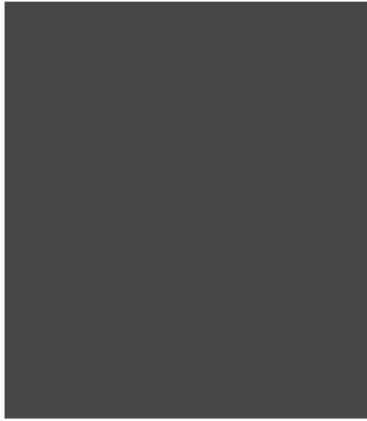


White Paper **2026**

Nepal's Economy
under the New Normal

Institute for Integrated
Development Studies (IIDS)

June 2026



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AN INSTITUTIONAL MILESTONE



On April 21, 2026, the Institute for Integrated Development Studies formally handed over the White Paper 2026: Nepal's Economy under the New Normal and A Development Strategy for Nepal to the Ministry of Finance at Singha Durbar, Kathmandu, marking a significant institutional milestone in IIDS's ongoing commitment to evidence-based policy engagement.

IIDS expresses its deepest appreciation to Honorable Finance Minister Dr. Swarnim Wagle for personally receiving these documents and for the thoughtful, substantive discussion that followed the presentation. His willingness to engage directly with an independent diagnostic of Nepal's structural economic challenges—and with the long-term strategic framework proposed in response—reflects a genuine commitment to grounded, evidence-informed policymaking. It is this kind of institutional openness that gives independent research its meaning and its purpose.

IIDS is equally grateful to the senior officials of the Ministry of Finance who attended the handover and participated in the discussion: Dr. Ghanshyam Upadhyaya, Finance Secretary; Mr. Bhupal Baral, Secretary – Revenue; Mr. Uttam Kumar Khatri, Joint Secretary – Revenue Management Division; and Dr. Suman Dahal, Joint Secretary – Budget and Programme Division. Their presence and engagement reflected the seriousness with which the Ministry of Finance received this work, and their insights during the discussion enriched the exchange considerably.

The IIDS delegation that presented and accompanied the handover comprised Dr. Biswash Gauchan, Executive Chair; Mr. Durga Prasad Bhattarai, Member of the Governing Council; Dr. Uttam Sharma, Research Lead; Mr. Akhilesh Upadhyay, Policy Lead – Strategic Affairs; Ms. Astha Bhatta, Program Specialist – Economics; Dr. Bijan Bhattarai, Program Specialist – Economics and Finance; and Mr. Amesh Pandey, Jr. Research Assistant – Economics.

WITH GRATITUDE



On May 25, 2026, the Institute for Integrated Development Studies (IIDS) presented its two flagship research outputs—White Paper 2026: Nepal's Economy under the New Normal and the Development Strategy for Vision 2100—to the National Planning Commission (NPC) at Singha Durbar, Kathmandu. This event marks a vital milestone in IIDS's ongoing mission to bridge rigorous, evidence-based research with high-level national policy formulation.

IIDS expresses its deepest appreciation to Honorable Vice-Chairman Dr. Gunakar Bhatta for personally presiding over the session and for the warmth and seriousness with which the Commission received both documents. The institute is equally grateful to the Honorable Members and leadership of the NPC who actively participated in the extended policy dialogue: Dr. Devendra Gauchan, Prof. Dr. Sanjaya Acharya, Dr. Pukar Malla, Prof. Dr. Sudan Jha, Mr. Arjun Jung Thapa, Ms. Reshu Aryal Dhungana, and Member Secretary Mr. Rabibal Pantha, alongside the senior ministry secretaries present. Their sharp, systemic inquiries into formalizing the informal economy, navigating demographic transitions, realigning education investments, and dismantling rent-seeking structures greatly enriched the exchange and highlighted a shared institutional resolve to break Nepal out of its low-growth trap.

The IIDS delegation leading the presentation and handover was led by Dr. Biswash Gauchan accompanied by Dr. Bijan Bhattarai, Ms. Astha Bhatta, and Mr. Amesh Pandey. IIDS remains deeply encouraged by the NPC's open collaboration, reaffirming that independent research is vital to carving out local blueprints for Nepal's structural transformation.

FOREWORD

Political moments often reward optimism. Serious policy work, however, must anchor that optimism in structural reality. Nepal today faces a defining paradox: external stability and political opportunity coexist with deep underlying economic fragilities. For decades, remittance inflows, consumption-led growth, and land-driven financialization sustained the appearance of stability, even as productive capacity weakened, industrial transformation stagnated, and large segments of the country's human capital steadily migrated abroad. To honestly confront these structural constraints—whether the erosion of productive sectors, widening gaps in foundational STEM education, underutilized infrastructure, allocative inefficiencies, or a fiscal structure where debt servicing increasingly outpaces capital expenditure—is not to diminish Nepal's future. It is to take that future seriously enough to design a credible pathway toward it.

Sustainable transformation cannot be built on sentiment, short-term stability, or speculative growth alone. It requires clarity about the deeper structural forces shaping the economy and a willingness to transition from a model driven primarily by remittance-supported consumption and asset inflation toward one grounded in productive investment, domestic value creation, institutional efficiency, and human capital development. Only by seeing Nepal's present condition with honesty and precision can the country chart a durable path toward long-term prosperity, resilience, and structural transformation.

Founded in 1979 (2036 BS), the Institute for Integrated Development Studies (IIDS) has consistently engaged with Nepal's major economic and political inflection points, seeking not just to interpret change, but to anticipate and shape national conversations around governance, growth, and long-term prosperity. Through our flagship annual policy conclaves—centered on themes like “Structural Reform 2.0,” “Nepal Vision 2100,” and “Next Nepal: Reimagining Governance, Growth, and Equity”—IIDS has actively engaged with the vibrant, generational realities defining our country today. This White Paper builds directly upon these deliberations, offering a critical assessment of Nepal's “New Normal.” Over my tenure, we have sought to carry this legacy forward by connecting rigorous technical analysis with the lived experiences of ordinary citizens. Through our Niti Daudaha dialogues across Nepal and with the global Nepali diaspora, it has become clear that our national economic discourse must evolve past generic narratives of “unlimited possibilities” toward a more powerful framework: one of focused, strategic, and high-impact priorities.

This White Paper is born out of that aspiration. It serves as an evidence-based diagnostic foundation for a new Development Strategy—one that treats our challenges not as permanent barriers, but as solvable design problems. Recognizing where our resources are finite allows us to aggressively prioritize where Nepal can uniquely win in a rapidly shifting global economy.

True national transformation requires moving beyond slogans into a space of clarity, discipline, and long-term vision. Backed by a renewed public mandate, political stability, and a growing national recognition that our challenges require systemic change, there has never been a more opportune or hopeful moment to execute the deep upgrades that will unleash Nepal's true potential. IIDS presents this paper as a catalyst for the vital economic course corrections our nation is ready to achieve.

Dr. Biswash Gauchan, FCA

Executive Chair, IIDS

ACKNOWLEDGMENTS

The White Paper 2026 is the product of a sustained institutional effort spanning several months of research, analysis, deliberation, and iterative revision. It represents the collective contribution of the entire IIDS team, and would not have been possible without the dedication, expertise, and goodwill of the individuals acknowledged below.

The intellectual architecture of this report – its core diagnostic frameworks, the WFDD Tetrad, the Complacency Trap, land monetization as the organizing pathology of the economy, and the New Normal as an analytical lens – was developed under the overall leadership and guidance of Dr. Biswash Gauchan, Executive Chair and Director of the Center for Economic Policy at IIDS. The analytical content of the White Paper was authored by Dr. Biswash Gauchan and Dr. Bijan Bhattarai (Program Specialist, Economics and Finance), whose combined expertise in macroeconomics, financial sector dynamics, fiscal policy, and development economics shaped the depth and rigor of the analysis throughout.

The research and data team provided the empirical foundation without which this diagnostic would not carry the weight it does. The team acknowledges Dr. Topraj Gurung, Ms. Astha Bhatta, Mr. Zaky Khan, Mr. Nanda Kumar Maharjan, Ms. Sneha Ghimire, Mr. Shreesh Tripathi, Mr. Amesh Pandey, Ms. Aakriti Kafle, Mr. Karan Mahato, and Mr. Subin Adhikari for their contributions and consistent support.

Special thanks to Mr. Amesh Pandey for developing the visual identity of this White Paper.

The team also acknowledges Mr. Shashwat Pokharel and Mr. Arnav Pokharel for their support in proofreading the report.

The operational continuity of IIDS through the course of this project was anchored by Mr. Devendra Shrestha, Ms. Nikky Khadgi, and Mr. Hem Raj Joshi.

IIDS is grateful to Honorable Finance Minister Dr. Swarnim Wagle and his team at the Ministry of Finance for receiving this work with generosity and engagement, and for the discussion that followed the handover on April 21, 2026.

The team also wishes to express its gratitude to the Honorable Vice-Chairman Dr. Gunakar Bhatta and the Honorable Members of the National Planning Commission (NPC) for receiving this White Paper, alongside its companion document — Nepal's Development Strategy for Vision 2100, on May 25, 2026. Such institutional recognition is a meaningful signal that evidence-based policy deliberation has a place in Nepal's governance architecture, and it is one that IIDS hopes to continue to merit.

The team is grateful to the Nepal Rastra Bank, the National Statistics Office, the Ministry of Finance, and the National Planning Commission for maintaining the quality and accessibility of official data that form the empirical backbone of this report. The team also acknowledges the World Bank, the International Monetary Fund, and other international data institutions whose published datasets contributed to the comparative and contextual analysis presented herein.

EXECUTIVE SUMMARY

The Socio-Political Mandate and a Historic Inflection Point

Nepal stands at a profound historical crossroads. For much of the past three decades, public discourse and the policy environment were severely constrained by chronic political instability, short-lived coalitions, and fragmented governance that collectively hindered long-term planning. Following recent elections, the emergence of a stable government backed by a strong legislative majority offers a rare, generation-defining political horizon to execute deep structural reforms. However, this political stability arrives precisely as Nepal's traditional economic engine has reached its structural limits. For over two decades, a passive growth model sustained the country, where large-scale labor outmigration generated massive remittance inflows that fueled household consumption and import-based customs revenues while driving real estate financialization. This model achieved minimal domestic productive transformation and instead systematically hollowed out industrial competitiveness, domestic production, and local job creation over time.

Consequently, Nepal has entered a structural socio-economic transition termed the New Normal. This phase exposes a critical macroeconomic contradiction where record external resilience coexists with profound internal fragility. While foreign exchange reserves, the balance of payments, and remittance inflows remain historically strong, the domestic economy is trapped in secular stagnation marked by anemic growth, compressed aggregate demand, weak investment, rising financial sector vulnerabilities, and intensifying public dissatisfaction with governance and economic opportunity. This White Paper offers a focused diagnostic assessment of Nepal's economic condition at this juncture, concentrating on key sectors where structural policy departures are most urgently warranted. Rather than analyzing temporary cyclical shifts, the report uncovers deeply rooted structural distortions that continue to impede the nation's long-term developmental trajectory.

Core Analytical Framework and Systemic Distortions

At the core of Nepal's economic stagnation is a matrix of mutually reinforcing structural distortions conceptualized as the WFDD Tetrad, which comprises Premature Welfarism, Financialization, Deindustrialization, and Depopulation. Premature Welfarism reflects the aggressive expansion of state distributive obligations and social commitments before establishing a sufficiently broad productive and tax-generating economic base, causing rigid recurrent expenditures to grow faster than the underlying capacity to sustain them. Financialization refers to the excessive concentration of formal credit and informal capital into speculative, non-productive assets, specifically land and real estate, rather than anchoring technology upgrades or industrial capacity. Deindustrialization captures the prolonged hollowing out of domestic production, characterized by a steady decline in the industrial sector's share of GDP, stagnating domestic value addition, and soaring import dependency. Depopulation reflects the systemic, large-scale outmigration of working-age youth and skilled human capital, which systematically drains the domestic economy of its labor force, entrepreneurial capacity, and long-term productivity.

Together, these four dynamics generate a self-reinforcing structural trap where public resources are consumed rather than invested, capital accumulates without production, the industrial base weakens prematurely, and vital labor exits the country. Paradoxically, Nepal exhibits the classic symptoms of an aging, advanced economy—such as subdued domestic demand, financial saturation, and demographic stress—without ever having completed industrialization. This structural gridlock is primarily driven by the prolonged monetization of land, which evolved from a factor of production into the ultimate store of wealth and speculative vehicle. Rapid credit expansion flowed into real estate, inflating collateral values, fueling excessive leverage, and creating a Complacency Trap. Remittance inflows and effortless speculative land gains acted as an artificial socio-economic safety valve that exported domestic unemployment and social discontent, severely eroding institutional urgency for difficult structural reforms and weakening incentives for genuine entrepreneurial risk-taking and innovation.

Macroeconomic Conditions under the New Normal

The fallout of these structural pathologies is written clearly across contemporary macro-financial indicators, leaving Nepal in a prolonged period of secular stagnation characterized by persistently low growth, weak aggregate demand, and declining investment dynamism. Although the external sector appears exceptionally robust, with remittance inflows exceeding 28 percent of GDP and foreign exchange reserves at historic highs, this resilience reflects domestic weakness rather than strength. External stability is heavily driven by compressed domestic demand and slowing import growth. For the first time in Nepal's history, labor export earnings effectively finance the entire import bill, decoupling external accounting balances from the health of domestic production.

Conversely, the domestic economy faces structural paralysis where economic growth remains far below the threshold required for meaningful transformation. Private sector investment has contracted sharply as businesses confront weak domestic demand, rising operational costs, and pervasive uncertainty, while household consumption has slowed despite rising remittances, indicating severe cost-of-living pressures and declining consumer confidence. The financial system increasingly reflects an acute liquidity paradox where commercial banks remain flush with cash, yet productive credit demand is missing. Credit growth has plummeted while rising non-performing loans signal escalating distress. Because historical credit expansion was tied directly to land transactions, the real estate slowdown that began in FY 2021/22 has caused deep systemic vulnerabilities to surface across commercial banks, savings cooperatives, and informal financial channels.

Fiscal pressures are equally severe as public expenditure tilts heavily toward non-discretionary recurrent obligations, social transfers, administrative overhead, and expanding debt-servicing burdens, while capital expenditure execution remains weak and fragmented. Rising debt obligations are actively squeezing out the fiscal space required for infrastructure expansion, a structural fiscal inversion that is further compounded by fragmented project selection, weak implementation capacity, and politically driven resource allocation. Ultimately, Nepal's fundamental challenge is not an absolute shortage of resources, but a systemic failure in the allocation of capital, labor, public expenditure, and institutional capacity.

Human Capital, Demographic Transition, and Sectoral Vulnerabilities

One of Nepal's most critical long-term risks is the rapid erosion of its demographic dividend, as sustained outward migration and overseas study have depleted the domestic stock of working-age labor. The nation faces a credible threat of growing old before becoming prosperous, as migration has become the default aspiration for youth, removing vital human capital that could accelerate growth and threatening the long-term sustainability of the state's fiscal and social protection systems. This erosion of capacity is visible across strategic sectors, beginning with healthcare, where expanding universal public welfare commitments have rapidly outpaced institutional delivery infrastructure, creating unsustainable fiscal strain on the state while leaving citizens heavily dependent on costly, out-of-pocket private care that transforms health shocks into a primary driver of household poverty.

Similarly, in education, rising outmigration for higher education accelerates domestic human capital leakage while generating substantial, unbacked financial outflows. The digital economy exhibits a distinct form over function paradox where surface-level digital adoption, such as mobile connectivity and digital payment surges, masks deeper structural weaknesses in technological capability, public governance, enterprise productivity, and institutional modernization, leaving the digital ecosystem exposed to systemic, single-point vulnerabilities. Furthermore, Nepal's strategic geographic position between two of the world's largest economies has not automatically generated shared prosperity, remaining defined instead by deep trade asymmetries, weak industrial competitiveness, and an asymmetric economic dependence on external labor and capital markets.

Long-Term Structural Risks and the Need for Transformation

Left unchecked, these compounding dynamics point toward severe long-term structural risks, putting Nepal in definitive danger of falling into prolonged lower-middle-income stagnation defined by structural growth traps, premature demographic exhaustion, and escalating financial vulnerabilities linked to over-leveraged asset books and banking sector stress. Prolonged stability without transformation has itself become a source of systemic vulnerability. Yet, strategic opportunities remain, as Nepal still commands a young demographic profile, vast untapped hydropower potential, expanding digital connectivity, substantial foreign exchange reserves, and a growing civic demand for institutional accountability. The arrival of political stability offers a rare, clear window to execute structural transformations that were impossible under fragmented governance.

The core message of this White Paper is one of urgency and structural realism, not pessimism, because Nepal's challenges cannot be solved through cyclical policy patches or short-term macroeconomic tuning. The country must execute a deliberate, structural transition away from an economic model anchored in remittance-fueled consumption, speculative land monetization, and fragmented public spending, pivoting instead toward an economy firmly grounded in productive investment, domestic value creation, institutional efficiency, and human capital resilience. Political stability has opened the window, and whether Nepal capitalizes on it will determine if the New Normal becomes an era of permanent stagnation or the foundation for a productive economic future.

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ABBREVIATIONS AND ACRONYMS

BFI	Banks and Financial Institutions
BoP	Balance of Payments
BS	Bikram Sambat (Nepali calendar)
CD	Credit-to-Deposit (ratio)
CNY	Chinese Yuan (Renminbi)
CPI	Consumer Price Index
DFID	Department for International Development (UK)
EU	European Union
EMIS	Education Management Information System
FDI	Foreign Direct Investment
FOREX / FX	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
GNI	Gross National Income
GoI	Government of India
IIDS	Institute for Integrated Development Studies
IELTS	International English Language Testing System
IMF	International Monetary Fund
IT	Information Technology
LDC	Least Developed Country
LMIC	Lower-Middle-Income Country
M2	Broad Money Supply
MCC	Millennium Challenge Corporation
MBBS	Bachelor of Medicine, Bachelor of Surgery
MSME	Micro, Small, and Medium Enterprise
MW	Megawatt
NLSS	Nepal Living Standards Survey
NOC	No Objection Certificate
NPL	Non-Performing Loan
NPA	Non-Performing Asset
NPR	Nepali Rupee
NRB	Nepal Rastra Bank
NSO	National Statistics Office
ODA	Official Development Assistance
PCI	Per Capita Income
RSP	Rastriya Swatantra Party
SAP	Structural Adjustment Program
SEE	Secondary Education Examination
SEM	Science, English, and Mathematics
SME	Small and Medium Enterprise
STEM	Science, Technology, Engineering, and Mathematics
Tbps	Terabits per second
UGC	University Grants Commission (Nepal)
UN	United Nations
USD	United States Dollar
VAT	Value Added Tax
WDI	World Development Indicators (World Bank)
WFD	Welfarism, Financialization, and Depopulation (Trinity)
WHO	World Health Organization

A. INTRODUCTION

In March 2026, Nepali voters delivered a decisive mandate for change.

The Rastriya Swatantra Party (RSP), led by a **35-year-old prime minister** and a cabinet of largely younger, highly educated ministers, emerged as the largest parliamentary force, falling just two seats short of the two-thirds majority needed for constitutional amendments. This election result did not arrive in a vacuum. For months leading up to the vote, a generation of young Nepalis, frustrated by corruption, governance failures, and the absence of domestic opportunities, mobilized in unprecedented ways. When the government briefly restricted social media access in September 2025, what could have been a passing controversy instead triggered a **"Gen-Z Awakening,"** a visible surge of youth demanding accountability and economic renewal.

The outgoing coalition government, formed in 2024 through a power-sharing arrangement among established elites, had been widely perceived as more interested in protecting vested interests than driving reform. By contrast, the incoming administration carries a clear mandate: deliver substantial structural change within its five-year term.

This transition marks the emergence of Nepal's **"New Normal"** — a critical socio-economic and political inflection point where the traditional policy assumptions of the last three decades, driven by passive remittance consumption and labor export, have reached the limits of their utility. While chronic political uncertainty was once considered an inherent, given feature of this New Normal, the landscape has fundamentally shifted with the emergence of a new, stable government. This newfound political stability offers a rare window to move beyond mere crisis management and implement the second-generation reforms.

For a new government taking office with both political capital and the urgency of a restless electorate, this diagnosis is indispensable. It provides the incoming government with an evidence-based diagnostic of Nepal's current economic condition, one that is **far more complex and fragile than surface-level indicators suggest**. It makes clear that Nepal's challenges are not cyclical; they cannot be solved through minor tweaks to policy or incremental adjustments to spending. They are structural and systemic, requiring a response of corresponding scale and intensity.

The new government will have a **rare five-year window of political stability** in which to undertake such transformation, but the window is narrow. As Nepal's demographics continue to shift due to outmigration, as the country grows older before becoming prosperous, as land prices continue to distort capital allocation, and as the complacency trap deepens, **the opportunity to reset will close**. This White Paper is more than just data and statistics; it provides the analytical foundation for understanding Nepal's current economic reality. It clarifies where the country stands today and underscores the urgency of action.

Unlike previous economic reports that often focus on retrospective fiscal accounting, this White Paper adopts a multidimensional approach designed to diagnose the systemic roots of Nepal's structural stagnation. By integrating the health sector, we reframe health not as a social expenditure but as a fundamental pillar of human capital resilience, arguing that premature welfare expansion without institutional delivery capacity erodes the very productivity needed for growth. The section on digitalization shifts the focus from simple connectivity to the functional digital stacks required to lower the cost of doing business and formalize the economy. Finally, our geopolitical analysis treats Nepal's proximity to India and China as a critical market variable rather than a passive geographic advantage, examining the trade, remittance, and capital imbalances that dictate the nation's long-term fiscal and monetary viability. Together, these sections transition the discourse from a narrow diagnosis of macroeconomic indicators toward a holistic, systems-based blueprint for structural transformation.

B. PURPOSE, SCOPE, ANALYTICAL APPROACH, AND POLICY RELEVANCE

01

Diagnostic Assessment of Nepal's Current Economic Situation

This White Paper is a diagnostic, evidence-based assessment of Nepal's current economic condition, prepared at a critical political and economic juncture. Its primary objective is to inform the incoming government's early reform priorities, particularly within the first 100 days, and to provide the analytical foundation for a forward-looking Development Strategy for Vision 2100. The paper is non-prescriptive by design and focuses on identifying structural constraints, systemic risks, and transition challenges.

03

Evidence-Based, Analytical, and Data-Intensive Review

This White Paper uses a rigorous, evidence-based analytical framework to assess Nepal's evolving economic realities. It integrates macroeconomic, sectoral, fiscal, financial, labor market, demographic, and external sector data, including official national statistics and internationally comparable datasets. The approach emphasizes consistency, identifying underlying drivers, and careful interpretation of indicators in light of Nepal's unique structural features. It prioritizes medium-term structural signals over short-term fluctuations, distinguishing between temporary stabilization and deeper constraints affecting productivity, competitiveness, and growth potential.

02

Anchored in the Concept of the New Normal

Nepal's economy has entered a New Normal with a stable external sector coexisting with deep structural stagnation. Remittance inflows and outmigration stabilize the external sector, masking declining domestic productivity, weak investment, and shrinking labor force participation due to premature depopulation. This New Normal persists over the medium to long-term, departing from pre-pandemic growth patterns and reshaping the country's economic, social, and political landscape.

04

Serves as the Foundation for the Development Strategy for Vision 2100

This White Paper serves as the analytical foundation for the Development Strategy for Vision 2100 by providing a shared understanding of Nepal's current economic position, constraints, and transition risks. It clarifies what has changed under the New Normal and what is unlikely to revert, offering a realistic baseline for long-horizon goals related to growth, employment, productivity, and macroeconomic stability. This ensures that Vision 2100 is grounded in empirical realities, institutional capacity, and structural conditions, rather than aspirational targets detached from Nepal's economic fundamentals.

C. NEPAL AT MULTIPLE STRUCTURAL INFLECTION POINTS

Nepal's economy and political system are currently passing through a series of structural inflection points. These developments—spanning the external sector, financial system, political landscape, and generational dynamics—represent turning points that could shape the country's future trajectory. These inflection points are deeply interconnected. The economic vulnerabilities exposed in FY 2021/22 strained the financial system, which in turn eroded confidence in the political establishment, triggering the generational awakening. Understanding this cascade of shocks is essential to appreciating the urgency of reform.

01

Financial Inflection Point

Nepal's financial inflection point can be traced to FY 2020/21, when private sector credit peaked at 95.1 percent of GDP — an extraordinary level for a lower-middle-income economy, and one reached after broad money supply (M2) had already exceeded GDP in the preceding year. This was the high-water mark of a decade-long credit expansion that averaged above 20 percent annually, financed largely by remittance-driven liquidity and heavily concentrated in land-backed collateral. The financial system had, by this point, grown well beyond the productive capacity of the real economy it was meant to serve. The years that followed exposed what that expansion had concealed. As credit growth slowed sharply — falling to an average of around 6.3 percent over the past three years — the asset quality weaknesses that rapid lending had masked began to surface. Non-performing loans have risen steadily, with official data placing NPLs at around 5.4 percent, though industry observers suggest the true level may be considerably higher once restructured loans, ever-greening practices, and regulatory forbearance are accounted for. This deterioration has coincided with a sharp decline in land and real estate transactions, laying bare the structural dependence of Nepal's financial system on land monetization as both collateral and growth engine. Given the size of the banking sector relative to the economy, a sustained weakening of bank balance sheets carries real risk of spillover into the broader macroeconomy — a vulnerability that grows more acute the longer the underlying correction is deferred.

02

Economic Inflection Point

A major economic inflection point emerged in FY 2021/22 when structural imbalances in Nepal's external sector became increasingly visible. During that year, the trade deficit reached nearly NPR 1,720 billion, equivalent to 34.6 percent of GDP, while the current account deficit widened to 12.5 percent of GDP and the balance of payments recorded a deficit of 5.1 percent of GDP. At the same time, exports remained extremely low at around 4 percent of GDP, reflecting Nepal's limited integration into global production and trade networks. Although foreign exchange reserves remained above seven

months of import cover, which meets international adequacy standards, the rapid deterioration in external balances raised significant concerns. Imports were growing at more than 16 percent annually, largely financed by remittances rather than by export earnings. Had this trajectory continued for a few more years, Nepal's external sector would have faced severe pressure, potentially spilling over into the broader macroeconomy. At the time, Nepal's deteriorating external position was frequently compared with developments in Sri Lanka, which entered a full-scale economic crisis amid rapidly declining foreign exchange reserves. Although Nepal avoided a similar outcome due largely to strong remittance inflows and policy adjustments, the episode marked a clear turning point highlighting the underlying structural fragilities of the country's external sector.

03

Political Inflection Point

Nepal experienced a significant political inflection point in July 2024, when the two largest rival political parties formed a coalition government and agreed to a rotational leadership arrangement among senior political leaders. This development marked a notable departure from Nepal's traditional adversarial political structure, where the two major parties historically competed from opposing ideological positions. Although the coalition justified its formation by citing the need for political stability and constitutional amendments aimed at facilitating economic reforms, critics widely perceived the arrangement as a mechanism for power-sharing among established political elites, particularly amid growing corruption investigations involving senior leaders. As a result, the coalition government was not widely expected to initiate bold structural reforms or accelerate economic transformation. This political configuration has important implications for governance quality, policy continuity, and public accountability, particularly at a time when the economy faces mounting structural challenges.

04

Generational Inflection Point: The Gen-Z Awakening

Parallel to these economic and political developments, Nepal has witnessed a generational shift in political consciousness. A government decision to temporarily restrict access to social media platforms in early September 2025 triggered widespread protests, particularly among younger citizens. For many youth who had already been expressing frustration through online platforms, the restriction served as a tipping point that catalyzed broader youth mobilization. For years, large-scale outmigration had effectively acted as a safety valve, with many young Nepalis seeking employment abroad rather than confronting domestic political and economic frustrations. However, when even the digital space for expression appeared constrained, a segment of the youth population mobilized domestically, raising broader concerns about corruption, governance failures, and the lack of economic opportunities. This development marked the emergence of a "Gen-Z Awakening," reflecting a generational shift in expectations regarding transparency, accountability, and the quality of public institutions.

