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Economic Stability and Central Banking in Nepal: Achievements and Future Directions

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ABSTRACT

Nepal initiated major policy reforms in the mid-1980s to address a severe Balance of Payments crisis, receiving support from the IMF and the World Bank through their economic stabilization and structural adjustment programs. The reform journey accelerated in the early 1990s with liberalization and privatization following the restoration of multi-party democracy. In the early 2000s, after distress in two large government-owned banks, a comprehensive financial sector reform program was launched with assistance from the World Bank. This program included rescuing the two banks and re-engineering Nepal Rastra Bank (NRB), which was granted greater autonomy under the NRB Act of 2002.

Nepal has achieved substantial progress in reducing poverty, expanding financial inclusion, and improving access to basic services, all within a generally stable macroeconomic environment. Strengthening the financial sector has improved credit intermediation and payment systems. Together, these factors have driven steady advances in inclusive development.

The NRB has effectively guided the orderly expansion of the banking system through sound licensing, consolidation reforms, and market development. Its focus on risk-based supervision and enhanced prudential standards has strengthened the soundness and resilience of institutions. Ongoing improvements in regulation, governance, and compliance have helped mitigate systemic risks. This balanced approach has not only supported sectoral growth but also ensured stability.

Macroeconomic stability helps anchor inflation expectations and build investor confidence, laying a foundation for sustainable growth. However, stability alone does not guarantee widespread prosperity; it must be supported by structural reforms that enhance productivity. Investments in infrastructure, human capital, and governance are crucial to this process. Therefore, to achieve lasting and inclusive growth, stability must be accompanied by effective development and financial sector policies.

KEYWORDS
Structural Adjustment Policy, Macroeconomic Management, Financial Stability

JEL CLASSIFICATION
E58, E63, O11

1. Structural adjustment program, policy reforms, and key lessons

In the mid-1980s, Nepal implemented significant policy reforms to address a severe balance-of-payments crisis, receiving assistance from the IMF and the World Bank through their economic stabilization and structural adjustment programs. The country faced growing fiscal deficits, decreasing foreign reserves, and pressures on its balance of payments,

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alongside stagnant exports and limited private investment due to an inward-looking import-substitution framework. In 1986, Nepal officially began stabilization and adjustment measures, supported by the IMF and World Bank, to restore macroeconomic stability and liberalize its economy. The implementation of these measures continued and accelerated after the political changes of 1990-1991 and under the Extended and Enhanced Structural Adjustment Facilities provided by the World Bank and IMF in the early 1990s.

1.1 Economic Stabilization and Structural Adjustment in Nepal (1985–1997)

In response to macroeconomic imbalances, Nepal launched an IMF-supported stabilization program in 1985/86, followed by a comprehensive structural adjustment program from 1987 to 1997. This was carried out under the IMF's Structural Adjustment Facility and Enhanced Structural Adjustment Facility, as well as the World Bank's Structural Adjustment Credits. The primary goals of these initiatives were to restore macroeconomic stability, liberalize markets, correct price and incentive distortions, strengthen the balance of payments, and modernize both the public and financial sectors.

1.2 Pre-Crisis Macroeconomic Conditions (Early 1980s)

By the early 1980s, Nepal was grappling with several interconnected economic challenges. The fiscal deficit had widened to approximately 8.5 percent of GDP by the fiscal year 1984/85, as government spending increased at a faster rate than revenue, which remained low at around 9 to 10 percent of GDP. Inflation surged past 16 percent due to drought conditions and supply disruptions. The external sector also experienced a severe decline, with the current account deficit nearing 10 percent of GDP and foreign exchange reserves dwindling to just 2.6 months' worth of imports. Furthermore, pervasive structural rigidities contributed to the crisis, including inefficient state-owned enterprises, controlled prices, import licensing restrictions, and a fixed exchange rate regime that led to an overvalued currency and diminished competitiveness (World Bank, 1990; Acharya et al., 2003; Acharya, 2000).

1.3 Stabilization Program (1985–1987)

In response, the Government of Nepal launched an IMF-supported stabilization program starting in the fiscal year 1985/86. The key components of this program included fiscal consolidation through improved tax administration, price adjustments for petroleum, utilities, and public enterprises, as well as stricter control of government spending. Monetary policy aimed to restrict the growth of reserve money by limiting Nepal Rastra Bank (NRB) credit to the government and state-owned enterprises (SOEs). On the external front, the Nepalese rupee was devalued by approximately 15 percent in 1985. The initial trade reforms involved simplifying tariffs and reducing certain quantitative restrictions.

1.4 Early Stabilization Results

These measures stabilized the economy but did not transform its structure. The fiscal deficit declined to approximately 6 percent of GDP, inflation fell below 10 percent, and reserves improved to about 3.5 months' worth of imports. However, without deeper reforms in production, finance, and the operations of public enterprises, these gains remained fragile. This situation provided the justification for the long-term structural adjustment program that began in 1987 (World Bank, 1990).

1.5 Structural Adjustment Program (1987–1997)

The Structural Adjustment Program lasted almost a decade and was supported by three structural credits from the World Bank and two concessional facilities from the IMF. The reforms were structured around three main pillars: the liberalization of trade and industry, modernization of the financial sector, and the restructuring of public enterprises, along with enhancements in public expenditure management.

1.6 Trade & Industrial Liberalization

Nepal implemented one of the most significant tariff reform programs in South Asia. Previously, tariffs varied from zero to over 200 percent, accompanied by extensive licensing requirements. By the mid-1990s, the maximum tariff rates were reduced to around 40 percent, and over 80 percent of import licenses were eliminated. Export taxes were removed, and facilities such as duty-drawback and bonded warehouses were established to support exporters. The 1992 Industrial Enterprises Act simplified the approval process for domestic and foreign investments. As a result, exports grew by approximately 9 to 10 percent per year; however, they remained heavily concentrated in carpets and garments, which limited economic resilience.

