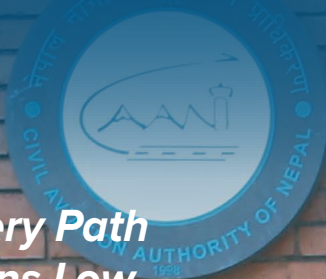


# Nepal Development Update

*Nepal's Economy on a Recovery Path  
but Private Investment Remains Low*

April 2024



त्रिभुवन  
अन्तर्राष्ट्रिय  
विमानस्थल



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# NEPAL DEVELOPMENT UPDATE

April 2024



# ACKNOWLEDGEMENTS

The Nepal Development Update is produced twice a year to report on key economic developments that occurred during the year, placing them in a longer-term and global perspective. The Update is intended for a wide audience including policymakers, business leaders, the community of analysts and professionals engaged in the economic debate, and the general public.

This report was produced by the World Bank Macroeconomics, Trade and Investment (MTI) team for Nepal led by Nayan Krishna Joshi (Country Economist, MTI) and Abdoul Ganiou Mijiyawa (Senior Country Economist, MTI) and consisting of Prabin Dongol (Consultant, MTI), and Anima Maharjan (Program Assistant, MTI). Inputs were received from Lokendra Phadera (Economist, ESAPV) and Prashant Raj Pandey (Economist, ESAF1). The report benefitted from data and consultations with Dr. Prakash Kumar Shrestha (Executive Director, Nepal Rastra Bank), Mr. Mahesh Acharya (Joint Secretary, Ministry of Finance), Mr. Hikmat B. Bhandari (Undersecretary, Ministry of Finance), and Mr. Suresh Neupane (Deputy Manager, CDS and Clearing Limited). The team thanks Mathew Verghis (Director, Equitable Growth, Finance and Institutions (EFI), South Asia Region), Faris Hadad-Zervos (Country Director for Maldives, Nepal and Sri Lanka), Shabih Ali Mohib (Practice Manager, MPSTI), Lada Strelkova (Manager, Operations), and Gregory Smith (Program Leader, EFI) for their guidance and comments on the report. Akash Shrestha and Avinashi Paudel managed media relations and dissemination.

The cutoff date is March 15, 2024, and includes data released up until that date.



# CONTENTS

	<b>ACKNOWLEDGEMENTS</b>	<b>2</b>
	<b>EXECUTIVE SUMMARY</b>	<b>5</b>
<b>A</b>	<b>RECENT ECONOMIC DEVELOPMENTS</b>	<b>10</b>
	A.1 Real Sector	10
	A.2 External Sector	15
	A.3 Monetary and Financial Sector	18
	A.4 Fiscal Sector	22
<b>B</b>	<b>OUTLOOK, RISKS, AND CHALLENGES</b>	<b>28</b>
	B.1 Real Sector Outlook	28
	B.2 External Sector Outlook	29
	B.3 Monetary and Financial Sector Outlook	30
	B.4 Fiscal Sector Outlook	30
	B.5 Risks and Challenges	30









# EXECUTIVE SUMMARY



# EXECUTIVE SUMMARY

## RECENT ECONOMIC DEVELOPMENTS

**Nepal's economy saw improved growth in the first half of FY24 (H1FY24) compared to FY23, supported by the services sector, helping its economic growth rebound from a low of 1.9 percent in FY23 to a forecast of 3.3 percent in FY24.** Accommodation and food services led the way, fueled by a significant rise in tourist arrivals. Financial and insurance activities also expanded, although there was a contraction in wholesale and retail trade. The industrial sector contributed to growth as well, supported by higher hydroelectric production. In agriculture, there was an increase in paddy production, aided by improved seed availability and favorable weather conditions.

**Private consumption drove growth on the domestic demand side, supported by a substantial increase of remittance inflows.** However, since H1FY21, remittances growth has not supported higher imports of consumption goods. Private investment remained sluggish, as evidenced by decreased imports of capital and intermediate goods. On the other hand, public consumption and investment contracted, driven by austerity measures and lower revenue collection.

**The external position strengthened, as the current account balance recorded a surplus, fueled by rising remittances and a shrinking trade deficit.** The half-year current account balance turned from a deficit of 0.7 percent of GDP in H1FY23 to a surplus of 2.7 percent of GDP in H1FY24, marking the first surplus in eight years. This turnaround stemmed from two key factors: a rise in remittance inflows, from 10.9 percent to 12.3 percent of GDP, and a narrowing trade deficit, which decreased from 13.2 percent to 11.6 percent of GDP. Imports declined, primarily due to lower import of goods. However, there was a surge in imports of electric cars, due to lower tax rate. Service imports surpassed pre-pandemic levels, driven by a rise in educational services. While exports of goods and services showed marginal growth, they remained below pre-pandemic levels, with notable expansions in international tourist arrivals and electricity exports.

**Official remittance inflows reached an eight-year peak in H1FY24, driven by increased outmigration and currency depreciation.** Government incentives for migrant workers further encouraged remittances to flow through official channels. As a result of higher remittance inflows, official foreign exchange reserves increased and reached 12.1 months of import cover by the end of H1FY24.

**Nepal also experienced a notable improvement in its fiscal deficit, with the half-year deficit shrinking to 0.4 percent of GDP in H1FY24 (from 1.4 percent in the same period last year), primarily attributed to reduced spending.** Recurrent and capital expenditure were reduced, as part of austerity measures to reflect revenue shortfalls. Half-year revenue fell to an eight-year low of 8.7 percent of GDP in H1FY24, mainly due to a decrease in non-trade revenues and lower VAT and income tax collections resulting from weakened domestic demand.

**To mitigate the revenue shortfall, the government adjusted its FY24 budget downward through mid-term reviews, revising both revenue and spending targets.** Moreover, there is also the need for improved budget execution efficiency, especially for sub-national governments whose budget execution rates have lagged the federal government's. Despite a small increase in public debt, it remains moderate and sustainable, supported by a significant share of concessional external loans and prudent fiscal management.

**Average consumer price inflation decreased from 8 percent year-on-year (y/y) in H1FY23 to 6.5 percent (y/y) in H1FY24, primarily attributed to declines in non-food and services inflation.** However, food and beverage inflation slightly increased, driven by cereal grain and spice inflation, partly due to India's export restrictions on rice, offsetting declines in ghee and oil prices.

**Nepal's poverty rate fell due to migration and remittances, alongside consumption increases.** The recent nationally household survey data from the Nepal Living Standard Survey 2022/23 shows a large decline in poverty from 25 percent to just 3.6 percent between 2011 and 2023 (using the 2011 National Poverty Line). The prosperity gap and inequality also reduced over the same period. However, challenges persist with a weak labor market and limited social assistance, posing risks amid economic and climate shocks.

**The monetary policy stance remained cautiously accommodative in H1FY24.** Despite a pick-up in inflation, the central bank adopted a more accommodative monetary policy, lowering the key interest rate by 1 percentage point to 5.5 percent in early December 2023. However, the recent rate cut in the policy rate below the inflation ceiling (6.5 percent) raises concerns regarding adherence to the central bank's new monetary policy rule. Real interest rates on deposits turned positive, boosting deposit growth to 102.3 percent of GDP by the end of H1FY24. Private sector credit, however, contracted to 90.7 percent of GDP. This decline can be attributed to a) tighter regulation on working capital loans, b) high lending rates, and c) weak domestic demand.

**The banking sector remained stable and profitable despite challenges.** Overall, asset quality remained solid, but there were signs of deterioration. Nonperforming loans increased, with private commercial banks experiencing a larger relative rise. Average capital adequacy ratio remained above regulatory requirements, but pressures were observed, particularly with three private commercial banks falling below the regulatory minimum for core capital adequacy ratio. Liquidity increased, supported by remittance inflows, prompting the central bank to implement measures to absorb excess liquidity. Moreover, efforts were made to mitigate further decline in banks' profitability through adjustments in loan loss provisions and restructuring of loans for select sectors.

**Overall, H1FY24 data corroborated the structural challenges facing Nepal's economy.** On the fiscal front, it highlighted the need to strengthen the execution and efficiency of capital expenditure to boost economic growth, as well as the importance of reducing dependence on imports tax revenue. Sound and consistent monetary policy will also be key to boosting confidence and stimulating economic growth. Addressing the increasing level of non-performing loans in the financial sector is crucial to strengthen financial stability and support private investment. On the external side, the high dependency on remittance inflows exposes the country to external shocks. Thus, there's a need to strengthen Nepal's international competitiveness for other sources of external earnings, such as tourism and foreign direct investment, by boosting exports of goods.

## OUTLOOK, RISKS, AND CHALLENGES

**Nepal's economic growth is set to rebound, from 1.9 percent in FY23 to a forecast 3.3 percent in FY24. Growth is then projected to further accelerate to 5 percent on average, over FY25-26.** This recovery is largely attributed to the easing of monetary policy, assuming productive use of private sector credit. Additionally, reforms to improve business environment could attract more private investment, further boosting medium-term growth prospects.

**The services sector is expected to be the key driver of growth in the coming years.** Accommodation and food services are poised to benefit significantly from the rise in tourist arrivals. The ongoing construction of new five-star hotels and government policies supporting real estate loans are expected to further stimulate the accommodation sub-sector. Meanwhile, the industrial sector is expected to grow, buoyed by significant expansions in electricity generation capacity, fostering a more conducive environment for industrial activities. However, agricultural growth is projected to slow down due to various factors, including the outbreak

of lumpy skin disease among livestock and a decrease in paddy production growth.

**In FY24, consumer price inflation is expected to remain high at 6.7 percent, close to the central bank's 6.5 percent ceiling, due to VAT exemptions removal, India's food export restrictions, and increased paddy minimum support prices.** However, inflation is forecasted to decline to 6 percent in FY25 and 5.5 percent in FY26, driven by global commodity price moderation and domestic price containment through monetary policy. Projected lower inflation in India may also help reduce domestic inflation via the currency peg, mitigating imported inflation.

**The current account balance is forecasted to return to surplus in FY24, driven by robust remittance growth and a narrowing trade deficit, but is expected to narrow subsequently as remittances taper off and the trade deficit expands.** The trade deficit is expected to improve in the medium term, falling below its FY23 level. This is due to a projected decline in goods imports in FY24, although imports are expected to rebound in FY25 and FY26. Goods exports, particularly in electricity, are expected to increase. While services exports could rise with tourism recovery, services imports may surpass exports due to continued emigration. Despite efforts to attract more foreign direct investment, inflows are likely to remain modest.

**Nepal's fiscal deficit is poised to decrease significantly from its peak in FY23 (about 6 percent of GDP), stabilizing around 3 percent of GDP in the medium term, despite a projected higher deficit in FY24 compared to the government's revised forecast.** Revenue is expected to rise to 20.1 percent of GDP by FY26, supported by robust GDP growth and increased goods imports. Meanwhile, spending is expected to increase to 22.8 percent of GDP by FY26, driven by enhanced execution of public investment. The National Project Bank's integrated guidelines, introduced in March 2023, aim to streamline project development and prioritization, contributing to more effective capital spending by FY25. Financing for the fiscal deficit will likely come from external concessional borrowing and domestic sources. However, public debt is projected to decline to 40.8 percent of GDP by FY26 from its FY23 peak because of higher economic growth.

**The forecast is subject to both domestic and external risks.** Externally, geopolitical uncertainty could trigger a rise in commodity prices, impacting all sectors. A growth slowdown in partner countries might also lead to a drop in remittances and tourism, hindering economic growth. Persistent inflation expectations and lower domestic demand could further dampen economic activity. Natural disasters pose additional risks to sustaining welfare gains. Finally, frequent political changes, a top headwind for businesses for over a decade, could continue to deter private investment.









# A RECENT ECONOMIC DEVELOPMENTS

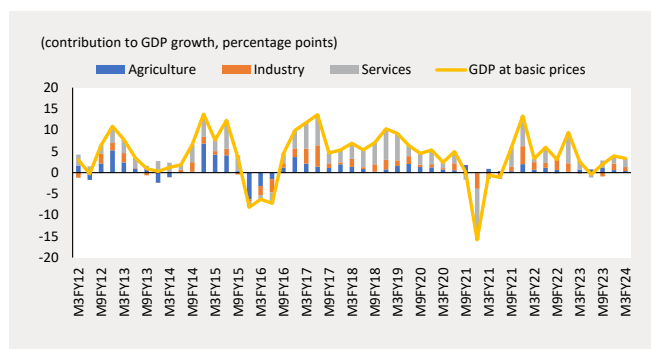
# A RECENT ECONOMIC DEVELOPMENTS

## A.1 REAL SECTOR

Nepal experienced improved economic growth in the first half of FY24, driven by a resilient services sector and increased private consumption from higher remittance inflows, despite subdued domestic demand attributed to lower private investment.

**Economic growth in the first half of FY24 (H1FY24) improved compared to the same period in FY23** (Figure 1). The services sector emerged as the primary driver of this growth on the supply side, buoyed by increased activity in tourism-related services. Additionally, expansion in the industrial sector, mainly due to increased electricity production, contributed to the overall growth. The agricultural sector also witnessed growth, propelled by an increase in main season rice paddy production.

