MACROECONOMIC REPORT

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NEPAL RASTRA BANK

ECONOMIC RESEARCH DEPARTMENT

Monetary and Capital Markets Division

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Macroeconomic Report

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Economic Research Department

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List of Abbreviations

AI	Artificial Intelligence
BFI	Bank and Financial Institution
BoP	Balance of Payments
CAR	Capital Adequacy Ratio
CPI	Consumer Price Index
CRR	Cash Reserve Ratio
DSA	Debt Sustainability Analysis
EMP	Exchange Market Pressure
EMPI	Exchange Market Pressure Index
FDI	Foreign Direct Investment
Fed	Federal Reserve
FOREX	Foreign Exchange
GaR	Growth at Risk
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
IMF	International Monetary Fund
INR	Indian Rupees
IRC	Interest Rate Corridor
LIDC	Low Income Developing Country
LMFF	Liquidity Monitoring and Forecasting Framework
MER	Macroeconomic Report
MMD	Monetary Management Department
MoF	Ministry of Finance
NEER	Nominal Effective Exchange Rate
NPL	Non-Performing Loan
NPR	Nepalese Rupees
NRB	Nepal Rastra Bank
NSO	National Statistics Office
OMO	Open Market Operation
OMOC	Open Market Operations Committee
Q1, Q2, etc.	First quarter, second quarter, etc.
QR	Quick Response
REER	Real Effective Exchange Rate
RTGS	Real Time Gross Settlement
SDF	Standing Deposit Facility
SLF	Standing Lending Facility
SLR	Statutory Liquidity Ratio
SME	Small and Medium Enterprise
USD	US Dollar
WEO	World Economic Outlook

Foreword

Nepal Rastra Bank (NRB), as the monetary authority of Nepal, has been formulating the monetary policy of Nepal as provisioned by the NRB Act, 2002. The formulation process has evolved, responding to evolving market needs and expectations in the monetary and financial sectors. Since 2002/03, NRB has issued a monetary policy annually for the respective fiscal year, with mid-term review starting in 2004/05 and quarterly reviews starting in 2016/17. The increase in the frequency of monetary policy reviews reflects the responsiveness of the NRB on assessment of policy suitability and adjusting accordingly amid an evolving macroeconomic and financial landscape.

In continuation of the NRB's practice of continuously reviewing its policy approach to improve its effectiveness and efficiency, I am pleased to introduce the first issue of the NRB's *Macroeconomic Report*. Currently envisioned to be published semiannually, the Report features current macroeconomic developments and outlook based on the analysis of the NRB's Economic Research Department, international institutions such as the IMF and the World Bank, as well as renowned national and international scholars. We at the NRB are committed to delivering dynamic, evidence-based, and forward-looking monetary policy that best suits the Nepalese context. I believe the publication of this report is a milestone step in that regard.

Being the first issue of its kind, I would like to acknowledge the tireless efforts of our staff from the Economic Research Department for the creation of this Report. I would like to thank Dr. Ram Sharan Kharel, Executive Director, for his vision and leadership in bringing about this Report. Likewise, Madhav Dangal, Director, and Satyendra Raj Subedi, Director, have provided guidance in shaping the outline and contents of this report. Dr. Guna Raj Bhatta, Deputy Director, has put in tremendous effort in drafting, editing, and shaping the Report in this format. Sona Rana, Deputy Director, Rohan Byanjankar, Assistant Director, and Victor Kumar Sapkota, Assistant Director, have contributed significantly in drafting various sections of this Report. Similarly, Assistant Directors from the Monetary and Capital Market Division, including Debakee Chaulagain, Aditya Pokhrel, Ashmita Dahal, and Narendra Raj Paneru, have also provided meaningful contribution in various sections in the Report. Furthermore, I would like to acknowledge all parties involved, directly and indirectly, in the publication of this report.

Finally, I expect that the first issue of the *Macroeconomic Report* will be warmly accepted by all concerned stakeholders. Despite the assiduous labor put in by our team, I recognize that there may be shortcomings in the first issue of this Report. Corrective and constructive feedback on any such flaws or areas for improvements would be heartily welcome. We remain committed to incorporating positive feedback for future renditions of this Report, as well as constantly working to better improve by our own terms in the coming days.

Prof. Dr. Biswo Nath Poudel
Governor

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Executive Summary

Nepal Rastra Bank (NRB) has initiated publishing macroeconomic reports on a semi-annual basis, following best international practices. The report provides comprehensive macroeconomic diagnostics and economic outlook, including forecasts of key macroeconomic variables. Likewise, the report also enhances transparency by communicating macroeconomic conditions and outlook to its stakeholders, thereby helping anchor inflation and policy stance expectations. Furthermore, the report serves as a primary source of macroeconomic analysis and the basis to reorient the existing monetary policy statement structure so as to enable the NRB to focus on formulating a dynamic, evidence-based, and forward-looking monetary policy.

The NRB Act, 2002, mandates the objectives and functions of the NRB. NRB is mandated to formulate necessary monetary and foreign exchange polices to maintain the stability of prices and balance of payments for economic stability and sustainable development. As such, NRB formulates a comprehensive monetary policy annually and conducts quarterly reviews, using various monetary instruments and policy rules to achieve its objectives. The policy draft is prepared by consulting various committees and stakeholders, and the final decision is taken by the NRB's Board of Directors, chaired by the Governor. In determining the policy stance, the NRB carefully considers domestic and external economic conditions and their outlook, such as actual and projected economic growth, inflation and its outlook, the outlook of the BoP, and the current level of foreign exchange reserves. Special attention is given to the interest rate and credit channels for the transmission of monetary policy.

The global economy remains broadly resilient, despite elevated geopolitical and trade tensions. The International Monetary Fund (IMF)'s World Economic Outlook, January 2026 update, shows subdued inflation and stable growth in 2024 and 2025, with similar growth projections for 2026. Following an easing global economic environment, global output growth and inflation are expected to be 3.3 percent and 3.8 percent, respectively. . Central banks across advanced and emerging economies have begun easing monetary policy through policy rate cuts to boost aggregate demand. In South Asia, economic growth is expected to decelerate despite various steps taken to address vulnerabilities and the adoption of cautiously accommodative monetary policy by the respective central banks.

The domestic economy is reviving, but it is not evenly spread across the sectors. Economic growth remains moderate, inflation remains relatively stable, and the monetary sector remains mixed with historically low interest rates but sluggish credit growth. The external sector is robust overall but the performance remains mixed across different indicators, and the fiscal sector is improving despite sluggish capital spending.

Nepal's economic growth performance has moderated after facing a decade of extremes with four major shocks to the economy: the 2015 mega-earthquake, the political restructuring in 2015, the COVID-19 pandemic, and the recent Gen Z movement. The structure of the GDP is evolving, with expansion in the service sector and shrinkage in agriculture and industry sectors. Likewise, aggregate demand in Nepal is mainly driven by consumption, followed by private investment and government expenditure. Inflation has stabilized in recent decades, yet food inflation tends to be more volatile compared to non-food inflation. The structure of inflation has changed with the share of food and beverages in CPI basket decreasing substantially over the years. Nepal's inflation displays convergence with Indian inflation, due to the effect of exchange rate peg, high trade linkages and other structural factors.

Nepal's monetary sector remains mixed, with abundant liquidity amidst challenges to financial sector persist. The financial deepening has expanded significantly after the liberalization policies adopted in 1980s and 1990s, with broad money and deposits well above Nepal's GDP and credit close to the GDP. The short-term interest rate rates started to decline in the middle of 2023, in line with monetary policy stance, but have now stabilized around the policy corridor's floor. The lending rates are historically low, and the deposit rates have not fallen below 3.0 percent, with the

efficient liquidity absorption with mix of instruments including the Standing Deposit Facility. Financial access has substantially improved over the last decade and commercial banks' branches have reached all 753 local levels. Financial stability measures remain satisfactory but challenging. While the capital adequacy ratio remains above the regulatory threshold with abundant liquid assets, non-performing assets rose significantly over the two years. This has resulted in balance sheet pressure on banks and financial institutions (BFIs). The recent data shows improved recovery with stabilized non-performing loans. Substantial progress has been achieved in the infrastructure, products, and usage of payment systems, with the digitalization of economic transactions.

The external sector remains robust, but not sustainable. The external sector indicators remain robust and have shown improvement; however, the trade deficit remains historically low. The export growth remains vulnerable due to its dependence on edible oil export. The balance of payments (BoP) is in record surplus, reflected in growing foreign exchange (FOREX) reserves; but this surplus is largely driven by remittance inflows, which itself is vulnerable to external factors. The exchange rate peg has stabilized trade and investment flows with India, but exchange rate with other currencies remain volatile and continue to face depreciation pressure.

The fiscal sector performance is mixed, showing signs of improvement. Key fiscal indicators exhibit signs of recovery after the COVID-19 pandemic, but revenue mobilization remains weak and has not returned to the pre-pandemic level. Likewise, the structure of spending continues to remain a pressing challenge with low capital expenditure and high seasonality in spending. The persistent negative fiscal balance and a gradual decline in external grants and subsidies have further widened financing needs. This has resulted in an elevated public debt mobilization for financing gaps, with total debt rising continuously. The concentration of debt mobilization to domestic debts is also a challenge, which usually suffers from interest rate and rollover risks. However, the overall debt level is still below the regional average and well below the debt sustainability risk, and thus the GoN has fiscal space for prioritizing spending on sectors that enhance economic productivity and employment.

The economic outlook remains stable, despite the Gen Z movement leading to political and social unrest in the first quarter of 2025/26. Consumer price inflation is expected to remain around 4.0 percent, lower than the annual projection of 5 percent. Economic growth is expected to hover around 4.0 percent, below the annual target of 6.0 percent. The external sector is projected to remain stable, with both current accounts and BoP in a surplus. The market liquidity is expected to remain high; but the effective liquidity absorption is expected to keep interest rates stable. Due to the liquidity influx because of high remittance inflows, the money supply is projected to grow in line with annual forecasts. However, the uptake in credit growth is conditional upon the fiscal performance, including post-election increase in public spending as well as improvements in the overall investment environment with a stable government formation. However, risks are emerging, with growing geopolitical tensions heightening global policy and trade uncertainty, and domestic uncertainties due to political transitions.

1. Introduction

The Monetary Policy Report serves as a flagship economic analysis document of the NRB. This report aims to serve an input to formulate forward looking and evidence-based monetary policy, thereby attempting to anchor inflation expectations and influence economic activities in a desired manner. Given the monetary policy framework of the NRB and its transmission mechanism, the report will be useful to reorient the existing monetary policy structure.

1.1 Introducing the Macroeconomic Report

Central banks publish analytical reports about the macroeconomy periodically for the purpose of communicating the state of the macroeconomy to the general public and clarify the rationale of the monetary policy stance. Most central banks have named it the Monetary Policy Report, which is often published quarterly or biannually. These reports include in-depth macroeconomic analyses as well as diagnostic review with medium-term outlook, including key variables' forecasts. The monetary policy report is therefore a basis for formulating the monetary policy and anchoring public expectations on inflation as well as other key macroeconomic variables. Nepal Rastra Bank (NRB) has also made an effort to publish a report of this kind, with this Report serving as the first issue.

Objectives of this Macroeconomic Report

In line with international practices, the NRB has started to publish the Macroeconomic Report. It is an effort to communicate the current state, diagnostics and forecast of the economy to stakeholders, as part of a process to modernize monetary policy making. This report is set to be published semi-annually, starting from 2025/26. As such, the Macroeconomic Report aims to:

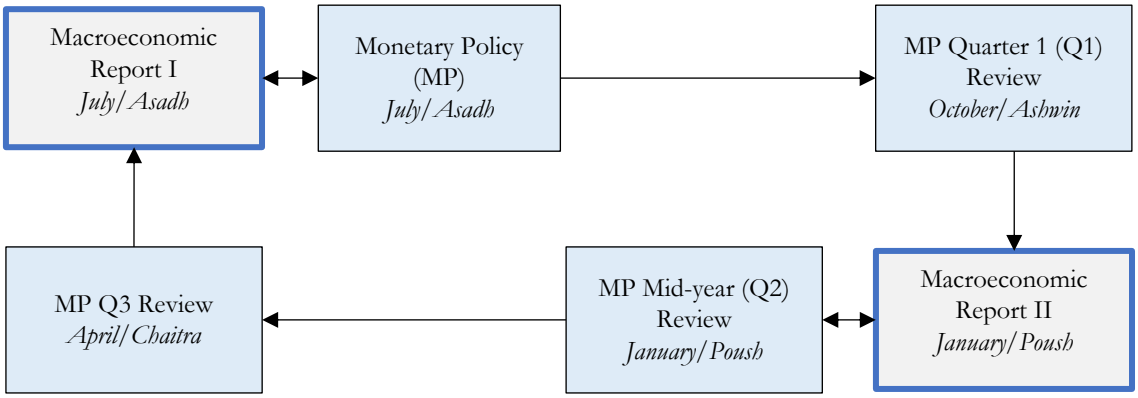
i. conduct an in-depth macroeconomic diagnostics and provide an economic outlook, including forecasts of key variables for formulating dynamic and forward-looking monetary policy,
ii. act as a medium to communicate the current and future states of the economy and rationale for the stance of monetary policy, and
iii. restructure the existing monetary policy statement in line with regional and international best practices.

The importance of fulfilling these objectives cannot be overstated. First, the publication of a comprehensive macroeconomic report fits right in the domain of central bank communications. By revamping the reporting on current macroeconomic landscape and outlook, and enhancing communication with stakeholders, the NRB expects more effective alignment of public expectations with ground realities – thereby ensuring a smoother transmission of the monetary policy. Second, the analysis of the current situation and its outlook would guide effective monetary policy formulation and its reviews. A thorough analysis not only helps preserve the central bank's credibility through better communications but also enhances the effectiveness of the monetary policy itself.

Key Timeline of the Report and Alignments to Monetary Policy

The Macroeconomic Report will be published twice a year. The report aims to reorient the structure of the NRB's annual monetary policy and quarterly review statements. The analysis part of the existing annual policy and its reviews is expected to be covered by this report, while a summary of this report and key policy decisions will be incorporated in the monetary policy as well as its review statements. This in turn provides the NRB an opportunity to make the official monetary policy document leaner and more streamlined, focusing on the key policy decisions and their rationale, such that the statement communicates its stance and policies clearly and concisely to the general public. Figure 1.1 shows the planned publication timeline of the Macroeconomic Report along with the annual monetary policy and its quarterly reviews. The macroeconomic report itself is a dynamic and evolving document in its content and analytical structure, and thus may not follow a strict outline. Rather, the report will incorporate and align with existing and emerging macroeconomic issues.

Figure 1.1: Macroeconomic Report and Monetary Policy Timeline



1.2 Monetary Policy Framework of the Nepal Rastra Bank

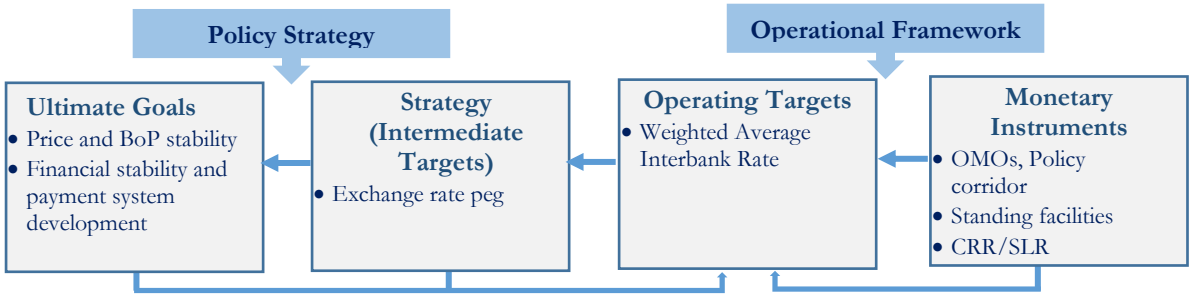
Legal Mandate

As Nepal's central bank and monetary authority, the NRB Act, 2002, mandates Nepal Rastra Bank (NRB) "to formulate necessary monetary and foreign exchange policies to maintain the stability of price and balance of payments for economic stability and sustainable development." Furthermore, it states that NRB "shall have full powers to formulate [and] implement [the] monetary policy of Nepal" (NRB Act, 2002). In addition to formulating the monetary policy, the NRB is also responsible for foreign exchange management thereby external sector stability, maintaining a stable, reliable, and efficient financial and payment systems. The NRB, therefore, formulates a comprehensive annual monetary policy each year, and also conducts its quarterly reviews, encompassing all aspects of its mandate. The policy formulation process takes place based on the institutional setup outlined by the NRB Act.

Policy Framework

The monetary policy framework is an arrangement under which monetary policy decisions are made and executed. The conventional monetary policy decisions need to establish a link between the monetary instruments and its ultimate goals through an operational framework and a policy strategy such that the framework can strengthen transmission mechanisms.

Figure 1.2: Monetary Policy Framework of the NRB



The NRB achieves its ultimate goal by [in]directly influencing the money market, through the usage of monetary instruments, and policy rules (Figure 1.2). The policy instruments follow the monetary policy stance, decided by the NRB's Board of Directors. The policy stance is forward looking linked to official commitment for inflationand import capacity of foreign reserves. The NRB has started a clear policy rule since 2022/23 to determine a policy stance that minimizes *ad hoc* monetary policy decisions and serves general public to understand the macroeconomic conditions upon which the NRB takes its decision on the policy rate. The policy rate is set based on the gap of the current and expected inflation, and the current and required level of FOREX reserve. Furthermore, the stance of the monetary policy also considers the level of credit growth, bank balance sheets

The transmission of monetary policy is mainly through the interest rate. The corridor guides the use of monetary policy instruments to influence short-term interest rates through interbank rate, an operating target, in the direction of the policy stance. The effect of the movement in interbank rate is then expected to transmit to deposit and lending rates, which affect the expectation of the general public and their behavior in relation to consumption, saving, credit, and overall aggregate demand of the economy. The aggregate demand then affects the domestic price level as well as the capacity to import.

The monetary policy, thus, takes the interest rate channel as the main window of adjustment of macroeconomic disequilibrium and defends the intermediate anchor of the policy.

The intermediate target, the pegged exchange rate, also effectively anchors the belief of the public and helps pin down the price level and minimize uncertainties. The regime has facilitated to maintain monetary-fiscal discipline as well. Pegging the value of Nepalese Rupee to Indian Rupee has also directly benefitted Nepal from the inflation targeting regime of India. Thus, being import dependent, inflation in Nepal is largely determined by inflation in India, as well as global commodity and energy prices. However, the role of the monetary policy to influence inflation in Nepal cannot be undermined for two reasons: a) the significant weight of non-tradable goods in the consumption basket and b) its power to influence consumers' behavior and aggregate demand on the one hand and firms' pricing decisions on the other.