05

Emergence of a New Political Landscape

These generational dynamics have begun to reshape Nepal's political landscape. In the national elections held on March 5, 2026, a large number of younger candidates were elected to parliament, signaling growing voter demand for political renewal. The Rastriya Swatantra Party (RSP) emerged as the largest party in the lower house, falling only two seats short of the two-thirds majority required for constitutional amendments. As a result, Nepal is now witnessing the formation of a new government led by a young prime minister (35 years old) supported by a cabinet composed largely of younger and highly educated ministers. Against this backdrop, this White Paper aims to offer an incisive assessment of select economic and institutional challenges facing Nepal, while the Development Strategy aims to present strategic policy directions for the incoming government at a critical moment of national transition.

D. CORE STRUCTURAL PARADOXES

Beyond these inflection points, Nepal's development trajectory is also shaped by several deep structural paradoxes. These paradoxes reflect the coexistence of seemingly contradictory economic and social dynamics that together constrain the country's long-term development prospects. Understanding these underlying tensions is essential for designing policies capable of unlocking sustainable growth.



The Remittance Paradox: The Export of Discontent

Nepal's economic stability today rests heavily on remittances generated by large-scale labor migration. Remittance inflows, which now exceed 28 percent of GDP, finance the country's persistent trade deficit, sustain domestic consumption, and support a strong foreign exchange reserve position, currently exceeding USD 23 billion. However, this economic stability comes with a significant underlying imbalance. Politically, large-scale outmigration effectively removes the demographic cohort most likely to demand systemic reform or challenge entrenched political structures. In this sense, migration acts as an export of discontent, reducing domestic political pressure while stabilizing the system. Economically, remittances sustain external stability but do little to expand domestic productive capacity. Millions of Nepali workers who generate this income abroad also remain largely excluded from political participation due to the absence of effective remote voting mechanisms. As a result, the very citizens whose labor sustains the economy have a limited voice in shaping national governance.



The Wealth–Income Paradox: Asset-Rich, Income-Poor

Nepal also exhibits a pronounced wealth–income paradox, where household balance sheets appear increasingly asset-rich while disposable incomes remain relatively low. The gap is likely among the highest in the world. This pattern is largely the result of premature financialization, in which rising private sector credit now approaching 93 percent of GDP has been disproportionately directed toward real estate rather than toward productive investment. As land prices have surged, many households appear wealthy on paper due to rising asset valuations while income growth often struggles to keep pace with the rising cost of living. Consequently, the middle class holds significant illiquid wealth in land assets but lacks sufficient disposable income to sustain robust consumption growth. This imbalance has contributed to weak aggregate demand growth, which has slowed to approximately 4.4 percent over FY 2022/23 – FY 2024/25, down from a decade average of 12.1 percent prior to FY 2021/22, reinforcing broader economic stagnation.



Nepal's Competitive Paradox:

Low Incomes, High Costs

Nepal also faces a structural competitiveness paradox. Despite being a low-income country, it does not benefit from the low-cost production advantage typically associated with such economies. Instead, key factors of production, land and logistics are very expensive and the minimum wage is higher than per capita income and is one of the highest in the region. This situation is reinforced by the remittance-driven price floor that sustains high asset prices and consumption levels independent of domestic productivity. As a result, Nepal has gradually experienced a form of passive deindustrialization: the country is too costly to compete in labor-intensive manufacturing but lacks the technological capability to compete in high-value innovation sectors. This structural constraint limits Nepal's ability to participate meaningfully in global value chains and risks locking the economy into a premature lower middle-income trap before a strong base for economic growth has been established.



The Demographic Paradox:

Growing Old Before Getting Rich

Finally, Nepal faces a demographic paradox in which the country risks growing old before becoming prosperous. With a median age of just 26 years, Nepal still possesses a potentially powerful demographic dividend. However, this dividend is being steadily eroded by large-scale outmigration of young workers. Annual outmigration and new labor market entrants are now approaching levels comparable to the number of new births, creating what can be described as a demographic replacement trap. Rather than utilizing its youth population to accelerate domestic economic development, Nepal is effectively exporting its most productive labor force during their prime working years. Unlike the East Asian economies that harnessed their demographic dividend to drive industrialization and rapid income growth, Nepal risks exhausting its demographic advantage before establishing a strong domestic economic base capable of supporting an aging population.

These paradoxes — remittance dependence masking weak productivity, wealth without income, high costs despite low incomes, and aging before prosperity — form a coherent pattern.

They reflect three mutually reinforcing structural distortions that can be termed the WFD Trinity: Premature Welfarism, Financialization, and Depopulation. Understanding this framework is essential to recognizing why incremental policy adjustments cannot resolve Nepal's challenges.

E. THE WFDD TETRAD

Premature Welfarism, Financialization, Deindustrialization, and Depopulation

Nepal's development trajectory presents a paradox rarely observed in economic history.

The country is experiencing several structural characteristics typically associated with advanced aging economies before reaching high-income status. This paradox can be conceptualized as the WFDD Quadrant — Premature Welfarism, Premature Financialization, Premature Deindustrialization, and Premature Depopulation, a combination that creates a powerful structural bottleneck for long-term growth.

01

Premature Welfarism

reflects a growing imbalance in fiscal policy where politically driven distributive programs increasingly crowd out productive public investment. As government spending shifts toward subsidies, transfers, social protection, and administrative consumption, the fiscal resources available for infrastructure, industrial development, and technological upgrading steadily decline. Rising debt-servicing obligations further constrain the fiscal space required for capital expenditure, gradually weakening the state's ability to invest in long-term growth drivers and structural transformation. This trend is reflected in the rapid expansion of welfare commitments, with nearly 3.8 million people (around 12.5 percent of the population) receiving some form of government cash grant. Among them, nearly 1.9 million senior citizens receive old-age allowances costing approximately NPR 87 billion annually, equivalent to 4.4 percent of the total FY2025/26 national budget.

02

Premature Financialization

emerges when the financial sector expands faster than the real economy over a prolonged period and grows disproportionately larger relative to GDP. In Nepal, the banking sector today holds substantial liquidity and foreign exchange reserves largely sustained by remittance inflows, yet much of this capital circulates through credit cycles linked to land, housing, consumption, and speculative activities rather than productive industries. This pattern distorts resource allocation, inflates asset prices, and increases systemic financial vulnerability while widening the disconnect between financial expansion and real economic productivity. The growing strain is increasingly visible in rising non-performing loans (NPL) within the banking system. Reflecting the scale of this imbalance, Nepal's money supply and total deposits exceeded GDP in 2020, while private sector credit peaked at above 95 percent of GDP in 2021 and still remains above 92 percent despite a significant slowdown in recent years, nearly two to three times higher than the average for least developed countries (LDC) and lower-middle-income countries (LMIC).

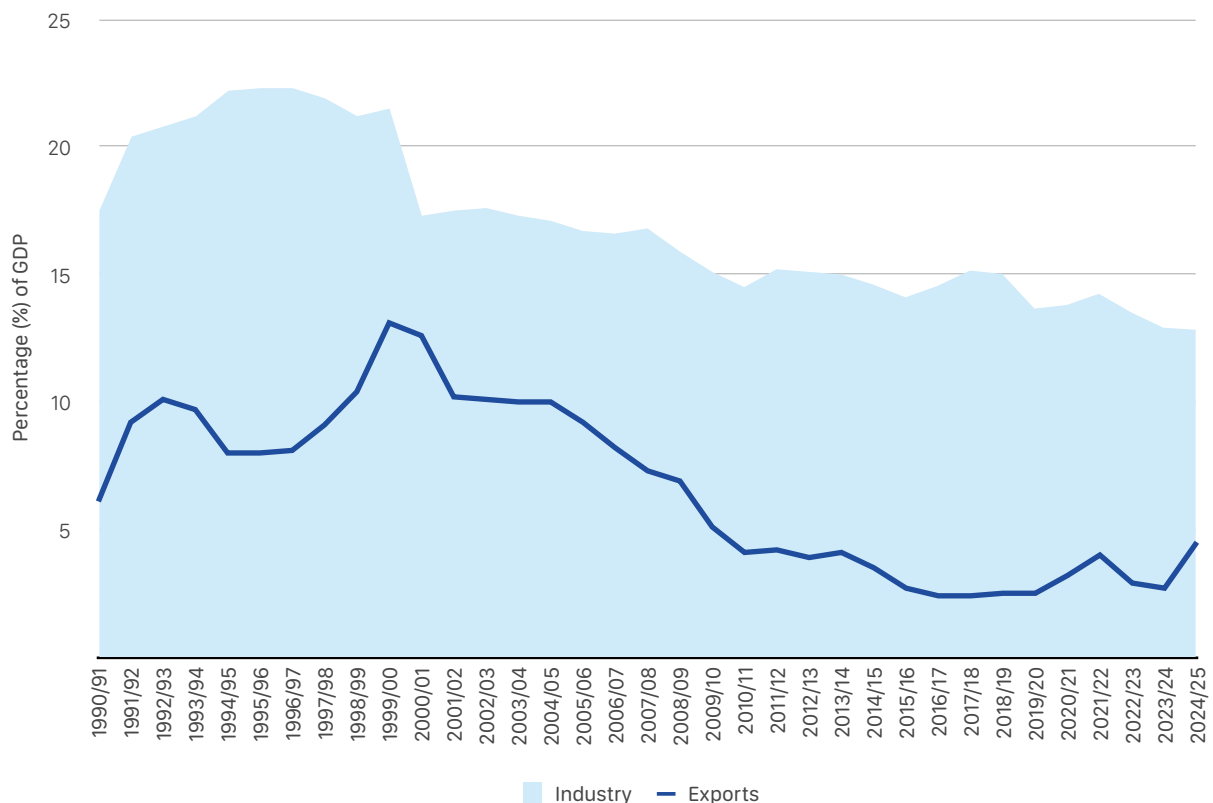
03

Premature Deindustrialization

compounds these pressures in ways that close off the most conventional escape route from structural stagnation. Nepal's industrial policy, like that of many developing economies, has long aspired toward industrialization through manufactured led growth. Yet this pathway has narrowed considerably. As virtually every developing country competes to attract the same labor-intensive manufacturing industries, the returns on this model have diminished globally. Nepal, burdened by high land costs, elevated logistics expenses, and a minimum wage that exceeds per capita income, is too costly to compete in low-margin assembly manufacturing yet lacks the technological depth to move into high-value industrial production. The result is that Nepal's industrial sector has gradually contracted from over 21 percent of GDP in the 1990s to barely 12.8 percent today not because it successfully graduated to a more sophisticated economy, but because it was priced and crowded out before it ever matured. This is deindustrialization without industrialization, a structural retreat that forecloses the most proven pathway to employment generation and export competitiveness precisely when Nepal needs them most.

Figure 1 — Share of Industry and Export in GDP

Source: Nepal Rastra Bank (NRB)



04

Premature Depopulation

may be the most consequential of the four. Large-scale outmigration has transformed Nepal into one of the world's most labor-exporting economies. The sustained departure of young workers and students has created a growing demographic replacement gap, steadily eroding the domestic stock of human capital required for long-term growth. In addition to labor migration, tens of thousands of students leave the country each year for foreign education, leading to significant outflows of both financial resources and skilled talent. While remittances provide short-term macroeconomic stability, the long-term effect is the gradual weakening of Nepal's demographic dividend and productive capacity. In recent years, net population dynamics, when adjusted for migration flows, suggest an effective decline of close to 1 percent annually over the past four years, underscoring a rare structural challenge for a lower-middle-income country that still possesses a relatively young population.

Taken together, the WFDD Tetrad generates a structural contradiction.

Fiscal resources are consumed rather than invested, financial capital accumulates without productive investment, the industrial base that could absorb returning workers or new entrants has shrunk before it was ever fully built, and the workforce necessary for economic transformation steadily exits the country. This configuration traps Nepal in a fragile equilibrium where consumption remains high but productive capacity stagnates.

F. THE “ALL ROADS LEAD TO ROME” ECONOMIC STRUCTURE

Migration, Imports, and Land Monetization

These paradoxes have created a self-reinforcing economic structure in which nearly all actors, households, firms, and government converge toward the same outcomes: outmigration for employment, imports for consumption, and real estate for investment. This pattern, which might be described as an “All Roads Lead to Rome” economy, explains why past reform efforts have had limited transformative impact.

01

Remittance-Dependent Economy Driven by Labor Export

At the center of this configuration lies the country’s heavy reliance on labor export as the primary employment engine. Each year, hundreds of thousands of Nepali workers leave the country for foreign employment, with around 840,000 labor approvals issued in FY 2024/25 alone, reflecting the inability of domestic economic sectors to absorb the growing labor force. In the same year, Nepal received over USD 12 billion in remittance inflows, equivalent to more than 28 percent of GDP, placing the country among the most remittance-dependent economies in the world. This outmigration has turned remittances into the dominant pillar of the economy.

03

Capital Trapped in Unproductive Real Estate Instead of Production

The final component of the cycle emerges within the domestic financial system: rather than flowing into productive investment, surplus liquidity generated by remittances and bank credit gravitates toward land and real estate investment, which has historically offered higher and more predictable returns than entrepreneurship or industrial investment.

02

Remittance-Fueled Consumption Over Productive Growth

While remittances have contributed to poverty reduction and macroeconomic stability, they have simultaneously created a consumption-driven growth model rather than a production-based one. Household income generated abroad is largely spent on imported goods, as domestic manufacturing and agricultural value chains remain too weak to meet domestic demand. This dynamic sustains a persistent trade deficit and reinforces reliance on foreign supply chains even for basic consumption items.

Consequently, capital that could have financed production and value addition remains trapped in unproductive asset markets. The result is a self-reinforcing loop where migration generates remittances, remittances finance imports, and excess capital inflates land prices while domestic productive capacity remains largely stagnant.

Left unchecked, this cycle progressively hollows out Nepal's productive base and entrenches remittance dependency.

Over time, this structural configuration gradually crowds out the productive base of the economy. Instead of nurturing industries capable of creating employment and generating exports, the economy becomes organized around external labor markets, import consumption, and asset speculation. In such a system, migration becomes not merely a coping strategy but the central organizing principle of the economic structure itself. Without deliberate policy intervention to redirect both financial capital and human capital toward productive sectors, the "All Roads Lead to Rome" model risks locking Nepal into a long-term equilibrium of remittance-dependent consumption without domestic economic transformation.

G. THE COMPLACENCY TRAP

Paradoxically, Nepal's relative stability has itself become an obstacle to reform. Nepal has not faced a severe economic crisis. Nepal's structural economic challenges persist not merely because of institutional weaknesses but also because the system itself has developed mechanisms that temporarily mask its underlying vulnerabilities. This phenomenon can be described as a Complacency Trap, in which short-term stability reduces the urgency for structural reform.

Figure 2 — The Complacency Trap

Source: Authors' own illustration



01

Entrenched Political Loyalty Sustaining Reform Inertia

At the political level, a combination of generational party loyalty and entrenched patronage networks has produced a governance environment resistant to accountability and structural reform. Political affiliation is often inherited rather than evaluated, allowing leaders to retain support irrespective of delivery. This has fostered a sense of political complacency, where electoral security is assumed and incentives are directed often in favor of short-term distributive policies over long-term structural reforms, reinforcing the cycle of premature welfarism and limited economic transformation. As a result, the urgency to undertake difficult but necessary reforms remains weak, reinforcing a cycle of policy inertia and limited economic progress.

02

Remittance Paradox as an Economic and Political Safety Valve

At macroeconomic and socio-political level, remittances create a powerful Remittance Paradox explained earlier that sustains stability while diffusing pressure for reform. Remittance inflows act as the lifeblood of the economy – strengthening foreign exchange reserves, supporting consumption, and stabilizing the balance of payments. However, this stability is achieved alongside the large-scale

outmigration of youth, effectively exporting not only labor but also voices, discontent, and potential agents of change. Those sustaining the economy from abroad remain largely excluded from political participation, while those at home often delay entry into the domestic labor force in anticipation of foreign employment. This dynamic reduces both economic and political pressure for reform, reinforcing a broader complacency where stability is maintained without addressing underlying structural weaknesses. Yet the social pressures that might otherwise destabilize this arrangement—such as unemployment or income stagnation—are partially absorbed by mass outmigration. Migration acts as a social safety valve, allowing the economy to export unemployment rather than address its underlying causes.

03

The Development Myths of Tourism and Hydropower

This environment is further reinforced by persistent development myths, particularly the belief that tourism or hydropower alone can drive national prosperity. While both sectors hold significant potential and must remain important pillars of Nepal's development strategy, their contribution to overall economic transformation is often overstated. Even under optimistic scenarios, the combined expansion of these sectors would increase Nepal's per capita income by only around USD 500—far below the level required to cross the lower threshold of middle-income country status. This highlights a fundamental mismatch between expectations placed on these sectors and the scale of economic growth required for structural transformation.

04

Premature Financialization Sustaining Economic Activity without Growth and Employment

Sustained credit expansion of over 20 percent, combined with remittance-backed liquidity, has created a pervasive sense of “easy money,” reinforcing complacency across the economy. Over time, high credit growth and rising land prices—further amplified through their monetization—have driven economic activity without corresponding gains in productivity, income, or employment. Remittance inflows have underwritten this dynamic by maintaining external stability, allowing the system to function without immediate stress. This has fostered an illusion of continuity, where economic agents assume that liquidity and asset price appreciation will persist, leading to a level of financialization disproportionate to Nepal's stage of development. As a result, consumption and speculative investments have expanded in the absence of real sector growth, weakening incentives to undertake difficult but necessary structural reforms.

Ultimately, the complacency trap has produced a model of “easy stability without enterprise,” that sustains the present while undermining the future.

Remittance-driven consumption, expansionary financial activities, and sustained outmigration collectively maintain a semblance of macroeconomic stability without generating meaningful structural transformation. The economy remains heavily oriented toward consumption rather than production, while productive investment continues to lag

behind. Agricultural productivity has remained largely stagnant, natural resource–based exports remain underdeveloped, and industries built around Nepal’s own endowments have yet to emerge at scale. At the same time, the economic structure remains overwhelmingly dependent on labor export rather than developing service sectors capable of productively absorbing Nepal’s growing youth population. This combination reinforces a cycle in which stability is maintained in the short term, but the foundations for long-term growth and employment generation remain weak.

H. ALLOCATIVE EFFICIENCY OF THE ECONOMY

01

Systemic Misallocation of Resources Across all Economic Actors

One of the fundamental structural constraints underlying Nepal's persistent underdevelopment is the pattern of inefficient allocation of resources across the economy. This inefficiency is systemic and involves all major economic actors—households, the private sector, public institutions, and development partners—operating within an ecosystem where prioritization has consistently remained weak. Despite decades of strong credit expansion, averaging nearly 20 percent annually, largely supported by sustained remittance inflows, and public expenditure exceeding 27 percent of GDP since the promulgation of the new Constitution—significantly higher than many peer economies—the overall economic outcomes in terms of productivity, employment generation, and structural transformation have remained modest and inadequate.

02

Inefficiency has Shifted from Public to Private Sector

The first generation of structural reforms was designed to shift the economy toward a more market-oriented framework by expanding the role of the private sector, liberalizing economic policies, and opening multiple sectors for private investment. While these reforms successfully reduced the dominance of the state in many sectors, the inefficiencies that once characterized the public sector appear to have gradually shifted to the private sector. Private enterprises have become increasingly leveraged, with bank credit to the private sector reaching more than 92 percent of GDP, yet without a commensurate expansion in productive capacity or real sector growth. Much of the credit expansion has flowed into non-productive activities such as real estate speculation, trading, and consumption-oriented sectors rather than into industries capable of generating productivity gains, exports, or large-scale employment.

03

Fragmented Public Expenditure

Public sector resource allocation has also contributed to the problem. Fiscal resources have been spread across an excessively large number of projects without adequate prioritization or implementation capacity. This has resulted in chronic delays, cost overruns, and incomplete infrastructure, reducing the economic returns on public investment. Rather than concentrating resources on a smaller set of strategically important projects, public spending has often been fragmented across politically motivated programs and geographically dispersed investments, limiting the overall impact of fiscal expenditure on growth and structural transformation.

04

Political Patronage and Cronyism

The political economy surrounding resource allocation further reinforces these inefficiencies. Both “crony capitalism” and “crony socialism” have shaped economic decision-making, leading to the misallocation of financial and public resources toward politically connected actors and short-term electoral considerations. Instead of creating an enabling environment for broad-based wealth creation and productive investment, resources have frequently been distributed through patronage networks, subsidies, and targeted programs designed to secure political support. This process has gradually increased leverage within the financial system while generating limited productive capacity in the real economy.

05

Fragmented Official Development Assistance (ODA)

Development partners, despite their intention to support structural transformation, have not been entirely immune from this ecosystem of misallocation. Fragmented project-based assistance, parallel institutional arrangements, and shifting donor priorities have at times reinforced the proliferation of initiatives without sufficient alignment to long-term national priorities or implementation capacity.

06

The 3V Trap & Misguided Public Investment

Nepal’s public policymaking is increasingly ensnared in the “3V Trap” (Vanity Policies, Plans, and Projects), a governance failure where economic interventions prioritize short-term political posturing over structural utility through a “penny-wise, pound-foolish” approach that risks “trading a kingdom for a horse” by sacrificing long-term transformation for immediate optics. Regulatory interventions frequently prove “worse than the disease” by introducing crippling distortions, such as absolute bans on importing reconditioned vehicles or ad-hoc export bans on natural resources that choke revenue, alongside aggressive banking capital hikes that forced rapid credit expansion into unproductive real estate rather than strengthening financial depth. This pattern extends heavily to infrastructure, where the state pursues high-cost, low-utility white elephant projects like underutilized international airports, the capital-heavy Budhigandaki hydropower project, and cross-border railway ambitions. Even well-intentioned green transitions suffer from this premature vanity; rushing to become the second-fastest EV adopter in the world is fundamentally reckless for a low-income economy, triggering severe customs revenue losses and massive foreign exchange outflows because EV import costs are roughly three times dearer than Internal Combustion Engine (ICE) alternatives. Furthermore, the stark deficit in fast-charging stations remains a crippling bottleneck that paralyzes intercity transit. Ultimately, these uncoordinated interventions scatter scarce public capital across politically driven commitments, deepening fiscal vulnerability and leaving the country with expensive, under-executed infrastructure that fails to generate a meaningful growth multiplier.

I. STRUCTURAL RISKS TO NEPAL'S LONG-TERM GROWTH TRAJECTORY

Nepal faces compounding structural risks that could undermine long-term development if left unaddressed. Nepal's long-term development prospects are shaped not only by structural opportunities but also by a set of emerging macroeconomic, demographic, and financial vulnerabilities that could constrain sustained economic transformation if left unaddressed. While the country has made important progress in poverty reduction, human development, and macroeconomic stability over the past two decades, recent trends point to slowing growth momentum, rising financial sector vulnerabilities, and significant demographic pressures driven by large-scale outward migration. With Nepal approaching graduation from Least Developed Country (LDC) status in November 2026, addressing these structural risks will be critical to sustaining growth, strengthening economic resilience, and enabling the country to transition toward higher-income status over the long-term.

01

Risk of Falling into the Lower-Middle-Income Trap

Nepal faces a credible risk of being entrenched in the lower-middle-income category if the current pattern of subdued growth persists. With Nepal scheduled to graduate from Least Developed Country (LDC) status in November 2026, sustaining stronger economic momentum will become even more important to ensure a smooth structural transition. In the post-COVID-19 period, economic expansion has struggled to reach even the long-term historical average of around 4.5 percent, reflecting emerging signs of secular stagnation. This pace is insufficient for meaningful income convergence. Empirical experience suggests that sustained annual growth of at least 6–7 percent over a prolonged period is required for countries at Nepal's income level to transition toward upper-middle-income status. Prolonged growth below this threshold would slow per capita income gains, weaken fiscal space, and limit structural transformation. In such a scenario, Nepal risks remaining in a low-productivity equilibrium characterized by modest income growth, limited value addition across the economy, and continued external dependence, making upward income mobility increasingly difficult over time.

02

Risk of Premature Depopulation

Nepal faces a structural risk of premature depopulation despite having one of the youngest populations in the region, with a median age of 26 years. Economic growth depends on both productivity - output per worker and the size and quality of the labor force. Sustained large-scale outmigration of working-age individuals reduces the domestic labor base, weakens entrepreneurial capacity, and lowers potential output. In the past four years, the average rate of depopulation has

exceeded 0.9 percent annually, largely driven by unprecedented levels of outward migration. This trend is further reflected in the 82.2 percent male absentee rate in the most productive age groups and the rise of female-headed households to 31.55 percent. While remittances support consumption, the continued departure of youth dampens domestic aggregate demand and limits long-term human capital formation. Unlike advanced economies that age after becoming rich, Nepal risks labor force contraction while still at a low-income level, constraining future growth. Additionally, given the open border with India and the fact that neighboring states such as Bihar and Uttar Pradesh have per capita incomes below Nepal's, persistent demographic outflows may gradually alter labor market dynamics and carry broader socio-economic and geopolitical implications.

03

Risk of Losing the Demographic Dividend Window

Nepal is currently in a demographic phase where the working-age population constitutes a large share of the total population, offering a potential demographic dividend. This dividend materializes only when the labor force is productively employed, savings increase, and investment rises in tandem. However, persistent outmigration, limited domestic job creation, and weak value addition across sectors mean that the economic gains from this favorable age structure are not being fully realized within the country. If employment opportunities remain inadequate and growth continues below the required threshold, the demographic window may close before Nepal achieves higher income status. Once the population begins to age and the dependency ratio rises, the burden on public finances and the working population will increase, further constraining growth. Losing the demographic dividend at this stage would significantly reduce the country's medium- to long-term development prospects.

04

Risk of Financial Instability

Prolonged rapid credit expansion, high land prices, and speculative behavior in segments of the share market have increased private sector leverage to levels that are significant relative to GDP and income. Nepal's private sector credit-to-GDP ratio now exceeds 92 percent, far above the average of around 33 percent for Least Developed Countries and roughly 46 percent for lower-middle-income countries. When additional credit from cooperatives and Microfinance institutions, estimated at around 17 percent of GDP is included, overall financial system exposure becomes even more substantial. Much of the borrowing over the past decades was linked directly or indirectly to real estate transactions rather than productivity-enhancing investment. Since the slowdown in land transactions beginning in FY 2021/22, credit growth has weakened and non-performing assets (NPAs) have risen above 5 percent, compared with levels below 2 percent during much of the period following the financial sector reforms of the early 2000s. Elevated asset valuations combined with rising repayment stress create vulnerabilities that could destabilize the financial system if not managed prudently.

05

Risk of Spillover into Broader Macroeconomic Instability

Given the size of the banking sector relative to the overall economy and its central role in financing consumption and investment, financial sector stress could transmit rapidly to the broader

macroeconomy. A sustained rise in NPAs, asset price correction, or prolonged credit stagnation would dampen investment, weaken aggregate demand, and strain fiscal resources. In an economy already experiencing subdued growth and demographic pressures, such spillovers could reinforce stagnation dynamics and reduce macroeconomic resilience. The interaction between weak growth, financial fragility, and structural demographic shifts therefore constitutes a material risk to long-term economic stability.

Addressing these risks demands a comprehensive strategy to unlock Nepal's structural potential and build long-term economic resilience.

Taken together, these structural risks highlight the urgency of a comprehensive development strategy focused on accelerating productivity growth, strengthening domestic value creation, expanding employment opportunities, and improving the resilience of key economic institutions. The policy interventions outlined in the Development Strategy therefore seek to address these challenges by unlocking Nepal's structural potential while mitigating vulnerabilities that could otherwise constrain the country's long-term growth trajectory.

