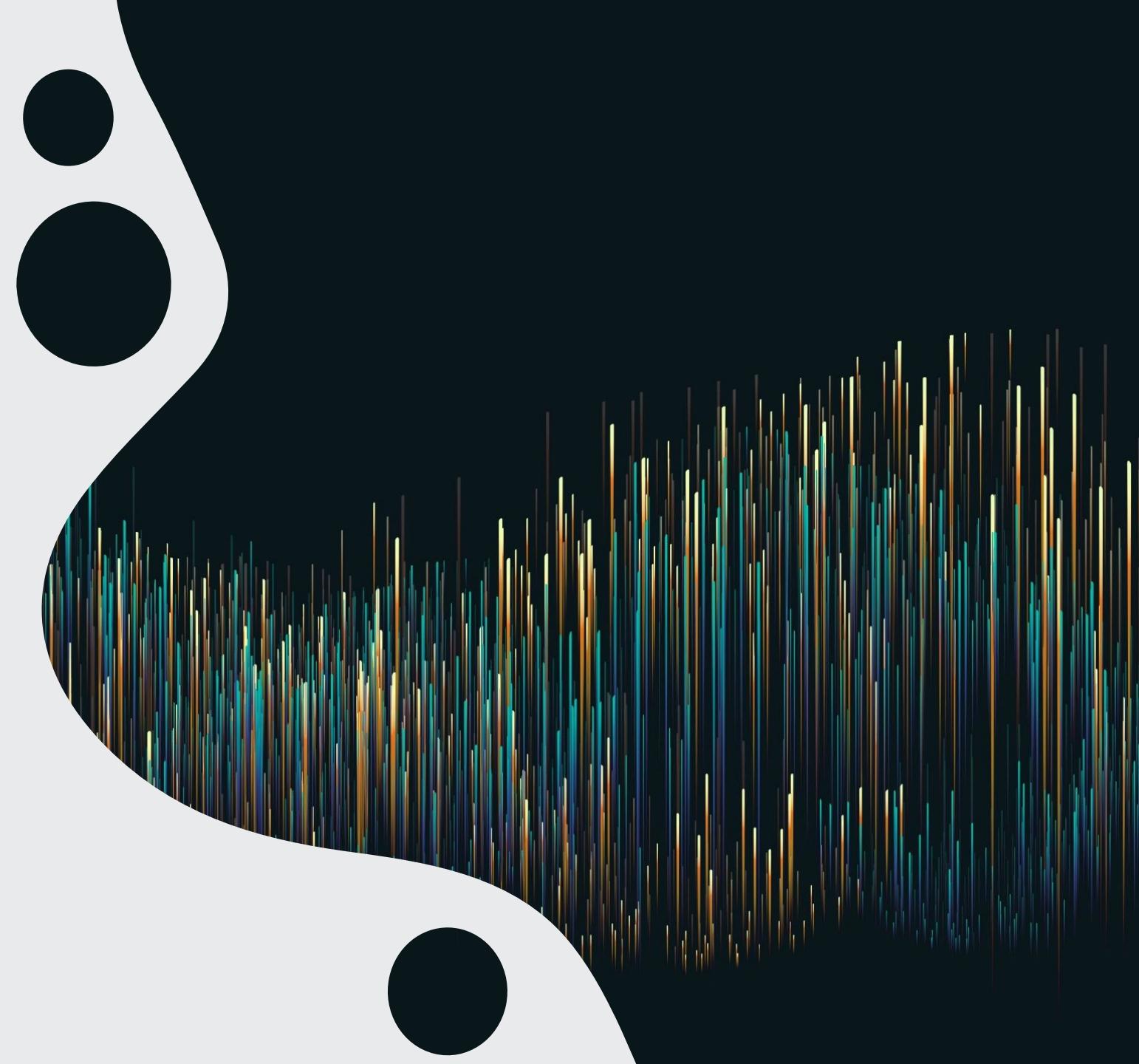


# 2023 Recap

**Kala Legal**



# **Nepal is at a critical juncture of development**

**2023**

*We stand at the movement of great challenges and great opportunities. These difficult times are not a result of history. To be sure, some of these problems are the result of wrong economic policies. However, to create widespread opportunities and economic prosperity in this, global economy; we cannot simply look backward for finding solutions to complex economic problems.*

*Our country needs to provide economic opportunities to the people to fulfil their dream. We need to provide economic security to the private sector with a continual spread of benefit to the general public. It is a complex phenomenon which not merely concerns the fiscal policy or behaviour but also touches upon the very structure of our economic politic.*

*There are a number of complex political and legal issues which required to be solved to ensure economic development. When the economy takes a downturn, wise market player usually respond by changing their financial behaviour. In difficult times, there's less room for ambiguity in defining financial goals. Traditionally, economists have focused on aggregate money stock measures such as M1 and M2 as indicators of future economic activity. However, the relationship between these aggregates and real GDP has deteriorated in the past several months.*

*We believe that our dream of converting challenges into opportunity would require reengineering of the complex economic situation and changing the mind set of planner integrating and implementing result-oriented action plans to shape our country as a developing country.*

*In the business world, it is often said that the rear-view mirror is always clearer than the windshield.*

The outlook is highly uncertain. Risks include commodity prices remaining high for longer, tighter and volatile financing conditions, and a sharper-than-expected slowdown in demand. **If not managed properly, price shocks could threaten social stability. Nepal may face pressures to meet current expenditures as revenue from imports as well as from the corporate tax may fall below the government target. Thus, it will be important to break the unsustainable cycle of relying on higher, untargeted government spending and instead opt for measures focused to reduce the current expenditure and improve tax coverage.**

## January 2023

NRB raises rates to contract demand and fight inflation, but they also need to take care of the economy. It's a calibration exercise NRB must balance "growth and inflation" objectives at the same time. A key element factoring into investor calculations is the cost of money and the liquidity policies, which are set by policymakers at NRB. In a cheap money environment, during the pandemic, investors have been rewarded for investing or putting the money to work by backing new opportunities and investing in the capital market, etc. that promises to create more tangible returns and support wealth maximization. Within a year, eventually after the policy tightening, the bill comes due, triggering a wave increasing the probability of default and of the high cost of borrowing. Managing the high debt levels will become increasingly difficult if the economic outlook continues to deteriorate and borrowing costs rise further.

As per IMF "Interdependencies between economies mean that such a prospect would be very costly, especially for Asia. About half of the imports in the United States and a third in Europe come from Asia. And, in turn, Asian countries account for almost half of the global demand for key commodities. Rolling back damaging trade restrictions and reducing uncertainty via clear communication of policy objectives should be a priority" Keeping the same view the World Bank has suggested the Government of Nepal lift import restrictions. Though the Government of Nepal lifted import restrictions, the importers are reluctant to import high-value goods. Even though the market is suffering from high cost of borrowings and a slowdown in demand for high-value commercial imported products, they are forced by the foreign manufacturers to meet the annual target of import. **NRB has lifted LC margin to facilitate import of high value goods, this will put more pressure on importers to import more despite of low market demand.**

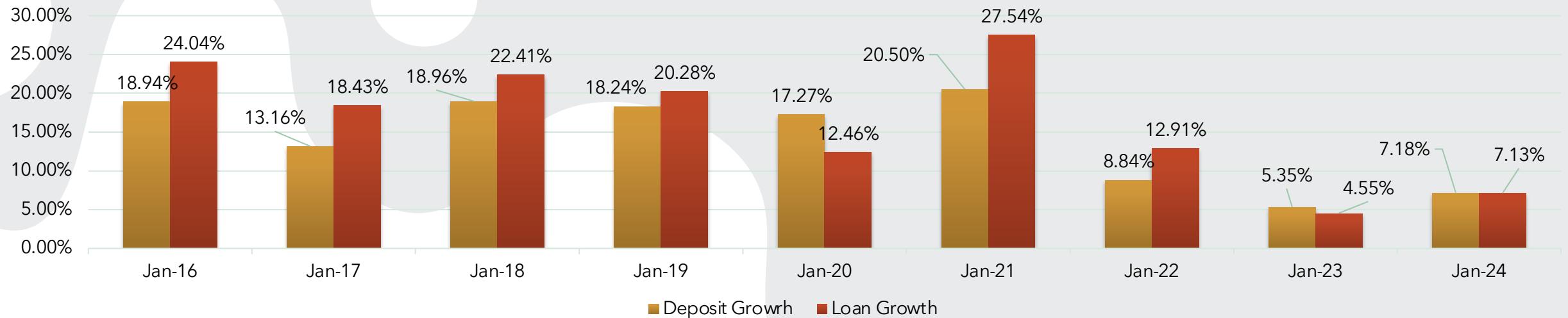
**Nepal should adopt fiscal strategies that help reduce inflationary pressures now and debt vulnerabilities over the medium term, including by containing expenditure growth—while protecting priority areas, including support to those hardest hit by the cost-of-living crisis. Accelerating ongoing structural reforms, including upskilling the labor force, improving education quality, further leveraging technology and digitalization, enhancing regulatory frameworks, strengthening institutions and governance, deepening regional integration, and addressing climate change adaptation and mitigation challenges. Implementing policies for sustained private sector-led economic growth and diversification will be as key as ever. Government should also facilitate the work of central banks and allow for smaller increases in interest rates despite market resistance.** In times of turbulence and turmoil, confidence in long-run stability is a precious asset.

