Nepal Development Update

The challenging path ahead

April 2018

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The Nepal Development Update is produced twice a year with the following two main aims: to report on key economic developments over the preceding months, placing them in a longer-term and global perspective; and to examine (in the Special Focus section) topics of particular policy significance. The Update is intended for a wide audience including policy makers, business leaders, the community of analysts and professionals engaged in economic debates, and the general public.

This Update was produced by the World Bank Macroeconomics and Fiscal Management (MFM) team for Nepal consisting of Damir Cosic, Sudyumna Dahal, Saurav Rana, Roshan Bajracharya under the guidance of Manuela Francisco. Jyoti Pandey and Jasmine Rajbhandari contributed to the special focus section. Sabin Shrestha contributed to the analysis of the financial sector. Mona Prasad, Christian Eigen-Zucchi and Bigyan Pradhan provided helpful comments. Rajib Upadhyya and Richa Bhattarai managed media relations and dissemination. Diane Stamm edited the document. Sunita Kumari Yadav managed the publication process.

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Cut-off date for data included in this report was April 9, 2018.
Credit growth slowdown continues as the contribution of net foreign assets to growth of money supply has dissipated. Money supply (M2) growth is at a record low. As a result, the REER has depreciated for the first time in five years. Inflation has remained broadly stable, with the exception of February 2018. …and is being outpaced by the widening trade deficit, resulting in larger current account deeper into deficit. The widening trade deficit and declining growth of remittances are pushing the current account deeper into deficit. In volume terms, imports of petroleum products have reached a record high. …driven by imports of industrial and capital goods. Imports continue to grow at a double-digit rate while exports are finally showing some signs of recovery. While central government revenue remains strong, growth of spending has increased even faster. The widening trade deficit and declining growth of remittances are pushing the current account deeper into deficit. Inflation continues to remain subdued. Money supply growth is at a record low. Credit growth has moderated but deposit mobilization declined faster, squeezing banks’ ability to lend. Stock market turns downward. Growth of remittances continues to slow. …and is being outpaced by the widening trade deficit, resulting in larger current account deficit. …leading to a decline in foreign reserves. Inflation has remained broadly stable, with the exception of February 2018. As a result, the REER has depreciated for the first time in five years. Money supply (M2) growth is at a record low. as the contribution of net foreign assets to growth of money supply has dissipated. Credit growth slowdown continues.
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Abbreviations

CCD  credit-to-core-capital-and-deposits ratio
FDI  foreign direct investment
FY  fiscal year
GDP  gross domestic product
M2  broad money supply
MoF  Ministry of Finance
NEPSE  Nepal Stock Exchange
NPLs  nonperforming loans
NPR  Nepalese rupee
NRB  Nepal Rastra Bank
REER  real effective exchange rate
SSA  Social Security Allowances
y-o-y  year-over-year
Executive Summary

Recent Economic Developments

There has been a broad-based upturn in the global economy on the back of a rebound in investment, manufacturing activity, and trade. Despite a marginal slowdown, growth in South Asia remained strong at 6.5 percent in 2017. The slight slowdown was a consequence of temporary disruptions from adverse weather conditions across the regions.

Economic activity in Nepal, after a strong rebound in FY2017, was adversely affected by floods during the first half of FY2018. As a result of severe flooding in the southern plains, paddy production is estimated to have contracted by 1.5 percent from the record-high output the year before. The contribution of industry and service sector is expected to remain strong.

Exports are showing signs of recovery, primarily driven by higher exports to India as disruptions from demonetization and introduction of the Goods and Services Tax dissipate. However, increased imports of reconstruction-related capital and industrial goods has widened the trade deficit. With slower growth in remittances, the current account deficit is pushed deeper into deficit. The outflow of migrant workers, which reached a five-year low in FY2017, continues to contract.

Owing to weak growth in remittances, growth of deposits in the banking sector has also slowed. Credit growth, which peaked during first half of FY2017, moderated to 16 percent, but remained higher than the growth of deposits at 12 percent. Consequently, the availability of loanable funds at the banks has remained tight. Banks can lend up to 80 percent of their local currency deposits and core capital and are running up against this regulatory limit. As a result, banks have increased interest rates to attract new deposits and, with unchanged spreads, lending rates have also increased, reaching a five-year high. Money supply growth is the lowest in recent years because of no contribution from net foreign assets and a slowdown in private sector credit growth.

With increased imports, tax collection was strong in the first half of FY2018, growing at 19.3 percent year-over-year. However, expenditure growth has been double that of revenue. Both recurrent and capital spending of the central government have picked up considerably compared to previous years. The first year of a budget system under a federal setup has
resulted in a sizable increase in the fiscal transfers to subnational governments. However, given the unfinished fiscal architecture in the federal setup, execution has been low. Of almost 8 percent of GDP transferred to the subnational governments so far in FY2018, less than 40 percent has been spent. Further, lack of consolidated data on public spending is posing a challenge in assessing government’s fiscal position within an on-going fiscal year.

**Outlook, Risks, and Challenges**

Economic growth in FY2018 is projected at 4.6 percent and is expected to average 4.3 percent during the forecast period, as growth moderates in line with potential. Construction is expected to remain strong, driven by reconstruction efforts, capital projects and construction of several big hotels. The industrial sector is also expected to remain strong with commissioning of new hydropower projects and cement factories, and due to improvements in power supply to industries. The services sectors are, however, expected to be adversely affected by the possibility of a further slowdown in growth of remittances.

Inflation is expected to be below the central bank’s target of 7.5 percent. Meanwhile, the current account deficit, which was marginal in FY2017, is expected to widen as the growth of imports remains strong, while remittances ease and exports grow modestly. The persistence of a large current account deficit will likely put pressure on Nepal’s foreign exchange reserves, which are currently adequate.

With increased government expenditure the fiscal deficit is expected to widen in FY2018 and during the forecast period. Debt-to-GDP ratio is low at 27 percent in FY2017 and is likely to grow relatively faster but remain sustainable during the forecast period.

Nepal successfully conducted elections at all three tiers of government, that is, the local, provincial, and federal levels, thereby completing decade-long political transition. The coalition government commands more than a 3/4 majority in the parliament. However, the new government faces a challenging path ahead.

The cost of establishing and running a federal system of government, the need for post-earthquake and flood reconstruction, higher spending on social assistance programs, and larger outlays on much-needed infrastructure are likely to result in significant increases in government spending. In addition, improving human resource capacity in the newly created subnational governments remains a critical priority. All of these are expected to increase public spending.

The risks from the external environment are increasing as well. The decline in migrant worker outflow has continued. Growth of remittances has significantly slowed over the last two years and further slowdown could result in a sharper deterioration in the balance of payments. This could further adversely affect growth of deposits in the financial sector.