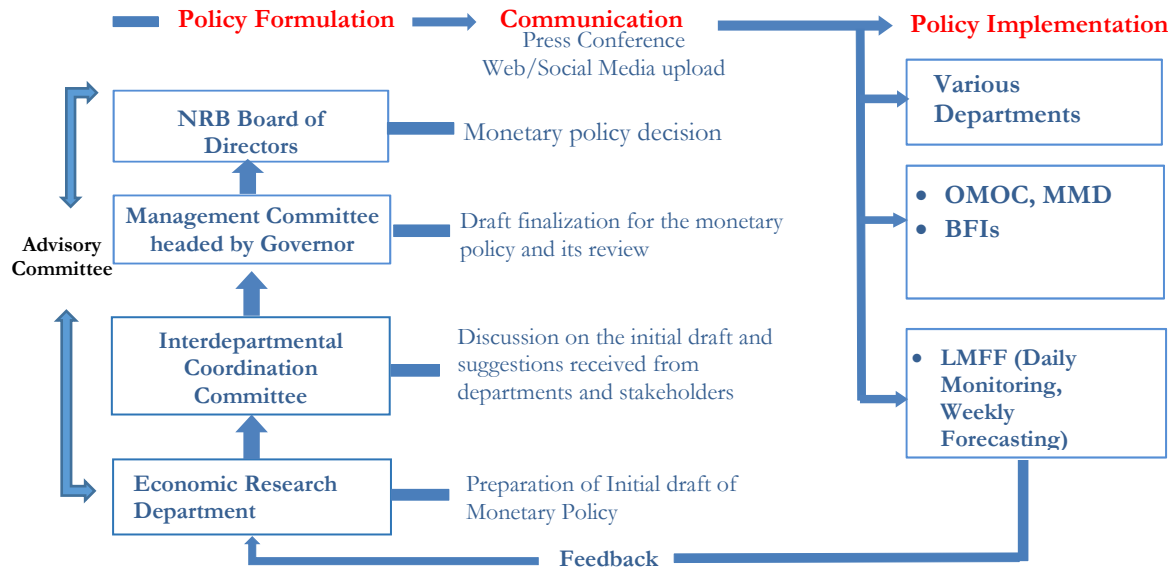
The key of the operational framework is the policy rule that determines the level of the operating target and the interest rate corridor (IRC), which guide the conduct of open market operations (OMOs) (Figure 1.1). Since 2016, NRB has gradually implemented the IRC framework by declaring its policy rate and setting the ceiling and floor rates of the IRC. Since 2022/23, the corridor is linked to its commitment to low inflation and sufficient import capacity of FOREX

reserves, thus endogenizing policy rate decisions to macroeconomic conditions. The movement of the corridor, thus, is guided by inflation and FOREX reserve level. In addition to the floor and ceiling rates, NRB also declares a *de-jure* policy rate between the floor and the ceiling. The policy rate is a desired level of WAIBR that helps communicate the 'stance' of the monetary policy. It essentially indicates whether the central bank is trying to stimulate, maintain, or slow down the economy. General stances include expansionary (accommodative), contractionary, and neutral stances. Based on the monetary policy stance, open market operations are expected to keep WAIBR close to the policy rate, and then, market rates are also expected to move in the same direction with the changes in the policy rate. Therefore, with a predefined range of WAIBR, the NRB helps rein in market expectations of interest rates through its monetary policy. Once the NRB changes the target range of WAIBR, the change is translated to other market interest rates, such as deposit, lending, and bond coupon rates. This, in turn, affects market dynamics through various transmission channels, which ultimately helps meet the goals of price and BoP stability.

Institutional Setup

The NRB Act has provisioned the institutional setup for the monetary policy decisions. The Board of Directors chaired by the Governor is the ultimate decision-making body for policy formulation. The policy's draft is prepared by the Economic Research Department while suggestions are being sought from other NRB departments and stakeholders. The suggestions and monetary policy stances are first discussed at the Interdepartmental Coordination Committee at the Economic Research Department. The draft of the monetary policy, both annual and quarterly reviews, is then presented to the Management Committee of the NRB chaired by the Governor. The committee then forwards the draft to the Board for final decisions. There is also a Monetary Policy Advisory Committee, chaired by the Deputy Governor, comprising two external expert members and head of the NRB's Economic Research Department, which advises on the monetary policy stance and the instruments directly to the Governor. The detailed institutional setup is presented in Figure 1.3.

Figure 1.3: Institutional Setup for the Monetary Policy



Note: OMOC: Open Market Operations Committee, MMD: Monetary management Department, LMFF: Liquidity Monitoring and Forecasting Framework.

Bases for Policy Decisions

Monetary policy decisions are taken based on the domestic and external economic situation and its outlook. The actual and projected economic growth, inflation and its outlook, the outlook for the BoP, and the current level of foreign reserve are the primary bases for determining the monetary policy stance. In 2022/23's monetary policy statement, the NRB had communicated that the policy rate will not be kept below the annual inflation target, providing the inflation variable as a key basis in setting the policy rate. The developments in the financial sector, such as the level of credit growth, the financial stability indicators, and the overall macro-financial context also provide the guidance on whether to allow a decrease or increase in the market interest rates, thereby setting up the overall policy direction. Macroprudential policies are also set in line with the monetary policy to enhance the effectiveness of policy transmission.

Monetary Policy Transmission Channels

NRB strives to achieve its multifaceted policy goals, such as price stability, BoP stability, and financial stability, through the operation of a set of monetary policy tools discussed earlier (Figure 1.2). The use of these tools usually transmits throughout the economy, albeit in varying degrees and pass-through, through different channels, such as interest rates and credit flow, which is then ultimately reflected in the policy goals. In monetary policy literature, these channels are often referred to as "transmission channels." The mechanisms through which the transmission channels help achieve the goals of the central bank are collectively known as the "transmission mechanism."

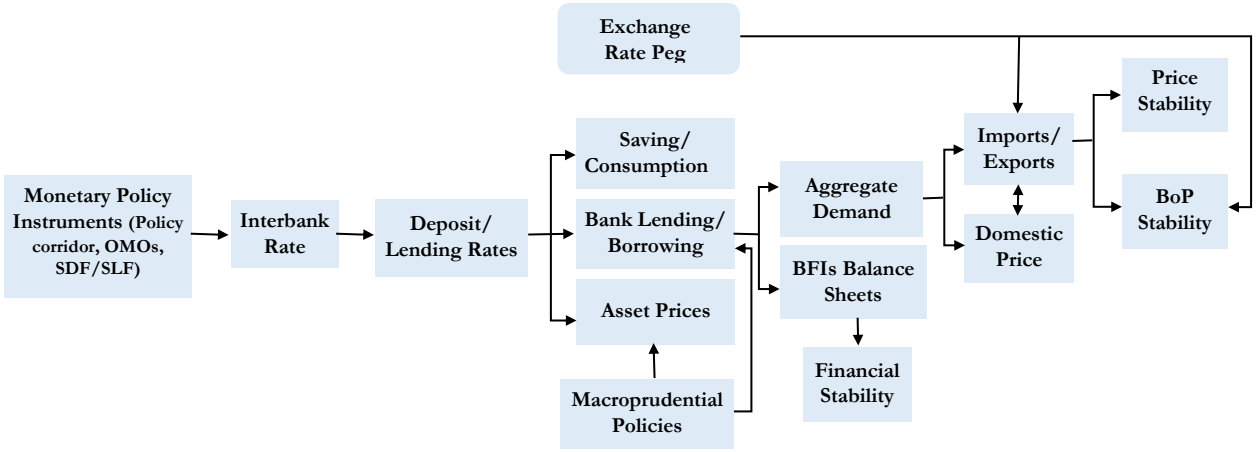
The initial point of the transmission mechanism is usually the operating target. Firstly, NRB influences the short-term money market conditions (the liquidity situation in the financial system and the interbank/overnight rate) in such a way that the market rates move in the direction of the policy stance, which mainly signal the direction of the interest rates. Once the short-term situations are synchronized, the position spreads to bank funding costs, borrowing behavior and credit conditions, as well as expenditure choices throughout the economy. These cumulative responses are then reflected in the ultimate policy goal: price, external and financial sector stability. The transmission channels adopted by the NRB are discussed below.

Interest-rate channel: Given the pegged exchange rate, NRB takes the interest rate channel as the main window of adjustment of macroeconomic disequilibrium. When the NRB adopts a tighter monetary policy stance by raising the policy rate and the interest rate corridor, the interbank rate goes up. Then, after some time lag, it is transmitted to the market interest rates including both deposit and lending rates, affecting saving, consumption, and investment decisions as well as asset prices. The upshot is the reduced domestic absorption with implications on domestic prices, credit flows, and imports. On the contrary, when NRB loosens its policy stance, the transmission mechanism works to relax domestic absorption (Figure 1.4).

Bank-lending/credit channel: The Nepalese financial market is mainly dominated by banks, and both the private and public sectors are predominantly dependent on BFIs for investment. The size of market financing is rising, but still in preliminary stage. Therefore, the bank lending channel is crucial in our context. Impacting banks' reserves and liquidity influences their lending behavior and the overall economic activities. Along with monetary policy instruments, the NRB uses macroprudential instruments to influence capital, liquidity, credit, and credit allocation of banks, as well as borrowers' behavior and their capacity to borrow (Figure 1.4).

Asset-price channel: Financial factors have an impact on asset valuation (in particular, the value of real estate and stocks) in terms of discount rates and access to credit. Boost-bust cycle in asset market has direct and indirect implications for monetary policy goals. The NRB does not directly take into account the asset market volatility in its policy decisions; but its policy decisions have asset price implications, which is then transmitted to domestic absorption (Figure 1.4).

Figure 1.4: Transmission Channels of the Monetary Policy



Latest Monetary Policy: Summary Indicators

In continuation of the accommodative stance of the monetary policy for 2025/26 due to low inflation and a more than sufficient level of FOREX reserves, but lower economic growth, the First Quarter Review of Monetary Policy for 2025/26 has adjusted the interest rate corridor's width by lowering the ceiling and policy rate by 0.25 basis points. As of January 2025, the policy rate is set at 4.25 percent, with the floor of the IRC at 2.75 percent and the ceiling at 5.75 percent. Additional measures, such as increasing the quantitative limits of credit products, providing some relief measures to those affected by natural disasters, facilitating the consolidation of BFI branches, and enhancing good governance in BFIs were the key policy measures introduced in the First Quarter Review of the monetary policy. The current and historical monetary policies are publicly available on the NRB's website through the following link:

https://www.nrb.org.np/category/monetary-policy/.

2. Regional and Global Developments

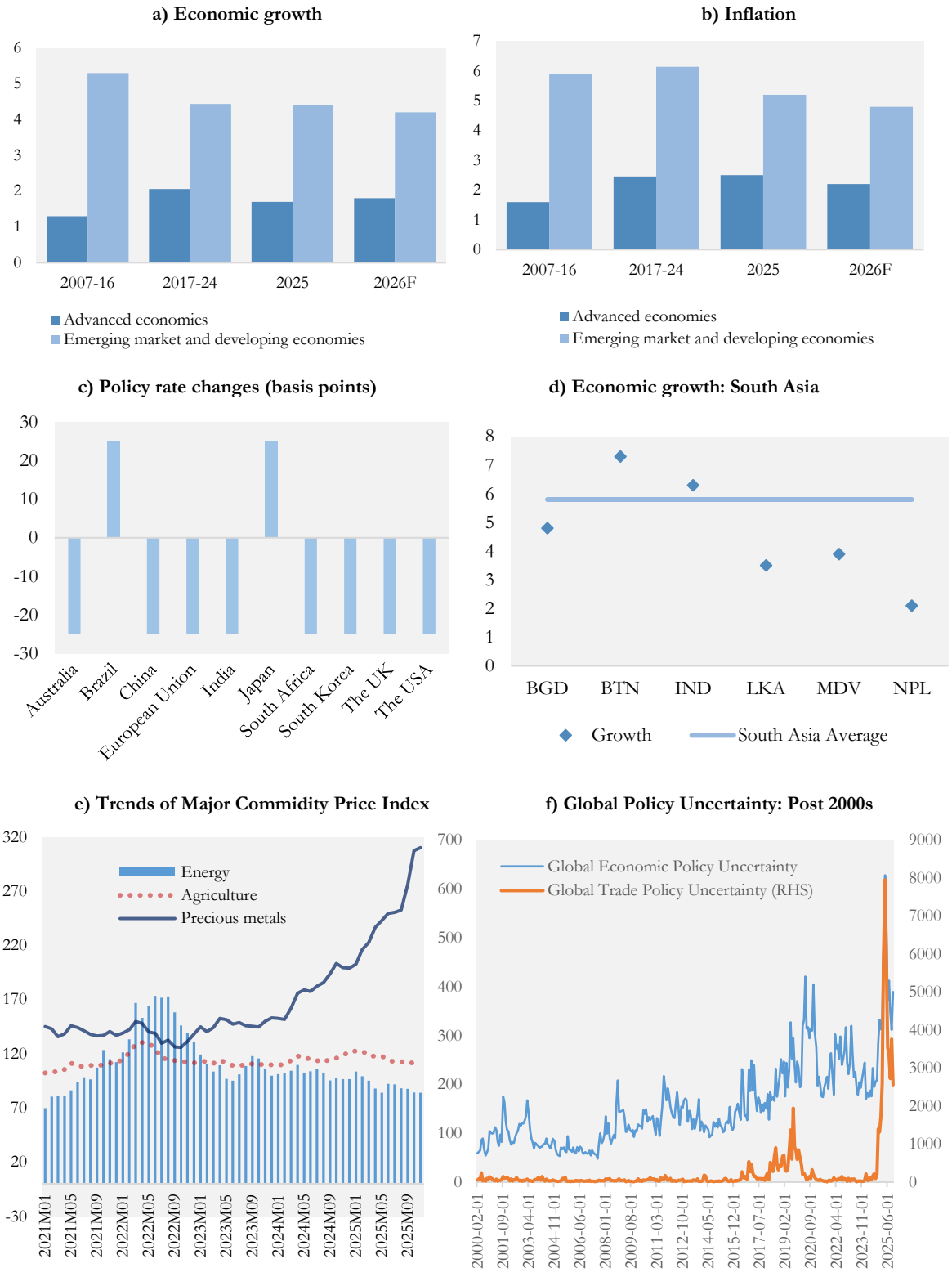
The global economy remains resilient despite rising geopolitical and trade tensions. The global economic uncertainty has spiked substantially, yet inflation is subdued and growth remained stable in both 2024 and 2025. The IMF projects growth to remain similar in 2026 as well. The major contributors include increased investment in technologies like artificial intelligence (AI), accommodative monetary policies, and smooth supply chains. However, risks persist as trade tensions are always in the doorstep, supply chains remain fragile, and geopolitical tensions continue with new ones emerging further.

Economic and policy fluidity weighs on global economic growth. The sizable import duty imposed by the United States administration on its major trading partners triggered retaliatory measures, contributing to frailty in the world trade in 2024. The reciprocal tariffs and retaliatory measures have been moderate though, with bilateral trade deals helping to minimize ruptures in trade relations. The Global Economic Policy Uncertainty Index, which peaked in April 2025, with a year-on-year increase of 142 percent indicating highly unpredictable policy conditions, has moderated recently, following ongoing trade negotiations (Figure 2.1f). The impact of the tariff, therefore, is observed to have a disproportionate impact on advanced and emerging market economies, with residual impacts on developing economies (IMF, 2026).

Signs of improvement in the global economic environment have emerged in the recent months. Bilateral and multilateral diplomatic engagements aimed at resolving ongoing trade as well as geopolitical tensions have helped moderate the previously volatile trade and investment environment. These favorable developments have eased the adverse impacts on the global economy (IMF 2025c, 2026), reflecting improved economic conditions. The International Monetary Fund's January 2026 Economic Outlook has thus kept the global inflation projection for 2026 broadly unchanged at 3.8 percent, with a slight upward revision in the forecast for global output growth to 3.3 percent (Figure 2.1a, Figure 2.1b).

Prices of precious metals are soaring, while prices of other commodities are gradually moderating. The fluid economic environment propelled economic agents to invest in precious metals as a safe-haven asset and hedging instruments, driving up their prices (Lucey and Li, 2015). The prices of energy and agriculture have moderated with weakening global demand, supply chain disruptions, followed by the slowdown in global productions (Figure 2.1e).

Figure 2.1: Global and Regional Developments



Note: i) 2017-24 averages growth and inflation from 2017 to 2024 excluding 2020, 2021, and 2022. *ii) Precious metals include Gold, Silver and Platinum. Energy includes coal, crude oil, and natural gas. Metals include Aluminum, Copper, Iron, Lead, Nickel, Steel, Tin, and Zinc.*

Source: IMF WEO January 2026, October 2025, and April 2025, Central Bank Rates from respective central banks, South Asia's Economic Growth Development Update, the World Bank. *f: Policy Uncertainty:* Source: Federal Reserve Bank of St. Louis.

Globally, central banks are easing monetary policy by reducing policy rates to stimulate aggregate demand amid weakening economic momentum. Most advanced economies, with the notable exception of Japan, have implemented policy rate cuts of around 25 basis points (Figure 2.1c). Similarly, several emerging market economies, including India also adopted accommodative monetary stances through policy rate reductions (Figure 2.1c). The widespread move towards monetary easing by central banks worldwide signals a strong commitment to restoring economic momentum and support to boost aggregate demand.

Growth in South Asia is expected to decelerate. While the region is taking steps to address vulnerabilities, significant risks remain. South Asian economies are becoming less resilient to global shocks arising from geopolitical tensions and export market disruptions (World Bank, 2025). Inflation has moderated; but given the high uncertainty in trade policies, central banks are proceeding cautiously, maintaining accommodative monetary policies.

3. Domestic Economic Developments

The economic growth averaged to around 4 percent and has not rebound to pre-COVID levels. The aggregate demand remained low, largely contributed by declined private consumption and investment as well as poor fiscal performance. The monetary sector remains mixed, with a continuous liquidity influx leading to the historically low interest rates on borrowings but a sluggish credit growth. Still, the interest rates are stabilized with effective open market operations. The fiscal sector is improving; but the capital spending is still meagre. The external sector remains stable, supported by a significant surplus in the current account alongside a sustained surplus in the overall balance of payments.

3.1 Economic Growth

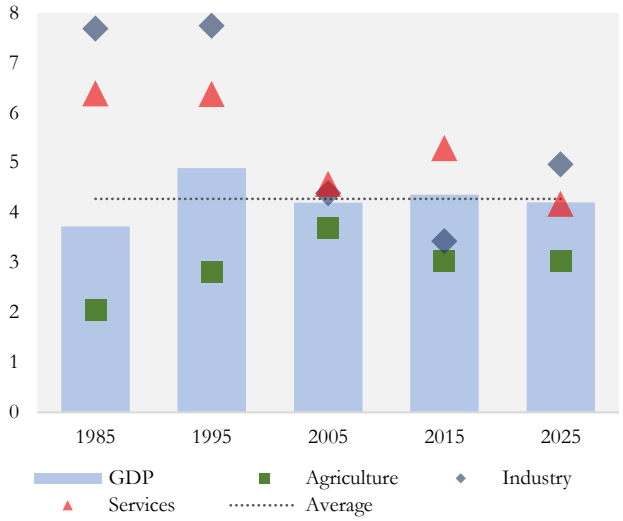
Nepal's economic growth performance averaged around 4 percent historically. The historical economic growth outlook posits scenarios of economic vibrancy (1986–1995) and economic slack (1996–2005). The average growth rate between 1986 and 1995 exceeded the potential growth rate of 4.3 percent (NRB 2017), marking this decade as a period of economic expansion. The economic growth is conspicuously stable at around the potential growth rate, yet with a waning industry sector thereafter. Nepal's industry sector proliferated from 8.2 percent of GDP in 1975 to 22.2 percent of GDP in 1995. Nevertheless, Nepal experienced premature deindustrialization evidenced by de-escalation of industrial growth for three decades since 1995, thereby shrinking and confining industry's share to 12.8 percent of GDP in 2025 (Figure 3.1b). In between, Nepal faced a decade of extremes, with four major shocks to the economic environment: 2015's mega earthquake, political restructuring in 2015, the COVID-19 pandemic, and the recent Gen Z movement.