## Outlook 2022/23

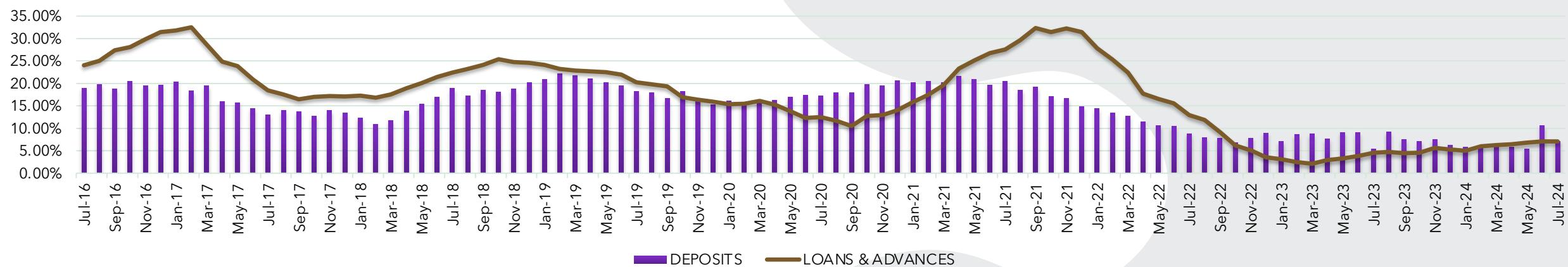
## Economic Performance

Real Sector	Outlook	Financial Sector	Outlook
Corporate performance	<p>Increasing number of MSMEs that generate negative economic profit may increase default rate</p> <p>Most of the large corporate the return on invested capital (ROIC) has been reduced significantly and the weighted average cost of capital (WACC) is increasing rapidly, therefore there is constant pressure on ROIC</p>	Banking system	<p>Higher cost of funds and balance sheet constraints will impact on BFIs profitability, as monetary policy is becoming less accommodative. Banking sector profitability is anticipated to remain under pressure given the low interest margin environment, restrictions on non-interest income and the risk of higher NPLs.</p> <p><b>Currently NPL and LLP of BFIs stood at \$ 998 million and \$ 987 million respectively</b></p>
Working Capital financing	<p>With the implementation of new guidelines, borrowers may face constant headwinds to inject fresh equity. Increased length of the working capital cycle will prevent borrowers to finance working capital from internal sources. Due to increasing length of working capital cycle, fresh equity injection will not be possible, there will be insufficient internal resources. Therefore, the impact of new working capital regulation will be adverse and affect industrial growth and misbalance the supply chain management. <b>NRB has revised the Guidelines.</b></p>	Non-performing assets	<p>NPL is likely reach 4.33 percent by the year ending on July 2024, it will materially impact bank capitalization levels and profitability and have additional spillover effects</p>
Household debt	<p>Although the corporate sector accounts for the largest share of debt, household indebtedness has risen rapidly and is approaching advanced economy levels</p>	Lending Growth	<p>Deleveraging the corporate sector and stabilizing the rise in household debt remains a priority but would probably create headwinds to economic activity</p>

# Annual Loan and Deposit Growth



## Y-o-Y Growth



## Observations:

- We expect liquidity crunch to continue for sometime and increasing corporate trade related debts and in absence of corporate debts recovery legislation, assets quality of BFIs will deteriorate significantly during next fiscal years. There will be pressure on revenue due to low profitability (low levels of interest rates spread and higher levels of capital), tighter regulation and moderate refraining. Banks continue to face heat from a credit growth and a decline in yields on loans.

## February 2023

### Outlook 2022/23

#### "Cautiously optimistic"

- Considering, the slowing global economy due to various reasons most of us are aware of, and analyzing the status of the Nepalese economy, (sluggish government expenditure, low-performing corporate sector, decreasing productivity, and increasing cash recovery cycle along with the inflation outlook) authorities need to redesign and implement appropriate policies response to avoid short-term economic shocks.
- Banking sector performance including levels of capital, profitability and default ratios, net interest margin, etc. suggest stable but vulnerable situations ahead. This will eventually force NRB to maintain its monetary policy stance, but it may not support medium-term growth objectives.
- Having said that, however, we also feel that due to several reasons, the aggregate ratio of non-performing loans (NPLs) to total loans is likely to increase from mid-2023. The sudden deterioration in asset quality may occur due to unreasonably long cash recovery cycles experienced by business owners, which will be translated into default. We also feel that interest rate policy, MSMEs, and consumer lending will be the primary focus of NRB.
- Many analysts believe the trade deficit will continue to rise. Indeed, the deficit will likely grow much faster as it will pick up seasonal demand. Imports dropped marginally and export does not show any sign of improvement. Nepalese authorities said pressure on the country's imports continued to be lower during the third quarter.
- However, we should remain cautious about Nepal's outlook. The rise in the middle class and urbanization had increased business opportunities for traders to import more merchandise.
- Nepalese policymakers should choose appropriate policy responses to kick-start the economy. They must work out the best possible solution to reduce import reliance. Though midterm monetary policy review has used a few appropriate tools to avoid long-term economic shock but, short-term vulnerability remains unaddressed.

# Known-unknown

Inflation, monetary and fiscal tightening, and the war in Ukraine continue to squeeze global activity, the pandemic is also weighing on the macroeconomic outlook.

Although the economic environment is one of the most challenging in many years, difficult times need not last forever. Judicious policy choices can help guide the global economy out of inflation and into an era of sustainable and inclusive growth.

Monetary policy is not merely a science where we tweak some instrument to achieve an objective. It is also an art of creating new instruments and taking policy calls in response to anticipated and evolving challenges and communicating them with prescience and clarity, especially during crisis times. Decisiveness, timing and communication are key to effective monetary policy.

In a cheap money environment, during the pandemic, investors have been rewarded for investing or putting the money to work by backing new opportunities and investing in capital market etc. that promises to create more tangible returns and support wealth maximization. Within a year, eventually after the policy tightening, the bill comes due, triggering a wave increasing probability of default and of high cost of borrowing.

NRB raises rates to reduce demand and fight inflation, but they also need to take care of the economy. It's a calibration exercise NRB must balance "growth and inflation" objectives at the same time. A key element factoring into investor calculations is the cost of money and the liquidity policies, which is set by policymakers at NRB.

**March 2023**

**Outlook  
2023/24**

**"We can't  
console  
ourselves by  
saying "there is  
no crisis"**

*The biggest challenge faced by the Nepalese economy is not the economic fundamental. They are relatively strong in short-term. The real challenge is the threat posed by business and loss of confidence of private sector. This is due to the rise in extremism, excessive politicking, bureaucratic huddle, complex regulatory requirements and decline in good governance! Those negative developments will not motivate investors and consumers.*

*Nepalese planners need to identify the causes that may push down relatively strong economic conditions into negative trajectory and find ways and means to alleviate these conditions.*

*Much more needs to be done to accelerate economic growth, through increasing savings and encouraging investment local as well as foreign, seeking foreign aid, using natural resources, increasing productivity and reducing trade deficit.*

*We must understand that the most successful free market environments are those where the government has enabled - but not attempted to direct or control - the economy.*

*We are now running the risk of emphasizing short term economic growth and losing sight of the medium to long-term challenges. We can't wait for a crisis to happen. We must act now. But are we preparing enough for the hard time?*

# **Smallest of firms facing the most severe pressure**

*We believe one of the more underappreciated signs of distress in corporate credit is already emanating from the Small and Mid-size Enterprises sector. Warning signs of a potential credit crunch were flashing even before the beginning of monetary policy tightening.*

*Many of the "smallest" firms face the most severe pressure from rising rates, persistent inflation, and slowing growth. This year closure of small businesses has surpassed a peak in comparison to the early stage of the pandemic. Business failures were on the rise.*

*Small and medium-sized businesses are "critical" to BFIs and MFIs, as they hold 30% of the loans and debt of these financial players. Microfinance (MFIs) are facing huge problems with credit associations' protests and lenders of those MFIs, mainly Commercial Banks, are concerned about MFIs' health under liquidity stress. BFIs started pulling back their lending from MFIs, businesses, and retail clients. SMEs with fewer than 10 staff members make up 58% of the informally employed workforce in Nepal.*

*What's unclear right now is how much of the banking stresses of the past few months are leading to a sustained credit crunch, slowing down the Nepal economy.*

*BFIs, on average, "have a lot of capital" and the NRB with other regulators is there to support the banking system. So that should give us all confidence. It's going to take us a while until we fully understand the impact of the current crisis.*

*Financial sector regulation and supervision needs to be strengthened. Progress is needed on policies that preserve the stability of the financial system while supporting growth through ensuring the availability of adequate and timely supervisory data, updating the regulatory framework to better capture risks including to banks' asset quality, and enhancing the quality of supervision.*

# April 2023

## Outlook 2023/24

### ***"Slow Further Amid Signs of Resilience"***

*Following a strong exit from the pandemic, Nepal was hit hard by the economic impact of Russia's invasion of Ukraine. Growth slowed drastically, inflation shot up, and episodes of financial stress, especially of non-banking financial institutions (Cooperatives), materialized. Even with decisive policy actions, Nepal has been unable to avoid a recession. Nepal now faces the difficult task of sustaining the recovery, defeating inflation, and safeguarding financial stability.*

*Though headline inflation continues to decline, uncertainty remains, and inflation may remain uncomfortably above central bank targets even by the end of next year. Recent and projected declines in energy prices will feed into lower underlying inflation, but not enough to bring it down quickly.*

*There are two threshold questions that a policymaker needs to ask before any decision to move forward with monetary policy. First, what problem is the policymaker trying to solve, and what is a potential solution? Second, what features and considerations--including unintended consequences--may a policymaker want to consider in deciding to design and adopt a policy?*

*While it would be impossible to provide a comprehensive analysis, my goal is to offer a perspective on these two threshold questions and conclude with thoughts about the imperative for future policy actions.*

*This time around, the Nepalese economic outlook hasn't worsened. That's good news, but not enough. The road back to a full recovery, with sustainable growth, stable prices, and progress for all, is only starting.*

**May  
2023**

*The Nepalese economy needs to create a wave of positive sentiment. Authorities need to consider major policy departures to bring the economy back into the right track without derailing long term objectives. After a considerable long period of nervousness, we feel that Nepalese economic leaders should work "very hard" to restore investors' confidence. It's not going to be an easy task. If authorities do not take corrective actions and market players do not change their behavior, we may witness a worse economic crisis within short-term.*

*NRB Nepal Rastra Bank (The Central Bank of Nepal) should find an alternative approach to anchor inflation and maintain financial stability. Sometimes we feel those two objectives may not go parallel. We understand that, particularly now, when we are working with an uncertain global outlook, financial stability is much more important than anchoring inflation. Therefore, it would be appropriate if NRB targets inflation with a 2% margin on either side and design other prudential regulations to achieve financial stability.*

**Outlook  
2023**

*We observed that NRB's recent policy stance failed to address the impact of high-interest rates on the economy and shortfall in government revenue due to contraction in economic activities and the impact on the cost of government borrowing.*

*An aggressive monetary-tightening campaign that started a year ago has raised risks of recession and financial instability. We observed even with the policy tightening and rates hike the growth rate of savings has declined. In the case of inflation due to external factors, it remains a percentage higher than the target. Though the primary motive of reducing demand has been achieved, the secondary motive of increasing gross national savings through rate hikes has not shown positive results. Instead, it has increased the risk of recession.*

**"A long  
tail"**

*We know there is still some room for policy mistakes when it comes to interest rates but, this may well end up being the biggest policy mistake in several decades. As it is said in the developed economies, we feel that, if we don't handle the current crisis properly it will have 'a long tail' as risks move to economic from financial contagion.*

*The effects of the potential deterioration in the asset quality, as well as the rising level of loan loss provisions, on the profitability and capital adequacy levels of banks, should be assessed. The effects of rising leverage on the real sector should also be monitored.*

# Budget 2023/24

According to the National Accounts Statistics (NAS) for the ninth months of FY 2022/23, the preliminary estimate of the growth rate of Gross Domestic Product (GDP) at basic price is 2.16%. Further, the NAS has revised the growth estimate for FY 2021/22 and 2020/21 to 5.26% and 4.49% respectively.