**Special Focus**

This edition of the *Update*, assesses the challenging path ahead facing the new government by taking a closer look at what has driven government spending post 2015, how expensive the transition to a federal structure could potentially be and how can the two be managed.

Even before the transition to the federal structure of government has started, fiscal pressures have mounted. From an average of 20 percent of GDP (FY2012–FY2014), total government spending has increased to 30 percent of GDP by FY2017. This is likely to further increase because transition costs of restructuring the government are estimated at 3 to 4 percent of GDP per year in the next four years.

To manage these pressures more adequately, a two-pronged approach is proposed. First, it is necessary to revisit increases in spending over the last few years and eliminate wasteful spending while improving the efficiency of necessary and productive spending. Second, a properly sequenced and time-bound transition plan is needed that would guide the transition to a federal system of government, anchor citizen expectations, and allow for detailed costing of the transition. It should be adopted at the earliest and rigorously executed by the new government.
A. Recent Economic Developments

Global growth picked up and growth in South Asia remained strong despite adverse weather conditions.

There has been a broad-based upturn in the global economy on the back of a rebound in investment, manufacturing activity, and trade. Global growth in 2017 increased to 3 percent from 2.4 percent in 2016. Global investment growth—accounting for three-quarters of the acceleration in global growth—was supported by favorable financing costs, rising profits, and improved business sentiment across both advanced economics and emerging markets and developing economies. This investment-led recovery is providing a substantial boost to global exports and imports in the near term (World Bank 2018).

Despite a marginal slowdown, growth in South Asia remained strong at 6.5 percent in 2017. The slight slowdown was a consequence of temporary disruptions from adverse weather conditions across the regions. In India, businesses’ adjustment to the newly introduced Goods and Services Tax also played a role. Growth in South Asia continues to be higher than in other regions, albeit marginally from East Asia, which grew at 6.4 percent in 2017 (World Bank 2018).

In Nepal, agriculture has been affected by floods, but other sectors remain strong.

After a strong rebound in FY2017, economic activity, primarily agriculture, has been adversely affected by floods during the first half of FY2018. Severe floods in mid-August of last year, the third major shock in three consecutive years, caused widespread devastation. Over 1.7 million people have been affected by flooding and landslides affecting more than one-third of the country. Bridges, roads, and other infrastructure were also damaged (United Nations 2017). As a result, economic activity, and primarily agriculture, was affected. Agricultural sector output, which was earlier expected to be bountiful, was already somewhat affected by below-average rainfall during June and July (Figure 1). The brief but heavy downpours during mid-August caused severe flooding in the southern plains and destroyed 64,000 hectares of standing crops. As a result, paddy production is estimated to contract by 1.5 percent from the record-high output of 5.23 million tons the year before (Figure 2).

Other sectors, although temporarily affected, rebounded quickly and have remained robust. The contribution of industry is expected to have
remained strong with the addition of hydropower capacity and the post-flood and post-earthquake reconstruction. Nearly 61 megawatts were added to the national grid in the first half of FY2018. The much awaited Chameleia hydropower project (30 megawatts), which was originally planned to be completed in 2011, finally came online in early 2018. After two years of slow progress, post-earthquake housing reconstruction has also picked up. Of the 667,662 beneficiaries eligible for housing grants, over 85 percent have been enrolled and received the first tranche in February 2018 (Figure 3). More than 40 percent of the houses are under construction as beneficiaries start receiving grants, and disbursement of the second tranche has also picked up, but third-tranche disbursements are still low. Capacity utilization of manufacturing industries has also improved on the back of improved power supplies. Growth in the services sector continues to be driven by trade and hotels. Tourist arrivals have remained strong and reached a record high in the fall tourist season (September–November) of 2017 (Figure 4).

On the demand side, a pickup in both private and public investment has supported growth. Though still very low at less than 1 percent of GDP, FDI in the first half of FY2018 was at a record high of US$140 million, an increase of 94 percent year-over-year (y-o-y), driven by
investment in the cement industry. Consumption, however, is expected to have softened as remittances have grown at one of the lowest rates in years. Government consumption is robust, especially as the transition to a new federal structure is necessitating an increase in spending at the subnational levels, and due to election-related spending. Even after netting out the fiscal transfers, the recurrent spending is 30 percent (y-o-y) in the first half of the fiscal year.

**Imports continue to grow at a double-digit rate while exports are finally showing some signs of recovery**

**Higher imports have become a new normal.** Goods imports continue robust double-digit growth averaging US$833 million per month in the first half of FY2018. This is well above the five-year average of US$557 million (Figure 5). The growth has been driven by both oil and nonoil imports. Among nonoil imports, consumer goods and household food items have remained fairly flat most likely due to a slowdown in growth of remittances. Both industrial and capital goods imports, however, have remained strong driven by materials needed for reconstruction and infrastructure projects (Figure 6).

**Oil imports are reaching pre-commodity collapse-era levels (Figure 7).** Oil imports, which were averaging US$73 million per month after the commodity price collapse of 2014, reached US$106 million per month in the first half of FY2018. This is similar to the level recorded before the collapse of international oil prices in 2015. However, this increase is driven not just by price, because international oil prices have remained well below the pre-2014 prices. Hence, oil imports in volume terms have also increased considerably. While some of the oil imports may have been driven by activities related to reconstruction and capital projects, the imports have particularly spiked in the election months. Hence, whether this is a temporary phenomenon or a permanent level shift is yet to be seen.

**Exports are finally showing signs of recovery (Figure 8).** Nepal's exports, which never fully recovered following the end of the trade blockade, steadily picked up pace through the
first half of FY2018, growing 28.8 percent (y-o-y) for the three months until February 2018. Following the earthquake and trade disruption, the exports demand may have further been dampened by disruptions caused by demonetization and the introduction of the Goods and Services Tax in India. As these disruptions dissipated and as the Indian economy regains its footing, Nepal’s exports to India are also recovering (Figure 9). The recovery in exports is primarily driven by industrial supplies and food products. However, with average exports of US$72 million per month so far in FY2018, they remain below their five-year average (Figure 9). Exports to China have also seen robust growth but still comprise only 5 percent of total exports, while exports to India account for 60 percent. Hence, even a smaller growth of exports to India provides a greater thrust on overall improvement in exports.

