Nepal Development Update

November 2018

Maximizing Finance for Development

WORLD BANK GROUP

NEPAL DEVELOPMENT UPDATE

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Acknowledgments

The Nepal Development Update is produced twice a year to reporton 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 debate, and the general public.

This Update was produced by the World Bank Macroeconomics Trade and Investment (MTI) team for Nepal consisting of Kene Ezemenari, Saurav Rana, and Roshan Bajracharya. Sabin Shrestha, Ilias Skamnelos, Ruchita Manghnani, Gonzalo Varela, Miles McKenna, and Shyamala Shukla contributed to the Special Focus section under the guidance of Esperanza Lasagabaster. Christian Eigen-Zucchi provided extremely useful comments. Oversight in preparing the report was provided by Mona Prasad under the overall guidance of Manuela Francisco, Faris Hadad-Zervos, and Qimiao Fan. Richa Bhattarai managed media relations and dissemination. Diane Stamm edited the document. Sunita Kumari Yadav managed the publication process.

Abbreviations

ADB	Asian Development Bank
BBIN	Bangladesh, Bhutan, India and Nepal
CAD	current account deficit
CCD	credit to core capital plus deposit
FDI	foreign direct investment
GDP	gross domestic product
GoN	Government of Nepal
ICT	information and communications technology
IPPs	independent power producers
IT	information technology
MFD	Maximizing Finance for Development
MOFAGA	Ministry of Federal Affairs and General Administration
MTEF	Medium-Term Expenditure Framework
MTI	Macroeconomics Trade and Investment
NDU	Nepal Development Update
NEA	Nepal Electricity Authority
NPC	National Planning Commission
NRB	Nepal Rastra Bank, the central bank of Nepal
PFM	public financial management
PPP	public-private partnership
RMIS	Revenue Management Information System
SME	small and medium-sized enterprise
SRN	Strategic Roads Network
y/y	year-over-year

Executive Summary

Recent Economic Developments

In FY2018, growth in Nepal remained strong at 6.3 percent despite less favorable monsoons and the easing of growth from the rebound following the 2015 earthquake. Continued strong activity in construction boosted private investment. Government activities and programs geared toward earthquake reconstruction and the establishment of offices at decentralized levels underpinned public investment. Private consumption was also a key driver of growth, financed by an uptick in remittances, in the last quarter of 2018. These trends coupled with record tourist arrivals, the reduction of load shedding, and an expansion of manufacturing capacity, all helped sustain growth. Inflation was 4 percent, anchored by the peg to the Indian rupee. Prices for non-food items grew at 5.5 percent, while food prices rose by 3.1 percent.

A higher trade deficit was only partially offset by higher remittances, widening the current account deficit (CAD). Exports registered record growth due to expansions into new markets in China and Turkey. Imports, however, grew at a faster pace due to higher oil prices, and needed inputs to support earthquake reconstruction and the establishment of subnational government offices. As a result, the trade deficit surged to 37.7 percent of GDP in FY2018 (from 33.9 percent in FY2017). Remittances grew by 10 percent, but as a share of GDP declined from 26.3 percent in FY2017 to 25.1 percent in FY2018, due to policy actions in migrant destination countries. In addition, the dollar-rupee exchange rate depreciated by 6.2 percent. Gross official reserves declined slightly but remained adequate to cover 8.3 months of imports (compared to 9 months in FY2017).

Driven by private sector credit, money supply growth was 19.3 percent (y/y) in FY2018, above the 18 percent target. Private sector credit contributed 17.2 percentage points to money supply growth due to higher lending to all sectors. These trends were supported by greater capacity utilization arising from increased availability of electricity and investment loans. Net claims on government contributed 3.3 percentage points to money supply growth, as government domestic borrowing rose due to increased expenditure

arising from the transition to federalism. Also, better implementation and monitoring of the 5 percent subsidy policy for agricultural and livestock loans together with policies to push commercialization, helped boost farmers' access to and uptake of loans. As deposit growth continues to trail credit growth, the banking sector's credit to core capital plus deposit (CCD) ratio was at 76.8 percent in July 2018, just shy of the 80 percent regulatory limit set by the Nepal Rastra Bank (the central bank). As a consequence, the weighted average of lending and deposit rates, which had shot up following the credit crunch in mid-FY2017, remain high at 12.1 and 6.5 percent, respectively, as of July 2018.

Difficulties in execution of the budget continued in FY2018, with overall spending at 82.4 percent of the total budget (and 71.2 percent of the capital budget). In addition, 37.5 percent of total spending (or 54.6 percent of capital expenditure) was spent in the last quarter of the fiscal year. Revenue growth was strong due to higher tax receipts from elevated imports (which constitute just under half of all revenue) coupled with collection rates that were close to planned targets. However, higher spending to establish subnational governments and finance the transition to federalism has contributed to a 3-percentage-point increase in the fiscal deficit. This was financed by government deposits and a 4-percentage-point increase in public debt as a share of GDP.

Outlook, Risks, and Challenges

GDP growth is projected to average 6 percent over the medium term, driven primarily by total investment. Agriculture growth is expected to average 4.3 percent over the forecast period, supported by programs to promote improved inputs, storage facilities, and irrigation for farmers. The focus will be on modernization, commercialization, and increased mechanization as well as connecting to agribusiness value chains. Reconstruction activities and improved capacity utilization in the manufacturing sector (as a result of improved electricity supply) will help support growth in industry. Steady remittance inflows will support growth in consumption as well as retail and wholesale trade, and a continuation of high tourist arrivals is expected under the Visit Nepal 2020 program. Inflation is projected to reach 5 percent over the medium term, assuming a continued increase in oil prices and depreciation of the exchange rate. The CAD will gradually narrow as import growth moderates.

The Government of Nepal (GoN) is shifting from consumption- to investment-based growth, with an emphasis on crowding in the private sector and raising the very low levels of FDI. In addition to infrastructure investments, key reforms will be needed to strengthen and update the legal and regulatory framework for public-private partnerships (PPPs), one-stop investor services, and e-government services for citizens. Consolidated spending of government is expected to reach 34 percent of GDP over the medium term, with 3 to 4 percentage points of the increase arising from the transition to federalism.

The implementation of federalism offers transformational opportunities but also considerable challenges for crowding in private investment. Urgent reforms are needed to strengthen the Public Financial Management (PFM) system to inform decentralized decision making and service delivery. An annual budgeting process is in place at the subnational level with guidelines issued by the Ministry of Federal Affairs and General Administration (MOFAGA), including accounting processes to underpin the budget process. However, existing IT systems are fragmented and not all local governments have adopted the subnational PFM system called SUTRA. Those local governments that have not yet adopted SUTRA have to manually upload their spending data, to report on their spending. Further more, revenue accounting, billing and collection are not captured in SUTRA and each locality uses its own system. A Revenue Management Information System (RMIS) is only fully operational at the federal level for tax collection.

Weak or incomplete systems, processes, and capacity at the subnational level pose an immediate risk to the use and management of resources, especially funds allocated for local governments. For example, medium-term planning or a three-year Medium-Term Expenditure Framework (MTEF) will take some time to implement at subnational levels given the difficulty of recording expenditures for local governments. Local governments do not know the provisions in the law or that they are required to do three-year budgets. An MTEF requires a good overview of local revenue. But, local governments are unable to forecast revenue, and revenue sharing information from the federal level will need to be solidly in place. Also, there is a heavy reliance on fiscal transfers. These weaknesses and shortcomings, if not addressed, could undermine the ability to provide the services necessary to crowd in the private sector.

Transfers to subnational governments are 8.3 percent of GDP in FY2018 and are expected to increase further as federalism proceeds. Setting up physical infrastructure, IT systems and human resources is expected to continue for the next two or three years. Raising the revenue potential of subnational governments will be critical, as will be their capacity to implement their projects and programs. Overall, tax reform, including a broadening of the tax base, will help increase revenue to 29 percent of GDP over the medium term. Public debt as a share of GDP will increase but will remain manageable at under 40 percent of GDP over the medium term, assuming large government deposits and continued low external debt levels.

Risks to the outlook arise primarily from the transition to and implementation of federalism, including the resource and capacity needs. Failure to raise the needed resources to meet the projected increase in spending could undermine service delivery or lead to a significant deterioration of the fiscal position. In that regard, there is a pressing need to expand the revenue capacity of subnational governments. Measures will also be needed to strengthen the implementation capacity of subnational governments to plan, budget, and execute their programs, including systems for tracking spending and the appropriate level of staffing. It will be particularly important to implement reforms that crowd-in the private sector to facilitate higher levels of investment. The multiple challenges underpinning the federalism process necessitate a comprehensive roadmap that harmonizes approaches across the three tiers of government, covering reforms to enhance functions, functionaries, and funding.

Delays in reforms to crowd in private sector investment could hamper the GoN's efforts to shift to an investment-led growth model. Critical reforms will entail strengthening the financial sector, unlocking investment bottlenecks, and developing long-term finance, particularly for closing key infrastructure gaps. These reforms are discussed under the special focus section of this edition of the "Nepal Development Update – Maximizing Finance for Development" and aim to find solutions to crowd in all possible sources of finance, innovation, and expertise to support Nepal's aspiration of achieving middle-income status by 2030.

Special topic –Maximizing Finance for Development (MFD)

Nepal is poised to embrace a new development model for a "Prosperous Nepal, Happy Nepalese," by achieving faster growth to become a middle-income country by 2030. Growth rates of at least 7 to 8 percent will be imperative. To achieve these levels of growth, the government targets a 10-percentage-point increase in the investment rate by 2021. But, this can only happen with a shift from remittance-led and consumption-based growth to one that is investment and productivity driven.

Business as usual will not be sufficient to accelerate growth and achieve graduation to middle-income-country status by 2030. The GoN's new growth model aims for growth fueled by higher levels of investment, productivity, and

effective public institutions to facilitate private sector dynamism, and will require reforms to (a) improve the competitiveness of the private sector and integrate with global markets; (b) strengthen the financial sector through development of long-term financing instruments; and (c) strengthen the framework for infrastructure finance, including PPPs.

Improving Competitiveness and Integration with Global Markets

Firm productivity and dynamism have been stagnant, with very few firms engaged in trade or technology transfer with other countries. The private sector is dominated by a few large family-run businesses, but the bulk of firms are small and do not grow much over their lifecycle. Only 18 percent of Nepal's formal firms have more than 20 employees compared to 37 percent and 43 percent in India and Bangladesh, respectively. Estimates of productivity or value added per worker in Nepal are less than half those of Bangladesh and less than a third of India's. Moreover, only a small share of firms' export possesses internationally recognized quality certificates or use technology licensed from foreign companies.

Merchandise export growth has stagnated, with exports concentrated in a narrow range of agricultural and low-value-added manufactured products, to a handful of countries. Firms in Nepal face high tariffs on intermediate and capital inputs and this, along with other supply-side constraints (such as the business environment; access to land, finance; transport and energy infrastructure; skills), have limited their participation in global value chains. Tariffs on inputs in Nepal are over twice those in Vietnam and Malaysia, countries that are well integrated into global value chains. Anecdotal evidence shows exporters are not benefiting from cash incentives and the duty-drawback system (where goods imported for manufacturing and export are exempt from various duties and taxes) because these schemes are not administered effectively and efficiently. Export subsidies often do not reach the intended firms due to the complex filing procedure, limited resources, and a first-come, first-served allocation mechanism. Trade facilitation efforts, including the strengthening of the Bhutan, Bangladesh, India and Nepal (BBIN) transit agreement are also needed for Nepalese exporters to reach ports at reduced transport costs.

Unlike other low-income countries, Nepal has not leveraged integration into global markets as a means of accelerating growth. Since 2000, Nepal's merchandise exports have grown at a meager 0.5 percent per year and FDI inflows have remained negligible and substantially below 1 percent of GDP. Specifically, in FY2017, FDI inflows were 0.79 percent of GDP or US$198 million, up 87 percent from US$106 million (in 2016). This contrasts with FDI levels in Cambodia of 12.55 percent of GDP or Lao PDR of 4.86 percent of GDP. For these Southeast Asian countries, FDI has been truly transformative, helping them to turn into regional export platforms, by improving domestic firms' capabilities and market access.

FDI could be a game changer for Nepal, helping it to boost productivity growth. The very low inflows of FDI have been focused on the energy sector, where substantial efforts are needed to boost the production capacity necessary for a stable and reliable supply of energy to households and firms. FDI into other productive sectors has been lackluster, but if it materialized, could have high impact. One high-potential niche product is medicinal and aromatic plants, for which Nepal's biodiversity and topography offers unique opportunities. But for Nepal to become a relevant global player in this value chain and linked to lucrative markets, local producers need to improve compliance with international standards and ensure sustainability of these rare species by introducing improved harvesting and processing practices.

To increase firm productivity and exports, it is necessary to raise FDI through development of a world-class investment and regulatory framework. It also requires reforms to reduce the infrastructure gap to support greater competitiveness

by enacting the PPP law, developing a pipeline of PPPs, and addressing constraints to skills and managerial capabilities especially in tourism, agribusiness, and information and communications technology (ICT).

Enhancing Financial Inclusion and Capacity for Long-Term Finance

Improved access to finance, improved intermediation, and the development of long-term finance will be crucially important to channel finance (foreign or local) to productive activities. The ongoing 14th Development Plan estimates that 55 percent of total investment required to implement the plan will be mobilized from the private sector. A well-developed financial sector that supports strong intermediation and financing will be necessary for the private sector to mobilize the needed resources for both small and micro-enterprises and large firms.