Expected Index

<b>Particulars</b>	<b>Budget 2020/21</b>	<b>Budget 2021/22</b>	<b>Budget 2022/23</b>	<b>Budget 2023/24</b>
Growth Rate	7.0%	6.5%	8.0%	6.0%
Inflation	7.0%	6.5%	7.0%	6.5%
Particulars	Actual 2020/21	Actual 2021/22	Estimated 2022/23	Estimated 2023/24
Growth Rate	5.26%	4.49%	2.16%	3.5-4.5%
Inflation	3.6%	7.3%	7-8%	6.7-7.7%

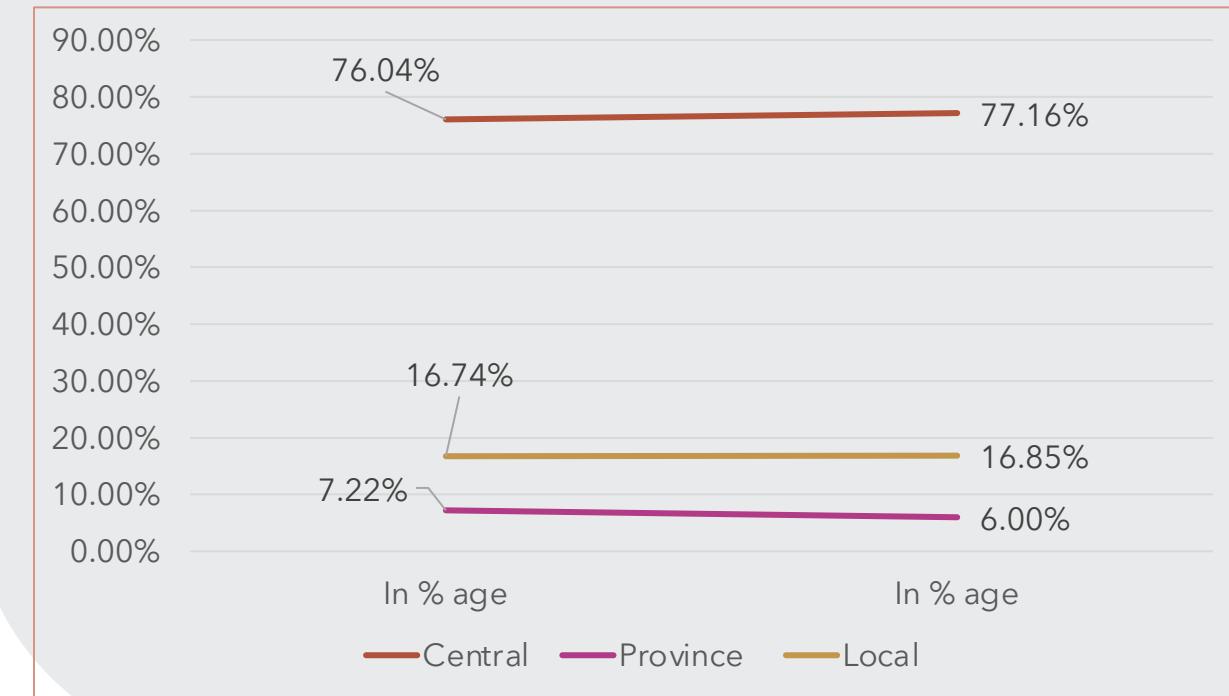
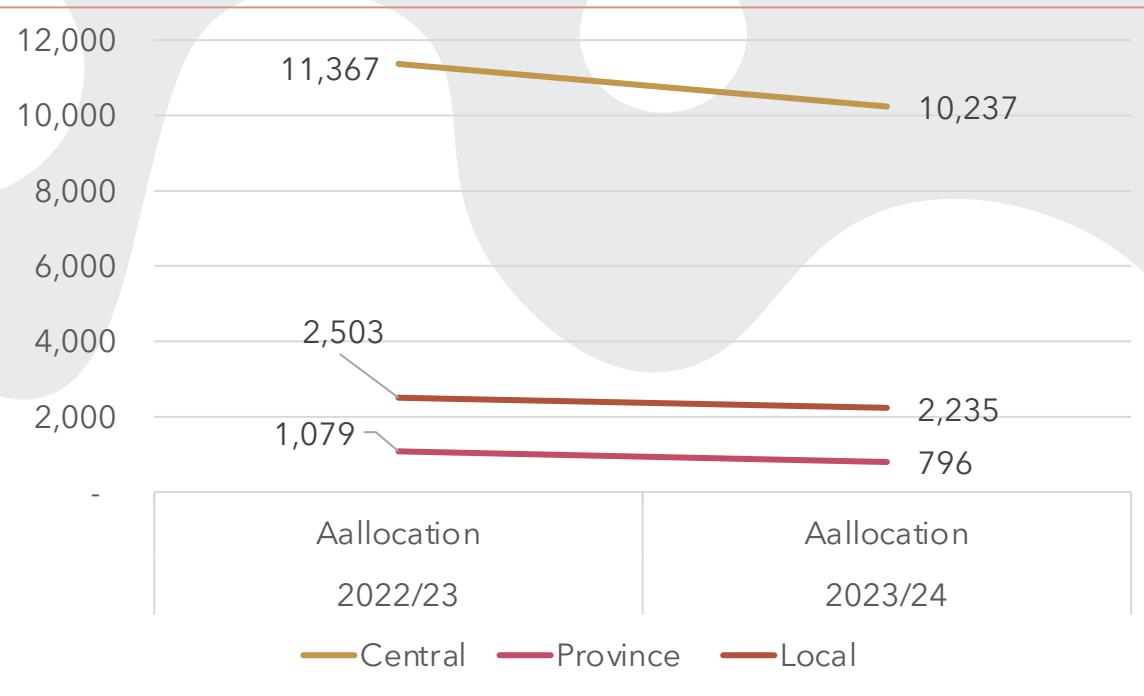
# Budget Source and Allocation 2023/24

## Budget Allocations

	Exchange Factor 1 USD = NPR 120							1 USD= NRP 132
	Allocated Budget	Actual Budget Amount (\$ Million) 2020/21	Actual Budget Amount (\$ Million) 2021/22	Budget Actual Amount (\$ Million) 2021/22	Amount (\$ Million) 2022/23	Revised Amount (\$ Million) 2022/23	Variance	Budget (\$ Million) 2023/24
Current Expenditure	3,764.18	5,655.11	4,535.35	6,278.36	5,336.60	-15.00%	5,618.92	
Capital Expenditure	1,906.97	3,118.91	1,801.78	3,169.87	2,152.88	-32.08%	2,288.44	
Financial Provisioning	1,864.53	1,733.15	1,752.41	1,918.48	1,693.83	-11.71%	2,329.19	
Intergovernmental Fiscal Transfer	3,287.63	3,222.64	3,383.96	3,581.94	3,358.33	-6.24%	3,030.96	
<b>Total</b>	<b>10,823.31</b>	<b>13,729.81</b>	<b>11,473.50</b>	<b>14,948.65</b>	<b>12,541.65</b>	<b>-16.10%</b>	<b>13,267.52</b>	

## Budget Sources

	Exchange Factor 1 USD = NPR 120							1 USD= NRP 132	
	Budget Amount (\$ Million) 2020/21	Budget Amount (\$ Million) 2021/22	Revised Amount (\$ Million) 2021/22	Budget Amount (\$ Million) 2021/22	Budget Amount (\$ Million) 2022/23	Revised Amount (\$ Million) 2022/23	Variance	Budget Amount (\$ Million) 2023/24	Change (Revised 2022/23 to Budget 2023/24)
Revenue Sources									
Tax Revenue	7,211.40	8,540.89	8,487.72	8,216.69	10,334.32	8,666.67	-16.14%	9,462.27	9.18%
Foreign Grant	304.01	528.14	206.74	229.07	462.15	320.49	-30.65%	375.33	17.11%
Deficit	3,307.90	4,660.78	3,368.19	3,027.74	4,152.18	3,554.50	-14.39%	3,429.92	-3.50%
Foreign Debt	1,441.24	2,577.44	1,440.65	1,089.11	2,018.84	1,421.16	-29.61%	1,611.74	13.41%
Domestic Debt	1,866.67	2,083.33	1,927.53	1,938.63	2,133.33	2,133.33	0.00%	1,818.18	-14.77%
<b>Total</b>	<b>10,823.32</b>	<b>13,729.80</b>	<b>12,062.64</b>	<b>11,473.50</b>	<b>14,948.64</b>	<b>12,541.65</b>	<b>-16.10%</b>	<b>13,267.52</b>	<b>5.79%</b>



### Observations:

- The global unrest and surge in commodity prices will impact government revenue receipt. Hence, the revenue growth target of 9.18% seems challenging
- Mobilization of \$1,611 million foreign loan seems ambitious. Besides, emergency financial assistance from multilateral agencies, mobilization of other loans hinges on progress made on projects. Hence, there is a need for ramping up of capital budget absorption capacity
- Domestic borrowing of \$ 1,818 million along with limited liquidity of bonds and unexpected additional tax burden related to M&A transactions, tax issues related to FPO, and increasing non-performing loans may pressure BFI's. BFIs will not be motivated to lend to the private sector.
- Target of mobilization of the foreign grant of \$375 million is higher than the grant received in the last few years.
- \$3,031 million has been allocated to the provincial and local government, approximately 22.84 of the budget. It is 1.12% less than the previous year's allocation.
- Government aims to enhance the role of sub-national governments in national priority projects

Some sections of the Finance Act has imposed tax retroactively therefore those clauses may require explanatory notes.