J. MOTHER OF ALL EVILS

Land Monetization and the Financialization of the Economy

Land monetization has been at the center of Nepal's economic distortion for three decades. It fueled rapid credit growth, inflated asset prices, financed migration, raised business costs, and diverted capital away from productive sectors. The post-FY 2021/22 slowdown marks the limits of this model. Without meaningful correction in land prices and a deliberate shift toward production-based growth, Nepal risks prolonged economic stagnation.

01

Excessive Financialization Driven by Land Monetization

Over the past three decades, rapid credit expansion, averaging around 20 percent annually, has increasingly flowed into land and real estate rather than productive sectors. In the absence of commensurate growth in production, exports, and income generation, land became the primary collateral and speculative asset, excessively financializing the economy. This prolonged and unproductive interrelationship between bank credit and rising land prices has amplified macroeconomic risks, diverted capital from productive investment, inflated asset bubbles, and entrenched structural imbalances that now constrain sustainable growth.

03

Distortion of Economic Incentives and Unproductive Consumption

Escalating land prices have weakened incentives for productive land use. Rather than being deployed for agriculture, industry, or commercial activities, land is increasingly held for investment. Rising collateral values have encouraged excessive borrowing, often financing consumption and imports beyond

02

Extraordinary Land Valuation and Systemic Risk

Land prices in urban centers, particularly within Kathmandu's Ring Road, have reached levels comparable to some of the highest globally relative to income levels. The estimated market value of private land within Ring Road is broadly comparable to the size of Nepal's entire GDP, reflecting a severe asset-price distortion. Such disproportionate valuation relative to the productive capacity of the economy poses systemic financial stability risks. Historical parallels, most notably Japan's asset price bubble of the late 1980s, illustrate how prolonged land inflation can suppress long-term growth and result in decades of economic stagnation.

04

Rising Cost of Doing Business and Declining Competitiveness

Elevated land prices directly increase the cost of investment, such as establishing factories, offices, warehouses, and infrastructure. High rental and acquisition costs reduce competitiveness, discourage domestic industry, and incentivize import-dependent trading activities. As land absorbs

sustainable income levels. This dynamic has reinforced a cycle in which asset appreciation substitutes for productivity, while the real economy remains underdeveloped.

05

Escalating Public Infrastructure Costs

The inflation of land values has sharply increased compensation costs for public infrastructure projects. Major national projects such as Gautam Buddha International Airport in Lumbini and the Budi Gandaki Hydropower Project have faced substantial cost escalations due to land acquisition expenses. As compensation becomes tied to speculative market rates rather than productive value, public investment efficiency declines, fiscal burdens rise, and infrastructure development slows.

07

Housing Unaffordability and Structural Emigration Pressure

High land prices have rendered home ownership unattainable even for senior public officials and established professionals. For instance, a Chief Secretary would require roughly two decades of total income to purchase four annas of land in Kathmandu and an additional 15 years to construct a modest house. Such structural unaffordability erodes confidence in long-term domestic prospects and pushes skilled individuals to seek opportunity abroad, contributing to brain drain and weakening institutional capacity.

09

Uncontrolled Road Expansion and Speculative Land Fragmentation

disproportionate capital, investment in technology, skills, and productive capacity is crowded out, further weakening Nepal's ability to compete regionally and globally.

06

Land as the Primary Financing Source for Outmigration

Land monetization has become the principal financial mechanism enabling mass outmigration. Households frequently sell land or use it as collateral to finance migration costs, overseas education, or settlement abroad. For citizens of a low-income economy, such expenditures are often unaffordable through regular income streams. Consequently, land assets rather than savings from productive activity have become the gateway to international mobility, reinforcing the cycle of domestic capital depletion.

08

Capital Flight through Asset Liquidation

The monetization of land has facilitated capital outflows, as emigrating households liquidate property to acquire assets abroad. Significant financial transfers occur through informal channels, reducing domestic liquidity and limiting reinvestment within Nepal. This process accelerates capital flight, undermines financial stability, and weakens the domestic investment base.

10

Unproductive Road Expansion and Idle Land

Rapid and often unplanned expansion of road networks has increased land fragmentation and speculative subdivision without generating proportional productive activity. Instead of catalyzing local value addition, improved connectivity has often strengthened dependence on external supply chains and imports.

Rapid road construction has often increased land fragmentation and speculation rather than local production. Agricultural land remains fallow as owners wait for prices to rise. Instead of generating value addition, connectivity has in many areas increased dependence on imported goods.

11

Societal Complacency and Erosion of Work Incentives

Persistent land appreciation has fostered a culture of passive wealth expectation. As land values rise independently of effort or productivity, segments of society perceive asset holding as a substitute for enterprise. Young people increasingly defer participation in local labor markets, anticipating migration as the primary pathway to prosperity. This mindset erodes entrepreneurial dynamism, suppresses domestic labor participation, and weakens the social foundation required for sustained economic transformation.

The cumulative impact of three decades of credit-fueled land monetization has entrenched structural distortions across Nepal's economy crowding out productive investment, inflating public project costs, driving migration, encouraging capital flight, and undermining competitiveness.

Unless land prices correct significantly to levels consistent with income and productive returns, the economy may remain stuck in low credit growth, weak investment, and limited job creation – making land monetization “The Mother of All Evils” behind Nepal's persistent economic malaise.

K. THE NEW NORMAL

Macroeconomic Conditions

The "New Normal" in Nepal represents a critical socio-economic inflection point where the traditional policy assumptions of the last three decades— defined by the paradox of record external sector strength alongside deep internal structural fragility, have reached the limits of their utility. This transition is marked by a fundamental shift in the national psyche, exposing deep-seated dissatisfaction with existing governance and economic fragilities. While chronic political uncertainty was once considered an inherent, given feature of this New Normal, the landscape has fundamentally shifted with the emergence of a new, stable government. The New Normal in Nepal is characterized by persistent patterns across the economy, which are expected to continue in the medium to long-term. The major features are as follows:

01

Apparent Stability in The Short to Medium Term

External Sector Resilience as a Buffer:

While the internal economy faces structural bottlenecks, positive developments are primarily observed in the external sector, which has provided stability to the economy. This external sector stability acts as a critical buffer, preventing a balance-of-payments crisis and providing the necessary liquidity to keep the nation's consumption-led model afloat. This resilience in the external sector serves as the primary anchor for the New Normal, allowing the state a narrow window of opportunity to address deeper structural issues without the immediate threat of an economic shock.

Stagnant Demand-Driven Current Account Surplus:

Building on this inflow, Nepal has enjoyed a Current Account Surplus since the beginning of FY 2023/24 after several consecutive years of deficits, reflecting strong external sector resilience. This shift from chronic deficit to surplus indicates that the nation is now a net lender to the rest of the world in terms of its current transactions. This surplus is not merely a result of rising remittances but also a reflection of stagnant internal aggregate demand, which has curtailed the growth of import volumes, thereby further strengthening the net position of the current account.

Remittances Surpassing Imports, Masking Weak Domestic Production:

Remittance inflows have grown massively, exceeding 28 percent of GDP in FY 2024/25, making Nepal one of the top five remittance-recipient countries in the world. This surge is the cornerstone of the external sector's strength, providing a steady stream of foreign currency that powers the domestic market. These inflows have averaged 19.6 percent growth over the last three years, with remittance surpassing the trade deficit since the beginning of FY 2024/25 and total imports since May 2025. For the first time in its history, the country is earning more from its labor exports than it is spending on the

totality of its physical imports, effectively decoupling the external balance from the health of domestic production.

Record Reserves as Unutilized Capital for Structural Transformation:

The most visible sign of this stability is that Nepal has recorded a Balance of Payments (BoP) surplus from FY 2022/23, leading to a record foreign exchange reserve exceeding 50 percent of GDP for the first time in the current year. This accumulation has been unprecedented; the reserves currently exceed USD 23 billion, sufficient to cover more than 18.5 months of imports. This level of coverage is nearly double the typical safety threshold for developing countries. Given current trends, reserves are expected to grow by an additional USD 6 billion in the current year alone, marking the highest single-year increase in history, providing the nation with an extraordinary yet largely unutilized capital pool that could theoretically fund a massive structural reset.

02

Underlying Fragility in the Medium to Long-Term

Structural Growth Plateau and Secular Stagnation:

The economy faces secular stagnation, with economic growth consistently below 4 percent. This persistent low-growth suggests that the traditional drivers of the Nepali economy have lost their momentum. Rather than a cyclical dip, this indicates a structural plateau where the absence of productive economic growth and a shrinking domestic workforce prevent the country from reaching the higher growth trajectories essential to escape this stagnation.

Systemic Demand Shock and Stalled Velocity of Money:

Aggregate demand has declined sharply from 12 percent to 4.4 percent. This dramatic contraction highlights a systemic demand shock. As the velocity of money slows down within the country, the domestic market is failing to provide the necessary pull for businesses to expand, leading to a stalled economic engine that is increasingly reliant on external stimulus.

Private Investment Collapse Deepening Demand Stagnation:

Private sector investment has contracted significantly, exacerbating the decline in demand. Business confidence has reached a low point as entrepreneurs face a market with few consumers and high operational costs. This investment strike by the private sector means that new jobs are not being created, which in turn feeds back into the cycle of weak demand and economic stagnation.

Low Interest Rates Repressing Savers and Encouraging Speculation:

Interest rates remain low, contributing to financial repression. In an attempt to stimulate the economy, rates have been pushed down, but this has created an environment of financial repression where savers, particularly pensioners and middle-class households, receive returns that may not cover the real cost of living. This further discourages domestic saving and encourages capital flight or speculative behavior.

Deflationary Slowdown and Weak Aggregate Demand:

Inflation remains benign, below the 5 percent target set by the Nepal Rastra Bank (NRB). While low inflation is typically seen as a positive, in the current Nepali context, it is a symptom of a cooling

economy. This disinflation is driven not by improved supply-side efficiencies, but by a significant drop in domestic purchasing power and a lack of competitive demand for goods and services.

Remittance Gains Eroded by Rising Essential Costs and Weak Consumption:

Household consumption has weakened over the past three years. Despite the steady inflow of remittances, the actual spending power within Nepali households is being eroded. High essential costs, such as rent and education, combined with economic uncertainty, have forced families to pull back on discretionary spending, further dampening the domestic retail and service sectors.

Excess Liquidity Trapped by Absent Bankable Investment Opportunities:

Credit growth has fallen sharply to an average of just above 6 percent, compared to more than 20 percent in the last three decades, resulting in excessive liquidity in the system. This represents a fundamental breakdown in the transmission mechanism of the economy. Banks are flush with cash, but there is a lack of bankable projects and a general fear of over-leverage, leaving billions of rupees sitting idle instead of fueling productive economic activities.

Rising Non-Performing Loans (NPLs) and Banking Sector Fragility:

Non-Performing Loans (NPLs) in the banking sector have risen from less than 2 percent to over 5 percent, indicating growing financial vulnerability. This spike is a ticking bomb for the financial system. It reflects the reality that many businesses and individuals who borrowed during the era of high land prices are now unable to service their debts as the economy slows, threatening the stability of the large banking sector.

Import Decline Reflecting Industrial Contraction, not Self-Sufficiency:

Imports have declined in the past three years, reversing an average annual growth rate of 16 percent. While a reduction in the trade deficit might look good on paper, this decline is primarily due to a collapse in the import of industrial raw materials and capital goods. This suggests that the domestic economic sectors are shrinking, rather than being replaced by local alternatives.

Revenue Stagnation Constraining Fiscal Space for Public Investment:

Government revenue growth has stagnated, limiting fiscal space. As imports and domestic consumption fall, the state's primary sources of tax, customs, and VAT have plateaued. This stagnation leaves the government with very little spending power to intervene in the economy or fund essential public services without resorting to further borrowing.

Debt Servicing Crowding Out Capital Expenditure for Future Growth:

Sovereign debt has risen, causing financial costs to exceed capital expenditure since FY 2023/24. For the first time, Nepal is spending more on paying back interest and principal on its debts than it is on building the roads, bridges, and power plants needed for future growth. This effectively crowds out development in favor of debt servicing.

ODA Decline Shifting Development Financing Burden to Domestic Treasury:

ODA, particularly foreign grants, has dropped from a long-term average of 1.64 percent of GDP to barely 0.4 percent in recent years. As Nepal prepares to graduate from LDC status, international donors are shifting away from grants toward concessional loans. This reduction in free capital places a greater burden on the domestic treasury to keep afloat social and developmental programs.

Replacement Trap Hollowing Out Nepal's Future Workforce and Consumer Base:

Over the past four years, Nepal's births have roughly matched the combined outflow of people entering the labor force and emigrating for work or study. This Replacement Trap signals that Nepal is approaching a stationary population far earlier than anticipated, effectively hollowing out from the middle, shedding its future producers and consumers at the precise moment they are needed most to escape the middle-income trap.

Land-Fueled Growth Model Stalling as Real Estate Transactions Decline:

Real estate transactions, particularly in land monetization, have slowed considerably. The land-fueled growth model that defined the last decade has hit a ceiling. With demand for new credit drying up and the wealth effect stalling, the ability of individuals to flip land for quick profits has diminished, removing a major albeit unproductive source of perceived wealth in urban centers.

Persistent Fiscal Deficits Driven by Federal Expansion and Borrowing:

Fiscal deficits have averaged around 6 percent of GDP since the promulgation of the new Constitution. The cost of maintaining a federal structure and a growing bureaucracy has kept expenditures high even as revenue stalls. These persistent deficits have forced the government to increase its domestic and external borrowing, leading to a ballooning public debt.

Declining Public Capital Spending Widening the Infrastructure Gap:

Public capital spending has declined notably in recent years. Because of the aforementioned fiscal squeeze, the government has repeatedly slashed its development budget to cover recurrent costs. This lack of public investment ensures that the infrastructure gap remains wide, further deterring private investment and lowering the country's long-term growth potential.

Youth Exodus Causing Brain Drain and Premature Demographic Decline:

Massive outmigration, for employment and studies, has contributed to premature depopulation, creating long-term demographic challenges. Nepal is exporting its most valuable resource, its youth. This exodus is not just a labor issue; it is a brain drain and a muscle drain that leaves behind an aging population and a domestic economy that lacks the human capital to reinvent itself.

L. MACROECONOMIC OUTLOOK

01

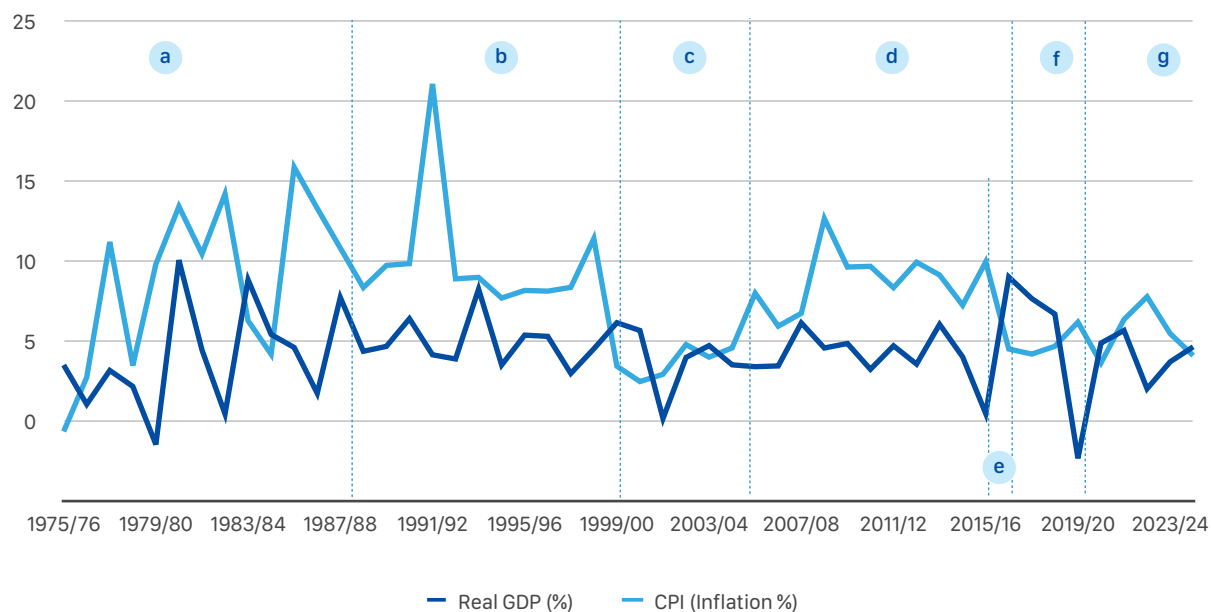
Economic Growth

Post-Pandemic Secular Stagnation Exposing Deep Structural Weaknesses:

The economy has entered a state of secular stagnation since the COVID-19 pandemic. This phase represents a low-growth trap where the internal engines of the economy, private investment and domestic consumption, have failed to reboot to their previous levels. Economic growth since the pandemic has averaged approximately 3 percent below the long-term average of 4.5 percent, suggesting that the pandemic was not merely a temporary hurdle but a catalyst that exposed and deepened existing structural weaknesses.

Figure 3 — Historical Macroeconomic Outlook

Source: Nepal Rastra Bank (NRB)



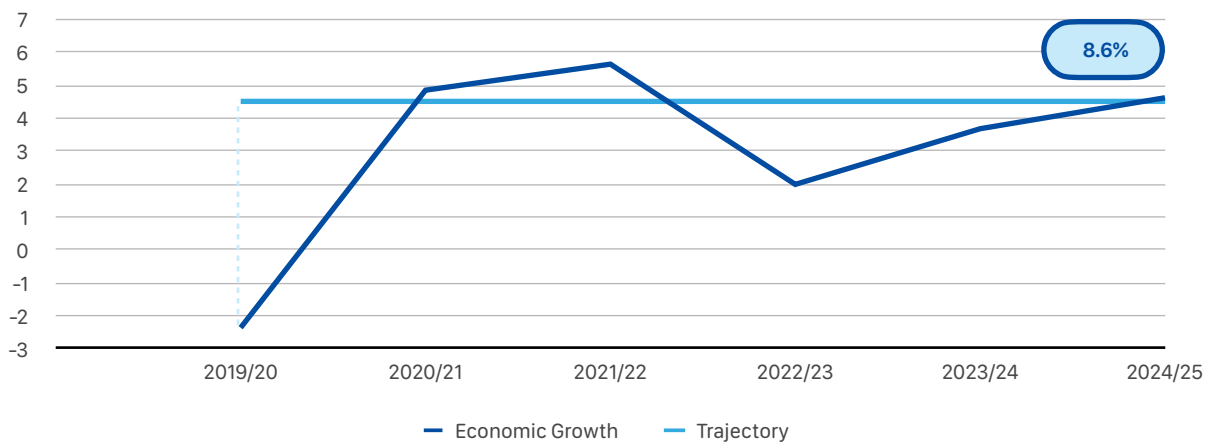
Period (Duration)	GDP (%)	Inflation (%)
a Panchayat (15 Years)	4.01	8.84
b Multiparty (11 Years)	5.01	9.57
c Maoist (6 Years)	3.54	4.42
d Power Outage (9 Years)	4.09	8.89
e New Constitution (9 Years) / Earthquake / Blockade	4.20	5.64
f 14th Plan (3 Years)	7.75	4.41
g COVID-19 (5 Years)	2.75	5.85

Pandemic-Induced Economic Scarring:

The cumulative loss in GDP since the pandemic is estimated at 8.6 percent, equivalent to two years of economic output. This highlights the permanent scarring of the economy. This lost output represents missing income for households and lost revenue for the state that can never be recovered, effectively pushing the timeline for Nepal’s development goals back by at least two fiscal cycles and reducing the overall wealth-generation capacity of the current generation.

Figure 4 — Economic Growth Since COVID-19

Source: Nepal Rastra Bank (NRB)

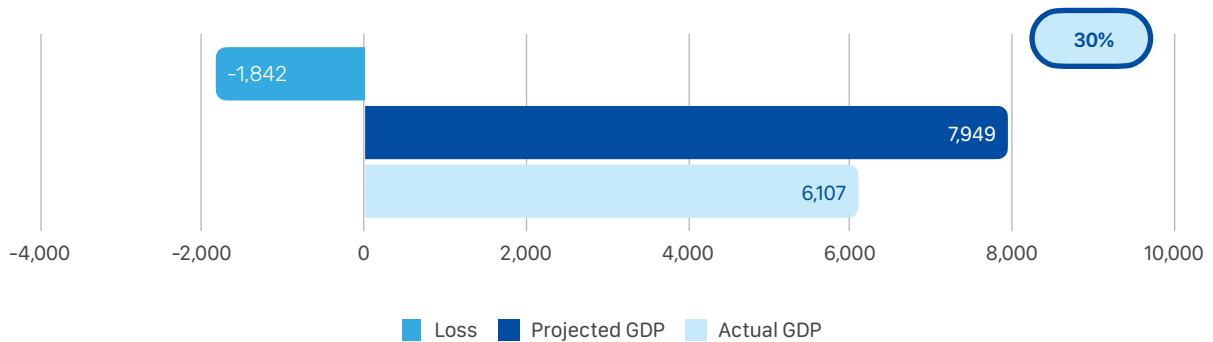


Nominal GDP Far Below Trajectory, Undermining Debt and Asset Sustainability:

In nominal terms, GDP is now 30 percent below its long-term trajectory. This massive deviation from the expected path indicates a significant cooling of the entire economy. Nominal GDP growth since FY 2022/23 has been 7 percent, compared to a long-term average of 12 percent, with the decline expected to impact income, consumption, and overall economic activity. This slowing nominal growth directly correlates with the Wealth-Income Paradox, as the ability of the economy to generate the cash flow needed to service debts and sustain high land prices begins to vanish.

Figure 5 — Loss of Economic Output Since COVID-19

Source: Nepal Rastra Bank (NRB)



Widest Ever Gap Between Development Plan Targets and Actual Growth:

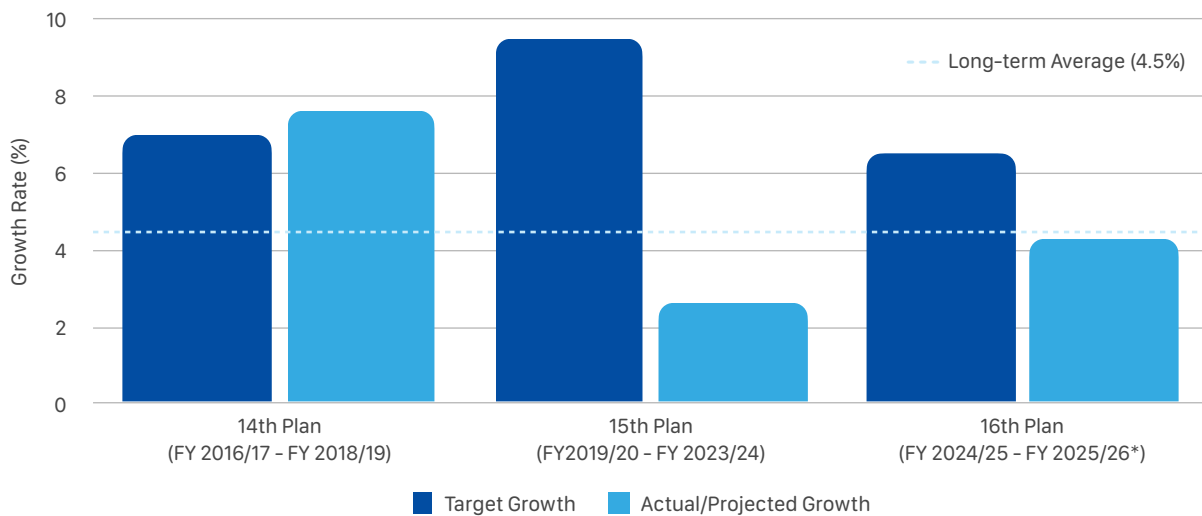
Nepal transitioned from a period of strong performance during the 14th Development Plan (FY 2016/17 – FY 2018/19), which averaged 7.75 percent GDP growth, to the weakest 15th Development Plan (FY 2019/20 – FY 2023/24) with only 2.75 percent growth, despite targeting a historically high growth of 9.58 percent. This plan failure is one of the most significant in the country’s history. The gap between the 9.58 percent target and the 2.75 percent reality demonstrates a complete decoupling of official planning from the actual economic constraints of the New Normal, highlighting the inefficiency of traditional top-down development models in the current landscape.

Optimism Bias Threatening 16th Plan Targets Amid Continued Stagnation:

Currently, Nepal is in the second year of the 16th Development Plan, and prospects remain weak relative to the plan’s target of 7.1 percent average growth. Early indicators suggest that the 16th Plan may suffer from the same optimism bias as its predecessor. Without a radical departure from existing policies, the economy is likely to continue tracking at its secular stagnation rate of 3–4 percent, falling well short of the targets required to achieve meaningful poverty reduction or a sustainable transition to middle-income status.

Figure 6 — Nepal GDP Growth: Plan Targets vs. Reality

Source: Nepal Planning Commission (NPC), Nepal Rastra Bank (NRB)



Structural Roots of Stagnation Demanding Second-Generation Reforms:

These growth challenges are structural, not solely attributable to one-off events such as the pandemic or the Gen-Z movement. While these events acted as triggers, the underlying issues, premature depopulation, the vicious cycle of remittances, and a banking sector trapped in real estate speculation, predate them. Consequently, there is an urgent need for a second-generation structural reform program implemented in a mission mode. This mission mode approach implies that incrementalism is no longer an option; Nepal requires a National Economic Charter and an economic reset on the scale of Vision 2100 to break the stagnation and re-anchor the economy on a productive path.

02

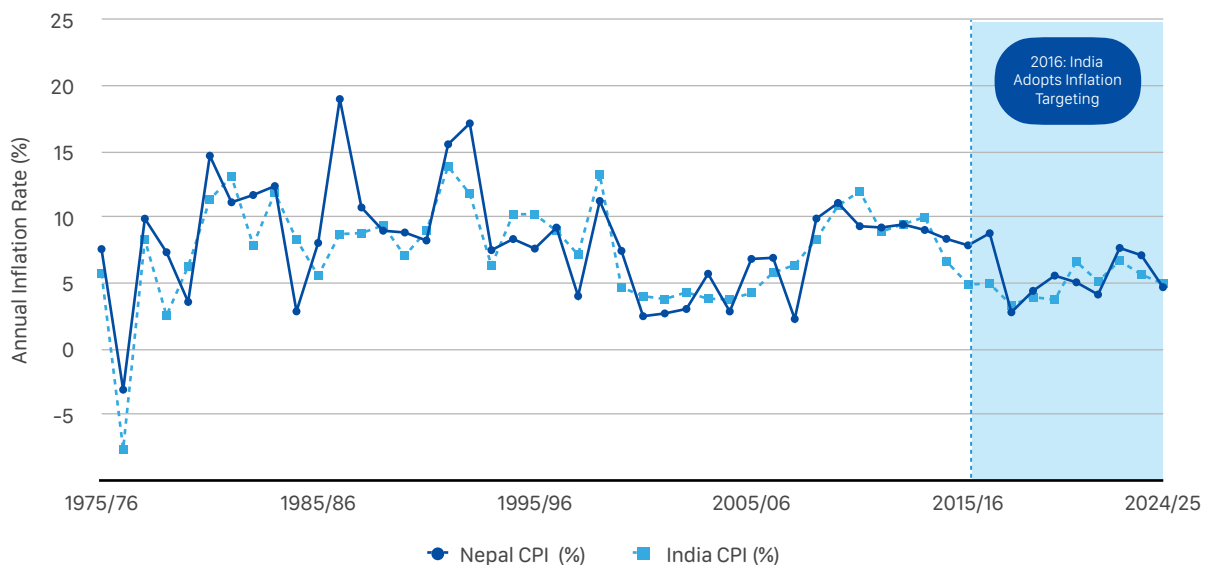
Inflation Dynamics

Nepal's Inflation Structurally Anchored to India's Monetary Policy Transmission:

Inflation in Nepal, as measured by the Consumer Price Index (CPI), remained persistently high prior to 1990, averaging in the double digits. During the early decades of development, a lack of integrated markets and high transport costs kept prices volatile. From the 1990s until the promulgation of the new Constitution, average inflation remained above 8 percent. However, a structural moderation is observed after 2017, with average inflation easing to slightly above 5 percent. This shift is not a coincidence of domestic policy alone; this decline coincides with India's adoption of a formal inflation-targeting framework in 2016, after which India's average inflation declined to below 5 percent from about 7.5 percent during the 1990s–2016 period, reflecting the strong price transmission link under Nepal's exchange rate peg. Notably, the period from 2000 to 2005 recorded the lowest average inflation in history at 3.7 percent over six years, influenced by both external and internal factors including subdued domestic demand amid the Maoist insurgency, the 2001 royal massacre, and the broader economic slowdown preceding the Comprehensive Peace Agreement in November 2006. Ultimately, these trends indicate that Nepal's inflation dynamics are shaped by external anchoring and domestic structural conditions rather than purely domestic monetary factors.