Yet, an estimated 40 percent of firms still report access to finance as a major constraint. These are firms that contribute significantly to job creation, but only 9 percent use banks to finance investments, compared to 17 percent on average nationally. Access is limited by the relatively high cost to financial institutions of individual screening and due diligence for typically modest loan amounts, high reliance on conventional collateral-based lending approaches, and concerns that borrowers might be accumulating many loans from multiple lenders. A regulatory cap on the spread on interest rates that financial institutions (domestic and international) can charge further reduces their ability to accurately price in risk or provide long-term financing. In addition, existing legal provisions of the Country Civil Procedure (Code) Act do not afford foreign financial institutions the same protection as local banks in terms of creditors' rights. Priority reforms to support increased access to finance for SMEs will be to remove financial infrastructure constraints to facilitate financial intermediation, strengthen the legislative and regulatory framework for movable assets, expand the coverage of the credit bureau, and promote digital financial services.

In addition, the financial sector is dominated by banks that are constrained in their ability to intermediate and provide long-term finance. Banks account for 87 percent of financial sector assets in Nepal. The headline bank capital adequacy ratiois 14 percent and the nonperforming loan ratio is below 2 percent. However, there are concerns over evergreening of bad loans and underprovisioning, vulnerability to exogenous factors (such as earthquakes, trade disruptions, and remittance slowdowns), and an underfunded safety net. Fueled by remittances and exposed to maturity mismatches, the sector is limited in its ability to perform financial intermediation and maturity transformation. Loan growth far exceeds deposit mobilization, and the loan-to-deposit ratio has reached 85 percent, placing pressure on liquidity and pushing interest rates up. Significant gaps in the financial infrastructure (for example, limited credit information, an unutilized secured transactions registry, and an underdeveloped payments system) pose a large constraint to intermediation.

Capital markets have a long way to go toward playing a significant role in the provision of long-term finance. A well-functioning government debt market is needed for capital market development, as it sets the risk-free rate and benchmark for pricing other instruments. The government is, however, not issuing sufficient market-based instruments and is not fulfilling the market-making function. The debt market is dominated by short-term government debt, and there is no active yield curve. There are only a few investors in debt instruments, and treasury instruments are bought largely by banks to satisfy statutory liquidity requirements. The equity market is also shallow. The stock market needs modernization, and banks and financial institutions make up more than 80 percent of listed companies. The Securities Board of Nepal lacks autonomy and capacity to provide effective risk-based supervision, and a new Securities Act is under discussion. Finally, private equity/venture capital is a novel concept (although few private equity funds are in operation) and does not have a specific legal and regulatory framework.

The assets of insurance companies, pension/ provident funds, and mutual funds can be critical in safely funding long-term investment. There are potential domestic institutional investors, including the Employees Provident Fund, the Citizen's Investment Trust, and the insurance sector with a combined asset size of around 15 percent of GDP. An important factor inhibiting its development includes the capacity of the regulator, with priority needed on risk-based supervision along with risk-based capital, as well as stronger asset liability management. Insurance companies need capacity building, product diversification, and price diversity, and the sector lacks awareness and trust.

Finally, foreign investors are constrained in terms of restrictions on foreign exchange, including regulations linked to off-shore funds, borrowing and capital repatriation. Foreign exchange restrictions (more in practice than in the law itself), make it difficult for small firms and individuals to open US dollar accounts to pay for services in US dollars. Unclear policies, complex procedures and inadequate investment facilitation also constrain investment. For example, the approval process for foreign loans is not clearly delineated in written guidelines. Rules, regulations and directives by NRB and other authorities are available only in the Nepalese language. Requirements such as Cabinet approval to mortgage land in favor of foreign lenders, interest rate caps on foreign currency loans (including for hedging against foreign exchange fluctuations for long tenure loans), and complicated offshore repatriation rules including unclear Double Taxation Agreements increase risks for foreign investors. This may require addressing legislative, regulatory, and institutional constraints that disincentivize foreign lending by amendments to the Foreign Investment Act and the issuance or amendments to notices/circulars by NRB. Establishing a sovereign rating may also help support these reforms and signal to international investors the government's commitment to them.

Strengthening Public Investment Management and PPPs

Nepal's public investment has averaged 4 percent of GDP, which is below average among both South Asian and low-income countries. There is chronic underspending of the capital budget, with spending averaging about 70 to 80 percent. According to the list of projects compiled from the Annual Development Plans of the National Planning Commission, projects on average have been ongoing for more than 11 years. In addition to delays, the budget does not sufficiently support service delivery or allocate resources for development priorities.

In addition to public investment in infrastructure, Nepal has also been promoting private sector participation to fill its infrastructure gap. The 14th Development Plan provides a policy framework for infrastructure projects, with a focus on the energy, roads, and airports sectors. The PPP Policy of 2015 emphasizes the role of private sector participation and allows for a range of PPP structures. Priority sectors include physical infrastructure, the electricity sector, the information and communications sector, the urban and rural environment, education and health-related infrastructure and services, and urban amenities. A PPP Law has been drafted and is ready to go to the Cabinet.

Nepal has faced several constraints in its overall governance of public investment including the implementation of PPPs; and the mobilization of private participation in infrastructure. PPPs have been few in number and slow to take off. Since 1990, 37 PPP transactions have reached financial closure, generating a total investment of US$2.5 billion. Twenty-three projects closed between 2010 and 2017. Of the 37 PPPs, 36 are active and one project, amounting to roughly US$400 million in investments that achieved financial closure in 2012, is in distress. Private participation in infrastructure is constrained by weak governance and public investment management; inadequate oversight and

accountability of public procurement due to weak capacity, compliance, and enforcement; lack of access to debt and equity financing; regulatory and institutional issues surrounding the environment for private participation in infrastructure; and sector-specific constraints, especially in the transport, energy, and urban sectors.

The above constraints are compounded by factors that deter foreign investors. These include the need for multiple approvals, delays in capital repatriation above US$10,000, absence of clear provisions in Nepalese law to protect rights of foreign lenders on loan collateral assets (the exception being hydropower projects), challenges to enforcing judicial awards against the government, wide-ranging authority of Nepalese courts to revise or revoke the enforcement of arbitral awards (that is, Article 30 of the Arbitration Act), and relatively weak corporate governance and quality of disclosure.

In addition, there are sector-specific constraints that impede the efficient and effective use of public investment and private participation in the transport, urban, and energy sectors.

- The **transport sector** is characterized by a lack of prioritization and planning of projects, inefficiency created by the problematic relationships between the private and public sector, and an overall lack of capacity. Funding for Strategic Road Network maintenance is inadequate and capacity for procurement and contract management is weak; the problem is exacerbated by the low capacity of the private sector. Within the airport subsector, the Civil Aviation Authority of Nepal is affected by weak institutional and financial capacity and the lack of a clear sector strategy and roadmap for airports.

- In the **urban sector**, municipalities face a severe lack of functional capacity, and limited processes and systems for capital investment planning and financial management, impacting accountability, credit worthiness, and the ability to plan and execute allocated budgets. The 2015 Constitution allows local governments to borrow, but, commercial borrowing is virtually nonexistent due to weak institutional and fiscal capacities of municipalities, limited capacity of domestic commercial banks and their inexperience lending to local governments, an underdeveloped capital market limiting their ability to raise capital, and the lack of a regulatory framework to facilitate borrowing. Private participation is limited by the inability to identify, prepare, appraise, and monitor projects, weak legal and institutional frameworks for PPPs, and failure to adequately articulate the role and powers of local governments.

- The **energy sector** is characterized by long and complex project development; high costs of connective infrastructure; inordinate delays in forest clearances, and other approvals; an unclear licensing and PPP process; and difficulties in raising debt financing. The National Electricity Authority's financial performance has not been encouraging despite an improvement of late, with its financial obligations set to increase over the medium term. Transmission and distribution have not kept pace with generation, leading to a mismatch.

Putting it all Together – Maximizing Finance for Development

Table ES.1 summarizes the key reforms needed to crowd in the private sector, given the above outlined constraints to firm growth and competitiveness, access to finance and public investment, and PPP implementation. The list of reforms in the table are those that are most critical to accelerate growth and is not meant to be an exhaustive list. The focus is on increasing firm growth and productivity to support links to global markets and higher exports. This would need to be underpinned by measures to improve financial intermediation, access to finance and long-term financing, including easing restrictive policies on borrowing from foreign lenders, foreign finance, and the development of capital markets. These

would need to be complemented with reforms to strengthen public investment management, including PPPs to support infrastructure finance and issues of contingent liability and debt management.

Overall, for Nepal, Maximizing Finance for Development (MFD) will require a systematic approach to leveraging all sources of finance, expertise, and technologies to accelerate growth and enable the country to reach middle-income country status and achieve the Sustainable Development Goals. As noted in this Nepal Development Update (NDU), the financing needs far surpass available public resources and available donor funding. It is therefore necessary to find ways to crowd in all possible sources of finance, innovation, and expertise, particularly from the private sector. For the exercise to be effective and successful the GoN would need to closely engage with the private sector and take their needs into account in designing reforms. Public resources and development partner assistance could then focus on areas where private financing is not forth coming or viable.

Table: ES.1. Priority Reforms to Maximize Finance for Development and Crowd in the Private Sector for Nepal's Accelerated Growth

Key Constraint	Selected Key Recommendations and Priority Interventions
Improving Competitiveness and Integration with Global Markets	
Complex procedures for firm entry and operations	• Introduce a single-window interface to facilitate regulatory compliance • Establish mechanisms to promote public-private-sector dialogue (such as the Nepal Business Forum)
High cost of trade, which undermines exports	• Adopt measures to facilitate trade and deepen integration by lowering import tariffs, streamlining border processes to reduce time and cost of trading, making the duty drawback accessible to both direct and indirect exporters, simplifying certification rules and providing faster duty refunds, and providing support to firms to meet the Generalized System of Preferences rule of origin
FDI restricted through limits on foreign exchange, foreign borrowing, repatriation of funds; unclear FDI policies	• Adopt measures to promote FDI by reducing and rationalizing the negative list; adopting a revised Foreign Investment Act aligned with international practice and obligations; streamlining investment approvals, repatriation, and exit; and reassessing interest rate caps on foreign currency loans; and clarifying the rules on funds repatriation and Double Taxation Agreements
Outdated land acquisition law; poor land records; weak institutions that make it difficult to deploy land for productive uses	• Adopt measures that facilitate increased firm/investor access to land by implementing land zoning, updating the Land Act and making it consistent with the Land Acquisition Policy, and developing industrial parks tailored to specific industries
Low availability of highly skilled workers	• Facilitate improved skills of the labor force and managerial capabilities by investing in domestic skills, simplifying visa procedures for skilled foreign workers, and introducing publicly supported management extension programs for firms in key sectors.
Sector-specific constraints that limit exports and economic growth	• Ease sector-specific constraints by (a)Tourism: upgrading airport safety, improving road access to key destinations, allowing investments in protected areas that are aligned with conservation; (b) Agribusiness: allowing private sector participation in distributing fertilizers, seeds; identifying priority activities to improve food safety to facilitate access to higher-value markets; and (c) ICT: improving the existing IT park through greater private sector investment
Enhancing Financial Inclusion and Capacity for Long-Term Finance	
Low access to finance and limited-to-nonexistent facility for long-term finance and weak capital markets	• Increase access to finance for SMEs by strengthening the legal and regulatory framework for movable assets; expanding coverage of the credit bureau; promoting digital financial services • Develop a long-term capital market by regularly issuing government bonds to create and maintain a yield curve; further developing capital markets by strengthening the independence and capacity of the securities supervisor and

	updating the legal infrastructure of the securities market; adopting legal and regulatory reforms for alternative investment funds to promote private equity and venture capital • Strengthen the capacity of institutional investors by strengthening the independence of the insurance sector supervisor, the capacity for risk supervision and asset liability management • Reinforce and signal to investors government commitment to reforms by establishing a sovereign rating
Strengthening Public Investment Management and PPPs	
Weak public investment management and coordination for selecting and implementing projects	• Establish a coordinating mechanism for infrastructure (or an infrastructure unit) to support strategic planning, selection, prioritization, and coordination among agencies • Improve the quality of public investment by strengthening capital project screening, appraisal, prioritization including contingent liabilities; building capacity within NPC and selected line ministries with large capital investments; developing an integrated database of projects within the central coordinating unit
Weak PPP laws and framework including missing processes and limited coordination across relevant agencies	• Strengthen the PPP Law and including a contingent liability framework by reviewing the draft PPP Law with respect to the roles of the National Planning Commission, Investment Board of Nepal and Ministry of Finance, and also in relation to the key sector-specific issues in energy, transport, and urban • Develop PPP guidelines and a pipeline of PPPs clearly articulating functional roles and responsibilities and the treatment of local government projects, identification, screening, preparation, procurement and including unsolicited projects, guidelines of managing fiscal commitments and liabilities; prioritizing PPP investments and allocating financing according to risk, with commercial financing taking priority if it is available and cost-effective • Address key constraints in core infrastructure sectors by (a) preparing a transport master plan and a program that consists of a few strategically important and economically high-priority projects under the Strategic Roads Network using performance-based contracts, adopt a strategic plan for airports along with a financing plan and operations and maintenance contracts; (b) fast-tracking the pipeline of independent power producers (IPPs) in the energy sector through clarifying the licensing and permitting, facilitating land acquisition and forest clearances, supporting long-term financing and complementary investments in transmission and distribution; and (c) improving credit worthiness of local bodies and identifying projects for private participation in the urban sector
Poor public and private sector awareness of the important and appropriate role of PPPs limits their development	• Increase awareness around the appropriate use and role of PPPs by designing and delivering a communications strategy and capacity-building program for both public and private stakeholders that outlines the GoN's objectives, implementation timeline and approach, stakeholders, and messages for each category of stakeholder

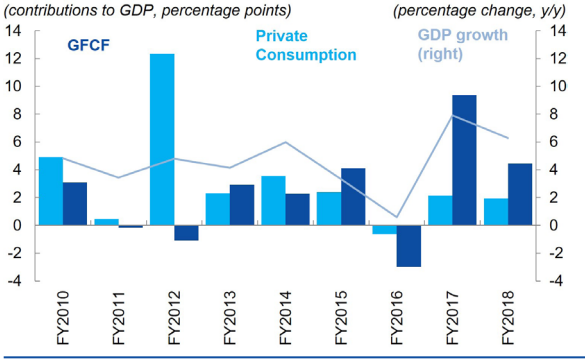
A. Recent Economic Developments

Recent Economic Developments

Nepal's economy grew by 6.3 percent in FY2018 despite less favorable monsoons and the easing of rapid growth that ensued following the trade blockade in FY2016 (Figure 1). On the demand side, investment drove overall Gross Domestic Product (GDP) growth, with gross fixed capital formation contributing 4.4 percentage points, led by private domestic growth of close to 16 percent. Public sector investments were supported by post-earthquake housing reconstruction, which is in full swing. Of the 707,443 beneficiaries eligible for housing grants, over 88 percent have been enrolled in the program and received the first tranche as of August–end 2018 (Figure 2). More than 71 percent of houses are now under construction, with a disbursement rate of 67 and 40 percent, respectively, for the second and third tranches. Foreign direct investment (FDI) also grew by a healthy 32 percent year-over-year (y/y) in FY2018 to reach a record US$168 million. The growth in FDI suggests a growing appetite to invest in Nepal by international investors such as Hongshi-Shivam Cement and Huaxin Cement Narayani. Still, FDI is equivalent only to 0.6 percent of GDP, low by international standards.