# Budget Source and Allocation 2023/24

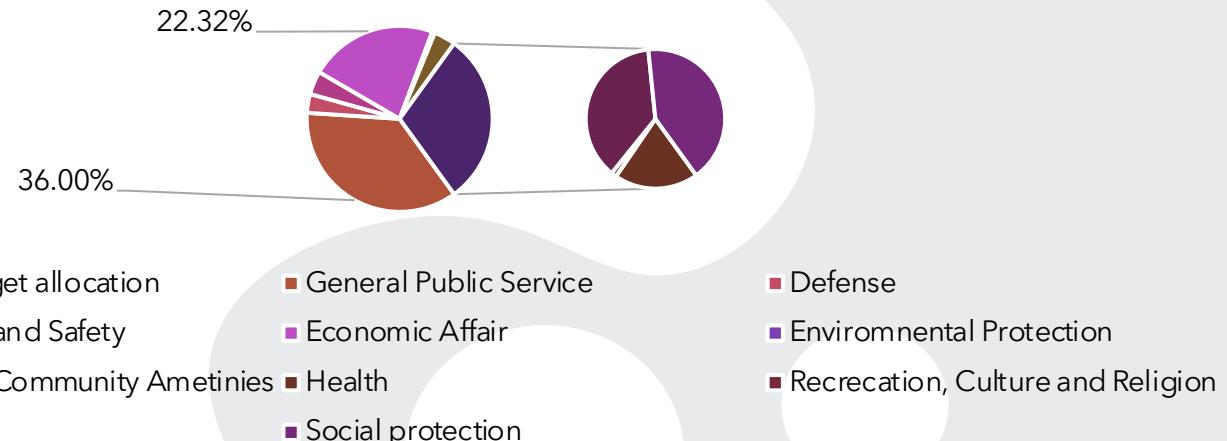
Areas of Budget allocation	2021/22		2022/23		2023/24		Compare to last year	
	Amount in \$ Mn	in % age	Amount in \$ Mn	in % age	Amount in \$ Mn	in % age	In figure	In %
General Public Service	4,034	29.42%	4,779	31.97%	4,777	36.00%	Down	Up
Defense	414	3.02%	462	3.09%	434	3.27%	Down	Up
Public Order and Safety	484	3.53%	545	3.65%	539	4.07%	Down	Up
Economic Affair	3,684	26.87%	3,890	26.02%	2,962	22.32%	Down	Down
Environmental Protection	105	0.76%	92	0.61%	65	0.49%	Down	Down
Housing and Community Ametinies	671	4.89%	738	4.94%	500	3.77%	Down	Down
Health	1,180	8.60%	1,027	6.87%	779	5.87%	Down	Down
Recreation, Culture and Religion	56	0.41%	80	0.54%	50	0.38%	Down	Down
Education	1,500	10.94%	1,641	10.98%	1,498	11.29%	Down	Up
Social protection	1,582	11.54%	1,694	11.34%	1,663	12.53%	Down	Up
Total	13,709	100%	14,949	100%	13,268	1.00		
Exchnage Factor	USD 1 = NPR 120			USD 1 = NPR 132				

## Sectoral distribution

- The allocation for general public service and Economic affair constitute approximately 58.33% of the budget.
- Decrease in allocation allocation of budget for Health and Environmental protection by 24% and 29% respectively.
- Budget for Recreation, Culture and Religion has been decreased by 37%.

## Commitment of Budget

- Boost to economic growth through by increasing economic activities for achieving sustainable growth%.
- Improve confidence of private sector.
- Improve business and investment environment.
- Maintain financial stability.
- Improve governance.



Due to unpredictable weather patterns, major natural disasters likely disrupt short-term financial and economic management, creating considerable confusion and uncertainty while simultaneously necessitating perhaps substantial realignments in spending plans, adjustments in economic targets, and shifts in monetary policy. Natural disasters are neither driven by nor immune from politics. If natural disasters are political, then they can be modeled similarly to other political acts. Clearly, natural disasters cannot be manipulated.

From a socio-economic perspective, a disaster is a 'shock' that results in a combination of losses in the human, social, and physical capital stock and a reduction in economic activity such as income generation, investment, production, consumption, and employment. There are substantial distributional implications because the poor are likely to be worst affected. There may also be severe effects on financial flows, such as the revenue and expenditure of public and private bodies. Disasters and related relief and rehabilitation requirements can disrupt the budgetary process. They typically impose significant pressure on public resources, potentially adversely impacting planned expenditures and having wider long-term implications for development.

Disasters often result in widespread, if largely non-transparent, immediate and inter-year reallocations of resources. The budget may need to be revised several times as the year unfolds. The brunt of reallocations appears to fall primarily on capital expenditures. Within the capital budget, cuts are often made across the board without protecting priority projects and programmes. Budgetary management difficulties can extend beyond the disaster year if, for instance, there is continuing uncertainty about the impact of the disaster on economic productivity and tax revenues.

Against a background of increased uncertainty, decisions are required not only on the nature and scale of direct assistance but also on the most appropriate form of fiscal and monetary responses. Should, for instance, the government expand overall credit availability to support productive recovery and refinance microcredit or tighten monetary growth to stem inflationary pressures from post-disaster food shortages and construction booms?

Such decisions inevitably involve trade-offs, of which the relative benefits and costs have to be calibrated. So assessment of the economic impacts of disasters typically should not be concentrated on the most easily measured direct losses—the financial costs of visible physical damage—but also needs to account for opportunities lost.

**June  
2023**

**Outlook  
2023**

**Natural  
Disasters**

**July 2023**

The Nepalese experience from 2015 to 2022 suggests that the high credit growth does not always indicate industrial development and support GDP growth. What is of relevance is the real interest rate, the expected real growth in the economy and the industry concerned. Demand for credit is influenced by several other factors, such as agricultural growth, export demand and competitive strength of Nepalese firms apart from interest rates.

During 2022-23, the credit off-take did not pick up; the real interest rates remained high with inflation rate a percentage higher than expected. Deceleration in the demand for credit reflected the slowdown in the industrial activities and the depressed investment climate.

**Outlook 2023**

**Effective demand for credit pre-supposes effective demand for goods and services via increase in income which reflects the trend in real activity. This implies that poor off-take of credit is a symptom rather than a cause of deceleration in industrial growth. The commercial banks investment in government securities which has exceeded the statutory levels, is reflective of the subdued conditions.** If Nepal wants to grow fast, it should create large corporates and firms that contribute at least 25% share of the GDP (which is not significant at the current level), in India it is about 40% while in China it is 70%. For us to be a \$100 billion economy, we need to take the number of large firms having assets size of \$ 5 billion from the current Zero level to at least 20.

Further, we need to support another 200 large firms to really grow to at least \$ 500 million size. This will only happen if more of the MSMEs become bigger and more of the mid-sized firms become large firms. That cycle in Nepal is working very slowly. In fact, the number of firms that are coming into this large circuit every year has been pushed back due to several reasons all of us are aware of, which is likely to block the journey towards a \$ 100 billion economy.

However, if we place the right economic policies and improve business confidence, improve productivity, and focus on fiscal and legal reforms, it may happen very soon. The policy should also focus on improving access to finance for SMEs to maintain backward and forward integration of business. Nepal should introduce stringent policies to reduce the informal economy.

**“Tried little,  
failed much!”**

# Lessons to be learned

*What can we learn from current crisis, and the many others that come to mind? If we look at shortcomings in the economic policies, we can see how difficult it can be to pursue the tough and controversial reforms that are necessary. The persistent failure to tackle chronic problems in banking and corporate sectors; continuing weak demand, the growing fiscal deficit: these have all highlighted the reluctance of policymakers to tackle awkward structural problems.*

*Structural reforms are needed. There is always room for improvement. The uncertainty inherent in the reform process. The problem is that economic policymaking always involves trying to measure the probability of one outcome as opposed to another, given the uncertainties in the world economy. From the economist's perspective, the best way to proceed is to adopt those policies that seem most likely to deliver the preferred outcome.*

*Reducing the risk and incidence of crises, though, is only part of the battle. Nepal is performing below potential. The ability to deliver faster growth, raise living standards and reduce poverty depends on sound economic policies. We do know what works, and what doesn't.*

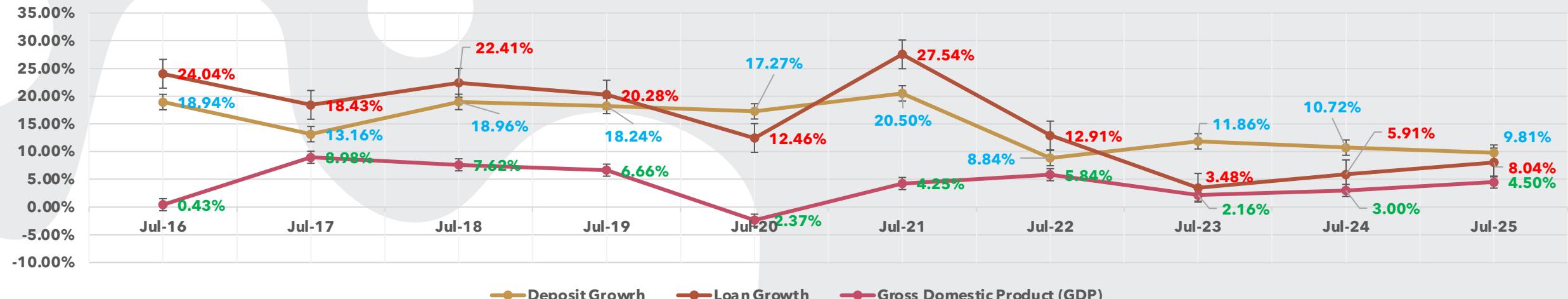
*Non-financial crisis, which consequently turned into a economic crisis, created a consensus that pre & post-crisis financial regulations didn't take the "Big Picture" of the system as a whole sufficiently into account. As a result, supervisors "missed the forest for the trees". Failed reforms tend to be judged more harshly—by economists, of course, but above all by those who suffer as a result—the poor, the jobless and the hungry. Policy failures can be catastrophic.*

*We also know that reform is more easily embraced in good times rather than bad. But every dark cloud has a silver lining. This threat could be a big opportunity to reshape economy. We learned a costly lesson. As is often said, one must pay for one's education! Nevertheless, we must appreciate effort made by all market agent and regulators till date to bring the economy up to this level. However, policymakers must take prompt and proper actions to cash the silver lining of this dark cloud in the economy.*