On average, Nepal's economy in the past ten years (2014/15–2024/25) grew at a potential growth of 4.2 percent. The devastating 2015 earthquake resulted in a low GDP growth of 0.4 percent in 2015/16; but massive reconstruction efforts in the subsequent year's bolstered growth (Figure 3.1a). Specifically, the expansion in the construction sector led to an unprecedented industrial sector growth of about 17.0 percent, which, along with the service sector's contribution, helped realize a GDP growth of 9.0 percent in 2016/17. Nonetheless, GDP growth plunged into negative territory in 2019/20 as an aftermath of the COVID-19 crisis, and has continued to remain below 5 percent thereafter (Figure 3.1a).

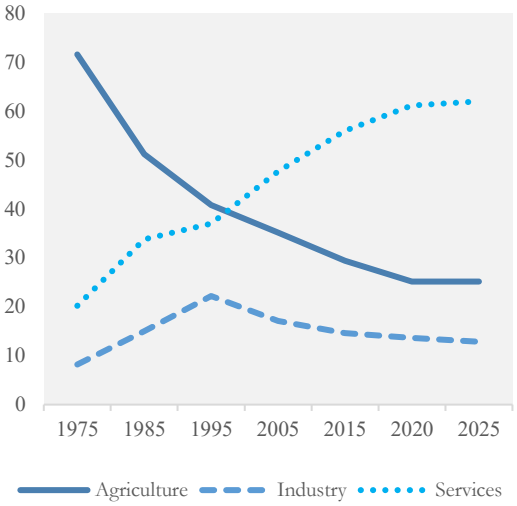
Service sector dominates the economy with more than 50 percent contribution in GDP. This composition is changing, with the service sector's contribution expanding and the shares of the agriculture and industry sectors shrinking. For example, in 2014/15, the contribution of the agriculture, industry, and service sectors was 30.3 percent, 15.0 percent, and 54.7 percent, respectively. This composition gradually changed over the decade. In 2024/25, the contribution of the agriculture sector had declined to 25.2 percent, the industrial sector had declined to 12.8 percent, and the services sector had expanded to 62.0 percent (Figure 3.1b).

Figure 3.1: Historical Economic Growth and Structural Transformation

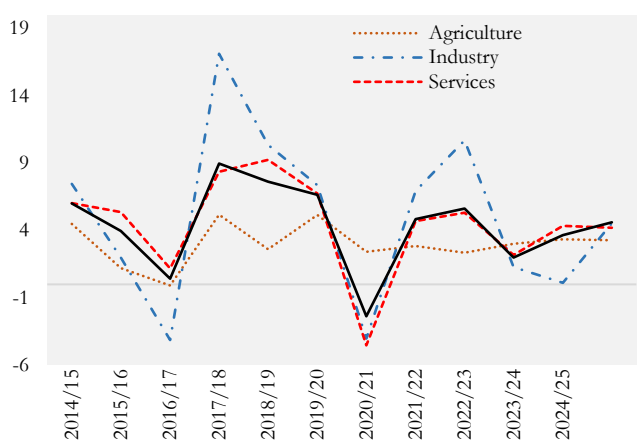
a) Historical trend of GDP growth



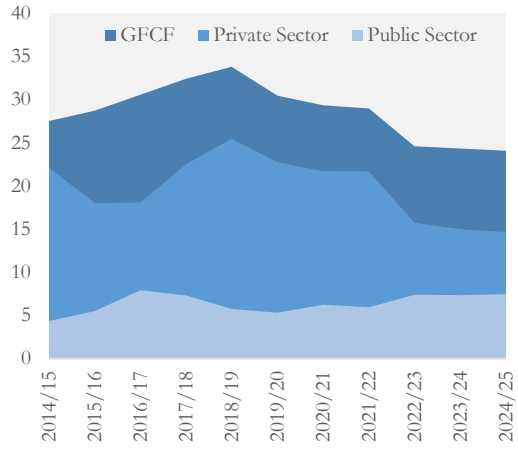
b) Evolvement in the Structure of GDP



c) Economic growth in the last decade



d) Gross capital formation, % of GDP



Data Source: Nepal Statistics Office

Aggregate Demand

Nepal's aggregate demand is primarily fueled by consumption, followed by private investment and government expenditure. The share of private consumption consistently hovered between 85 and 90 percent of GDP historically. In the last five years, the average private consumption was 87.8 percent (Table 3.1). However, private investment experienced a sharp shortfall from 21.7 percent in 2021/22 to around 15.7 percent in 2022/23 and has been falling thereafter. Private consumption and investment demand collapsed in 2022/23, potentially attributable to sharp decline in imports following the government-adopted imports restriction implemented to tame the growing pressure on balance of payments. The private investment demand was about 30 percent less and private consumption is still about 5.3 percent less compared to 2021/22, which can be the major cause of economic slowdown post 2021/22.

Table 3.1: Breakdown of Aggregate Demand

Items	Unit	2020/21	2021/22	2022/23	2023/24	2024/25
Domestic demand (A+B+C)	Share of GDP	128.8	131.1	123.9	124.2	121.5
	Growth (%)	13.8	8.6	-6.7	1.5	-0.4
A. Private consumption	Share of GDP	88.5	88.1	87.2	87.7	87.5
	Growth (%)	7.7	6.8	-1.6	1.4	1.7
B. Investment	Share of GDP	21.7	21.7	15.7	15.0	14.7
	Growth (%)	8.8	4.6	-28.1	-1.7	0.2
C. Government expenditure	Share of GDP	12.7	12.6	14.5	15.4	15.4
	Growth (%)	7.1	4.3	15.1	8.8	2.4
Gross Domestic Savings	Share of GDP	6.4	6.6	7.2	6.2	6.6
Net external demand	Share of GDP	-32.8	-35.6	-27.6	-25.3	-24.5
	Growth (%)	28.1	13.8	-22.6	-5.8	-0.7
Imports	Share of GDP	-37.9	-42.3	-34.6	-32.9	-33.2
	Growth (%)	18.8	16.4	-18.8	-2.5	3.2
Exports	Share of GDP	5.1	6.7	7.0	7.6	8.7
	Growth (%)	-21.3	34.1	4.3	11.8	17.7

Source: National Statistics Office, 2025.

The subdued domestic demand in 2021/22 has been striving to recover. Still, the domestic demand is much lower, 121.5 percent of GDP in 2024/25, than 131.5 percent of GDP in 2021/22 (Table 3.1). However, the demand is catching up, with a swift recovery of economic growth and positive sectoral growth. The manufacturing, construction, and wholesale and retail trade sectors, which experienced negative growth in the previous two years, have rebounded with positive growth. As a result, the overall economic growth is in the recovery trajectory; but the total demand has still not bounced back to the pre-COVID level.

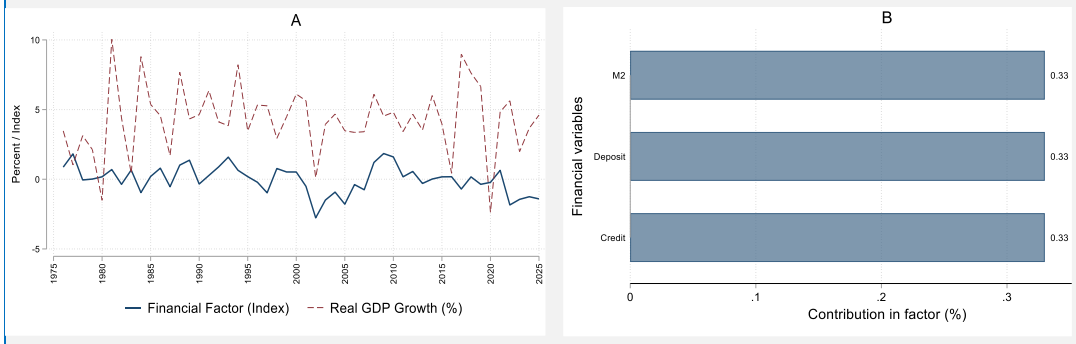
Box 1: Growth-at-Risk

Growth-at-Risk (GaR) estimates the expected distribution of GDP growth conditional on the given macroeconomic and financial conditions (Ossandon Busch et al., 2022). GaR is the extended version of Value-at-Risk, a tool popular in finance to estimate expected investment losses conditional on market situations. Unlike traditional growth forecast, GaR provides the entire distribution of growth, accommodating both downside and upside risks (Prasad et al., 2019). Furthermore, it helps quantify how the worst future scenario of GDP growth might perform in response to systemic risks, thereby providing a credible guide for macroeconomic policy analysis.

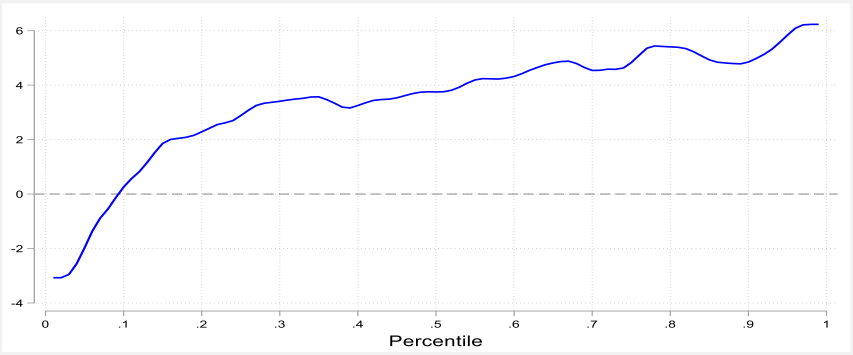
Growth-at-Risk (GaR) model for Nepal has been constructed following Prasad et al. (2019). We utilized a quantile regression framework to forecast growth across various percentiles. The model incorporates two sets of principal components. The first one is derived from seven key macroeconomic variables: consumer price index (CPI), imports, exports, exchange rate, current account balance, government recurrent expenditure, and government capital expenditure. The second one is derived from three key financial variables: deposits, private sector credit, and broad money supply (M2). GAR moves beyond the average and shifts its focus to the worst-case scenarios stemming from build-up of financial vulnerabilities, making this a popular analytical tool among the central banks. Figure 2.2a plots the financial factor against the real GDP growth to demonstrate their co-movement. The GDP growth and the financial factor have co-movement; for example, when GDP growth slowed down in 2001/02, financial factor also declined. Similar patterns have been observed in the later years. Figure 3.2b derives a common factor from the banking variables.

Figure 3.2: Growth at Risk Estimations

a) Financial Factor against GDP growth **b) Contribution of Core Variables to Financial Factors**



c) Estimates of Growth at Risk



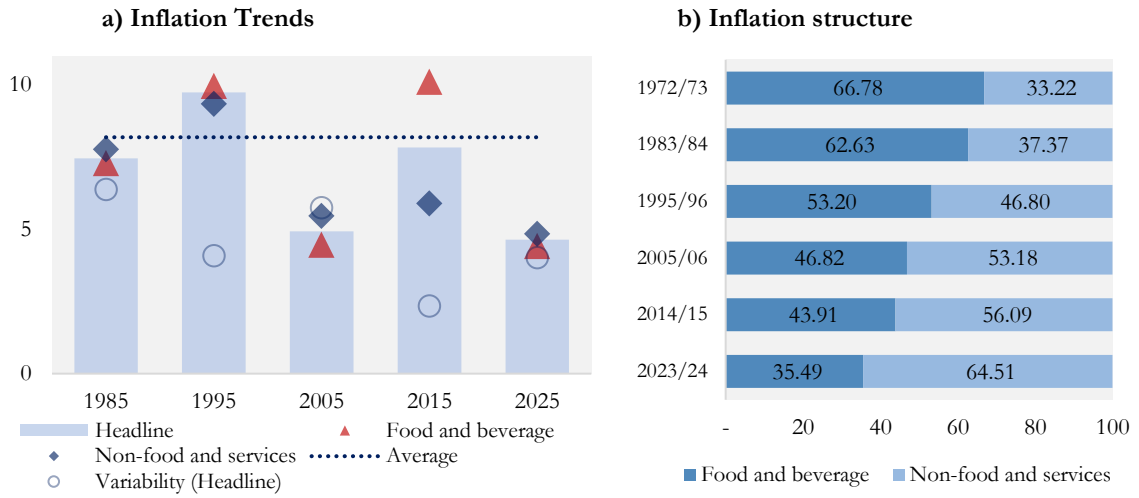
Source: Nepal Rastra Bank Staff Estimates.

Figure 3.2c illustrates the distributional growth forecast for Nepal. The curve is monotonically increasing, thereby capturing the evolution of GDP growth from severely adverse to highly favorable macro-financial conditions. The estimates of GAR curve indicates a pronounced downside risks at lower percentiles and moderate to strong upside potential at the upper percentiles. The asymmetric distribution of risks with downside tail is sharper than the upside tail. The lower tail indicates that economic growth could fall into negative territory in the worst 10 percent scenarios, suggesting that left tail is materially weak and the economy is vulnerable to shocks. Nepal remains exposed to tail risks associated with external sector pressures, supply disruptions, monsoon variability, and financial system vulnerability. Importantly, we observe that a financial easing compresses the left tail more than it boosts the right tail. The central outlook is stable with median forecast of approximately 4 percent, suggesting that under normal conditions the growth rate is expected to hover around 4 percent in the near term. Notably, upside scenarios exist but are incremental rather than explosive. High growth outcomes (>6%) require favorable conditions across multiple fronts, such as strong remittances, robust tourism, and improved capital spending.

3.2 Inflation

Nepal's inflation has been stabilizing in the last two decades. The inflation trend shows that Nepal observed two extreme decades: one of high inflation (1986-2005) and the other of stable inflation (2006-2015). Inflationary pressures moderated after 1995 following the stabilization of pegged exchange rate coupled with growing trade concentration with India. Between 1986 and 1995, inflation, including food and beverage as well as non-food and services, remained high edging beyond 9 percent, which is primarily fueled by upward revision of peg with the Indian currency as well as increase in electricity tariffs and fertilizer prices (NRB, 2007). Since 1995, non-food and services inflation – commonly used as a proxy for core inflation – has remained stable for nearly three decades. In contrast, food and beverage inflation spiked between 2006 and 2015, attributable to a combination of political disruptions, supply chain bottlenecks, and the severe impact of the April 2015 earthquake (NRB, 2024). Globally, food inflation tends to be more volatile (Walsh, 2016), a pattern consistent with the trend observed in Nepal.

Figure 3.3: Inflation Trends and its Structural Dynamics

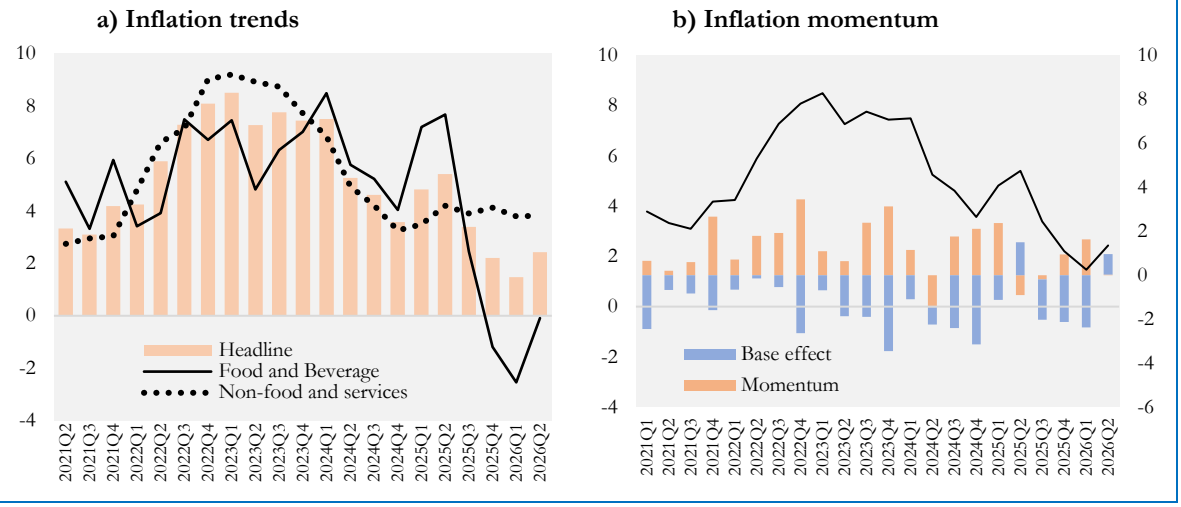


Note: Here, 1985 denotes the decade from 1976-1985. Variability is calculated as the ratio of decadal standard deviation to mean headline inflation; variability has been expressed in the multiple of 10. A lower value indicates a more stable headline inflation.

The structure of the inflation, i.e., the weights of the consumption basket, has been evolving. The NRB periodically revises the weights of each item in the commodity basket to capture the evolving dynamics of household consumption patterns. Expansion in economic activities induces households to broaden their consumption baskets and enrich their preferences by allocating a growing share of expenditure toward non-food and services (Aguiar & Bils, 2015), a pattern consistent with Engel's law. Transition patterns across consumption quintiles further show that higher-income households devote a substantially larger share of their expenditure to non-food items compared to lower-income households (NSO, 2024). A similar pattern has been observed in Nepal as well. For instance, the share of food and beverages in the CPI basket was approximately 66.8 percent in 1972/73, which substantially decreased to 46.8 percent in 2005/06 and to 35.4 percent in 2023/24 (Figure 3.3b). This dynamics also influences the inflation patterns and supports prices to be more stable.

Headline inflation is gradually declining over the period, with the decline more pronounced since third quarter of 2025. The year-on-year headline inflation eased to 2.43 percent in 2026Q2; a sharp moderation compared to a 5.41 percent in the corresponding period of the previous year (Figure 3.4a). The persistent decline in the food inflation is the primary driver of this easing. Food inflation exhibited a sharp decline since 2025Q2 and entered into negative territory beginning 2025Q4. Prices of vegetables contracted the most, followed by spices, pulses and legumes, and cereal grains. Consequently, this strong downward movement caused food inflation to decline significantly to -2.54 percent in 2026Q1 and remained marginally negative in 2026Q2. In contrast, within the non-food and services category, prices for all sub-categories increased with the single exception of insurance and financial services. In contrast, the non-food inflation has remained relatively stable, maintaining a moderate and steady rate of around 3.8 percent (Figure 3.4a). More importantly, Indian inflation bust has been observed in recent quarters with Indian inflation plunging to 0.25 percent in 2026Q1 and but a correction to 1.70 percent in 2026Q2, which is one of the major factors contributing to inflation easing in Nepal.

