is needed from the NRB to open these branches. For Class D institutions, up to NPR. 2 million at zero interest; for Class A, B, and C institutions, loans of up to NPR 5 million for opening branches in headquarters of those districts and NPR 10 million for expanding branches outside district headquarters.

Finally various public sector agencies are involved in the subsidization of a diverse set of credit schemes

⁵ Productive sector lending comprises (i) agriculture lending that goes to sectors such as cash crops, tea, coffee, tobacco, fruits and floriculture, livestock, bee keeping, fertilizer and pesticide enterprises, cold stores, irrigation and fishery, among others., (ii) lending to the energy sector including hydropower and renewable energy projects, (iii) tourism, covering trekking, travel agencies, mountaineering, rafting, camping, resorts, hotels and recreational activities, and (iv) cottage and small industries refers to industries having a fixed capital of less than Rs 30 million.

⁶ The underserved districts are: Bhojpur, Okhaldhunga, Manang, Rukum, Salyan, Jumla, Mugu, Humla, Kalikot, Dolpa, Jajarkot, Bajhang, Bajura and Darchula.

- **The Rural Self-Reliance Fund (RSRF)** is an apex fund that provides wholesale credit at relatively low interest rates to cooperatives, FINGOs, MFIs, and ADBL operating in rural areas. It was set up in 1991 by the NRB and the government of Nepal to ease credit access to self-entrepreneurs, cottage industries and SMEs to help in the reduction of poverty in the country. It can extend wholesale loans to cooperatives and NGOs working as financial intermediaries and long term wholesale loans to MFIs and Agriculture Development Bank Limited. The borrowers should be based in rural areas and priority should be given to the areas that fall in the poverty map created by the National Planning Commission.
- **The Youth Self-Employment Fund (YSEF)** is managed by Ministry of Finance (MOF), and is funded by a one-time loan from a third of the deprived sector lending requirement in 2010. It was set up to facilitate self-employment programs, and providing orientation, vocational and skills development training to the unemployed youths. YSEF helps provide collateral free loan up to NPR 200,000 for an individual and up to NPR 5,000,000 for a group (max. 25 people) at low interest rate to run commercial farming, agro-based industry or service oriented self-employment programs. If the payment of interest and the loan is made on time, YSEF reimburses 60% of the interest amount.
- **Credit guarantee schemes:** The Deposit and Credit Guarantee Corporation (DCGC) has a twin mandate of deposit insurance and credit guarantees. The credit guarantee component offers three schemes: livestock insurance, SME credit guarantee and a Microfinance credit guarantee. The SME credit guarantee scheme has very little uptake, due to the settlement mechanism where the guarantee can only be invoked once the SME loan is declared non-performing, a process which takes more than a year. The Microfinance credit guarantee scheme is somewhat more used. However both schemes are subject to adverse selection and high transaction costs because they are not portfolio-based.

The policies currently implemented or envisaged imply tangible risks in terms of effectiveness, unintended distortions and stability

A lot has been achieved in Nepal to expand the frontier of outreach but much remains to be done. Although the GoN and the NRB have initiated many programs and policies, they do not amount to an overall strategy and coherent approach towards access to finance. Policies, regulations and laws, introduced to enhance access to finance do not seem to be founded on evidence-based analysis of the underlying problems or an appreciation of best practices from other countries. Also, there is little monitoring as to whether policies have achieved their intended purpose.

The current set of policies raises several serious concerns in terms of effectiveness, and distortionary side effects. The combination of deprived and productive sector targets with the envisaged introduction of the cap on the deposit-lending spread imply restrictions on banks' room to maneuver through both prices and quantities. Of particular concern is the channeling of large amounts of funding through deprived sector lending, which may discourage eligible MFIs from developing products and targeting clients beyond those specified in the policy, leaving a segment of the market unserved by formal financial institutions. In addition, the interest rate spread cap could also prove counterproductive, as it likely induces banks to reduce their exposures to sectors that carry a higher interest rate. Among the sectors likely to be affected are SMEs and

long term finance – precisely two segments that are currently underserved by the banking system. Lastly, restrictions on banks from charging fees in mobile banking will likely dissuade them from investing in innovative delivery channels, due to the inability to recoup their investment costs – although such channels hold significant promise for expanding outreach in the geographically remote areas of the country.

Current policies are also associated with a series of stability risks. To comply with the deprived sector requirements, class A, B and C banks are building up a significant exposure to not only class D financial institutions, but also to the largely unregulated cooperative sector which is known to be problematic. The deprived sector targets may be leading to an oversupply of credit to the bottom of the pyramid, possibly setting the stage for an Andhra Pradesh type microfinance crisis, with incipient signs of personal indebtedness.

The introduction of the 5pp intermediation spread would impact the banking sector's capacity to internally rebuild capital buffers through earnings. It is common knowledge that banks in Nepal frequently “evergreen” non-performing assets. As a consequence, banks are not setting aside the necessary provisions, which leads to a potentially serious overstatement of reported capital adequacy figures. It is unknown which banks are most impacted. The diagnostic review that is to take place later this year should bring greater clarity to the true financial state of the banking system. However, preliminary evidence suggests that the true capital adequacy for the banking sector could be significantly lower than reported. The introduction of a fixed intermediation spread could therefore squeeze profitability at a time when there is a likely need to rebuild capital through earnings.

In part, these problems are symptomatic of the obfuscation of promotion and prudential responsibilities, with the former taking precedence over the latter. This is also illustrated in the mandate of the NRB's class D supervisory department, which explicitly includes regulatory as well as promotional activities. Similar issues affect the DoC that considers itself both promoter and regulator of the cooperatives under its purview. Typically, the promotional activities take precedence over the regulatory responsibilities.

What needs to be done? Strengthen the enabling environment for the market to operate smoothly and efficiently.