While central government revenue remains strong, growth of spending has increased even faster

Central government revenue continues to remain strong on the back of growing imports. Both tax and nontax revenues are growing at healthy rates and the central government has met the six-month revenue target. Taxes and levies on imports (including the value-added tax

**FIGURE 8.** Exports of goods are showing signs of recovery.

<table>
<thead>
<tr>
<th>(US$ millions, 3-month moving average)</th>
<th>(percent change, y/y)</th>
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</thead>
<tbody>
<tr>
<td>Exports Growth (right)</td>
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<tr>
<td>Exports 5-Year Average</td>
<td></td>
</tr>
</tbody>
</table>

**FIGURE 9.** Exports to India are picking up largely because exports to India are picking up

<table>
<thead>
<tr>
<th>(US$ millions, 3-month moving average)</th>
<th>(percent change, y/y)</th>
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<tbody>
<tr>
<td>Exports to Other Countries</td>
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<tr>
<td>Exports to China (5-Year Average)</td>
<td></td>
</tr>
<tr>
<td>Exports to India (Growth of Exports to India)</td>
<td></td>
</tr>
</tbody>
</table>

**FIGURE 10.** As imports grow, government revenue continues to remain strong

<table>
<thead>
<tr>
<th>(NPR billions, 3-month moving average)</th>
<th>(percent change, y/y)</th>
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<tbody>
<tr>
<td>Revenue Growth (right)</td>
<td></td>
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<tr>
<td>Total Revenue</td>
<td></td>
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</tbody>
</table>

**FIGURE 11.** Growth of government spending has increased even faster

<table>
<thead>
<tr>
<th>(NPR billions, 3-months moving average)</th>
<th>(percent change, y/y)</th>
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</thead>
<tbody>
<tr>
<td>Total Expenditure</td>
<td></td>
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<tr>
<td>Expenditure Growth (right)</td>
<td></td>
</tr>
</tbody>
</table>
and excise imports) amount to approximately 43 percent of the government’s domestic revenue or nearly 10 percent of GDP. The strong growth of imports is translating into strong revenue collection for the government, which has increased by 19.3 percent (y-o-y) in the first half of FY2018 (Figure 10).

However, expenditure growth has been double that of revenue (Figure 11). Both recurrent and capital spending of the central government have picked up considerably compared to previous years. While capital spending has increased on the back of the construction of various government projects, recurrent spending growth has been driven by a sizable increase in fiscal transfers to subnational governments and election-related spending. Even after netting out the fiscal transfers to local governments, recurrent spending growth has been high at 30 percent (y-o-y).

More importantly, transfers to subnational governments are not necessarily translating into higher spending. Of the NPR 147 billion transferred to subnational governments in the first half of FY2018, NPR 93 billion remained unspent. The Constitution (2015) stipulates mandatory grants to subnational governments, which started in FY2018 and to be transferred in three tranches. By mid-March, all three tranches amounting to NPR 225 billion had been transferred. FY2018 is the first year under the federal setup; subnational governments are in place, but eight months into the fiscal year, many are still grappling with basic functions, especially at the provincial level. As a result, given the unfinished fiscal architecture in the federal setup, realizing expenditure is proving to be difficult. Subnational governments, while receiving funds from the federal government, may not have the capacity or be ready to execute public services assigned in the constitution, leading them to retain the funds in the Local Authorities Account at the central bank. In addition, in federal Nepal, subnational government spending from own-source revenues also needs to be consolidated, not an easy task due to the lack of a system to track the spending.

Budget deviation, which increased sharply in the last two years due to unrealistic budget estimates, continued in FY2018. Despite the increase in spending so far in FY2018, including record-high capital spending, the ambitious expenditure envisioned in the budget is unlikely to materialize (Table 1). Hence, the Ministry of Finance (MoF) in its midyear budget review has revised its expenditure estimate down by 25 percent of the original FY2018 budget. The overly ambitious and unrealistic appropriations envisioned in the budget is becoming a recurring theme in Nepal.

The widening trade deficit and declining growth of remittances are pushing the current account deeper into deficit.

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**Table 1. Selected fiscal indicators**

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</thead>
<tbody>
<tr>
<td><strong>Total Revenue and Grants</strong></td>
<td>20.6</td>
<td>20.8</td>
<td>23.2</td>
<td>25.9</td>
<td>25.4</td>
<td>28.3</td>
<td>26.5</td>
</tr>
<tr>
<td>Total Domestic Revenue</td>
<td>18.8</td>
<td>19.3</td>
<td>21.6</td>
<td>21.8</td>
<td>24.1</td>
<td>25.8</td>
<td>25.1</td>
</tr>
<tr>
<td>Tax</td>
<td>15.9</td>
<td>16.7</td>
<td>18.7</td>
<td>19.6</td>
<td>21.5</td>
<td>23.5</td>
<td>22.7</td>
</tr>
<tr>
<td>Nontax</td>
<td>2.6</td>
<td>2.3</td>
<td>2.7</td>
<td>2.1</td>
<td>2.6</td>
<td>2.3</td>
<td>2.4</td>
</tr>
<tr>
<td>Grants</td>
<td>2.1</td>
<td>1.8</td>
<td>1.8</td>
<td>4.1</td>
<td>1.3</td>
<td>2.5</td>
<td>1.4</td>
</tr>
<tr>
<td><strong>Total Expenditure</strong></td>
<td>18.8</td>
<td>20.1</td>
<td>23.7</td>
<td>38.3</td>
<td>29.4</td>
<td>42.9</td>
<td>32.4</td>
</tr>
<tr>
<td>Recurrent</td>
<td>15.5</td>
<td>15.9</td>
<td>16.5</td>
<td>23.7</td>
<td>19.8</td>
<td>28.4</td>
<td>21.8</td>
</tr>
<tr>
<td>Capital</td>
<td>3.4</td>
<td>4.2</td>
<td>5.4</td>
<td>12.0</td>
<td>8.0</td>
<td>11.8</td>
<td>9.0</td>
</tr>
<tr>
<td>Net Lending</td>
<td>1.1</td>
<td>1.8</td>
<td>1.7</td>
<td>2.6</td>
<td>1.6</td>
<td>2.7</td>
<td>1.6</td>
</tr>
<tr>
<td><strong>Fiscal Balance</strong></td>
<td>0.6</td>
<td>-1.1</td>
<td>-0.4</td>
<td>-12.4</td>
<td>-3.9</td>
<td>-14.5</td>
<td>-5.9</td>
</tr>
</tbody>
</table>

Sources: MoF, MRR for history and estimates; World Bank staff for forecasts.
Note: b=budget, e=estimate, f=forecast.
The outflow of migrant workers, which reached a five-year low in FY2017, continues to contract. During the first half of FY2018, an average of 30,000 Nepalese workers per month departed for employment opportunities abroad (Figure 12). This is the lowest monthly average outflow of migrant workers since FY2011, when the global economy was still recovering from the impact of the 2007–08 global financial crisis. Workers leaving for Qatar, Malaysia, Saudi Arabia, and the United Arab Emirates—four main destinations—continues to remain soft (Figure 13). There are several reasons behind this decline, but the primary one is the cutback of these oil-producing countries on public spending to ease fiscal pressures from the persistently low crude oil prices in international markets.