Figure 3.4: Recent Inflation Trends and its Momentum



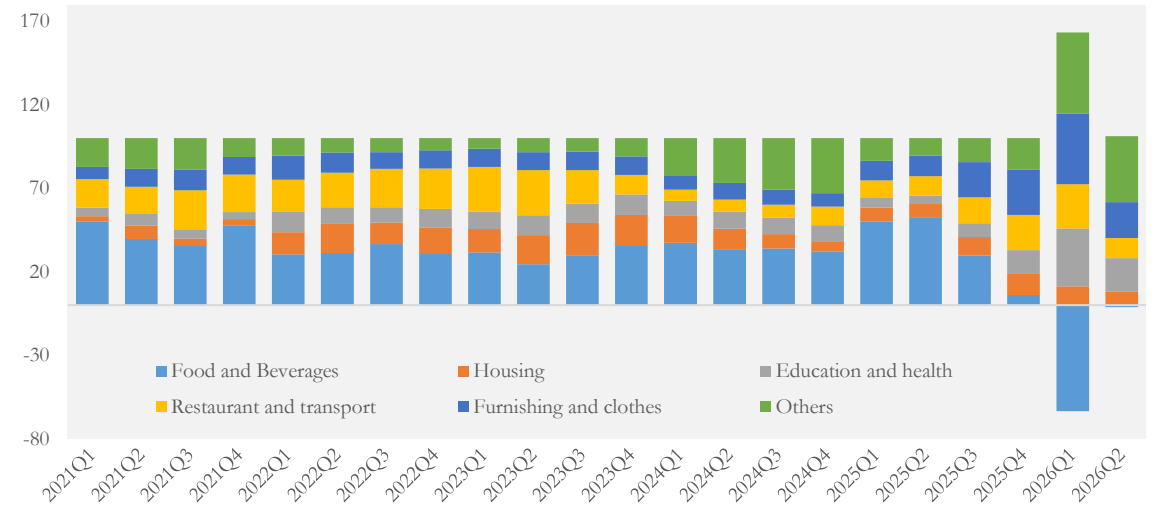
Note: 2021Q2 denotes 2020/21Q2. The fiscal year starts from August and concludes in July.

Decomposing inflation into base effects and momentum demystifies the underlying propeller of price dynamics. The disinflation is attributable to negative base effects, owing to a higher level of inflation in 2022/23 (Figure 3.4b). Base effect and momentum combined demonstrate the evolution of inflation dynamics. Base effect compares inflation at *t* period with *t-n* period and is generally higher if inflation at *t-n* period is lower and vice-versa. Momentum shows how inflation evolved over the consecutive periods, that is, between *t* period and *t*-1 period. Therefore, the inflation at *t* period can be decomposed into inflation at *t*-1 period, base effects, and momentum, that is,

$$\pi_t^{yoy} = \pi_{t-1}^{yoy} + BaseEffect_t + Momentum_t. \quad \ldots (1)$$

With about 35 percent weight in the headline inflation, food inflation plays a substantial role in shaping the trajectory of headline inflation. Cereals grains (22.78 percent), meat and fish (19.04 percent), and vegetables (13.09 percent) play a crucial role in determining aggregate food inflation. The deflationary pressure on food prices since 2025Q4 is largely attributable to 15.63 percent contraction in vegetables prices. This decline has been heavily influenced by base effects, with vegetable prices expanding over 50 percent in the corresponding period of the previous year (Figure 3.4b).

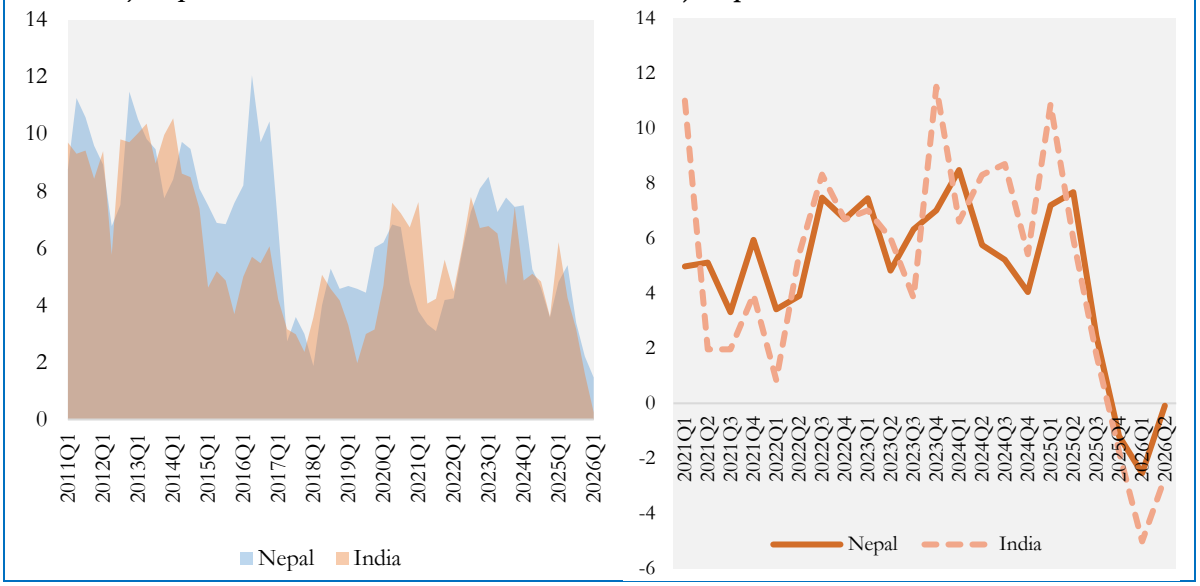
Figure 3.5: Sub-groupwise Inflation



Note: The methodology to disentangle momentum and base effects from the headline inflation has been adopted from the Sri Lanka Monetary Policy Report.

Subgroup-wise inflation has remained largely positive, except in the most recent quarter when food and beverage inflation entered negative territory. Historically, food and beverages have been the major driver of overall inflation in Nepal, with their contribution peaking at around 53 percent in 2025Q2. The influence of the furnishing and clothing sector has been rising steadily, reaching about 42 percent by 2026Q1. The recent disinflation is primarily attributable to the sharp decline in food and beverage inflation (Figure 3.5).

Figure 3.6: Nepal's Inflation Convergence with India



Inflation convergence with India is an obvious phenomenon in Nepal. Nepal's inflation has been plotted against Indian inflation (Figure 3.4), and they share co-movements with a correlation coefficient of 0.74. Price dynamics formed in Indian market are easily transmitted to Nepal through exchange rate peg, high trade dependence, and unrestricted labor mobility with India (Budha, 2025). Empirical studies such as NRB (2007), Poudyal (2017) and Shrestha & Bhatta (2018) demonstrate that Indian inflation plays a significant role in determining Nepal's inflation. Likewise, Budha (2025) finds evidence of inflation convergence between the two economies and shows that the impact of India's CPI on Nepal's CPI persists up to 10 months. Nepal's inflation tends to follow that of India, with Nepal's price level acting as an attractor that trails the Indian price level over time.

Box 2: Why Should We Care About Inflation?

The widely accepted definition describes inflation as a general rise in the price level of goods and services over a period of time. In a layman sense, inflation is simply the rise in the price level of goods and services we consume; but it has deeper macroeconomic underpinnings. The price dynamics results from the dynamic interaction of the demand for and the supply of goods and services in the market and their interplay in determining market clearing price. Macroeconomic diagnosis of inflation calls for understanding the forces affecting the demand for and the supply of goods and services in an economy.

Inflation reflects both supply capacity and macroeconomic policy outcomes. The expansion in supply capacity – through economies of scale, innovations, or efficiency gains – subverts supply side pressures, thereby easing out inflationary pressures. Likewise, macroeconomic policies work by manipulating the effective aggregate demand in an economy. The policy outcomes thus need to translate into tangible

economic outcomes through the aggregate demand, which ultimately affects the general price level in an economy.

Stable prices anchor non-distortionary resource allocation, by preserving the information content of relative prices, enabling efficient consumption, production, and investment decisions across households and firms. High inflation erodes real incomes and disproportionately hurts fixed income earners. Volatile inflation affects household's intertemporal choice, resulting in inconsistency in consumption and saving decisions. On contrary, low inflation translates into lower profit margin, thereby discouraging suppliers and producers, and potentially misallocating resources (Afrouzi, Bhattarai, and Wu, 2025). Notably, investment decisions are typically long-term and irreversible. Uncertainty of price dynamics thus makes real returns unpredictable and firms are reluctant to invest if future costs and market prices are unclear.

Understanding the optimal level of inflation is, therefore, crucial for macroeconomic stability and economic growth. Optimal level of inflation promotes growth and maintains purchasing power erosion to its minimal (NRB, 2017). The permanent component of Nepal's inflation has been declining over time, indicating a gradual moderation in core inflation. This declining trend likely suggests a gradual decline in the natural rate of interest. The optimal level of inflation differs across economies, based on their development level, the inflation structure (weights of different products in the consumption basket). From Nepal's perspective, it is worthwhile to discuss some of the limitations that hinders Nepal to maintain effective inflation trajectory. The pegged exchange rate, high trade dependence, and free labor mobility with India makes it difficult for the NRB to fully control the aggregate demand, thereby domestic price level. The target of central banks can be considered the optimal level of inflation for general understanding.

3.3 Monetary and Financial Sector

Nepal's monetary and financial sectors have expanded significantly, especially after the liberalization policies adopted in 1980s and 1990s. Growth of monetary aggregates have remained high mostly throughout the past decades until the COVID-19 pandemic. Recent data show recovery in the monetary sector and stability in the financial sector even though the overall ratio of non-performing loans in BFIs remain slightly elevated than desirable levels. Favorable inflow of remittances and subdued credit growth have contributed to excess liquidity in the banking system, resulting in declining short-term interest rates in recent months. BFI interest rates are currently being maintained through central bank policies and the operation of Standing Deposit Facility.

Historical developments

Nepal's financial development initiatives were founded only in 1973 with the establishment of Nepal Bank Limited as the first commercial bank. The momentum in the financial sector development built only after the establishment of Nepal Rastra Bank (NRB) as the central bank in 1956. In the late 50s and early 60s, many institutions were established in both financial institutions and markets. It further expedited after the financial sector reform program. During the first phase of the reform, initiated in the mid-1980s, focused on liberalizing the banking sector, increasing the number of financial institutions, and enhancing the range of financial services offered. This phase led to a rapid expansion of banks and financial institutions, fostering greater competition and accessibility. Phase II, starting in the early 2000s, concentrated on improving regulatory frameworks, strengthening financial stability, and enhancing operational efficiency of financial institutions. However, post-2010, the focus shifted towards financial consolidation, driven by concerns over the proliferation of financial institutions and the need to address risks associated with rapid expansion. This period saw efforts to merge and consolidate financial institutions to create stronger, more resilient entities, capable of withstanding economic shocks and contributing to sustainable economic growth.

The financial sector reforms and rapid expansion of institutions have deepened the

financial services significantly in the past two decades. For instance, the broad money-to-GDP ratio, which was about 23 percent in 1980, has risen fivefold in 2025. Likewise, the credit-to-GDP ratio was 8 percent in 1980, which soared to 91 percent in 2025 (Table 2.2). These indicators are very much competitive with the neighboring economies, and at the top of the rank in some indicators, such as the credit-to-GDP ratio. The other performance indicators, such as efficiency indicated by the interest rate spread, are also competitive.

Table 3.2: Financial Deepening Indicators

Year (Mid-July)	*% of GDP*			*Number*	
	M2	*Credit*	*Deposit*	*BFIs*	*Branches*
1980	22.6	8.2	14.4	4	
1990	30.5	11.3	21.2	7	
2000	56.0	28.8	40.8	74	
2010	77.2	42.0	52.0	203	2265*
2020	108.8	84.3	98.7	155	9765
2025	122.1	91.2	113.1	108	11530

** As of January, 2012.*

Nepal's monetary policy framework has historically been characterized by an exchange rate peg to the Indian Rupee. While the NRB evolved through a single currency peg to the different currency than the INR and a currency basket system for the exchange rate determination, the peg regime and its level has not been changed since 1993. This has led to the adoption of the policy trilemma constraints of the Mundell-Fleming[1] model by maintaining capital controls but losing the monetary policy independence. Together, these factors have shaped the unique challenges and opportunities in Nepal's monetary policy framework. The monetary policy instruments like CRR and interest rate regulation, were introduced in the mid-1960s. The NRB relied more on a direct approach to monetary policy implementation until 1980s. Since the late 1980s, the NRB moved to an indirect monetary control through interest rate liberalization, replacement of the credit ceiling, and introduction of open market operations.

The newly enacted NRB Act 2002 mandated the NRB to formulate, announce, and implement the monetary policy. Accordingly, the NRB formally started announcing and publishing monetary policy statements in 2002/03, with operating target as excess liquidity of commercial banks, broad money (M2) as the intermediate target, and the exchange rate peg as the nominal anchor. The NRB introduced the interest rate corridor (IRC) in 2016/17, aiming to stabilize the interest rate, enhance the effectiveness of open market operations, and switch towards rate-based operating target. With the introduction of IRC, the NRB introduced the weighted average interbank rate of commercial banks as the operating target of the monetary policy in 2018/19. The NRB fully departed from its quantity-based excess reserve targeting operating framework to the rate-based operating framework with weighted average interbank rate of BFIs as the operating target of the monetary policy since 2020/21. The NRB also introduced a standing deposit facility (SDF) at the floor rate of the IRC in 2024 February (Figure 2.8a).

Recent Developments

Liquidity and interest rates

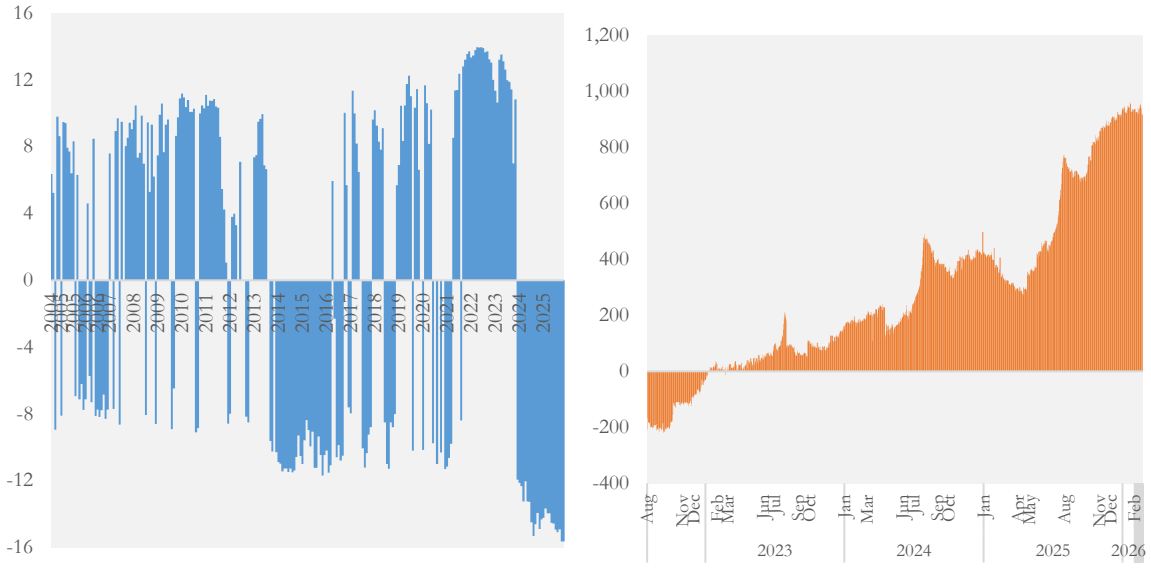
The NRB monitors liquidity in the banking system to contain liquidity volatility. Such monitoring helps inform the Open Market Operations Committee (OMOC) for the conduct of open market operations (OMOs), a monetary operation conducted against BFIs to either inject or absorb liquidity. This liquidity management is aimed at stabilizing short-term domestic market interest rates, such as the interbank rate and the Treasury bills rate, gradually influencing them to move toward NRB's direction, primarily determined by the monetary policy stance. In the last 20 years, the monthly net absorption and injection of liquidity is mixed, with clear

[1] A modern reincarnation of Mundell-Fleming's trilemma, Economic Modelling, Joshua Aizenman.

episodes of excess liquidity in 2014-2015 and liquidity shortage in 2021-2023 (Figure 3.7a). Since 2023, the financial system has been continuously accumulating excess liquidity, denoted by the inverted bars of liquidity absorption toward the end (Figure 3.7a) and the upsurge in liquidity in the banking system (Figure 3.7b).

Figure 3.7: Liquidity Episodes and Recent Liquidity Situation

a. Net of Liquidity Operations, Log Scale b. Liquidity in the banking system, Billion Rs.



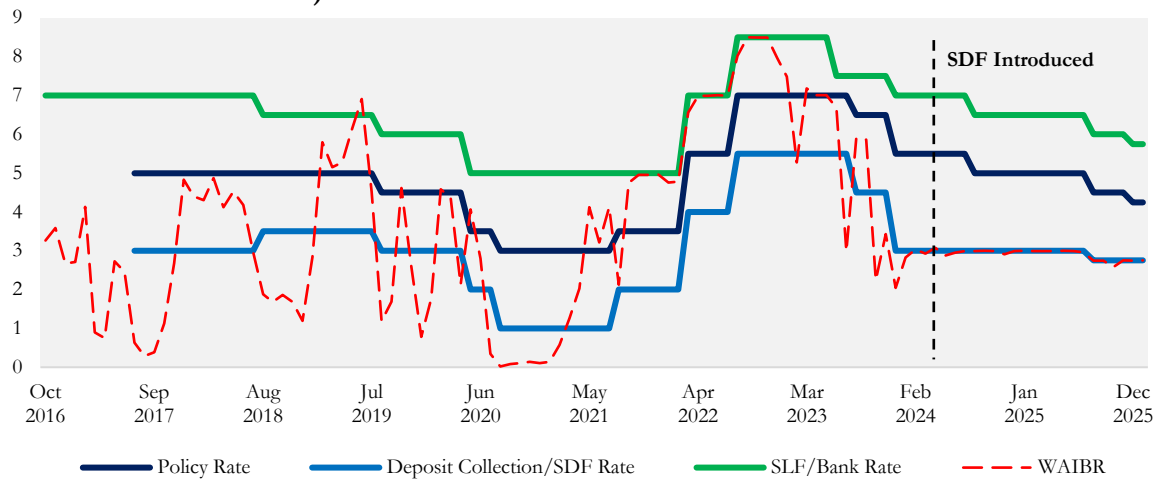
Note: Figure a: Net absolute values of liquidity operations (absorption – injection), represented on a natural logarithmic scale.
Figure b: Central bank reserves, excluding the mandatory reserve requirments, without NRB's market operations.