## Economic Performance

Real Sector	Outlook	Financial Sector	Outlook
<b>Corporate performance</b>	<p>Increasing number of MSMEs that generate negative economic profit may increase default rate</p> <p>Most of the large corporate the return on invested capital (ROIC) has been reduced significantly and the weighted average cost of capital (WACC) is increasing rapidly, therefore there is constant pressure on ROIC</p>	<b>Banking system</b>	<p>Higher cost of funds and balance sheet constraints will impact on BFIs profitability, as monetary policy is becoming less accommodative.</p> <p>Banking sector profitability is anticipated to remain under pressure given the low interest margin environment, restrictions on non-interest income and the risk of higher NPLs.</p> <p>Currently <b>NPL and LLP of BFIs stood at \$ 1.13 billion and \$ 968 million respectively</b></p>
<b>Working Capital financing</b>	<p>With the implementation of new guidelines, borrowers may face constant headwinds to inject fresh equity.</p> <p>Increased length of the working capital cycle will prevent borrowers to finance working capital from internal sources. Due to increasing length of working capital cycle, fresh equity injection will not be possible, there will be insufficient internal resources. Therefore, the impact of new working capital regulation will be adverse and affect industrial growth and imbalance the supply chain management.</p> <p><b>Sectorial adjustment is still pending.</b></p>	<b>Non-performing assets</b>	<p>NPL is likely remain around 3% by the year ending in July 2024, <b>significant drop from previous month forecast.</b> However, it will materially impact bank capitalization levels and profitability and have additional spillover effects</p>
<b>Household debt</b>	Although the corporate sector accounts for the largest share of debt, household indebtedness has risen rapidly and is approaching advanced economy levels	<b>Lending Growth</b>	Deleveraging the corporate sector and stabilizing the rise in household debt remains a priority but would probably create headwinds to economic activity

# Annual Loan and Deposit Growth

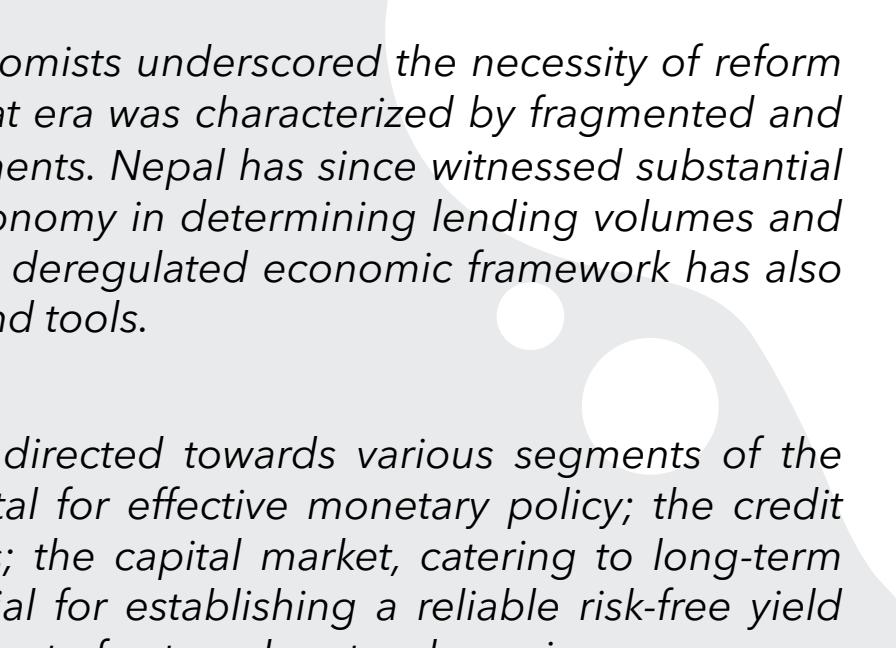


## Y-o-Y Growth



## Observations:

- We expect liquidity crunch to continue for sometime and increasing corporate trade related debts and in absence of corporate debts recovery legislation, assets quality of BFIs will deteriorate marginally during next fiscal year 2024/25. Improving net interest income will soften the pressure on profitability. **However, capital constrain will hit the loan growth. Banks will continue to focus on managing non-performing loan.**



*Taking a historical lens, we discover that in the early 1990s, economists underscored the necessity of reform within Nepal's banking sector. The financial landscape during that era was characterized by fragmented and underdeveloped markets, along with a dearth of financial instruments. Nepal has since witnessed substantial transformations in its banking sector, granting banks greater autonomy in determining lending volumes and terms. The transition from a tightly regulated to a liberalized and deregulated economic framework has also prompted significant shifts in monetary management strategies and tools.*



## **AUGUST 2023**



*Throughout this reform journey, significant attention has been directed towards various segments of the financial market spectrum, encompassing the money market, vital for effective monetary policy; the credit market, crucial for channeling resources into productive sectors; the capital market, catering to long-term capital requirements; the Government securities market, essential for establishing a reliable risk-free yield curve; and the foreign exchange market, integral to the management of external sector dynamics.*

## **OUTLOOK 2023**



*The fierce competition for both assets and liabilities, coupled with mounting volatility in domestic and international markets, has forced banks to recalibrate the delicate equilibrium between short-term profitability and long-term sustainability. This painful recalibration process may lead to uneven recoveries and further disruptions in microeconomic stability. Recent upheavals in the credit market have exerted tremendous pressure on banks and financial institutions, compelling them to resort to lending reductions as a last resort.*

## **"PAST AND PRESENT"**

*In recent times, the expense of government borrowing has escalated significantly. In an unprecedented occurrence in Nepal's fiscal history, the current fiscal year observes the Government of Nepal (GoN) allocating more budgetary resources to meet financial obligations rather than capital commitments.*

## **The Great Gorkha Earthquake**

Following the Great Gorkha earthquake, credit growth surged, leading to a decrease in interest rates and spreads, propelling Nepal into an upswing in the business cycle. This period reduced perceived project risks and funding costs, resulting in heightened demand for credit and increased loan returns.

Banks, caught up in the optimism of this buoyant phase, tended to underestimate forthcoming risks, a phenomenon commonly referred to as "disaster myopia."

The overestimation of credit quality further fueled credit expansion, exacerbating the cycle. In the midst of fierce competition, banks relaxed their risk assessment standards, accommodating borrowers with lower credit quality. The eventual tightening of monetary policy towards the end of the boom, coupled with the ensuing economic downturn, led to the deterioration of non-financial firms' balance sheets and credit quality, a deterioration that became increasingly evident in 2023.

The severity of the subsequent credit crunch reflects the consequences of unchecked credit expansion. Lacking access to fresh capital, which proved elusive amid deteriorating financial conditions, banks were compelled to curtail lending, even when borrowers were willing to accept higher interest rates.

Authorities found themselves with limited options once risks had piled up, as waning market confidence and domestic monetary contraction took hold. External constraints, such as statutory requirements, were heightened, making it challenging for the banking system to operate effectively.

Nevertheless, in dire circumstances, authorities might be compelled to implement additional measures, introducing significant policy challenges, particularly in the fiscal and structural investment domains, further constricting banks' lending capacity.

Several known and unknown developments during the recent past have confused economic agents. Regulators are not prepared enough to calibrate their actions and at the same time, market agents also failed to judge tail risks appropriately

Some analysts believe the economy is not likely to change its course soon, therefore regulators and market players must rethink their business model. They viewed that though the economy has been through difficult situations before and always comes out stronger, but the situation now is a bit different from the past, and we may not have a strong tide shortly to lift us.

In sum, the pattern of tail risk-taking in, some aggressive firms are likely to pay it off for a considerable time. Therefore, looking at a possible downturn, I would like to request government and regulators, in a situation, where we are nearing the rock-bottom, we should ease out the transition to the next expansion and avoid long-term economic damage.

What can we learn from current crisis, and the many others that come to mind? If we look at shortcomings in the economic policies, we can see how difficult it can be to pursue the tough and controversial reforms that are necessary. The persistent failure to tackle chronic problems in banking and corporate sectors; continuing weak demand, the growing fiscal deficit: these have all highlighted the reluctance of policymakers to tackle awkward structural problems.

Structural reforms are needed. There is always room for improvement. The uncertainty inherent in the reform process. The problem is that economic policymaking always involves trying to measure the probability of one outcome as opposed to another, given the uncertainties in the world economy. From the economist's perspective, the best way to proceed is to adopt those policies that seem most likely to deliver the preferred outcome.

Reducing the risk and incidence of crises, though, is only part of the battle. Nepal is performing below potential. The ability to deliver faster growth, raise living standards and reduce poverty depends on sound economic policies. We do know what works, and what doesn't.

Non-financial crisis, which consequently turned into a economic crisis, created a consensus that pre & post-crisis financial regulations didn't take the "Big Picture" of the system as a whole sufficiently into account. As a result, supervisors "missed the forest for the trees". Failed reforms tend to be judged more harshly—by economists, of course, but above all by those who suffer as a result—the poor, the jobless and the hungry. Policy failures can be catastrophic.

We also know that reform is more easily embraced in good times rather than bad. But every dark cloud has a silver lining. This threat could be a big opportunity to reshape economy. We learnt a costly lesson. As is often said, one must pay for one's education! Nevertheless, we must appreciate effort made by all market agent and regulators till date to bring the economy up to this level. However, policymakers must take prompt and proper actions to cash the silver lining of this dark cloud in the economy.

## **Policy Rates**

According to the IMF's Article IV evaluation, "Nepal, like other nations with underdeveloped financial markets, demonstrates a weak correlation between the policy rate and market rates. Nepal has weak pass-through from the policy rate to market rates". Nevertheless, the policy rate does impact Nepalese short-term money market rates and directly affects government borrowing costs.

*It's important to acknowledge that Nepal contends with a fragile connection from the policy rate to market rates, as the policy rate doesn't exert direct influence on lending rates. Financial institutions primarily utilize the policy rate as a benchmark for the Lender of Last Resort (LOLR). When setting interest rates, the Nepalese banking system doesn't rely on policy rates; they rather employ the "Base Rate" to determine lending rates, lacking a solid foundation for establishing deposit rates and rates for other debt instruments.*

*Additionally, I firmly believe that the Nepal Rastra Bank's (NRB) policies shouldn't directly dictate market lending rates; instead, equilibrium should be determined by the market.*

*Currently, market rates are hovering around the 10-year average. In the short term, the NRB could encourage BFIs to use the policy rate as a benchmark for determining deposit and lending rates. However, for interest rate policies to function as effective monetary tools in the economy, the NRB must strengthen its interest rate corridor framework. Therefore, NRB must set clear policy guidelines related to the pricing policy.*

## **Navigating Uncertain Waters**

A period of uncertainty appears on the horizon, though not as an inevitability. Many economic analysts are understandably concerned about the potential repercussions, given the unfavorable outcome it could entail. This situation demands a delicate equilibrium: while worst-case scenarios remain relatively improbable, their potential impact is disconcerting. As a result, economic policies often advocate proactive measures to mitigate these risks.

However, as stakeholders call for increased action, there is a risk of overreacting, potentially exacerbating the situation. While short-term measures may be necessary to address immediate challenges, they should not overshadow the broader, medium-term vision for economic reform aimed at enhancing living standards.

It is crucial for policymakers to distinguish between short-term crisis responses and medium-term policy adjustments, fostering confidence among market participants in the stability and direction of economic policies.