**Figure 1.** Real GDP grew by 3.7 percent (y/y) in the first quarter of FY24.



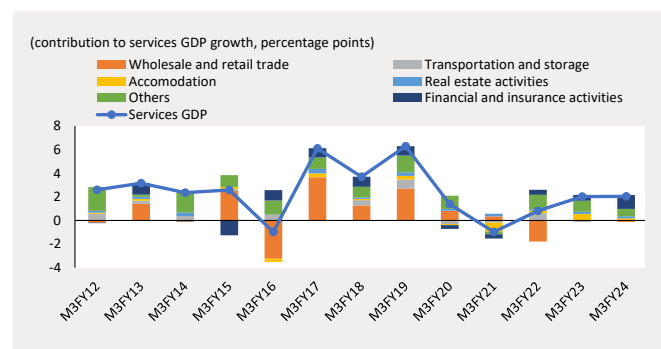
Sources. National Statistics Office and World Bank staff calculations.

## GROSS DOMESTIC PRODUCT BY INDUSTRIAL CLASSIFICATION

### Services Sector

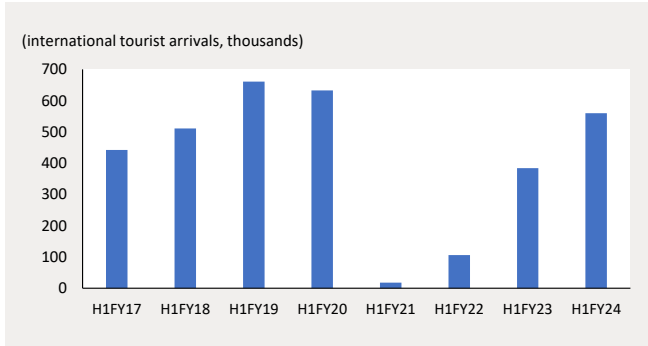
The services sector drove the growth, expanding by 3.7 percent (y/y) in the first quarter of FY24 (Q1FY24), with this trend continuing into Q2FY24. Accommodation and food service activities fueled the growth due to a significant increase in tourist arrivals of 45.8 percent (y/y) in H1FY24 (Figures 2 and 3). Financial and insurance activities also experienced growth, with net interest income of commercial banks rising by 9.7 percent (y/y) (Figure 4). However, the expansion was tempered by a contraction in wholesale and retail trade, indicating a potential decline in goods imports. Other services sub-sectors also witnessed growth. A surge in real estate transactions of 19.8 percent (y/y) and a rise in value-added tax (VAT) from services by 43.6 percent (y/y) support this (Figures 5 and 6).

**Figure 2.** Services sector growth was supported by accommodation and food service activities...



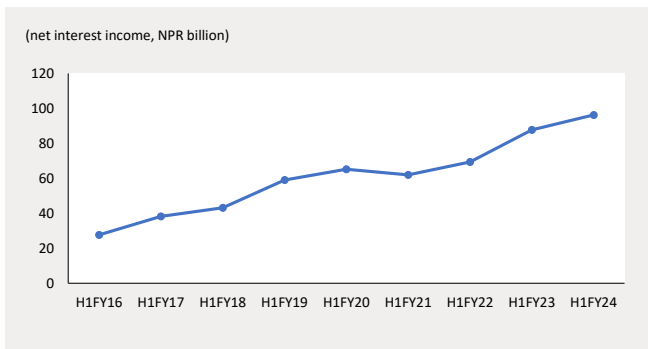
Sources. National Statistics Office and World Bank staff calculations.

**Figure 3.** ...which rose on the back of the increase in international tourist arrivals, back towards pre-pandemic levels



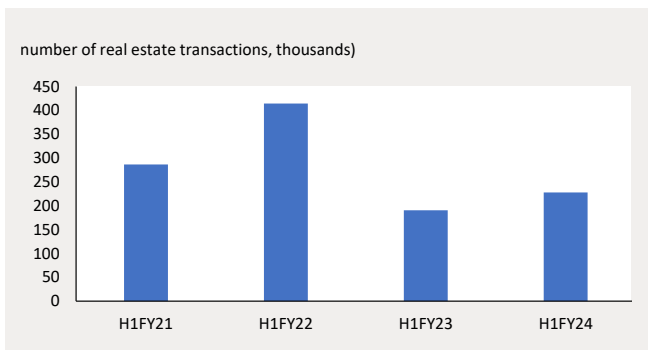
Sources. Nepal Rastra Bank and World Bank staff calculations.

**Figure 4.** Financial and insurance activities also grew, reflected in part by the increase in net interest income of commercial banks



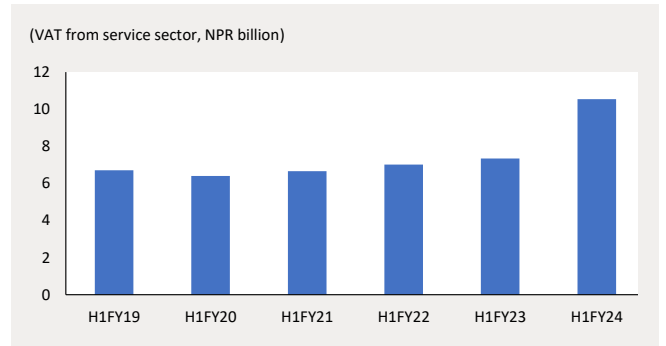
Sources. Nepal Rastra Bank and World Bank staff calculations.

**Figure 5.** An increase in real estate transactions...



Sources. Department of Land Management and Archive and World Bank staff calculations.

**Figure 6.** ...and a rise in VAT from services sector suggest point to an increase in services

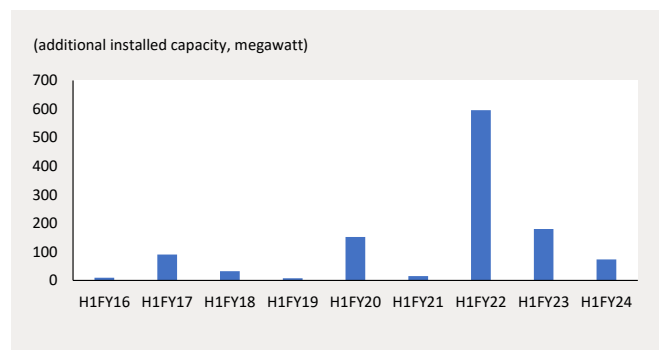


Sources. Ministry of Finance and World Bank staff calculations.

### Industrial Sector

Quarterly GDP data indicates a 6 percent (y/y) growth in the industrial sector in the first quarter of FY24, with high-frequency indicators suggesting this momentum likely continued in the second quarter of FY24. Higher hydroelectric production contributed to this growth (Figure 7). The manufacturing sub-sector also increased by 1.7 percent (y/y) in Q1FY24, driven partly by higher production of food products and flat-rolled products of steel (Figure 8), and this trend continued in Q2FY24, as suggested by goods exports data. Additionally, the construction sub-sector expanded by 11.1 percent (y/y) in Q1FY24. However, a contraction in the production of key construction materials like cement and iron and steel bars and rods, coupled with declining imports of goods related to construction sector (Figures 9 and 10) and construction material prices, and lower public investment, suggests a slowdown in construction activities in the second quarter of FY24 (see Fiscal Section).

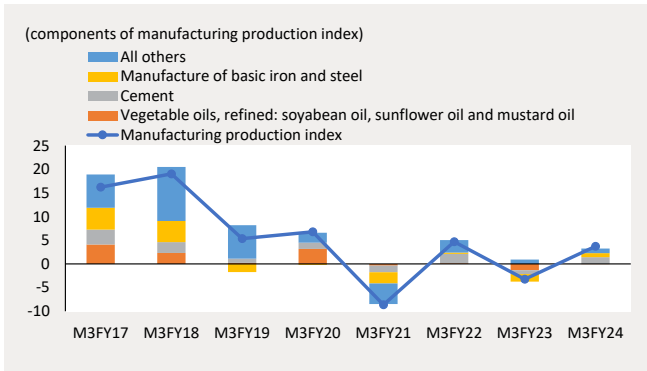
**Figure 7.** Hydroelectric production continued to grow, albeit at a slower rate.



Sources. Department of Electricity Development and World Bank staff calculations.

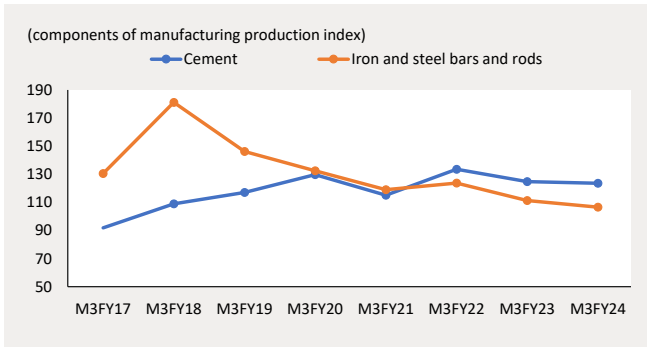


**Figure 8.** Manufacturing sector contributed to growth but remains subdued



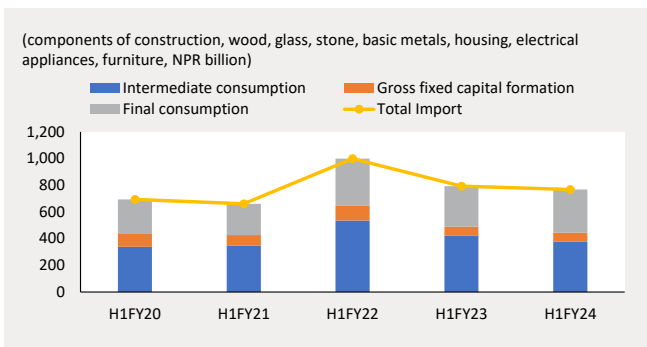
Sources. National Statistics Office and World Bank staff calculations.

**Figure 9.** Production of key construction materials like cement and iron and steel bars and roads contracted...



Sources. National Statistics Office and World Bank staff calculations.

**Figure 10.** ...along with a decrease in imports of intermediate consumption goods related to the construction sector



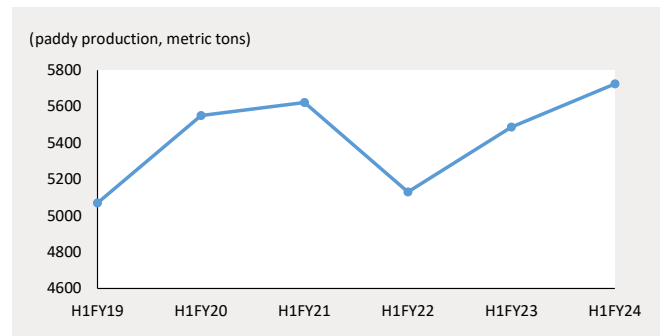
Sources. Nepal Rastra Bank and World Bank staff calculations.

### Agricultural Sector

The agricultural sector expanded by 1.2 percent (y/y) in the first quarter of FY24. This growth continued in second quarter with a 5.2 percent (y/y) increase in main season paddy production (Figure 11). Improved seed availability, agricultural

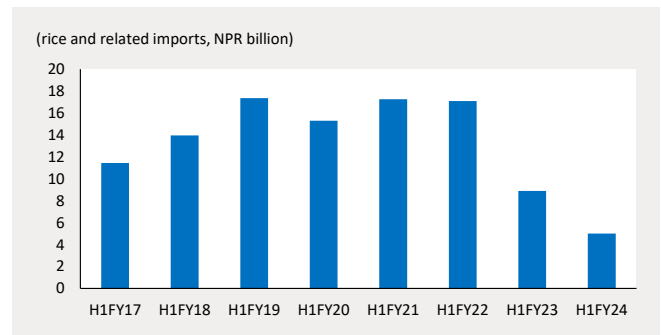
mechanization, and favorable weather conditions--despite the lack of rainfall in one province--contributed to the rise in paddy production. Notably, this increase in production, combined with a decrease in paddy cultivation area, led to a 5.6 percent (y/y) rise in paddy productivity. However, Nepal remains a rice importer, although imports decreased in H1FY24 due to India's restrictive measures on rice exports (Figure 12).

**Figure 11.** Agriculture expanded due to the increased production of paddy...



Sources. Ministry of Agriculture and Livestock Development and World Bank staff calculations.

**Figure 12.** ...however, Nepal remains a rice importer



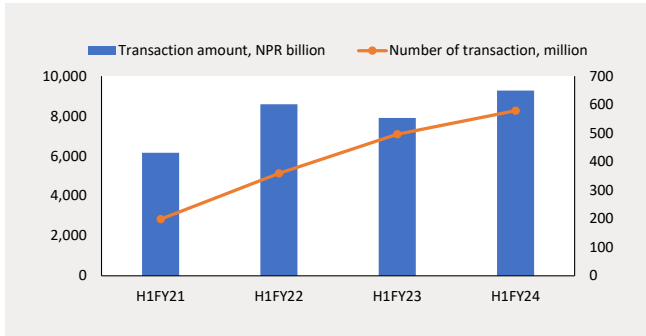
Sources. National Statistics Office and World Bank staff calculations.

