



Dispatches from The Hall of Ideas!

YEAR 02 | ISSUE 03 | APRIL, 2025

THE NEPALI ECONOMY AND THE PRIORITIES OF THE NEW GOVERNOR APPOINTEE*

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Nepal faces a series of problems. Banks have excess liquidity, growth has been stagnant, and private sector confidence is visibly low. It would be worthwhile to take a step back and analyse how we got here. I would argue that the year 2015 is a good starting point for that analysis. Two things happened that year. A devastating earthquake wreaked havoc across Nepal, and Nepal also promulgated a new constitution, significantly restructuring its governance apparatus to a federal one. It should not be surprising that the fundamental restructuring was a political settlement; Nepal was, after all, a fragile economy coming out of a civil conflict, and it desperately needed a viable political settlement.

Two things happened immediately afterwards. Nepal's debt increased—both to support its ambitious federal restructuring and also to rebuild post the earthquake. Because the decade-long deadlock over the new constitution had ended and the peace process was finally close to completion, the private sector became optimistic in its outlook. The reconstruction effort also significantly boosted

private sector optimism. That GDP growth of close to 7 per cent that followed should come as no surprise, then. From 2016-2019, Nepal prospered, and it was visibly apparent too. Demand was modest, private sector capital formation was high, and lending rates, as high as they had been, weren't a problem because returns were even higher.

But in 2019, things changed. The COVID pandemic, followed by restriction measures and the resulting disruptions to the supply chain, fundamentally altered the Nepali economy. For 12 months, people spent their lives in their homes. When restrictions were eased, demand suddenly increased, which provided a false signal to the private sector. In addition, the Nepal Rastra Bank had taken certain steps to limit the effects of the pandemic. Consequently, money was easily available. Refinancing facilities and loan deferral services extended to the private sector made it easier for them to sustain themselves coming out of the pandemic. But nearly everyone knew that these facilities would someday stop; they would have to be wound down.

I would argue that this was a critical juncture. The Nepal Rastra Bank had the crucial task of steering the economy, insofar as the steps it would take to unwind its previous policy stance would determine the course of the economy. In normal times,

* The text is an abridged and translated version of the April 2025 edition of Sambaad @ Samridhi. Sambaad @ Samridhi is a monthly discussion on contemporary issues held on the last Friday of each month. In this edition, C.A. Anal Raj Bhattarai shares his insights on Nepali Economy and the Priorities of the New Governor Appointee. The discussion was moderated by Robin Sitoula.

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perhaps the NRB would have taken gradual steps instead of sudden ones, but these weren't normal times. In the South Asian region, several countries faced problems, including but not limited to a foreign exchange reserve crisis. Debates regarding whether Nepal could suffer the same fate surfaced; to that end, the political class felt the need to act decisively. Through the Nepal Rastra Bank, it acted swiftly, unwinding previous policies taken, increasing the policy rate by around 2.5 percentage points, and ensuring foreign exchange reserves were adequate by placing import restrictions. The situation we find ourselves in today is a result of these factors.

In the post-COVID era, central banks globally have become stronger institutions, and Nepal is no exception. Extraordinary measures taken during and after the pandemic elevated the role of monetary policy as a primary tool for economic revival. As a result, the institutional clout of NRB has grown significantly. This isn't problematic in itself—central banks are meant to be powerful, given their mandate for price stability, economic growth, and employment generation. In Nepal's case, the mandate is narrower—limited to price stability and growth—but the prominence of the Governor's role has also acquired a political dimension.



Anyone following recent news will have noticed that public discourse has been dominated by speculation over who will be appointed as the next Governor of Nepal Rastra Bank (NRB). The obvious question is: why has this position become so important in recent years?

In past years, political attempts to dismiss sitting governors have been overturned by the Supreme Court, thereby affirming the autonomy and security of the office. Ironically, this very autonomy has fueled political interest in the post. Political actors now seek to “capture” the central bank—not to

remove governors arbitrarily, but to ensure their own influence is entrenched regardless of whether they are in power. The NRB, in this context, risks being perceived as a parallel government. Consequently, the appointment of the Governor has turned into a highly politicised affair, with parties hoping the appointee will safeguard their interests rather than fulfill an independent mandate.

This politicisation is even more concerning amid Nepal's visible economic slowdown, where effective monetary policy is more critical than ever. Yet, monetary policy today is not functioning as an effective economic instrument. The transmission of monetary policy—through interest rates, lending rates, exchange rates, and asset prices—remains weak across most channels.

Only the interest rate channel shows some effectiveness, largely because the NRB mandates commercial banks to invest in the short-term money market, thereby preserving its relevance. However, even here, market depth and breadth remain limited. The lending rate channel is ineffective, as policy rate changes barely influence commercial banks' lending rates. While rates have dropped recently, this is more due to excess liquidity in the banking system than central bank interventions. The exchange rate channel is naturally constrained due to Nepal's currency peg with India. And the asset price channel is practically non-functional, as evidenced by the underperforming stock market, despite low policy rates. Ideally, low interest rates should stimulate equity markets—clearly, that isn't happening in Nepal.

Given these limitations, it is unrealistic to expect the new Governor to single-handedly resolve Nepal's macroeconomic challenges. However, there are key priorities the new appointee must embrace.

1. Defend Institutional Independence

First and foremost is ensuring institutional independence. The NRB is, by design, an autonomous and technical body. Yet, the current process of appointing a Governor is politically compromised. If the appointee is beholden to a political party, it undermines public confidence in the currency and

the financial system. A truly independent central bank leadership is essential for macroeconomic stability, and restoring this independence must be the top priority.

2. Strengthen Monetary Transmission Mechanisms

Second, the new Governor must focus on enhancing the effectiveness of monetary policy transmission. Structural weaknesses in the financial system, such as a rigidly directed credit allocation system, prevent efficient policy implementation. For example, 40% of all bank lending is directed toward so-called "priority sectors" determined by the government. But channeling credit alone does not spur growth unless complementary factors—like human capital and infrastructure—are also addressed. A more holistic approach is needed to align credit flows with actual sectoral needs and developmental impact.

3. Tackle the Rising Threat of Non-Performing Assets (NPAs)

Finally, and perhaps most critically, is addressing the growing problem of non-performing assets in the banking sector. In the post-COVID recovery period, NRB imposed regulatory restrictions to prevent window-dressing and loan evergreening. These included tightened working capital rules and curbs on month-end credit surges. However, macroeconomic stagnation has weakened borrowers' ability to repay, pushing NPA ratios from below 1% to over 8% in some institutions—a stark indication of systemic fragility.

The new Governor must spearhead a comprehensive reform of the provisioning framework. This involves redefining asset classification norms and transitioning toward a risk-based model. Provisioning should be aligned with expected losses, considering metrics such as loss given default (LGD) and collateral coverage ratios. Such reforms are crucial to improve transparency, strengthen balance sheets, and safeguard the long-term health of the financial system.