## **A Call for Evaluation**

Now is the time to evaluate the progress made in reforming Nepal's financial system. While some strides have been taken, they remain insufficient. The existing mechanisms, including recent adaptations, do not fully align with the demands posed by financial globalization.

In the context of financial sector reforms, it is imperative to consider not only the desired directions and carefully sequenced measures but also the emerging uncertainties, both domestic and global. From a macroeconomic standpoint, significant changes have yet to materialize: GDP growth remains stagnant, structural shifts in the economy are absent, new employment opportunities have not surfaced, and investment levels remain lackluster.

# Monetary Policy Stances 2023/24



NRB moved towards accommodative monetary policy

NRB will introduce Macro Stress Testing Framework, improve regulatory capacity enhancing the quality of supervision, supported by the data and regulatory upgrades and improve the autonomy and accountability framework of the NRB.

Though private sector credit target kept slightly higher at 11.5%, NRB aims to reduce credit concentration. NRB policies will guide BFIs to concentrate on credit management rather than credit creation

NRB will move towards capital account convertibility

NRB will review assets quality and implement Internal Credit Risk Grading system and introduce credit scoring

Review the directed lending guidelines. NRB will review credit concentration. NRB will conduct Financial Corporation Survey

NRB will implement Expected Credit Loss Model (ECL)



## Monetary policy Review 2023/24

Monetary measures	Policy expectations	Impact	Policy Actions
<b>Policy Shift</b>	NRB is expected to shift policy stance toward an accommodative policy	Stabilized market demand for liquidity increase supply of the liquidity	<b>As anticipated NRB adopted accomodative policy</b>
<b>Policy Rates</b>	Policy rates are expected to reduce by more than 75 bps within the next fiscal year, and 50 bps at the time of policy announcement	Rate will be calibrated in line with inflation. Market lending rate will be decreased	<b>Policy &amp; Deposit collection rates reduced by 50 bps &amp; 100 bps respectively whereas bank rate kept unchanged. However, NRB will review rates with reference to forex position and inflation.</b>
<b>Liquidity ratios</b>	NRB is expected to increase CRR ratios by 50 bps. SLR will be revised upward	The average market lending rate may reach at 11.03 % at the year end	<b>CRR and SLR kept unchanged</b>
<b>BOP Position</b>	NRB is expected to maintain Forex reserve to cover more than 6.5 months of import of goods and services	External sector will be stabilized and credibility of foreign exchange rate peg will be maintained	<b>NRB aims to maintain 7 months reserve to cover import of goods and services</b>
<b>Credit Growth</b>	NRB is expected to restrict credit growth below 10% and private sector credit growth will be restricted to 8.5%	Restrict easy credit flow to imports (especially to the trading sector). Credit flow to households will be reduced to a sustainable limit.	<b>Though the private sector credit target kept slightly higher at 11.5%, NRB aims to reduce credit concentration. NRB policies will guide BFIs to concentrate on credit management rather than credit creation</b>
<b>Growth of broad money (M2)</b>	Growth of broad money (M2) will be kept around 10%	Deposit rate will be maintained slightly lower than current level, motivate more savings and reduce domestic consumptions	<b>Broad Money target kept at 12.5%</b>
<b>Bank Supervision</b>	Stringent policies will be introduced to regulate BFIs more effectively	Assets quality review of systemically important banks will be done	<b>NRB will review assets quality and implementan Internal Credit Risk Grading system and introduce Credit Scoring</b>
<b>Capital market</b>	Policy will be introduced to facilitate entry of Non-resident Nepali in the capital market	Policy will streamline capital market volatility.	<b>NRB will move towards capital account convertibility</b>
<b>Digitization</b>	Digitization will be promoted to make the payment system more secure, healthy and efficient	Reduce informal market and reduce the cost of doing business	<b>NRB will address operational issue and initiate legal reforms</b>
<b>Growth target</b>	NRB is expected to aim to achieve sustainable GDP growth	Achive sustainable GDP growth of 4-5 %	<b>NRB aims to achieve sustainable growth.</b>
<b>Inflation</b>	Monetary management will focus to contain consumer price inflation of 6.5 percent within margin of 1% either side of targeted rate	1% margin will allow NRB to calibrate policies to provide supports for the fiscal policy to achieve some of its objectives	<b>Maintain inflation at 6.5%</b>

# Monetary Policy Review 2023/24

Improve regulatory capacity enhancing the quality of supervision, supported by the data and regulatory upgrades and improve the autonomy and accountability framework of the NRB.	<b>NRB will introduce Macro Stress Testing Framework, improve regulatory by capacity enhancing the quality of supervision, supported by the data and regulatory upgrades and improve the autonomy and accountability framework of the NRB.</b>
Review aggressive monetary-tightening stance and review policy rates. As interest rates higher for longer than currently anticipated. Debt servicing costs could escalate default of nonfinancial corporates and add to financial stability risks.	<b>NRB moved towards accommodative monetary policy</b>
Redesign other policies to maintain inflation targets with a margin of 2% on either side.	<b>Not addressed</b>
Provide a clear guidance on restructuring and rescheduling of loan. Review the risk grading, rescheduled and restructured loans of hard-hit sectors and SMEs facing cash flow crisis. (The provisioning requirement of 12.5% has discouraged BFI to enter workout arrangements and encourage the auction of collateral.)	<b>Not addressed</b>
Implement interest rate spread effectively. It is more than a permissible level.	<b>Interest rate spread will be kept under 4%</b>
Review the working capital guidelines to match sectorial requirements.	<b>NRB will review working capital guidelines</b>
Ensure that banks' loan classification correctly reflects the asset quality of the banking system and review loan classification policy and implement NFRS 9 (currently default is determined based on non-payment (3 months 6 months and year).)	<b>NRB will implement Expected Credit Loss Model (ECL)</b>
Review assets and liability pricing.	<b>Not Addressed</b>
Review liquidity policy and provide liquidity in the system where necessary and review the refinance facility.	<b>NRB will maintain interest rate corridor and NRB will continue to supply liquidity when needed</b>
Review the accounting treatments for capitalized interest during the construction period.	<b>Not addressed</b>
Review risk weighted on margin loans and private vehicle loans and introduce home equity finance	<b>NRB will review the risk weighted and housing loan limit has been increased</b>
Implement Countercyclical capital buffer in phase wise manner and rollout policies to reduce the impact of by accounting treatment of debenture/bond. Introduce policy to spread the impact of the retroactive tax introduced by Fiscal Policy.	<b>Not addressed</b>
Promote loan to the sector which encourage use of domestic resources improve productivity and competitiveness	<b>Review the directed lending guidelines. NRB will review credit concentration. NRB will conduct Financial Corporation Survey</b>
Support highly impacted sectors such as MSMEs, construction, retail, etc. through some regulatory forbearance	<b>Stressed Loan Resolution Framework will be introduced</b>

The banking system remains robust and resilient. In response to increased interest rates, rising funding costs, and anticipated regulatory changes, banks have enforced stricter lending standards. As a result of these tightened standards, there has been a pronounced reduction in credit availability, leading to a substantial deceleration in economic activity.

During the first quarter of the previous fiscal year (2022/23) and the current fiscal year (2023/24), the utilization of credit has remained sluggish. The demand for credit is closely linked to income growth, which, in turn, reflects the true state of the economy. Additionally, various factors influence the demand for credit, including agricultural expansion, export needs, domestic consumption, infrastructure demands, and the competitive prowess of Nepalese businesses, all in conjunction with prevailing interest rates. The Nepal Rastra Bank (NRB) has set a credit growth target of 11.5% for the current year. However, given market sentiment and domestic consumer demand, it is anticipated that credit growth will significantly lag behind the initial projections. This underscores that the sluggish credit uptake is a consequence of the deceleration in growth rather than its primary cause.

When the NRB raised rates in 2022, it became evident that restoring price stability required addressing both the unwinding of pandemic-induced supply and demand imbalances and implementing a restrictive monetary policy to temper robust demand while allowing supply to catch up. However, these forces are currently not working in harmony to combat inflation. In September 2023, inflation reached its peak at 8.19 percent. Real interest rates have remained elevated, and inflation rates have exceeded projections by one percentage point.

Inflation readings increased during the festival season, and the September inflation data continued this upward trajectory, albeit with less encouraging signs. The duration of these elevated inflation readings and where inflation will eventually stabilize in the upcoming quarters remain uncertain. While the journey is expected to be challenging and time-consuming, the NRB must reconsider its policy objectives to maintain inflation within a 2 percent margin. Nepal should prioritize fostering transparency and consistency in the face of numerous challenges confronting the Nepalese financial system. These challenges range from a rising default rate and sluggish domestic demand to the underutilization of the industrial sector and the difficult conditions faced by the labor force.

The growth of bank loans has decelerated, and the ongoing financial difficulties experienced by households and businesses, coupled with challenges in nonbank lending, underscore the necessity for effective monetary policy to bolster economic recovery focusing on expanding domestic demand, while fending off financial risks. This policy should yield more positive impacts on bank lending and the overall economy compared to previous approaches.

**September  
2023**

**Outlook  
2023**

**Policy  
Dilemma**

# Charting a New Course for Reform

The foremost objectives of financial sector reform should encompass the prevention of credit crunch and banking crises, along with effective management should they occur. Additionally, these reforms should prioritize support for low-income earners. Prudential regulation and supervision must account for not only microeconomic but also macroeconomic risks associated with boom-bust cycles.

## Asset Management Company

With the increasing levels of non-performing assets (NPAs) and the potential for corporate defaults to trigger a ripple effect, leading to a sharp decline in economic growth and employment now is the opportune moment to commence the establishment of an Asset Management Company (AMC). Establishing an AMC to manage the bad loans of Banking and Financial Institutions (BFIs) can be a strategic move to address non-performing assets (NPAs) and improve the financial health of the banking sector. The establishment of an NPA management AMC is a critical step toward addressing the challenges posed by bad loans in the banking sector. It not only benefits BFIs by improving their financial health but also contributes to the overall stability and growth of the economy. I wholeheartedly support the creation of such an institution and believe it can be a game-changer in addressing NPA-related issues in the financial industry.

## Amendment to the NRB Act

The Act amendment should place a strong emphasis on conducting a comprehensive evaluation of the composition of the NRB Board. The current composition, primarily comprising retired NRB employees, should be revamped to include experts from diverse economic and professional backgrounds. However, it's essential to carefully consider the specific qualifications and selection criteria for these external experts to ensure they have the necessary skills and knowledge to contribute effectively to the central bank's functions. Additionally, the governance structure should strike a balance between external expertise and the central bank's internal knowledge and experience.