### Gross Domestic Product by Demand

On the demand side, private consumption emerged as the primary driver of growth in H1FY24. High-frequency indicators include an increase in the numbers of digital payments, and a significant rise in remittances (up in nominal terms by 22.6 percent, y/y). Together these point towards a recent increase in private consumption (Figures 13 and 14). However, since H1FY21, the increase in remittances may not have contributed to the rise in consumption goods imports. Additionally, a slower growth of wages and salaries, relative to inflation, suggests a slowdown in private consumption among earners (Figure 15). Furthermore, the 2021 agricultural census reveals that nearly one-third of the total population

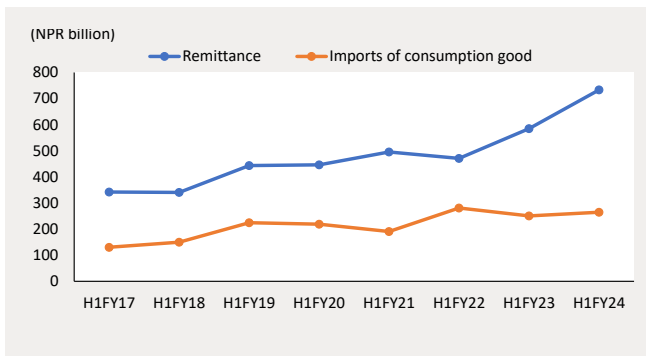
is engaged in farming, with almost 94 percent of agricultural holdings primarily producing for household consumption. Consequently, it remains unclear whether the reported increase in private consumption, evidenced by the rise in digital payments, extends to sectors that rely on traditional payment methods.

**Figure 13.** Private consumption remained strong as suggested by an increase in digital payments...



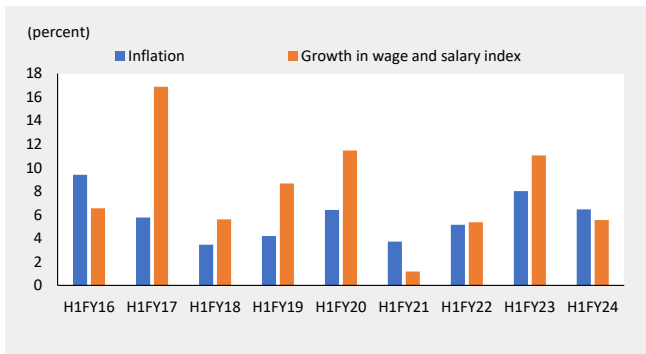
Sources. Nepal Rastra Bank and World Bank staff calculations.

**Figure 14.** ...and remittances also grew, but did not lead to matched increase in imports of consumption goods



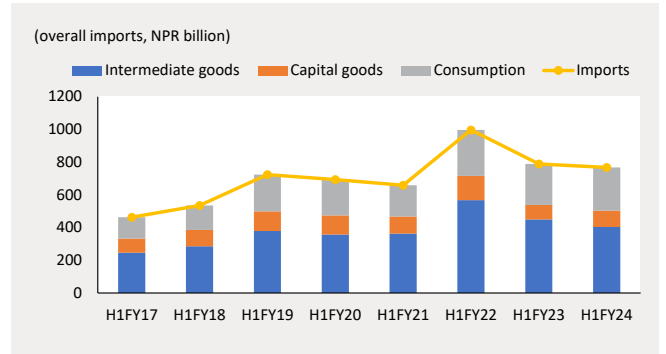
Sources. Nepal Rastra Bank, Department of Customs and World Bank staff calculations.

**Figure 15.** However, slower growth of wages and salaries, relative to inflation, suggests a slowdown in private consumption



Sources. Nepal Rastra Bank and World Bank staff calculations.

**Figure 16.** Private investment was subdued as suggested by a slight decline in the import of capital and intermediate goods



Sources. Department of Customs and World Bank staff calculations.

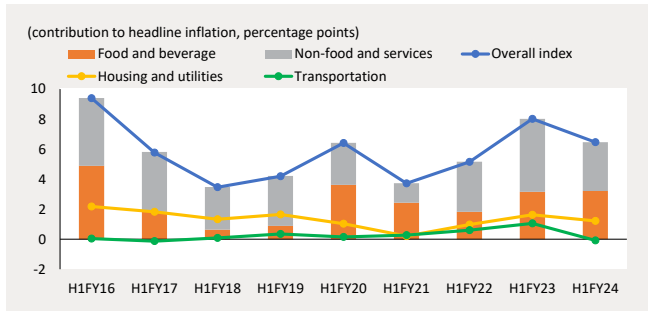
Private investment remained subdued in H1FY24, indicated by a 6 percent (y/y) contraction in nominal imports of capital and intermediate goods (Figure 16). Additionally, there was low nominal growth of non-financial business credit of 5.9 percent (y/y), primarily due to tighter regulation on working capital loans, elevated lending rates, and weak domestic demand (see Monetary and Financial Sector).

**Public consumption and investment remained weak.** Nominal public consumption, as measured by the growth of wages and goods and services, contracted by 11 percent (y/y) (see Fiscal Sector). Similarly, nominal public investment, proxied by capital spending, declined by 5.6 percent (y/y). These declines can be attributed to two key factors (see Fiscal Sector); i) implementation of austerity measures; and ii) lower budget for capital spending.

*Overall inflation moderated in H1FY24 due to declining non-food and service costs*

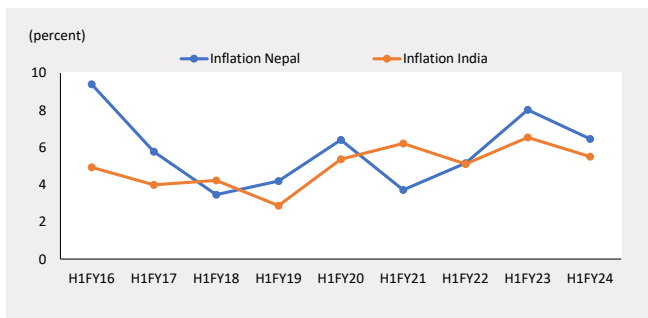
**Average consumer price inflation decreased in H1FY24, driven by declines in non-food and services inflation.** The average inflation rate decreased from 8 percent in H1FY23 to 6.5 percent (y/y) in H1FY24, which is equal to the central bank's FY24 inflation target of 6.5 percent (Figure 17). Despite the decrease, this marks the second-highest inflation rate since H1FY16. Non-food and services prices decreased by 1.7 percent points to 3.2 percent (y/y) in H1FY24 (down from 4.9 percent (y/y) in H1FY23). This decline reflects the easing of housing and utility prices and transportation prices amid the global decline in oil prices, leading to the lower overall inflation rate.

**Figure 17.** Average consumer inflation decreased in H1FY24 due to lower non-food and services inflation



Sources. Nepal Rastra Bank and World Bank staff calculations.

**Figure 18.** Average consumer inflation for India in H1FY24 remained lower than Nepal



Sources. Nepal Rastra Bank, Ministry of Statistics and Programme Implementation (India), and World Bank staff calculations.

**Conversely, food and beverage inflation increased marginally from 7.2 percent (y/y) in H1FY23 to 7.3 percent (y/y) in H1FY24.** An increase of cereal grain and spice inflation was offset by declines in prices of ghee and oil associated with the global decline in edible oil prices. The rise in cereal grain inflation can be partly attributed to two factors. One is the government’s increase in the minimum support price for paddy by more than 7.5 percent. The other is India’s restrictive measures on rice exports, and additional 20 percent export duty. Additionally, higher spice inflation was triggered by increased prices of large cardamom and cumin.

**Among other factors, Nepal’s inflation is influenced by India’s inflation due to the currency peg, but inflation in India during H1FY24 remained lower than in Nepal** (Figure 18). The imposition of VAT on air travel and other select goods, such as potatoes and onions, coupled with India’s export ban on onions could have also contributed to the relatively higher inflation in H1FY24.

*Nepal’s poverty rate fell due to migration and remittances, alongside consumption increases, but challenges persist with a weak labor market and limited social assistance, posing risks amid economic and climate shocks.*

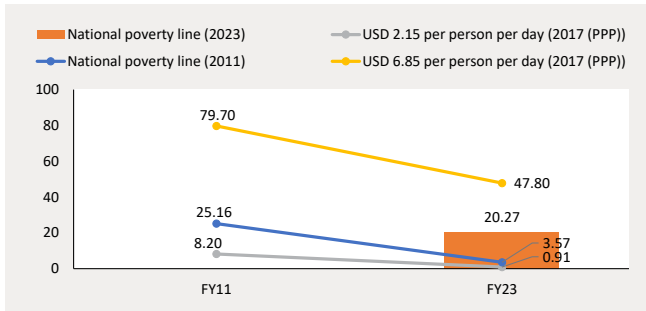
**Nepal’s poverty rate fell, due in large part to a surge in migration and their remittances.** The recent nationally household survey data from the Nepal Living Standard Survey 2022/23 shows a large decline in poverty from 25 percent to just 3.6 percent between 2011 and 2023 (using 2011 National Poverty Line), while the extreme poverty rate (using the USD 2.15 line) dropped to below 1 percent. Meanwhile the share of population living below the USD 6.85 poverty line (used by upper middle-income countries) fell from 79.7 to 47.8 percent (Figure 19).<sup>1</sup> This reduction was accompanied by a 66 percent increase in average real per capita consumption, with a 70.8 percent rise among the bottom 40 percent of the population. Migrants’ remittances played a crucial role in this poverty reduction, directly contributing about a third of the decrease, while indirectly boosting domestic wages. The higher wages followed a shift in demand for labor away from agriculture. The percentage of households receiving remittances and the per capita remittances increased for both poor and non-poor households, but it especially benefitted those at the lower end of the income distribution. Emigration remains an attractive choice for Nepalis due to limited job opportunities at home and significantly higher wages abroad, where migrant workers earn three times more than domestic workers on average.

**The prosperity gap and inequality also reduced over the last decade.** The prosperity gap, defined as the average factor by which per capita expenditure fall short of the prosperity standard of USD 25 per person per day, decreased from 6.7 in FY11 to 3.7 in FY23. The inequality, defined by Gini index for consumption inequality, fell by 1.5 percentage points from 32.8 in FY11 to 31.3 in FY23 (Figure 20). While the gap between the richest 10 percent and the poorest 10 percent (90/10 ratio) is still substantial (7.1 times higher consumption in 2023), it narrowed slightly compared to 2011. Similarly, the gap between the richest 10 percent and the middle class (90/50 ratio) also decreased from 3.5 to 3.2 over the same period. Nepal has even raised its official poverty line, by raising the real value of the threshold by 70 percent to reflect rising living standards and changing consumption patterns. Under the revised new poverty threshold, one-fifth of the Nepal’s population now lives in poverty (Figure 19).

<sup>1</sup> The FY23 poverty rates using the international lines and the Gini index presented in the trends are based on the 2022/23 welfare aggregate, which is comparable with the NLSS III. The same indicators with the newly updated 2022/23 welfare aggregate, which will serve as benchmarks for future comparisons, are as follows: poverty headcount rates at USD 2.15 and USD 6.85 per person per day thresholds are 0.37 percent and 44.07 percent, respectively, while the Gini index is 30.02.

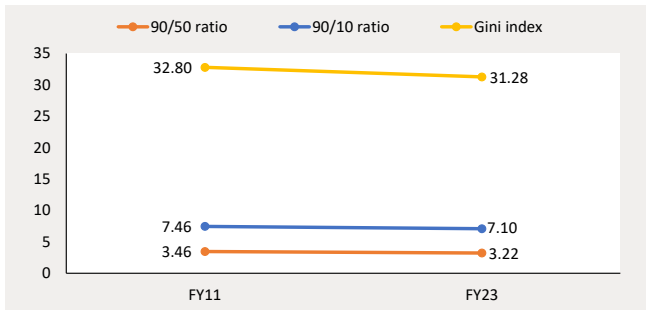


**Figure 19.** Poverty rate fell in 2023 using 2011 National Poverty Line



Sources. National Statistics Office and World Bank staff calculations.

**Figure 20.** Inequality also reduced over the decade to 2023



Sources. National Statistics Office and World Bank staff calculations.

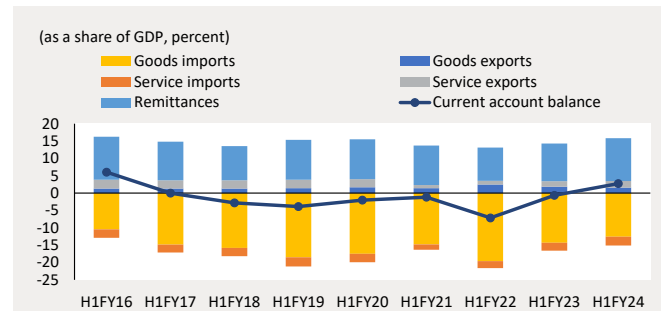
**Observed progress remains at significant risk from economic and climate shocks, mainly due to the lack of targeted policy instruments for the poor and a weak domestic labor market.** The rate of being out of the labor force remains high even for those with secondary education (52 percent) and tertiary education (28 percent), with high unemployment prevalent across the education distribution. Self-employment or unpaid work comprised a third of all employment in FY23. Despite this, the current social assistance programs are largely categorically targeted and have limited reach among the poor. Even with a significant increase in senior citizens’ and single women’s allowances (by 10 and 6 times, respectively) and the introduction of new cash-based support programs over the last decade, social assistance contributes marginally to poverty reduction (by 2 percentage points in FY23). The absence of well-targeted social protection that can reach both the poor and be scaled up in response to shocks adds to the increasing risk of falling back into poverty, particularly in the face of Nepal’s high vulnerability to climate change<sup>2</sup> and weak insurance markets.