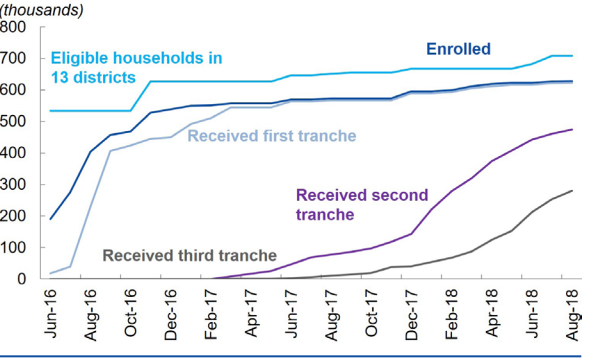
On the supply side, the main growth drivers were the service and industry sectors (Figure 3). Both tourist seasons – Autumn 2017 and Spring 2018 – during the fiscal year saw record levels of tourist arrivals (Figure 4). Furthermore, with continued strong remittance growth (see further analysis below), consumption continues to boost the service sector, as well. Together these have supported growth in the retail (9.1 percent y/y) and hotels and restaurants (9.8 percent y/y) subsectors of the service sector. Industry grew by 8.8 percent (y/y) in FY2018, well above its 25-year average of 4 percent. The elimination of load shedding has enabled greater capacity utilization. This has been possible through better electricity management by the Nepal Electricity Authority (NEA), and the additional 102 megawatts added to the national grid through the commissioning of new hydropowerplants and electricity trade with India.

Figure 1. Investments are increasingly contributing more to GDP growth…



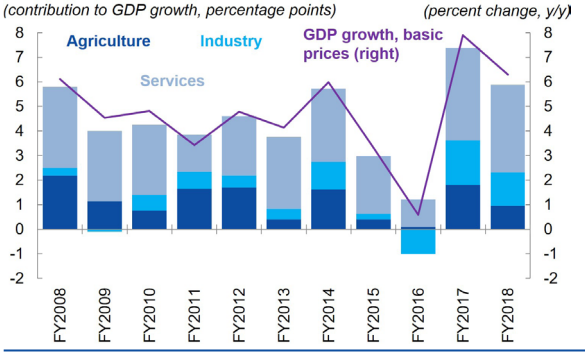
Sources: Central Bureau of Statistics and World Bank staff estimates.

Figure 2. …supported by housing reconstruction, which is in full swing as the second and third tranche disbursements have picked up



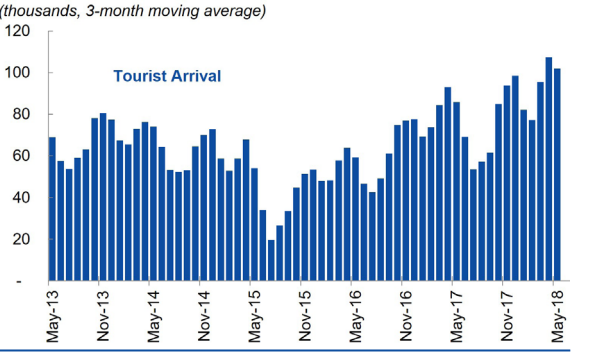
Source: Ministry of Urban Development.

Figure 3. Service sector continues to drive growth…



Sources: Central Bureau of Statistics and World Bank staff estimates.

Figure 4. …with tourist arrivals reaching record levels during the two FY2018 tourist seasons



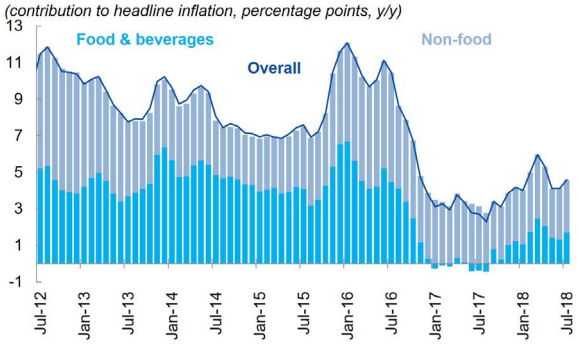
Source: Department of Immigration and World Bank staff calculations.

Strong growth globally and in the South Asia Region has helped buoy growth in Nepal. Despite the tightening of financial conditions globally and higher-than-expected oil prices, growth in advanced economies remained robust. Continued recovery in commodity-exporting emerging markets and developing countries also helped keep global growth stable in 2018. Robust growth in advanced economies should help sustain tourist arrivals. However, a faster-than-expected rise in global interest rates, combined with renewed strength of the U.S. dollar has moderated capital inflows to emerging markets and developing economies (World Bank 2018a). If this trend continues, it could have a moderating effect on remittance flow to Nepal. In South Asia, India's strong growth between 2017 and 2018, driven by the recovery of investments, carried regional growth. However, expansionary policies in many South Asian countries have led to increasing fiscal and current account deficits and inflation.

Inflation remained subdued throughout the fiscal year and was 4.0 percent (y/y) in July 2018 (Figure 5). After reaching a 13-year low of 2.3 percent (y/y) in August 2017, inflation picked up during the first half of the fiscal year driven by non-food items, which contributed 2.9 percentage points to headline inflation in July 2018, before moderating again during the second half of the

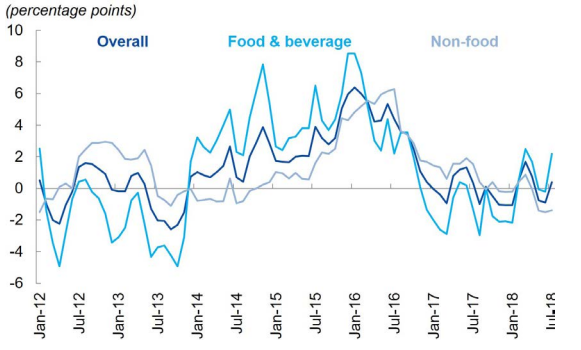
year. However, the contribution of food prices has also grown to 1.7 percentage points in July 2018 compared to -0.4 percentage points the previous year. This sharp increase in food inflation (y/y) mirrors the trend in India, which was -0.3 percent in July 2017 but rose to 1.3 percent in July 2018, since Nepal's inflation generally follows India's with a lag (Figure 6).

Figure 5. Inflation was driven by non-food prices but remained low throughout the fiscal year



Sources: NRB and World Bank staff calculations.

Figure 6. Price differential with India was largely neutral throughout FY2018

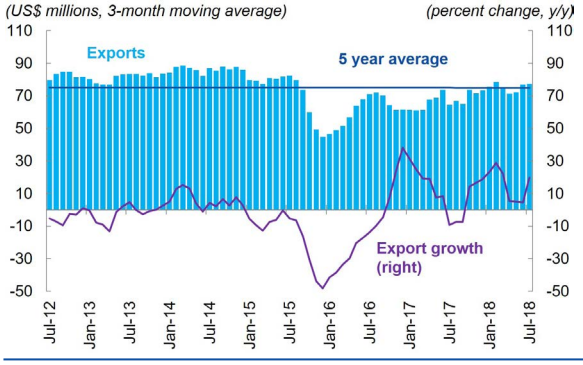


Sources: NRB, Ministry of Statistics & Program Implementation of India, and World Bank staff calculations.

Exports growth accelerated to reach 15.6 percent (y/y) in FY2018 (Figure 7). Nepal's exports are recovering from the trade disruption of FY2016. While India continues to be the destination of exports (Figure 8), Nepalese exports are reaching new markets such as China and Turkey. Exports to China grew by 184.9 percent (y/y) in July 2018 (Figure 9) and exports to Turkey rose by 100 percent (y/y) between April 2016 and February 2018. The high growth of exports to these two countries has resulted in them becoming the fourth and third-largest export destinations, accounting for 5.5 percent and 5.3 percent of total exports, respectively, as of July 2018 (Figure 10).

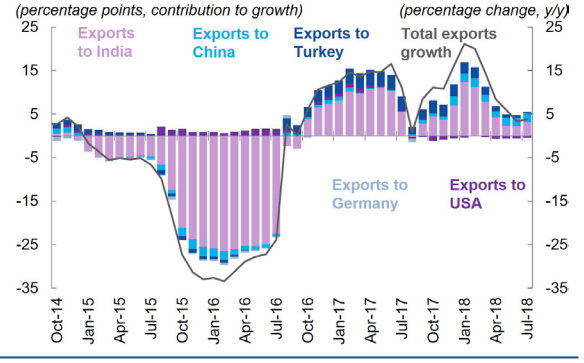
Imports surged by 27.8 percent (y/y) in the last quarter of FY2018 to yield the largest import bill in Nepal's history(Figure 11). With average monthly imports of US$979 million during FY2018, monthly imports were more than one-and-half-times

Figure 7. Exports picked up during FY2018…



Sources: NRB and World Bank staff calculations.

Figure 8. …driven by exports to India, China, and Turkey…

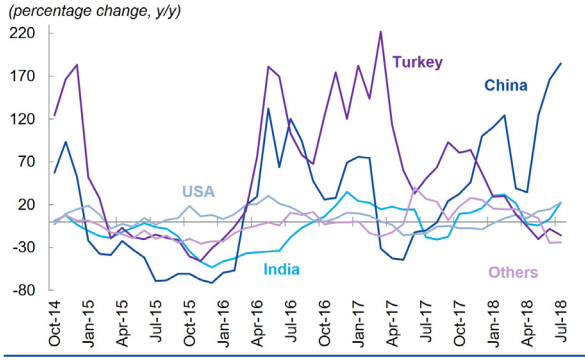


Sources: Department of Customs and World Bank staff calculations.

greater than the average of US$614 million during the previous five years. Oil imports increased over the course of the fiscal year, reflecting higher oil prices in global markets.

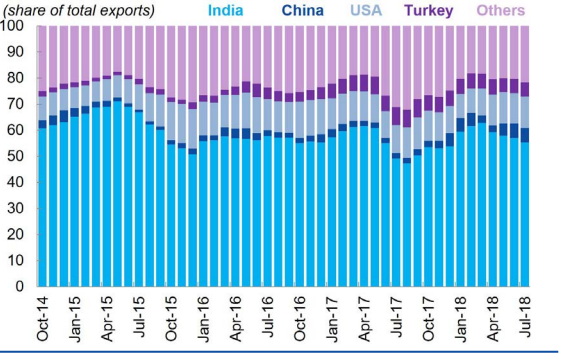
Non-oil imports, consisting mainly of industrial supplies and capital goods, contributed 10.7 percentage points and 4.2 percentage points, respectively, to overall import growth. This is due to ongoing reconstruction activities, increased infrastructure investment, and the uptick in industrial activity. Some of this was also driven by the federalism transition, as the process of establishing local governments continues, including the construction of offices and other capital investments. Consumer goods imports also grew, contributing 1.9 percentage points to growth, as remittance inflow into the economy continued to drive consumption (Figure 12).

Figure 9. Exports to these countries have grown rapidly …



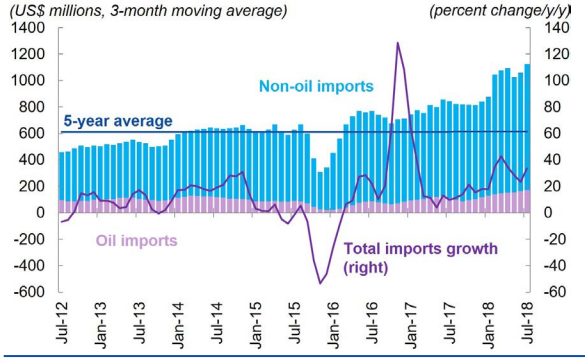
Sources:Department of Customs and World Bank staff calculations.