1.7 Exchange Rate & External Sector Reforms

Exchange reforms worked in tandem with trade liberalization, leading to a gradual shift of the rupee from a strict peg to a system of managed flexibility. Current-account transactions were liberalized, and foreign exchange auctions were briefly implemented. Although depreciation improved competitiveness in the late 1980s, inflation differentials led to appreciation in the early 1990s. During this time, remittance inflows remained below 3 percent of GDP, making export performance the primary driver of external adjustment.

1.8 Financial Sector Reform

Financial reform aimed to modernize monetary policy and enhance banking supervision. By 1989, interest rates were liberalized, and amendments to the NRB Act increased both policy autonomy and supervisory authority. Directed credit programs were reduced, allowing private banks to enter the market, which raised competition and improved fi-

nancial intermediation. Consequently, financial depth increased, with M2 rising from about 30 percent to 45 percent of GDP. However, the two dominant state banks continued to struggle with high levels of non-performing loans, exceeding 25 percent, which constrained overall credit efficiency.

1.9 Public Sector and SOE Reform

Public sector reform in Nepal focused on addressing the country's numerous loss-making state-owned enterprises (SOEs). Changes were made to tariffs for utilities and petroleum and some manufacturing companies were privatized. Budget priorities were redirected towards primary education, healthcare, and rural infrastructure. Although efficiency improved in certain areas, weak governance and underdeveloped markets restricted the effectiveness of privatization efforts, and significant losses continued in strategic enterprises.

1.10 Macroeconomic Outcomes (1987-1997)

Overall macro performance improved under adjustment. GDP growth averaged about 4.8 percent, higher than earlier decades but still volatile and heavily dependent on agriculture, which remained near 40 percent of GDP. Revenue mobilization strengthened to around 12.5 percent of GDP, keeping deficits contained near 5 to 6 percent. Inflation was generally moderate, and foreign reserves rose significantly to around six to seven months of imports by the mid-1990s.

1.11 Social & Structural Outcomes

Despite some improvements in macroeconomic stability, poverty reduction was still limited. Surveys from the early 1990s showed that over 40 percent of the population lived in poverty. This situation was largely due to weak job creation outside of agriculture and insufficient diversification in exports. Additionally, shortages in infrastructure and limited industrial capacity hindered deeper structural transformation.

1.12 Lessons for Central Banking & Policy

Nepal's experience provides three important lessons for central banks:

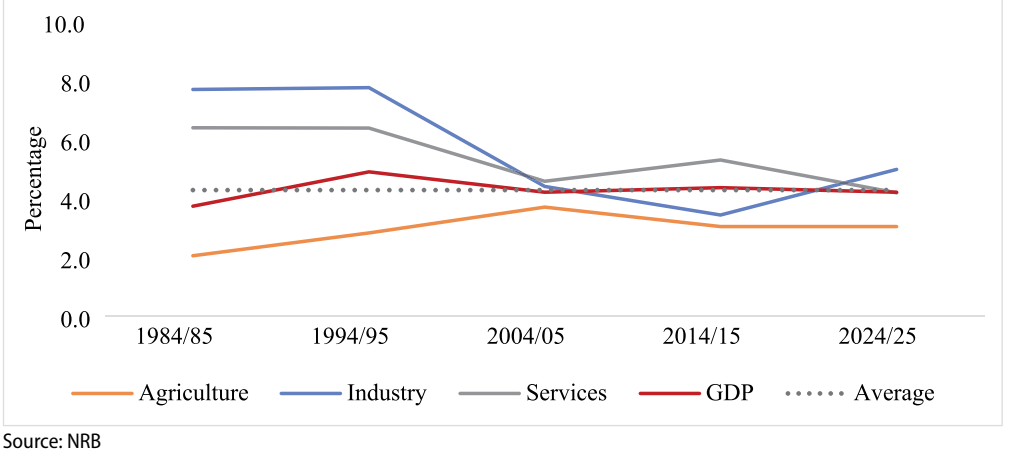
1. Macro stabilization must go hand in hand with reforms in the real sector and productivity to achieve lasting benefits.
2. Liberalization, in the absence of strong institutions, yields only limited advantages; effective supervision and governance are crucial.
3. Coordinating monetary and fiscal policies is essential, especially in a pegged exchange rate environment where the actions of the central bank must align with fiscal discipline.

1.13 Stabilization achieved – Transformation incomplete

In conclusion, Nepal's stabilization and structural adjustment programs successfully restored macroeconomic stability, liberalized markets, and modernized policy institutions. However, incomplete implementation and existing structural constraints hindered significant transformation in production and exports. These lessons are important for informing future program designs and enhancing central bank policy coordination.

2. Stable Decadal Growth Pattern

The long-run average GDP growth stood at 4.3 percent. Growth was higher during mid-1980s to mid 1990s whereas the following decade saw a lower growth due to Maoist conflict. Over the past decade, Nepal's economic growth has shown a relatively stable pattern, particularly when compared to other low-income and post-conflict economies. The growth rate has fluctuated within a moderate band, supported largely by service-sector expansion and strong consumption demand supported by inflow of remittances (Figure 1). On the demand side, consumption constitutes more than 85 percent of GDP in this decade.



Source: NRB

Figure 1: GDP and Sectoral Growth

However, the stability masks underlying structural issues. Productivity growth remains low, manufacturing contributions continue to decline, and much of the consumption-led growth is not supported by a strong domestic production base. This raises questions about how sustainable this stable growth pattern actually is.