## Establishment of a Monetary Policy Committee:

The establishment of a Monetary Policy Committee is essential, ensuring both independence and accountability in the policymaking process. While the separation of the roles of monetary policy and credit policy can offer advantages, it's essential to underscore the significance of coordination and communication among the responsible authorities. These factors are vital for safeguarding both overall economic stability and the health of the financial system.

# Charting a New Course for Reform

## **BAFIA Amendment:**

Amendments to the BAFIA (Banking and Financial Institutions Act) should incorporate provisions for an exit mechanism for the promoters of Banking and Financial Institutions (BFIs). Encouraging a large public holding will enhance governance standards and practices within these institutions.

Additionally, it is advisable to revisit the composition of the Board, introducing a mix of executive and non-executive directors for better governance. Furthermore, consider restructuring BFIs based on their functions rather than solely on their capital, promoting efficiency and relevance in the financial sector.

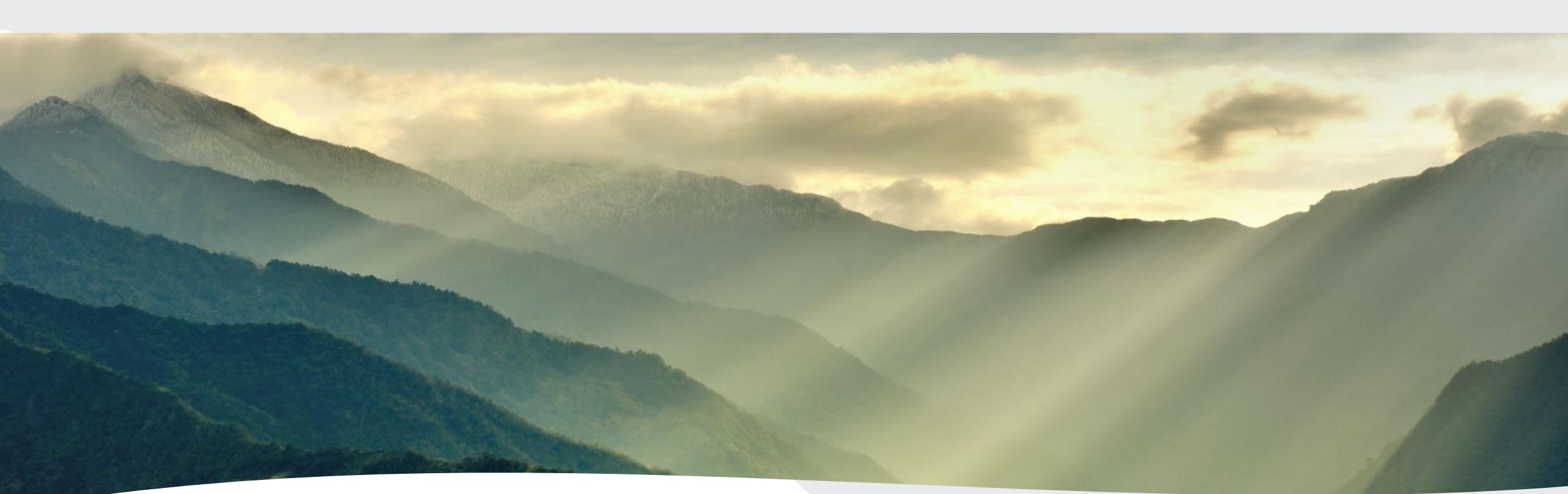
## **Review the GDP base**

The Government of Nepal should consider updating the base year for GDP calculation from 2010/11 to 2020/21. This adjustment is warranted due to four significant events that occurred after the Great Gorkha Earthquake, a trade embargo, changes in the government structure, and the impact of the Covid-19 pandemic. Shifting the base year to 2020/21 would offer a fresh perspective for policy formulation and response, considering the evolving economic landscape.

## **Prompt corrective action**

In addition to the existing PCA guidelines, the NRB should consider these supplementary provisions: If the net NPA level is below 7%, no further action is required. When a bank's net NPA exceeds 7% but remains below 9%, it falls under the first threshold, and BFIs should refrain from approving new loans. If the Net NPA crosses the 9% threshold, it triggers the second tier, and BFIs should refrain from accepting new deposits.

However, if this metric reaches 11% or higher, the bank will be classified into the third grade, and PCA initiation will follow. Further, in relation to the Income Tax Act, the permissible provisions charged to the Profit and Loss statement (P&L) should be raised from 5% to 9%.



**October 2023**

**Outlook 2023**

**Climate Change:  
Assessing Nepal's  
Role and Urgent  
Needs**

*Nepal, though not a contributor to climate change, grapples with its consequences. While our nation has made no significant contributions to climate-altering activities, we are feeling the impact acutely.*

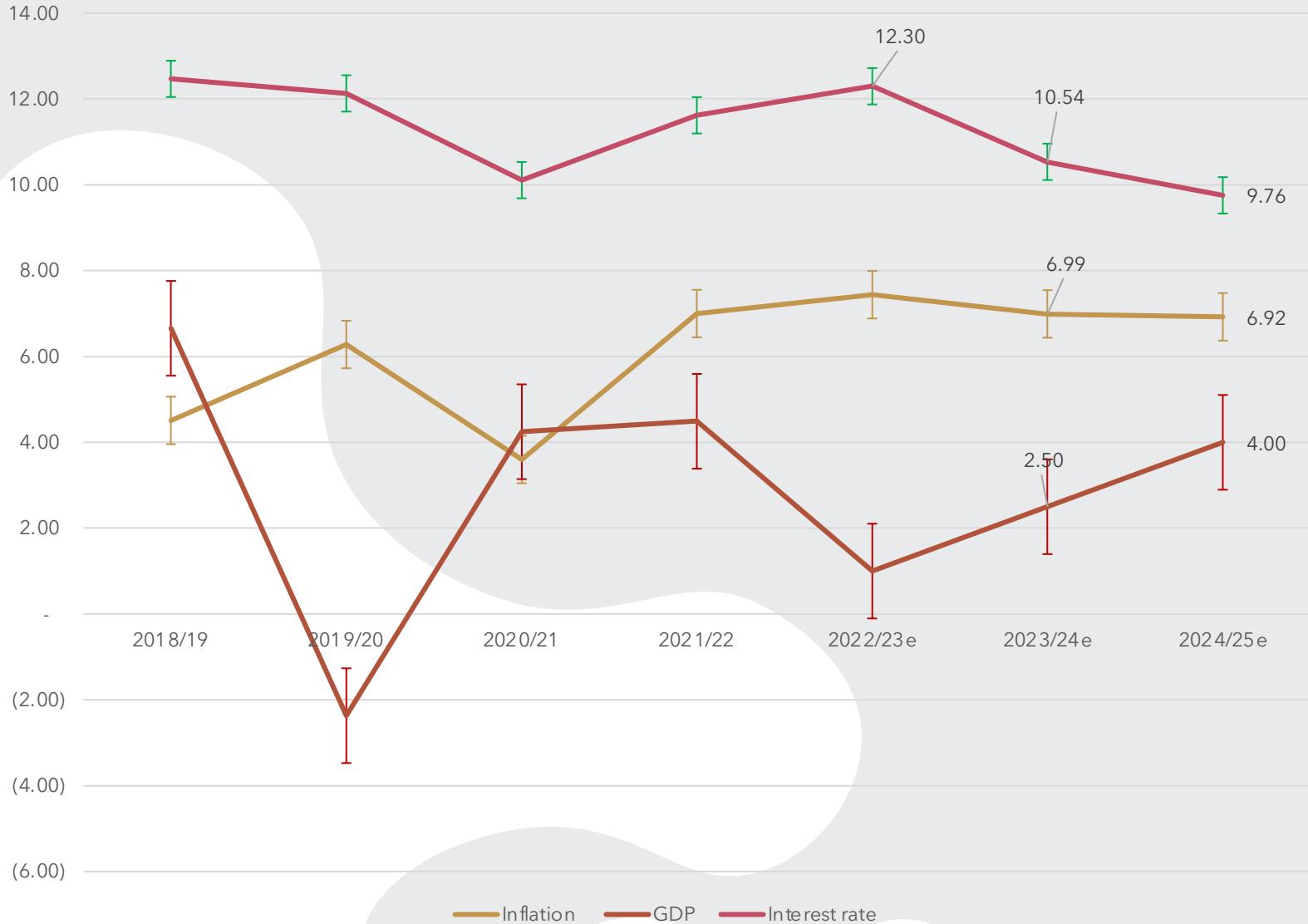
*As we strive to protect our beautiful country of Nepal from the adverse effects of climate change, it's crucial that we encourage countries with significant emissions to recognize their role in this global challenge.*

*We must work together to ensure that Nepal receives its fair share of assistance for effective climate protection..*

## Inflation expectations

In the current landscape of uncertain global prospects, it is imperative for the Nepal Rastra Bank (NRB) to contemplate an alternative approach that acknowledges the potential misalignment between inflation control and financial stability goals.

Given the prevailing conditions, wherein financial stability takes precedence, a prudent strategy for the NRB would be to concentrate on sustaining a target inflation rate with a permissible margin of 2% on either side. Furthermore, the adoption of supplementary prudential regulations can serve as a reinforcing measure to enhance overall financial stability.



## November 2023

Financial stability risks have become a focal point in central banks' decision-making processes. This is driven by the realization that financial instability could hinder central banks from achieving their primary objectives. Moreover, it acknowledges that monetary policy, in isolation, may inadvertently introduce stress into the financial system.

For example, raising the policy rate to address inflationary pressures may bring existing financial vulnerabilities to the forefront, potentially leading to financial instability. The type of inflationary pressure prompting the tightening of monetary policy initially is a crucial factor in determining the extent to which a central bank can raise its policy rate without posing a threat to financial stability.

## Outlook 2024 "Optimistic"

The economic data for November signals an improvement in consumer spending compared to the first quarter, marked by a rise in retail sales—a departure from the decline observed since January 2023. Notably, spending on motor vehicles, a sector sensitive to interest rates, has increased, suggesting a potential impact of the accommodative monetary policy implemented by the Nepal Rastra Bank (NRB).

Fuel station expenditures are also on the rise, primarily due to a significant drop in oil prices and an uptick in the movement of products and services. The retail sector witnesses increased demand, reflecting a widespread enhancement in consumer demand. Furthermore, there are indications of positive developments in both manufacturing and non-manufacturing activities by businesses.

While these trends are encouraging, they do not provide conclusive evidence of their continuity. Just a few months ago, both inflation and economic activity rebounded, introducing a degree of uncertainty about the future trajectory.