Figure 10. …resulting in the increase of their shares in total exports



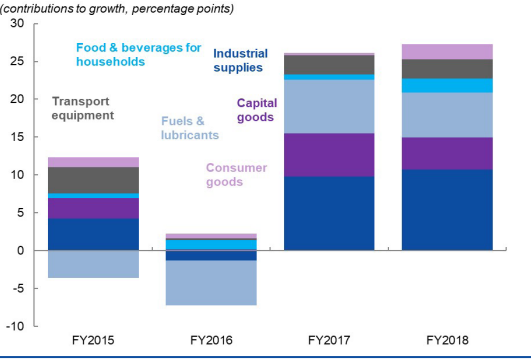
Sources: Department of Customs and World Bank staff calculations.

Figure 11. While imports continued to grow in double digits…



Sources: NRB and World Bank staff calculations.

Figure 12. …driven by industrial supplies and capital goods



Sources: Department of Customs and World Bank staff calculations.

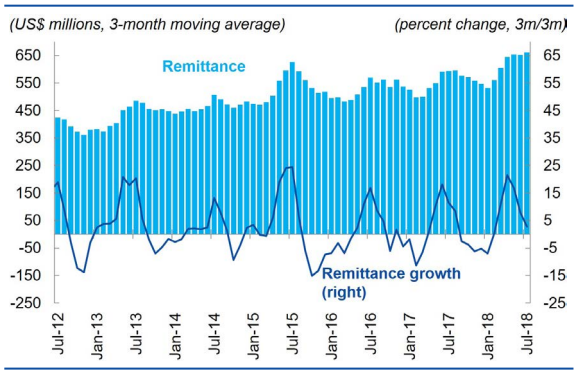
Officially recorded remittances rose to US$7.2 billion, but eased as a share of GDP to 25.1 percent (Figure 13 and Figure 14). The gain came despite contracting outflows of migrant workers due to policy actions in destination countries (Figure 15). Malaysia, the largest destination of Nepalese migrants (or 29 percent of the total), closed some agencies that process visas for Nepalese migrant workers due to concerns about overcharging migrant workers. In the Gulf countries, [1] fiscal pressures led to expenditure cuts that might adversely affect the demand for migrant workers. In this context, higher remittance receipts may be due to the depreciation of the Nepalese rupee

1 Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and theUnited Arab Emirates.

against the U.S.dollar, encouraging migrant workers to remit a greater share of their savings to benefit from the favorable exchange rate. In addition, Nepalese migrants are increasingly going to and remitting money from Japan and the Republic of Korea, where wage rates are much higher.

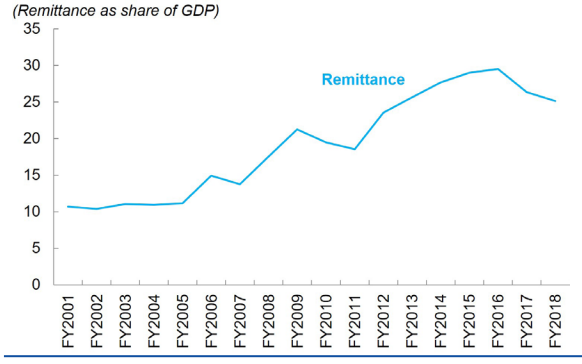
The widening trade deficit was partially offset by remittance growth, leading to a substantial increase in the CAD to US$2.4 billion, 8.2 percent of GDP (Figure 16). With the trade deficit reaching US$10.9 billion, and remittances unable to cover it as in the past, and given that FDI and external borrowing and other financing sources remained low, Nepal's foreign exchange reserves fell to US$9.3 billion in July 2018 from a peak of S$9.5 billion in January 2018. This is still equivalent to a comfortable 8.3 months of imports (Figure 17).

Figure 13. Remittances (in US$, millions) continue to rise…



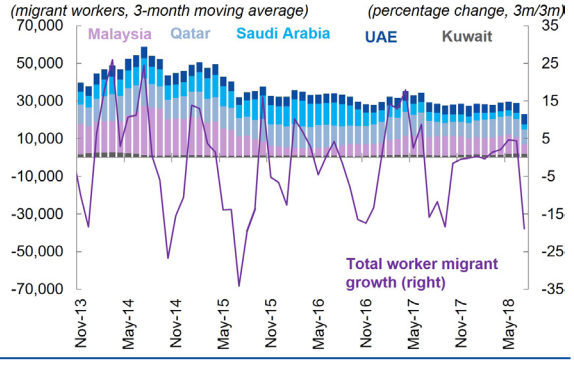
Sources: NRB and World Bank staff calculations.

Figure 14.… as its share in GDP is declining…



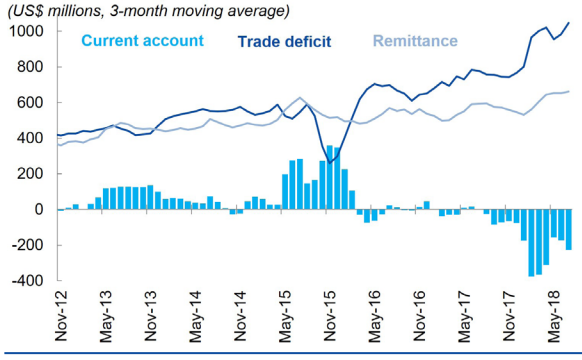
Sources: NRB and and World Bank staff calculations.

Figure 15. …and migrant worker outflows to major destination countries also declined



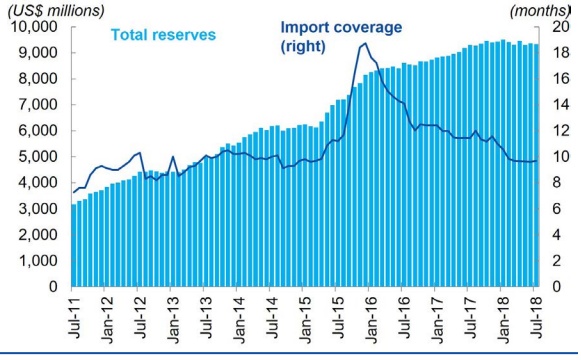
Source:Department of Foreign Employment and World Bank staff calculations.

Figure 16. These trends, coupled with faster growth of the trade deficit relative to remittances, are widening the CAD…



Source: NRB.

Figure 17. …causing a decline in the accumulation of foreign reserves, though the import cover remains adequate at 8.3 months



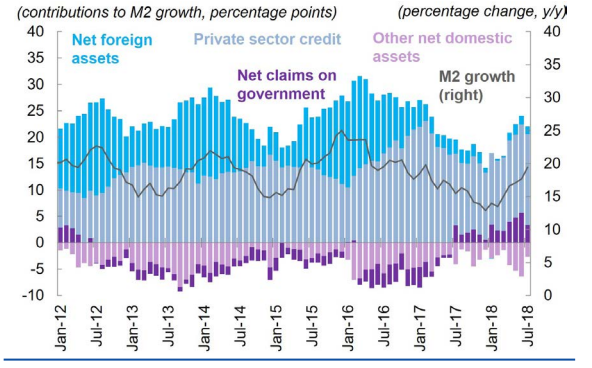
Source: NRB and World Bank staff calculations.

Money supply (M2) growth was above target. At 19.3 percent (y/y) growth as of July 2018 (Figure 18), M2 growth was above the FY2018 monetary policy target of 18 percent. Of that growth, private sector credit was the main force, contributing 17.2 percentage points. Net claims on government contributed 3.3 percentage points to M2 growth, due to increased government domestic borrowing and increased expenditure arising from the transition to federalism, among other spending needs.

Credit growth picked up as lending to all sectors increased. Credit growth rose steadily during the second half of the fiscal year to reach 22.4 percent (y/y) in July 2018 driven by increased lending to all sectors (Figure 19). Lending to the service sector contributed the most to credit growth (at 10.2 percentage points), while the contribution to credit growth of lending to industry and agriculture rose to 4 and 2.3 percentage points, respectively. These trends are in line with the recent uptick in industrial activity observed during FY2018. Specifically, there may have been more take-up of working capital loans in the industrial sector as capacity utilization increased with the improved availability of electricity. In the case of agriculture, the better implementation and monitoring of the 5 percent subsidy policy for agricultural and livestock loans together with policies[2] to push commercialization have helped farmers access more loans.

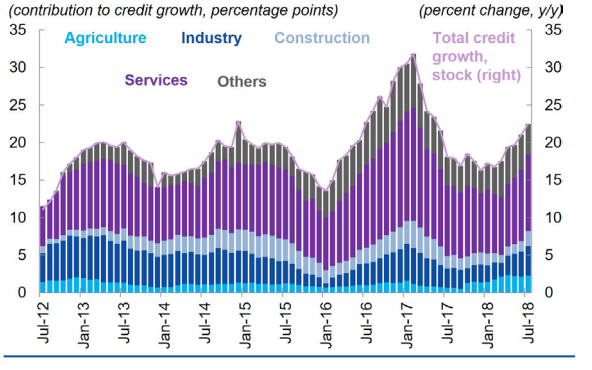
Deposits picked up but continued to lag behind credit growth. Deposits grew by 18.8 percent (y/y) in July 2018 (Figure 20). Individual deposits contributed the most (11 percentage points in July 2018) to deposit growth mainly due to the uptick in remittance inflows in the last quarter of FY2018.

Figure 18. Money supply (M2) growth picked up as private sector credit growth accelerated…



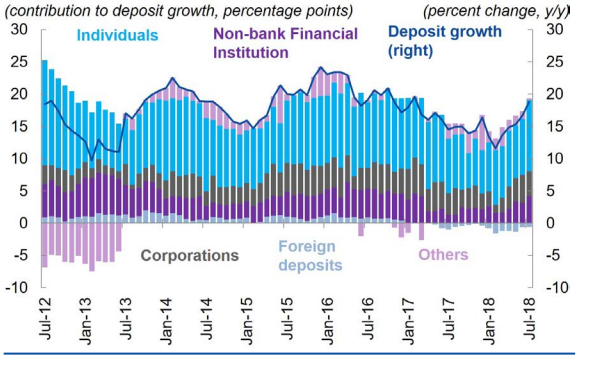
Sources: NRB and World Bank staff calculations.

Figure 19.…due to increased credit to all sectors, especially the service sector



Sources: NRB and World Bank staff calculations.

Figure 20. Deposits growth also picked up

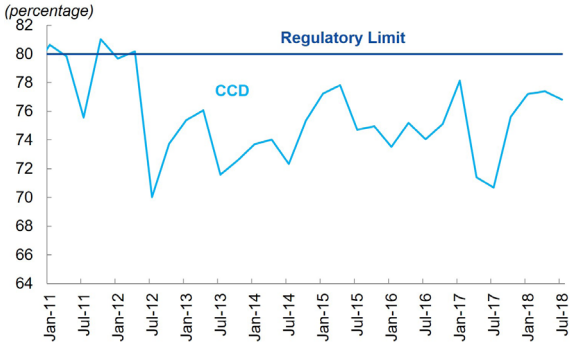


Source: NRB and World Bank staff calculations.

2 NRB's Productive Lending directive requires banks to invest 10 percent of their total loan portfolios in the agriculture sector.

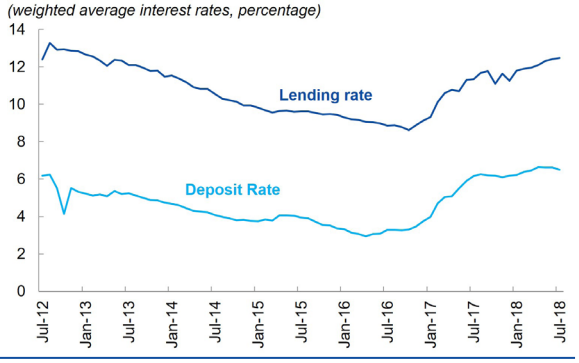
The banking sector's CCD ratio remains close to the regulatory limit. As deposit growth continues to trail credit growth, the banking sector's CCD ratio was 76.8 percent in July 2018 (Figure 21), just shy of the 80 percent regulatory limit set by the Nepal Rastra Bank. As a consequence, the weighted averages of lending and deposit rates, which had risen sharply during the credit crunch in mid-FY2017, remain high at 12.3 percent and 6.5 percent, respectively, as of July 2018 (Figure 22).

Figure 21. The banking sector continues to push close to its regulatory limits for the CCD ratio…



Source: NRB and World Bank staff calculations.

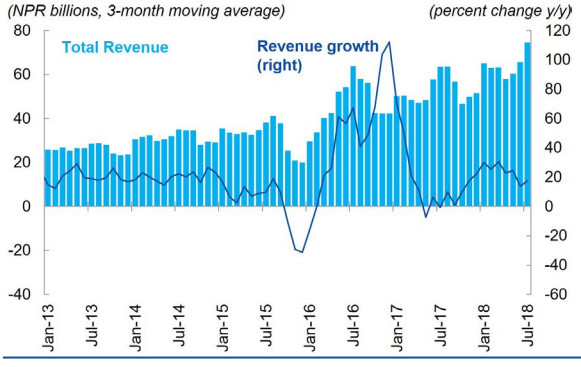
Figure 22. …causing the weighted average interest rates to remain high



Source: NRB.