Figure 7 — Long-Term CPI Comparison: Nepal vs. India (1975 - 2025)

Source: The World Bank

**Structural Shift from Food to Services as Primary Driver of Inflation:**

The current CPI basket assigns 34.5 percent weight to food and beverages and 64.5 percent to non-food and services. This weighting reflects a modernizing consumption pattern, yet it changes how we view volatility. Historically, food inflation exhibited higher volatility due to supply shocks and weather

variability but over the past nine years, non-food and services inflation has become relatively more persistent and volatile. Data confirms this inversion: during this recent period, average food and beverage inflation stood at 4.9 percent, while non-food and services inflation averaged 5.4 percent. This contrasts with the longer historical period between 1975 and 2016, when food and beverage inflation averaged 9.4 percent and non-food and services inflation averaged 8.3 percent. The moderation in food inflation alongside rising pressure in non-food and service components suggests a structural shift toward cost-driven and service-sector inflation, with implications for monetary transmission and supply-side reform priorities.

Fixed Exchange Rate Peg Importing India's Inflation Stability into Nepal:

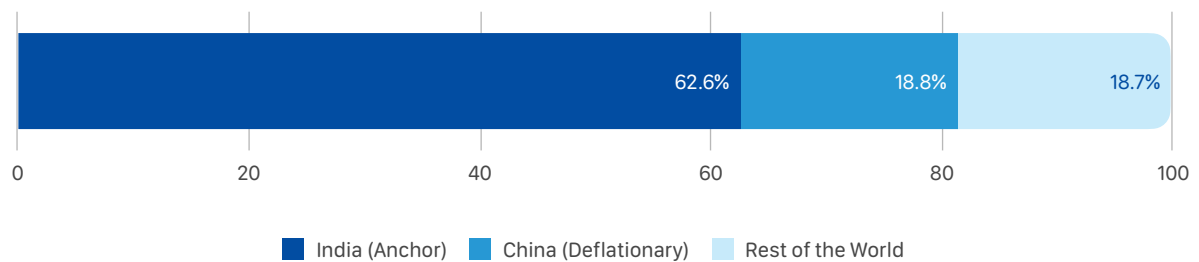
Inflation dynamics in Nepal are shaped by structural constraints, including the fixed exchange rate regime with India, the open border that transmits external price shocks, and persistent market imperfections. This imported stability means that inflation has remained benign in recent years, partly due to India’s adoption of an inflation-targeted regime since 2016. Because Nepal, being heavily dependent on imports from India (above 60 percent), has benefited from low inflation in India, the peg effectively acts as the primary anchor for domestic price expectations.

Chinese Deflation and Easing Global Shocks Shifting Inflation to Domestic Inefficiencies:

Expanding on the geographic origins of these pressures, imports from China, which account for under 20 percent of total imports, have had a deflationary effect on the price level, largely due to the influx of low-cost manufactured goods. Imports from the rest of the world, also constituting almost 20 percent, have seen inflation gradually ease from the highs of 2022, which were driven by pandemic-related supply chain disruptions and the Russia-Ukraine war. This easing suggests that while global commodity shocks have subsided, Nepal’s internal price level is now more sensitive to domestic inefficiencies than global supply chains.

Figure 8 — Nepal Import Dependency & Inflation Influence in FY 2023/24

Source: Nepal Rastra Bank (NRB)



Supply Chain Inefficiencies and Credit Defaults Embedding Hidden Costs in Consumer Prices:

The internal drivers of these costs are rooted in systemic failures. Inefficient supply chains characterized by multiple intermediaries in the supply chain, the absence of a clear legal framework governing trade credit and recovery of dues, and rising defaults among consumers are the domestic factors amplifying cost pressures. A major bottleneck is that a significant portion of trade is conducted on credit without effective enforcement mechanisms, leading to accumulated unrecovered receivables across the supply chain. Consequently, these losses are often embedded into pricing structures, forcing

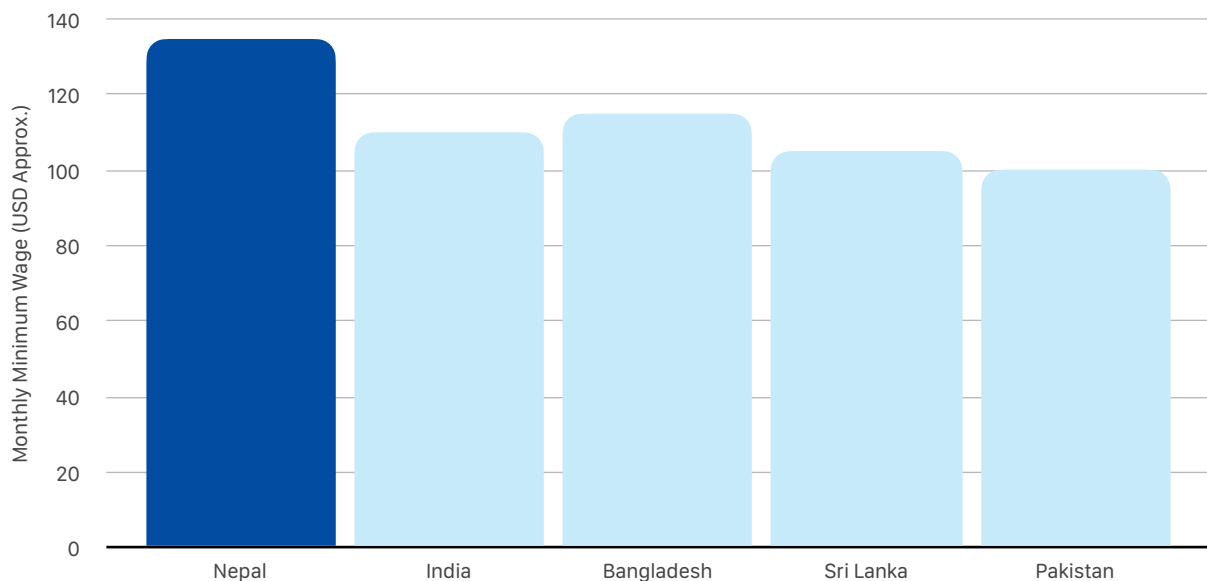
final consumers to bear higher margins that incorporate bad-debt risks, essentially creating an inefficiency tax on every purchase.

Structurally High Price Level Undermining Nepal's Regional Competitiveness:

Crucially, Nepal's overall price level is among the highest in South Asia, second only to the Maldives, a fact that reflects structural cost factors rather than recent inflation alone. Elements such as high logistics and transport costs associated with landlocked geography, relatively elevated minimum wage levels compared to regional peers, and exceptionally high land prices have all raised the cost structure of both consumption and production. It is therefore important to distinguish between inflation and price level in this context; while inflation measures the rate at which prices increase over time within a country, price level compares the absolute cost of a similar basket of goods and services across countries. Nepal's challenge is therefore not only managing inflation, but also addressing the structurally high price level that undermines competitiveness, discourages investment, and reduces real purchasing power relative to peer economies.

Figure 9 — Regional Competitiveness: Minimum Wage Comparison

Source: The World Bank



Inflation outcomes are frequently driven more by imported inflation and structural rigidities than by domestic liquidity conditions alone, limiting the transmission effectiveness of conventional monetary tools.

This reality underscores that the Nepal Rastra Bank faces a limited toolkit; without addressing the underlying high price level and the Wealth-Income Paradox of real estate, traditional interest rate adjustments will struggle to produce the desired macroeconomic resets.

03

External Sector Dynamics

Record External Sector as a Pillar of Macroeconomic Stability:

One of the most positive and defining features of Nepal’s economy has been the sustained strength of its external sector, which has played a critical role in maintaining macroeconomic stability over the years. Driven primarily by remittance inflows, the external sector has consistently provided the foreign exchange liquidity needed to finance imports, stabilize the balance of payments, and maintain confidence in the exchange rate regime. This has helped Nepal avoid the kind of recurrent external crises experienced by many developing economies, making the external sector a key anchor of overall economic stability even during periods of internal structural weakness.

Strengthened External Buffers Amid Demand-Led Adjustment:

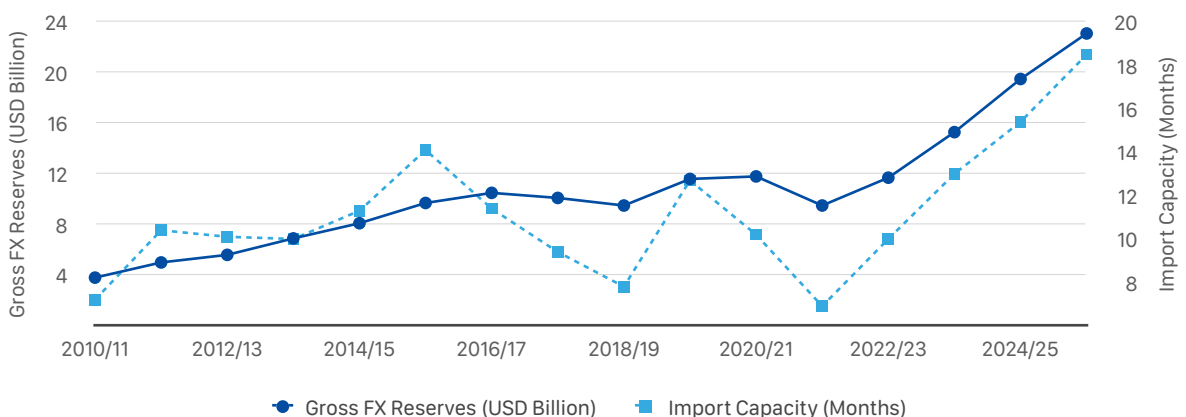
Nepal’s external position has improved significantly in recent years, with foreign exchange reserves reaching record levels of over USD 23 billion in the first eight months of FY2025/26, up from USD 19.5 billion at the end of FY 2024/25. This strengthening reflects a combination of robust remittance inflows and a sharp moderation in imports. While this has enhanced external stability and reduced immediate vulnerability, it is important to recognize that the adjustment has been largely demand-driven. The decline in imports is primarily the result of subdued domestic consumption and weak private investment rather than increased domestic production or import substitution. As a result, the external sector appears strong, but this strength is underpinned by a slowdown in internal economic activity.

Trade Deficit Compression Reflecting Weak Domestic Demand rather than Competitiveness Gains:

The narrowing of Nepal’s trade deficit from a peak of 34.6 percent of GDP in FY 2021/22 to around 25 percent in FY 2024/25 marks a significant correction. Imports have declined from 38.6 percent to approximately 29.5 percent of GDP over the same period, a reduction of nearly 9 percentage points. However, this adjustment has not been driven by improvements in export competitiveness or domestic production capacity. Over the past nine years since the 2015 Constitution, the structural imbalance remains pronounced, with average imports at 33 percent of GDP, exports at barely 3 percent, and the trade deficit averaging around 30 percent of GDP. The recent compression therefore reflects weakened aggregate demand and private investment, rather than a structural shift in the trade profile.

Figure 10 — Foreign Exchange Reserves and Import Capacity

Source: Nepal Rastra Bank (NRB)

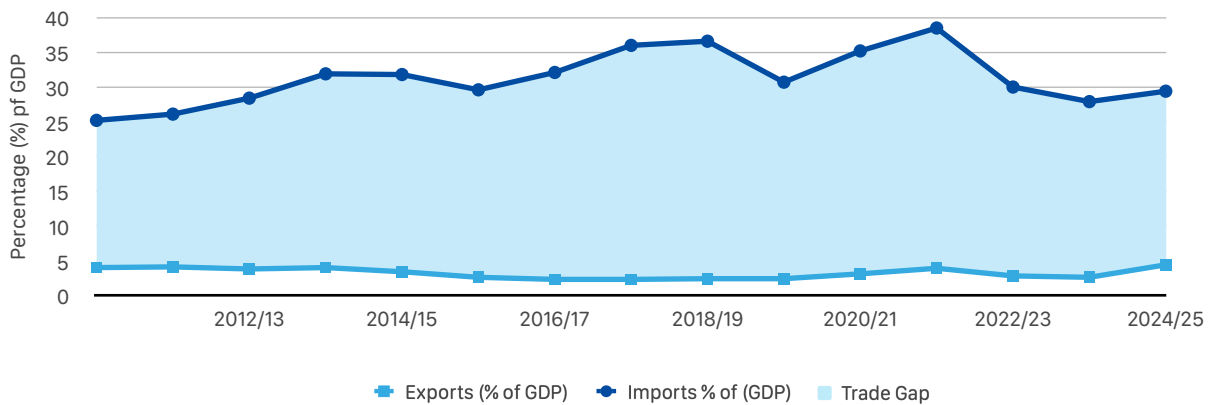


Persistently Low Export Base Highlighting Structural Constraints:

Exports continue to remain marginal, fluctuating between 2.7 percent and 4.5 percent of GDP, and have not gained meaningful traction in regional or global markets. This persistent stagnation points to a hollowed-out productive base, limiting Nepal’s ability to benefit from value-added trade. While the reduced trade deficit has contributed to short-term external stability, it largely reflects a contraction in import demand rather than an expansion in export capacity, underscoring the structural challenges in building a competitive export sector.

Figure 11 — Exports vs Imports: Widening Gap and Recent Contraction

Source: Nepal Rastra Bank (NRB)

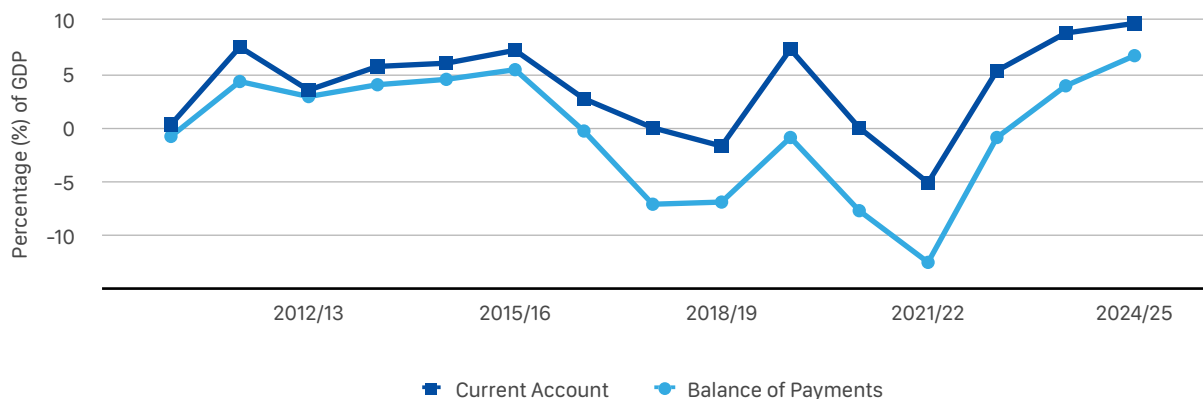


Current Account Surplus Indicating Excess Savings and Weak Domestic Absorption:

Nepal has recorded a current account surplus for the first time since FY 2015/16, reaching 3.9 percent of GDP in FY 2023/24 and 6.7 percent in FY 2024/25, with further improvement expected. This reversal has been driven by strong remittance inflows alongside compressed imports. By definition, the surplus reflects an excess of national savings over domestic investment, indicating that available financial resources are not being fully absorbed within the domestic economy. For a capital-scarce country with significant investment needs, this signals a gap in the ability to translate financial inflows into productive economic activity, reinforcing the pattern of external strength coexisting with subdued domestic growth.

Figure 12 — Current Account and Balance of Payments (BoP) Trends

Source: Nepal Rastra Bank (NRB)



FY 2021/22 as a Structural Inflection Point:

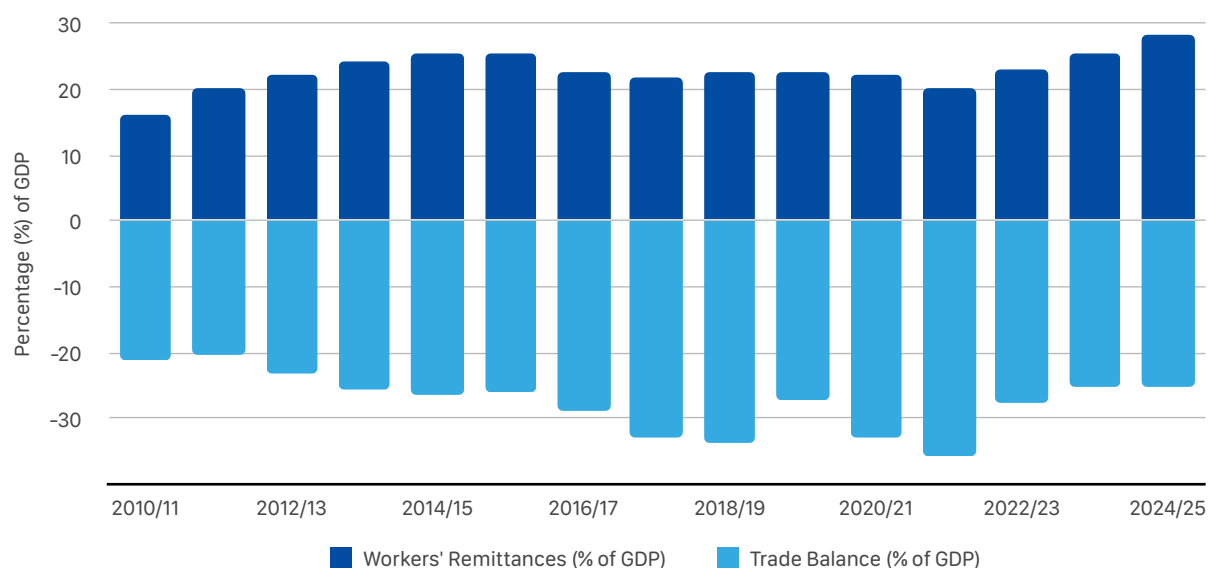
The external sector experienced a critical stress episode in FY 021/22, with simultaneous deficits in trade (34.6 percent of GDP), the current account (12.5 percent), and the balance of payments (5.1 percent). Despite reserves covering 7 months of imports, the speed and scale of outflows raised serious concerns about macroeconomic stability, drawing comparisons with crisis-hit economies. This episode highlighted the inherent vulnerability of the remittance-import model, where surges in domestic demand quickly translate into unsustainable external imbalances, placing pressure on the exchange rate regime and overall economic stability. The severity of such vulnerabilities is underscored by the historical precedent of three consecutive years of balance of payments deficits during FY 1982/83 - FY 1984/85, which required IMF intervention under the Structural Adjustment Program (SAP), highlighting the risks of prolonged external imbalances.

Remittance as the Anchor of External Stability with Emerging Structural Limits:

Remittance has remained the central pillar of Nepal’s external stability, consistently financing a large share of the trade deficit and enabling the accumulation of foreign exchange reserves. However, this stability is not without structural limits. Periods of rising domestic demand have historically translated into sharp increases in imports, often outpacing the growth of remittance inflows. This dynamic became evident during FY 2017/18 and FY 2018/19, when the economy experienced consecutive balance of payments deficits (in dollar), exposing underlying vulnerabilities. The pressure was only temporarily alleviated by the COVID-19-induced compression in imports in FY 2019/20. These episodes reveal a fundamental “speed limit” in the economy, where demand expansion is quickly constrained by external sector pressures. More recently, since May 2025 (Baisakh 2082), remittance inflows have, for the first time, exceeded imports even as average monthly imports since January 2025 have returned to their FY 2021/22 peak levels. While this marks a significant strengthening of external buffers, it also underscores the economy’s continued reliance on remittance as the primary stabilizing force. This reinforces a structural dependence where external stability is sustained not by export competitiveness or domestic production, but by labor income generated abroad, thereby constraining the economy’s ability to achieve sustained, demand-driven growth.

Figure 13 — Remittance Inflows vs. Trade Balance (as % of GDP)

Source: Nepal Rastra Bank (NRB)



04

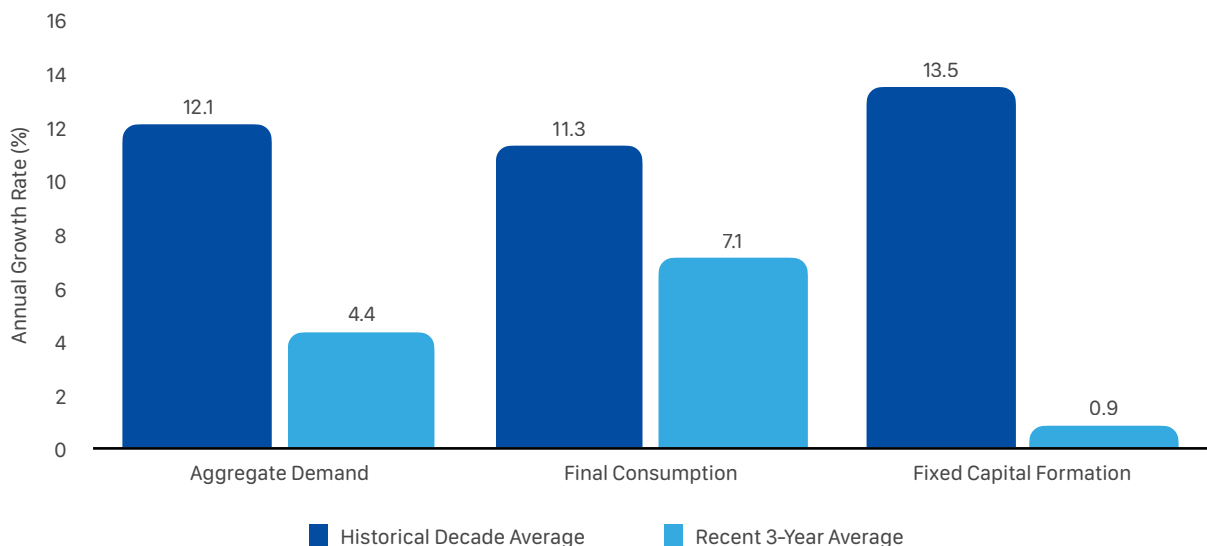
Collapse of Aggregate Demand

Structural Collapse in Aggregate Demand Compressing Growth, Employment, and Fiscal Sustainability:

Nepal's economy is experiencing a pronounced collapse in aggregate demand, reflecting a structural weakening of both consumption and investment dynamics. Aggregate demand, comprising gross final consumption and gross capital formation, has declined sharply from an average growth rate of 12.1 percent in the decade preceding FY 2021/22 to just 4.4 percent over the past three years. This represents not merely cyclical moderation but a deep demand compression with implications for growth, employment, and fiscal sustainability.

Figure 14 — The Great Demand Compression: Growth Stagnation

Source: Nepal Rastra Bank (NRB)

**Demand Weakening Faster than Output, Signaling Deep Private Sector Retreat:**

The slowdown in aggregate demand exceeds the deceleration in nominal GDP growth, which declined from a ten-year average of 11.1 percent to 7.1 percent during the same period. This divergence suggests that domestic demand drivers have weakened more rapidly than overall output, pointing toward subdued private sector investment and constrained spending behavior.

Income Stagnation and Negative Wealth Effects Slowing Household Consumption:

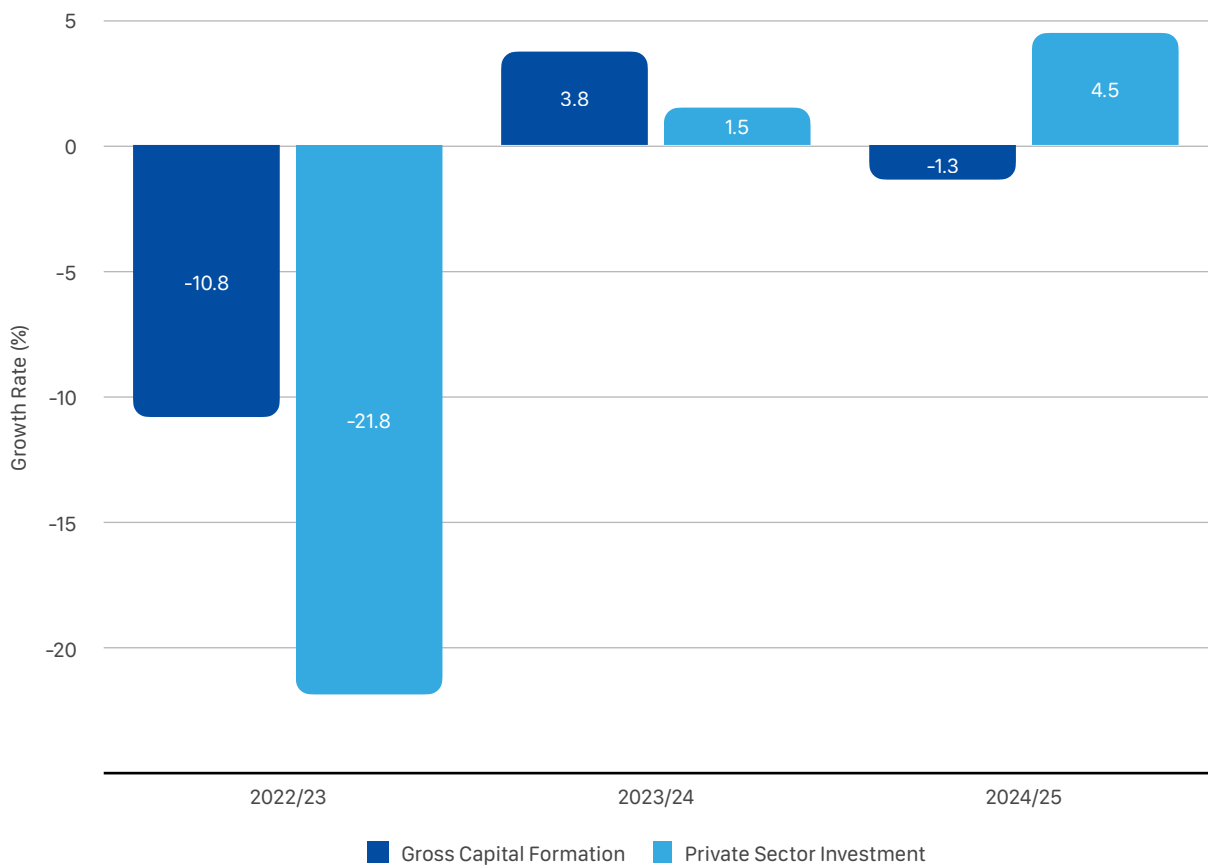
Final consumption growth has mirrored nominal GDP trends, declining from 11.3 percent to 7.1 percent. While consumption has not collapsed outright, it has slowed sufficiently to reflect income stagnation, and declining purchasing power. The erosion of wealth in real estate and financial markets has further dampened household spending through negative wealth effects.

Capital Formation Collapse Undermining Future Productive Capacity and Growth Potential:

The most severe adjustment has occurred in capital formation. Gross capital formation contracted sharply by –10.8 percent in FY 2022/23, recovered marginally by 3.8 percent in FY 2023/24, and declined again by –1.3 percent in FY 2024/25, resulting in an average contraction of –2.7 percent over the three-year period. Similarly, gross fixed capital formation has fallen from 13.5 percent to just 0.9 percent. This volatility and overall negative trend signal a structural weakening of investment activity across the economy. The collapse in capital accumulation undermines future productive capacity, employment generation, and medium-term growth potential. Similarly, gross fixed capital formation has decelerated from robust double-digit growth in the previous decade to near stagnation in recent years, reinforcing the erosion of long-term growth foundations.