## A.2 EXTERNAL SECTOR

The external sector saw continued improvement, as the current account balance shifted to a surplus fueled by rising remittances and a shrinking trade deficit, resulting in an increase in foreign exchange reserves.

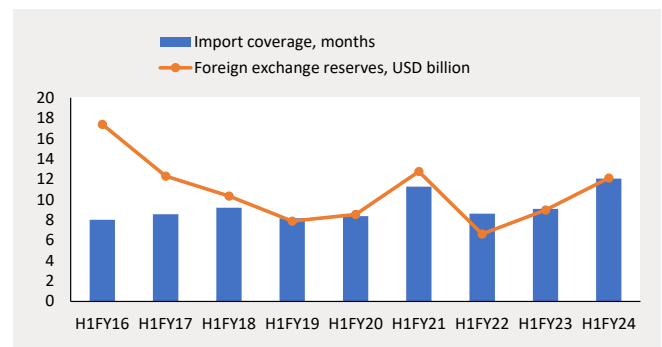
**The current account balance turned positive in H1FY24 as remittances expanded and trade deficit narrowed.** The current account balance shifted from a deficit of 0.7 percent of GDP in H1FY23 to a surplus of 2.7 percent of GDP in H1FY24, the first surplus in eight years (Figure 21). The surplus was primarily driven by higher remittances, which rose from 10.9 percent of GDP in H1FY23 to 12.3 percent of GDP in H1FY24, plus the narrowing trade deficit, which decreased from 13.2 percent of GDP to 11.6 percent of GDP over the same period. As a result of the surplus, official foreign exchange reserves increased to 12.1 months of import cover at the end of H1FY24 (Figure 22).

**Figure 21.** The current account balance turned positive in H1FY24...



Sources. Nepal Rastra Bank and World Bank staff calculations.

**Figure 22.** ...leading to an accumulation of reserves.



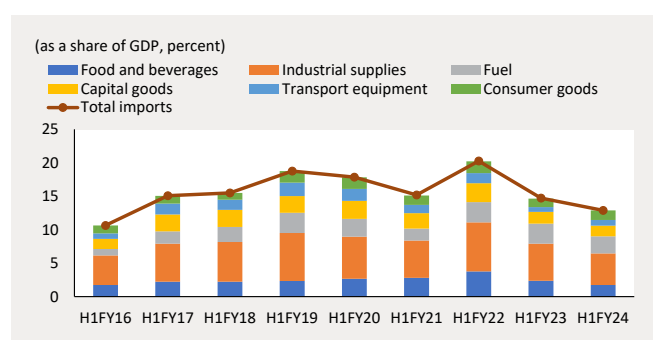
Sources. Nepal Rastra Bank and World Bank staff calculations.

<sup>2</sup> Nepal also faces increasing climate risks; while it ranks 10th in the world as a country most affected by past climate hazards, it is 44th most vulnerable to future climate risks.

**Imports continued to decline from a peak of H1FY22.**

Imports fell from 14.3 percent of GDP in H1FY23 to 12.6 percent of GDP in H1FY24, due to a decrease in goods imports (Figure 23). A decline in industrial supplies import significantly contributed to lower goods imports in H1FY24. By contrast, imports of electric cars, jeeps, and vans (included under transport equipment) increased by more than 100 percent (y/y) in part due to lower customs duties on these vehicles compared to their fossil fuel counterparts. The pace of decline in goods imports, however, was in H1FY24 slower compared to H1FY23 when import restriction measures were in effect. Key factors contributing to the decrease in goods imports included: i) India’s reduction in custom duties on edible oil imports, leading to a 64.7 percent (y/y) decrease in crude edible oil imports; ii) lower fossil fuel prices; and iii) lower imports of unwrought gold.

**Figure 23.** Goods imports continued to decline in H1FY24



**Sources.** Department of Customs, Nepal Rastra Bank, and World Bank staff calculations.

**Note:** Goods imports do not include electricity imports.

**While goods imports declined, services imports in H1FY24 surpassed their pre-pandemic level of H1FY20.**

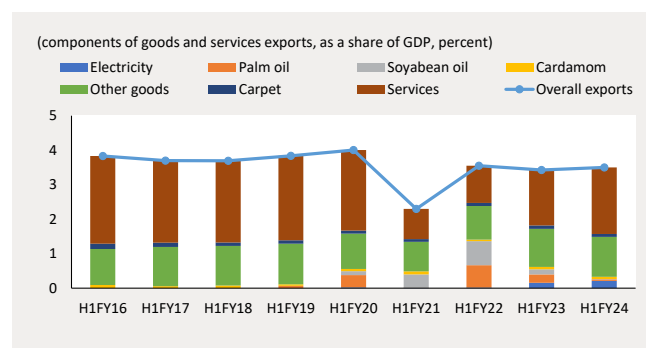
In H1FY24, services imports reached 2.6 percent of GDP, expanding by 0.3 percentage points compared to H1FY23. This growth was

primarily driven by a rise in educational services imports, fueled by Nepalese students pursuing higher education abroad. During H1FY24, over 45,000 Nepalese obtained no objection certificates from the government to study abroad.

**Exports of goods and services grew marginally but remained below their pre-pandemic level of H1FY20.**

Exports expanded by 0.1 percentage points to 3.5 percent of GDP in H1FY24 (Figure 24 and Table 1), driven by a significant surge in international tourist arrivals, which rose by 45.8 percent (y/y) in H1FY24. However, the travel component of services exports continued to lag the travel component of services imports since the first half of FY20. Goods exports, excluding electricity, on the other hand, declined due to lower exports of refined edible oil. Electricity exports continued to expand, reaching 0.2 percent of GDP and surpassing imports, supported by increased hydroelectricity production. Among the components of goods exports, iron and steel exports also experienced a significant increase, doubling their share to 0.1 percent of GDP. The government added iron and steel, as well as electricity, along with other goods and services, to the list of promising export items in the new Nepal Trade Integration Strategy, which has been implemented since July 2023.

**Figure 24.** Exports of goods and services grew marginally



**Sources.** Department of Customs, Nepal Rastra Bank, and World Bank staff calculations.

**Table 1.** Selected External Sector Indicators (percent of GDP)

	H1FY18	H1FY19	H1FY20	H1FY21	H1FY22	H1FY23	H1FY24
Current Account Balance	-2.8	-3.9	-2.0	-1.2	-7.1	-0.7	2.7
Balance of Goods and Services	-14.5	-17.3	-15.9	-14.0	-18.1	-13.2	-11.6
Total Exports of Goods and Services	3.7	3.8	4.0	2.3	3.6	3.4	3.5
Total Imports of Goods and Services	-18.2	-21.1	-19.9	-16.3	-21.6	-16.6	-15.1
Remittances	9.9	11.5	11.5	11.4	9.5	10.9	12.3
Net Foreign Direct Investment	0.4	0.1	0.3	0.2	0.2	0.0	0.1
Gross Official Reserves (USD billion)	10.5	9.4	9.7	12.8	9.9	10.3	13.7

**Source:** Nepal Rastra Bank and World Bank staff calculations

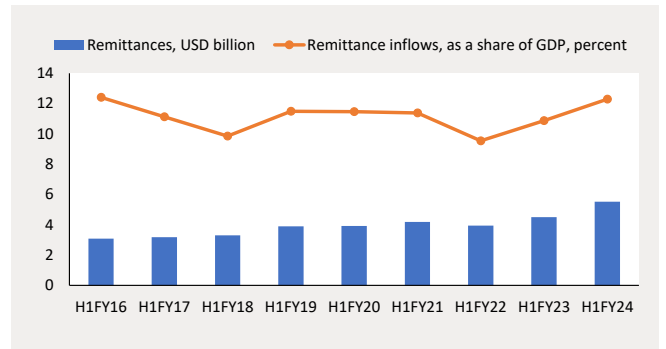
**Official remittance inflows continued to expand in H1FY24 at the same rate observed in H1FY23.**

Remittance inflows jumped from 10.9 percent of GDP in H1FY23 to reach an eight-year peak of 12.3 percent of GDP in H1FY24 (Figure 25). Higher outmigration in previous years (Figure 26), plus a 2.2 percent (y/y) depreciation of the Nepalese rupee (NPR) against the US dollar, fueled the rise in remittances in H1FY24. Additionally, the expansion of money transfer agencies and government incentives for migrant workers, such as reserving 10 percent of Initial Public Offerings, providing social security benefits, and offering higher interest rates on fixed deposits, encouraged these funds to flow through official channels, further contributing to the higher remittance inflows.

**The nominal effective exchange rate (NEER) remained relatively unchanged, while the real effective exchange rate (REER) appreciated.**

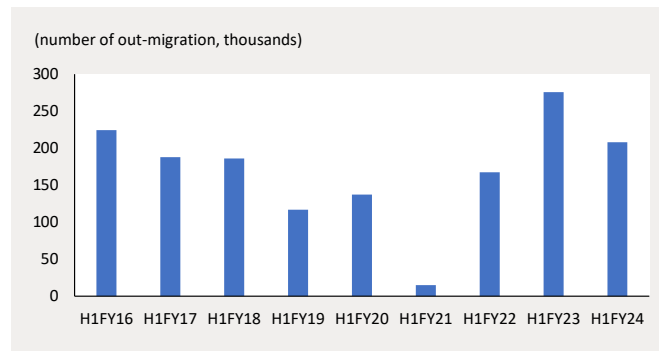
In H1FY24, the NEER - calculated as the geometric weighted average of nominal bilateral rates between the NPR and a basket of currencies of major trading partners- declined marginally by 0.1 percent (y/y) (Figure 27). Conversely, the REER, which adjusts the NEER by relative consumer prices, appreciated by 2.4 percent (y/y). The REER appreciation - with relatively unchanged NEER - suggests that consumer prices in Nepal increased at a higher pace than in its major trading partners.

**Figure 25.** Remittance inflows continued to expand in part due to ...



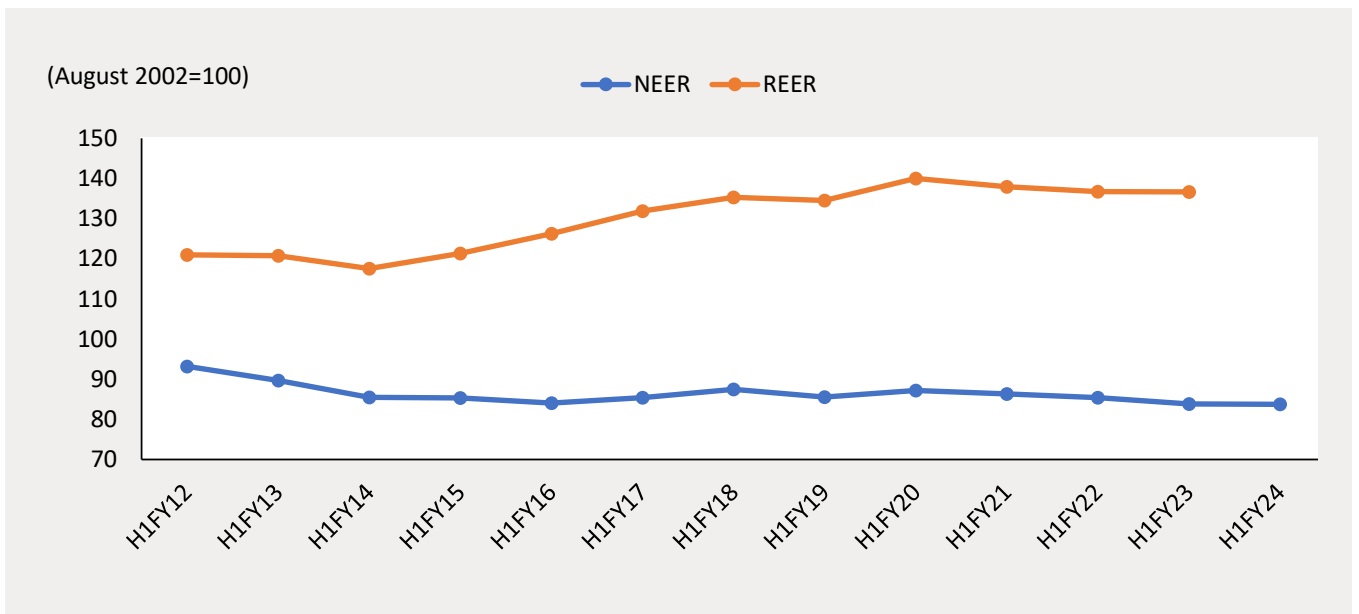
Sources. Nepal Rastra Bank and World Bank staff calculations.

**Figure 26.** ... increasing outmigrant from previous years



Sources. Nepal Rastra Bank and World Bank staff calculations.