Slowing remittances are being outpaced by the growing trade deficit, and have resulted in a record-high current account deficit. While the volume of remittances continued to average over US$550 million per month in FY2018, its growth has been slowing (Figure 14). In contrast, the trade deficit continues to surge (Figure 15). With remittances no longer able to finance the trade deficit as in the past, the current account deficit has significantly increased to US$737 million in the first six months of FY2018, up from US$9 million compared to the same period in FY2017.
Foreign exchange reserves have fallen. With FDI and other financing sources remaining low, Nepal’s foreign exchange reserves have been used to finance the growing deficit. Although still comfortable at US$10.2 billion in February 2018 and able to cover 9.8 months of imports (Figure 16), foreign reserves have declined in the last few months from a peak of US$10.6 billion in October 2017.

Inflation has remained low and stable for the last year. Inflation reached a 13-year low in July 2017, and has continued to remain broadly stable, except for February 2018, when it spiked to 5 percent (y-o-y) (Figure 17) due to a sharp increase in vegetable prices. Nonfood items have been driving inflation but have moderated compared to the same period last year. The contribution of nonfood prices to headline inflation declined to 3.3 percentage points in February 2018 from 3.5 percentage points, year-over-year. The contribution of food prices has slightly increased but remains stable. Food prices contributed 1.7 percentage points to headline inflation in February 2018. Lower and stable inflation has also had a positive impact on Nepal’s external competitiveness, with the real effective exchange rate (REER) depreciating over the last six months for the first time since 2013 (Figure 18).

Money supply growth is at a record low
Money supply (M2) growth has slowed because of no contribution from net foreign assets and a slowdown in private sector credit growth. At 13.5 percent (y-o-y) in February 2018, money supply growth is the lowest in recent years (Figure 19). With the slowdown in foreign reserve accumulation, the contribution of net foreign assets to M2 growth has been steadily declining over the last two years. From contributing 18 percentage points to M2 growth in February 2016, its contribution fell to 0.3 percentage points in February 2018 (Figure 20). Similarly, the contribution of private sector credit to M2 declined to 13.2 percentage points in February 2018 from a peak of 23.1 percentage points in February 2017.
Credit growth continued to slow as lending to most segments of the market declined. Credit growth in February 2018 stood at 16.7 percent (y-o-y), which is a significant decline from the peak of 31.9 percent in February 2017 (Figure 21). The initial credit slowdown during the second half of FY2017 was precipitated by a temporary restriction on lending channeled for consumption and for speculative purposes when the availability of loanable funds dried up in the banking system. The aim of these restrictions was to slow the overall growth of credit. While the restrictions have since expired, growth rates of vehicle loans, margin lending, and overdraft loans have remained subdued because criteria to provide loans to these sectors have remained relatively stricter than before. In contrast, lending for commercial purposes (such as working capital loans, term loans, and so forth) picked up to 17.9 percent (y-o-y) in February 2018 after having slowed to 14.1 percent (y-o-y) at the end of FY2017, indicating a likely pickup in commercial activity (Figure 22).

Deposits have not picked up and continue to squeeze banks’ ability to lend. Deposit growth decelerated to 11.1 percent (y-o-y) in February 2018 (Figure 23). The growth in deposits has declined steadily for two years since it peaked at 24.2 percent in FY2016.
percent (y-o-y) in December 2015. The cumulative impact of slower deposit growth compared to credit growth once again led to a rise in the credit-to-core-capital-and-deposits ratio (CCD) to 77.2 percent in January 2018 (Figure 24). It is approaching a similar level to a year ago (78.1 percent in January 2017), when the central bank intervened with measures to curb lending and, to allow banks some extra space for lending, temporarily changed the method of calculating CCD ratio of banks. While these measures did slow lending, and provided breathing space for banks, the fundamental issue of the credit crunch persists because banks have not been able to increase deposit mobilization even as credit growth has dampened.

The government’s continued borrowing, even as it accumulates large deposits, is likely to have contributed to the problem. Government borrowing reached NPR 365 billion in February 2018, even as the government’s deposit in the NRB account stood at NPR 302 billion (Figure 25). The government borrowed heavily at the end of FY2016 in anticipation of massive spending in FY2017, which did not materialize. As a result, the Government of Nepal’s deposits remained in the central bank. This situation has been repeated in the current fiscal year as well. The government borrowed from the market primarily to fund the fiscal transfers of the local bodies. However, as the spending of the local bodies has been low so far, the government deposits at the Local Authorities Account of the central bank has increased. These deposits, which are held at the NRB, effectively remain outside the banking system, and have contributed to creating and sustaining the credit squeeze in the financial system. The effect is similar to monetary operations by central banks employed to “mop up” excess liquidity.

While deposit and lending rates have gone up, there are signs of anti-competitive behavior by commercial banks to maintain them at these levels. With bank CCD ratios approaching the regulatory limit, some banks are attempting to mobilize deposits more aggressively by offering higher interest rates. As a result, the weighted average deposit rates reached 6.4 percent in February 2018 (Figure 26), the highest recorded level in recent years. Although it has narrowed somewhat, the spread between deposit and lending interest rates spread has remained fairly stable. As a
result, the rise in deposit rates is pushing up lending rates as well. The weighted average lending rate climbed to 11.9 percent in February 2018. Higher interest rates have not attracted many fresh deposits, but rather contributed to shifting of deposits among banks. Feeling squeezed by the CCD ratio limit, some banks’ attempts to attract new deposits by offering higher rates in excess of 10 percent have been curtailed by the Nepal Bankers’ Association. This is a clear example of anticompetitive behavior by coercing banks to maintain interest parity among themselves.

While nonperforming loans (NPLs) remain low, the vulnerability in the financial sector may be increasing. Nearly all loans in Nepal have variable interest rates. The recent uptick in lending rates affects not only newly issued loans, but virtually all the existing loans as well. A continued increase in interest rates might have an adverse effect on the ability of some borrowers to service their loans, potentially leading to a greater number of NPLs. At present, asset quality in the banking sector remains solid as NPLs account for only 1.7 percent of total loans. Further, banks have prudent capital backing, with an average Capital Adequacy Ratio of 14.1 percent. While banking sector stability appears sound at the aggregate sector level, the recurring problem of the shortage of loanable funds and increasing borrowing costs could lead to deteriorating asset quality for individual banks. In turn, this could have an adverse impact on their profitability and stability.