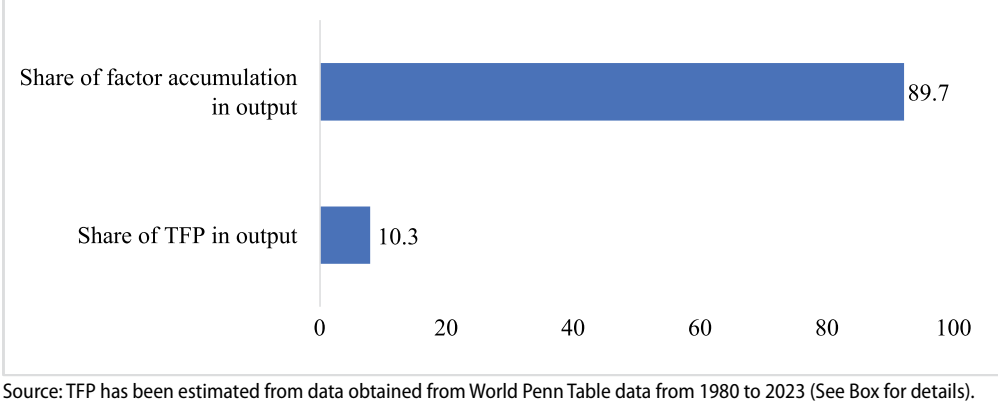
2.1 Contribution of TFP is low

Total factor productivity share in output is one of the lowest in the world (Figure 2) (The World Bank, October 2023). The productivity of labor and capital has not improved significantly, suggesting that growth has been driven more by the accumulation of resources and increased consumption rather than by technological advancements, innovation, or improvements in institutional efficiency.

Key constraints include:

- Low levels of mechanization and technological adoption, especially in agriculture.
- Small firm sizes and informality inhibiting economies of scale.
- Inadequate infrastructure—although notable improvements in electricity reliability have been observed since 2017.
- Weak innovation ecosystems and limited R&D activity.

Energy availability has recently improved due to the expansion of hydropower capacity, potentially lifting productivity in the medium term.



Source: TFP has been estimated from data obtained from World Penn Table data from 1980 to 2023 (See Box for details).

Figure 2: Total Factor Productivity (TFP)

Box: Methodology to estimate Total Factor Productivity

This study estimates Nepal's Total Factor Productivity (TFP) over the period 1980–2023 using the Penn World Tables version 11.0 (PWT 11.0). TFP, commonly referred to as the Solow residual, measures the portion of economic growth that cannot be explained by increases in physical capital and labour inputs and is therefore interpreted as reflecting improvements in efficiency, technology, institutions, and resource allocation.

The analysis adopts a standard Cobb–Douglas production function:

$$Y_t = A_t K_t^{\alpha} L_t^{1-\alpha}$$

where Y_t denotes real output, K_t is physical capital stock, L_t represents quality-adjusted labour input, and A_t denotes TFP. Consistent with the growth-accounting literature, the capital share parameter is fixed at $\alpha = 0.35$, implying a labour share of 0.65.

Real GDP data are obtained from the output-side GDP series (rgdpo) in PWT 11.0, while labour input is constructed as:

$$L_t = emp_t \times hc_t$$

The human capital index incorporates educational attainment and Mincerian returns

to schooling, thereby capturing both the quantity and quality dimensions of labour.

Because PWT does not report a capital stock series for Nepal, the study estimates capital stock using the Perpetual Inventory Method (PIM):

$$K_t = (1 - \delta_t) K_{t-1} + I_t$$

where K_t is the real capital stock at the end of period t, δ_t is the depreciation rate drawn from the PWT variable delta, and I_t is real gross investment computed as:

$$I_t = csh_{i,t} \times Y_t$$

Any observations with missing δ_t are replaced by the standard assumption $\delta = 0.04$ (four per cent), consistent with the value commonly applied in the literature for developing economies (King and Levine, 1994).

The initial capital stock is derived using the steady-state approach:

$$K_0 = I_0 / (g + \delta_0)$$

where I_0 is real investment in the initial year (1980), δ_0 is the depreciation rate in the initial year, and g is the sample-average real GDP growth rate computed as:

$$g = (1/T) \Sigma_{t=1}^{n} \Delta \ln Y_t$$

TFP is then calculated as the Solow residual:

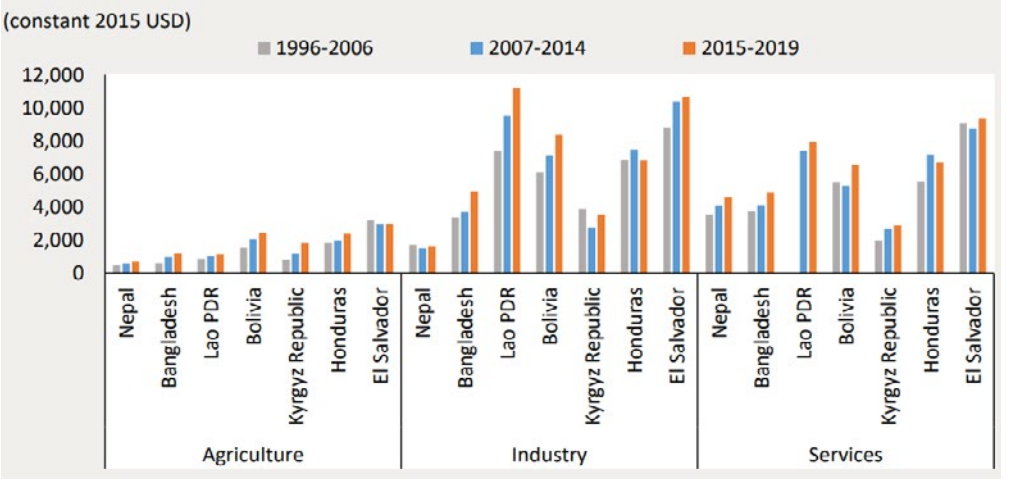
$$A_t = Y_t / (K_t^{\alpha} \times L_t^{1-\alpha})$$

A TFP index is subsequently constructed with 1980 as the base year (=100). Economic growth is decomposed into the contributions of capital accumulation, labour input growth, and TFP growth using standard growth-accounting techniques.