Recently, the banking system is witnessing a longer liquidity cycle after 2015, with 2022-23 a period of shortage, followed by excess in 2024-25, and a contentious influx (Figure 3.7 a&b). The onset of the COVID-19 pandemic induced a shock in the economy, which slowed down economic activities. Similar to other central banks, the NRB responded with an expansionary monetary policy, including unconventional policy measures such as refinancing. Such measures provided an immediate relief to the economy, with businesses able to run smoothly as usual. However, the policy easing could not be fully absorbed by the market, especially in productive sectors. Instead, it was partially reflected in the asset prices, with a record stock market index and real estate prices. At the same time, Nepal's external sector started to be adversely affected due to the lowered export, tourist income and foreign aid, while imports were soaring (Figure 3.16).

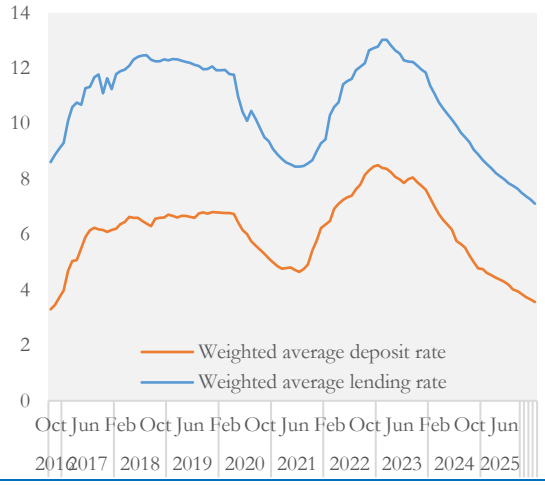
On the other hand, the supply disruptions soared the inflation globally, with world consumer prices soaring to 8.7 percent in 2022. This was reflected on Nepal's consumer prices as well, with the inflation reaching 8.6 percent in September 2022 from 3.5 percent in September 2021. Furthermore, Nepal experienced pressure on its external sector, with the BoP in deficit since June 2021, and foreign reserves depleting to as low as 6.6 months of imports in January 2021 (Figure 3.15a). The NRB responded with policy tightening measures, using both monetary policy instruments and macroprudential policies aimed at containing inflation and preserving the foreign exchange reserve depletion. The policy rate was raised from 3.0 percent in June 2021 to 7.0 percent in September 2022 (Figure 3.8a), coupled with measures to contain the excessive credit growth.

Figure 3.8: Short-term and Long-term Interest Rates

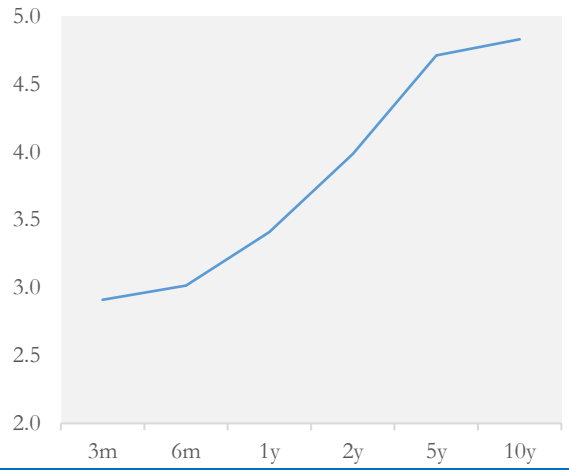
a) Interest Rate Corridor of the NRBfrom its introeuction.



b. Deposit and Lending rates (Weighted Average)



c. Term Rate Structure of Fixed Deposits



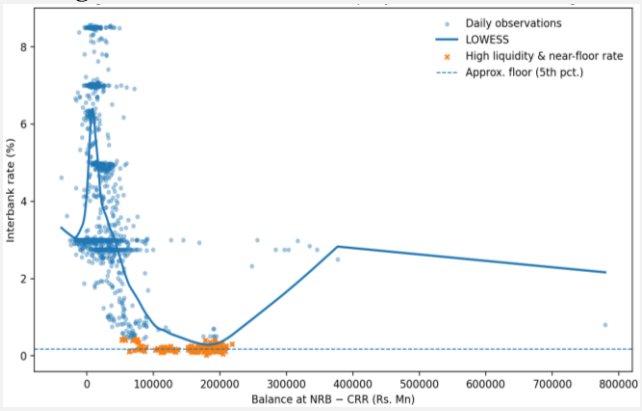
Note: Figure 3.8a. Interest rate structure after the implementation of IRC. The vertical dotted line denotes first implementation of SDF. Figure 3.8b. Weighted average lending and deposit rates at commercial banks. Figure 3.8c. Term structure of interest rates for fixed personal deposits (normal) at commercial banks as of December 16, 2025. The rates expressed are simple averages of the interest rates provided for the specified term by all licensed commercial banks.

The pass-through of the policy measures remained immediately effective, but with sluggish pickup afterwards. The interest rates, with the lending rate up, surged to 13 percent in 2023 February, inflation started moderating, and foreign exchange reserves gradually bounced back. After the gradual decline in inflation and improvements in the external sectors, the NRB followed its easing monetary stance since June 2023, gradually lowering the policy rate, downsizing its interest rate corridor (Figure 3.8a). The stances were accommodative but cautious, in both monetary and macroprudential tools. The easing path continues still today, as Nepal witnessed a continuous fall in inflation and a record foreign exchange reserve, but sluggish aggregate demand. The accommodative policy stances, however, did not translate to the economy. The financial system started accumulating excess liquidity in early 2023, continuing to reach its new highs, boosted by the post-COVID rebound and recovery, as well as growth in remittances. The excess reserves of BFIs at the central bank, including mandatory cash reserve, reached a historically high level, crossing Rs. 1.20 trillion in December 2025. The lending rates remain historically low, yet credit growth remains quite low compared to the NRB projections.

Box 3: Does Nepal's current trend show a liquidity trap situation?

While some argue that Nepal is passing through a liquidity trap situation, our analysis does not exhibit this. In Figure 3.9, the interbank rate decreases at first with increasing excess reserves, but it seems to be less sensitive as the interbank rate forms around a low area. This is in line with the mechanics of abundant-reserves adopted in the floor system of interest rate corridor, where the deposit facility tends to anchor with the interbank rates, such that additional reserves have a marginal effect on the interbank rates (Borio, 2023). In Figure 3.9, we use the balance at NRB minus CRR to plot the graph on the x-axis because the interbank rate is the price of the central-bank settlement balances (reserves). Hence, a reserve-based proxy is the most explicit variable to be used in the analysis of floor-binding in the interest rate corridor floor (Borio, 2023). The excess liquidity leads to a reduction in the incentive to borrow and lend reserves, and it may further reduce the incentives to BFIs for interbank trading. While Figure 3.9 shows a liquidity-trap-like situation in the money market with abundant reserves held at the low level of the interbank rate (floor-binding), this is not the decisive characteristic of a theoretical macro liquidity trap situation. The state of the economy being in a bigger trap is based on the ability of credit and spending to be weak despite easy financial conditions. There exists money-market floor-binding condition though, and this could be due to the credit overhang/balance-sheet repair, not like the condition of typical liquidity trap.

Figure 3.9: Interbank Rate and Excess Reserves

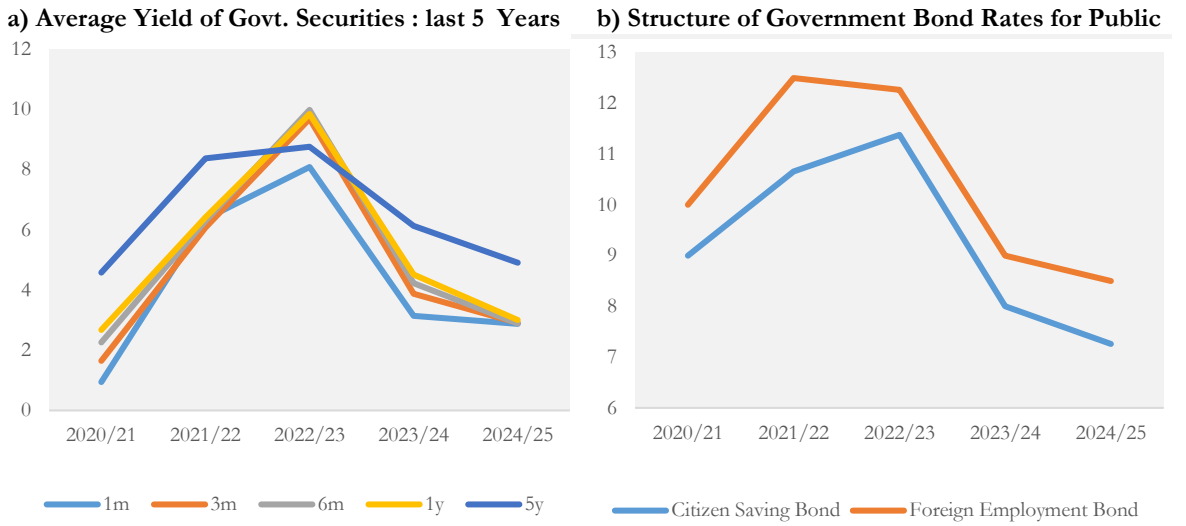


Note. The Locally Weighted Scatterplot Smoothing (LOWESS) flattening depicts a floor-binding pattern in the case of the surplus reserves, and the dashed line is an empirical floor taken as a proxy (at the 5th percentile).

The monetary policy stance of the NRB is transmitted to the interest rates. Figure 3.6b shows lending and deposit rates of commercial banks over the past 10 years. Peaks and troughs observed in the graph are comparable to the highs and lows seen in Figure 3.6a: the policy rate as well as the entire corridor. Figure 3.6c shows the yield curve for fixed personal deposits at commercial banks for the month of December 2025. It is mostly smooth and upward sloping, except for a slight kink at the end. The kink is observed because most banks provide the same interest rate for fixed deposits with a term of 5 years or above. The upward-sloping yield curve indicates a proper term premium of the interest rate, though the premium is not much higher toward the end.

The long term interest rates are in line with the monetary sector's rates. The average yield on government securities for different fiscal years aligns with the lending rates of the BFIs (Figure 3.10a). The term structure in 2022/23 is peculiar where yield rate on 5-year development bond is lower than most short-term and medium-term rates. It is consistent with the fall in interest rates observed in subsequent years. The structure of interest rates on Citizen Saving Bond and Foreign Employment Bond follows a similar trend as that of the borrowing rates at BFIs (Figure 3.10.b).

Figure 3.10: Interest Rates of Government Securities

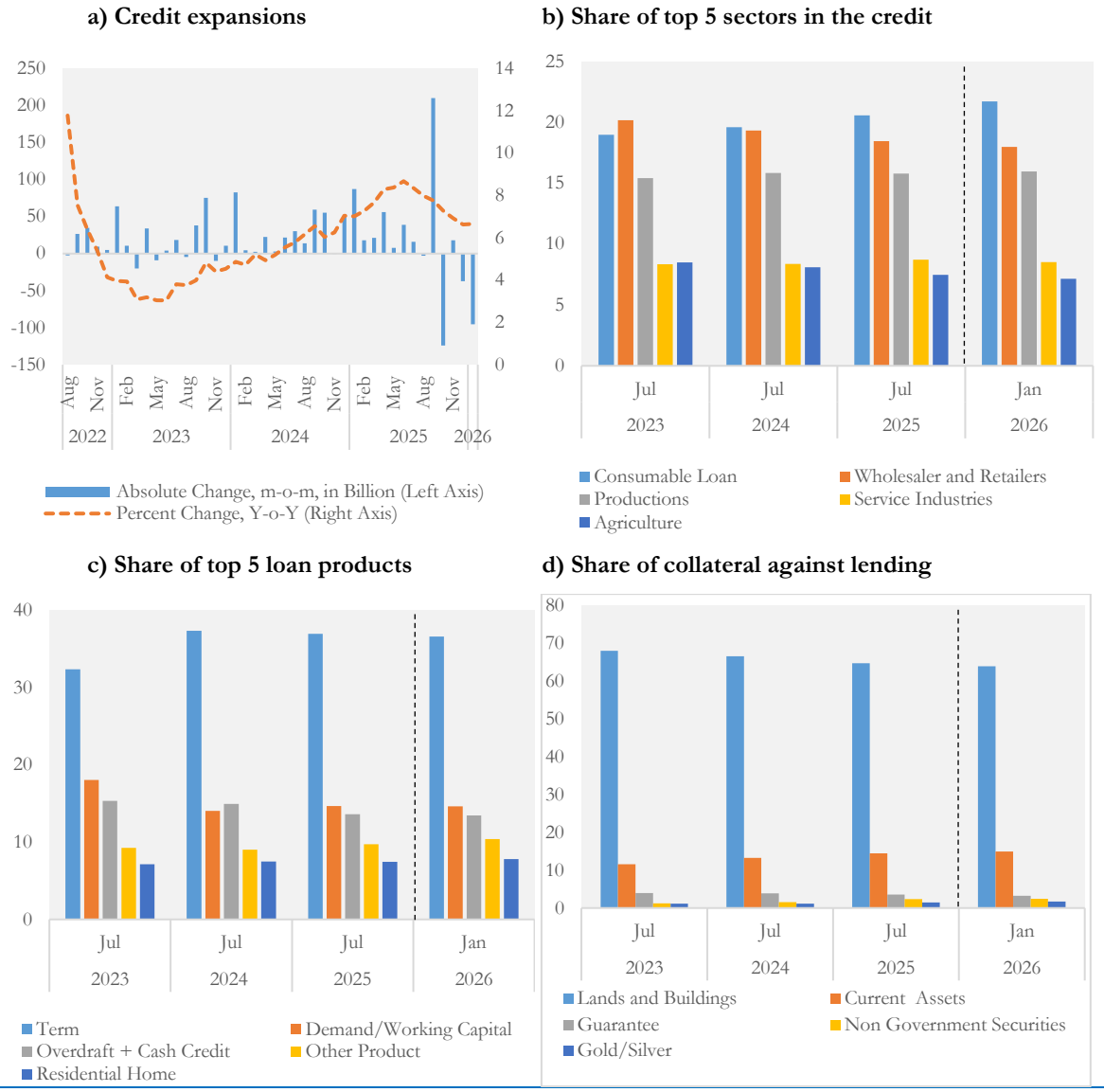


The Money Supply and Credit Growth

While credit growth followed the monetary policy stance in the past, the recent credit uptake has remained sluggish. The post-COVID policy easing saw an extraordinary growth, following a sluggish path after the subsequent policy tightening. However, the recent accommodative stance did not translate to credit flow despite historically low interest rates. The Gen Z unrest of September 2025 seems to have further deteriorated the investment climate, as seen by the sharp negative drop in the credit growth in October 2025, followed by December 2025 and January 2026 (Figure 3.11a). The consumable loan saw a dramatic increase after the COVID-19 pandemic, reaching a growth rate of 468.4 percent in July 2022 (Figure 3.11b). In contrast, the construction sector experienced the largest negative credit growth in 2022, falling by 53.8 percent, and has not yet recovered to pre-COVID levels. Recently, credit to the transportation, communication, consumable loans and loans to services industries have been higher, while the agriculture sector experienced a negligible growth (Figure 3.11b).

The real estate-backed loan is the most dominant loan. The lending against collateral of lands and buildings comprises about two-thirds of the total credit in 2026. The lending against the collateral of current assets hovers around 15 percent. Loans against the valuable metals like gold and silver is also on an increasing trend, but its share is still below 2 percent. The challenge, therefore, is diversifying the concentration of lending against fixed assets as collateral.

Figure 3.11: Credit to the Private Sector by BFIs



Box 4: Why Has Credit Growth Moderated in Recent Years?

Several factors have contributed to subdued credit growth in recent years, the dominant one being the deceleration effect. BFIs' lending was aggressive between 2015 and 2022, from a level of Rs. 1374 billion to Rs. 4140 billion, an increase of Rs. 2766 billion in 7 years, with an average growth of 17 percent per annum. This had contributed to the rise of the credit level from 56.7 percent of GDP to 94.2 percent of GDP during this period. Such a growth helped reach Nepal's credit-GDP ratio comparable to high-income economies, surpassing the regional level (Table 3.2.). This level of credit volume is deemed to be much higher, given that the country's income has not increased, such that households and firms might have suffered from a potential risk of over indebtedness.

Table 3.3: Private Sector's Credit, % of GDP

Nepal	India	Bangladesh	Sri Lanka	Pakistan	Region*		
					High Income	Middle Income	Low Income
91.1	56.6	35.7	27.3	11.5	147.9	130.0	15.6

* as of 2023. Source: Respective central banks, economic survey and world development indicators.

The excessive credit growth has thus constrained the additional borrowing capacity of both households and firms. The post-COVID-19 pandemic credit boom was a specific concern, driven by both pent–up demand and ample liquidity on supply side. However, the rapid expansion of credit growth led to huge imports, exerting pressure on

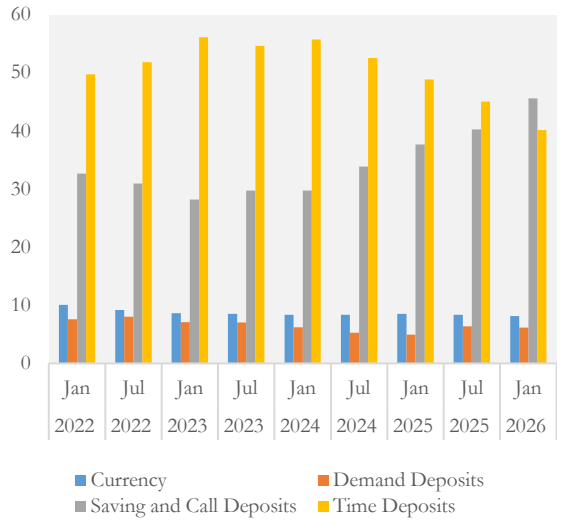
foreign exchange reserves, resulting in balance of payment deficit and FOREX reserve adequacy below the target level. In response, NRB adopted contractionary monetary policy with macroprudential measures to moderate credit growth. Furthermore, NRB introduced Working Capital Loan Guidelines to curtail the loan ever greening and reduce moral hazard. While these policies supported to contain excessive credit growth with a quick recovery to FOREX reserve and a positive BoP position, the private sector credit has remained subdued thereafter despite subsequent accommodative monetary policy, abundant liquidity and historically low interest rates.

While the supply side also has some issues, credit demand seems sluggish. On the supply side, BFIs have seen a rise in their NPLs over recent years, thereby affecting their non-banking assets, affecting their capital and profitability. The focus of the BFIs is thus on loan recovery, rather than expanding the business. On the demand side, one of the reasons could be attributed to the significant increase in the number of blacklisted individuals and companies. Similarly, a plunge in aggregate demand with slowed down economic activities, and a low business confidence is also equally responsible. Furthermore, poor fiscal performance, especially capital spending, further contributed to this slow-down. The government spending experienced a negative growth in 2023/24, leading to fiscal contraction. The decrease in imports and production observed in those years also caused a decrease in the aggregate demand, whose aftereffects are still palpable. The Gen Z protests in 2025 could have further deteriorated investment climate in the short-run, whose full-scale impact remains yet to be seen.

Figure 3.12: Money Supply

a) Broad money and its sources, % share

b) Broad money and its uses, % share



The money supply has continued to grow at an average rate. The broad money (M2) growth sharply declined from October 2021 for a year, despite a high growth in the private sector's credit. This decline was largely attributable to the negative growth of net foreign assets when the credit growth was excessive (Figure 3.12a, Figure 3.11b). However, the M2 growth picked up after October 2022 and continued throughout 2023, with improvements in the net foreign assets, despite moderate growth in domestic credit. Nevertheless, the growth rate has been averaged since then due to the subdued credit growth, as seen in the share of net domestic assets (Figure 3.11a, Figure 3.12a).