**Figure 27.** Nominal effective exchange rate remained relatively unchanged, while real effective exchange rate appreciated



Sources. World Bank staff calculations

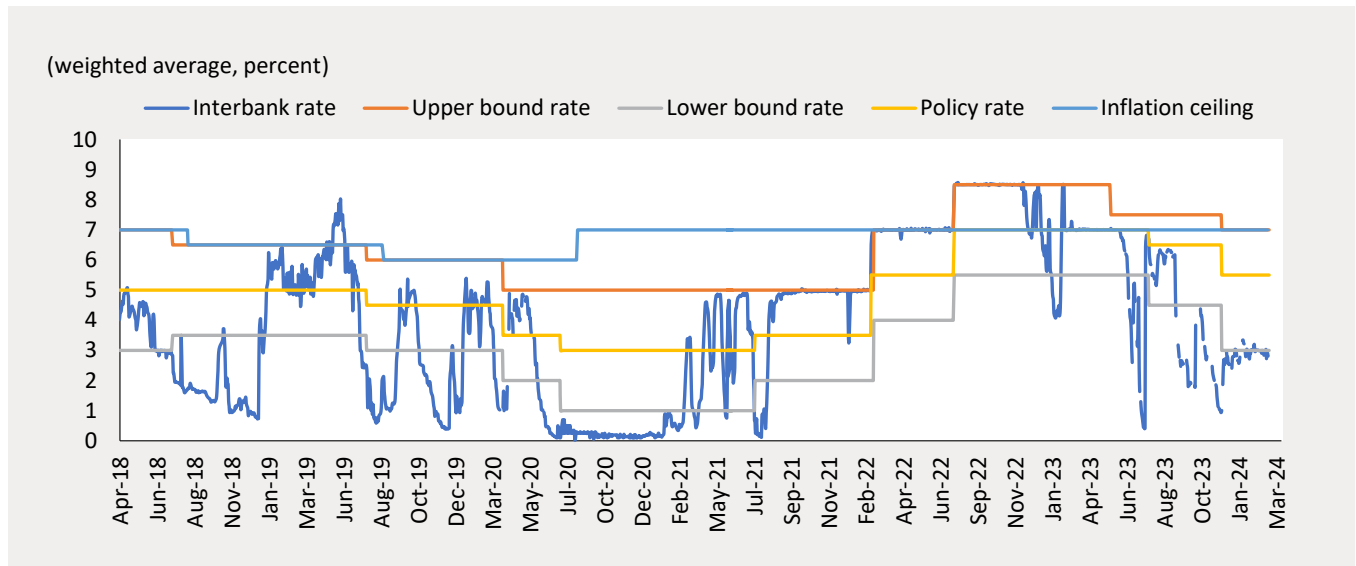
## A.3 MONETARY AND FINANCIAL SECTOR

Monetary policy remained cautiously accommodative, balancing the need to manage inflation and external pressures, while supporting credit flow towards productive sectors.

**After three hikes in FY22 and FY23, the NRB lowered its policy rates twice in H1FY24 as inflationary and external pressures eased.** The NRB raised its policy rate by 400 basis

points in FY22 (August 2021 and February 2022) and FY23 (July 2022). However, at the beginning of FY24 (July 2023), it lowered its policy rate by 50 basis points, and further by 100 basis points to 5.5 percent in December 2023 (Figure 28). Since FY23, the NRB implemented a rule for setting the policy rate based on foreign exchange reserves and inflation rate ceiling.<sup>3</sup> While inflation pressures are gradually easing and the external sector is stable, the recent policy rate reduction below the inflation ceiling (6.5 percent) contradicts the NRB’s new monetary policy rule.

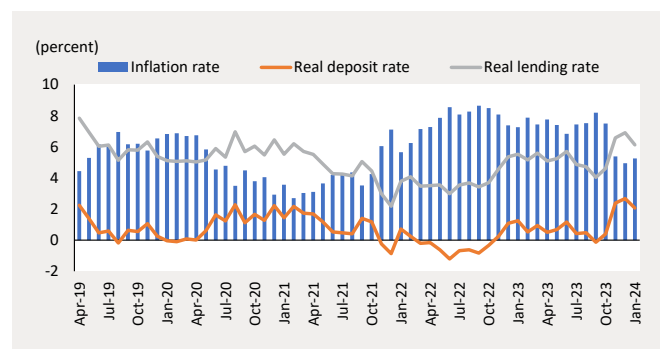
**Figure 28.** The central bank cut the policy rate twice in H1FY24



Sources. Nepal Rastra Bank and World Bank staff calculations.

**Real interest rates on deposits turned positive in November 2022, and continued this trend in H1FY24.** With inflation trending downwards at a pace higher than the nominal weighted average interest rate on deposits, the real interest rate on deposits picked up and reached above 2 percent in the last three months of H1FY24, the first since February 2021 (Figure 29).

**Figure 29.** Real interest rates remained positive in H1FY24...



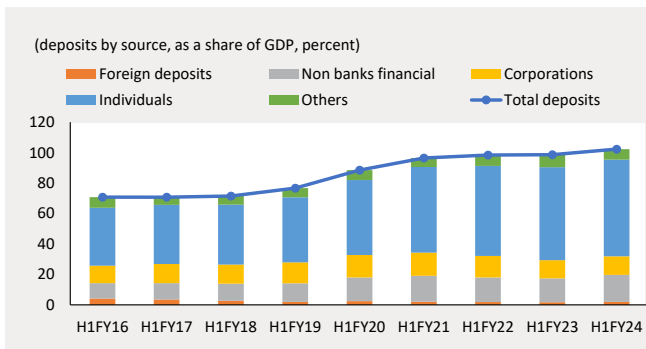
Sources. Nepal Rastra Bank and World Bank staff calculations.

<sup>3</sup> The Central Bank Act defines the objective of the central bank as follows: ‘...to formulate necessary monetary and foreign exchange policies in order to maintain the stability of prices and balance of payments for economic stability and sustainable development of the economy and manage it...’. Starting from FY23, the central bank explicitly stated in its monetary policy speech that the policy rate will be determined based on the capacity of foreign exchange reserves to cover imports of goods and services, as well as inflation. Furthermore, it was announced that the policy rate will not be set lower than the annual inflation target.



**Positive real interest rates increased remittances and spurred deposit growth.** As a result, deposits reached 102.3 percent of GDP by the end of H1FY24, a 3.7 percentage point increase compared to H1FY23 (Figure 30). Individual deposits, which accounted for more than 60 percent of overall deposits, contributed 2.3 percentage points to this rise, followed by non-banking financial institutions (2.1 percentage points). Within deposit types, time deposits and saving deposits led the growth, driven by higher interest rates.

**Figure 30.** ...resulting in an increase to overall deposits



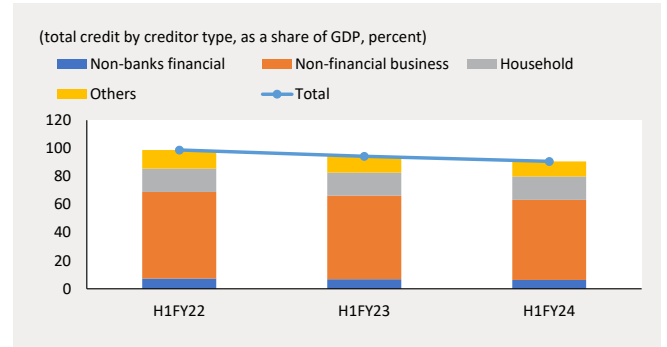
Sources. Nepal Rastra Bank and World Bank staff calculations.

Note: Others include local government, Non-profit organizations, and miscellaneous

**In contrast, private sector credit contracted by 3.6 percentage points to 90.7 percent of GDP by the end of H1FY24.** Non-financial business credit, the largest category, led the decline, falling by 2.6 percentage points, despite a 1.4 percentage point decrease in lending rates (Figure 31). This decrease was primarily due to tighter regulation on working capital loans implemented by the central bank from October 2022 and in line with FY24’s monetary policy to shift its focus towards channeling credit towards productive sectors, particularly small and medium-sized enterprises, while discouraging excessive concentration of loans. These guidelines capped loans to a company’s annual turnover and required repayment of excess amounts in installments by mid-June 2025. Additionally, elevated lending rates, lower public investment execution, and weak domestic demand could have also contributed to the lower non-financial business credit. However, in contrast, household credit, consisting primarily of education, hire purchase, personal, and real estate loans, expanded by 0.4 percentage points, driven by higher educational and personal loans. During H1FY24, the central bank implemented several key measures to stimulate credit growth. These included: i) increase in the maximum loan amount for first-time residential homes from NPR 15 million to NPR 20 million; ii) increase in the loan-to-

value ratio for personal loans up to NPR 5 million, from a range of 30-40 percent to 50 percent; and iii) increase in the loan-to-value ratio for real estate loans within the Kathmandu Valley, from 40 percent to 50 percent.

**Figure 31.** However, private sector credit declined driven by non-financial business credit...

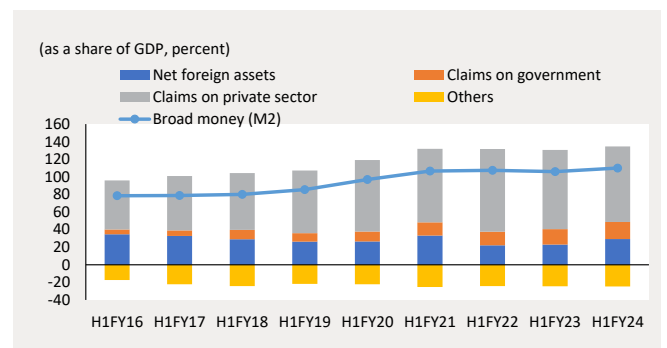


Sources: Nepal Rastra Bank and World Bank staff calculations.

Note: Others include “Others” as defined in private credit by sector and lending to staff of banking and financial institutions

**While private sector credit contracted, the broad money supply (M2) increased from 106.6 percent to a record high of 110 percent of GDP between H1FY23 and H1FY24** (Figure 32). This growth was primarily driven by a rise in credit to the government (1.8 percentage points) and foreign assets (5.5 percentage points), offsetting the effect of declining private sector credit on money supply. Government borrowing increased due to moderate revenue performance (see fiscal section), and foreign assets rose on the back of higher remittances (see external section).

**Figure 32.** ...but this was more than offset by the increase in credit to government and foreign assets resulting in a record high for broad money supply



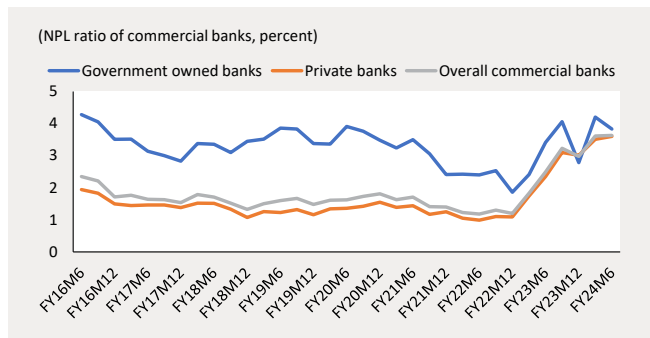
Sources. Nepal Rastra Bank and World Bank staff calculations.

Note: Others stand for government deposits, claims on non-financial government enterprises, claims on financial institutions, and net non-monetary liabilities

The banking sector maintained its stability and profitability, supported by robust asset quality, steady liquidity, and prudent capital adequacy ratios, despite facing a slight uptick in nonperforming loans and challenges to the capital adequacy fund.

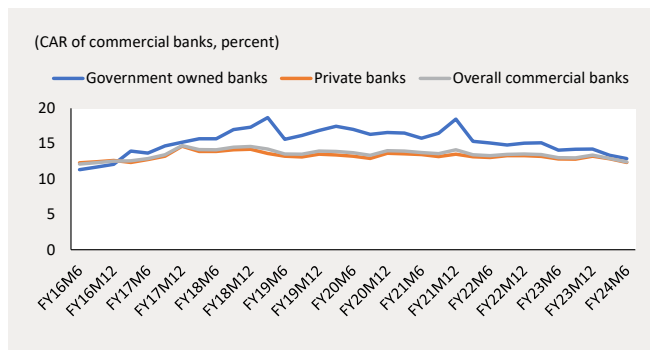
**The banking sector’s asset quality remained adequate through the first half of FY24 but continued to show signs of deterioration.** The share of nonperforming loans (NPLs), defined as loans overdue by 90 days or more, stood below 5 percent in January 2024 for commercial banks. However, during the first half of FY24, NPLs of commercial banks increased on aggregate, with private commercial banks experiencing a larger relative increase<sup>4</sup> compared to state-owned commercial banks (Figure 33). Consequently, the number of borrowers being blacklisted<sup>5</sup> surged by close to 90 percent (y/y) in H1FY24. Therefore, close monitoring of the banking sector’s asset quality is warranted, given the potential deterioration of loans in sectors such as hotels, restaurants,

**Figure 33.** Banking sector’s asset quality deteriorated recently but remained below 5 percent level...



Sources. Nepal Rastra Bank and World Bank staff calculations.

**Figure 34.** ...while capital adequacy ratio stood well above the regulatory minimum capital adequacy ratio



Sources. Nepal Rastra Bank and World Bank staff calculations.

construction, and livestock, which were granted a six-month extension for restructuring and rescheduling until mid-January 2024 in October 2023. A recently announced audit of the 10 largest banks, scheduled to take place later this year, would help assessing the quality of their loan portfolios.