Figure 15 — Annual Growth in Capital Formation (FY 2022/23 - FY 2024/25)

Source: Nepal Rastra Bank (NRB)



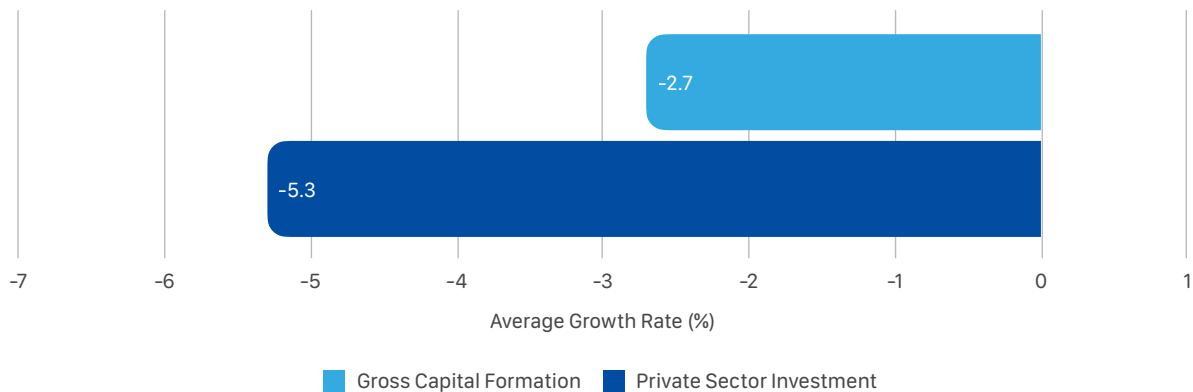
Private Investment Collapse Reflecting Failure to Transition Beyond Real Estate and Import-led Trade:

Within capital formation, private sector investment has experienced the most dramatic contraction. Capital formation by the private sector declined by –21.8 percent in FY 2022/23, followed by modest growth of 1.5 percent in FY 2023/24 and 4.5 percent in FY 2024/25, yielding an average contraction of

–5.3 percent over the three-year period. However, this downturn is less a reflection of short-term investor pessimism or policy uncertainty and more the outcome of a structural correction. For over a decade, private investment was disproportionately concentrated in import-led trading activities and real estate speculation, both of which peaked around FY 2021/22. As these sectors reached saturation, the private sector has struggled to reallocate capital toward new, productivity-enhancing sectors capable of driving sustained growth and employment. The challenge is therefore structural: an innovation deficit and limited entrepreneurial transition into higher value-added sectors.

Figure 16 — Average Annual Contraction (Past 3 Years)

Source: Nepal Rastra Bank (NRB)



Liquidity Paradox: Abundant System-Wide Liquidity Failing to Reach Productive Investment:

The investment slowdown has occurred alongside an unprecedented surge in remittance inflows, leaving the banking system with excess liquidity. Yet this liquidity has not translated into productive credit expansion. Nepal is currently facing a liquidity paradox: banks hold surplus liquidity, while firms and households remain credit-constrained. Weak credit growth, crises in savings and credit cooperatives, declining stock market turnover, subdued real estate transactions, and cautious borrowing behavior have limited the transmission of financial resources into productive investment. In effect, liquidity is abundant at the systemic level but scarce at the transactional level.

Broad-Based Public and Private Investment Slowdown Compounding Capital Accumulation Weakness:

Although the decline in public investment has been less dramatic than that of the private sector, it remains subdued relative to development needs. Government capital expenditure growth has moderated from 17.9 percent in the previous decade to 16.1 percent in the past three years, while public enterprise investment growth has declined from 28.4 percent to 22.5 percent. This broad-based slowdown indicates systemic weakness in capital accumulation across public and quasi-public sectors, compounding the private investment collapse.

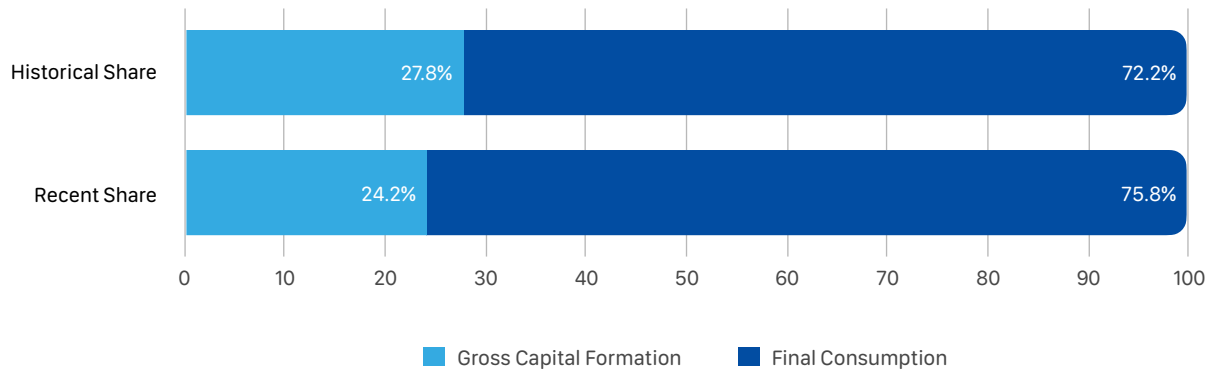
Demand Composition Shifting Toward Consumption as Investment Share Declines:

As a result of this sustained investment contraction, the composition of gross domestic demand has shifted toward consumption. The share of gross capital formation in total demand has declined from

27.8 percent to 24.2 percent, while final consumption has increased from 72.2 percent to 75.8 percent over the past three years. This rebalancing toward consumption, absent strong investment momentum, weakens the economy’s ability to expand productive capacity and export competitiveness.

Figure 17 — Changes in the Composition of Gross Domestic Demand

Source: Nepal Rastra Bank (NRB)



The Cumulative Effect of These Trends is a Self-Reinforcing Demand Trap:

Weak investment reduces job creation and income growth; lower income growth suppresses consumption; subdued demand discourages further investment. Without strategic reallocation of capital toward new growth engines and high-multiplier sectors, Nepal risks entering a prolonged phase of low-growth equilibrium characterized by secular stagnation.

05

Monetary Policy

Limited Effectiveness in Achieving Price Stability:

Monetary policy in Nepal is formally designed to achieve price stability by influencing aggregate demand through interest rate adjustments. In practice, however, its effectiveness has been constrained by structural characteristics of the economy. Inflation dynamics are heavily influenced by the fixed exchange rate peg with India, open-border price transmission, supply-side rigidities, inefficient distribution networks with multiple intermediaries, and lack of legal enforcement of trade credit. The absence of a robust legal framework governing sales on credit has led to large unrecovered receivables within supply chains, and such bad debts are often embedded in pricing margins, ultimately raising consumer prices. As a result, inflation outcomes are frequently driven by imported and structural factors rather than domestic liquidity conditions alone, limiting the effectiveness of conventional monetary tools. Over time, this has weakened the credibility of the central bank in anchoring inflation expectations and decisively containing inflationary pressures.

Interest Rate Corridor and Weak Signaling Mechanism:

Nepal Rastra Bank (NRB) operates an interest rate corridor framework introduced in FY 2017/18 as its principal monetary policy instrument. However, the corridor width ranging from 300 to 400 basis points (currently 300 bps as of December 2025) is excessively wide compared to regional peers such as India (50 bps), Sri Lanka (100 bps), and Bangladesh (400 bps after recent widening). Such breadth weakens the signaling function of policy rates. The overnight interbank rate tends to cluster near the lower bound during periods of excess liquidity and near the upper bound during liquidity tightening. Under normal conditions, it often trades outside the corridor, frequently below the floor, with occasional distortions driven by a small number of outlier transactions. This undermines the corridor's credibility as an effective operational anchor.

Monetary Independence Under the Fixed Exchange Rate Regime:

The relevance of the Mundell-Fleming Trilemma (the Impossible Trinity) must be interpreted within Nepal's institutional context. Given the absence of capital account convertibility, Nepal retains a degree of monetary autonomy despite maintaining a fixed exchange rate peg with the Indian rupee. Monetary policy is therefore not mechanically constrained by the Reserve Bank of India. However, the peg does import price movements and constrains exchange-rate-based adjustment mechanisms, thereby increasing reliance on domestic structural reforms to manage inflation.

Weak Monetary Transmission and Market Failures:

Monetary policy transmission in Nepal remains weak and inefficient. Empirical trends indicate that a small number of outlier banks exert disproportionate influence over market interest rates, often overshadowing policy signals from the central bank. Unless liquidity facilities provided by NRB are treated as eligible regulatory deposits for balance-sheet purposes, transmission distortions are likely to persist. Persistent excess liquidity in the banking system coexists with constrained liquidity in the real economy, reflecting structural market failure rather than policy calibration alone.

Risk of Financial Repression:

Deposit rates have declined to below 4 percent at the beginning of FY 2024/25 while inflation has also remained below 2 percent. Although real rates are currently positive, a supply-side or imported inflation shock without a commensurate adjustment in deposit rates could push the economy into financial repression, eroding depositor wealth and undermining savings mobilization. Given Nepal's bank-dominated financial structure, such erosion could have systemic implications.

Excessive Historical Credit Expansion and Structural Distortions:

Over the past three decades, average annual private credit growth exceeded 20 percent, above the nominal GDP growth. This expansion largely fueled imports, land prices, and asset inflation rather than productive capacity or export competitiveness. The result has been an over-leveraged economy relative to income levels, rising asset price volatility, and increased vulnerability to credit cycles. The recent collapse in credit growth reflects structural correction rather than purely cyclical downturn.

Rising Non-Performing Assets (NPAs) and Systemic Risks:

The slowdown in credit expansion has exposed structural weaknesses in asset quality, with rising non-performing assets (NPAs) posing significant risks. Given the size of the banking sector relative to GDP, financial instability could quickly spill over into macroeconomic instability. The emergence of stress across banks, corporates, and households reflects early signs of a twin balance sheet problem, requiring proactive supervisory intervention.

Systemic Liquidity Abundance Failing to Transmit into Real Economic Activity:

Nepal is currently experiencing a liquidity paradox, a condition in which liquidity is abundant at the systemic level but constrained in productive deployment, reflecting weak transmission from financial intermediation to real economic expansion. The banking system holds substantial excess loanable funds, yet aggregate demand, credit absorption, and private investment remain persistently weak due to structural imbalances, balance sheet stress, and limited confidence in emerging productive sectors. Liquidity in the banking system has expanded significantly, largely driven by unprecedented remittance inflows, and interest rates have softened accordingly. However, credit demand remains subdued and economic activity restrained. Real estate transactions and stock market turnover have declined, cooperative sector distress has weakened household balance sheets, and high private leverage combined with the absence of new scalable investment avenues has dampened borrower appetite.

Structural Allocative Failure, not Classical Liquidity Trap, Constraining Credit Deployment:

This differs from a classical liquidity trap in which monetary policy becomes ineffective because interest rates approach the zero lower bound and economic agents hoard cash despite expansionary measures. In Nepal's case, interest rates are not at zero, banks are willing to lend, and deposits continue to grow; the constraint lies not in the price of money but in the structure of the economy, characterized by past over-investment in unproductive sectors, high leverage, demand compression, and limited bankable projects in high-productivity areas. The challenge is therefore structural and allocative rather than purely monetary.

06

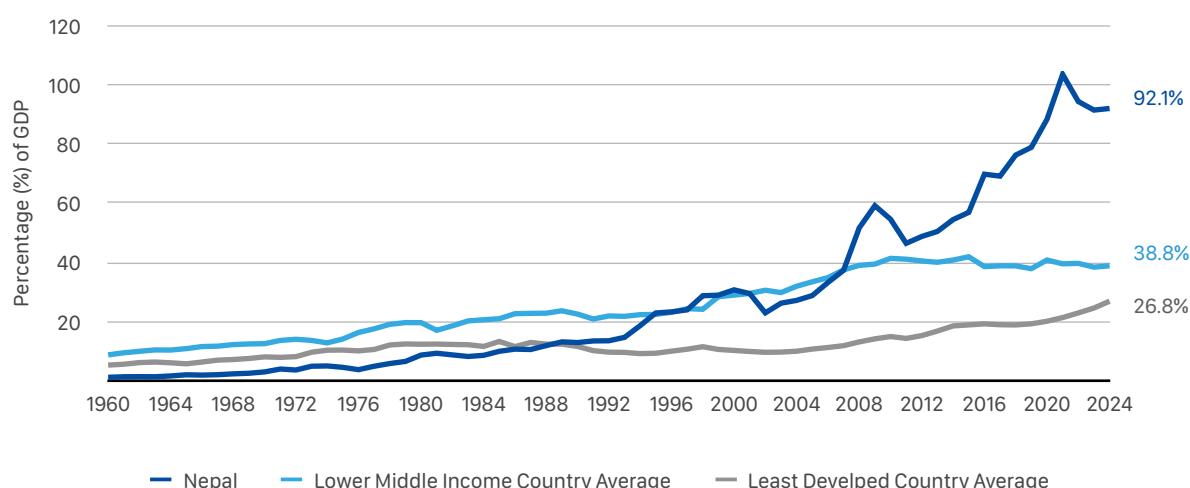
Financial Sector Diagnosis

Disproportionate Financial Deepening Creating Excessive Leverage Relative to Productive Capacity:

Nepal's financial sector has been the principal beneficiary of first-generation economic reforms, expanding at a pace unmatched by the real economy. Private sector credit increased from less than 12 percent of GDP in 1990 to a peak of 95 percent in 2021, before moderating slightly to around 92 percent. Between 2012 and 2021 alone, private credit more than doubled from 46 percent to 95 percent of GDP in just nine years. This level of financial deepening is unusually high for a lower-middle-income country at Nepal's stage of development and is comparable to ratios observed in high-income economies. Reflecting this expansion, the financial sector's contribution to GDP has also risen—from 2.17 percent in FY 2000/01 to 6.6 percent in FY 2024/25, after peaking at 7.06 percent in FY 2019/20. Such rapid financial sector growth indicates a highly leveraged household and corporate sector relative to national income and underlying productive capacity.

Figure 18 — Domestic Credit to Private Sector (% of GDP)

Source: The World Bank

**Recapitalization Reform Accelerating Credit Growth without Productive Transformation:**

A major inflection point occurred after the 2015 policy mandating a 4 to 25-fold increase in minimum paid-up capital for Banks and Financial Institutions (BFIs), aimed at enforcing consolidation and strengthening resilience. While the reform improved capitalization and encouraged mergers, it also coincided with a surge in credit growth. Private credit rose from 57 percent of GDP in 2015 to over 84 percent by 2020. Notably, even 57 percent of GDP was already elevated relative to peer benchmarks, well above the average for Least Developed Countries and above the broader lower-middle-income country average. The subsequent acceleration intensified financial leverage without commensurate gains in productive transformation.

Premature Financialization Amplifying Asset Inflation Beyond Real Economy's Absorptive Capacity:

By 2020, broad money supply (M2) and domestic credit exceeded GDP, and by 2021 total deposits surpassed GDP, an extraordinary development for an economy with a per capita income of roughly USD 1,500. The scale of financial intermediation relative to income levels signals premature financialization, where the financial sector expands beyond the absorptive and productive capacity of the real economy. In such circumstances, credit expansion risks amplifying asset inflation rather than supporting structural transformation.

Decades of Credit Growth Financing Speculation Instead of Productivity-Enhancing Investment:

Despite decades of sustained credit growth averaging above 20 percent annually for much of the post-1990 period, real economic growth has remained low, generally below 4.5 percent. This divergence reveals a fundamental misallocation of financial resources. Much of the credit expansion has financed imports, real estate activity, and land monetization rather than productivity-enhancing investments in agriculture, natural resource(s), industries, exports, services, or technological upgrading. The result has been rising land prices, import dependency, and periodic inflationary pressures rather than durable gains in output and employment. In effect, inefficiencies once attributed primarily to the public sector have, over time, shifted into the private sector through misdirected capital allocation.

Directed Credit Failing to Transform Priority Sectors without Complementary Structural Reforms:

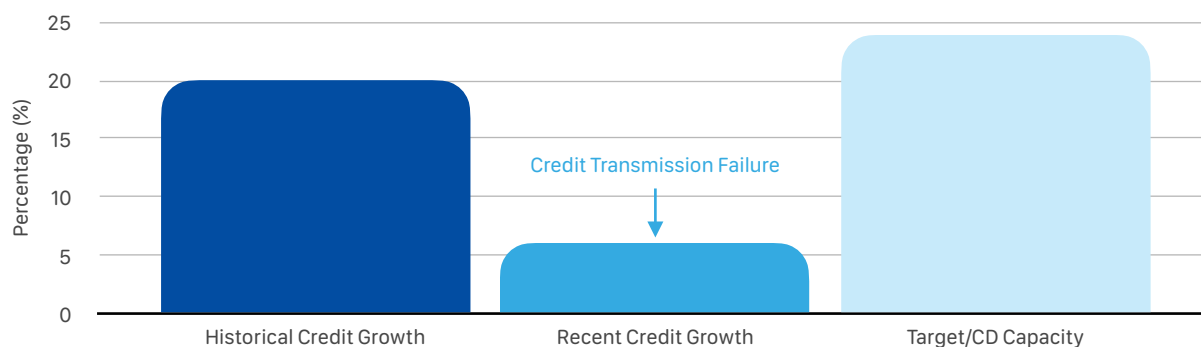
Directed lending policies have long attempted to steer credit toward priority sectors, such as agriculture, energy, and SMEs. However, the measurable impact of such policies remains ambiguous. Agriculture has been one of the largest recipients of concessional and directed credit in recent years, yet sectoral growth has decelerated compared to the previous decade. This suggests that credit targeting alone without complementary reforms in productivity, market access, value chains, and technology has limited transformative impact.

Sharp Credit Deceleration Exposing Structural Break from High-Growth Lending Regime:

Private credit growth has now slowed sharply, falling to an average of 6.3 percent over the past three years, compared to historical averages exceeding 20 percent. The Credit-to-Deposit (CD) ratio stands at approximately 76 percent midway through the current fiscal year, leaving more than NPR 1 trillion in excess loanable funds within the banking system. The deceleration marks a structural break from the high-credit-growth regime that previously masked underlying vulnerabilities.

Figure 19 — The Liquidity Paradox: Systemic Abundance vs. Deployment Failure

Source: Nepal Rastra Bank (NRB)



Remittance-Driven Liquidity Surplus Paralyzed by Weak Demand and Borrower Caution:

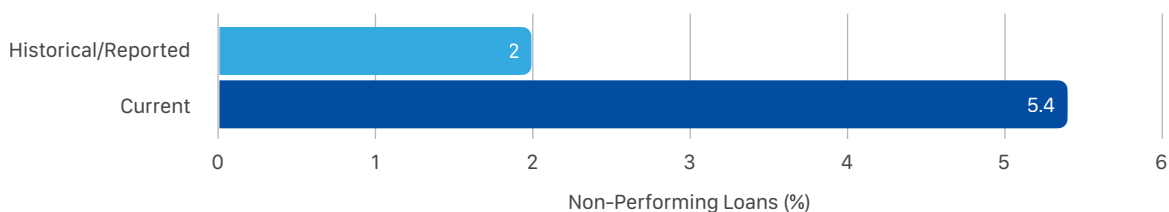
Nepal is currently experiencing a liquidity paradox. The banking system is flush with liquidity driven largely by unprecedented remittance inflows, yet credit demand remains weak and economic activity subdued despite historic low interest rate. Aggregate demand has contracted, real estate transactions and stock market turnover have declined, cooperative crises have eroded household liquidity, and cautious borrower sentiment has constrained credit absorption. Thus, liquidity is abundant at the systemic level but scarce in productive deployment.

Slowing Credit Growth Unmasking Hidden NPL Vulnerabilities Threatening Systemic Stability:

The slowdown in credit expansion has simultaneously exposed asset quality weaknesses. Non-Performing Loans (NPLs) have risen from below 2 percent to over 5.4 percent, signaling mounting stress in both the banking sector and among leveraged corporates and households. In the earlier high credit growth phase, rapid credit expansion enabled debt rollover and loan ever-greening, keeping reported NPLs artificially low. With slower credit growth, these vulnerabilities have surfaced, creating elements of a twin balance sheet challenge. Given the large size of the banking sector relative to GDP, rising NPLs pose systemic risks, with potential spillovers into broader macroeconomic instability if not managed proactively.

Figure 20 — Surfacing Risks: The Surge in NPLs

Source: Nepal Rastra Bank (NRB)



Unregulated Cooperative Sector Crisis Amplifying Systemic Financial Fragility:

The crisis in large Savings and Credit Cooperatives further compounds financial fragility. Many cooperatives engaged heavily in real estate and consumption-based lending without adequate prudential oversight, proper risk assessment, or governance safeguards. Weak internal controls, maturity mismatches, and concentrated exposures have triggered acute liquidity and solvency pressures. Unlike BFIs, cooperatives do not fall under the full regulatory and supervisory perimeter of the central bank and, crucially, do not have access to lender-of-last-resort or liquidity support facilities from the NRB. This regulatory vacuum, combined with the proliferation of thousands of lightly supervised entities has resulted in systemic governance failures, poor asset quality, and erosion of depositor confidence. The absence of effective oversight and emergency liquidity backstops has worsened the cooperative crisis, amplifying spillover risks to the broader financial system and undermining trust in community-based financial intermediation.

Microcredit Financing Consumption Over Production, Amplifying Systemic Contagion Risks:

Similarly, despite the rapid expansion of microcredit over the past decade, evidence of its transformative impact on income generation and productivity remains limited. A significant portion of microcredit appears to finance consumption smoothing rather than productive enterprise, and circular borrowing

practices have emerged in some regions due to oversupply. Combined lending by cooperatives and Microfinance institutions accounts for roughly 17 percent of total BFI lending, increasing interconnectedness within the financial system and magnifying contagion risks.

Nepal's financial system has outgrown the real economy it serves, making reorientation, not further expansion, the central challenge. Taken together, these trends reveal a system that expanded far faster than the productive base it was meant to support. The priority is no longer financial deepening, but financial reorientation, redirecting credit toward high-productivity, export-oriented, and employment-intensive sectors while strengthening prudential oversight, resolving impaired assets, and restoring confidence. Without such recalibration, the financial sector risks remaining large in size but limited in developmental impact.

07

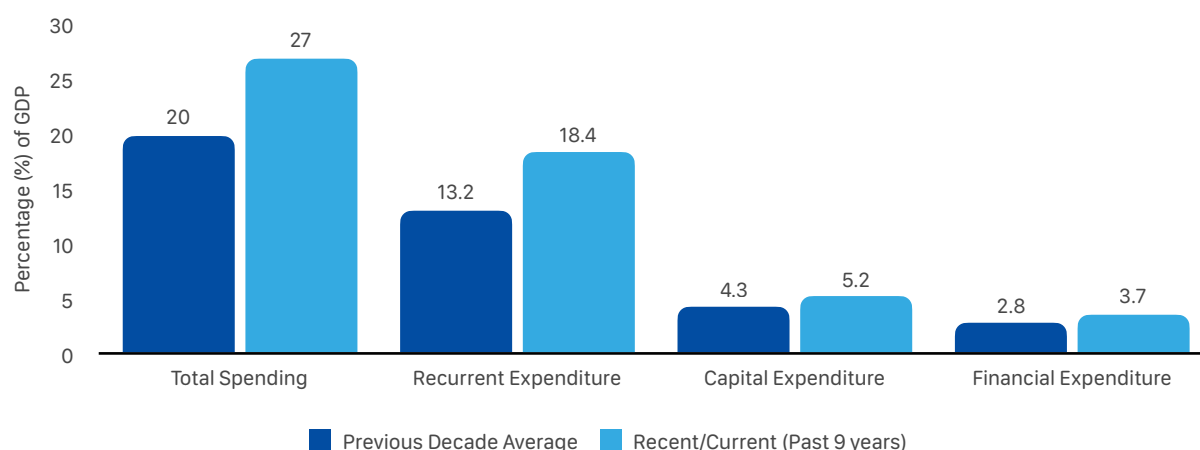
Fiscal Management and Public Finance

Fiscal Expansion Driven by Recurrent Spending without Proportional Development Returns:

Public expenditure has increased significantly since the promulgation of the new Federal Constitution — primarily driven by recurrent expenditure — resulting in a larger, consumption-oriented state. Total spending rose from an average of around 20 percent of GDP in the previous decade to over 27 percent during the past nine years. This expansion has been driven primarily by recurrent expenditure, which increased from 13.2 percent to 18.4 percent of GDP, and financial expenditure, which rose from 2.8 percent to 3.7 percent in the last two years. Nepal's recurrent expenditure alone is now comparable to the total public expenditure of many peer economies. Although overall expenditure has moderated to below 25 percent of GDP in the last two fiscal years, the structural shift toward a larger and more consumption-oriented state remains entrenched. For a lower-middle-income economy with limited productive capacity, such fiscal expansion without proportional gains in growth, productivity, or service delivery raises fundamental concerns about efficiency and sustainability.

Figure 21 — Shift in Public Expenditure Structure in Nepal

Source: Nepal Rastra Bank (NRB)

**Fragmented Capital Expenditure Undermining High-Multiplier Infrastructure Growth Potential:**

Public capital expenditure has declined sharply and suffered from a fragmentation of resources, weakening the growth impulse that high-multiplier infrastructure projects should generate. Spending peaked at NPR 270 billion (7.8 percent of GDP) in FY 2017/18 but declined sharply to 3.6 percent of GDP (NPR 222 billion) by FY 2024/25. Between FY 2016/17 and FY 2018/19, capital spending averaged around 7 percent of GDP; over the past four years, it has fallen to below 4 percent. Nearly two dozen so-called national pride infrastructure projects have suffered from chronic underfunding, resulting in prolonged completion timelines and cost overruns. Several large irrigation projects have remained incomplete for years due to thin budgetary allocations spread across numerous projects. This pattern reflects

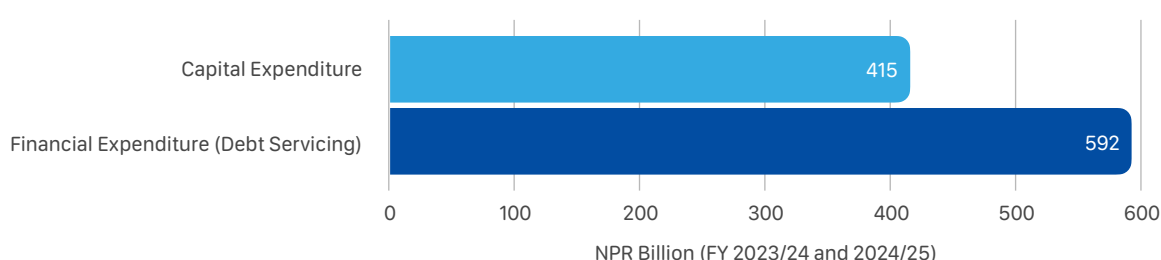
fragmentation of resources rather than strategic prioritization, weakening the growth impulse that high-multiplier capital expenditure could otherwise generate.

Debt Servicing Exceeding Capital Expenditure, Shifting Fiscal Policy from Growth to Liability Management:

In the last two fiscal years, financial expenditure (totaling NPR 592 billion) exceeded capital expenditure (totaling NPR 415 billion) by 1.4 times. The rising burden of debt servicing and other financial obligations is increasingly crowding out productive development spending. When interest payments grow faster than capital formation, fiscal policy shifts from enabling growth to merely sustaining past liabilities, creating intergenerational fiscal stress.