On the usage side of the money supply, the deposit structure has been volatile. The growth in currency as well as saving and call deposits was mostly negative during the sharp money supply fall of 2021-2022 (Figure 3.12b). The subsequent rise was reflected in the saving and call deposits as well as time deposits. However, since 2024, saving and call deposits have continued to grow at higher rates, while growth in time deposits have declined and even turned negative. This coincides with the decrease in interest rates following the accommodative stance of the monetary policy, explaining the declining share of time deposits.

Box 5: Assessing Foreign Exchange Market Pressure due to the Credit Growth

Central banks use the foreign exchange market pressure (EMP) index to assess pressure on the external sector arising from exchange rate movements, interest rate differentials, and changes in international reserves. EMPI captures the both episodes of external sector - stress and easing. Central banks use it as a benchmark indicator to assess the health of the external sector and compare it with key monetary indicators, including monetary policy stances. This comparison helps central banks evaluate the synchronization between the external and monetary sectors, particularly in identifying the buildup of external sector pressure following the monetary easing. Girton and Roper (1977) initially proposed EMP as the sum of changes in the exchange rate and international reserves. Eichengreen et al. (1996) extended this definition by incorporating interest rate differentials, thereby accounting for the role of liquidity in the interaction between the domestic currency and the foreign exchange market. The EMPI for Nepal has been developed following Eichengreen et al. (1996)[2], as follows.

$$EMPI = \frac{1}{\sigma_{\Delta exc}} \times \frac{exc_t - exc_{t-1}}{exc_{t-1}} + \frac{1}{\sigma_{\Delta i}} \times i_t - i_t^* - \frac{1}{\sigma_{\Delta NFA}} \times \frac{NFA_t - NFA_{t-1}}{M1_{t-1}} \quad \ldots\ldots (3)$$

$$EMPI = \frac{1}{\sigma_{\Delta exc}} \times \Delta exc_t + \frac{1}{\sigma_{\Delta i}} \times \Delta i_t - \frac{1}{\sigma_{\Delta NFA}} \times \Delta NFA_t \quad \ldots\ldots (4)$$

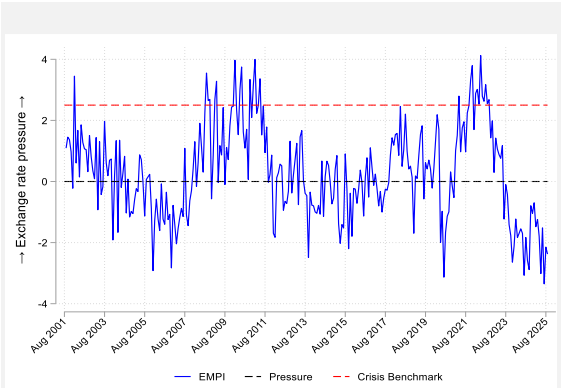
In equation (1), exc is cross exchange rate between Nepali rupees (NPR) and US dollar (USD), i is the 91-days T-bill rate for Nepal, NFA is the net foreign assets for Nepal and $M1$ is narrow money, i^* is 3-months Treasury rate of the US Fed, representing foreign variable.

Since Nepal adopts a fixed exchange rate regime, the NRB has no scope to adjust the exchange rate in response to the external sector pressures. Consequently, the stress should be reflected in the foreign exchange reserves, as external pressures are largely absorbed through changes in reserves. Although EMPI also incorporates exchange rate movements against the USD and interest rate differentials, fluctuations in these variables are ultimately accommodated through adjustments in foreign exchange reserves under the pegged exchange rate regime.

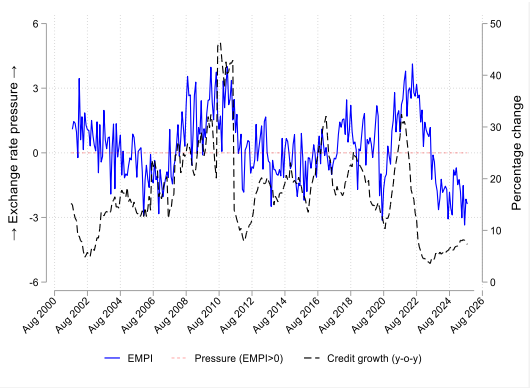
Nepal's EMPI highlights distinct episodes of external-sector pressure (Figure 3.13a). Nepal experienced balance of payments stress during 2009/10–2010/11 and in 2022/23. The pressure on foreign exchange reserves during 2009/10–2010/11 was triggered by strong import growth particularly, driven by gold, silver, and vehicle-related imports amid declining exports and a deceleration in workers' remittance inflows following the global financial crisis. The 2022/23 episode, by contrast, is attributable to the combined effects of accommodative monetary policy implemented to counter the COVID-19–induced economic slowdown and the subsequent pent-up demand (Figure 3.13a).

Figure 3.13: Nepal's Exchange Market Pressure Index

a) EMPI – overall



b) EMPI due to Credit Growth



Note: EMPI denotes the Exchange Market Pressure Index. Pressure is an indicator that get activated when EMPI > 0. The crisis benchmark captures episodes of excessive external-sector pressure and is triggered when EMPI > 2.5.

EMPI has been plotted against key monetary indicator, private sector credit growth, to illustrate their relationships over time. The EMP intensifies during periods of rapid private sector credit expansion and

[2] We also construct EMPI following Girton and Roper (1977) and the resulting EMPI is consistent with baseline EMPI, with correlation coefficient of 0.8.

subsides as credit growth contracts. This pattern is clearly evident in Figure 3.13b for 2022/23, where a surge in credit growth is followed by heightened exchange market pressure, which subsequently eases as private sector credit growth slows. Therefore, we can conclude that the credit growth is also a predominant factor for the exchange market pressure for Nepal.

Financial Access and Stability

Incredible strides have been made in improving financial access over the last decade. The commercial banks' branches have reached into all the 753 local levels, with the total number of BFI's branches exceeding 11 thousand 5 hundred. This has resulted the population per branch one of the lowest in South Asia[3]. The layered financial services across the country, with commercial banks, development banks and finance companies as financial intermediaries and microfinance financial institutions providing rural financial services to their members, have contributed to strengthening the overall financial inclusion initiative of the NRB.

Table 3.4: Key Financial Access Indicators, Jan 2026

Bank/BFI Class	Total
No. of BFIs	106
No. of Branches	11,503
Population per branch (A, B and C class BFIs)	4,479
Population per Branch (All BFIs)	2,535

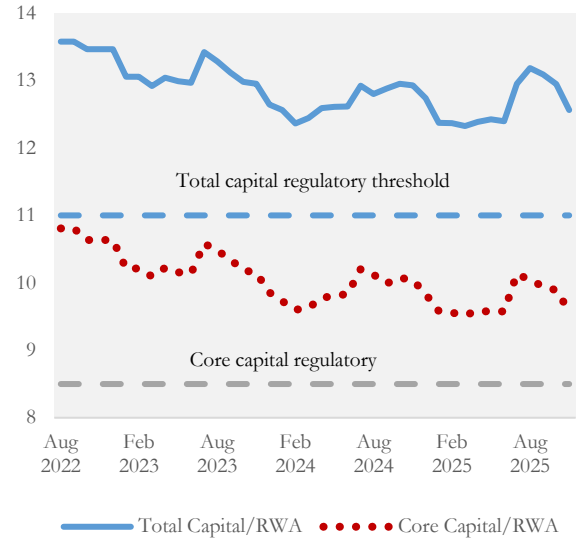
Financial stability measures remain resilient, despite challenges persist. The overall capital adequacy ratio (CAR) remains above the regulatory threshold, with core capital-to-risk-weighted assets ratio being at 9.80 and the total capital-to-risk-weighted assets ratio being at 12.89 in November 2025 (Figure 3.14a). Similarly, liquid assets of the BFIs remain sufficient with the total liquid assets-to-total deposits ratio being at 23.4 in November 2025 (Figure 2.13b). Overall, the BFIs are capable of extending further loan, in line with the projection of NRB's credit growth of 12 percent considering their capital and liquidity ratios.

The non-performing loan (NPL) exponentially increased in the last two years, and moderated recently. The ratio was 1.3 percent in January 2022, which soared to 5.2 percent in April 2025 (Figure 3.14c). Specifically, the agricultural and SME loans remained relatively more non-performing, which contributed to a higher NPL ratio (Figure 3.14d). The higher NPL ratio is the accumulation of multiple economic and policy shocks, beginning in 2015. The NPL primarily depends upon the quality of credit while lending and the macroeconomic environment that further affects it later on. It seems that both factors contributed to increasing the NPL. Nepal faced two major economic shocks and one policy shock in between, which largely contributed to a six-fold rise in the level of credit in a decade. Since the non-performance of the lending results with a substantial lag, this rise in NPL can be argued a buffer created before the pandemic, that further amplified the post-pandemic policy granting a easy access to credit while the post-pandemic loss of revenue by businesses. Nevertheless, based on the level of NPL observed in neighboring economies, this level of NPL ratio compared to credit growth and the impact of the shocks seems justifiable, and remains within a manageable level. The issue however, is the need for some credible ways in managing the NPL, like the establishment of a separate institution envisioned in the 2024/25's budget and monetary policy, or other exploring other options that aims at managing non-banking assets. It not only essential to effectively manage the NPL, but also preventing the BFIs from the moral hazard.

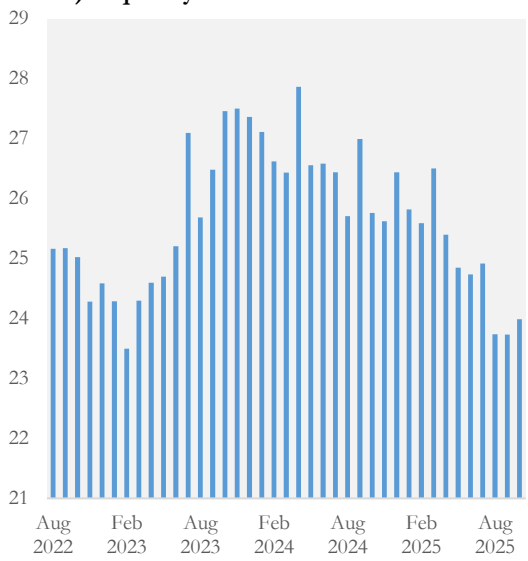
[3] Approximately, the population per branch of Bangladesh is 15147, India 8506, Pakistan, 15096 and Sri Lanka 2859; based on the latest publicly available data.

Figure 3.14: Financial Stability Indicators

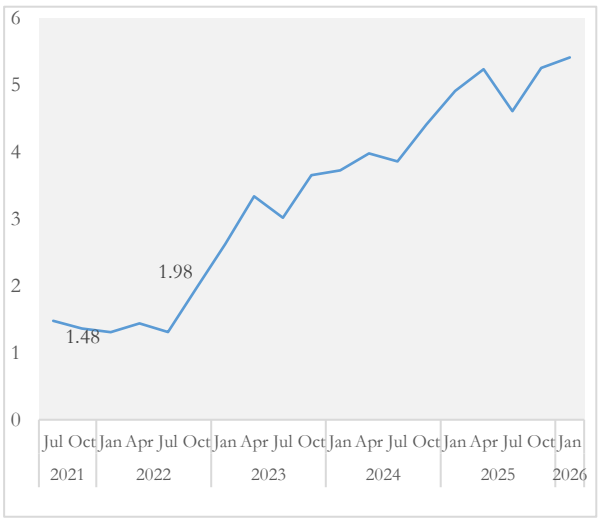
a) Capital adequacy ratios (CARs)



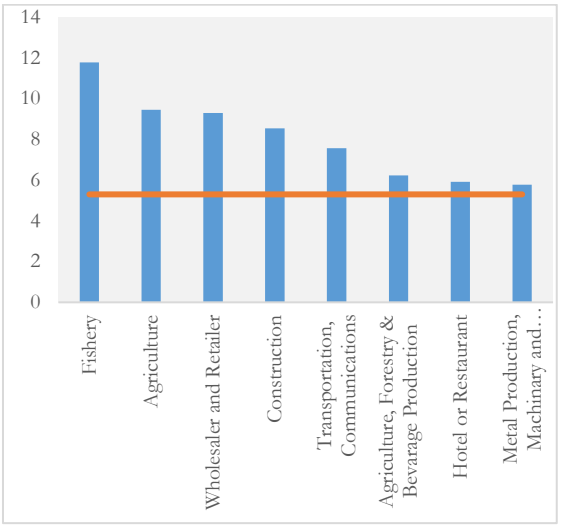
b) Liquidity ratio



c) Non-performing loan (NPL) ratio



d) Sectorwise NPL – top 5, January 2026

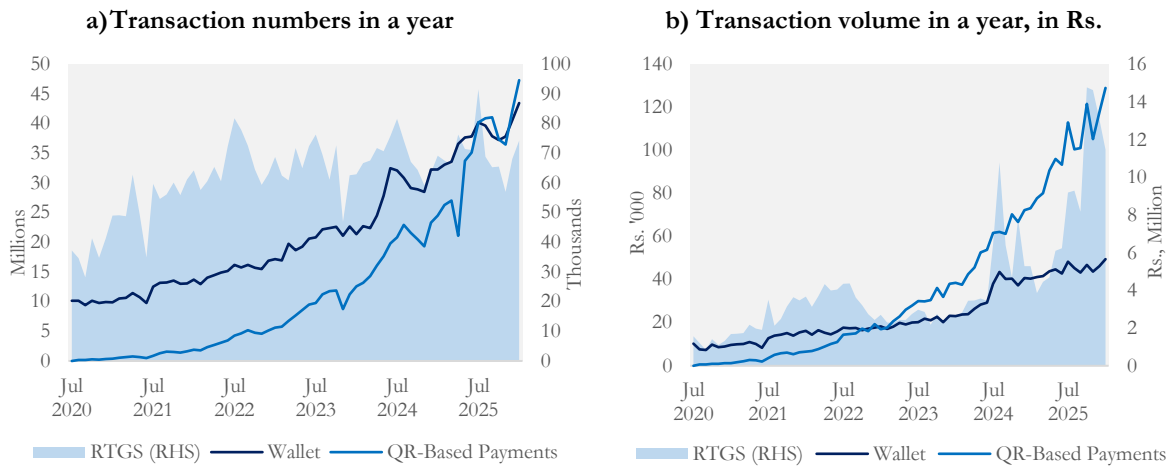


Payment System Development

The legal, institutional and infrastructure development of the payment system has made milestone progress in the last decade. The payment system infrastructure, products and their usage have been overwhelming. The NRB has implemented its National Payment System Development Strategy (2014), a separate Payment and Settlements Act (2019), a dedicated Payment Systems Department (2015), licensing, supervision and regulation of payment system providers and operators and several digital infrastructures, including Real Time Gross Settlements System (RTGS). With this, digital payments have grown tremendously, especially after the COVID-19 pandemic, which led to the introduction of new payment instruments such as QR code-based payments. These initiatives have resulted into a wider shifts to the digital payments, through the rise of RTGS, usage of wallets, and QR-based payments, in both by transaction number and the amounts (Figure 3.15a, Figure 3.15b). Economic theory suggests that an increase in the efficiency of payment systems leads to an increase in the income

velocity of money, which directly affects monetary policy making and transmission (Mishkin, 2019). Furthermore, the payment system developments further enhances the financial stability.

Figure 3.15: Selected Digital Payments Indicators



3.4 External Sector

The external sector remains robust, with substantial recovery of international trades, a positive balance of payments (BoP) and a record foreign exchange (FOREX) reserves. However, the exchange rate remained volatile except the INR due to NPR's peg. Remittance inflow is the primary driver of current account surplus, thereby a record reserve and BoP surplus.

Historical Developments

The external sector constitutes an integral element of Nepal's macroeconomic framework, given the economy's openness and reliance on external sources of income and financing. The NRB mandates for the formulation and implementation of policies related to foreign exchange management, thereby maintaining the external sector stability. Some notable policy measures include historically pegged exchange rate regime serving as a nominal anchor for the monetary policy framework, regulation of balance of payments (BoP) accounts, including investment inflows and outflows. Past episodes of external sector stresses include the BoP pressures of the early 1980s, episodes of trade and transit disruptions, and the post-pandemic surge in imports, that put forward in the critical role of prudent external sector management to have the adequate foreign exchange reserve buffers.

Balance of Payments

Balance of payments (BoP) stability is one of the key mandates of the NRB. As the NRB has a fixed exchange rate regime, the inflow and outflow of foreign currencies do not alter the rate of exchange and thus exchange rate adjustments do not serve as the primary mechanism for correcting external imbalances. Instead, fluctuations in foreign currency inflows and outflows are absorbed through changes in the BoP position. As a result, a surplus in the BoP adds to the foreign exchange reserve, while a deficit in the BoP depletes the accumulated reserve. Nepal has recorded the BOP deficits in only eight years, out of the past forty-five years (1980–2025). The first major episode, spanning 1982/83 to 1984/85, constituted a prolonged BOP crisis primarily driven by fiscal dominance. During this period, extensive reliance on domestic bank financing to fund fiscal deficits stimulated import-intensive domestic

demand, resulting in widening trade deficits and a rapid depletion of foreign exchange reserves, that further exacerbated by subdued foreign aid inflows and weak service receipts (World Bank, 1987). Subsequent deficit in 1994/95 was due to the import surges following economic liberalization alongside declining garment and carpet exports, and in 2001/02 due to political conflict and global shocks that sharply reduced tourism and trade. The BOP deficit in 2009/10 was mainly due to decline in remittance growth amid global financial crisis which couldn't offset the surge in imports. The 2018/19 deficit was driven by higher import demand associated with increased government expenditure and an acceleration in economic activity, fueled by post-earthquake reconstruction and state restricting. And the external sector pressure of 2021/22 reflected post-COVID surge in import caused by pent-up demand, accommodative monetary policy, soaring global commodity prices, and slower remittance growth. Collectively, these episodes show that Nepal's BOP pressures arise from a recurring pattern in which demand-led growth often driven by credit expansion, fiscal stimulus, or external inflows such as remittance inducing consumption demand consistently outpaces the country's weak domestic supply response and limited export capacity.

Table 3.5: Developments at the External Sector, % of GDP

Year (Mid-July)	Next Export	Current Account	Balance of Payments	Remittance
1980	-6.6	-1.5	0.1	
1990	-10.1	-7.4	2.6	
2000	-8.5	-2.4	3.8	
2010	-26.8	-2.4	-0.3	19.4
2020	-27.3	-0.9	7.3	22.5
2025	-25.3	6.7	9.7	28.2

Structural divergence between Nepal's trade balance and its external sustainability has grown over the years. Net exports which was just -6.6 percent of GDP in 1980 has deteriorated sharply over time reaching around -25% by 2025 (Table 3.4). This deterioration in the trade balance indicates that Nepal experiences a persistent and widening trade deficit. However, despite this worsening trade position, the current account and overall BOP remains mostly in surplus, especially after 2000s, reflecting the rising role of remittances as the dominant offsetting inflow. Remittances increased from negligible levels to 19.4 percent of GDP in 2010 and further to 28.2 percent by 2025, more than compensation for the larger trade deficit and even turning the current account positive in most of the years. This pattern indicates that Nepal's external balance is driven more by transfers, primarily remittances than by exports of goods and services, making the BOP outcomes heavily reliant on sustained remittance inflows rather than through the trade competitiveness.