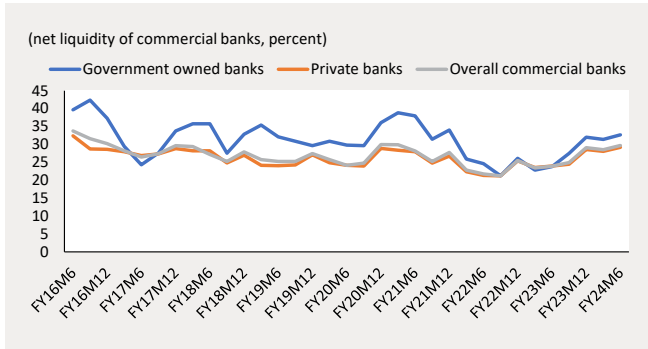
**The banking sector’s capital adequacy remained well above the regulatory minimum capital adequacy ratio (CAR) of 11 percent, but recent pressures have been observed.** In mid-January 2024, the CAR of commercial banks was 12.4 percent, with state-owned and private commercial banks at 12.9 percent and 12.3 percent respectively, as of mid-January 2024 (Figure 34). Commercial banks are mandated to maintain a countercyclical buffer of 0.5 percent by the end of FY24, raising the minimum CAR to 11.5 percent. Additionally, in February 2024, the central bank increased the threshold for loans extended to agricultural, small, cottage, and medium-scale enterprises counted in the ‘Regulatory Retail Portfolio’ from NPR 10 million to NPR 20 million. This measure is anticipated to alleviate pressure on the capital adequacy fund, as these portfolios carry a relatively low risk weight of 75 percent. As of mid-January 2024, three private commercial banks had a core capital adequacy ratio (CCAR) below the regulatory minimum of 8.5 percent.

**The aggregate liquidity of the banking sector increased in H1FY24 relative to H1FY23, with the key indicator of aggregate liquidity, net liquidity (defined as net liquid assets to total deposits), staying above the regulatory requirement of 20 percent throughout the first six months of FY24** (Figure 35). This increase could be attributed to a surge in remittance inflows during H1FY24 (refer to the external section) and the lack of demand for credit. Consequently, the interbank rate mostly stayed below the lower bound rate of the interest rate corridor in H1FY24, even after a 150-basis point decrease to 3 percent in December 2023, and despite the central bank’s attempt to absorb the excess liquidity of NPR 315 billion through the deposit collection (Figure 28). However, starting from mid-February 2024, the central bank began implementing the standing deposit facility to absorb excess liquidity, under which banks will be able to deposit excess funds in the central bank at the deposit collection rate rather than waiting for the central bank to conduct periodic auctions. As of March 3, 2024, it had absorbed over NPR 400 billion of excess liquidity from the market, thereby maintaining the interbank rate close to the lower bound rate of the interest rate corridor.

<sup>4</sup> The level of NPLs represents the absolute amount of problematic loans at a specific point in time, while the growth rate of NPLs indicates how rapidly this level is changing over time. NPL of state-owned commercial banks increased by 12 percent (y/y), while that of private commercial banks increased by 53 percent (y/y).

<sup>5</sup> Borrowers may be blacklisted for following reasons; i) failing to repay loans of NPR 1 million after one year; ii) misusing collateral; and iii) providing false statements regarding their business or collateral.

**Figure 35.** The aggregate liquidity of the banking sector also increased.

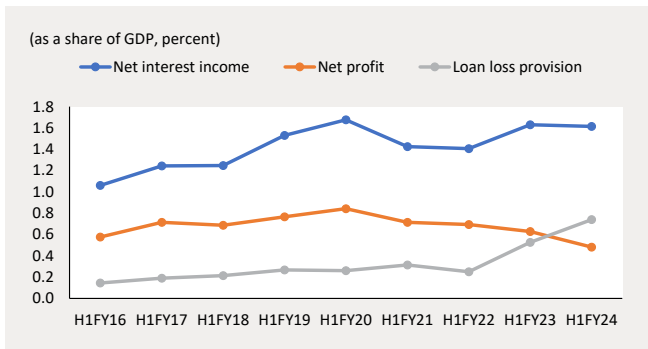


Sources. Nepal Rastra Bank and World Bank staff calculations.

**The overall banking sector has remained profitable, but net profits have been decreasing since H1FY23.**

In H1FY24, the net profit of commercial banks decreased by 14.9 percent (y/y), compared to a decline of 1.3 percent (y/y) in H1FY23, reflecting a decrease in net interest income (Figure 36). This decline primarily resulted from increased interest expenses on fixed deposits with a tenure of over one year. Additionally, the increase in loan loss provisions resulting from the increase in NPL, which stood at 3.2 percent of GDP by the end of H1FY24, also contributed to the decline in net profit. However, the central bank introduced provisions aimed at preventing further increases in loan loss provisions. For example, in October 2023, the central bank reduced the loan loss provision on good loans from 1.3 percent to 1.25 percent and allowed an extension for restructuring and rescheduling of loans for select sectors, which would carry a loan loss provision of only 5 percent.

**Figure 36.** Banking sector’s net profit declined in H1FY24 due to a decrease in net interest income and increase in loan loss provision



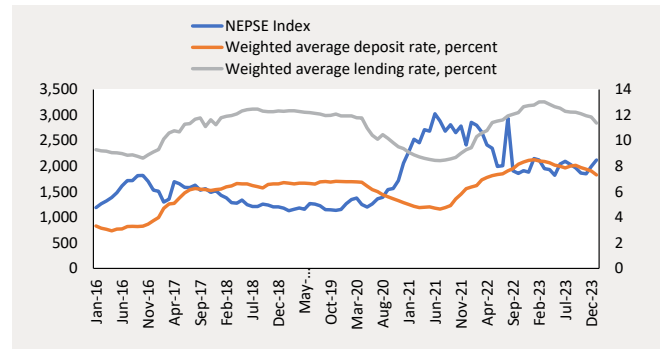
Sources. Nepal Rastra Bank and World Bank staff calculations.

Despite marginal improvements, Nepal’s stock market remained subdued relative to the peak of June 2021.

**The stock market continued to remain below the peak of June 2021 in H1FY24.**

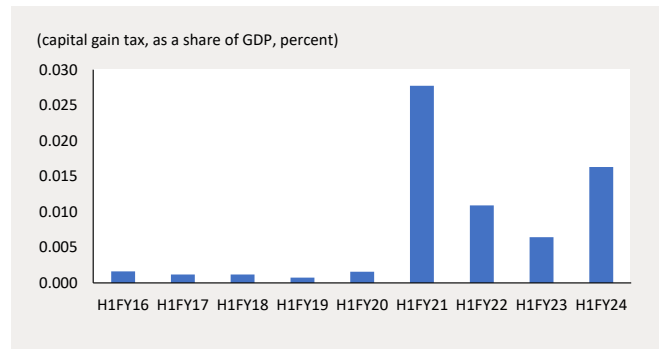
Although the Nepal Stock Exchange Index (NEPSE) rose by 1.1 percent during this period, partly attributed to the decrease in interest rates, it remained below its peak in June 2021 (Figure 37). Moreover, trading volume and value increased in H1FY24 after a contraction in H1FY23. Consequently, capital gains tax from the stock market rose by more than 50 percent (y/y) (Figure 38). To bolster the stock market, the central bank modified the risk weightage for share mortgage loans, increasing the limit to NPR 5 million (up from NPR 2.5 million previously), while maintaining a 100 percent risk weight for loans up to NPR 5 million (extended from NPR 2.5 million under the previous policy). Additionally, the central bank raised the maximum single obligor limit for lending against shares from NPR 120 million to NPR 150 million for individual investors and NPR 200 million for institutional investors dedicated to the securities market.

**Figure 37.** Stock market index rose in H1FY24 but remains below the peak of June 2021



Sources. Nepal Stock Exchange and World Bank staff calculations.

**Figure 38.** Capital gains tax raised from the stock market increased, due to increase in trading value and volume



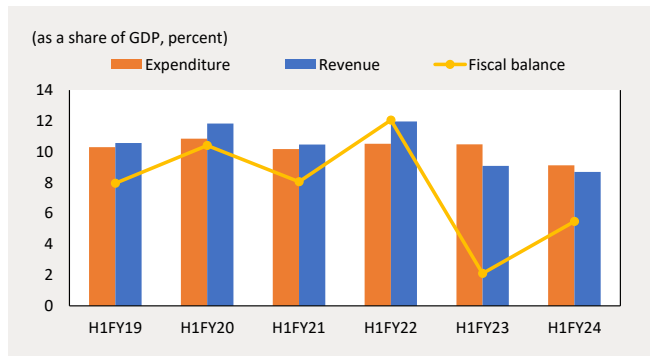
Sources. CDSC and World Bank staff calculations.

## A.4 FISCAL SECTOR

Despite revenue hitting an eight-year low, Nepal's fiscal deficit shrank as spending decreased. Public debt remains manageable, buoyed by a significant share of external concessional loans.

The fiscal deficit decreased in H1FY24, with the half year number narrowing from 1.4 percent of GDP in H1FY23 to 0.4 percent of GDP in H1FY24, primarily due to reduced spending. This marks the second consecutive year of a negative fiscal balance, after consistent surplus from H1FY19 to H1FY22 (Figure 39). The government faced a revenue shortfall in H1FY23 due to import restrictions, which contributed to the larger fiscal deficit in that period.

**Figure 39.** Lower spending led to reduction in the fiscal deficit in H1FY24

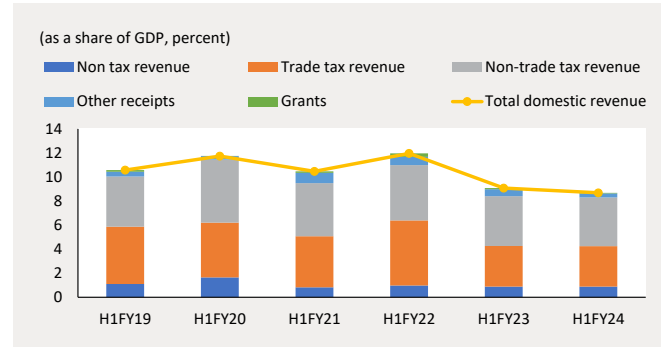


Source: Ministry of Finance and World Bank staff calculations.

Revenue (including grants) reached an eight-year low in H1FY24, with half-year numbers declining from 9.1 percent of GDP in H1FY23 to 8.7 percent of GDP in H1FY24. This decline was primarily driven by lower non-trade revenues (Figure 40), attributed to: i) reduced excise revenue resulting from decreased demand for health-damaging products such as tobacco, liquor, and beer<sup>7</sup>; and ii) diminished VAT revenue from domestic production and distribution of goods, as well as lower income tax revenue from individuals and private limited companies, due to weakened domestic demand (Figure 41). However, there was an improvement in VAT on tourism and travel services due to the implementation of VAT on air travel (except for inbound in case of international travel), carriage service, and cargo services<sup>8</sup> (except for export). Furthermore, income tax revenue from public limited companies increased following the FY24 budget provision requiring banks, financial institutions (including insurance companies), to pay income tax on profits derived from mergers or acquisitions and issuance of Further Public Offerings at a premium rate. Trade revenues

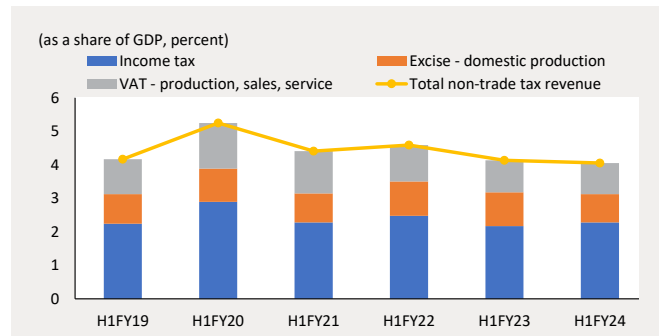
remained relatively stable at 3.4 percent of GDP (Figure 42), as the decline in imports was less pronounced in H1FY24 compared to H1FY23. Non-tax revenues also rose marginally on the back of an increase in dividend receipts from financial institutions, and passport fees from increased migration (Figure 40). Tax expenditure also contributed to the decline in revenue, with an increase of 0.3 percentage points of GDP in H1FY24.

**Figure 40.** Revenue reached an eight-year low in H1FY24 driven by lower non-trade revenue...



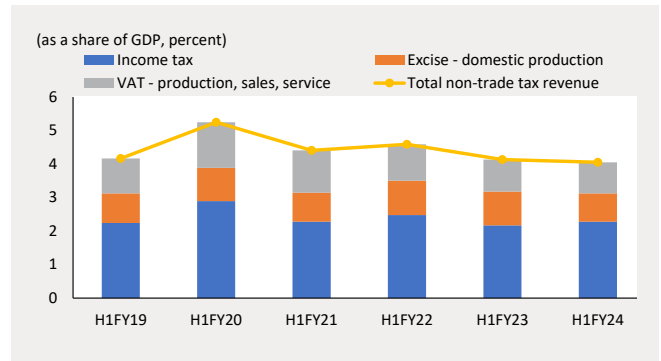
Source: Ministry of Finance and World Bank staff calculations.

**Figure 41.** ...indicating weak domestic demand and lower demand for health-damaging products...



Source: Ministry of Finance and World Bank staff calculations.

**Figure 42.** ...while trade revenues remained below trend levels



Source: Ministry of Finance and World Bank staff calculations.

<sup>6</sup> Most public spending is bunched into the last quarter of the fiscal year, and this is particularly pronounced for capital spending. As such large share of fiscal deficit does not occur in the first half of fiscal year.