The methodology has several limitations. The assumption of a constant capital share may not fully capture structural changes in the Nepalese economy, while the PIM approach is sensitive to the initial capital-stock estimate. In addition, the human capital index relies on international estimates of returns to schooling rather than Nepal-specific estimates. Nevertheless, the framework provides a transparent and internationally comparable measure of Nepal's productivity dynamics over the long run. Alternative approaches to estimate TFP include using AK type or endogenous growth models.

2.2 Labour productivity

Nepal suffers from a considerable labor productivity deficit compared to its regional and structural peers, and the gap to India widened (Figure 3). It is especially striking in the agriculture and industry sectors, where Nepal's productivity is lower than in any other peer country. In the industry sector, the average Nepali worker adds less than one-third of what the workers in peer countries add on average. The value added by an industrial worker in Nepal is less than half of that of a domestic service worker.

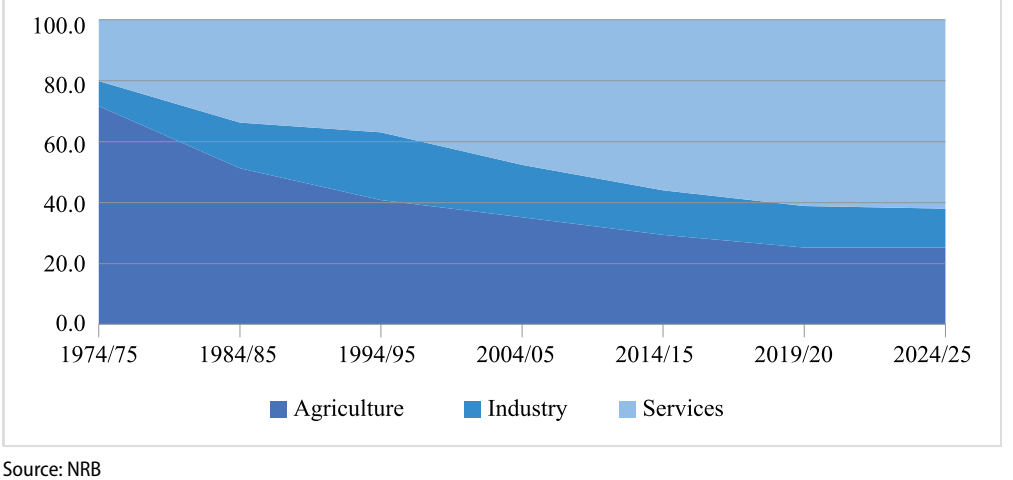


Source: Nepal Development Update, World Bank, 2023

Figure 3: Labour Productivity

2.3 Premature deindustrialization/jobless growth

Nepal is experiencing what economists refer to as 'premature deindustrialization', a situation in which the manufacturing sector starts shrinking at a very early stage of development, long before reaching the industrial peak seen in advanced economies and a phenomenon seen in other South Asian countries as well (Rodrik, 2016). In Nepal's case, manufacturing's share of GDP has been falling for years, despite the economy being far below the per-capita income threshold at which such declines are typically observed. This trend is concerning because manufacturing is traditionally the engine of job creation, export growth, and productivity improvement.

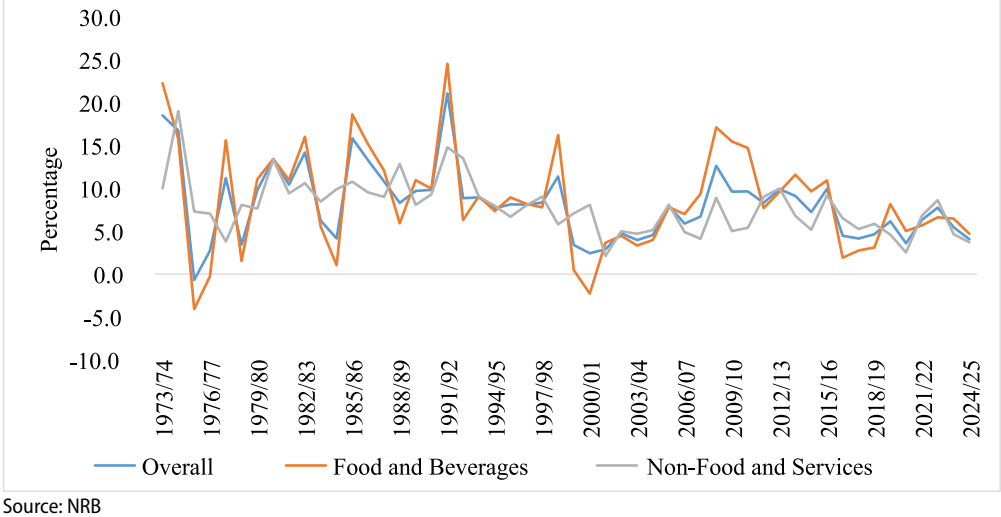


Source: NRB

Figure 4: Sectoral shares in GDP

2.4 Inflation is gradually easing out

Higher fluctuations in inflation were observed before 1993. The spikes in these years are attributable to revisiting and updating the peg exchange rate. Since 1993, peg with India is stable at 1 INR is equivalent to 1.6 Nepalese rupee. Moreover, trade concentration with India expanded since 1993 with about 65 percent trade share in 2025 from about 30 percent in 1990. The stable peg and high trade concentration with India is one of the prime reasons for stable inflation in Nepal.