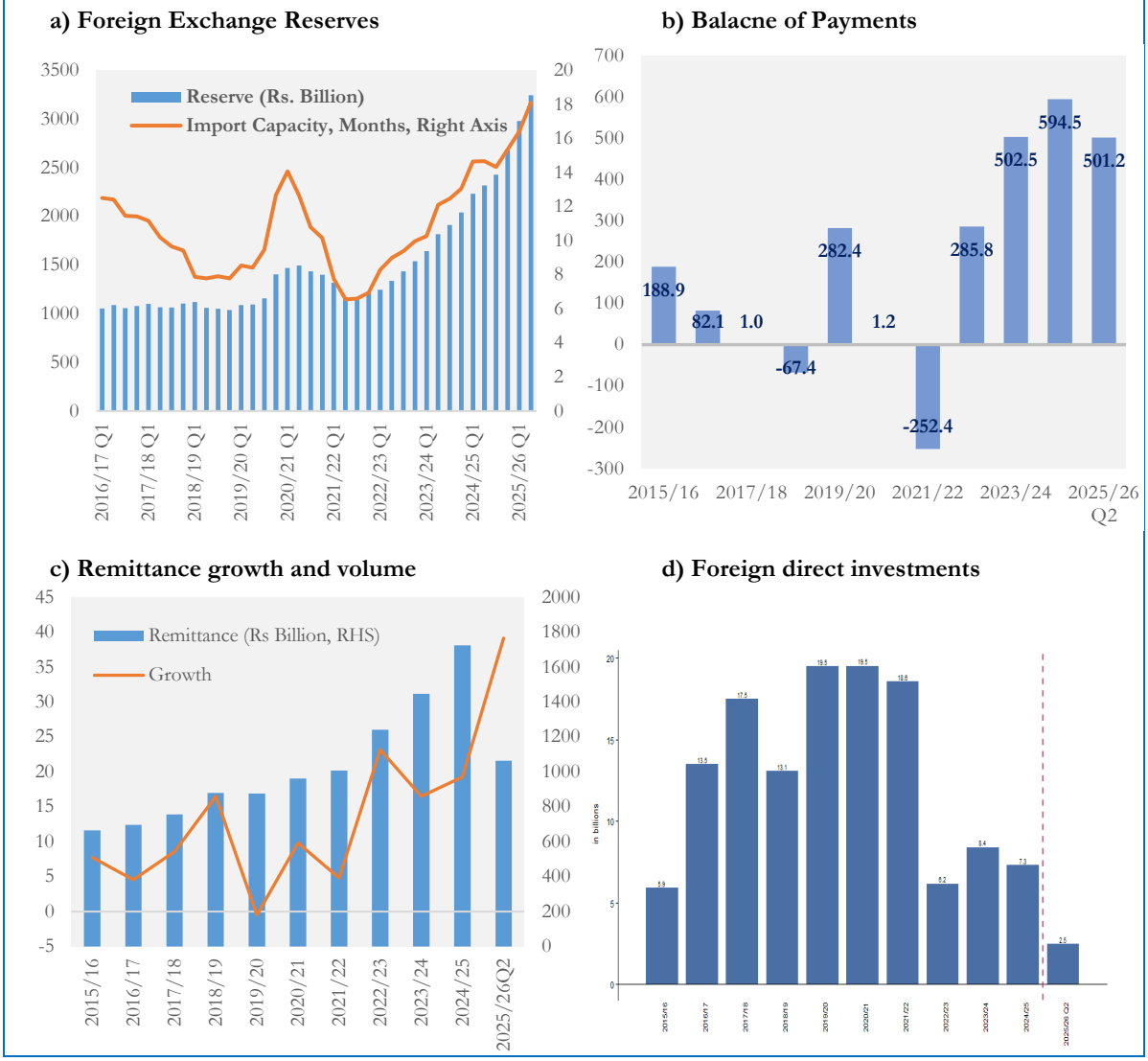
Recent Developments

The external sector remained robust, supported by a significant surplus in the current account alongside a sustained surplus in the overall balance of payments. Nepal's balance of payments has remained in overall surplus in the recent period, supported primarily by strong workers' remittances and official external inflows, despite a persistently large merchandise trade deficit. The BoP, which was negative since 2020 June due to the sluggish remittance inflows along with burgeoning trade deficit, followed a positive trajectory since October 2022 (Figure 3.16b). These scenarios have been reflected in the foreign exchange reserves, with a substantial drop in the import capacity of exchange

reserves, and now a record in the merchandise and services import capacity in recent months. The current account also recorded a notable surplus, driven primarily by robust workers' remittances despite a widening merchandise trade deficit.

Nepal's foreign reserve is in a comfortable position, with a record import capacity. Overall, the gross foreign exchange reserves are Rs. 3242.4 billion (USD 22.45 billion) in mid-January 2025, which is able to import merchandise and services equivalent to 18.1 months (Figure 3.16a). The reserve increased by 21.1 percent in NPR terms and by 15.2 percent in USD terms on y-o-y basis.

Figure 3.16: External Sector Indicators



The international trade, both import and export, has rebounded but largely supported by edible oils. Over the past decade, Nepal's exports have expanded at an average annual rate of 16.1 percent, while imports have grown at a rate of 10.1 percent. Despite this growth, foreign trade has exhibited considerable volatility on both the export and import fronts. Import growth was particularly pronounced in 2021/22, reaching NPR 1,920 billion, driven by a combination of strong post-pandemic domestic demand and elevated global commodity prices. Subsequently, imports contracted in the following two years, reflecting both deliberate import-curbing measures and subdued domestic demand, before recovering in the most recent year.... Export growth has

exhibited pronounced volatility since 2018/19, largely reflecting policy shifts in India, particularly changes in customs duties on crude oil and edible oil. Headline exports recorded historically strong growth in 2020/21 and 2021/22 reaching level not seen since 2000, followed by a sharp contraction of 21.4 percent, before rebounding to 81.8 percent in the most recent year. This fluctuation underscores the sensitivity of Nepal's export performance to external policy changes and cross-border tariff differentials, highlighting the role of trade arbitrage opportunities between Nepal and India in shaping export dynamics. During the second half of 2025/26, the export grew by 43.8 percent, however, when Soybean oil export is excluded, export growth drops sharply to just 5.7 percent, indicating a stagnation in traditional and non-traditional export sectors. Import dynamics reinforce this assessment through a pattern of matching trade, with crude soybean oil accounting for 6.1 percent share of total imports. Import grew by 14.2 percent in the review period. Besides, crude Soybean oil, import growth is led by chemical fertilizers, gold, transport equipment, vehicles and spare parts, and telecommunication equipment and parts, among others.

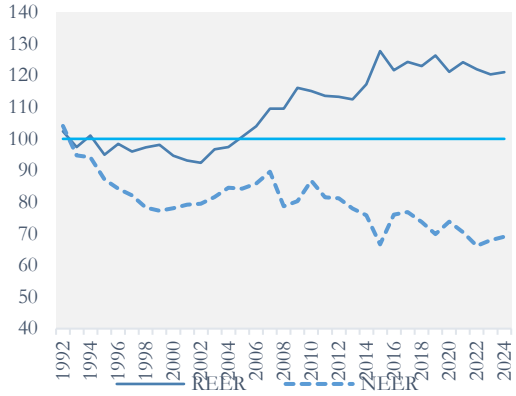
The services account surplus narrowed, mainly due to weaker performance in the transport sector as higher trade volumes raised transportation costs. Travel-related services recorded a deficit: although tourism income increased with the rise in the number of tourists, substantial outflows for education-related travel outweighed these gains. The primary income account surplus declined, reflecting higher repatriation of dividends by foreign direct investment companies and increased interest payments on external loans.

The secondary income account has been in surplus in the recent years. It recorded a substantial surplus, supported by a 39.1 percent rise in workers' remittances which played a key role in sustaining the overall current account surplus. In the last five years, remittance inflows have steadily increased, indicating a consistency in their growth. However, the growth rate has remained volatile, ranging from a negative increment to a sharp positive turnaround, peaking at its highest growth in 2023Q3 before declining in 2023Q4 (Figure 3.16c). This suggests that while remittance volumes are rising steadily, the pace of growth is sensitive to seasonal factors or external shocks.

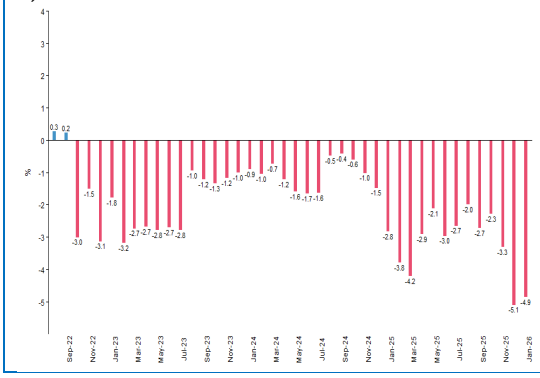
Financial account has remained in surplus, but with the restricted flows. The financial account reflects how financial capital flows into and out of Nepal through various investment and financial instruments. Given Nepal's partial capital account convertibility, the financial account is primarily reflected by foreign direct investment (FDI) inflows, external borrowings by government, commercial banks and few private sectors on account of approvals, and reserve assets. With respect to the FDI, Nepal has opened up its economy since the mid-1980s, but with regulations. However, at the beginning of 2025/26, the NRB has permitted limited outward investment to the information technology sector, marking a breakthrough in the gradual relaxation of capital outflow restrictions. Meanwhile, net foreign direct investment inflows declined by 33.6 percent in the six months of 2025/26, compared to

Figure 3.17: Exchange Rate Volatility

a) NPR vis-a-visUSD



b) NEER and REER: Historical Movements



the previous year. (Figure 3.16d). The inflows concentrated in the manufacturing, telecommunications, and hotel sectors, indicating a moderate shift in private capital flows. External borrowing under the financial account is largely dominated by government external debt, which constitutes around 81 percent of total liabilities to non-residents, indicating a significant concentration of sovereign exposure in the external debt structure. Over the past decade, government external borrowing has followed a mixed and uneven trajectory rather than a sustained upward trend, reflecting fluctuations in fiscal financing needs, project implementation cycles, and the timing of disbursements from development partners. A notable spike was observed in 2019/20, likely driven by elevated fiscal requirements associated the growing public spending post-2015's new constitution implementation. More recently, external borrowing declined by 20.1 percent in the first six months of the current fiscal year.

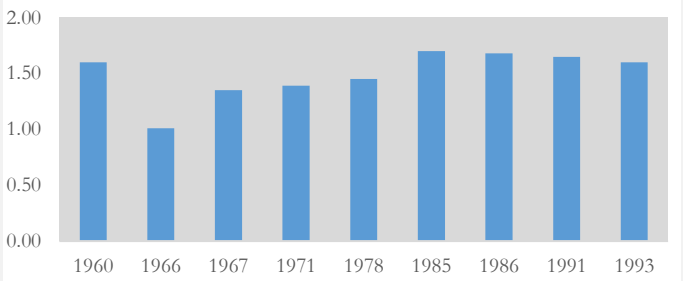
Nepal witnessed a persistent depreciation of the foreign currency, but effective exchange rates are appreciated. Under the pegged regime, the NPR continues to move in line with the INR against the United States dollar (USD). During the review period alone, the NPR depreciated 4.9 percent in mid-January 2026 from mid-July 2025 (Figure 3.17a). The Nominal Effective Exchange Rate (NEER) reflected this trend. However the Real Effective Exchange Rate (REER), continued to appreciate since 2005 until 2015, which seems now stabilized and depreciated marginally (Figure 3.17b). The NPR is still appreciated by around 20 percent in the real terms.

Box 6: Nepal's Fixed Exchange Rate Regime

An exchange rate regime constitutes the formal framework adopted by a country to manage the value of its currency relative to other currencies. This framework determines how the exchange rate is set, how much it can fluctuate, and what role the central bank plays in the foreign exchange market. Exchange rate regimes are typically divided into three broad categories. At one end of the spectrum are hard exchange rate pegs. Hard pegs are exchange rate regimes in which a country firmly commits to maintaining its currency at a fixed value relative to another currency, or adopts a foreign currency entirely. Soft exchange rate pegs fall in the middle of the exchange rate spectrum. Under these arrangements, a country keeps its currency stable relative to an anchor currency or a basket of currencies within a fluctuation band where the currency is allowed to move within a narrow band (for example, ±1%) or a much wider band (up to ±30%). At the other end of the spectrum are floating exchange rate regimes in which the exchange rate is mainly market-determined (IMF, 2008). The choice of an exchange rate regime is a fundamental economic policy decision and involves complex trade-offs. Therefore, it depends upon several economic, structural, and political/institutional factors.

Nepal has maintained a pegged exchange rate regime, with a fixed rate of exchange of Nepali rupees (NPR) vis-à-vis Indian rupees (INR) effective from April 13, 1960. This peg is considered a conventional peg or soft peg. The level of peg, i.e., the exchange rate of NPR, has been revised several times considering the macroeconomic fundamentals as well as international developments. However, the current level of peg stands at 1.6 NPR per INR since February 12, 1993 (Figure 3.18).

Figure 3.18: History of Peg-Level Revisits



The NPR is pegged to the INR by the GoN's own decision, following economic rationality. Due to a combination of economic, geographic, and structural reasons, the economic analysis favors a pegged

regime for Nepal. Nepal is a small, open economy with a high level of trade dependence on India, with a long and porous border that allows free labor mobility, leading to a deep economic and geographic integration. Because of this integration, fixing the exchange rate helps eliminate the exchange rate risks for trade, investment and remittances and reduces transaction costs, thereby anchoring the domestic inflation. Therefore, the exchange rate peg has provided a credible nominal anchor for the monetary policy (IMF, 2020), being able to contribute to inflation stability, greater trade predictability, and smoother cross-border financial flows, including remittances and direct investments. However, the arrangement comes with some policy trade-offs. Nepal's monetary policy becomes constrained, as it needs to broadly align with India's interest rate policy decisions, while those decision being affected by their economic conditions. This limits Nepal's flexibility to use its own exchange rate or follow an independent monetary policy to respond to the domestic economic shocks. Overall, the peg has strengthened stability and predictability in external transactions, but at the cost of reducing Nepal's ability to conduct autonomous macroeconomic management. Still, the analysis indicates that the benefits of peg outweigh the costs.

3.5 Fiscal Sector

Nepal's fiscal sector has had mixed performance over the years. Key fiscal indicators show signs of recovery after the COVID-19 pandemic, with some decline in the fiscal balance deficit. Revenue mobilization remains weak and well below the international average. The structure of spending continues to remain a pressing challenge, with low capital expenditure and high seasonality in spending.

Historical developments

Nepal has made substantial progress on both the size of the government and the revenue. The size of the government represented by the public spending to GDP ratio rose from 14.9 percent in 1980 to 17.5 percent in 2000 and 24.9 percent in 2025. Likewise, the revenue-GDP ratio also substantially increased, from 8.0 percent in 1980 to 11.3 percent in 2000 and 19.6 percent in 2025. However, the foreign sources of financing represented by the foreign aid has been declined, from 5.7 percent of GDP in 1980 to 2.4 percent in 2025 (Table 3.6). However, the expenditure mix has been found reversed, from the substantial weight of capital to the least, in the last 45 years. For instance, the share of capital spending was 9.9 percent of GDP in 1980, which declined to 6.7 percent in 2000 and further plunged to 3.6 percent of GDP in 2025. This declining share is added to both recurrent and financial spending (Table 3.6).

Table 3.6: Key Fiscal variables, % of GDP

Year	Expenditure				Revenue	Foreign Aid
	Recurrent	Capital	Financial	Total		
1980	4.6	9.9	0.4	14.9	8.0	5.7
1990	5.7	12.6	0.8	19.0	9.0	7.7
2000	9.4	6.7	1.4	17.5	11.3	4.6
2010	15.6	3.4	2.7	21.8	15.1	4.2
2020	20.2	4.9	3.0	28.1	21.6	3.6
2025	16.1	3.6	5.2	24.9	19.6	2.4

Note: 1980 means Fiscal Year 1979/80, and so on.

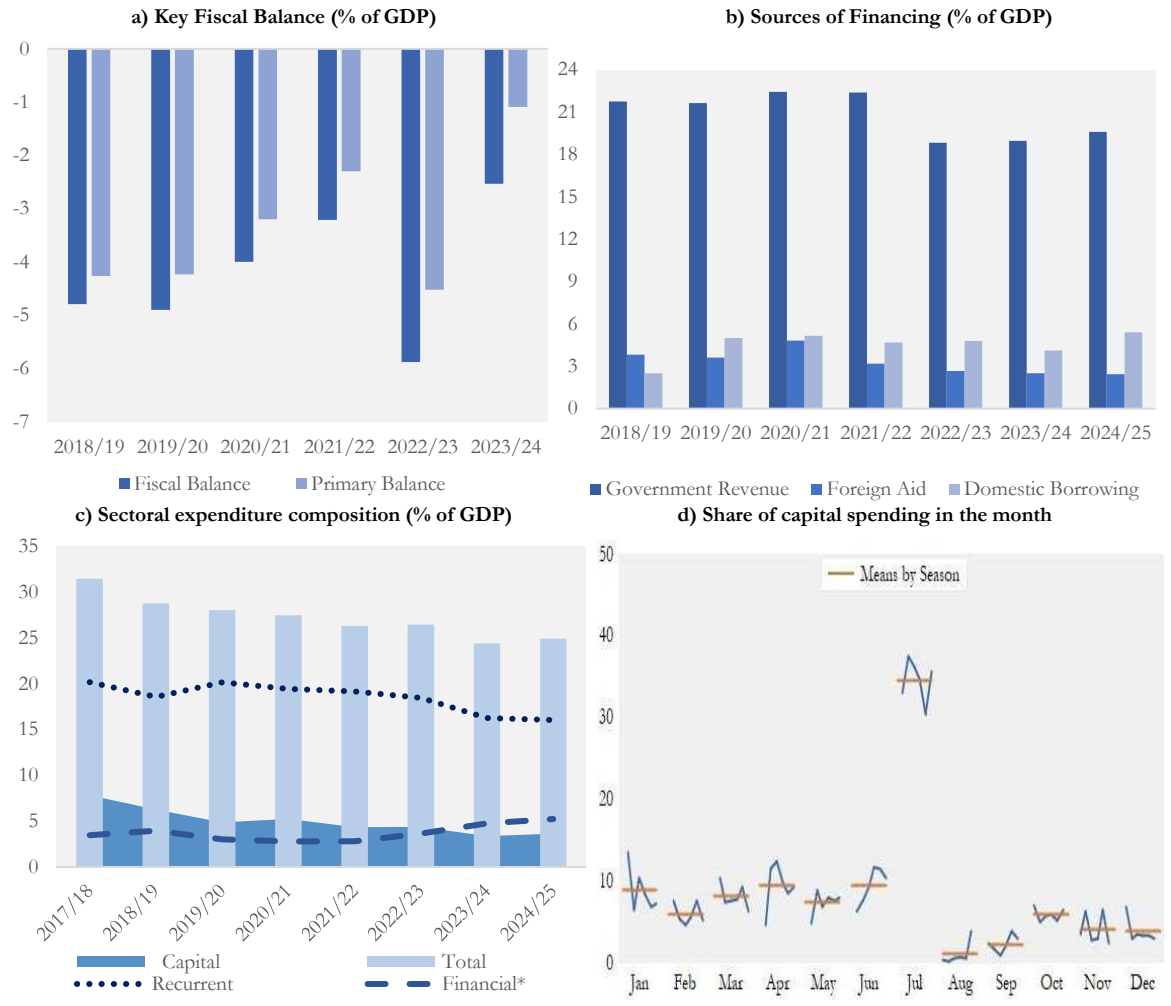
Recent Developments

Nepal has negative fiscal balance but remains within the stability thresholds. The overall fiscal balance is calculated by taking the difference between gross government revenue (including grants) and total government spending, which then expressed as a percentage of GDP. The overall fiscal balance has not crossed 5 percent in the last 5 years,

except in the general election year 2022/23 (Figure 3.19a). Over the past six years, overall fiscal balance and primary balance remained in deficit, with overall fiscal balance averaging at - 4.2 percent of GDP and primary balance 3.3 percent of GDP, respectively. In 2023/24, these indicators improved significantly, with overall fiscal deficit moderating to 2.5 percent of GDP, while primary deficit narrowing to 1.1 percent of GDP. The fiscal consolidation in 2023/24 was supported by moderate revenue recovery, contained recurrent spending, and promising efforts to strengthen fiscal discipline (Figure 3.19a). While the revenue was declining, followed by the foreign aid, it seems that domestic borrowing rose significantly in the last 5 years (Figure 3.19b).