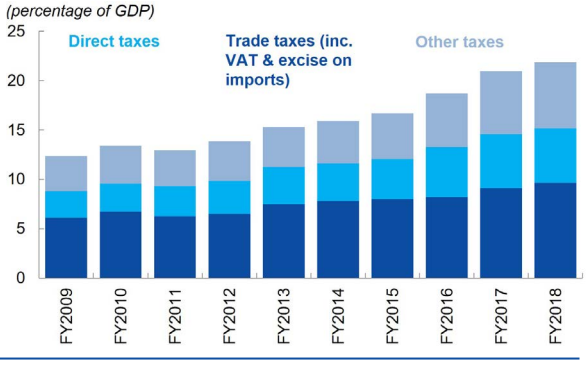
Domestic revenue collection was largely due to taxes on growing imports (Figure 23). Tax revenues in FY2018 grew by nearly 1percentage point of GDP to reach 21.9 percent of GDP. Non-tax-revenue collection was above the target projected in the FY2018 budget. This helped domestic revenue collection reach 99.8 percent of the target. The growth in tax collection was supported by a high import bill. Taxes and levies on imports (including the value-added-tax and excise on imports) was 9.6 percent of GDP in FY2018, up from 9.1 percent of GDP in FY2017 (Figure 24).

Figure 23. Revenue growth remained healthy…



Sources: NRB and World Bank staff calculations.

Figure 24. …due to taxes on international trade, which accounted for nearly 10 percent of GDP

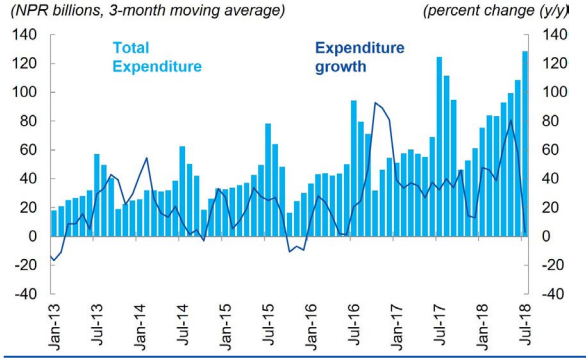


Sources: Ministry of Finance and World Bank staff calculations.

Expenditure has also grown but remains below target (Figure 25). While total expenditure grew by 3.7 percentage points of GDP to reach 31.2 percent of GDP in FY2018, it amounted to only 82.4 percent of the budgeted expenditure. Recurrent expenditure reached 23.3 percent of GDP, with fiscal transfers to subnational governments comprising 8.3 percent of GDP. It is the largest budget item in the Nepal government's budget. Even when accounting for preexisting grants to local governments that may have been transferred through the new Fiscal Transfer budget code, it still amounts to approximately 5.5 percent of GDP. With such large transfers being provided to subnational governments, it is imperative for Nepal to ensure robust public financial management systems are in place across all three tiers of government, to ensure accountability and transparency in public expenditure. As such, the GoN is conducting a Federalism Needs Assessment to assess capacity gaps and help inform the transition to the federal structure.

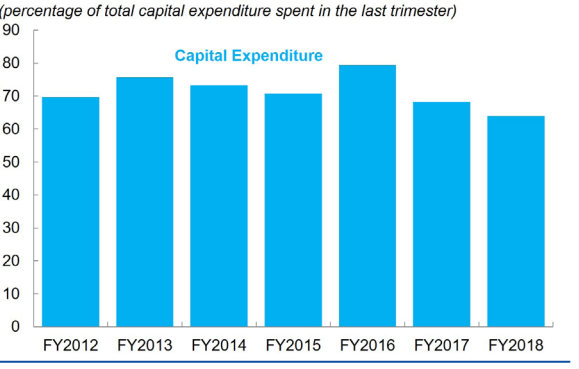
Final trimester bunching and underspending of capital expenditure persists. About 64 percent of total capital expenditure was spent in the final four months of the fiscal year in FY2018 (Figure 26). While this is an improvement over past years, where on average 70 percent was spent in the final trimester of the fiscal year, it is still a very large proportion of the budget. Further, the spending rate is well below the planned amount. In FY2018, only 71.2 percent of the planned capital and 82.4 percent of the total budget was spent (Figure 27). Yet, over the last few years, capital and total expenditure have grown as a share of GDP (Figure 28). One of the reasons for both last trimester bunching and underspending of the capital budget is that funds are not released in time for projects to start as scheduled in the fiscal year. Another reason is that funds continue to be allocated to projects that are not ready for implementation. Poor budget execution can have severe consequences for the future growth potential of the economy. It reduces the amount of infrastructure built and ready to use within a given year and compromises its quality, which leads to frequent renovation, does not maximize the value of funds spent, and hinders productivity.

Figure 25. Government expenditure increased significantly in FY2018…



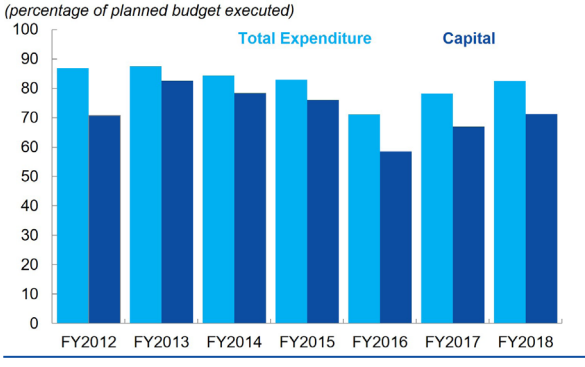
Sources: NRB and World Bank staff calculations.

Figure 26.…but last trimester bunching of capital expenditure persists



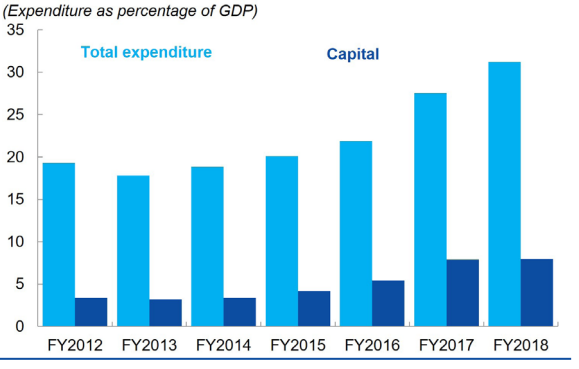
Sources: NRB and World Bank staff calculations.

Figure 27. And underexecution of the budget, especially the capital budget, continues…



Source: Ministry of Finance.

Figure 28. …while expenditure as a share of GDP increases



Sources: Ministry of Finance.

Underspending of the budget coupled with the achievement of revenue targets has helped contain the fiscal deficit and keep debt at prudent levels. However, the fiscal deficit has been on a widening trend, (driven mainly by spending linked to the establishment of local governments). The fiscal deficit is largely financed by domestic debt. In FY2018, total public debt, as a share of GDP, increased by 4 percentage points (Table 1). Domestic debt accounted for 72 percent of the increase in total public debt. Given the remaining work and resources needed to complete the transition to federalism, it will be important for the GoN to address the ongoing problem of underspending of the budget. This implies the need to strengthen implementation of the Medium-Term Expenditure Framework (MTEF) at the national level and to build capacity for planning and budgeting/budget execution at the local levels, particularly public investment management. It will also be important to raise domestic revenue.

Measures to address underspending of the capital budget will be particularly important to effectively crowd in the private sector resources needed to accelerate GDP growth. Currently, public investment is insufficient to crowd in the private sector and improve service delivery. Nepal is ranked 105th out of 190 countries in the World Bank's 2018 Doing Business Indicator. The majority of firms identify infrastructure gaps as a major impediment to the business and investment climate. The Special Focus section of this NDU discusses these challenges and outlines reforms needed to crowd in the private sector. While the government has recently made attempts to tackle transportation syndicates and cartels, other forms of cartels continue to exist, limiting competition and distorting markets. Slow issuance of clearance and permits for projects continues to hinder project implementation. Outdated and ambiguous laws impede commercial arbitration, for which there needs to be trained commercial judges who can provide effective and efficient commercial dispute resolution and enforce contracts. The financial sector and dynamism need to be enhanced to support the growth of smaller firms. In addition, reforms are needed to establish a well-functioning capital market that supports long-term financing, particularly for infrastructure.

The government will also need to ensure revenue generation is efficient, transparent, and progressive. The FY2019 budget outlines reforms to increase revenue through widening the tax base and streamlining the tax system. To expand the tax base the government will focus on modernizing tax administration. To ensure financial transparency, the government plans to link tax payer systems and financial institutions to the government's tax administration through a digital system. Further, the development of a tax payer information system is proposed to integrate the tax payer information that exists in various regulatory bodies into a single system to enhance efficiency and transparency. To develop a more progressive tax system, individual income tax rates have been revised to 10, 20, and 30 percent from the previous tax rates of 15 and 25 percent. The excise tax has been increased on alcohol and tobacco-based goods, as well as luxury goods.

In the transition to federalism, timely implementation of reforms is of critical importance. The focus should be on reforms to ease infrastructure constraints and improve the business and investment environment. As noted, the Needs Assessment (being conducted with support from the World Bank and United Nations Development Programme), will help identify priority areas for building capacity at local levels and shed more light on the additional resources needed. It would inform identification also of the critical bottlenecks to planning, public investment management, budget execution, and revenue capacity at the subnational levels.

B. Outlook, Risks, and Challenges

Outlook

GDP growth is projected to average 6 percent over the medium term driven primarily by investments. Agriculture growth in FY2019 is expected to increase on the back of a good monsoon supporting paddy output. Industry and services growth rates will be sustained. Overall, growth is projected to remain strong as the government shifts from consumption- to investment-based growth (Table 1).

On the supply side, services are expected to continue to drive growth, with the agriculture and industry sectors contributing more to overall growth. Agriculture growth is projected to reach an average 4.3 percent per year over the forecast period. It will be supported by new programs announced by the GoN that include investments for improved inputs and storage facilities including irrigation, modernization, commercialization, mechanization, and the expansion of value chains. Industry growth is likely to remain a healthy 8.4 percent per year over the forecast period as construction and manufacturing continue to perform well. Reconstruction activities will continue through FY2019. Capacity utilization in the manufacturing sector will continue as the availability of reliable electricity improves and the large cement factories come online in FY2019. Services are expected to grow at an average of 6.3 percent per year over the forecast period. Steady remittance inflows will support growth in retail and wholesale trade. The continuation of high tourist arrivals is expected as the GoN implements the Visit Nepal 2020 program with the aim of attracting 2 million visitors per year, which will boost growth in the hotels and restaurants subsector.

On the demand side, gross investment is expected to drive growth. The government has emphasized engaging the private sector and raising the low levels of FDI through increasing investment by 4 percentage points of GDP by 2021. The increase in FDI in FY2018 is a good start. Reforms will focus on strengthening the framework for infrastructure development. Work on two international airports and road projects will help boost investment, and gross fixed capital formation growth is expected to remain strong during the forecast period. Government consumption is expected to grow significantly in FY2019 as the fully established provincial and local governments

begin operations. However, government consumption growth will moderate and taper off in the future as the establishment of subnational governments concludes.

Inflation is expected to accelerate slightly in FY2019 but remain within the GoN's target. The Nepalese economy is expected to face some inflationary pressures during FY2019 due to public-spending-induced aggregate demand and from rising petroleum prices in global markets. NRB's stated monetary policy stance is to maintain the exchange rate peg with the Indian rupee, ensure adequate liquidity to support growth, achieve domestic credit growth of around 22 percent, and maintain at least eight months of foreign reserves.

The CAD, which grew in FY2018, is expected to narrow over the forecast period as the trade deficit moderates. Imports are expected to continue to grow but at a slower rate, while exports will pickup slightly with the strengthening of the manufacturing sector. While there is some uncertainty, remittances as a share of GDP are expected to ease further, given the dip in the outflow number of migrant workers. The cumulative effect will likely be slower growth of the trade deficit. By 2020, the CAD is expected to moderate to 6.8 percent of GDP.

Table 1: Macroeconomic Projections of Selected Key Indicators

	2015	2016	2017	2018e	2019f	2020f
Real GDP growth, at constant market prices	3.3	0.6	7.9	6.3	5.9	6.0
Private Consumption	2.9	-0.7	2.6	2.5	4.7	4.7
Government Consumption	7.4	-0.4	10.4	9.4	30.2	7.0
Gross Fixed Capital Investment	19.6	-12.3	44.2	15.7	13.2	7.7
Exports, Goods and Services	6.8	-13.7	13.7	4.4	7.6	9.5
Import, Goods and Services	9.6	2.8	30.3	14.8	12.7	6.2
Real GDP growth, at constant factor prices	3.0	0.2	7.4	5.9	5.9	6.0
Agriculture	1.1	0.2	5.2	2.8	4.0	4.5
Industry	1.4	-6.4	12.4	8.8	8.8	8.0
Services	4.8	2.3	7.4	7.1	6.2	6.3
Inflation (Consumer Price Index)	7.2	9.9	4.4	4.0	4.7	4.7
Current Account Balance (% of GDP)	5.1	6.2	-0.4	-8.2	-7.8	-6.8
Fiscal Balance (% of GDP)	1.0	1.4	-3.1	-5.8	-5.8	-5.5
Debt (% of GDP)	25.6	27.9	26.6	30.5	32.7	35.2
Primary Balance (% of GDP)	1.5	1.8	-2.8	-4.9	-4.8	-4.2

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast

Risks and Challenges

Nepal is vulnerable to external pressures. External shocks to outmigration and remittances can lead to a deterioration of the balance of payments, a reduction in growth of savings deposits, and a shortage of loanable funds and credit. Such a shock would also lower consumption and adversely affect growth and poverty reduction. Nepal is also vulnerable to climatic shocks that could disrupt growth and push vulnerable populations into poverty. Droughts are becoming more frequent in Nepal, particularly in the winter months and in the western Terai plains, which are dry due to the late arrivals of the monsoons. Effective response mechanisms would be needed to deal with natural disasters and mitigate the country's vulnerability to climate change, which could have serious consequences for growth overall and development of agriculture and agribusiness. Also, Nepal is susceptible to earthquakes. Another earthquake of the magnitude experienced in 2015 would seriously damage existing infrastructure, causing an even larger infrastructure gap. The resulting loss of GDP would set the country back several years in terms of reaching its middle-income-country goal.