Stock market turns downward

The Nepal Stock Exchange (NEPSE) index contracted by 5.1 percent in March 2018 to drop to its lowest point in the past year. The downward trend of the NEPSE index reaching 1,286 points is likely a market correction following the NEPSE index’s surge to a historic high of 1,820 points in October 2016 (Figure 27). The credit crunch in the domestic market has likely had an impact on the stock market. With banks having limited loanable funds and increasing borrowing costs, investors have decreased their borrowing to invest in the stock market. In addition, the restriction imposed by the NRB for issuance of margin loans and overdrafts has decreased the amount of borrowed money being channeled into the stock market (Figure 28).
B. Outlook, Risks, and Challenges

Outlook

Looking ahead, economic growth is expected to be in line with earlier forecasts of 4.6 percent in FY2018. Economic activity, particularly agriculture, which was expected to progress well in FY2018, was set back by the worst flooding in decades. Over the medium term, growth will remain moderate, in line with the potential, averaging 4.3 percent in the forecast period (Figure 29). By 2020, output growth will be close to its potential rate of 4 percent. The key challenge for the Nepalese economy during the forecast period will be managing both a fiscal and current account deficit, which are expected to persist.

On the supply side, the service sector is expected to continue driving growth but is likely to be affected by uncertainty stemming from a further slowdown in remittances. Services are expected to grow at 5.5 percent on average in the forecast period, more slowly than in previous years. Growth will be driven by trade, tourism, and transport. However, the outlook in services is also dependent on remittances, particularly given the large share of wholesale and retail trade subsectors. The boost in tourism is expected to continue in the forecast period but will be constrained by the infrastructure deficit. For example, Tribhuvan International Airport, the only international airport in Nepal, is already reaching its limit in terms of passenger arrivals per year. While agriculture will be affected in FY2018, it is expected to grow thereafter in line with its historical average growth rate, as no major irrigation projects are expected to be completed during the forecast period. Industry is likely to continue getting a boost in FY2018, as the construction subsectors continue to perform well. Reconstruction activities are expected to continue to pick up at a relatively faster pace in the remainder of FY2018 and are expected to grow during the forecast period. Construction of several big hotels is also expected to aid this subsector. Manufacturing is also expected to pick up due to better availability of electricity, new cement factories, and improving prospects for export to India.

On the demand side, gross investments are expected to drive growth, while consumption is expected to slow. Growth in gross fixed capital formation is expected to remain strong during the forecast period. Public investment will remain robust in FY2018, with projects like the Babai Irrigation Project picking up. Private investment is also expected to remain strong. The record-high FDI in FY2018 is a positive sign and could be sustained with improvement in overall...
TABLE 2. Nepal macroeconomic outlook
table shows annual percent change unless noted otherwise.

<table>
<thead>
<tr>
<th></th>
<th>FY2015</th>
<th>FY2016</th>
<th>FY2017e</th>
<th>FY2018f</th>
<th>FY2019f</th>
<th>FY2020f</th>
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<tr>
<td>Real GDP Growth, at Constant Market Prices</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Private Consumption</td>
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<td>0.4</td>
<td>7.5</td>
<td>4.5</td>
<td>4.5</td>
<td>4.2</td>
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<td>1.9</td>
<td>1.8</td>
<td>1.7</td>
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<td>Gross Fixed Capital Investment</td>
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<td>15.0</td>
<td>9.7</td>
<td>7.1</td>
</tr>
<tr>
<td>Exports, Goods and Services</td>
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<td>-13.7</td>
<td>16.9</td>
<td>8.0</td>
<td>8.8</td>
<td>9.8</td>
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<tr>
<td>Imports, Goods and Services</td>
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<td>2.8</td>
<td>22.0</td>
<td>7.4</td>
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<td>3.5</td>
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<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>Agriculture</td>
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<td>0.0</td>
<td>6.3</td>
<td>4.5</td>
<td>4.5</td>
<td>4.2</td>
</tr>
<tr>
<td>Industry</td>
<td>1.1</td>
<td>0.0</td>
<td>5.3</td>
<td>2.7</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Services</td>
<td>1.4</td>
<td>-6.3</td>
<td>10.9</td>
<td>5.5</td>
<td>3.7</td>
<td>3.5</td>
</tr>
<tr>
<td>Inflation (Consumer Price Index)</td>
<td>4.8</td>
<td>2.0</td>
<td>6.9</td>
<td>5.7</td>
<td>5.7</td>
<td>5.1</td>
</tr>
<tr>
<td>Current Account Balance (% of GDP)</td>
<td>5.1</td>
<td>9.9</td>
<td>4.5</td>
<td>4.5</td>
<td>5.0</td>
<td>5.0</td>
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<tr>
<td>Fiscal Balance (% of GDP)</td>
<td>-1.1</td>
<td>-0.4</td>
<td>-3.9</td>
<td>-5.9</td>
<td>-6.2</td>
<td>-6.2</td>
</tr>
<tr>
<td>Debt (% of GDP)</td>
<td>26.6</td>
<td>28.0</td>
<td>27.0</td>
<td>30.7</td>
<td>34.4</td>
<td>37.6</td>
</tr>
</tbody>
</table>

Sources: CBS, MRE, MoF for history and estimates; World Bank staff for forecasts.
Notes: of fiscal balance includes net lending, e = estimate, f = forecast.

Competitiveness, which the current government has made a priority. Growth in private consumption is expected to moderate during the forecast period in line with a more sanguine outlook for growth of remittances. Government consumption, however, is expected to grow substantially in FY2018 and at a slower pace in the remainder of the forecast period. Local elections followed by federal and provincial elections in 2017 have already added to government consumption in FY2018. In addition, implementing a federal structure will further add to government consumption in FY2018 and beyond. Exports of services are expected to continue as tourism continues to pick up. Exports of goods are also expected to grow, albeit modestly in FY2018 and thereafter, considering the normalization of demand in India as the demonetization and the Goods and Services Tax effects subside. Imports growth is expected to remain strong in FY2018 but likely to experience a slowdown in the forecast period, as the consumption-related imports slow because of a decline in remittances.