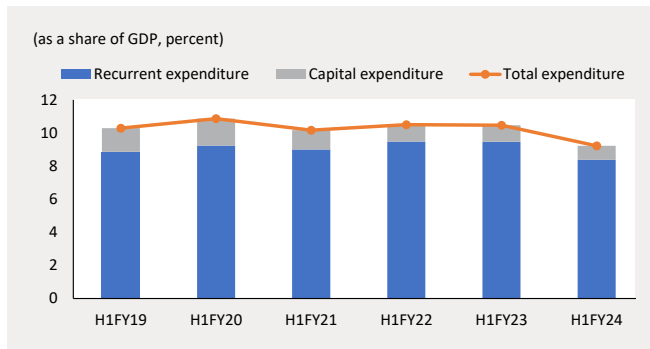
<sup>7</sup> Data for the first quarter of FY24 suggests that the production of tobacco and beer decreased by 1.5 percent (y/y) and 6 percent (y/y), respectively.

<sup>8</sup> The government-imposed VAT on these services through the FY24 budget.



Expenditures also contracted in H1FY24, declining from 10.5 percent of GDP in H1FY23 to 9.1 percent of GDP in H1FY24, primarily due to lower recurrent expenditure (Figure 43). The recurrent expenditure declined due to two key factors: i) reduced fiscal transfers, including revenue sharing with subnational governments (Figure 45), aligned with lower budget allocations resulting from revenue shortfalls; and ii) implementation of austerity measures, such as the abolition of incentive allowances, additional time allowances<sup>9</sup>, purchase of new vehicles and furniture, as well as restructuring and vacancies in government agencies (Figure 44). Additionally, capital expenditure also saw a decrease (Figure 43) due to lower budget allocations<sup>10</sup> and structural issues of underspending of the capital budget.

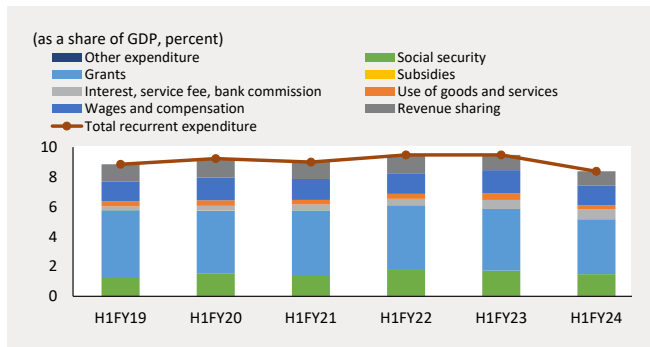
**Figure 43.** Expenditures declined mainly due to a lower recurrent spending...



**Source:** Ministry of Finance, Nepal Rastra Bank, and World Bank staff calculations.

**Note:** Recurrent spending includes revenue sharing to sub-national governments.

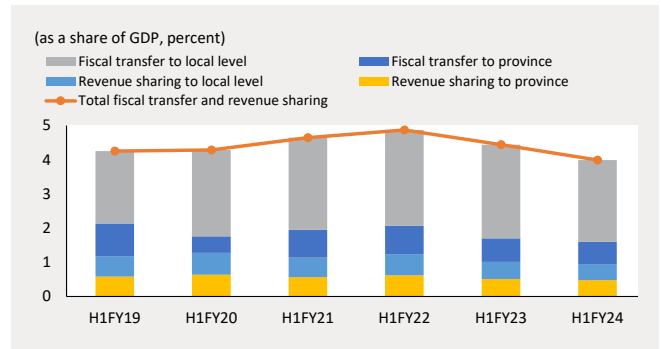
**Figure 44.** ...reflecting lower administrative spending...



**Source:** Ministry of Finance, Nepal Rastra Bank, and World Bank staff calculations.

**Note:** Recurrent spending includes revenue sharing to sub-national governments.

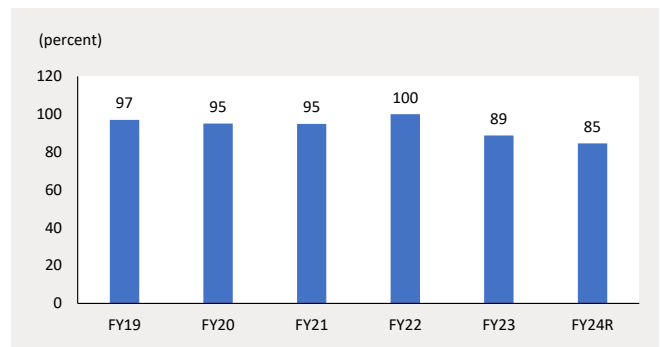
**Figure 45.** ...and reduced fiscal transfers



**Source:** Ministry of Finance and World Bank staff calculations.

To address the revenue and external borrowing shortfall, the government adjusted original FY24 budgeted expenditure downward. Given the revenue performance in H1FY24, the government revised the original FY24 revenue target downward by 15.5 percent as part of its mid-term review (Figure 46). This adjustment was one of the largest downward revisions of revenue since FY19. Together with the lower expected receipt of external borrowing (Figure 47), this led to a downward revision of the original spending budget by 13.8 percent (Figure 48). Additionally, the downward revision of capital spending (15.9 percent) exceeded that of recurrent spending (13.3 percent). As in the past, spending is likely to be further revised downward towards the end of the fiscal year and then during the period of actual data release. The progress report of FY24 on major policies and programs for H1FY24 from the Office of the Prime Minister mentioned the top three reasons for programs not meeting their targets, including lack of preparation for projects' implementation, lack of source assurance, and lack of suggestions or opinions from other agencies. Smoothing expenditures over the fiscal year would support spending efficiency and spending quality.

**Figure 46.** The government revised downward the original FY24 revenue target by 15.5 percent in H1FY24...



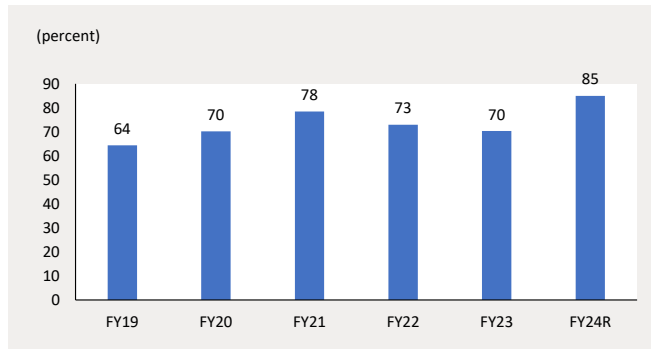
**Source:** Ministry of Finance and World Bank staff calculations.

**Note:** The data refers to the ratio of revised estimate made during the mid-term review to the original budget, expressed as percentage.

<sup>9</sup> Incentive allowances include additional compensation provided as a reward for achieving specific performance targets, whereas overtime allowance refers to compensation provided to public civil servants for working beyond their regular working hours.

<sup>10</sup> The government allocated NPR 302.1 billion for capital expenditure in FY24, down from NPR 380.4 billion. One reason for the decreased allocation is to compensate for the increased allocation for domestic debt servicing (interest and principal repayments).

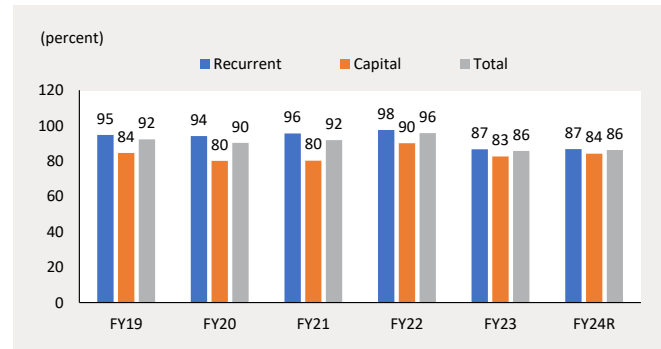
**Figure 47.** ...and also external borrowing target by the same magnitude...



**Source:** Ministry of Finance and World Bank staff calculations.

**Note:** The data refers to the ratio of revised estimate made during the mid-term review to the original budget, expressed as percentage.

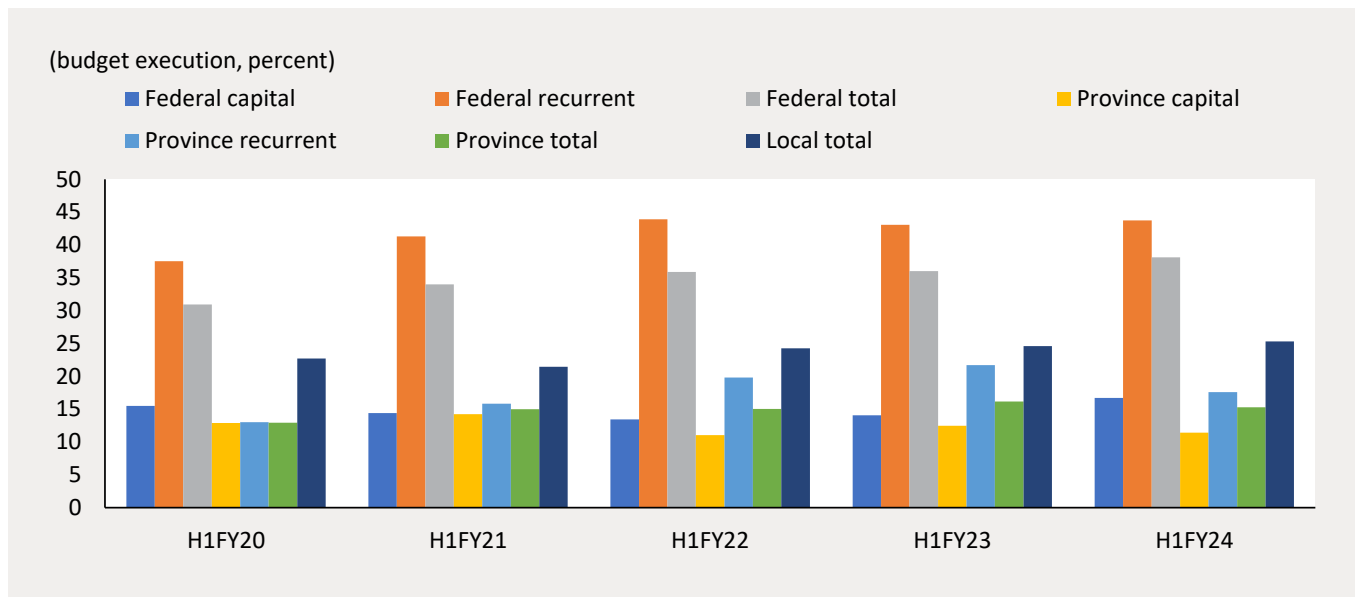
**Figure 48.** ...leading to a downward revision of spending target by 13.8 percent



**Source:** Ministry of Finance and World Bank staff calculations.

**Note:** The data refers to the ratio of revised estimate made during the mid-term review to the original budget, expressed as percentage.

**Figure 49.** Budget spending executions of subnational governments were lower than those of the federal government in H1FY24



**Sources.** Ministry of Finance and World Bank staff calculations.

**Note:** The data refers to the ratio of actual spending in the first half to the original budget, expressed as percentage.

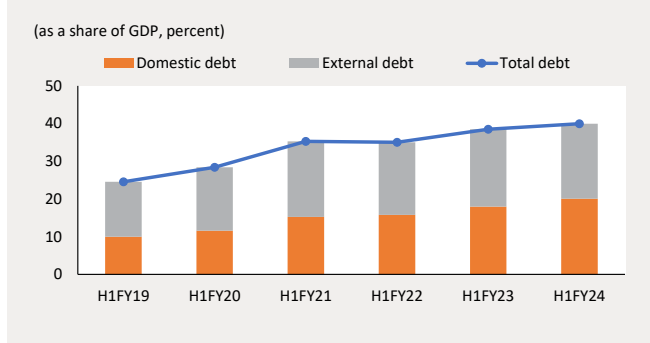
**Spending budget executions of provincial and local governments were lower than those of the federal government in the first half of FY24.** Provincial governments spent only 15.3 percent of the FY24 budget (Figure 49), slightly lower than 16.2 percent of H1FY23 spending execution rate, but significantly lower than the federal budget execution rate of 34.2 percent. Local governments were also able to spend only 25.3 percent in the first half of FY24, marginally up from 24.3 percent in H1FY23. Similarly, provincial governments’ capital budget execution was lower than the recurrent budget execution, mirroring the trend seen at the federal level.

**Public debt remains moderate and sustainable due to a largely concessional external debt stock and prudent fiscal management.** It increased by 12.7 percentage points since FY19 and 1.5 percentage points since H1FY23, reaching 39.9 percent of GDP in H1FY24 (Figure 50). Despite this increase, public debt remains moderate and sustainable, with concessional public and publicly guaranteed external debt accounting for 49.8 percent of total public debt in H1FY24 (Table 2). The other half of the debt stock is domestic public debt denominated in local currency, and mainly comprised of development bonds,

and Treasury bills. By the end of H1FY24, banking and financial institutions held close to 95 percent of domestic public debt, higher than 85 percent end H1FY23 (Figure 51). The National Natural Resources and Fiscal Commission annually sets the ceiling for domestic borrowing for all three tiers of government. For the federal government, the

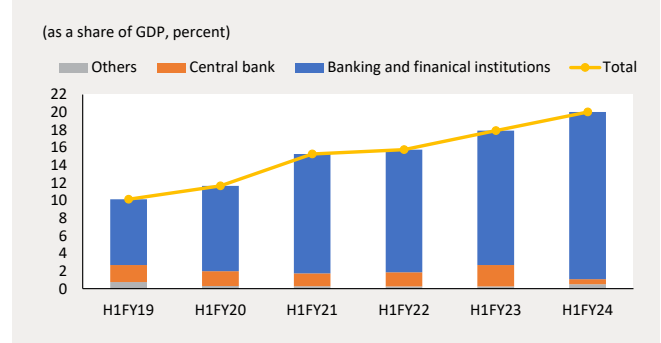
ceilings for FY24 and FY25 were set at 5.5 and 5 percent of their projected GDP, respectively. The Public Debt Act has set the ceiling for external public debt at one-third of the previous fiscal year's GDP. The debt amortization grew by 0.1 percentage points to 1.3 percent of GDP by the end of H1FY24.