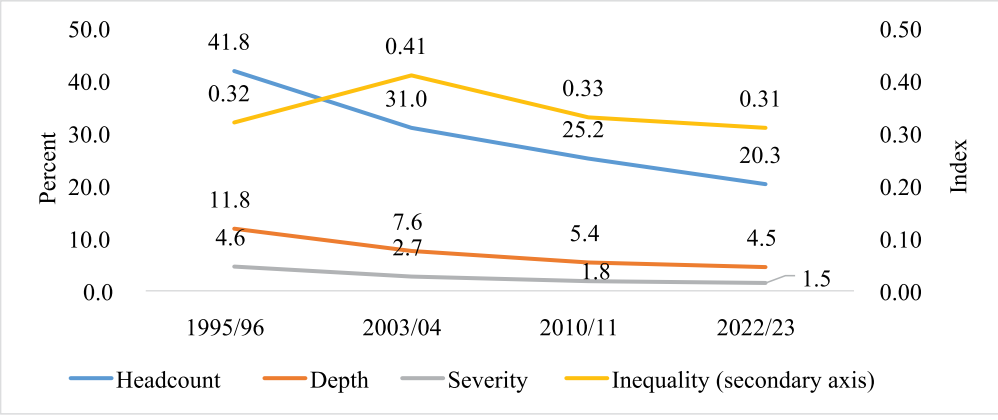
Source: NRB

Figure 5: Inflation trend

2.5 Poverty and Inequality are declining

One of Nepal's success stories in recent decades has been the remarkable decline in poverty and the gradual reduction in inequality.

However, this improvement is largely consumption-driven due to remittances rather than productivity-driven. Poverty reduction is not emerging from structural shifts in sectors like manufacturing or agriculture but rather from remittance-supported household spending. While inequality has decreased in aggregate terms, vulnerability remains high. Many households can fall back into poverty with even mild shocks–such as health expenditures, job loss abroad, or climatic events.



Source: Nepal Living Standard Surveys, Nepal Statistical Office (previously Central Bureau of Statistics)

Figure 5: Poverty and Inequality

2.6 Imports and exports as percent of GDP

Trajectory of imports and exports as per of GDP exhibits crucial macroeconomic development of Nepal (Figure 6).

Nepal's trade structure is heavily imbalanced. Imports as a percentage of GDP are exceptionally high for an economy of our size and level of development, whereas exports have remained stagnant or even declined relative to GDP.

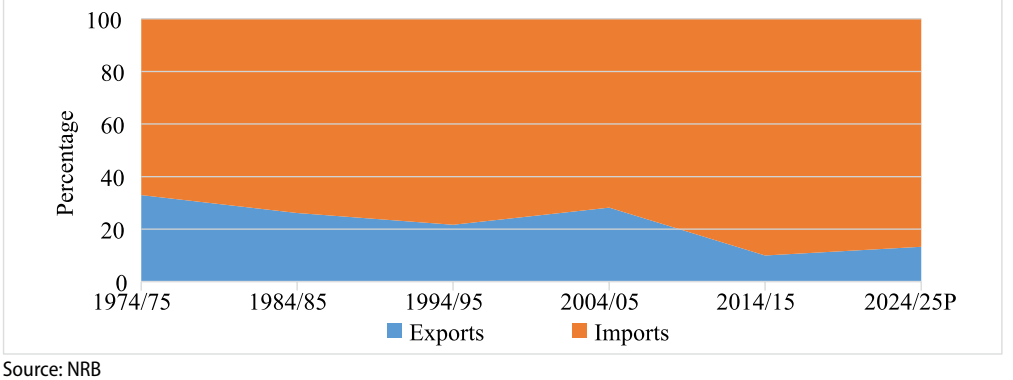
Source: NRB

Figure 6: Exports and Imports Share in GDP

This imbalance indicates a structural weakness: domestic industries cannot meet domestic demand, resulting in heavy reliance on imports. Nepal imports almost everything–from raw materials to essential goods to capital equipment–which exposes the economy to external price fluctuations and foreign exchange risk. Exports, on the other hand, remain narrow and concentrated in a few products with low value addition. Limited diversification, high production costs, and poor international competitiveness restrict Nepal's ability to generate foreign exchange through exports.

2.7 Imports expanding while exports shrinking

This section highlights a concerning divergence: while imports continue to expand rapidly, exports are shrinking or growing far too slowly to keep pace with imports (Figure 7).



Source: NRB

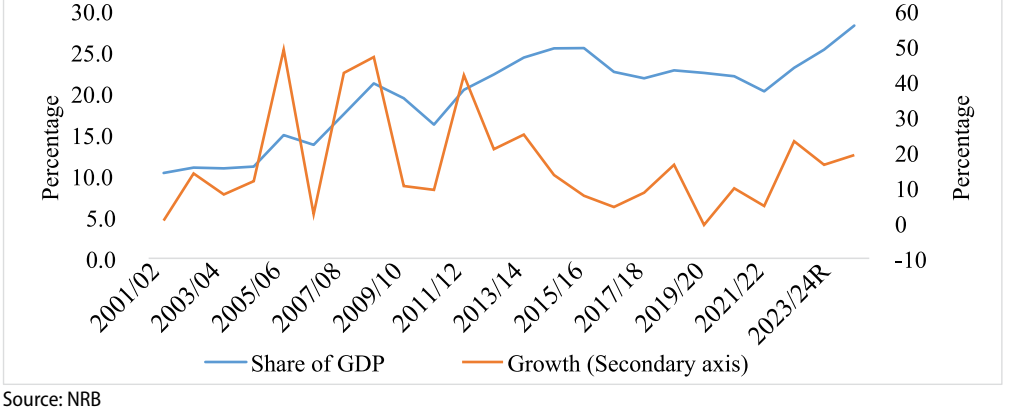
Figure 7: Exports and Imports

Import growth is driven by rising consumption, infrastructure needs, and the increasing aspiration levels of households supported by remittances. Meanwhile, structural constraints–like weak industrial capacity, high cost of production, and limited innovation–continue to hold back export growth.

The widening trade deficit puts pressure on the foreign exchange regime and limits the scope of monetary and fiscal policy. Over the long term, sustained import expansion without a corresponding export base erodes economic resilience and increases dependence on remittances and external financing.