With increased government spending to implement federalism, earthquake- and flood-related reconstruction, and bigger social assistance programs, the fiscal deficit is expected to widen in FY2018 and during the forecast period. While there is considerable uncertainty on the scope and pace of the implementation of federalism, higher spending is likely because of the establishment cost for subnational governments, increased infrastructure spending by state and local governments, and additional fund transfers for decentralized service delivery. Revenue collection is expected to grow but at a slower rate, with an increase in trade taxes related to import growth. Nontax revenues are also expected to increase because of dividends from institutions (such as Nepal Telecom) and royalties from new hydropower projects (such as Upper Tamakoshi). However, expenditure growth is likely to outpace the increase in revenue, resulting in a wider fiscal deficit of 5 to 6 percent of GDP in the forecasted period (Figure 30). The higher deficit will be financed by domestic and international borrowing. As the domestic borrowing in FY2018 is already high, the space for further increase of domestic borrowing in the forecast period will be limited, putting greater emphasis on international borrowing.

Financing is not expected be a problem yet, due to a low debt-to-GDP ratio of 27 percent of GDP in FY2017 and large government deposits at hand. Debt is likely to grow relatively faster and reach 37.6 percent of GDP by 2020, but is expected to remain sustainable during the forecast period. The joint World Bank-International Monetary Fund Debt Sustainability Analysis (2017) has maintained the “low” risk
The new government faces a challenging agenda. Nepal successfully conducted elections in all three tiers of government, that is, local, provincial, and federal, a first under a new constitution. The new coalition government has been sworn by a 3/4 majority in the parliament has increased the prospect of a stable government for the next five years. The new government faces a challenging agenda with the transition to a federal state.

Managing spending pressure in the context of federalism will pose a challenge. The cost of establishing and running a federal country, the need for post-earthquake and post-flood reconstruction, higher spending on social assistance programs, and larger outlays on much-needed infrastructure could all lead to significant increases in spending. In addition, capacity in the newly created subnational governments is a critical constraint.

The risks to the external environment are increasing as well. The decline in migrant worker outflow has continued. Remittances growth has significantly slowed in the last two years. A further slowdown is likely with the recent policy changes in Gulf Cooperation Council countries, such as the imposition of a value-added tax to ease fiscal pressures arising from low crude oil prices affecting migrant workers’ earnings. A sharper deterioration in the balance of payments could a slowdown in remittances could also affect liquidity in the banking sector.

Inflation is expected at 4.5 percent in FY2018, below the central bank’s target of 7.5 percent. Inflation is expected to pick up slightly owing to the increase in global oil prices and in line with India’s inflation. Nonfood prices are expected to drive the headline inflation as in the last two years, while food prices are expected to remain stable.

### Risks and Challenges

The new government faces a challenging agenda. Nepal successfully conducted elections in all three tiers of government, that is, local, provincial, and federal, a first under a new constitution. The new coalition government has been sworn by a 3/4 majority in the parliament has increased the prospect of a stable government for the next five years. The new government faces a challenging agenda with the transition to a federal state.

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### Figure 29. GDP growth is expected to moderate

### Figure 30. Managing the “twin deficits” will be a challenge
C. Special Focus: The challenging path ahead

Background

The successful completion of historic elections in 2017 marks the completion of the political transition in Nepal that has lasted for more than a decade. The Comprehensive Peace Agreement ended the decade-long insurgency in 2006 and paved the way for a peaceful settlement of Nepal’s political conflict. After more than a decade, the political transition ended in 2017, with successful elections at the federal, provincial, and local levels. Following the elections, the new prime minister was sworn in. The coalition government commands more than a two-thirds majority in the federal parliament. In addition, the same coalition parties forming the government at the federal level also command a majority in six of the seven provincial governments. These results have significantly increased the prospect of a stable government for the duration of its five-year term.

The central task of the new government relates to the successful transition to a federal state. Nepal has embarked on an ambitious path to shift from a unitary to a federal system of government. The new system is expected to fundamentally transform the nature of service delivery and to transform Nepal from a centralized polity to a much more decentralized system of administration. Nepal has chosen to base its new federal structure on two levels of subnational governments that are being established from scratch. Though there were districts and village development committees before, the decision to establish 753 new local governments at the lowest level of the federal system means that extensive institutional capacity will have to be built before local governments have the required capability to perform their constitutional functions effectively. Similarly, little government infrastructure exists at the provincial level. The government has taken some significant steps towards implementing federalism for example, the Inter-Governmental Fiscal Arrangement Act has been adopted, the Fiscal Commission has been established and some key laws pertaining to provincial and local government operations have been approved. Hence, while some basic mechanisms for the new federal arrangements are being put in place full framework of fiscal arrangements, needed civil servants, and robust financial management and reporting systems will need to be developed and capacities augmented at both the state and local levels.
 Trends in public expenditure prior to implementation of the new federal structure

From adoption of the new constitution in late 2015 to formation of new governments in early 2018, government spending has picked up significantly. Over the last decade, Nepal’s fiscal policy has maintained balanced budget thanks to strong revenue growth and underspending of the capital budget, in particular. However, government spending started to increase from FY2015, and there has been a shift upwards in the level of spending since. From an average of 20 percent of GDP (FY2012-FY2014), total government spending increased to 30 percent of GDP by FY2017.

Both recurrent and capital spending have contributed to the increase. (Figure 31 and Figure 32) Recurrent spending as a percent of GDP increased from an average of 15 percent of GDP during FY2012-FY2014, to about 20 percent of GDP in FY2017. The increase in spending has primarily been driven by higher civil service wages, increased social protection spending, and partly by increases in transfers to local governments. For example, social protection spending has grown from 2.5 percent of GDP in FY2011 to 3.7 percent in FY2017. Social protection programs include three categories: (a) social insurance: contributory programs such as pensions and unemployment insurance; (b) social assistance: noncontributory cash transfers such as social security allowances, school feeding and targeted food assistance, and subsidies; and (c) labor market programs: skills-building programs, job-search and matching programs, and improved labor regulations.

Similarly, capital spending, which historically averaged 3 percent of GDP, increased to almost 8 percent of GDP by FY2017. Capital spending has primarily been driven by reconstruction related to earthquake expenditures, but also by much needed spending on capital goods.

As a result, before any concrete steps toward implementation of the federal system of government were taken, fiscal pressures have mounted. The salient fact of this period is that increased spending had little to do with new spending that relates to transition costs to the new federal system of government. The fiscal deficit reached 3.9 percent of GDP in FY2017, from a situation of surplus or marginal deficit in the previous years. While some of the increased spending was for legitimate needs, such as for post-earthquake reconstruction, flood recovery, and public civil works, much of the increased spending has gone to other uses as well. For example, more than 40 percent of the increase in recurrent spending from FY2016 to FY2017 came just from the increase in civil service salaries and social protection spending. The net increase in civil service salaries was about NPR 30 billion (or 1 percent of GDP) in FY2017. Due to the complex indexation methodology of pensions to civil service salaries in Nepal, pension expenses also increased by about NPR 30 billion, another 1 percent of GDP. In addition, the largest social assistance program, the

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**FIGURE 31.** Recurrent spending has increased substantially in the last three years

**FIGURE 32.** Capital spending has more than doubled

Source: Ministry of Finance.
SSA (old-age allowance, single women’s allowance, disability allowance, child grant, and allowance for endangered ethnicities) was doubled in FY2016, which resulted in the total social assistance program reaching NPR 35 billion in FY2017. This is one of the highest expenditures on overall social protection in South Asia as a share of GDP. While increased spending on social protection is needed, current programs and delivery systems need to be reviewed and strengthened for better overage of the poor and vulnerable.