**Figure 50.** Public debt remains moderate and sustainable



Source: Public Debt Management office and World Bank staff calculations.

**Figure 51.** The vast majority of domestic debt is held by banking and financial institutions



Source: Nepal Rastra Bank and World Bank staff calculations.

**Table 2.** Nepal’s Stock of public debt (in NPR billion) and as percentage of GDP

Financing Source	FY22			FY23			H1FY23			H1FY24		
	Stock	Share of total (%)	Share of GDP (%)	Stock	Share of total (%)	Share of GDP (%)	Stock	Share of total (%)	Share of GDP (%)	Stock	Share of total (%)	Share of GDP (%)
<b>Public and publicly guaranteed external debt</b>	<b>1025.8</b>	<b>51.0</b>	<b>20.8</b>	<b>1170.2</b>	<b>50.9</b>	<b>21.7</b>	<b>1102.5</b>	<b>53.3</b>	<b>20.5</b>	<b>1185.7</b>	<b>49.8</b>	<b>19.9</b>
Multilateral	894.5	44.4	18.1	1029.8	44.8	19.1	963.4	46.6	17.9	1044.4	43.9	17.5
o/w World Bank	509.7	25.3	10.3	580.3	25.2	10.8	551.2	26.7	10.2	579.6	24.4	9.7
o/w ADB	315.0	15.6	6.4	370.1	16.1	6.9	258.9	12.5	4.8	379.2	15.9	6.4
o/w IMF	43.7	2.2	0.9	52.1	2.3	1.0	45.3	2.2	0.8	58.9	2.5	1.0
Bilateral	131.4	6.5	2.7	140.5	6.1	2.6	139.1	6.7	2.6	141.3	5.9	2.4
o/w Non-Paris Club	75.8	3.8	1.5	78.9	3.4	1.5	77.3	3.7	1.4	80.7	3.4	1.4
o/w China	35.3	1.8	0.7	34.6	1.5	0.6	35.4	1.7	0.7	34.7	1.5	0.6
o/w India	36.4	1.8	0.7	39.6	1.7	0.7	37.3	1.8	0.7	40.8	1.7	0.7
o/w Paris Club	55.6	2.8	1.1	61.5	2.7	1.1	61.8	3.0	1.1	60.6	2.5	1.0
<b>Domestic public debt</b>	<b>987.4</b>	<b>49.0</b>	<b>20.0</b>	<b>1129.1</b>	<b>49.1</b>	<b>21.0</b>	<b>964.2</b>	<b>46.7</b>	<b>17.9</b>	<b>1193.9</b>	<b>50.2</b>	<b>20.0</b>
Treasury Bills	355.8	17.7	7.2	457.8	19.9	8.5	329.7	16.0	6.1	413.3	17.4	6.9
Development Bonds	620.4	30.8	12.6	656.4	28.5	12.2	625.4	30.3	11.6	769.8	32.3	12.9
Others	11.2	0.6	0.2	14.8	0.6	0.3	9.1	0.4	0.2	10.9	0.5	0.2
<b>Total</b>	<b>2013.30</b>	<b>100.0</b>	<b>40.8</b>	<b>2299.4</b>	<b>100.0</b>	<b>42.7</b>	<b>2066.7</b>	<b>100.0</b>	<b>38.4</b>	<b>2379.7</b>	<b>100.0</b>	<b>39.9</b>
Nominal GDP (NPR billion)	4933.7			5381.3			5381.3			5964.7		
Nominal Exchange Rate Average (NPR/USD)	120.8			130.7			130.7			132.9		

Source: Public Debt Management Office, National Statistics Office, and World Bank staff calculations









# B OUTLOOK, RISKS, AND CHALLENGES

# B OUTLOOK, RISKS, AND CHALLENGES

## B.1 REAL SECTOR OUTLOOK

**Nepal's economic growth is projected to rebound from a low of 1.9 percent in FY23 to 3.3 percent in FY24.** This momentum is expected to continue, with the forecast reaching 4.6 percent growth in FY25, and 5.3 percent by FY26, close to its long-term potential (Table 3). Further easing of monetary policy is a key driver of this projected recovery, assuming that there is productive usage of private sector credit. Moreover, medium-term growth could be bolstered by business environment reforms aimed at attracting more private investment.

**The services sector is expected to continue to be the primary driver of growth over the medium term.** The accommodation and food services sub-sectors are poised to benefit significantly from a projected increase in both international and domestic tourism. This growth is fueled by the ongoing construction of over 20 new five-star hotels, adding to the existing 16. The hotel sector is currently estimated to handle over 3 million tourists annually. Real estate services are also expected to see a boost due to the central bank's policies, including an increase in the loan-to-value ratio for real estate loans and a higher lending ceiling (NPR 20 million) for first-time homebuyers. Finally, the wholesale and retail sub-sector is anticipated to contribute from FY25 onwards, supported by a recovery in goods imports. Taking these factors into account, service sector growth is projected to accelerate to 4 percent in FY24 and average 5.6 percent over FY25-FY26.

**Nepal's industrial sector is poised for growth in the medium term, fueled by a significant expansion in**

**the electricity sub-sector.** Over 3,000 megawatts of additional electricity generation capacity are currently under construction, with some new generation expected by FY26. This increased and more reliable power supply will create a more favorable environment for industrial activity, as businesses will have better access to the energy they need to operate, expand, and increase productivity.

**Agricultural growth is projected to decelerate to 2.2 percent in FY24, before averaging 2.5 percent annually over FY25-FY26.** This slowdown is attributed to factors such as the outbreak of lumpy skin disease, which affected more than 65,000 livestock by October 2023, but was largely contained by mid-January 2024. Additionally, a decrease in the pace of paddy production growth to 4.3 percent in FY24 from 6.9 percent in FY23 is expected to further contribute to the overall slowdown in agricultural growth. The government has allocated NPR 30 billion (0.5 percent of FY24 GDP) in the FY24 budget for the purchase of fertilizers, ensuring timely availability for paddy transplantation in June 2024.

**Consumer price inflation is anticipated to remain elevated in FY24 before gradually declining.** With an average annual inflation projected at 6.7 percent in FY24, close to the central bank's 6.5 percent ceiling, factors such as the removal of VAT exemptions on select basic food items, India's food export restrictions, and increased minimum support prices of paddy contribute to this trend. In subsequent years, inflation is forecasted to decrease to 6 percent in FY25 and further to 5.5 percent in FY26, driven by the moderation of global commodity prices and containment of domestic price pressures through monetary policy. The expected lower inflation in India could also aid in reducing domestic inflation through the currency peg, as imported inflation will subdue.



**Table 3.** Macroeconomic projections of selected key indicators  
(annual percent change unless indicated otherwise)

	FY21	FY22	FY23e	FY24f	FY25f	FY26f
<b>Real GDP growth, at constant market prices</b>	4.8	5.6	1.9	3.3	4.6	5.3
Private Consumption	8.0	6.8	4.1	3.5	3.7	3.7
Government Consumption	-1.7	9.6	-35.2	-16.5	9.2	9.3
Gross Fixed Capital Formation	9.8	3.8	-10.9	-4.4	15.4	12.1
Exports, Goods and Services	-21.3	34.1	5.5	5.4	12.5	14.7
Imports, Goods and Services	18.8	15.1	-17.2	-4.5	13.1	9.7
<b>Real GDP growth, at constant factor prices</b>	4.5	5.3	2.2	3.3	4.6	5.3
Agriculture	2.8	2.2	2.7	2.2	2.4	2.5
Industry	6.9	10.8	0.6	2.9	5.7	8.6
Services	4.7	5.3	2.3	4.0	5.4	5.8
<b>Inflation (Consumer Price Index)</b>	3.6	6.3	7.7	6.7	6.0	5.5
<b>Current Account Balance (% of GDP)</b>	-7.7	-12.6	-1.3	3.9	1.6	1.0
<b>Net Foreign Direct Investment (% of GDP)</b>	0.4	0.4	0.1	0.2	0.4	0.6
<b>Fiscal Balance (% of GDP)</b>	-4.0	-3.7	-6.2	-3.1	-2.8	-2.7
<b>Revenues (% of GDP)</b>	23.3	23.1	19.2	18.7	19.6	20.1
<b>Debt (% of GDP)</b>	39.9	40.8	42.7	42.5	41.7	40.8
<b>Primary Balance (% of GDP)</b>	-3.2	-2.7	-4.8	-1.7	-1.6	-1.7

**Source:** Ministry of Finance, Nepal Rastra Bank, and National Statistics Office for history. World Bank staff for estimates and forecasts. Notes: e=estimate; f=forecast.

## B.2 EXTERNAL SECTOR OUTLOOK

**The trade deficit (goods and services) is expected to improve in the medium term.** This is due to a projected decline in goods imports in FY24, driven by factors such as restrictions on Indian exports, lower global oil prices, and weak domestic demand. Although goods imports are expected to rebound in FY25 and FY26 as domestic demand strengthens, they will likely remain below FY23 levels, mainly due to lower commodity prices. Goods exports, particularly in electricity, are set to increase from FY25 onwards, which will help reduce reliance on fossil fuel imports. Services exports are expected to rise as tourism recovers. Meanwhile, services

imports are likely to surpass exports due to continued emigration for work and study. Nepal's government has a medium-term goal of reducing the trade deficit to 15 percent of GDP by FY28.<sup>11</sup> This ambitious target hinges on a two-pronged strategy: lowering imports to 35 percent of GDP and boosting exports to 20 percent of GDP.

**Nepal's current account balance is projected to record a surplus in FY24, for the first time since FY16.** This is driven by robust remittance growth fueled by record migration in FY23 and a narrowing trade deficit. However, the surplus is expected to narrow from about 3.9 percent of GDP in FY24 to an average of 1.3 percent of GDP over FY25-26 as the trade deficit expands, outweighing the increased remittance inflows which are anticipated to taper off from FY25. Despite efforts to attract more foreign direct investment (FDI), inflows are likely to remain modest.

<sup>11</sup> See Nepal Trade Integration Strategy, 2023.

## B.3 MONETARY AND FINANCIAL SECTOR OUTLOOK

**The central bank is anticipated to gradually ease monetary policy over the medium term.** Following a 100-basis points reduction to 5.5 percent in the policy interest rate during the first quarter review of FY24, it is expected to remain unchanged in the second half of FY24. However, cuts of 50 basis points each are forecasted at the beginning of FY25 and FY26, leading to a policy interest rate of 4.5 percent by the start of FY26, slightly above the pandemic-low and below the pre-pandemic level. The central bank will retain the exchange rate peg of the Nepalese Rupee against the Indian Rupee as a nominal anchor of monetary policy throughout the forecast period.

## B.4 FISCAL SECTOR OUTLOOK

**Nepal's fiscal deficit is projected to fall significantly from its record high in FY23, stabilizing around 3 percent of GDP in the medium term.** The projected

fiscal deficit in FY24 is higher than the revised government forecast.<sup>12</sup> Revenue is expected to reach 20.1 percent of GDP by FY26, bolstered by stronger GDP and rising goods imports. Spending is also anticipated to increase, reaching 22.8 percent of GDP by FY26, fueled by enhanced public investment execution. The National Project Bank's integrated guidelines, issued in March 2023, are expected to streamline project development, selection, and prioritization, leading to better capital spending by FY25. The fiscal deficit is expected to be financed through external concessional borrowing and domestic sources. As a result of smaller deficits and higher economic growth, the total public debt is projected to decline to 40.8 percent of GDP by FY26 from its peak in FY23.

## B. 5 RISKS AND CHALLENGES

**The forecast is subject to both domestic and external risks.** Externally, geopolitical uncertainty could trigger a rise in commodity prices, impacting all sectors. A growth slowdown in partner countries might also lead to a drop in remittances and tourism, hindering economic growth. Persistent inflation expectations and lower domestic demand could further dampen economic activity. Natural disasters pose additional risks to sustaining welfare gains. Finally, frequent political changes, a top headwind for businesses for over a decade, could continue to deter private investment.

<sup>12</sup> In February 2024, the government slightly increased the expected fiscal deficit for FY24 to 2.5 percent of its forecasted GDP from 2.4 percent of the original budget in May 2023. These revisions were underpinned by the capital budget execution of 88.2 percent, external borrowing execution of 85 percent, and 57 percent of targeted revenue collection in the second half of the FY24 fiscal year, surpassing historical five-year averages. However, meeting these targets in FY24 is less likely due to economic challenges and structural issues, exacerbated by the recent change in government.















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