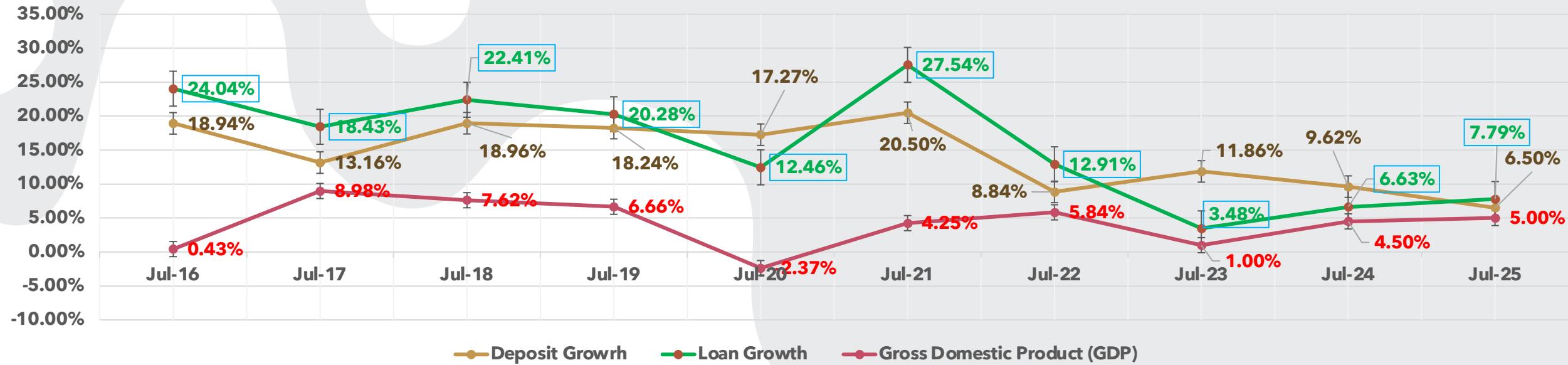
The ongoing discussions about the overall relaxation of financial conditions this month, as evidenced by market interest rates and asset prices, are noteworthy. Although long-term interest rates remain above average, the general improvement in financial conditions is expected to support household and business spending. However, the recent easing of financial conditions serves as a reminder that numerous factors can influence these conditions, emphasizing the need for policymakers to exercise caution when relying on such measures to fulfill their responsibilities.

## Economic Performance

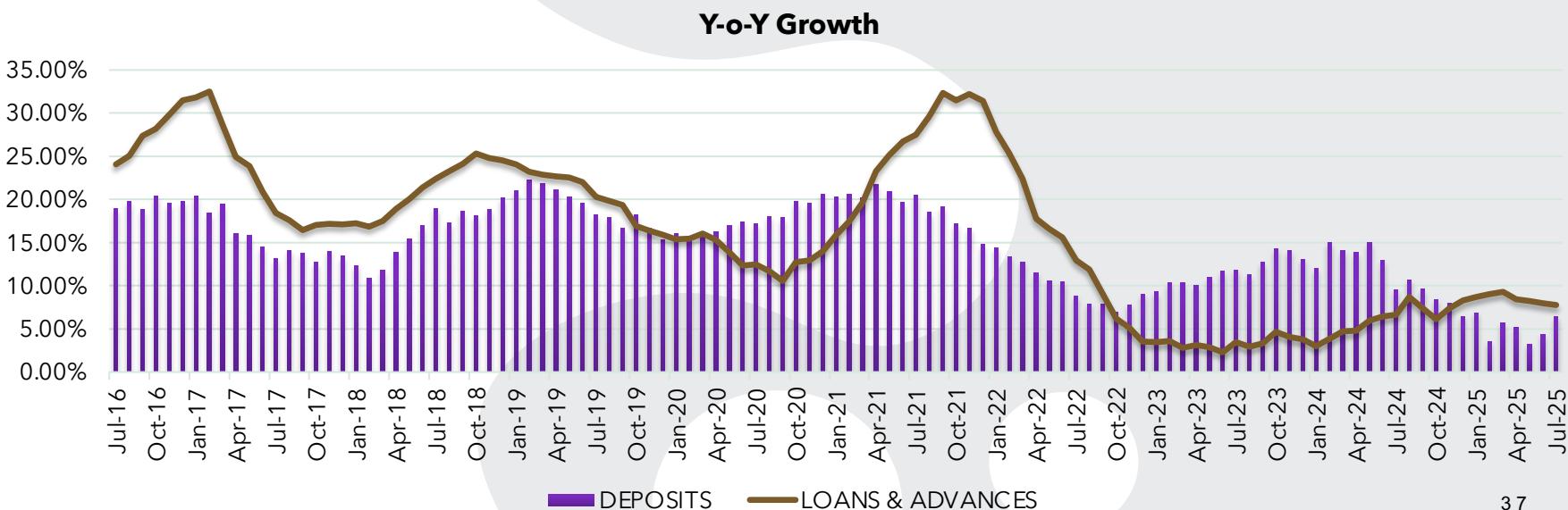
Economic Performance		Financial Sector	Outlook																
Real Sector	Outlook																		
Corporate performance	<p><b>Following the accommodative stance adopted by the NRB, there is a promising outlook for a substantial decrease in the population of MSMEs experiencing negative economic profitability. This positive trend is likely to contribute to a reduction in default rates. Additionally, a considerable portion of large corporations has witnessed notable enhancements in the return on invested capital (ROIC), accompanied by a rapid decline in the weighted average cost of capital (WACC). As a result, there is a lessened pressure on sustaining a favorable ROIC for these corporations.</b></p>	Banking system	<p><b>The outlook for enhanced profitability in BFIs is promising, primarily attributed to the positive effects stemming from the availability of loan reconstruction and rescheduling facilities. Despite the imposition of additional taxes and challenges associated with a low-interest margin environment and constraints on non-interest income, the sector is expected to experience an improvement in profitability, particularly with the reduction in Non-Performing Assets (NPA). As of now, the NPLs and Loan Loss Provisions (LLP) of BFIs stand at \$1.40 billion and \$1.47 billion, respectively.</b></p>																
		Non-performing assets	<p><b>NPLs are expected to hover around the 3% mark by the end of July 2024.</b> Nevertheless, uncertainty is likely to have a significant impact on bank capitalization levels and profitability, with potential ripple effects extending to other areas.</p>																
		Lending Growth	<p>Giving precedence to reducing corporate sector indebtedness and limiting the growth of household debt is crucial, although it is anticipated to present challenges to overall economic activity</p>																
Working Capital financing	<p>Under the newly introduced guidelines, borrowers may encounter ongoing challenges when attempting to infuse new equity into their operations. The extension of the working capital cycle will hinder borrowers' ability to fund their working capital needs from internal funds. This elongation of the working capital cycle will make it impractical to inject fresh equity, as internal resources will be insufficient. Consequently, the implementation of these new working capital regulations is expected to have a detrimental effect, potentially impacting industrial growth and disrupting the balance in supply chain management. <b>Sector-specific adjustments are still pending.</b></p>	Household debts \$ million																	
		<table> <tbody> <tr> <td>Residential Personal Home Loan (Up to Rs. 20 million) #</td> <td>2,896.81</td> </tr> <tr> <td>Margin Nature Loan</td> <td>624.31</td> </tr> <tr> <td>Hire Purchase Loan</td> <td>990.81</td> </tr> <tr> <td>Credit Card</td> <td>45.86</td> </tr> <tr> <td>Education Loan</td> <td>363.91</td> </tr> <tr> <td>Gold/Silver</td> <td>395.37</td> </tr> <tr> <td>Fixed A/c Receipt</td> <td>388.87</td> </tr> <tr> <td>Total</td> <td>5,705.93</td> </tr> <tr> <td>% of total Loan</td> <td>30%</td> </tr> </tbody> </table>		Residential Personal Home Loan (Up to Rs. 20 million) #	2,896.81	Margin Nature Loan	624.31	Hire Purchase Loan	990.81	Credit Card	45.86	Education Loan	363.91	Gold/Silver	395.37	Fixed A/c Receipt	388.87	Total	5,705.93
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% of total Loan	30%																		
Household debt	Despite the corporate sector shouldering a significant portion of the debt burden, there is a positive aspect to note as household debt has experienced a substantial increase, nearing levels observed in advanced economies.																		

Major Risks/Impact	High	Medium	Low	Remarks
<i>Excessive capacity, supply constraints, and intense competition within the manufacturing sector could potentially have adverse repercussions on asset quality.</i>		✓		Improve
<i>Substantial surges in the market prices of vital raw materials, energy, or transportation, along with supply disruptions, may negatively impact the performance of the industrial sector. This, in turn, could intensify the pressure on short-term loan demand and exacerbate financing mismatches due to working capital guidelines.</i>		✓		Improve
<i>A heavy reliance on imported raw materials, capital goods, and consumer products can potentially strain the Balance of Payments. Additionally, a supply-demand mismatch could lead to a deterioration in the asset quality of Banking and Financial Institutions (BFIs).</i>	✓			No-change
<i>Variations in the current market interest rates applicable to loans and debts, both within the financial market and the overall financing landscape, have the potential to negatively impact business operations and financial health, leading to a decline in asset quality. With credit growth remaining subdued due to sluggish domestic demand, it is expected that many market lending rates will be adjusted downward. This could also lead to a reduction in yields on government securities.</i>			✓	Improve
<i>The profitability of the banking sector continues to face challenges, including a low-interest margin environment, limitations on non-interest income, and a rising trend in corporate payment defaults. These factors pose challenges to the successful implementation of NFRS 9.</i>	✓			No-change
<i>The asset quality of Banking and Financial Institutions (BFIs) may experience a decline due to microeconomic vulnerabilities. Additionally, there is a potential for a significant increase in Income Tax liabilities in the event of changes to tax laws and regulations or unfavorable interpretations and inconsistent enforcement, particularly in transactions involving bargain pricing, share premiums, FPOs, and ownership transfers, among other factors.</i>		✓		<b>(BFI paid \$ 92 million in taxes for the FPO bargain pricing)</b>
<i>Variations in the exchange rate between the Nepalese Rupee and the U.S. dollar have the potential to influence the market prices of raw materials.</i>		✓		Improve
<i>Global supply constraints have the potential to negatively impact both operations and financial stability. An inability to effectively manage supply and distribution gaps could disrupt economic activities.</i>		✓		No-change

# Annual Loan and Deposit Growth and LLP



Particulars	Amount in USD Million	
	Incremental LLP	Y-o-Y Growth
Loan loss Provision	127	91.83%
Watch List Provision	13	249.37%
Special Loan Loss Provision	88	58.03%



Thank You!

Best regards,  
Kala Legal  
Protecting your creations

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