The implementation of federalism offers transformational opportunities but also considerable challenges for crowding in private investment. Enhancing implementation capacities of subnational governments and establishing systems to track spending is urgent, as is the continued transfer of functions and functionaries to their equivalent provincial and municipal levels. This is required to strengthen budget execution, to ensure public expenditure is efficient and productive and improve public service delivery. Expanding revenue to meet the resource needs of federalism will also be a challenge.

Reforms are needed to strengthen the PFM system to inform decentralized decision making and service delivery. An annual budgeting process is in place at the subnational level with guidelines issued by the Ministry of Federal Affairs and General Administration (MOFAGA), including accounting processes to underpin the budget process. However, existing IT systems are fragmented and not all local governments have adopted the subnational PFM system called SUTRA. Those local governments that have not yet adopted SUTRA have to manually upload their spending data to report on their spending. Furthermore, revenue accounting, billing, and collection are not captured in SUTRA, and each locality uses its own system. wA Revenue Management Information System (RMIS) is only fully operational at the federal level for tax collection.

Weak or incomplete systems, processes, and capacity at the subnational level pose an immediate risk to the use and management of resources, especially funds allocated for local governments. For example, medium-term planning or a three-year MTEF will take some time to implement at subnational levels given the difficulty of recording expenditures for local governments. Local governments do not know the provisions in the law or that they are required to do three-year budgets. An MTEF requires a good overview of local revenue. But, local governments are unable to forecast revenue, and revenue sharing information from the federal level will need to be solidly in place. Also, there is a heavy reliance on fiscal transfers. These weaknesses and shortcomings, if not addressed, could undermine the ability to provide the services necessary to crowd in the private sector.

Transfers to subnational governments are 8.3 percent of GDP in FY2018 and are expected to increase further as federalism proceeds. Setting up physical infrastructure, IT systems and human resources is expected to continue for the next two or three years. Raising the revenue potential of subnational governments will be critical, as will be their capacity to implement their projects and programs. Overall, tax reform, including a broadening of the tax base, will help increase revenue to 29 percent of GDP over the medium term. Public debt as a share of GDP will increase but will remain manageable at under 40 percent of GDP over the medium term, assuming large government deposits and continued low external debt levels.

Risks to the outlook arise primarily from the transition to and implementation of federalism, including the resource and capacity needs. Failure to raise the needed resources to meet the projected increase in spending could undermine service delivery or lead to a significant deterioration of the fiscal position. In that regard, there is an urgent need to expand the revenue capacity of subnational governments. Measures will also be needed to strengthen the implementation capacity of subnational governments to plan, budget, and execute their programs, including systems for tracking spending and the appropriate level of staffing. It will be particularly important to implement reforms that crowd in the private sector to facilitate higher levels of investment. The multiple challenges underpinning the federalism process necessitate a comprehensive roadmap that harmonizes approaches across the three tiers of government, covering reforms to enhance functions, functionaries, and funding.

Slow implementation of reforms would undermine initiatives to crowd in the private sector and increase investment. Key reforms are required to increase private sector investments, especially for FDI, and the establishment of PPPs needed to close the infrastructure gap. Delays in reforms that crowd in private sector investment could risk the GoN's aim of shifting to investment-led growth. A critical reform will entail increasing the dynamism of the financial sector, unlocking investment bottlenecks, and developing long-term finance. The next section outlines the key reforms for scaling up private investment.

C. Special Focus - Priority Reforms to Maximize Finance for Development and Crowd in the Private Sector for Accelerated Growth

Nepal is poised to embrace a new development model for a "Prosperous Nepal, Happy Nepalese," by achieving faster growth to become a middle-income country by 2030. Growth rates of at least 7 to 8 percent will be imperative. To achieve these levels of growth, the government targets a 10-percentage-point increase in the investment rate by 2021. But, this can only happen with a shift from remittance-led and consumption-based growth to one that is investment and productivity driven.

Business as usual will not be sufficient to accelerate growth and achieve middle-income -country status by 2030. The GoN's new growth model aims for growth fueled by higher levels of investment, productivity, and effective public institutions to facilitate private sector dynamism, and will require reforms to (a) improve the competitiveness of the private sector and integrate with global markets; (b) strengthen the financial sector through development of long-term financing instruments; and (c) strengthen the framework for infrastructure finance, including PPPs.

Improving Competitiveness and Integration with Global Markets

Firm productivity and dynamism have been stagnant. The private sector is dominated by a few large family-run businesses, but the bulk of firms are small and do not grow much over their lifecycle. Only 18 percent of Nepal's formal firms have more than 20 employees compared to 37 percent and 43 percent in India and Bangladesh, respectively. Estimates of productivity or value added per worker in Nepal are less than half those of Bangladesh and less than a third of India's.[3]

Very few firms engage in trade or technology transfer with other countries. Only 5.1 percent of Nepalese formal firms export (directly or indirectly) compared to 21.8 percent and 8.8 percent in Bangladesh and India, respectively. Firms in Nepal trail behind other countries in the region in the adoption of ICT technology. Only about 49 percent of formal Nepalese firms regularly use computers compared to the South Asian average of 68 percent. Moreover, only a small share of firms' exports possess internationally recognized quality certificates or use technology licensed from foreign companies.

[3] Estimates in PPP terms from World Development Indicators, Staff calculations.

While trade and investment can be important drivers of growth, Nepal has been lagging on this front. Even after accounting for size, remoteness from main markets, and its landlocked status, Nepal's overall export and import performance is below average and has worsened relative to the 1990s. While Nepal has performed well in exports of services in recent years, this has not compensated for the poor performance in merchandise exports.

Merchandise export growth has stagnated, with exports concentrated in a narrow range of agricultural and low-value-added manufactured products, to a handful of countries. Firms in Nepal face high tariffs on intermediate and capital inputs and this, along with other supply-side constraints (such as business environment; access to land, finance; transport and energy infrastructure; skills), have limited participation in global value chains. Tariffs on inputs in Nepal are over twice of those in Vietnam and Malaysia, countries that are well integrated into global value chains. While exporters in Nepal can potentially benefit from the duty-drawback system (where goods imported for manufacturing and export are exempt from various duties and taxes) and cash incentive schemes, anecdotal evidence from exporters suggests that these schemes are not administered effectively and efficiently and that export subsidies often do not reach the intended firms due to the complex filing procedures, limited resources, and a first-come, first-served allocation mechanism. Trade facilitation efforts, including the strengthening of the Bhutan, Bangladesh, India and Nepal (BBIN) transit agreement, are also needed for Nepalese exporters to reach ports at reduced transport costs.

Unlike other low-income countries, Nepal has not leveraged integration into global markets as a means of accelerating growth. Since 2000, Nepal's merchandise exports have grown at a meager 0.5 percent per year and FDI inflows have remained negligible and substantially below 1 percent of GDP. Specifically, in FY2017, FDI inflows were 0.79 percent of GDP, or US$198 million, up 87 percent from US$106 million in FY2016. This contrasts with FDI levels in Cambodia of 12.55 percent of GDP or Lao PDR of 4.86 percent of GDP. For these Southeast Asian countries, FDI has been truly transformative, helping them turn into regional export platforms, by improving domestic firms' capabilities and market access.[4]

FDI could be a game changer for Nepal, helping it boost productivity growth. The very low inflows of FDI have been focused on the energy sector, where substantial efforts are needed to boost the production capacity necessary for a stable and reliable supply of energy to households and firms. FDI into other productive sectors has been lackluster, but if it materialized, could have high impact. Take the example of the underexploited, yet high-potential activity of medicinal and aromatic plants, for which Nepal's biodiversity and topography offers unique opportunities. Many of these plants are used as ingredients in traditional and modern medicines, cosmetics, perfumes, and culinary products. But for Nepal to become a relevant global player in this value chain and linked to lucrative markets, local producers need to improve compliance with international standards and ensure sustainability of these rare species by introducing improved harvesting and processing practices. This is exactly what happened when the Indian multinational company, Dabur International, invested in Nepal. A resource- and market-seeking investor, Dabur's Nepal-based subsidiary introduced higher standards and extension services to its local suppliers, helping to improve the quality and ensure the sustainability of locally sourced medicinal and aromatic plants. The company now produces for both the domestic and the export market, with sales growth generating new jobs for Nepalese and tax revenues for the government. Needed reforms could focus on creating the environment to bring in more firms to invest in other viable value chains.

4 Instead, in Nepal, evidence suggests that exporters remain small and struggle to increase shipments once they enter new markets. In addition, they underutilize granted trade preferences, often due to limits linked to managerial and bookkeeping capabilities to comply with rules of origin. FDI could help overcome some of these challenges (Narain and Varela 2017).

Nepal needs a world-class investment and regulatory framework to attract foreign investors. The 2017–18 Global Investment Competitiveness Report revealed that in addition to political stability, a business-friendly regulatory environment was paramount in the decision of multinational corporations to invest in a developing country. In Nepal, the FDI regulatory environment demands some changes. First, the processes for the repatriation of funds and for hiring foreign workers needs to be simplified. Regarding the repatriation of funds, while the law does provide foreign investors the right to repatriate funds related to foreign investment, in practice, repatriation is difficult, and obtaining approvals is a lengthy process. Second, entry barriers to foreign investment need to be lowered, including foreign ownership limitations, sector caps, a long negative list, and restrictions in non-equity modes of investment.

Examples of these limitations are the 51percent ownership limit for sectors such as legal, accounting, and engineering services. However, the law does allow up to 70 percent ownership for banking and finance, with the remaining 30 percent allocated as public shares. More allocation can be approved by NRB on a case-by-case basis. Restrictions in non-equity modes of investment, such as franchising, in which there can be significant technology, training, and skills transfer, cause additional delays and costs during entry and operations in Nepal. Slow and arbitrary approval processes, dual registration procedures, delays in trademark registration, and difficulties in remitting royalties and technical fees are among the obstacles faced by these types of investments.

Attracting FDI will also require reforms to ease the huge infrastructure constraints. Nepal ranks 130th out of 138 countries on the 2016 Global Competitiveness Index of infrastructure of the World Economic Forum, and is ranked 114th out of 160 countries on the 2018 Logistics Performance Index. The country has a relatively low road density, and this presents a constraint for critical sectors such as agroprocessing, which are intensive in their use of transport inputs. Limited air and land connectivity also reduces the attractiveness of key tourist destinations in Nepal. There have been concerns about anticompetitive behavior in the transport sector, including collective price fixing and regional truck and bus syndicates. Besides transport, Nepal also lags behind in other dimensions of infrastructure, such as digital access, electricity consumption per capita, and transmission losses in the power sector. In fact, according to the 2013 Enterprise Survey, two-thirds of Nepalese firms operating in the formal sector identified electricity as a major constraint and about a third considered transport a major constraint.

Poor governance and a complex and opaque regulatory environment form additional deterrents to private sector growth and investment. Institutions have not been able to insulate policy making from frequent regime changes, and this uncertainty has discouraged private investment and made it difficult to undertake PPPs. Nepal ranks 105th on the 2018 edition of the World Bank's Doing Business Indicators. It scores particularly low on the ease of getting electricity (133rd out of 190), dealing with construction permits (157th out of 190), paying taxes (146th out of 190), enforcing contracts (153rd out of 190), and starting a business (109th out of 190). Weak contract enforcement and regulatory hassles dampen investor confidence in Nepal's overall business climate.

Other constraints that undermine investment and firm productivity include shortages in managerial and technical skills, access to finance, and access to land. There is a scarcity of medium- to high-skilled technical and managerial workers in Nepal, and this poses a problem for firms seeking to move up the value chain. Strict visa regulations for foreign workers, the lack of a distinction between temporary and permanent movements of workers, and the nontransparent and expensive visa process further exacerbate the situation. There are several gaps in Nepal's financial infrastructure, which limit the system's ability to provide capital, particularly long-term finance. According to the World Bank Enterprise Survey, around 40 percent of Nepalese firms in the organized sector identify access to

finance as a major constraint. An outdated land acquisition law, poor land records, and weak institutions have made it difficult to deploy land for productive uses.

To address these roadblocks, the following key reforms are needed:

Ease barriers to firm entry and operations by simplifying business regulations and streamlining processes, introducing single-window interfaces for regulatory compliance, and using platforms like the Nepal Business Forum for regular public-private-sector dialogue.

Facilitate trade and deepen integration by lowering tariff rates, particularly on crucial intermediates, which are key to producing priority products; streamlining processes at key border customs stations to reduce time and cost of trading; simplifying the duty-drawback system by making it accessible to both direct and indirect exporters; simplifying certification rules and providing faster duty refunds to firms; and providing support to firms to comply with the Generalized System of Preferences rules of origin, through the provision of trainings on bookkeeping and management of input certifications.

Remove constraints to FDI by reducing and rationalizing the negative list; adopting a new draft Foreign Investment Act aligned with international best practice and obligations; and streamlining processes critical to entry and operations, such as investment approvals, repatriation, and exit.