2.8 Remittances to GDP ratio consistently rising

Remittances have become one of the most dominant macroeconomic forces in Nepal. The remittances-to-GDP ratio has been rising steadily, making Nepal one of the most remittance-dependent economies in the world.



Source: NRB

Figure 8: Remittance and GDP Growth

These inflows support household consumption, reduce poverty, stabilize foreign exchange reserves, and help finance the massive import bill. However, this reliance comes with significant risks:

- First, External shocks–like changes in Gulf labor markets–can severely affect Nepal's economy.
- Second, Remittances discourage labor participation domestically, creating shortages in key sectors like agriculture and manufacturing.
- Third, they can contribute to real exchange rate appreciation, making exports less competitive (a classic Dutch disease effect).
- Fourth, Growth becomes decoupled from domestic production, making the economy structurally fragile.

Thus, remittances stabilize the economy in the short term but create long-term vulnerabilities.

2.9 Public Debt

The total amount of government debt has increased rapidly, rising by nearly 70 percent over five years to NPR 2.43 trillion by FY2023/24. A significant structural change has occurred with a shift towards domestic borrowing, which has increased its share from about 43 percent to nearly 50 percent of the total debt. Although total borrowing remains moderate by international standards, domestic debt tends to be more expensive and has shorter maturities.

On the external side, Nepal's obligations are primarily with concessional multilateral lenders, with almost 50 percent from the International Development Association (IDA) and 32 percent from the Asian Development Bank (ADB). This concessional borrowing helps keep coupon rates low and maturities long, which in turn helps manage debt service ratios.

Nepal's most recent joint Debt Sustainability Analysis (DSA) conducted by the IMF and World Bank confirms that, despite the increasing public debt, the country remains at low risk of debt distress (IDA/IMF, 2020). Total government debt is approximately 42.7 percent of GDP, with interest payments making up about 1.45 percent of GDP and an average effective interest rate of only 3.4 percent, reflecting the concessional nature of external borrowing.

While external stability has improved, the main macroeconomic vulnerability lies in the relationship between fiscal deficits, increasing domestic borrowing, and rollover risk. These factors characterize Nepal's current macroeconomic environment as stable but increasingly sensitive to medium-term shocks.

2.10 Stability vs Sustainability/Resilience

The central message is that while Nepal shows relative macroeconomic stability, the deeper question is whether this stability is sustainable in the long run.

On the positive side, GDP growth has remained stable and inflation has been relatively contained.

Foreign exchange reserves are often supported by remittance inflows, and fiscal stability has been maintained through customs revenue.

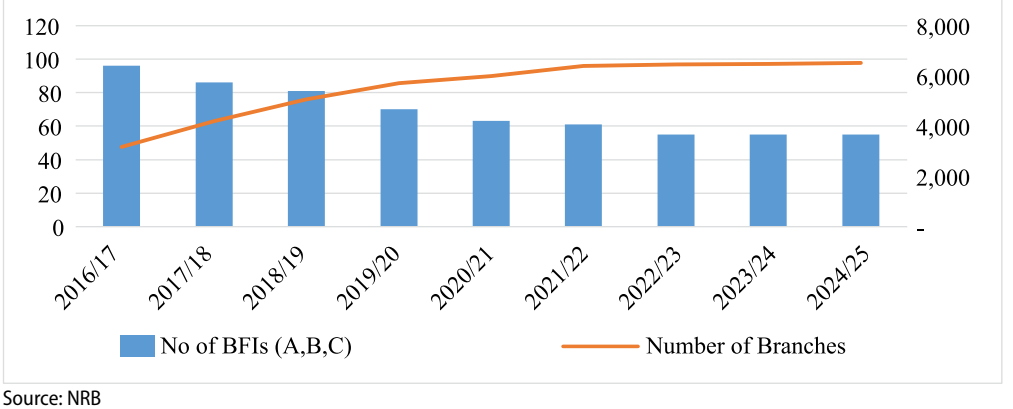
However, sustainability is undermined by several structural constraints as mentioned earlier: Premature deindustrialization, rising dependence on remittances, import-led growth rather than driven by domestic production or exports, on the fiscal side, Government revenue is overly dependent on customs and import-related taxes.

3. Nepal's Financial Sector: Four Decades of Transformation, Stability, and Future Challenges (Mid-1980s–2025)

Over the past forty years, Nepal's financial sector has undergone a significant transformation. We have transitioned from a small, state-dominated system in the 1980s to a diversified, bank-led financial system characterized by extensive physical and digital outreach, strong remittance intermediation, and increasingly sophisticated regulatory oversight.

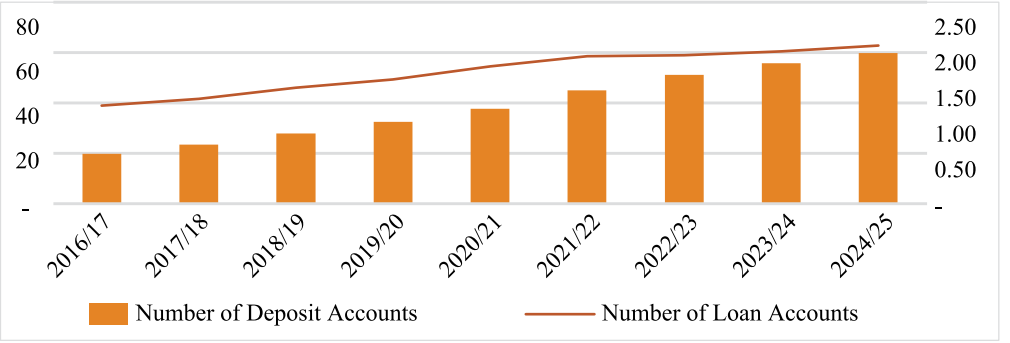
3.1 Structural evolution of the sector

Nepal's financial liberalization began in the late 1980s, transitioning from a monopolistic state banking system to a market-oriented competitive environment. In the 1990s, the country licensed private commercial banks, development banks, and finance companies, which led to a significant increase in financial intermediation and the expansion of branch networks. The post-conflict years further accelerated financial inclusion, particularly through microfinance.