Figure 22 — The “Inversion”: Debt Servicing Overtakes Investment

Source: Nepal Rastra Bank (NRB)

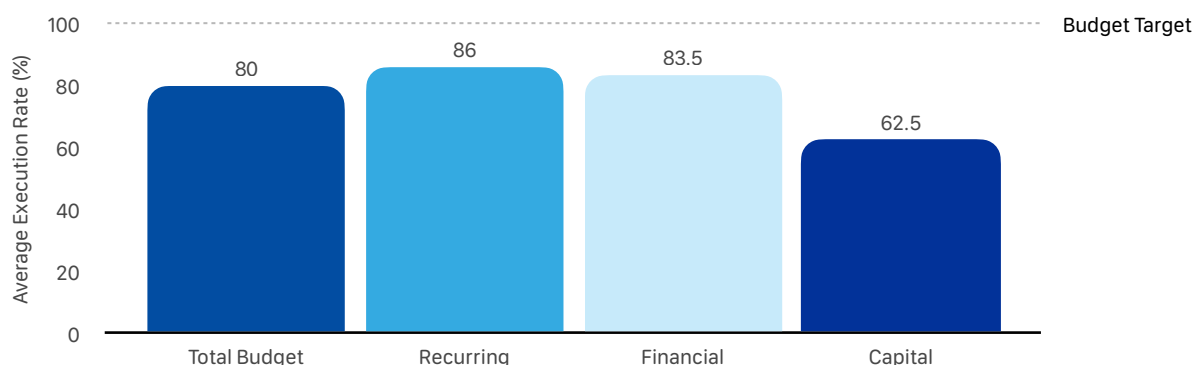


Chronic Budget Under-Execution Disproportionately Penalizing Growth-Enhancing Capital Spending:

Nepal has consistently delivered only around 80 percent of its approved budget over the past nine years. Capital expenditure has the weakest implementation rate at just 62.5 percent, compared to 86 percent for recurring and 83.5 percent for financial expenditure. This chronic under-execution signals systemic weaknesses in project preparation, procurement, coordination across tiers of government, and administrative accountability. The practice of presenting oversized budgets averaging around 34 percent of GDP and subsequently revising them downward toward the end of the fiscal year further erodes fiscal credibility. For an economy of Nepal’s size and income level, a budget equivalent to one-third of GDP is unusually large, yet the inability to execute planned capital spending means that high-multiplier investments suffer the most. In effect, fiscal indiscipline disproportionately penalizes growth-enhancing expenditure.

Figure 23 — The Credibility Gap: Average Budget Implementation Rates (9-Year Average)

Source: Nepal Rastra Bank (NRB)

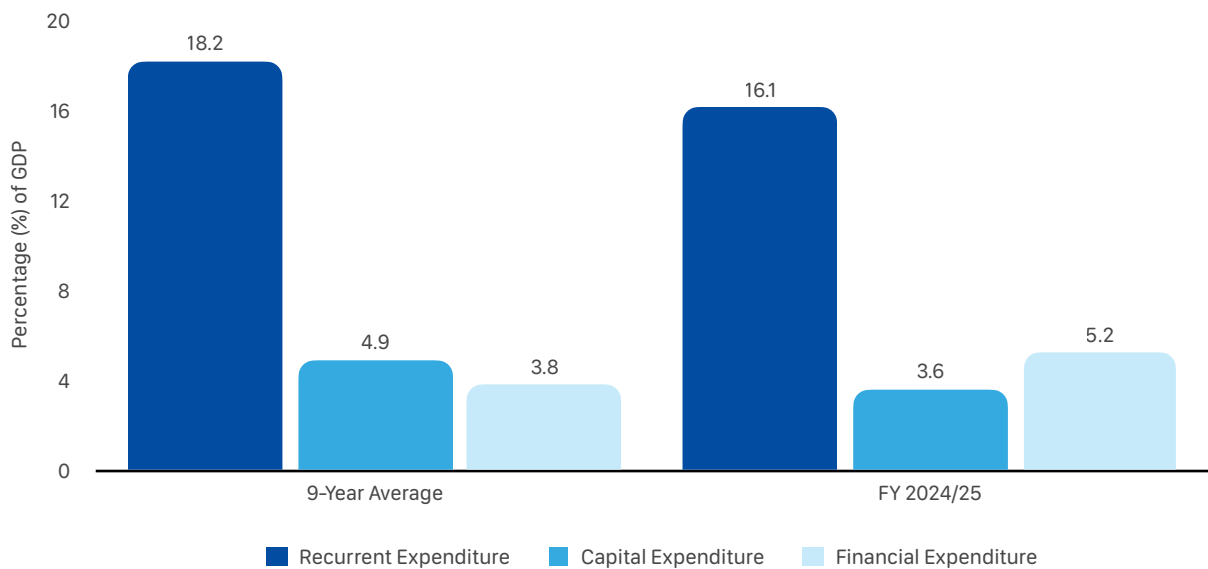


Fiscal Composition Shifting Toward Low-Multiplier Spending as Capital Share Shrinks:

Over the past nine years, average delivery of recurrent, capital, and financial expenditure stood at 18.2 percent, 4.9 percent, and 3.8 percent of GDP respectively. In FY 2024/25, these declined to 16.1 percent, 3.6 percent, and 5.2 percent, totaling 24.9 percent of GDP. The composition of total expenditure has also shifted: capital spending, which averaged 18.3 percent of total expenditure over nine years, declined to just 14.6 percent last year, while financial expenditure rose sharply to 21 percent. This reallocation toward recurrent and financial obligations both associated with relatively lower fiscal multipliers signals growing allocative inefficiency. Combined with time and cost overruns in capital projects, the quality of fiscal spending has deteriorated even as the size of the state expanded.

Figure 24 — Structural Shift in Public Expenditure Composition

Source: Nepal Rastra Bank (NRB)



Revenue Stagnation Widening Structural Fiscal Imbalances After Decades of Strong Growth:

Government revenue peaked at 22.4 percent of GDP in FY 2020/21 and FY 2021/22 but declined to 19.6 percent by FY 2024/25. Revenue contracted by more than 9 percent in FY 2022/23 — the first such decline in decades and has since remained largely stagnant, averaging less than 3 percent annual growth over the past three years compared to over 18 percent average annual growth in the preceding fourteen years (Since Dr. Baburam Bhattarai’s historic 33 percent revenue growth in FY 2008/09). The likelihood of a sustained revenue rebound without deep structural reform in tax administration, compliance, and economic formalization appears limited. Revenue stagnation amidst high expenditure commitments has widened structural fiscal imbalances.

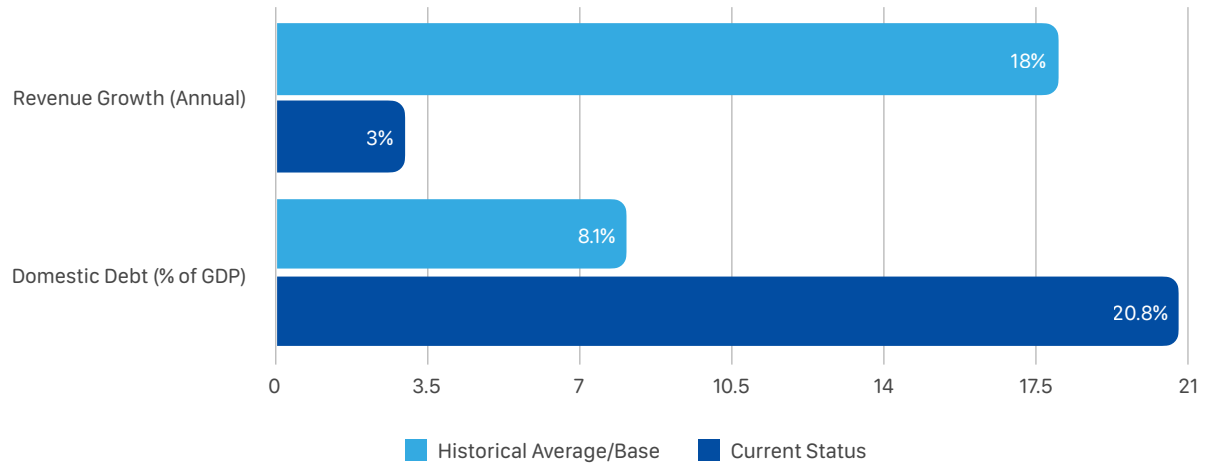
Ballooning Domestic Debt Insufficient to Cover Debt Servicing Obligations:

Average public expenditure of over 27 percent of GDP, combined with average revenue of 20.7 percent over the past nine years, has resulted in fiscal deficits averaging 5.8 percent, compared with 3.2 percent in the previous decade. Declining donor grants have further exacerbated financing pressures. Domestic debt has increased more than 6.4 times over the past decade, rising from 8.1 percent to 20.8 percent of

GDP. In the last two fiscal years alone, domestic borrowing (NPR 565 billion) was insufficient even to meet debt servicing obligations (NPR 592 billion). Such debt dynamics signal growing fiscal vulnerability and declining fiscal space for productive investment.

Figure 25 — Fiscal Vulnerability: Revenue Stagnation vs. Debt Surge

Source: Nepal Rastra Bank (NRB)



Post-Constitution Fiscal Expansion Amplifying External Sector Vulnerabilities:

The rapid expansion of public expenditure from 20 percent to over 28 percent of GDP in the first six years after the new Constitution contributed to macroeconomic pressures, including strains on the external balance. Combined with rapid credit expansion and import-led growth patterns, fiscal expansion amplified vulnerabilities that culminated in heightened external sector risks leading up to FY 2021/22.

Premature Welfare Expansion Sacrificing Low-Debt Window for Transformative Investment:

Fiscal management has increasingly mirrored the misallocation patterns observed in private credit allocation. A significant portion of public resources has been directed toward low-multiplier and politically driven programs, including universal senior citizen allowances, expansive health insurance commitments, and disproportionate subsidies in medical education. While social protection is essential, expansion beyond fiscal capacity without productivity-enhancing reforms constitutes premature welfare expansion. The opportunity cost has been substantial. During the decade when public debt remained historically low (averaging below 27 percent of GDP until FY 2018/19), Nepal had the fiscal space to consolidate transformative infrastructure and structural reforms. Instead, resource dispersion, weak prioritization, and inefficient execution diluted potential gains.

Nepal's fiscal problem runs deeper than size, it is an issue of structure, composition, and execution that undermines the state's capacity to drive transformation. The expansion of public spending has not translated into proportional improvements in growth, productivity, or service delivery. Chronic under-execution, particularly in capital expenditure, reflects weak accountability and institutional capacity, while the growing dominance of recurrent and financial expenditure erodes the fiscal multiplier effect necessary for structural change. Without recalibrating expenditure toward high-return investments, strengthening execution discipline, and restoring allocative efficiency, fiscal policy will continue to constrain rather than catalyze economic transformation.

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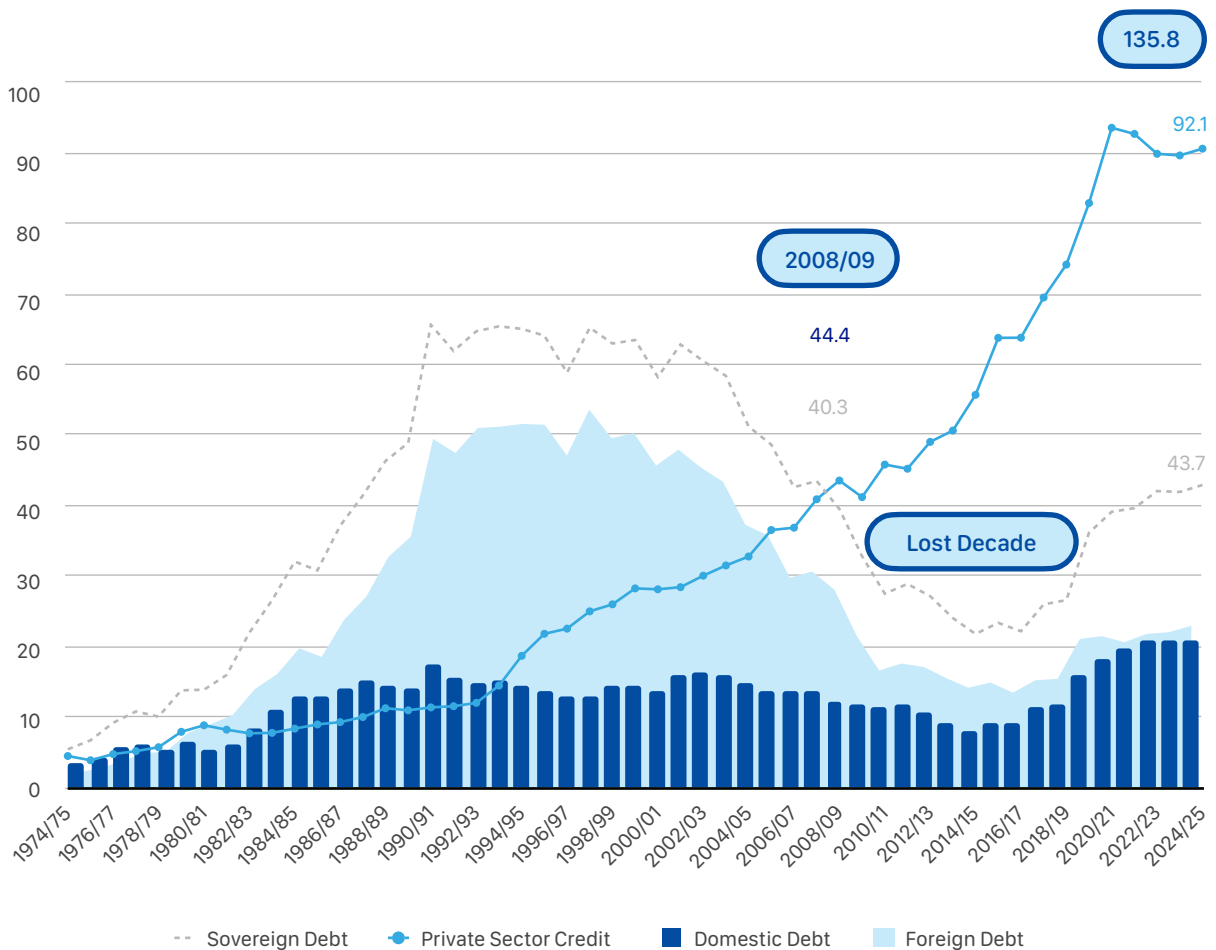
Debt Profile and Sustainability

Unprecedented Debt Reflecting Premature Leverage Without Structural Transformation:

Nepal’s total debt — combining public and private liabilities — has reached an all-time high of 135.8 percent of GDP, the highest among comparable peer economies. Unlike most developing countries where sovereign debt dominates total leverage, Nepal’s private sector debt (92.1 percent of GDP) exceeds public debt (43.7 percent). This structure is unusual for a lower-middle-income or least developed economy with modest per capita income and limited industrial depth. The scale of financial leverage relative to national income reflects a premature deepening of credit without commensurate structural transformation in productivity, exports, or employment.

Figure 26 — Sovereign and Private Debt (% of GDP)

Source: Nepal Rastra Bank (NRB)

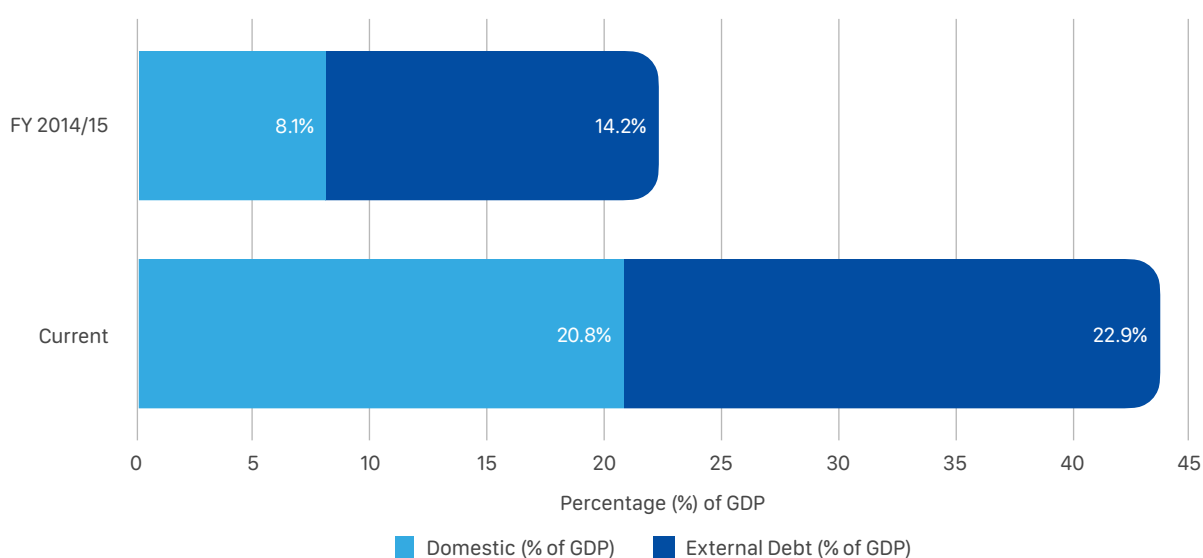


Private Debt Surpassing Public Debt, Channeled into Low-Productivity Speculative Sectors:

Private sector debt surpassed public debt in FY 2008/09, reaching 44.4 percent of GDP compared to public debt at 40.3 percent. Thereafter, private leverage expanded rapidly, peaking at 95 percent of GDP in FY 2020/21. During the same period, public debt declined to a historic low of 22.7 percent of GDP in FY 2016/17 before rising again in the aftermath of the COVID-19 pandemic, now standing at 43.7 percent of GDP. This trajectory suggests that while fiscal consolidation reduced sovereign leverage during the mid-2010s, private sector borrowing filled the gap often directed toward low-productivity sectors such as real estate and import-based trade. Although Nepal's sovereign debt ratio appears moderate relative to peers and may indicate some fiscal space, the effectiveness of further borrowing will depend critically on whether it is allocated toward high-multiplier, productivity-enhancing investments rather than recurrent liabilities.

Figure 27 — Shift in Public Debt Composition: Surge in Domestic Debt

Source: Nepal Rastra Bank (NRB)



Fiscal Deficits Driving Sharp Rise in Domestic Debt as External Grants Decline:

Both domestic and external public debt have increased since the pandemic to finance widening fiscal deficits caused by stagnating revenue growth and declining donor grants. Domestic debt has risen sharply over the past decade, from 8.1 percent of GDP in FY2014/15 to 20.8 percent in FY2024/25, while total external public debt remains moderate at 22.9 percent from 14.2 percent of GDP. The composition of debt is therefore shifting increasingly toward domestic borrowing.

High-Cost Domestic Debt Crowding Out Capital Expenditure and Constraining Fiscal Flexibility:

Although most external public debt consists of long-term concessional loans with relatively low servicing costs, domestic debt carries higher interest rates and shorter maturities. The rapid growth in domestic borrowing has consequently increased annual debt servicing obligations, contributing to the sharp rise in financial expenditure observed in recent years. The growing interest burden is crowding out capital expenditure and constraining fiscal flexibility, reinforcing the structural shift toward lower-multiplier spending.

Decade of Missed Opportunity: High Leverage Without Productivity or Structural Transformation:

Nepal's debt trajectory illustrates a deeper structural issue. Prior to economic liberalization, inefficiencies were concentrated largely in the public sector. Over time, however, leverage expanded rapidly within the private sector without delivering sustained productivity gains or structural diversification. Despite private sector debt accumulation reaching levels comparable to advanced economies, average economic growth has remained modest. Credit expansion largely fueled asset price inflation, imports, and consumption rather than industrial upgrading or export competitiveness. The result is a highly leveraged economy without corresponding structural transformation, a decade of missed opportunity in which both private and public borrowing failed to generate durable growth and employment momentum.

Rising Debt Sustainability Risks Demanding Strict Allocative Discipline in Future Borrowing:

While current sovereign debt levels may not yet signal immediate distress, the combination of high private leverage, rising debt servicing obligations, stagnating revenue growth, and weak capital formation presents medium-term sustainability risks. Future borrowing, whether public or private must, therefore be anchored in strict allocative discipline, prioritizing investments with demonstrably high fiscal and economic multipliers. Without correcting the structural inefficiencies underlying past debt accumulation, further leverage risks amplifying fragility rather than enabling transformation.

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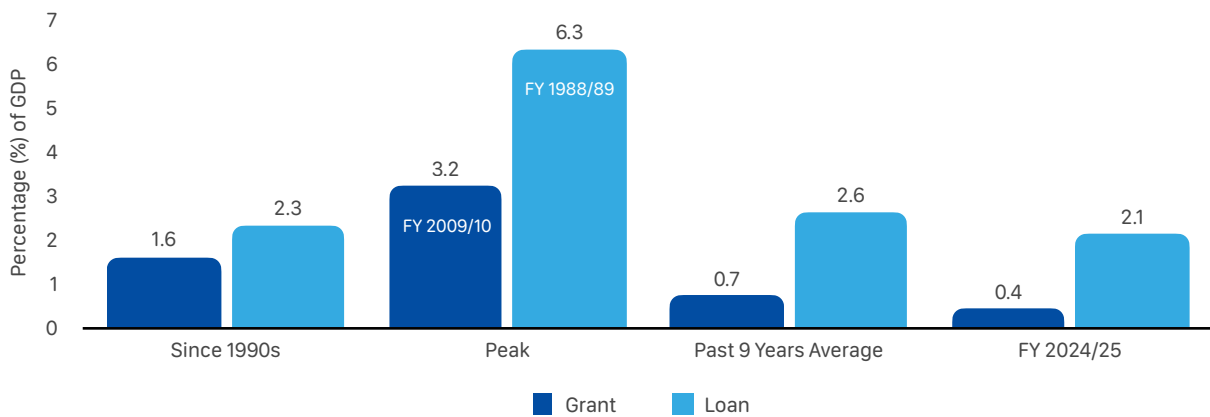
Development Finance

Long-Term Grant Decline Approaching FDI Levels Amid LDC Graduation Trajectory:

Foreign grants to Nepal have been on a long-term declining trajectory since FY 2009/10, falling from a peak of 3.2 percent of GDP to just 0.4 percent in FY 2024/25. Although grants averaged 1.64 percent of GDP since the 1990s, the average has dropped to 0.7 percent over the past nine years and further to 0.4 percent in the last three years, approaching the level of average annual FDI inflows. In nominal terms, grants peaked at NPR 46 billion in FY 2010/11 but have declined to NPR 23 billion in FY 2024/25. This contraction coincides with Nepal’s graduation trajectory from LDC status and the gradual reorientation of global development finance priorities.

Figure 28 — Nepal: Structural Shift in Foreign Aid (% of GDP)

Source: Nepal Rastra Bank (NRB)

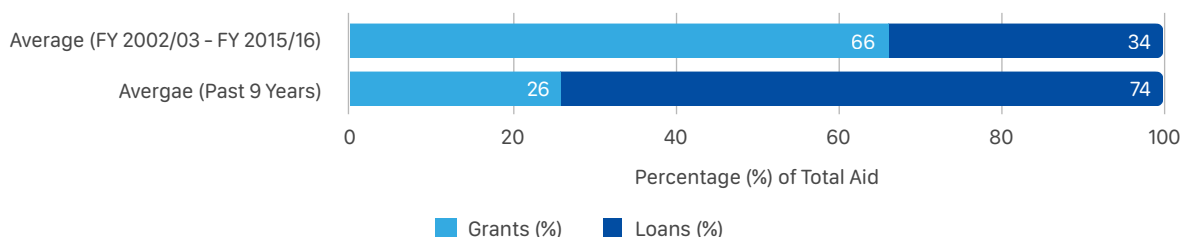


ODA Composition Reversing from Grant-Dominant to Loan-Heavy Since FY 2016/17:

While grants have declined, foreign loans have remained relatively stable in GDP terms, averaging 2.34 percent of GDP since the 1990s and rising modestly to 2.6 percent over the past nine years. The composition of Official Development Assistance (ODA) has shifted over time. Following the introduction of Structural Adjustment Programs in the mid-1980s, the loan component increased substantially until the early 2000s. Between FY 2002/03 and FY 2015/16, grants exceeded loans by two times. However, since FY 2016/17, the mix has reversed decisively: grants now account for less than 0.7 percent of GDP compared to loans exceeding 2.6 percent of GDP.

Figure 29 — The Flip: From Grant-Heavy to Loan-Heavy ODA

Source: Nepal Rastra Bank (NRB)



Structural Shift from Grant to Loan-Heavy Aid Raising Future Debt Servicing Obligations:

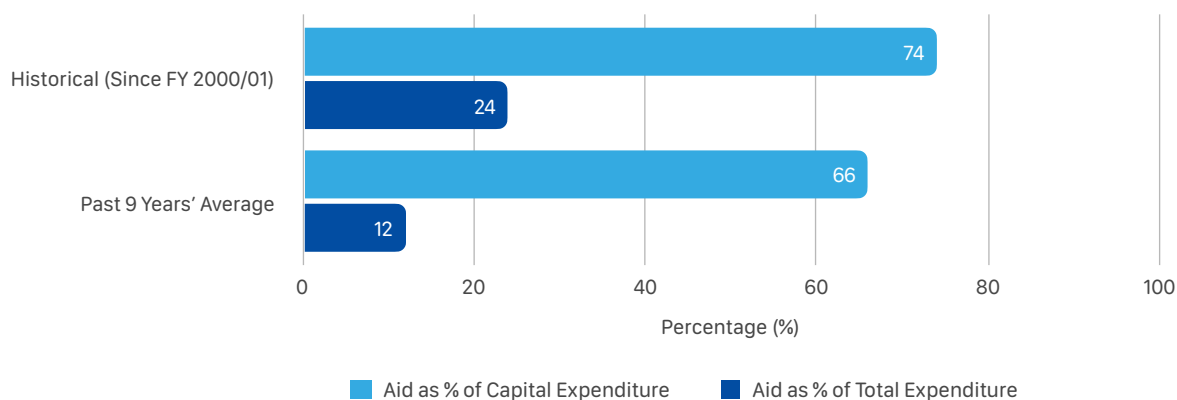
The composition of Nepal’s development assistance has undergone a clear structural transition over time. Until FY 2015/16, the overall aid mix was marginally in favor of grants over loans. However, this pattern has reversed in recent years, with the composition now standing at approximately 45 percent grants and 55 percent loans. This shift reflects the increasing dominance of foreign loans, which have constituted nearly 80 percent of total foreign aid flows over the past nine years. The transition from grant-heavy to loan-heavy financing marks a fundamental change in Nepal’s development finance architecture—implying rising debt obligations, higher future servicing costs, and reduced fiscal flexibility. Without addressing absorptive capacity and the efficiency of project implementation, the country risks a future where debt servicing on foreign loans outpaces the productivity gains those loans were meant to generate. As Nepal graduates from LDC status, this evolving composition underscores the urgency of improving aid effectiveness, strengthening project returns, and reducing long-term dependence on debt-financed development.

Capital Expenditure Heavily Aid-Dependent Despite Declining Grant Financing:

Despite the changing composition, ODA remains fiscally significant. Over the past nine years, foreign aid has financed on average, 66 percent of total capital expenditure and 12 percent of overall public expenditure. Historically, these ratios were even higher, averaging 74 percent of capital expenditure (since FY 2000/01) and 24 percent of total public expenditure. Although the relative contribution of ODA has declined, Nepal’s capital formation remains substantially dependent on external financing. This dependency raises concerns about sustainability, especially as grants decline and loans dominate the financing mix.

Figure 30 — Persistent Capital Dependency on Foreign Aid

Source: Nepal Rastra Bank (NRB)



ODA Delivering Modest Structural Returns Despite Decades of Cumulative Inflows:

Despite decades of ODA inflows, Nepal’s structural transformation has been limited. Questions persist regarding project efficiency, fragmentation, tied conditionalities, absorptive capacity constraints, and alignment with national priorities. While ODA has supported social sector development and infrastructure expansion, its long-term impact on productivity growth, export competitiveness, and employment generation remains modest relative to cumulative inflows. As Nepal transitions toward middle-income aspirations, reliance on concessional aid without parallel domestic capacity enhancement may yield diminishing returns.