Strengthen infrastructure by enacting the PPP Law and developing a PPP pipeline, together with a contingent liability framework; strengthening the Road Board of Nepal and identifying strategic roads to be improved through PPPs; prioritizing airport development through PPPs; setting up Hydropower Commons for hydropower expansion; and strengthening the NEA.

Facilitate improved access to land by implementing land zoning, updating the Land Act and making it consistent with the Land Acquisition Policy,and developing industrial parks tailored to specific industries.

Improve skills and managerial capabilities by investing in domestic skills, simplifying visa procedures for highly skilled foreign workers, and introducing a publicly supported management extension program for firms in key sectors.

Tourism. Upgrade airport safety, accelerate construction of Gautam Buddha International Airport and Pokhara Airport, improve road access to key destinations, review regulations governing the use of protected areas to allow investments that are not in conflict with conservation, and designate organizations in charge of designing and implementing plans for the integrated development of key destinations.

Agribusiness. Allow private sector participation in procuring and distributing fertilizers and seeds, strengthen the efficiency of input subsidies, and identify priority activities to improve food safety/sanitary and phytosanitary measures to facilitate access to higher-value markets.

ICT. Partner with industry to review the market relevance of the Information Technology (IT) curriculum, and improve the existing IT park through greater private sector investment and attraction of anchor firms.

Enhancing Financial Inclusion and Capacity for Long-Term Finance

Improved access to finance, improved intermediation, and the development of long-term finance will be crucially important to channel finance (foreign or local) to productive activities. The ongoing 14th Development Plan estimates that 55 percent of total investment required to implement the plan will be mobilized from the private sector. A well-developed financial sector that supports strong intermediation and financing will be necessary for the private sector to mobilize the needed resources for both small and microenterprises and large firms.

Despite progress to date, significant gaps in access to finance for smaller firms, including unequal access by gender and geography, continue to hamper firm growth and productivity. An estimated 40 percent of firms still report access to finance as a major constraint. Significant gaps exist for small and medium-sized enterprises(SMEs), startups, women, and rural businesses. These are firms that contribute significantly to job creation, but only 9 percent use banks to finance investments, compared to 17 percent on average nationally.[5] Access is limited [4] by the relatively high cost to financial institutions of individual screening and due diligence for typically modest loan amounts, high reliance on conventional collateral-based lending approaches, and concerns that borrowers might be accumulating many loans from multiple lenders. A regulatory cap on the spread on interest rates that financial institutions (domestic and international) can charge further reduces their ability to accurately price in risk or provide long-term financing.

When firms can access credit, financial institutions have to rely on conventional collateral-based lending approaches, given the asymmetry in credit information. [7] In addition, existing legal provisions of the Country Civil Procedure (Code) Act do not afford foreign financial institutions the same protection as local banks in terms of creditors' rights. [8] Finally, the agriculture sector receives less than 5 percent of bank loans, and agricultural finance is often impeded by ineffective government policies.Priority reforms to support increased access to finance for SMEs will be to remove financial infrastructure constraints to facilitate financial intermediation, strengthen the legislative and regulatory framework for movable assets, expand the coverage of the credit bureau, and promote digital financial services.

The ability of banks, which dominate the financial sector, to intermediate and provide long-term finance is constrained by several factors. Banks account for 87 percent of financial sector assets in Nepal. While headline bank capital adequacy and asset quality figures appear comfortable (a capital adequacy ratioofover 14 percent and a nonperforming loan ratio below 2 percent), there are concerns over evergreening of bad loans and underprovisioning, vulnerability to exogenous factors (such as earthquakes, trade disruptions, and remittance slowdowns), and an underfunded safety net. Fueled by remittances and exposed to maturity mismatches, the sector is limited in its ability to perform financial intermediation and maturity transformation. With loan growth far exceeding deposit mobilization, the loan-to-deposit ratio has reached 85 percent, placing pressure on liquidity and pushing interest rates up. There are significant gaps in the financial infrastructure (for example, limited credit information, an unutilized secured transactions registry, an underdeveloped payments system). There is an almost complete lack of non-recourse project finance-based structures (wherein loan repayment is from the profits of the project the loan is funding, and not from other assets of the borrower). Infrastructure projects face higher interest rates, a result of a high-risk perception. Addressing these constraints is essential to promote financial sector development more generally, and to increase long-term finance in particular.

Capital markets have a long way to go toward playing a significant role in the provision of long-term finance. A well-functioning government debt market is needed for capital market development, as it sets the risk-free rate and benchmark for pricing other instruments. The government is, however, not issuing sufficient market-based instruments and is

5 SMEs comprise more than 96 percent of the total industrial establishment, contribute 83 percent to industrial employment generation, and share 80 percent of the industrial sector's contribution to national GDP.

6 About 45 percent of the adult population has a formal bank account (compared to 69 percent in the region). The numbers fall further for those in rural areas (43 percent) and the poorest (38 percent) (FINDEX 2017; https://www.worldbank.org/en/events/2018/04/23/global-findex-fintech-inclusion).

7 The Credit Bureau coverage is a mere 1.7 percent of the adult population (the South Asia average is 14.1 percent).

8 They typically resort to partnering with a local bank or a consortium under a pari-passu security arrangement for debt recovery. (A pari-passu agreement is one in which two or more assets, securities, creditors or obligations are equally managed without preference. This can refer to loans, bonds or classes of shares that have equal rights of payment or equal seniority.)

not fulfilling the market-making function. The debt market is dominated by short-term government debt, and there is no active yield curve (see Box 1).[9] There are only a few investors in debt instruments, and treasury instruments are bought largely by banks to satisfy statutory liquidity requirements. Some development partners, such as the Asian Development Bank (ADB) and International Finance Corporation, are trying to support the raising of local currency bonds. The equity market is also shallow. The stock market needs modernization, and banks and financial institutions make up more than 80 percent of listed companies. The Securities Board of Nepal lacks autonomy and capacity to provide effective risk-based supervision, and a new Securities Act is under discussion. Finally, private equity/venture capitalis a novel concept (although few private equity funds are in operation) and lacks a specific legal and regulatory framework.

Box 1. Building benchmark yield curves

The sequencing of capital market development is not straightforward, but the development of a benchmark yield curve is considered a fundamental step. There are several determinants of capital markets development. Among structural factors, macro-financial stability, the level of savings, and the presence of institutional investors are important. Regarding the enabling environment, while some preconditions are common, the sequencing of reforms can be complex. Nevertheless, the existence of a deep, liquid government yield curve is key for the pricing of instruments, and the developing of government bond markets can be a catalyst for the bond market infrastructure and the fixed income markets.

For many countries at an earlier stage of development, the reform agenda involves a fundamental set of issues that includes bearing the initial cost of market development (that may be more expensive and of shorter duration than concessional financing); developing the legal and regulatory framework, and institutional arrangements and capacity for undertaking market-based financing; supporting a regular issuance program in a range of maturities; and, more broadly, achieving macro- and political stability to attract long-term participation. The World Bank has been advising multiple countries on developing the government bond market (including Brazil, Egypt, Kenya, Nigeria, and South Africa), with a multiyear project in Egypt helping lengthen the yield curve by designing an issuance program that enabled the government to use market-based funding.

Even when fiscal needs are met, governments in many countries issue bonds to maintain a functioning yield curve toward the development of capital markets. For example, the Ministry of Finance of Sweden announced in 2017 the intention to establish a sovereign wealth fund to buy the excess debt supply (beyond funding needs) to provide more liquidity to government bonds. Singapore has the fiscal objective of a balanced budget, but issues debt totaling just under 30 percent of GDP to maintain a market. New Zealand commits to a floor ratio of 20 percent domestic-debt-to-GDP. Australia announced in 2003 its intention to issue debt to maintain the government bond futures market; at the time, treasury bonds outstanding were around 6 percent of GDP. Brazil is also an example of a country that has systematically and successfully built benchmark yield curves for domestic and external markets. In 2008, it became an external creditor and keeps operations in the international market just to provide reference rates for corporate issuers. Colombia and Panama also face the same need to build liquid benchmarks on the back of low debt levels, and for that, liability management operations are being considered.

9 The absence of a yield curve can also make it difficult for multilaterals and corporates to pursue offshore local currency bond issuances, and can hold back the issuance of foreign-currency-denominated infrastructure project bonds.

Local institutional investors are underdeveloped and mostly invest in short-term instruments. The assets of insurance companies, pension/provident funds, and mutual funds can be critical in safely funding long-term investment. There are potential domestic institutional investors, including the Employees Provident Fund, the Citizen's Investment Trust, and the insurance sector with a combined asset size of around 15 percent of GDP. An important factor inhibiting its development includes the capacity of the regulator, with priority needed on risk-based supervision (including Regtech/Suptech)[10] along with risk-based capital, as well as stronger asset liability management. Insurance companies need capacity building, product diversification, and price diversity, and the sector lacks awareness and trust.

A key policy question is whether regional capital market integration or financial hubs could be the way forward; both, nevertheless, are difficult endeavors with limited success where they have been attempted. Theoretically, regional integration is an attractive proposition for small countries whose domestic markets do not offer the necessary diversification of investment opportunities to investors or of funding sources to companies. Nevertheless, very few such projects have achieved any degree of "success". Only Europe has had a relative degree of capital markets integration. In all other regions, regional integration projects are at a much earlier stage, including the Mercado Integrado Latinoamericano or MILA (which focuses on the less ambitious integration of the equities markets of Chile, Colombia, Mexico, and Peru), and the example from Central America (aimed at integrating the capital markets of Costa Rica, El Salvador, and Panama), or the East Africa Community (inspired by the experience of the European Union). Regional integration entails complex processes that require a significant amount of political support, usually involving significant changes and/or adjustments for market participants (for example, technology, business models) and public authorities (for example, legal amendments, supervisory approaches).

Overall, the following key constraints need to be eased to facilitate increased access to finance and promote instruments for long-term finance:

Financial infrastructure constraints. Removing financial infrastructure constraints will facilitate financial intermediation and should include strengthening the legislative and regulatory framework for movable assets, expanding the coverage of the credit bureau, and promoting digital financial services.

Lack of a yield curve and weak capital markets. The government should issue bonds to create and maintain a functioning yield curve. The independence and capacity of the securities supervisor should be strengthened, and the legal infrastructure of the securities market updated. In addition, legal and regulatory reforms for alternative investment funds could promote private equity and venture capital.

Weak institutional investors. In the short term, this would require strengthening the independence of the insurance sector supervisor; the capacity for risk-based supervision; and asset liability management, including the sector's investment regime.

At the same time, foreign investors are constrained on several fronts, which could be addressed by policy action. This may require addressing legislative, regulatory, and institutional constraints that disincentivize foreign lending by amendments to the Foreign Investment Act and the issuance or amendments to notices/circulars by NRB. Establishing a sovereign rating may also help support these reforms and signal to international investors the government's commitment to them. These policy actions include:

Foreign-exchange restrictions. These significantly impact the entry of foreign investors and constrain

10 Regtech is a technically familiar word in the financial sector that refers to applications of innovative technologies to support compliance with regulatory and reporting requirements by regulated financial institutions.Suptech refers to technologies used by supervisory agencies.

links to international markets. Many of these problems derive from practice more than from the law itself. For example, although firms are formally allowed to open U.S.-dollar-denominated accounts, small firms and individuals report that this is difficult in practice. Even with such an account, it is difficult to pay for services in U.S. dollars due to caps on the size of U.S.-dollar-denominated contracts. This creates a difficult environment for exporters, who often need to pay for foreign travel or inputs from foreign suppliers.

Regulatory constraints on foreign investment. FDI inflows have been hurt by unclear policies, complex procedures, and inadequate investment facilitation. Entry barriers to foreign investment include sector caps, a long "negative list"of sectors barred from receiving FDI, and restrictions on non-equity modes of investment. Offshore funds and onshore vehicles with foreign shareholders are both considered foreign investors and require FDI approval for every new investment in a Nepalese company. Rules, regulations,and directives by the NRB and other authorities are available only in the Nepalese language. FDI approvals can take several months. Finally, there are lengthy processes needed to hire foreign workers.

Restrictive policies on borrowing from foreign lenders. While land and buildings are the main forms of collateral for lending, mortgaging of land in favor of foreign lenders needs Cabinet approval, and enforcement of security requires a court order. As a result, foreign lenders often resort to partnering with a local bank or a consortium under a pari-passu security arrangement for debt recovery. Foreign lenders are required to set aside capital at the time of signing loan contracts, with commitment fees accruing only after NRB approval. As a result, the capital allocation remains uncompensated during the time lag between the signing of the contract and disbursement of the loans. Foreign lenders are subordinated to local banks in priority of repayment. Furthermore, there are interestrate caps on foreign currency loans, including those on the cost of hedging against foreign exchange fluctuations for long tenure. Finally, the approval process for foreign loans is not clearly delineated in written guidelines and, as implemented, is subject to stringent requirements for NRB approvals, including separate approvals for loan payments (after the loan itself has been approved).

A complicated process for offshore capital repatriation. Nepal has a fixed currency regime (pegged to the Indian rupee) and closely monitors foreign exchange reserves. Offshore funds require approval of the NRB to repatriate proceeds of their divestments. Approvals are granted only for amounts calculated under valuation rules set by the regulator, not for the actual proceeds. Strict foreign exchange controls create an incentive for undervaluing transactions so that less foreign exchange leaves the country. Furthermore, despite numerous Double Taxation Agreements, there has been uncertainty with respect to their enforcement, which increases uncertainty for foreign investors when exiting investments.