In addition, some of the spending increases have also been for unproductive uses such as discretionary funds for parliamentarians (known as constituency funds) or new vehicles for election commission officers. In FY2017, funding for the constituency fund known as the constituency development program was increased to NPR 5 million per constituency, and funding for the constituency fund known as the constituency infrastructure special program was increased to NPR 30 million per constituency. These funds were spent per the direction of individual parliamentarians, which resulted in total spending of about NPR 10 billion (0.4 percent of GDP). Globally, and in Nepal, such funds to parliamentarians have been criticized as being unproductive and wasteful.

Cost of transitioning to a federal structure

Transition from a unitary to a federal system of government will invariably involve one-off costs. Given the radical restructuring of the system of government that Nepal is undertaking, it is to be expected that it will involve costs, as the new subnational levels of government need to be built up while existing national and local levels require restructuring. These “transition costs” have been estimated using the information publicly available so far. Given that considerable uncertainty exists on the scope and pace of the implementation of federalism, this is just an estimate. In the process, some critical assumptions have been made that drive the results. Should these assumptions not materialize, the results could be radically different.

At present, transition costs of restructuring the government are estimated at 3 to 4 percent of GDP per year over the next four years (Table 3). The employed methodology is a simple one. The current fiscal outlook anticipates total expenditures for all levels of government in Nepal going forward. Then a counterfactual scenario of future expenditures assuming a no-change, or trend-growth, scenario is built. The difference between the two scenarios is the transition cost. Increased spending for the transition is due to establishment costs for state and local governments, additional infrastructure spending by state and local governments, and, additional expenditures for decentralized service delivery. Critical assumptions have been made in this outlook, which are described below.

Critical assumption #1: The consolidated wage bill of the overall government is not expected to change significantly. It is expected that the wage bill at the central level will decline with the decentralization of service delivery, as central-level civil servants get reassigned to subnational governments and the federal-level ministries are significantly reduced. Concurrently, with the devolution of service provision to state and local governments, the civil service bill will increase at the subnational levels. Initial estimates of the number of civil servants to be transferred from the federal government to state and local governments, along with an offer of voluntary retirement packages to those who are not willing to be reassigned, has been included in the calculation.

<table>
<thead>
<tr>
<th>TABLE 3. Estimates of transition costs to a federal system of government (percent of GDP unless noted otherwise)</th>
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</thead>
<tbody>
<tr>
<td>Total Revenues</td>
<td>23.2</td>
<td>25.4</td>
<td>26.5</td>
<td>27.6</td>
<td>28.4</td>
<td>28.9</td>
</tr>
<tr>
<td>Total Expenditure at current trends with transition costs</td>
<td>23.7</td>
<td>29.3</td>
<td>32.4</td>
<td>33.8</td>
<td>34.6</td>
<td>34.3</td>
</tr>
<tr>
<td>Expenditure at current trend w/o transition cost</td>
<td>30.6</td>
<td>31.0</td>
<td>30.7</td>
<td>30.3</td>
<td></td>
<td></td>
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<tr>
<td>Expenditure for transition costs</td>
<td>1.8</td>
<td>2.8</td>
<td>3.9</td>
<td>4.0</td>
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<td></td>
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<tr>
<td>Fiscal Balance</td>
<td>-0.4</td>
<td>-3.9</td>
<td>-5.9</td>
<td>-6.2</td>
<td>-6.2</td>
<td>-5.4</td>
</tr>
</tbody>
</table>

Sources: MoF for history and estimates; World Bank staff for forecasts.
Note: FY2016-17 actual, FY2019-21 forecast.
Critical assumption #2: Spending by subnational governments, and fiscal transfers financing this spending, will grow gradually as the capacity of local and provincial government increases. The essence of a federal system of government is decentralized public service delivery. As subnational governments are constituted and their capacity is built up over time, they will increasingly shoulder greater responsibility for decentralized service delivery. Given the current revenue structure, the bulk of financing for decentralized service delivery will occur through fiscal transfers. Consequently, fiscal transfers are expected to grow from an average of 2 percent of GDP in the pre-federalism era (FY 2013–FY2016), to 6.6 percent of GDP by FY2021. Critically, the bulk of this spending by subnational governments will be reallocation of existing functions, not provision of new or duplicative functions.

Critical assumption #3: One-off establishment costs of subnational governments are expected to account for the bulk of additional spending needed. This spending category is also assumed to be large with additional buildings and vehicles required at the local and state levels for carrying out their activities. The additional cost in this category is assumed to be about 3 percent of GDP between FY2017–FY2021 at the local and state levels. Costs of both temporary and permanent structures have been included in the calculations. The standard per unit cost provided by the government has been used to derive the calculation.

If not addressed adequately, the increased spending needs could lead to fiscal vulnerabilities in the future. To manage these pressures more adequately, we propose a two-pronged approach. First, it would be necessary to revisit increases in spending over the last few years and eliminate wasteful spending, while improving the efficiency of necessary and productive spending. Second, a properly sequenced and time-bound plan that will guide the transition process needs to be developed and implemented.

Review and streamline existing spending

The government can further improve efficiency by carrying out reforms in several other areas, thereby extending the benefits to a greater number of citizens. Several programs have increased in the last few years and it is important to review, consolidate, and improve the efficiency of these programs.

(1) Public sector pensions

Public sector pensions have increased in the last few years, but their coverage is extremely low in terms of total labor force. Nepal’s public sector pension system mostly comprises a noncontributory civil service pension scheme and a mandatory retirement savings scheme via the Employee Provident Fund. Public pension expenditure as a share of GDP has increased from 0.5 percent of GDP in 2007 to 1.5 percent in 2017 (Figure 33). However, the pensions cover less than 3 percent of the total labor force. A majority of the labor force, for example, agricultural workers, who are two-thirds of the labor force, are involved in informal activities without any such facilities or benefits.