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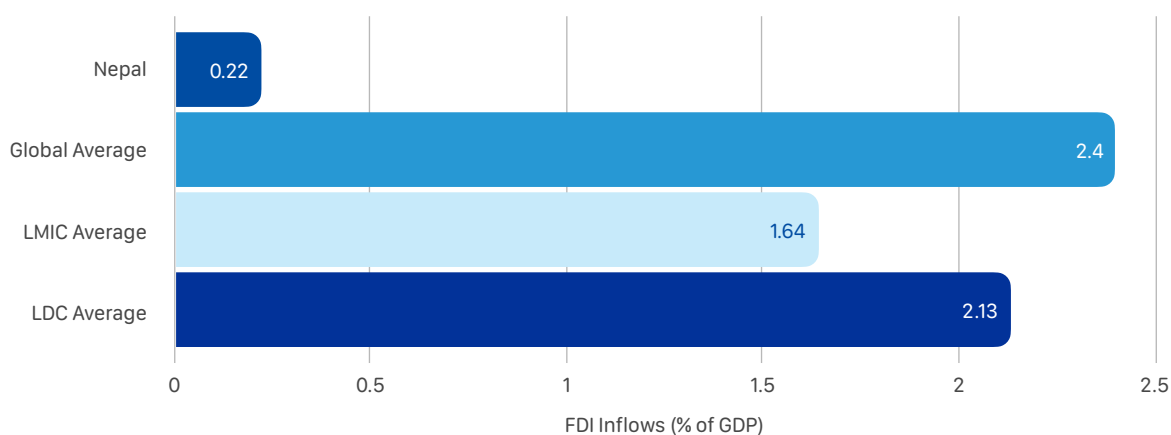
Foreign Direct Investment (FDI)

Among World's Weakest FDI Performers, Relying on Aid Over Productive Foreign Investment:

Nepal's FDI performance is among the weakest globally. Since 1990, FDI inflows have averaged just 0.22 percent of GDP, compared to a global average of 2.4 percent, a lower-middle-income country (LMIC) average of 1.64 percent, and a least developed country (LDC) average of 2.13 percent. Over the same period, foreign grants averaged 1.64 percent of GDP, more than seven times higher than FDI inflows. This imbalance underscores Nepal's heavy reliance on aid relative to productive foreign investment.

Figure 31 — Nepal: Global FDI Performance Comparison (Since 1990)

Source: The World Bank

**Less Than One-Third of Committed FDI Materializing Due to Structural Investment Barriers:**

As of the first eleven months of FY 2024/25, total approved foreign direct investment (FDI) commitments reached approximately NPR 570 billion. Two countries China (44.8 percent) and India (19.6 percent) together account for over 64 percent of total committed FDI, indicating significant concentration of investment sources. The next three largest contributors Hong Kong (5.4 percent), South Korea (4.6 percent), and the United States (3.5 percent) collectively represent a relatively modest share. More critically, the conversion of commitments into actual capital inflows remains structurally weak. Over the past fourteen years, only NPR 163 billion has been realized out of more than NPR 555 billion in approved commitments, amounting to less than one-third of pledged investment.

FDI's Superior Productivity Spillovers Make Its Absence Costlier Than Low ODA:

If the relative contributions of grants and FDI had been reversed, i.e., if Nepal had attracted FDI averaging 1–2 percent of GDP while grants remained marginal the growth, employment, and productivity outcomes would likely have been stronger. Unlike ODA, which primarily finances social development and infrastructure, FDI brings not only capital but also technology transfer, managerial know-how, integration into global value chains, export market access, and productivity spillovers. These dynamic externalities are far more limited in traditional aid flows.

Structural Impediments and Remittance Dominance Keeping Nepal Marginal to Global Production Networks:

Nepal's low FDI performance reflects structural impediments — political instability, policy unpredictability, regulatory complexity, land and labor rigidities, infrastructure bottlenecks, contract enforcement challenges, and limited scale of industrial ecosystems. The dominance of remittance-driven consumption and credit-financed real estate investment has also reduced the urgency of export-oriented industrialization. As a result, Nepal has remained marginal to regional and global production networks.

Inaugural BB- Credit Rating Reflecting Stability but Falling Short of Investment Grade:

Nepal received its first sovereign credit rating of BB- (Stable Outlook) from Fitch Ratings in November 2024, with reaffirmation in November 2025. The rating reflects moderate public debt, strong remittance buffers, and macroeconomic stability, while highlighting structural constraints such as low per capita income, narrow export base, and institutional weaknesses. Although comparable to several frontier economies in the region, it remains below investment grade. The rating enhances transparency and provides global investors with an independent risk assessment, but it does not automatically translate into higher capital inflows without structural reform.

Development Finance Inflection Point Demanding Shift from Aid Dependency to Productive FDI:

Nepal's development finance architecture is at an inflection point. Declining grants, rising loan dependence, and persistently weak FDI inflows highlight the need to recalibrate external engagement. Future sustainability will depend less on concessional inflows and more on the country's ability to attract productivity-enhancing foreign investment while strengthening domestic absorptive capacity and fiscal discipline.

Nepal's failure to attract productive foreign investment, documented in the FDI section above, stands in sharp contrast to the flow of remittances.

While remittances have enabled income growth on paper, this progress masks a fundamental fragility. Nepal's per capita income has risen to USD 1,517, facilitating statistical graduation from LDC status. However, this numerical advancement conceals a critical reality: the income is neither sustainable nor distributive in a way that strengthens the economy's structural foundations. Examining the income level in detail reveals a paradox — growth that appears resilient on the surface remains vulnerable to external shocks beneath.

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Income Level

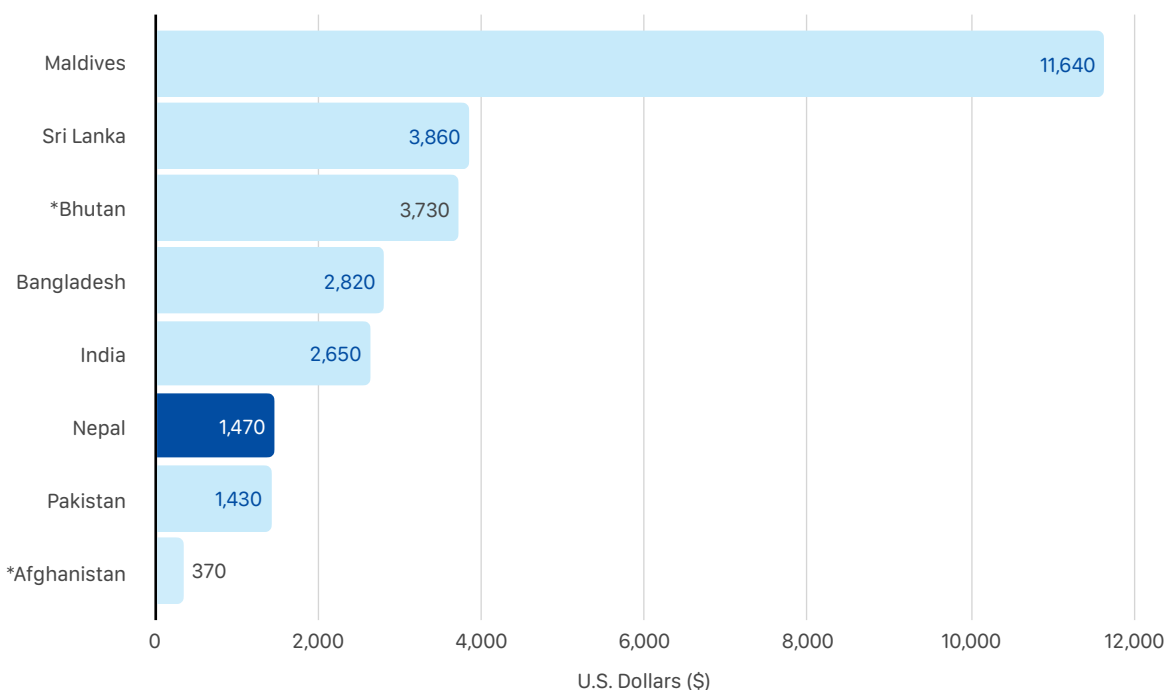
Income Level Reflecting Modest Gains Amid Structural Constraints:

According to the Economic Survey 2024/25, Nepal's GNI per capita income reached USD 1,517 in FY 2024/25, placing it within the lower middle-income country category. Nepal graduated from low-income country status in 2019, just prior to the COVID-19 pandemic, and is scheduled to graduate from Least Developed Country (LDC) status in November 2026. While these milestones signal progress in classification, they mask the underlying fragility of income growth and the limited pace of structural transformation required to sustain upward mobility.

Figure 32 — Gross National Income (GNI) Per Capita in South Asia

Source: The World Bank

*Atlas Method Data for Bhutan and Afghanistan refer to 2023/24; all other countries reflect 2024/25 estimates.

**Long-Term Income Growth Lagging Behind Regional Peers:**

Over the long-term, Nepal's per capita income growth has remained modest relative to regional comparators. According to World Bank data, Nepal's GNI per capita increased from USD 200 in 1991 to approximately USD 1,470 in 2024 making it one of the lowest in South Asia after Afghanistan. This translates to an average annual growth rate of 6.23 percent in dollar terms, which is significantly lower than China's 11.65 percent and slightly below India's 6.33 percent over the same period. The widening gap, particularly with China, underscores Nepal's limited integration into high-productivity sectors and global value chains.

Nominal Growth Dynamics Constrained by Structural Factors:

Per capita income growth in dollar terms is determined by a combination of nominal GDP growth in local currency (driven by real growth and inflation), exchange rate movements, and population growth. Nepal's average nominal GNI growth rate between 1991 and 2024 stood at 12.35 percent, lower than China (13.24 percent) and broadly comparable to India (12.58 percent). However, this similarity in nominal growth has not translated into comparable gains in dollar-denominated income, reflecting the influence of other offsetting structural factors.

Currency Depreciation Eroding Income Gains in Dollar Terms:

Exchange rate dynamics have played a significant role in moderating Nepal's per capita income growth in dollar terms. Over the same period, the Nepali currency depreciated at an average annual rate of 3.96 percent against the US dollar—higher than China's 0.91 percent and broadly similar to India's 4.02 percent. This persistent depreciation has diluted the impact of nominal income growth, limiting the pace at which Nepal has been able to converge toward higher income levels in global terms.

Population Growth Diluting Per Capita Gains:

Population dynamics have further constrained per capita income growth. Nepal's population grew at an average annual rate of 1.2 percent between 1991 and 2024, twice that of China's 0.61 percent but lower than India's 1.51 percent. While moderate, this growth has nonetheless diluted aggregate income gains, highlighting the importance of accelerating productivity and structural transformation to achieve meaningful improvements in living standards.

Slow Convergence Reflecting Structural Rigidities:

Taken together, Nepal's income trajectory reflects a pattern of slow convergence, where low real economic growth, currency depreciation, and demographic pressures have combined to limit gains in per capita income. Despite progress in income classification, the economy has yet to generate the sustained, high-productivity growth required to significantly narrow the gap with regional peers or transition toward upper middle-income status.

Measured Progress Masking Structural Vulnerabilities:

Nepal's transition to lower middle-income status and its impending graduation from LDC status suggest a degree of progress, but this remains modest in a regional context, with per capita income still among the lowest in South Asia. Lower income levels, driven by historically weak growth and relatively high inflation, continue to leave the economy vulnerable to both internal and external shocks. As the country moves beyond the LDC support framework, the absence of a strong domestic income base poses risks to long-term fiscal sustainability. Moreover, income statistics capture averages but reveal little about the underlying human capital that generates this income. In Nepal's case, this foundation is weakening, as its most valuable asset—a young population—is increasingly being depleted through large-scale outmigration.

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Education, Human Capital, and Demography

Cascading Foundational Learning Crisis Undermining Human Capital Formation:

Nepal's education system is facing a deep and systemic crisis in foundational learning, particularly in Science, English, and Mathematics (SEM). This begins early, with only 32 percent of Grade 8 students meeting minimum standards in Mathematics and 38 percent in Science, and worsens at higher levels. In 2024/25, 52.13 percent of students at SEE (Grade 10) and 47 percent at Grade 12 were ungraded, with Mathematics alone accounting for a 40 percent failure rate. This reflects a structural breakdown in core competencies, effectively blocking a majority of students from progressing into higher education and technical fields.

School Dropout Crisis Driven by Poor Learning Quality and Socioeconomic Pressures:

Despite progressive policy frameworks, Nepal's school education system is grappling with a profound retention crisis that threatens the country's long-term human capital formation. A tracking of the student cohort enrolled in Grade 1 in BS 2073 reveals a stark systemic hemorrhage: over a ten-year period, nearly 59% of students dropped out of the formal education system, leaving only 430,667 out of over one million initial enrollees to sit for the Secondary Education Examination (SEE) in BS 2082. According to data from the Nepal Living Standards Survey (NLSS) 2081, this massive attrition is driven less by structural school availability and more by a combination of deficient classroom quality and deep-seated socio-economic pressures. Weak learning outcomes and academic disengagement constitute the single largest driver of dropouts at 28.1%, signaling that the current pedagogical environment fails to support struggling learners. This is severely compounded by domestic and cultural realities, where the compulsion to engage in household chores (21.4%) and the persistence of early marriage (19.2%) collectively pull more than 40% of vulnerable students—particularly girls—out of the classroom.

Reasons Why Students Drop Out of School:

Source: NLSS 2081 - National Office of Statistics (NSO)

28.1%

Poor academic performance

21.4%

Family/work responsibilities

19.2%

Early marriage

12.8%

Other reasons

6.7%

Financial problems

5.4%

Employment/work obligations

3.2%

Lack of parental support

2.7%

Dissatisfaction with obtained qualification

0.5%

No opportunity for further study

Weak Academic Competitiveness Limiting Global Employability:

Beyond domestic challenges, Nepal’s students struggle to compete globally. Only around 2 percent of IELTS test takers achieve a band score of 8, placing Nepal behind regional peers such as India, Pakistan, the Philippines, and Sri Lanka. This indicates that even those entering the global education and labor market are often underprepared, limiting their ability to access high-quality opportunities in an increasingly skills-driven global economy.

Severe STEM Gap Misaligning Education with Future Workforce Needs:

Nepal’s education system is structurally misaligned with future labor market demands. While global demand for STEM-related jobs is rapidly increasing, only 19.7 percent of Nepali students are enrolled in STEM fields, compared to 44.5 percent in management. A significant share is also concentrated in education, resulting in an oversupply of graduates in non-tradable sectors such as teaching, which primarily serves the domestic market. In contrast, STEM professionals have the potential to integrate into global value chains. This imbalance is further compounded by low female participation in STEM at just 14.6 percent, limiting the country’s ability to fully utilize its human capital.

Higher Education System Weakening Amid Rising Outmigration:

Nepal’s higher education system is increasingly hollowed out, even as demand for foreign education surges. Of the 1,304 university-affiliated colleges, nearly 31 percent have fewer than 100 students, reflecting declining domestic enrollment. At the same time, 112,256 No Objection Certificates (NOCs) were issued in FY 2023/24 alone—a 264 percent increase over the past decade. This trend is driven by weak foundational learning and limited domestic opportunities, resulting in a large-scale outflow of students and future skilled workers.

Remittance-Funded Brain Drain Reinforcing Structural Weaknesses:

A significant portion of remittance income is being used to finance foreign education, creating a cycle where resources earned abroad are reinvested in migration. On average, around 300 students leave Nepal daily, and over the past four years, more than half of Grade 12 graduates have gone abroad. This reflects a systemic lack of confidence in domestic education and employment opportunities, further weakening the country’s long-term human capital base.

Figure 33 — Gender Distribution of Absent Population Abroad

Source: National Statistics Office (NSO)

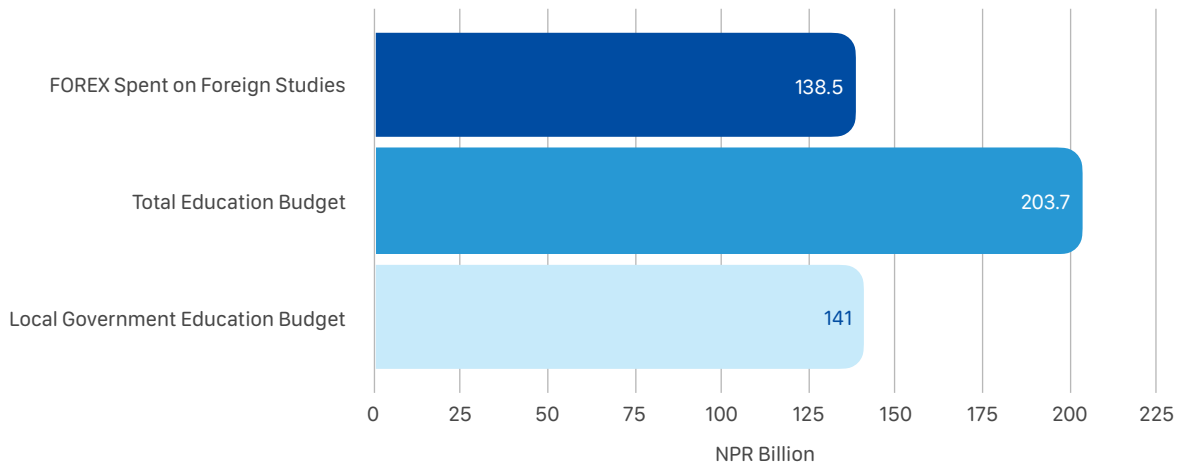


Foreign Education Driving Major Foreign Exchange Outflows:

The growing preference for foreign education has turned human capital development into a significant external sector pressure. Nepal spends almost NPR 139 billion annually on foreign education, making it one of the largest sources of foreign exchange outflow—surpassing even key imports such as diesel. This amount is equivalent to around 68 percent of the national education budget, reflecting a major leakage of financial resources.

Figure 34 — Education Spending: Foreign Outflow vs. Public Budgets (FY 2024/25)

Source: Ministry of Finance (MoF), Nepal Rastra Bank (NRB)

**Demographic Dividend at Risk Due to Mass Outmigration:**

Despite a relatively young population with a median age of 26, Nepal is at risk of losing its demographic dividend. According to the 2021 Census, 2.19 million people are living abroad, and 23.4 percent of households are affected by migration. The scale of outmigration suggests that the country may grow old before becoming economically prosperous, as its most productive workforce increasingly exits the domestic economy.

Labor Market Distortions and Emerging Workforce Shortages:

The outmigration trend has led to significant distortions in the domestic labor market. With 82.2 percent of absentees being male, female-headed households have risen to 31.55 percent, particularly in rural areas. At the same time, Nepal faces acute shortages in skilled labor, even as 57.3 percent of the workforce remains concentrated in low-productivity agriculture. This creates a paradox where labor is both abundant in theory and scarce in practice, constraining industrial and economic development.

Emerging Depopulation and Declining Labor Force Participation:

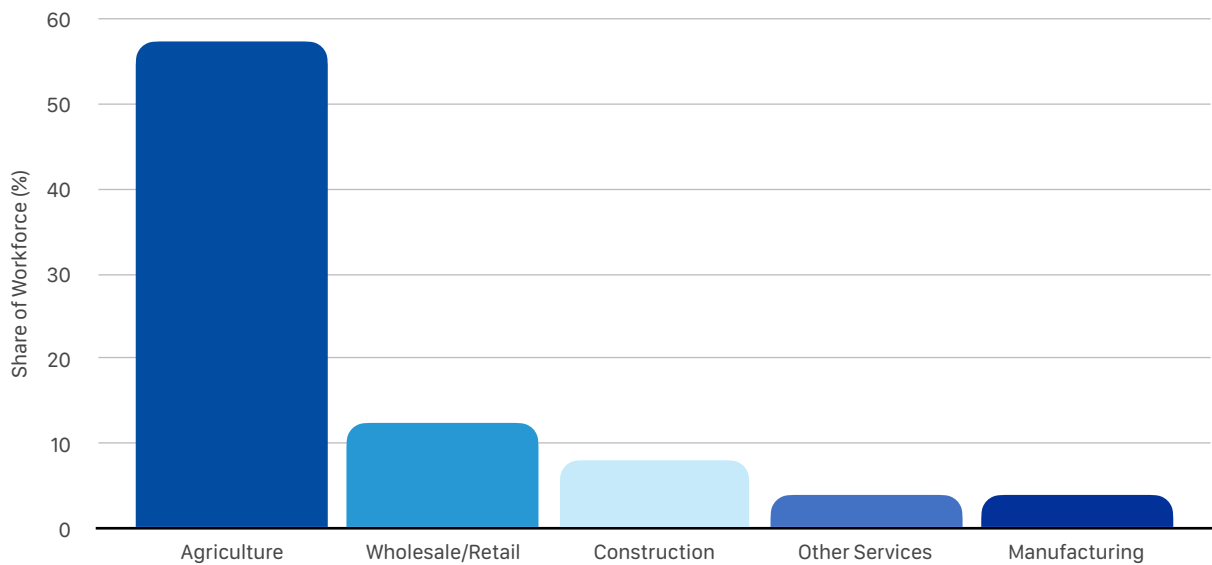
Recent trends indicate a worrying shift toward premature depopulation, where the number of people leaving the country is roughly equal to those entering the labor force. Combined with declining birth rates, this has resulted in a net reduction in the working-age population in recent years. Additionally, 34.3 percent of the population remains economically inactive, suggesting that a large segment of potential labor is either disengaged or waiting for opportunities abroad rather than participating in the domestic economy.

Structural Mismatch Between Education and Employment Outcomes:

While literacy has improved to 76.2 percent, there remains a significant gap between education and employability. Only 3.8 percent of the workforce is engaged in manufacturing, the sector most critical for productivity growth and structural transformation. The current system produces graduates who are not aligned with market needs, resulting in underemployment, low productivity, and continued dependence on migration.

Figure 35 — Workforce Distribution by Sector: Low Productivity Trap

Source: National Statistics Office (NSO)

**Broken Skills Pipeline and Long-Term Growth Risks:**

Overall, Nepal's human capital system is characterized by a broken pipeline—from weak foundational education to misaligned higher education and large-scale outmigration. The country is effectively investing in basic education while the returns, in the form of skilled labor and innovation, are captured by foreign economies. This creates a persistent low-productivity trap, making it difficult to achieve sustainable growth without a fundamental shift toward creating domestic opportunities, particularly through investment-driven and globally integrated sectors.

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Labor Market Structure

Structure and Paradox

Nepal's labor market presents one of its most striking structural contradictions. Large-scale youth migration, domestic unemployment, reliance on imported foreign labor, skills shortages, and rising labor costs all coexist simultaneously — not as transitional symptoms but as entrenched features of the same system. This paradox is rooted in a broader pattern of factor market misallocation, where labor, land, and capital are directed toward political protection, speculation, and institutional inertia rather than productive activity. The cumulative effect is a labor market where costs have risen relative to productivity levels, weakening competitiveness precisely in the labor-intensive sectors through which developing economies historically industrialize.

Politicization of Labor Relations

Trade unions across manufacturing, transport, utilities, education, and state-owned enterprises have, in many sectors, evolved beyond their original function as worker welfare institutions into politically affiliated power structures. Major political parties maintain affiliated unions across most key industries, and labor relations in practice have become extensions of political competition rather than mechanisms for improving productivity or workplace standards. The consequences are visible across the economy. Politically motivated strikes, institutional disruptions, and politically influenced hiring practices have weakened operational efficiency in both public and private institutions. In strategic sectors — water utilities, public enterprises, universities, and banking — entrenched union structures have frequently obstructed administrative reform and professional management systems. Industries in Nepal's border corridors with India have increasingly responded by hiring foreign workers, citing greater labor flexibility and lower exposure to politically driven disruptions.

Labor Costs vs. Productivity

Nepal's statutory minimum wage, set at NPR 19,550 per month following the revision effective from Shrawan 2082, now exceeds estimated average monthly GNI per capita income of approximately NPR 17,202 (Annual 206,424) — an unusual structure for a low-income economy characterized by limited industrial depth, high underemployment, and weak export competitiveness. This wage-productivity misalignment exists alongside high logistics costs, energy bottlenecks, and geographic disadvantages relative to neighboring economies, compounding the cost burden on productive sectors. Wage adjustments have increasingly reflected political bargaining dynamics and union pressure rather than productivity growth or industrial capacity, and the result is a factor cost structure that discourages precisely the labor-intensive investment Nepal requires at its current stage of development.

Dependence on Foreign Labor

Despite high domestic youth unemployment, Nepal imports foreign workers across a range of sectors including plumbing, tailoring, electrical work, jewelry making, barbering, construction, hospitality, tea plantations, and small-scale manufacturing. Migration data from Census 2021 and CESLAM's State of Migration in Nepal show that Lumbini and Madhesh provinces account for approximately 22 percent and 18 percent of outbound labor migrants respectively, reflecting deep structural dependence on foreign employment in regions with limited domestic industrial absorption. The simultaneous export and import of labor, alongside persistent unemployment, points to a profound mismatch between what the education and training system produces and what the domestic labor market demands.

The Aspiration Trap: Foreign Employment Ambitions Displacing Domestic Trade Participation

A compounding dimension of this foreign labor dependence is the extent to which the prospect of foreign employment has structurally disincentivized domestic labor force participation. For a significant share of working-age youth, engagement in local trade occupations is perceived as a temporary or inferior option relative to migration. This has created a self-reinforcing dynamic in which domestic vacancies in skilled trades go unfilled not because workers are unavailable, but because the aspiration structure of the workforce has been reoriented toward foreign labor markets. The irony is significant: the trade and craft occupations that foreign workers currently fill in Nepal—are among those least vulnerable to automation and artificial intelligence displacement. Nepal is therefore in the paradoxical position of exporting its workforce, while simultaneously importing labor to fill domestic roles that carry long-term structural resilience—a misallocation with consequences for both productivity and employment security.

Skills and Workforce Gaps

Technical and vocational education has historically been socially undervalued, institutionally fragmented, and poorly connected to actual market demand, leaving many sectors increasingly dependent on imported labor even for relatively basic technical occupations. A significant portion of Nepal's artisan economy—spanning metalwork, tailoring, sculpture, jewelry, textiles, wood carving, and traditional architecture—operates entirely outside formal certification systems, modern supply chains, and scalable commercial networks. Highly specialized craftsmanship that has accumulated over generations generates low incomes domestically while substantially greater value is captured elsewhere through branding, processing, design integration, and international retailing.

Women's Labor Force Participation

Women's economic participation remains concentrated in unpaid agricultural labor, informal household enterprises, and low-productivity activities with limited income security or upward mobility. Female participation in formal, higher-productivity, and leadership-oriented sectors remains disproportionately low. Structural barriers include unpaid care responsibilities, limited childcare infrastructure, workplace discrimination, safety and mobility constraints, unequal access to finance, and concentration in informal employment. Nepal's service-oriented and increasingly digitally connected economy is creating new entry points — in education, healthcare, IT services, digital work, tourism, finance, and professional services—but the structural barriers constraining women's participation have yet to be systematically addressed.

Exposure to Technological Disruption

Nepal's emerging IT services export sector, which surpassed USD 515 million in 2022, and employed nearly 66,500 freelancers, represents one of the most promising pathways out of the remittance-dependent growth model. However, this sector faces a structural vulnerability that is often underappreciated in policy discussions. As global technology firms and their clients increasingly adopt AI tools that can perform routine programming, documentation, and back-office digital functions at a fraction of the cost, the entry-level service niches that Nepal's IT sector currently occupies face significant demand compression. Nepal's digital economy remains structurally concentrated at the layer of the value chain most susceptible to near-term AI substitution. The risk is therefore not distant or hypothetical—it threatens the viability of the sector at precisely the moment Nepal is beginning to rely on it as a productive alternative to labor export.