The difficulties that Nepal is experiencing in terms of limited reach of the financial system and the high cost of finance are, to a large degree, typical for low income countries. At a fundamental level, the lack of depth and the high costs of finance reflect a series of structural weaknesses in the overall lending environment that exacerbate information asymmetries between lenders and borrowers. The sectors that are typically underserved by the financial system, particularly SMEs and households, are among the most impacted.

To minimize the need for potentially distortionary policies and let the markets allocate credit efficiently the emphasis should be to strengthen the enabling environment. Administrative measures to influence the amount and cost of credit to underserved sectors does not address the root causes. Put differently, the current set of policies target the symptoms of deeper structural weaknesses, rather than addressing the issues at the very root. Specific areas of

action would include: improving the credit information bureau (CIB) and implementing the long-overdue secured transactions framework.

Financial infrastructure improvements reduce the information asymmetry that constrains access to credit and raise the costs and risk of financial intermediation. CIB's information is only collected quarterly, above an NPR 1 million (US\$ 10,000) threshold, thereby excluding exactly those smaller borrowers that stand most to gain.⁷ Many banks reportedly do not meet these requirements without penalty, undermining the quality of information. In addition, the lack of a unique identifier means that verification of information is time-consuming and prone to error.

The implementation of a secured transactions framework and collateral registries could make the use of collateral more feasible, particularly the kind of lower value movable collateral that is more suited to microenterprise loans. The Secured Transactions Act has been in place since 2006 but has not yet been implemented. The law provides for the establishment of a Registrar's Office, and the operation of an electronic registry, which is pending. Banks have reported numerous cases of multiple charges on the same movable collateral. This has resulted in many disputes, prolonging debt enforcement, and explains the over-collateralization of loans and the over-reliance on immovable collateral.

To advance innovations in retail electronic payments in the spheres of internet and mobile banking, cross-border inward remittances and cards, it is an urgent priority to establish interoperability of cards, switches and mobile payments, as well as to incentivize other innovations.

In addition, weaknesses in the debt enforcement and insolvency framework weigh heavily on the lending environment. Although the passage of new laws has helped to improve the regulation of NPLs, there are several inconsistencies between the various pieces of regulation, creating confusion amongst creditors, and leading to time-consuming court disputes. Also, the 5 specialized Commercial Benches of the Court of Appeal are typically ill-prepared to deal with matters pertaining to companies law in large part due to the very short tenure of the judges. As a consequence, there is poor continuity in knowledge and weak uniformity of judgments. The effectiveness of the Debt Recovery Tribunal (DRT), which is used by both secured and unsecured creditors, is compromised by onerous threshold requirements, and time consuming proceedings, reducing the likelihood of creditor recovery. While the enactment of the Insolvency Act 2006 was an important landmark, providing the legal framework for corporate liquidations and restructurings, liquidations under the Act are rare and those that take place are excessively long.

Complementing these improvements in the enabling environment, there is also substantial scope for making markets work better. While the outcomes of the spread decomposition analysis point to an imperfect functioning of markets, these should be addressed by strengthening the preconditions for markets to function. This points to a need to establish a more robust competition authority⁸ and but also to enhance transparency in the disclosure of the

⁷ The CIB is launching a Microfinance bureau in July 2014, but the enabling NRB regulations have yet to be issued.

⁸ The Competition Promotion and Market Protection Act was enacted in 2007 and a Board was set-up, but it is either weak or non-functioning.

effective cost of financial services in an environment characterized by low levels of financial literacy. This could be done by designing a methodology to calculate, disclose and monitor the cost of basic financial products in a standardized and comparable manner for typical user-groups. These measures could usefully complement newly introduced transparency and disclosure guidelines, and would be helpful in enabling consumers to make educated financial decisions by facilitating the comparison between different providers and similar types of financial products. Similarly, to promote true competition in loan pricing, the practice by banks of charging prepayment penalties for regular loans could be restricted so that consumers can more easily switch between various suppliers.

Overall it would make sense to restore the balance between stability and development objectives of policy. A natural goal for any policy framework aimed at improving financial access is to maximize, on a sustainable basis, the availability to as wide a range of users as possible of suitable financial products at affordable prices. It is equally crucial, however, to ensure that policies to improve access do not compromise soundness and stability of the financial system.

Until the liquidity crisis of 2011, developmental objectives appear to have taken precedence over stability. However, even the more recent set of policies aimed at strengthening access to finance, could potentially lead to a steady build-up of risks in various parts of the financial system. These challenges justify a recalibration of the policy stance, and likely require a stronger separation between potentially conflicting regulatory and promotional mandates. More specific measures to reconsider include (i) the discontinuation of the liberal licensing policy for class D financial institutions, (ii) the deprived sector lending targets, which lead to the build-up of exposures of the banking system to risky and under-regulated cooperatives, and which has set the stage for a microfinance credit boom, and (iii) the cap on the intermediation spread which could limit bank profits and affect the ability of banks to provision adequately and build their capital.

Lastly, it would be helpful to adopt a more structured and strategic approach to public policy interventions aimed at strengthening access to finance. The starting point for public policy should be a thorough gap analysis, explicitly specifying in detail the unmet demand for financial services (i.e. “market failure”). The assessment should then inform policies aimed at strengthening the provision of suitable financial products at affordable prices. Cost and benefit of new policies should be assessed systematically and built around the strategic priorities emerging from the gap analysis. New measures should be subjected to a more rigorous impact assessment, while the effectiveness of existing measures should be assessed periodically. The different institutions, programs, policies and directives also need to be analyzed and reviewed collectively, to eliminate contradictions and unintended side-effects. The upcoming Financial Sector Development Strategy (FSDS) provides a window of opportunity for developing a more coherent and effective access to finance framework.