Source: NRB

Figure 9: Banks and Financial Institutions' Branches



Source: NRB

Figure 10: Financial Service Usage (In million)

Since the 2015 earthquake and the COVID-19 pandemic, the financial system has entered a phase of consolidation and modernization.

3.2 Financial soundness indicators

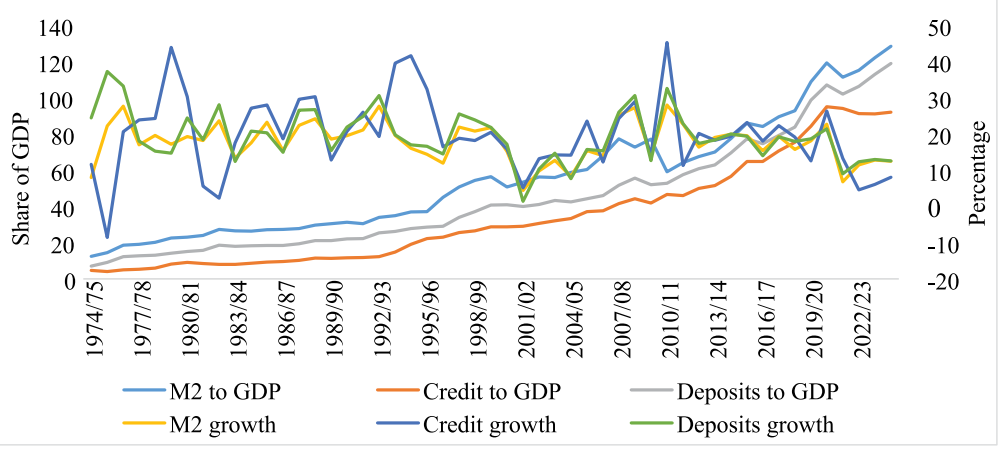
Financial stability indicators are generally adequate, though there are signs of emerging pressures. Non-performing loan (NPL) ratios, which had improved during much of the late 2010s, rose again following the COVID-19 pandemic and the slowdown in domestic demand, approaching four percent systemwide by mid-2024. The weaknesses are mostly concentrated in smaller finance companies, cooperatives, and specific sectoral loan portfolios.

Capitalization remains broadly comfortable, with overall capital adequacy near thirteen percent, though the buffers vary significantly across different institutions. Profitability at the system level continues to be positive, supported by interest spreads; however, provisioning needs and slower lending growth have narrowed profit margins.

Liquidity conditions are significantly bolstered by stable remittance inflows, although funding is heavily reliant on short-term deposits, creating a risk of maturity transformation.

3.3 Trend and growth of monetary indicators

The figure illustrates three steady financial deepening ratios–M2/GDP, Deposits/GDP, and Credit/GDP–showing an upward trend over time, alongside three highly volatile growth rates for M2, deposits, and credit. Both broad money and deposits as a percentage of GDP have increased steadily, reflecting Nepal's long-term monetization driven by remittance inflows, expanded banking services, and growing formal savings. In contrast, the Credit/GDP ratio rises in uneven increments because credit growth is the most volatile of the three measures, exhibiting pronounced boom-bust cycles that consistently outpace the growth of both deposits and M2.



Source: NRB

Figure 11: Trend and Growth of Monetary Indicators

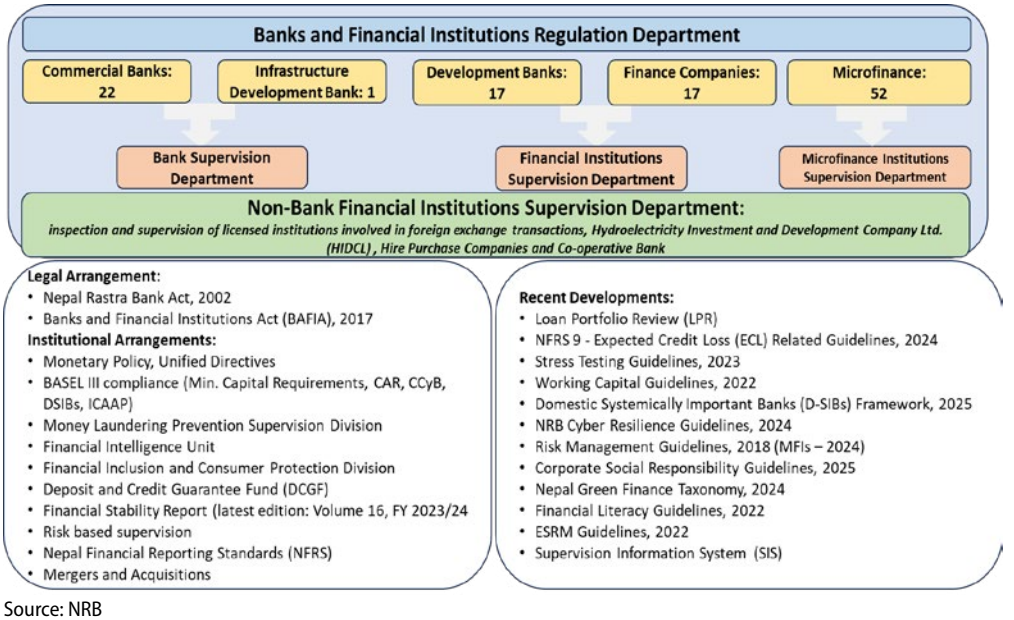
When credit growth outstrips deposit growth for several consecutive periods, the Credit/GDP ratio increases, while liquidity tightens, leading to sharp slowdowns in lending. This pattern is a typical of Nepal's stop-go credit cycle. M2 growth tends to fall between the growth rates of deposits and credit, acting as a framework within which leverage expands. This indicates that while broad liquidity creation facilitates credit surges, it does not impose discipline on them.

