

from lower-than-expected revenue growth (-15% for the first six months of FY2022/23 compared to the same period a year ago, leading to a budget cut of 13% to maintain fiscal deficit and debt sustainable). From FY2021/22 the central bank shifted from the previous accommodative policies adopted during the peak of COVID - which resulted in high credit growth - to more cautious policies aimed to preserve the credibility of the exchange rate peg, contain inflation and progressively improve financial supervision of commercial banks. Policy rates were raised in August 2021, February 2022 and July 2022 to curb excessive credit growth and encourage deposits. Through such measures the buffer of foreign exchange reserves increased, and reserves were at 9.4 months of imports in mid-January 2023, much above the 5.5 months recommended by the IMF and above the Nepal Rastra Bank target of 7 months of imports cover.

Inflationary pressures are therefore being managed and inflation is expected to remain between 6-8% in the present fiscal year (Nepal's Rastra Bank target is to reduce inflation and maintain it below 7%), despite international inflationary pressures to which Nepal is vulnerable as an import dependant country. The budget deficit is expected to remain at about 5% of GDP, which is lower than the previous fiscal year (-6.3% in FY21/22) and is forecasted to converge after 2024 to 4.5%.

Economic activity is supported by tourism, remittances (with a strong recovery since mid-2022), and private consumption post-pandemic. However, government policies adopted to reduce credit growth, and to reduce the previous surge in imports, had its impact on the economy as well, and Nepal's growth slowed in the first half of the fiscal year 2022/23.

Overall debt distress and external debt distress are considered low and this outlook is expected to continue. Debt to GDP (stock) was 44% and debt service is estimated at 1.93% of GDP, following the IMF's February 2023 assessment. As further confirmed by the Extended Credit Facility review, Nepal's macroeconomic framework is on a sustainable path with risks mitigated and several agreed measures to be adopted which should further consolidate macroeconomic fundamentals.

In conclusion, the authorities are pursuing a stability-oriented macroeconomic policy and the eligibility criterion is met.

2.3.3 Public Financial Management

Progress in public financial management has been consistently assessed as relevant and credible in the context of yearly assessments to ascertain continued eligibility for the on-going budget support programmes with Nepal. The most recent assessment is the Public Finance Management and Transparency Assessment report (from April 2023) which focuses on reviewing progress specifically over the past year i.e. from January 2022 to January 2023.

PFM financial, and technical support (through the World Bank) as well as continuous dialogue between government of Nepal and donors and international development agencies including the IMF and World Bank (which manages the PFM Multi-donor Trust Fund) have helped keep on track the implementation of reforms both broad and focused on key weaknesses.

The Public Financial Management Reform Strategy is in the process of being updated, a draft was shared with development partners in mid-October 2022, and the Government with PFM Multi-donor Trust Fund support conducted a PEFA assessment in 2022 now being finalised for peer review. The PEFA results will also inform the finalisation of the revised Public Financial Management Reform Strategy, ensuring its relevance. The PEFA 2022 report and the revised Financial Management Reform Strategy are two much-expected documents to better integrate fiscal federalism and to reconfirm PFM reform directions. Approval of PEFA is ongoing, as are the discussions on the review of the PFM reform.

Key achievements compared to targets in last year's follow-up PFM matrix confirm the credibility of the PFM reform agenda in Nepal. This includes: finalisation of the Citizens Engagement Strategy; progress on a) tax exemptions; b) the establishment of a fiscal risks' register and c) the development of a domestic revenue mobilisation strategy; roll-out of the medium-term expenditure framework guidelines at the three-tiers of the government; the Project Bank's Standard Operating Procedures (SOPs) were issued, and the management information system populated; Internal Control Framework and guidelines were developed based on international standards and the Internal Audit Code of Conduct was approved by Cabinet in May 2022; Public Debt Management Act was adopted by Parliament in September 2022; the Public Assets Management System (PAMS) was rolled out at federal and provincial levels and the Financial Management Information System (FMIS) was interfaced with major PFM IT systems.

In conclusion, the public finance management reform strategy is sufficiently relevant and credible, including on domestic revenue mobilisation, and the eligibility criterion is met.