Strengthening Public Investment Management and PPPs

Nepal's public investment has averaged 4 percent of GDP, which is below average among both South Asian and low-income countries. There is chronic underspending of the capital budget, with spending averaging about 70 to 80 percent, over the past 5 years. According to the list of projects compiled from the Annual Development Plans of the National Planning Commission, projects on average have been ongoing for more than 11 years. Aside from delays, the budget does not sufficiently support service delivery or allocate resources for development priorities.

In addition to public investment in infrastructure, Nepal has also been promoting private sector participation to fill its infrastructure gap. The 14th Development Plan provides a policy framework for infrastructure projects, with a focus on the energy, roads, and airports sectors. The PPP Policy of 2015 emphasizes the role of private sector participation and allows for a range of PPP structures. Priority sectors include physical infrastructure, the electricity sector, the information and communications sector, the urban and rural

environment, education and health-related infrastructure and services, and urban amenities. A PPP Law has been drafted and is ready to go to the Cabinet.

Nepal has faced several constraints implementing PPPs, mobilizing private participation in infrastructure, and overall governance of public investment. PPPs have been few in number and slow to take off. Since 1990, 37 PPP transactions have reached financial closure, generating a total investment of US$2.5 billion. Twenty-three projects closed between 2010 and 2017. Of the 37 PPPs, 36 are active and one project, amounting to roughly US$400 million in investments that achieved financial closure in 2012, is in distress. Private participation in infrastructure is constrained by weak governance and public investment management; inadequate oversight and accountability of public procurement due to weak capacity, compliance and enforcement; lack of access to debt and equity financing; regulatory and institutional issues surrounding the environment for private participation in infrastructure; and sector-specific constraints, especially in the transport, energy, and urban sectors.

Nepal lacks key features of countries with successful private programs in infrastructure. These include sector regulations and institutions conducive to private financing in infrastructure, a systematically created pipeline of infrastructure projects, appropriate capacity within line ministries to effectively prepare and implement projects, and investment-friendly FDI policies and repatriation regulations. The domestic financial sector lacks capacity, increasing the need to attract international financing from various sources. These issues are further compounded by market distortions such as syndicates and cartels, prolonged processes for issuing clearances and permits (as in the forestry sector), land acquisition, weak strategic planning and project selection, poor project monitoring, and the need to address environmental and social concerns in a timely manner.

There are currently no methodologies deployed for early screening and prioritization of projects. Project preparation capabilities are lacking within government, and this results in projects going to market without adequate preparation, which in turn results in projects not being able to attract private interest. A lack of capacity among institutions, exacerbated by a lack of standardized processes and optimal risk allocation, and inadequate tender procedures, results in ineffective PPPs.

The above constraints are compounded by factors that deter foreign investors. These include the need for multiple approvals, delays in capital repatriation above US$10,000, absence of clear provisions in Nepalese law to protect rights of foreign lenders on loan collateral assets (the exception being hydropower projects), challenges to enforcing judicial awards against the government, wide-ranging authority of Nepalese courts to revise or revoke the enforcement of arbitral awards (that is, Article 30 of the Arbitration Act), and relatively weak corporate governance and quality of disclosure.

In addition, there are sector-specific constraints that impede the efficient and effective use of public investment and private participation in the transport, urban, and energy sectors.

- The **transport sector** is characterized by a lack of prioritization and planning of projects, inefficiency created by the problematic relationships between the private and public sector, and an overall lack of capacity. Funding for SRN maintenance is inadequate and capacity for procurement and contract management is weak, a problem exacerbated by the low capacity of the private sector. Within the airport subsector, the Civil Aviation Authority of Nepal is affected by weak institutional and financial capacity and the lack of a clear sector strategy and roadmap for airports.

- In the **urban sector,** municipalities face a severe lack of functional capacity, and limited processes and systems for capital investment planning and financial management, impacting accountability, credit worthiness, and the ability to plan and execute allocated budgets. The 2015 Constitution allows local governments to borrow, but commercial

borrowing is virtually nonexistent due to weak institutional and fiscal capacities of municipalities, limited capacity of domestic commercial banks and their inexperience lending to local governments, an underdeveloped capital market limiting their ability to raise capital, and the lack of a regulatory framework to facilitate borrowing. Private participation is limited by the inability to identify, prepare, appraise, and monitor projects, weak legal and institutional frameworks for PPPs, and failure to adequately articulate the role and powers of local governments.

- The **energy sector** is characterized by long and complex project development; high costs of connective infrastructure; inordinate delays in forest clearances, and other approvals; an unclear licensing and PPP process; and difficulties in raising debt financing. NEA's financial performance has not been encouraging despite an improvement of late, with its financial obligations set to increase over the medium term. Transmission and distribution have not kept pace with generation, leading to a mismatch.

Several recommendations need to be implemented to improve public investment management and public-private partnerships that crowd in the private sector:

Develop a strong PPP pipeline in key sectors. This requires the adoption of a systematized process and methodologies to identify, screen, prioritize, and structure sector investments for implementation as PPPs. The government should integrate its public investment managementand PPP processes and work on prioritizing PPPinvestments by allocating financing according to risk, with commercial financing taking priority, if such financing is available and cost-effective.

Address key constraints in core infrastructure sectors such as transport, energy, and urban. In the transport sector, the GoN needs to urgently prepare a transport master plan and launch a program with a focus on a few strategically important and economically high-priority projects under the SRN using performance-based contracting and other suitable PPP modalities. In addition, the government needs to adopt a comprehensive strategy for airports along with a financing plan, and explore operation and maintenance contracts for identified airports. It also needs to urgently carry out an urban transport assessment aimed at increasing connectivity, reducing congestion, and addressing safety issues in the Katmandu Valley. In the energy sector, the government needs to focus on fast-tracking the pipeline of independent power producers through clarity in licensing and permitting, facilitating land acquisition and forest clearances, supporting long-term financing, and providing much-needed complementary investments in supporting transmission and distribution infrastructure. In the urban sector, it is important to initiate key actions to improve creditworthiness of local bodies and identify projects for private participation in key urban sectors.

Establish a central coordinating mechanism for infrastructure. An infrastructure unit, preferably located at the Prime Minister's Office, should be established to support strategic planning, selection, and prioritization of investments; coordination among government agencies; and performance monitoring.

Improve the quality of investment decisions. This includes (a) strengthening capital project screening, appraisal, prioritization, and fiscal and contingent liabilities management processes, methodologies, and practice; (b) building capacity within the National Planning Commission (NPC) and selected line ministries with large capital investment budgets; and (c) developing an integrated database of projects within the central coordinating entity and/or the NPC to track and monitor project performance on a continuous basis.

Examine the draft PPP Law vis-à-vis global benchmarks. This will include examining the roles of institutions like the NPC, Investment Board of Nepal, Ministry of Finance, and relevant energy, transport, and urban sector entities. With a new government in place and against the backdrop of the ongoing federalism, this is an opportune time to review the law vis-à-vis the institutional

roles in this evolving landscape.

Develop guidelines to inform the PPP process and methodologies. PPP guidelines will be important for clearly articulating functional roles and responsibilities; treatment of local government projects; identification, screening, preparation, and procurement of projects, including treatment of unsolicited projects; guidance on disclosure of information; and management of fiscal commitments and contingent liabilities.

Design and deliver a communications strategy and capacity-building program. The GoN should design and deliver a communications strategy and capacity-building program for PPPs for both public and private sector stakeholders. It should include the GoN's objectives, an implementation timeline and approach, stakeholder mapping, and key messages for different stakeholders.

Putting it all Together – Maximizing Finance for Development in Nepal

Table 2 summarizes the key reforms needed to crowd in the private sector, given the above-outlined constraint to firm growth and competitiveness, access to finance and public investment, and PPP implementation. The list of reforms in the table are the most critical to accelerate growth, but the list is not exhaustive. The focus is on increasing firm growth and productivity to support links to global markets and higher exports. This would need to be underpinned by measures to improve financial intermediation, access to finance, and long-term financing, including easing restrictive policies on borrowing from foreign lenders, foreign finance, and the development of capital markets. These would need to be complemented with reforms to strengthen public investment management, including PPPs to support infrastructure finance, including issues of contingent liability and debt management.

Overall, for Nepal, Maximizing Finance for Development (MFD) will require a systematic approach to leveraging all sources of finance, expertise, and technologies to accelerate growth and enable the country to reach middle-income status and achieve the Sustainable Development Goals. As noted, the financing needs far surpass available public resources and available donor funding. It is therefore necessary to find ways to crowd in all possible sources of finance, innovation, and expertise, particularly from the private sector. For the exercise to be effective and successful, the GoN would need to closely engage with the private sector and take their needs into account in designing reforms. Public resources and development partner assistance could then focus on areas where private financing is not forthcoming or viable.

Table 2: Priority Reforms to Maximize Finance for Development and Crowd in the Private Sector for Nepal's Accelerated Growth

Key Constraint	Selected Key Recommendations and Priority Interventions
Improving Competitiveness and Integration with Global Markets	
Complex procedures for firm entry and operations	• Introduce a single-window interface to facilitate regulatory compliance • Establish mechanisms to promote public-private-sector dialogue (such as the Nepal Business Forum)
High cost of trade, which undermines exports	• Adopt measures to facilitate trade and deepen integration by lowering import tariffs, streamlining border processes to reduce time and cost of trading, making the duty drawback accessible to both direct and indirect exporters, simplifying certification rules and providing faster duty refunds, and providing support to firms to meet the Generalized System of Preferences rule of origin
FDI restricted through limits on foreign exchange, foreign borrowing, repatriation of funds; unclear FDI policies	• Adopt measures to promote FDI by reducing and rationalizing the negative list; adopting a revised Foreign Investment Act aligned with international practice and obligations; streamlining investment approvals, repatriation, and exit; and reassessing interest rate caps on foreign currency loans; and clarifying the rules on funds repatriation and Double Taxation Agreements
Outdated land acquisition law; poor land records; weak institutions that make it difficult to deploy land for productive uses	• Adopt measures that facilitate increased firm/investor access to land by implementing land zoning, updating the Land Act and making it consistent with the Land Acquisition Policy, and developing industrial parks tailored to specific industries
Low availability of highly skilled workers	• Facilitate improved skills of the labor force and managerial capabilities by investing in domestic skills, simplifying visa procedures for skilled foreign workers, and introducing publicly supported management extension programs for firms in key sectors.
Sector-specific constraints that limit exports and economic growth	• Ease sector-specific constraints by (a)Tourism: upgrading airport safety, improving road access to key destinations, allowing investments in protected areas that are aligned with conservation; (b) Agribusiness: allowing private sector participation in distributing fertilizers, seeds; identifying priority activities to improve food safety to facilitate access to higher-value markets; and (c) ICT: improving the existing IT park through greater private sector investment
Enhancing Financial Inclusion and Capacity for Long-Term Finance	
Low access to finance and limited-to-nonexistent facility for long-term finance and weak capital markets	• Increase access to finance for SMEs by strengthening the legal and regulatory framework for movable assets; expanding coverage of the credit bureau; promoting digital financial services • Develop a long-term capital market by regularly issuing government bonds to create and maintain a yield curve; further developing capital markets by strengthening the independence and capacity of the securities supervisor and

	updating the legal infrastructure of the securities market; adopting legal and regulatory reforms for alternative investment funds to promote private equity and venture capital • Strengthen the capacity of institutional investors by strengthening the independence of the insurance sector supervisor, the capacity for risk supervision and asset liability management • Reinforce and signal to investors government commitment to reforms by establishing a sovereign rating
Strengthening Public Investment Management and PPPs	
Weak public investment management and coordination for selecting and implementing projects	• Establish a coordinating mechanism for infrastructure (or an infrastructure unit) to support strategic planning, selection, prioritization, and coordination among agencies • Improve the quality of public investment by strengthening capital project screening, appraisal, prioritization including contingent liabilities; building capacity within NPC and selected line ministries with large capital investments; developing an integrated database of projects within the central coordinating unit
Weak PPP laws and framework including missing processes and limited coordination across relevant agencies	• Strengthen the PPP Law and including a contingent liability framework by reviewing the draft PPP Law with respect to the roles of the National Planning Commission, Investment Board of Nepal and Ministry of Finance, and also in relation to the key sector-specific issues in energy, transport, and urban • Develop PPP guidelines and a pipeline of PPPs clearly articulating functional roles and responsibilities and the treatment of local government projects, identification, screening, preparation, procurement and including unsolicited projects, guidelines of managing fiscal commitments and liabilities; prioritizing PPP investments and allocating financing according to risk, with commercial financing taking priority if it is available and cost-effective • Address key constraints in core infrastructure sectors by (a) preparing a transport master plan and a program that consists of a few strategically important and economically high-priority projects under the Strategic Roads Network using performance-based contracts, adopt a strategic plan for airports along with a financing plan and operations and maintenance contracts; (b) fast-tracking the pipeline of independent power producers (IPPs) in the energy sector through clarifying the licensing and permitting, facilitating land acquisition and forest clearances, supporting long-term financing and complementary investments in transmission and distribution; and (c) improving credit worthiness of local bodies and identifying projects for private participation in the urban sector
Poor public and private sector awareness of the important and appropriate role of PPPs limits their development	• Increase awareness around the appropriate use and role of PPPs by designing and delivering a communications strategy and capacity-building program for both public and private stakeholders that outlines the GoN's objectives, implementation timeline and approach, stakeholders, and messages for each category of stakeholder

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The World Bank Group
Nepal Country Office, PO Box: 798
Yak and Yeti Hotel Complex
Durbar Marg, Kathmandu, Nepal
Tel: 4236000, Fax: 4225112
Email: infonepal@worldbank.org

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