From a policy perspective, the chart conveys two key messages: first, Nepal has achieved significant financial deepening, demonstrating an increasing capacity for formal financial intermediation; second, this deepening has been achieved through procyclical leverage rather than smooth, structural expansion, resulting in recurrent liquidity strains and the buildup of risk. Therefore, stabilization depends on aligning credit expansion more closely with the pace of deposit mobilization and broad money growth.

For the Nepal Rastra Bank (NRB), the crucial operational lesson is to use the divergence between credit growth and the growth of deposits/M2 as an early-warning indicator. This can help calibrate macroprudential tightening, liquidity sterilization, and sectoral risk weights, with the aim of transitioning from boom-bust financial cycles to steady, sustainable financial deepening that supports real investment without accumulating systemic risk.

3.4 Regulation and Supervision: towards less regulation and more supervision

As of mid-October 2025, the Nepal Rastra Bank oversees a consolidated financial system comprising 107 licensed institutions including commercial banks, development banks, finance companies and microfinance institutions, and 1 infrastructure development bank (Figure 12). Supervision is functionally specialized: the Bank Supervision Department manages commercial and infrastructure banks through off-site surveillance, utilizes the Supervisory Information System, and conducts risk-based on-site inspections.



Source: NRB

Figure 12: Structure and evolution of Financial Sector

The legal foundation for this oversight is established by the NRB Act of 2002 and the Bank and Financial Institution Act (BAFIA) of 2017. Prudential oversight adheres to Basel III standards. Bank-level risk governance is integrated through the Internal Capital Adequacy Assessment Process (ICAAP) within a Risk-Based Supervision regime.

Financial reporting is aligned with the Nepal Financial Reporting Standards (NFRS). Consumer protection and financial inclusion are managed through dedicated institutional arrangements.

Recent enhancements to the financial system include forward-looking Loan Portfolio Reviews and provisions related to Expected Credit Loss under NFRS-9. Mandatory stress testing was introduced in 2023, along with standardized Working Capital Guidelines to limit circular lending. Updated Risk Management Guidelines, including those for microfinance institutions, and the introduction of cyber resilience standards through the Supervision Information System have also been implemented. Additionally, climate risk integration has advanced through the Green Finance Taxonomy and Environmental and Social Risk Management (ESRM) Guidelines. Governance standards have been further strengthened through initiatives on Corporate Social Responsibility (CSR) and Financial Literacy.

3.5 Key vulnerabilities

Despite measurable progress, vulnerabilities still exist. Credit portfolios continue to be heavily concentrated in trade, real estate, and related activities, which raises concerns about cyclicality risks. Domestic savings remain structurally weak, making credit expansion reliant on volatile remittance-related deposits. Maturity mismatches persist, with

banks funding long-term housing and project loans primarily through short-term deposits. Governance issues are still significant in some segments of the cooperative and finance company sectors, complicating supervisory enforcement. Additionally, Nepal's shallow capital markets limit the availability of genuine long-term funding, forcing banks to take on project finance risks that do not fit their liability structures well. Lastly, the increasing digitalization of financial services raises systemic operational and cyber risks, which are only partially addressed by the current supervisory frameworks.

3.6 Financial Stability

Asset quality has sharply deteriorated, with the non-performing loan (NPL) ratio rising to 4.62 percent by July 2025, up from 1.3 percent in mid-2022–a more than threefold increase. Despite an excess liquidity of approximately NPR 1,000 billion, credit demand remains weak, and lending rates are historically low, indicating impaired monetary transmission.

Market concentration increases vulnerability, as deposits amount to roughly 123 percent of GDP and private credit accounts for 93 percent of GDP. The shallow government securities market further limits diversification and long-term financing alternatives. Nepal's status on the FATF grey list reflects compliance gaps in anti-money laundering (AML) and countering the financing of terrorism (CFT), raising correspondent banking risks and increasing costs for cross-border transactions.

Fragility in the cooperative sector presents contagion risk due to weak governance and regulatory oversight and arbitrage. Internally, the rising number of banking fraud cases highlights deficiencies in governance, internal controls, and digital security.

Operationally, elevated cyber threats target digital payments, while the growth of shadow banking challenges the effectiveness of macro-prudential measures. Additionally, financial misinformation increasingly undermines public trust, enabling fraud and market manipulation.

3.7 Financial sector: Way forward

The strategic direction is shifting from compliance-focused supervision to proactive cyber resilience and systemic risk management that aligns with global standards and sustainable finance objectives.

An integrated supervisory framework must cohesively combine macro-prudential oversight and micro-supervision. The deployment of SupTech is essential for enhancing early-warning detection, real-time compliance monitoring, and advanced risk analytics.

The strategic execution of the Second Financial Sector Development Strategy should drive reform momentum. Additionally, high-level inter-agency coordination among the Ministry of Finance, SEBON, NIA, CIB, and the Deposit Guarantee Fund is necessary to address cross-cutting risks, including financial crime and market abuse.

To resolve asset quality pressures, an institutionalized non-performing loans (NPL) management framework should be established, along with the creation of an Asset Management Company and continuous loan portfolio diagnostics. Liquidity management reforms must tackle transmission breakdowns to effectively channel surplus funds into productive investments.

Regulatory oversight of cooperatives needs to be strengthened to contain contagion risk and to integrate non-bank financial institutions (NBFIs) within the macro-prudential framework. Payment resilience should be bolstered by ensuring the full functionality of the National Payment Switch and implementing universal interoperability standards.

To counter escalating digital threats, advanced cyber defense that leverages AI-based anomaly detection is required. Lastly, governance reform should focus on transparency, accountability, digital controls, and the integration of environmental, social, and governance (ESG) principles, along with the active use of green finance tools and climate-linked liquidity facilities to build a resilient and sustainable financial system.

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