Realizing the discrepancy, the government has drafted a bill to introduce a contributory pension system, which is a longer-term objective. It is important, however, to carry out parametric reforms that will provide immediate benefits in the short and medium term. The government has drafted a bill that will reform the public sector pension as a contributory scheme, and this will be important as a long-term reform. Nepal is among the few countries that still have a noncontributory public pension system. However, given Nepal’s nascent capital market and regulatory mechanism, it could be challenging to implement such schemes.
Hence, the government first needs to focus on parametric reforms, as well, which will bring immediate results. For example, currently, civil servant pensions in Nepal increase with the increase in civil service wage, making it difficult to administer the wage and pension policies separately. Decoupling pension increases from civil service wages could lead to substantial government savings. Second, government employees can ask for early retirement and claim their pension at any age after 20 years of service. This means that someone who started a job in their 20s can begin receiving a pension in their 40s, even though the retirement age is 58. Clearer definitions on when pensions can be claimed, with adequate reductions for early retirement, will help reduce pension costs. Reforming the pension system at the federal level before the full rollout of federalism will also be important to allow provincial and local governments to also set up similar systems.

Social assistance programs

Nepal’s social assistance programs have evolved and expanded significantly over the last decade, but many people remain poor and vulnerable. The government implements a wide portfolio of social assistance programs that include cash transfers, public works programs, scholarships, and various health schemes aimed at protecting the poor and vulnerable. The largest program is the Social Security Allowance (SSA), which comprises the old-age allowance, the single women’s allowance, the disability allowance, child grants, and the allowance for endangered ethnicities. The SSA benefits, which ranged from NPR 200 for a child grant to NPR 1,000 for the monthly old-age allowance, which reaches over 2.3 million beneficiaries, were doubled in FY2016. Nepal’s spending on social assistance programs increased from 0.3 percent of GDP in FY2008 to an estimated 1.4 percent in FY2017, making it one of the highest in South Asia (Figure 34). However, the existing programs have limited poverty impact and are not scalable in times of disaster. A quarter of the population is poor, and a large portion remains vulnerable to falling into poverty in the event of shocks (natural disasters, health, or economic). Almost half of households reported experiencing a shock in FY2015 and FY2016, and about 30 percent reported two or more shocks during the same period.
FY2017/18 is the first year of transition to a federal structure of government. By the start of the fiscal year in July 2017, heads of local governments and councils had been elected in three rounds of local elections. Remaining elections took place in the first half of FY2018, and the new federal and provincial government and parliaments were constituted in February 2018, effectively leaving little more than one-quarter of the fiscal year where all three tiers were in place. This process ends the political transition; however, administrative transition to a federal structure of government is just starting.

While considerable preparatory work has been done, a comprehensive transition plan needs to be formally adopted. Until the formation of the new federal government, the preparatory work for transition to a federal structure of government was carried out by three different groups within the civil service. These working groups focused on three thematic areas—fiscal, administrative, and functional restructuring. Fiscal restructuring has progressed the furthest, resulting in the adoption of key legislation. However, the new government has yet to make formal decisions on the recommendations made under the administrative and functional restructuring. Thus, institutional responsibility for the management of the transition remains scattered across different agencies. As a consequence, greater clarity on the overall transition is needed through development, adoption, and execution of an adequately sequenced and time-bound plan. Such a plan would ensure greater accountability on the part of whoever is preparing decisions and adopting them, and whoever is tasked with their implementation. Further, such a plan would enable the government to sequence the transition across several fiscal years in order to provide a clearer set of costs associated with this transition.

The problems caused by the lack of a unified transition management plan are evident from FY2018 activities. The central government appropriated nearly NPR 225 billion to the subnational governments, and particularly to local governments. Consequently, the central government transferred NPR 150 billion of the appropriated amount to accounts designated for subnational governments by the first half of the current fiscal year, and the remaining amount by March 2018. However, there has been confusion on the functions of the new levels of government on the ground, while civil service staff are yet to be assigned. Also, relevant supporting legislation is yet to be adopted. As a result, of the allocated NPR 150 billion to local governments, more than NPR 90 billion remained unspent in the first half of the fiscal year.

Further, the existence of old structures has added to the confusion. The new constitution created new federal structures, but old structures remain in place, which has resulted in administrative confusion. There are vestiges from the Panchayat era, such as zonal and regional offices, of which there are at least 1,000, representing more than 10 percent of total government offices in Nepal (Table 4). As a result, there are now at least the following seven layers, depending upon the sector, of administrative bodies:

i) The central government, ministries, and various constitutional bodies and commissions
ii) Regional administrative offices and directorates (remnants of five different regions)
iii) Old zonal offices (subregional offices)
iv) New elected provincial governments and parliaments
v) District-level offices
vi) Local governments
vii) Ilaka (area)-level offices

In some cases, particularly in infrastructure service delivery, there is a lack of capacity in the local and provincial governments. Hence, there is a need for the previous structure to help build the capacity of the local and provincial governments during the transition period. For example, though districts have no functional assignment as per the constitution, there is need for the District Technical Office to help particularly in implementing local roads projects. However, in other cases, for example, in education, the parallel structure is creating confusion and spending pressures. Primary education has been devolved to local governments, which have started taking on this role and responsibility. Hence, it is unlikely that District Education Offices are needed.

Conclusion

A comprehensive transition plan is urgently needed in Nepal. The government has carried out
considerable preparatory work for transition to a federal structure, particularly on three thematic areas—fiscal, administrative, and functional restructuring. However, a comprehensive transition plan and a responsible authority to oversee the transition are needed. In the absence of a clear transition management plan, the implementation of the federal constitution in terms of devolution of funds, functions, and functionaries will be neither smooth nor well sequenced. To ensure strong local and provincial institutions, and to make state restructuring a success, a strong and capable center is equally important. The outcomes of the transition toward a federal system of public administration and the creation of new institutions (and the associated realignment of public sector employees across the three federal levels) are hard to predict, and have the potential to introduce uncertainty and tension into the implementation process. Even in countries where constitutional reforms are well planned and well coordinated, such a transition process usually takes at least three to five years and involves several iterative, incremental rounds of policy improvements and investments focused on building organizational and institutional capacity for accountable and inclusive service delivery.

To successfully transition to the new government structure, authorities should (a) eliminate wasteful or duplicative spending, (b) improve efficiency of spending to reach the greatest number of neediest citizens, and (c) adopt and implement a plan to transition to federalism. It is important for the government to carry out a spending review and identify wasteful spending (such as constituency funds or vestiges of old institutions) that can be eliminated. In addition, the government can further improve efficiency by carrying out reforms in several other areas, thereby extending the benefits to a greater number of citizens, such as social security programs. Above all, a clearly defined and properly executed multiyear plan would allow the authorities to effectively manage the transition process and anchor citizen expectations.
References