The public spending continued to decreasing before reaching its historical peak in 2017/18. The government spending rose significantly during the state restructuring and post-2015 earthquake reconstructions, reaching an all-time high of 31.5 percent of GDP in 2017/18 (Figure 3.19c). This trend has then been reversed, and continuously moderated. This spending ratio has now been at par with average of the Low-Income Developing Economies in 2025[4].

Figure 3.19: Fiscal Indicators



[4] In 2025, the average government size was is 24.4 percent in the Low-income Developing Economies, 32.5 percent in the Emerging Market and Middle-Income Economies and 40.92 percent in the Advanced Economies (IMF, 2025a).

Nepal's expenditure structure continues to reflect persistent low allocation for capital spending, and its under-execution. Capital spending has remained lower than debt-servicing spending since 2023/24. Over the past sixteen years, capital expenditure averaged only 17.7 percent of total expenditure, averaging to 4.4 percent of the GDP (Figure 3.19c). Furthermore, out of the total spending, a significant portion has been observed being spent at the end of the fiscal year, exhibiting the strong seasonality of the capital spending (Figure 3.19d). In the last five years, 5 percent each was spent in the first and second quarter, 7 percent in the third quarter and remaining in the fourth quarter. In the final month alone, is has been observed around 35 percent spending of the total annual capital expenditure (Figure 3.19d).

Table 3.7: Structure of the Government Revenue

Heading	1980	1990	2000	2010	2020	2025
Value Added Tax	21.5	17.2	23.0	29.7	26.6	28.6
Income Tax	5.5	9.9	15.7	18.7	26.1	24.9
Customs	32.7	28.9	25.2	19.5	16.4	19.3
Excise	11.6	11.5	7.3	13.5	12.0	14.6
Other Tax	11.0	10.9	6.0	4.6	2.1	0.3
Non-Tax Revenue	17.7	21.6	17.6	14.0	16.8	12.2

Source: Nepal Rastra Bank.

Nepal's revenue structure continues to rely heavily on imports, making revenue performance highly sensitive to fluctuations in trade, global commodity prices, and domestic demand. Over the past six years, tax revenue based on import averaged 46.7 percent of the total tax revenue. In 2024/25, this ratio was 47.9 percent (MoF, 2025). Over the history, while the income tax shows some improvements, the share of import-based revenue has not been moderated, posing challenges of trade-off between import and the government revenue.

Nepal's public debt has remained elevated over the years, with total debt rising from 36.9 percent of GDP in 2019/20 to 43.7 percent in 2024/25. The upward trend reflects a persistent negative fiscal balance, implying consistently higher government expenditure than revenue. In addition, gradual decline in external grants and subsidies has further widened financing needs, necessitating greater reliance on domestic debt to meet fiscal obligations. As the domestic debt suffers the rollover and interest rate risks[5], the bilateral and official development assistance loans can be the optimal financing source for Nepal.

Box 7: Nepal's Public Debt: Is it sustainable?

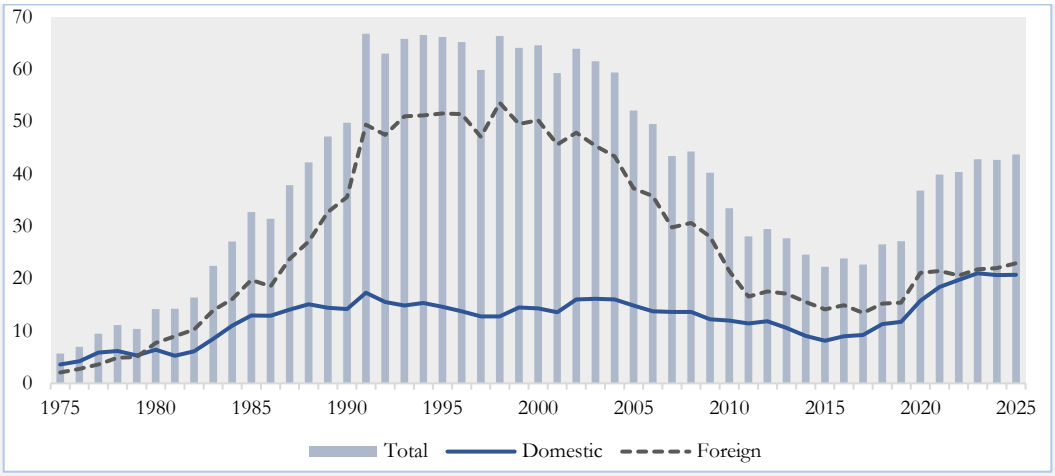
The level of public debt is considered one of the key sources of macroeconomic stability. Annual budgetary operations affect the financial system, the real sector, as well as the external sector, and it sets the level of outstanding public debt. In general, domestic debt has interest rate and rollover risks, whereas external debt has exchange rate risks. Therefore, the level of total public debt, its composition, and debt servicing costs per annum will have macroeconomic implications. Governments try to maintain the outstanding public debt to a certain level with a proper and strategic mix of domestic and external debt, at a level that can be served without any stress and without default. Experience shows that a high level of debt can cause macroeconomic instability. Sri Lanka's public debt rose rapidly after 2013, reaching more than 100 percent of GDP by 2021. The debt distress that accumulated over two decades and worsened in the last few years was one of the leading causes of economic instability in Sri Lanka (Athukorala & Wagle 2022).

Nepal's current public debt level is below the low-income developing countries (LIDCs) level. For example, the LIDC's average was 50 percent of GDP in 2023 (IMF, 2024), while Nepal had about 43 percent. While Nepal's public debt has been rising sharply since 2015, almost doubling in 10 years, this was partly contributed to by the three major shocks: 2015's earthquake, the state restructuring of 2016 onwards following the new constitution of 2015 and the COVID-19 pandemic. Nepal's public debt level is also lower in the South Asian region, the second lowest in the ranking. The recent debt sustainability analysis (DSA) of the IMF (2023) assesses Neal's both external and overall public debt distress at low risk. They observe

[5] The average maturity period of outstanding debt at the end of 2023/24 was 8.0 years, with 13.0 years for the external debt and 2.7 years for the domestic debt.

that the present value of the debt-to-GDP ratio is between 35 percent and it is projected to reach 40 percent, well below the 70 percent benchmark. For the reference, the global public debt averaged at is 92.8 percent of GDP in 2025, while advanced economies and emerging market & developing economies debt averaged at 109.7 percent and 69.0 percent of GDP, respectively (IMF, 2025b). It shows that Nepal's public debt remains below the global average, and hence, Nepal could still have some room to mobilize additional fiscal resources for development.

Figure 3.20: Nepal's Public Debt Structure, % of GDP



Data Source: Nepal Rastra Bank

Legal provisions are in place for debt sustainability. The domestic borrowing limit is set by an independent Natural Resource Commission each year. Likewise, the limit is set for monetizing the debt, by imposing the NRB a limit to hold government securities at a maximum of 10 percent and overdraft to the government maximum of 5 percent, of the previous year's revenue mobilization. For external borrowing, Public Debt Management Act 2022 limits the external outstanding borrowing to a maximum of 33 percent of nominal.

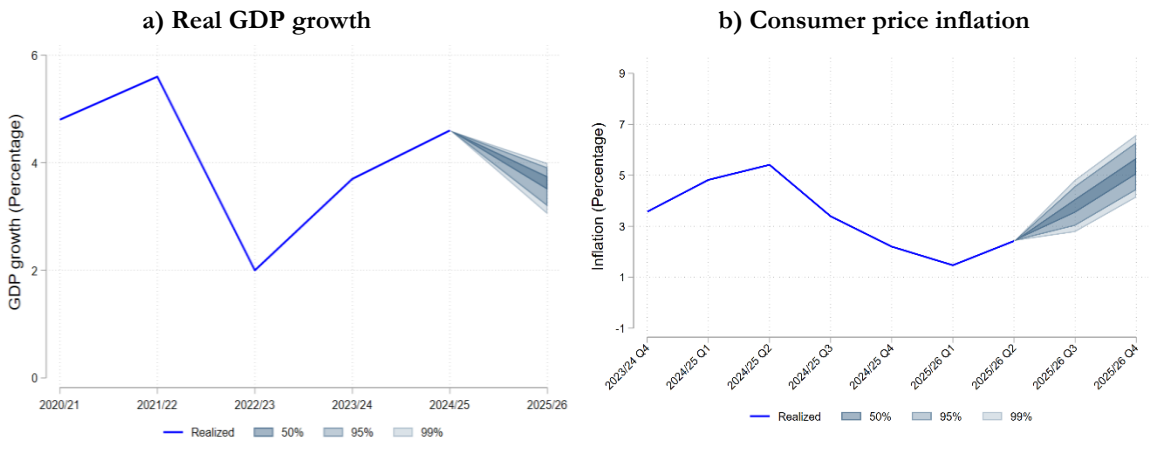
4. Domestic Economic Outlook

Despite the Gen Z movement leading to political and social unrest in the first quarter of 2025/26, the economic outlook remains stable. The timely formation of the government and its commitment to conduct election on time to settle the political transition is improving the overall business environment. Furthermore, the accommodative monetary policy, expedition of the reconstruction works, initiation of reforms in the fiscal policy and rebound of the tourism to the pre-COVID levels and the election spending are generating additional demand in the economy, thereby boosting the economic activities in the second half of the 2025/26. Both the inflation and lending rates are their lowest level in the last two decades, and the FOREX reserve is in record level. Given the NRB's eased credit conditions, economy has a larger space of investment, for both public and private sectors, and thus has an opportunity to uplift the economy.

4.1 Inflation

The average consumer price inflation in the six months of 2025/26 stands at 1.7 percent, well below the revised projection of 4 percent. The easing inflationary pressures in the global economy, a decline in international fuel and food prices, as well as Indian inflation has been reflected in Nepal's inflation trend. For the remaining months of 2025/26, crude oil prices, along with fertilizers and metals except precious metals, are expected to remain moderate. Indian inflation is projected to continue in the further declining trend, and domestic agricultural production - particularly of paddy and other monsoon crops - is likely to dampen. In addition, a rise in public spending due to the upcoming elections and the government's initiative to boost capital spending may exert some inflationary pressure. Nevertheless, annual average consumer inflation is projected to hover around 4 percent (Figure 4.1b).

Figure 4.1: Macroeconomic Forecasts



4.2 Economic Growth

Nepal's growth outlook for 2025/26 remains cautiously optimistic, supported by easing inflationary pressures, accommodative monetary conditions, and a gradual recovery in the industrial and services sectors. While agricultural output—particularly paddy production—is expected to be adversely affected by the delayed monsoons and erratic rainfall, improvements in agricultural modernization and diversification are likely to offset part of this impact. Industrial activity is projected to recover gradually, underpinned by improved liquidity conditions, declining interest rates, stable input prices, encouraging completion of new hydropower projects and supportive government policies. The services sector is expected to remain a key growth driver, supported by strong remittance inflows, increased reconstruction activities, election-related demand, growing domestic and international tourist flows and expanding trade and digital services.

However, downside risks persist following the abrupt political turmoil associated with the Gen Z movement, which culminated in unprecedented destruction of public and private property in September 2025. The scale of property damage was enormous – estimated at around NPR 800 billion – with losses disproportionately concentrated in the public sector. Against this backdrop, the GDP growth is likely to hover below 4.0 percent (Figure 4.1a). NRB's growth outlook is broadly aligned with those of the World Bank and the IMF. The World Bank adopts a more conservative stance, forecasting the economic growth for 2025/26 at 2.1 percent, while the IMF presents a relatively more optimistic outlook, projecting it within 3.0 percent to 3.5 percent.

4.3 The External Sector

The external sector is projected to remain stable. The trade deficit remains historically low, which is deepening further. However, both current accounts and the balance of payments (BoP) have witnessed a record surplus in recent months. The BoP's trend is expected to continue, despite the projection of a rise in imports. The services export is expected to boost as the NRB has further eased the IT investments abroad, and tourist income is expected to rise, supported by the increased tourist arrivals, coupled with exchange rate depreciation. In turn, the foreign currency reserve is projected to reach its record level by the end of this fiscal year. The direct inward investments are expected to moderate due to the political transition. Remittances to keep their current trend, both supported by the workers abroad and the currency depreciation.

4.4 Liquidity and Interest Rates

The liquidity influx in the financial system seems to be continuing. The market liquidity is expected to remain high due to the continued influx of remittances, but will remain stable, as further pumping will be offset by credit uptake and imports. Furthermore, the NRB will be actively absorbing structural liquidity through long-term instruments, such as NRB bonds. Both short-term and long-term interest rates are expected to be stabilized. The deposit and lending rates have fallen to their low, thus, further fall is not necessary given the current monetary policy stance. As our analysis indicates that the current situation is not a liquidity trap, the improvements in the economic activities post-election are expected to further absorb the current level of excess liquidity, thereby preventing the interest rate from plunging further. Till that situation, the NRB will continue to absorb the liquidity by using mix of instruments as part of regular, fine-tuning and structural liquidity management operations.

4.5 Money Supply and Credit Growth

The money supply is projected to grow in line with the annual forecasts. The broad money growth's projection continued to be around 13.0 percent made in July 2025, largely supported by the growth in net foreign assets that largely contributed by the remittance inflows. Credit growth is expected to pick up in the next six months, but expected to be lower than the 12.0 percent projection made in July 2025. However, the pace of credit growth depends upon the overall business climate, especially the settlement of the current political transition through a timely election, and the formation of a stable government to enhance the investors' confidence. Since the interest rate has been historically low, resulting in low aggregate demand, increased public spending, a further boost in the import, and an increase in private sector confidence after the formation of a stable government post-election. Moreover, growing non-performing loans (NPL) has a threefold impact: an increased number of blacklisted entrepreneurs who should have been in additional investment demand, rising non-banking assets of the banking system, and deteriorating capital adequacy. These three scenarios are, on the one hand, affecting the banking system's profitability and further dampening the credit demand on the other. The expedition in the recovery depends upon the economic activities; therefore, the quicker the absorption of liquidity in the financial system by the private and government sectors, further ease to relieve the financial stability pressures.

4.6 Fiscal sector

The fiscal performance is expected to improve in the second half of 2025/26. Despite close to 40 percent spending of the annual budget being spent during the first half, the capital spending remained dismal, averaging about 12 percent. However, the spending has been expected to boost post-election, nearing the budgeted spending at the end of the fiscal year. The government has initiated couple of reforms, in both spending and revenue, which has already reflected in the revenue mobilization. Thus it is expected to meet the revenue target, while the spending will also near its target.

4.7 Key Assumptions of the Projections/Outlook

The key assumptions of the forecasts are based on the baseline scenario and the forecasts without additional shocks. The subdued inflationary pressure is expected to continue, with the smoothing geopolitical tensions, and supply channels. The timely election and formation of a stable government is assumed to expedite the reconstruction, capital spending and strengthening the investment climate. The continuation of the trend of the current account variables is assumed at the existing state, without further trade tensions and supply disruptions.

4.8 Risks to the Outlook

Risks to growth

Growing geopolitical tensions are heightening global policy and trade uncertainty. The protracted Russia–Ukraine conflict, recent tensions between the United States and Venezuela, and political and social unrest in Iran underscore a rapidly evolving global security environment. These developments carry significant implications for global commodity markets, particularly crude oil prices, with potential spillovers to inflation, external balances, and economic growth. For Nepal, as a net importer of energy and other essential commodities, elevated and volatile global prices could increase import costs, exert upward pressure on domestic inflation, and strain the balance of payments. Persistently high energy prices may quickly translate to inflationary pressure and also dampen domestic demand and investment,

thereby posing downside risks to the growth outlook. Furthermore, since Nepal is passing through a political transition, a successful election and formation of the stable government is a fundamental factor to achieve the forecasted growth.

Risks to inflation

Nepal's price dynamics are deeply integrated with those of India; consequently, price movements in the Indian market are easily transmitted to Nepal. India is a net importer of crude oil, and geopolitical tensions in major crude oil–exporting countries are likely to exert upward pressure on global oil prices, which could translate into higher prices in the Indian market. Given the deep market integration and the pegged exchange rate regime between Nepal and India, such price pressures are quickly transmitted to Nepal through trade and cost channels. As a result, elevated global commodity prices—particularly energy—are likely to exert upward pressure on domestic inflation in Nepal, posing risks to price stability. Since Nepal is having its early election for federal parliament, it might affect both the demand for and supply of goods and services. Its impact to prices depends upon multiple factors, like the administrative efficiency of market monitoring, peaceful elections and post-election settlements.

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Appendix 1 Macroeconomic Report (MER) Team

	Name	Function
MER Facilitators	Directors Madhav Dangal Satyendra Raj Subedi	Provide necessary facilitation and guidance for MER preparation and publication.
MER Coordinator	Deputy Director Dr. Guna Raj Bhatta	Final Draft Writing: Coordinate MER preparation team, Intensive editing of the MER to this shape.
Drafting Team	Deputy Director Dr. Guna Raj Bhatta & Assistant Director Debakee Chaulagain – Fiscal sector. Deputy Director Sona Rana – External sector. Assistant Director Rohan Byanjankar – Real sector. Assistant Director Victor Kumar Sapkota – Monetary and financial sector. Further Support of Monetary and Capital Market Division Staffs with their contribution order: Assistant Directors Aditya Pokhrel, Ashmita Dahal and Narendra Raj Paneru.	