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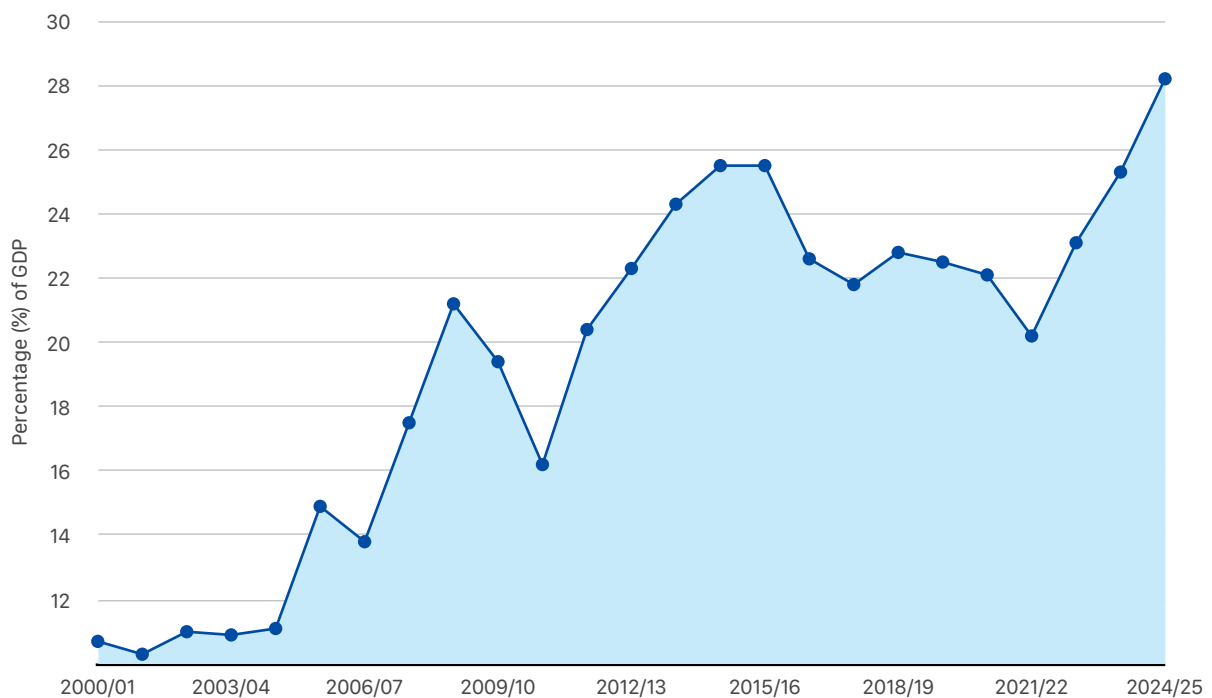
Remittance and Outmigration

Remittance as the Backbone of External Stability with Growing Structural Dependence:

Remittance has emerged as the single most important pillar of Nepal's external sector, accounting for over 61 percent of total foreign exchange earnings. Since the early 2000s, remittance inflows have surged from around 2 percent of GDP to an all-time high of 28.2 percent in FY 2024/25 (USD 12.64 billion), with the potential to exceed 30 percent of GDP in the current year. For the first time, remittance inflows have surpassed both the trade deficit (FY 2023/24) and monthly imports (since mid-2025), highlighting the scale of dependence. In comparative terms, remittance inflows far exceed government revenue (61 percent) and official development assistance (less than 9 percent), underscoring that no other external flow comes close in sustaining Nepal's macroeconomic stability.

Figure 36 — Nepal: Remittance Inflows (% of GDP)

Source: Nepal Rastra Bank (NRB)

**Household Use of Remittance Reflecting Consumption-Led Allocation Patterns:**

At the household level, remittance is overwhelmingly directed toward consumption, accounting for 72.4 percent of total usage, primarily for food, housing, health, and daily living expenses. Debt servicing absorbs a significant 15.8 percent, often reflecting high-cost borrowing from informal channels. Education accounts for 4.6 percent, supporting both domestic and foreign studies, while only about 1.2 percent is channeled into capital formation or productive investment. The remaining share is held as savings. This distribution highlights that while remittance substantially improves living standards and supports human capital development, its first-round contribution to long-term productive capacity and economic transformation remains limited.

Remittance as the Primary Driver of Poverty Reduction Since 2000:

Remittance has been the single most powerful force behind poverty reduction in Nepal over the past two decades, far exceeding the impact of government programs or donor-supported interventions. While policy efforts and development assistance have contributed incrementally over time, it is remittance that has delivered scale and immediacy. Despite modest economic growth averaging 4.18 percent and inflation of around 6.5 percent, the poverty rate declined sharply from 38 percent in 2000 to around 20 percent in 2024. At the household level, remittance has enabled basic consumption, improved nutrition and health outcomes, and expanded access to education—fundamentally enhancing human capabilities across millions of families.

The Remittance Paradox - External Stability Without Domestic Transformation:

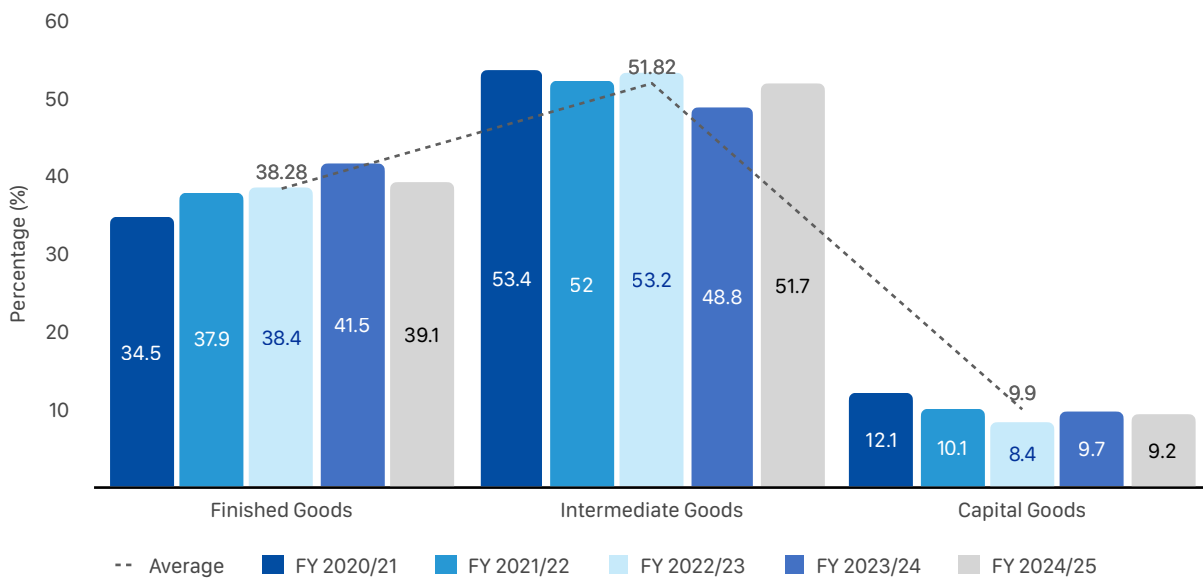
Remittance has become the backbone of Nepal’s macroeconomic stability, with inflows exceeding 28 percent of GDP and foreign exchange reserves surpassing USD 22 billion, more than 50 percent of GDP. It has effectively addressed one of the most critical constraints faced by developing economies - external sector vulnerability by financing the trade deficit and stabilizing the balance of payments. However, this has created a structural paradox: while external stability has been secured, it has not translated into domestic economic transformation. At the same time, large-scale outmigration reduces internal pressure for reform, while those sustaining the economy from abroad remain largely excluded from national decision-making processes.

Weak Transmission into Productive Investment and Structural Transformation:

The central challenge lies in the weak transmission of remittance into productive sectors of the economy. While remittance has fueled consumption and created demand, the domestic economy has not responded with a corresponding expansion in production. This has led to a structural imbalance where demand is increasingly met through imports rather than domestic production, limiting industrial growth and reinforcing dependence on external sources.

Figure 37 — Composition of Imported Goods (Last Five Years)

Source: Nepal Rastra Bank (NRB)



Rising Outmigration and Socio-Economic Costs of Remittance Dependence:

The economic benefits of remittance come with significant socio-economic and demographic costs. In the last four years alone—an estimated 3.4 million people, accounting for over 11 percent of the population—have left the country for foreign employment and education. This translates to an average of more than 2,350 youth departing daily, effectively emptying the equivalent of one small municipality each day. The result is a hollowing out of the country’s productive workforce, rising feminization of rural households, and an aging population. With 23.4 percent of households having members abroad, migration has reshaped the social fabric, creating long-term challenges for community cohesion and local economic activity.

Remittance-Fueled Migration Reflecting Structural and Aspirational Drivers:

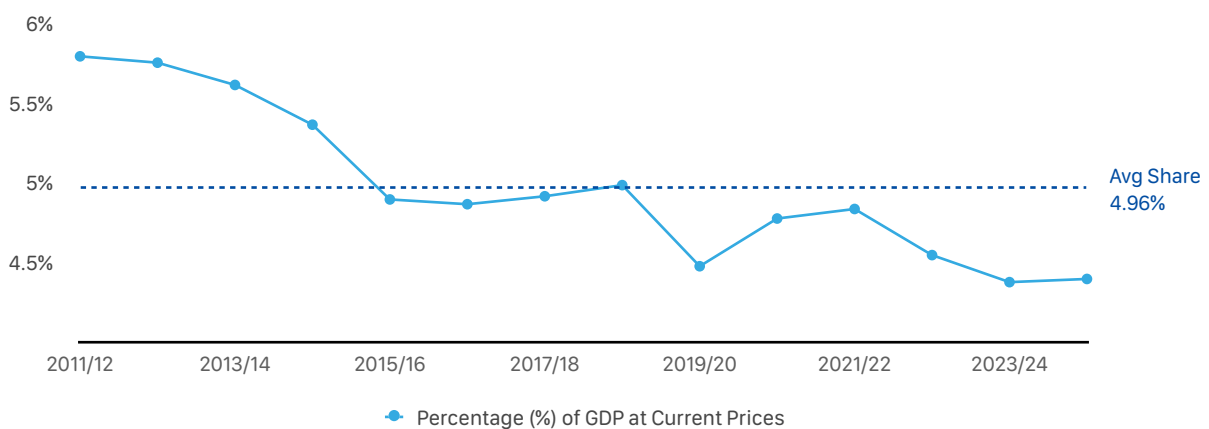
For many young Nepalis, migration is no longer simply a choice; it has become an economic necessity. Basic aspirations such as owning a house or a vehicle have become increasingly unattainable within the domestic economy due to high asset prices, rising land costs, and limited income opportunities. Even at significantly higher income levels at par with the lower threshold of high-income countries (PCI of USD 14,000), ownership of key assets remains difficult, pushing youth toward foreign employment as the primary pathway to upward mobility. Over time, however, migration has also evolved into an aspiration rather than purely a necessity. Many Nepalis now seek to live abroad to secure better education, health services, public amenities, and overall quality of life for themselves and their families. This dual dimension—economic compulsion and aspirational pull—highlights a serious structural challenge for Nepal in retaining its youth, even when domestic opportunities exist.

Structural and Institutional Barriers Limiting Productive Use of Remittance:

Efforts to mobilize remittance into formal investment channels have had limited success. Instruments such as remittance bonds have largely failed due to low returns and long maturity periods, which are unattractive compared to high-interest informal lending markets. At the same time, high borrowing costs for migration financing reduce household savings and investment capacity. Improving access to affordable formal credit, alongside better delivery of public services such as education and healthcare and reducing the cost of living, will be critical to enhancing savings and channeling remittance into productive uses.

Figure 38 — Stagnant Manufacturing Sector (% of GDP)

Source: Nepal Rastra Bank (NRB)



From Remittance-Dependent Stability to Investment-Driven Growth:

Nepal now faces the critical challenge of transitioning from a remittance-driven economic model to an investment-driven growth model. While remittance has ensured stability and supported household welfare, its long-term contribution will depend on how effectively it is leveraged to build productive capacity. This requires channeling financial inflows and accumulated reserves toward sectors that enhance domestic production, promote export diversification, and create jobs. Without this shift, remittance will continue to sustain stability in the short term but fall short of driving the structural transformation needed for long-term growth.

Remittance as a Foundation for Stability, Not a Driver of Transformation:

Remittance has been central to Nepal's economic stability, delivering strong first-round effects by strengthening the external sector, building foreign exchange reserves, reducing poverty, and sustaining household consumption and liquidity. These inflows have provided the essential preconditions for a higher growth trajectory. However, the challenge lies not in remittance itself, but in the economy's limited ability to translate these gains into productive transformation. The second-round effects have been constrained by structural and institutional factors, including low-risk, import-based trading with limited value addition, weak entrepreneurship, overregulation, market failures, and crony practices. As a result, financial inflows have been largely intermediated into consumption and asset markets, particularly land and real estate, rather than being channeled toward productive sectors that enhance competitiveness, generate employment, and diversify exports.

From Stability to Structural Transformation:

While remittance has done its part in providing stability and welfare gains, the economy has, for over two decades, fallen short of leveraging this foundation to drive structural transformation. This gap between potential and outcome points to deeper issues in how resources are allocated and incentives are structured across the economy, which the subsequent chapter seeks to examine.

M. STRUCTURE OF THE ECONOMY

Analysis of Changes Since 1990

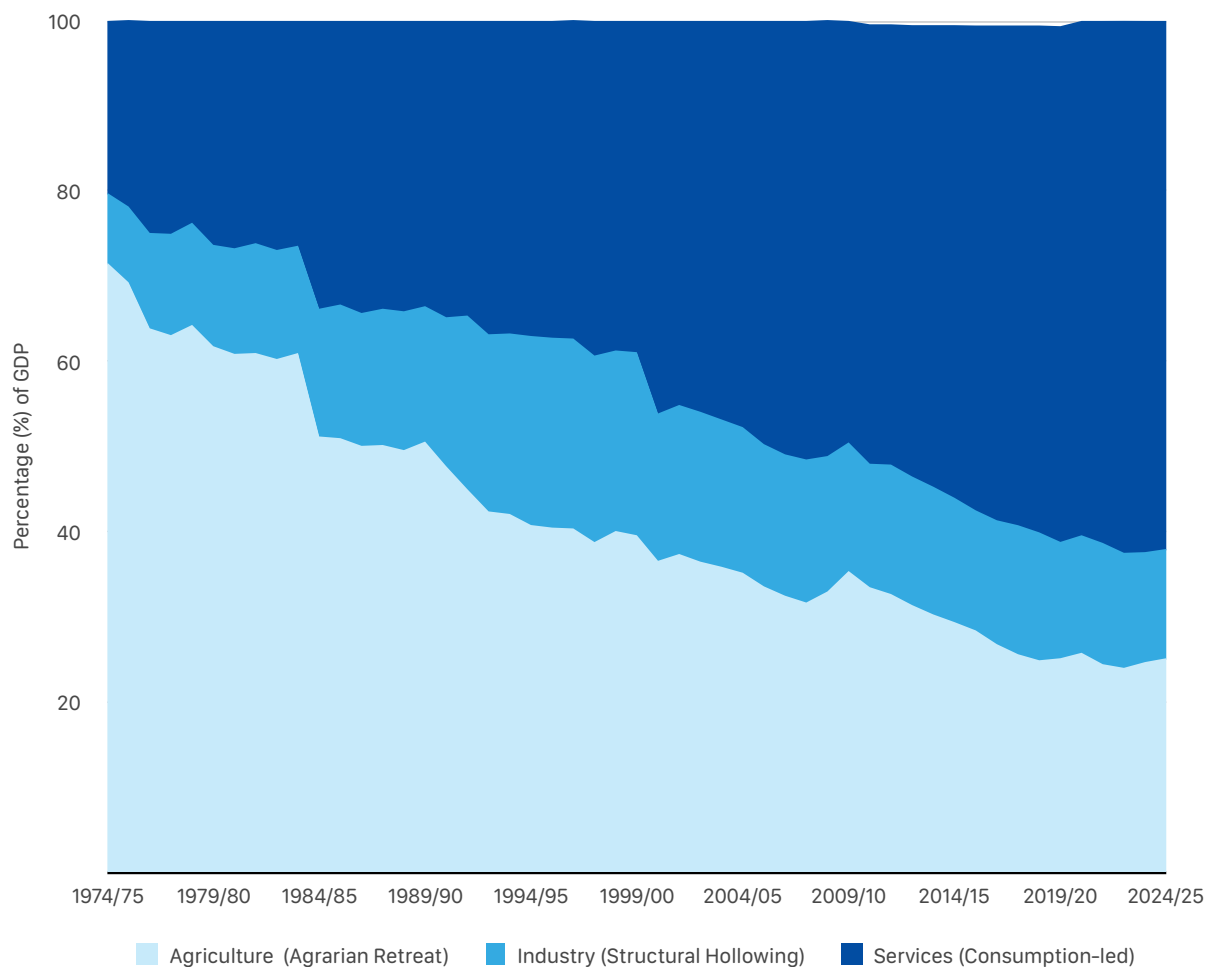
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Structural Changes with Emerging Imbalances

Nepal's economic structure has undergone a significant shift since 1991, transitioning from an agriculture-dominated economy to a service-led one. Agriculture's share of GDP has declined from 47.7 percent in 1991 to 25.2 percent in 2024/25, while services have expanded from 34.8 percent to 62 percent over the same period. However, this transformation has not followed the typical pathway of structural change led by industrialization. Instead, it reflects a remittance-supported consumption economy with a weakening industrial base and limited expansion of productive capacity. At a per capita income of around USD 1,500, Nepal's transition to a service-dominated economy appears premature compared to historical patterns observed in successful economies, especially in East Asia.

Figure 39 — Evolution of Nepal's Economic Structure

Source: Nepal Rastra Bank (NRB)



Agriculture:**Declining Share with Persistent Labor Dependence**

The central challenge lies in the weak transmission of remittance into productive sectors of the economy. While remittance has fueled consumption and created demand, the domestic economy has not responded with a corresponding expansion in production. This has led to a structural imbalance where demand is increasingly met through imports rather than domestic production, limiting industrial growth and reinforcing dependence on external sources.

Industry:**Stagnation and Erosion of Productive Capacity**

Nepal's industrial sector has experienced long-term stagnation, with its share of GDP declining from 17.5 percent in 1991 (and over 21 percent in 1990s) to 12.8 percent in FY 2024/25. The manufacturing sub-sector contributes only about 5 percent to GDP, reflecting a significant erosion of domestic production capabilities. This decline has reduced the economy's ability to produce tradable goods, limiting export diversification and reinforcing dependence on imports.

Services:**Rapid Expansion Driven by Remittance and Domestic Demand**

The service sector has become the dominant component of the economy, accounting for 62 percent of GDP. Its growth has been largely driven by remittance-fueled consumption, supporting sectors such as trade, real estate, financial services, education, and public administration. Key sub-sector trends include the expansion of trade (from 11.9 percent of GDP in FY 2000/01 to 14.6 percent in FY 2024/25), financial services (from 2.17 percent to 6.6 percent, though moderating in recent years), and real estate (from 6.8 percent to 8.3 percent). Social sectors such as education have also grown (from 3.14 percent to 7.9 percent). Increasing digitalization and the gradual emergence of digital service exports are beginning to reinforce the service sector's role, although their scale remains modest relative to overall economic needs.

02**Sectoral Composition and Weak Domestic Linkages**

The structure of the economy is concentrated in a few sectors – Agriculture (25.2 percent), Trade (14.6 percent), Public Administration (8.7 percent), Real Estate (8.3 percent), and Education (7.9 percent) with Manufacturing ranking only ninth. Construction has also declined from around 7 percent of GDP before the COVID-19 pandemic to 5.2 percent, reflecting weakened domestic investment activity. The limited presence of high-productivity and tradable sectors has weakened inter-sectoral linkages. Consequently, a large share of remittance inflows is spent on imported goods, resulting in low domestic value retention and limited multiplier effects

03**Tourism and Hydropower: Important but Structurally Limited Growth Drivers**

Tourism and hydropower are often viewed as key pillars of Nepal's economy, and both sectors remain critically important. However, their current scale and structural characteristics suggest limited capacity to independently drive large-scale income transformation. International tourist arrivals have yet to exceed around 1.2 million annually, with peak earnings of less than USD 700 million prior to COVID-19. While tourism contributes to employment and foreign exchange, it remains relatively small and highly sensitive to external shocks.

Similarly, hydropower development has progressed, with installed capacity reaching 4,100 MW compared to an estimated economically feasible potential of around 43,000 MW. Despite this progress, hydropower is a capital-intensive and relatively labor-light sector, limiting its direct impact on broad-based employment and income growth. Even at higher levels of development, the combined contribution of tourism and hydropower, while essential, would be modest in raising per capita income to levels required for high-income country status.

N. HEALTH SECTOR

Premature Welfare Expansion, Fiscal Stress, and Weak Returns on Public Spending

01

Welfare Expansion Outpacing Delivery Capacity

For over a decade, Nepal's health sector has expanded through a welfare-driven approach, with constitutional guarantees, free care provisions, and insurance schemes significantly widening the scope of state commitments. However, this expansion has taken place without a commensurate strengthening of fiscal capacity or institutional delivery systems. Despite a wide network of public facilities, a large share of healthcare continues to be delivered through private providers, reflecting persistent gaps in quality, reliability, and trust in the public system. This indicates that welfare expansion has not been anchored on a sufficiently strong delivery platform.

02

Unequal Access and Regional Disparities

The expansion of health infrastructure has not translated into equitable access or balanced capability across regions. Wide disparities in facility density across provinces and the concentration of higher-end services in urban centers highlight that Nepal has expanded the physical footprint of healthcare faster than its functional effectiveness. As a result, access to care remains uneven, and the system continues to rely on costly private provision, undermining the objective of equitable public health delivery.

03

Structural Weakness in Health Financing

Nepal's health financing model remains structurally weak, with out-of-pocket expenditure accounting for 55.8 percent of total health spending in 2022, up from 51.3 percent in 2021. At the same time, public health expenditure remains low at around 5.1 percent of the national budget (NPR 95.81 billion in FY 2024/25). This reflects a fundamental mismatch where policy commitments toward universal access have expanded faster than the public financing base required to support them, resulting in a system that is formally welfare-oriented but functionally dependent on private spending.

04

Fragility of the National Health Insurance Program

The national health insurance program has expanded geographically but remains structurally fragile due to weak financial and institutional foundations. While enrollment has reached around 28 percent of the population, active coverage stands at only 17 percent due to low renewal rates, leading to a shallow and unstable risk pool. The scheme is already running persistent deficits, with expenditures of NPR 13.16 billion exceeding income of NPR 10.67 billion in FY 2023/24, alongside outstanding liabilities exceeding NPR 7 billion. The combination of low premiums, high benefit coverage, and rising

utilization has transformed the scheme into a fiscally stressed system increasingly dependent on government subsidies.

05

Underfunded and Operationally Weak Public Hospitals

Public hospitals, which are expected to anchor the health system and deliver welfare commitments, remain underfunded and operationally weak. This creates a structural disconnect where insurance expansion and free care policies are layered on top of institutions that lack adequate staffing, medicines, diagnostics, and management capacity. As a result, patients are often pushed toward higher-cost private providers, and insurance mechanisms transmit fiscal stress rather than delivering effective financial protection.

06

Misaligned Human Resource Strategy in Health

Nepal's human resource strategy in health is characterized by significant misalignment between investment and system needs. While doctor density has improved, the broader health workforce remains inadequate, with total density of doctors, nurses, and midwives at around 34 per 10,000 population, below the WHO threshold of 44.5. At the same time, policy distortions have led to a disproportionate allocation of resources toward medical education, with nearly 70 percent of scholarships concentrated in MBBS programs, while critical shortages persist in nursing, midwifery, and allied health services.

07

High Fiscal Leakage through Outward Migration

The fiscal and economic returns on public investment in medical education are further undermined by large-scale outward migration, with around 74 percent of newly registered doctors between 2020 and 2023 seeking employment abroad. This represents a direct leakage of publicly financed human capital from a resource-constrained economy, weakening the domestic health system while imposing a high fiscal cost.

08

Regulatory and Policy Distortions in Workforce Development

Regulatory and policy distortions have further weakened the health workforce pipeline, particularly in nursing and allied health education. Stringent infrastructure requirements have led to the closure of multiple training institutions and a sharp decline in enrollment, while only a fraction of registered nurses remain actively licensed. This has created a structural imbalance where high-cost doctor training is prioritized over the broader workforce required for effective service delivery.

09

Overemphasis on Curative Care

Nepal's health system remains heavily biased toward curative care, with insufficient investment in preventive health, early diagnosis, and community-level interventions. This increases long-term treatment costs and fiscal pressures while limiting improvements in population health outcomes, indicating an inefficient allocation of already constrained resources.

10

Premature Welfare Expansion Without Alignment

Taken together, Nepal's health sector reflects a pattern of premature welfare expansion, where ambitious policy commitments have been introduced without aligning fiscal capacity, institutional readiness, and system design. This has resulted in rising fiscal liabilities, inefficient allocation of resources, weak service delivery outcomes, and limited progress toward a sustainable and equitable health system.

O. DIGITALIZATION AND THE EMERGING DIGITAL ECONOMY

01

Digital Expansion without Commensurate Outcomes

Nepal's digital ecosystem has expanded rapidly, yet this progress has not translated into meaningful gains in productivity, institutional efficiency, or global competitiveness. The country ranks 119/193 in the UN e-Government Development Index and 150/193 in the Government AI Readiness Index, while the World Bank's GovTech Maturity Index places Nepal at only a "some focus" level behind regional peers such as India, Bangladesh, and Sri Lanka. This reflects a broader structural pattern where digitalization has advanced in form, but not in function or impact.

03

Underdeveloped Digital Infrastructure and Stressed Telecom Sector

The foundational layers of the digital economy remain constrained. Nepal's data center ecosystem is nascent, with only 350–400 racks available for colocation and no domestic hyper-scale cloud capacity, resulting in reliance on foreign providers. At the same time, the telecommunications sector—central to digital growth—has weakened structurally, with its GDP contribution declining from 3.9 percent in 2016 to 1.8 percent in 2023, while operators face tax and regulatory burdens exceeding 48 percent of earnings. Key enablers such as the 700 MHz spectrum band remain unallocated, further limiting sectoral expansion and future readiness.

02

Connectivity Gains Masking Low Utilization and Structural Vulnerabilities

While mobile broadband penetration exceeds 100 percent and fixed broadband stands at around 40 percent, these figures largely capture access rather than effective usage. Average bandwidth consumption remains significantly below regional comparators, indicating limited depth of digital engagement. Despite the expansion of nearly 12,000 km of optical fiber and connectivity to over 16,000 public institutions, Nepal's digital backbone remains fragile, with almost the entire 1 Tbps international bandwidth routed through India, creating a critical single point of failure.

04

Fragmented Digital Public Infrastructure and Limited Service Delivery Depth

Nepal has made important investments in digital payments and national identity systems, but these remain non-interoperable and institutionally fragmented, operating as parallel systems rather than an integrated national digital stack. Citizen-facing platforms such as the Nagarik App provide access to services, but most remain informational rather than transactional, reflecting weak backend integration. Digital systems are largely designed around administrative processes rather than citizen needs, resulting in front-end digitization without corresponding transformation in service delivery.

05

Emerging but Fragmented Digital Economy With Limited Scale and Recognition

Nepal's digital economy is growing but remains structurally fragmented. It is dominated by approximately 3,000 small IT firms focused on the domestic market, alongside a limited number of mid-sized firms and a small but dynamic export-oriented segment. A growing pool of freelancers participates in global digital platforms but faces tax ambiguity and high transaction costs. Despite these constraints, IT service exports have exceeded USD 1 billion in 2025, although the absence of formal tracking mechanisms leads to misclassification as remittance, reflecting a disconnect between economic reality and policy recognition.

07

Human Capital Deficits and Digital Divide as Binding Constraints

The most critical constraint to Nepal's digital transformation lies in human capital. Although approximately 7,000 engineering graduates are produced annually, only 28.5 percent passed the Nepal Engineering Council's licensure examination in 2023, highlighting quality concerns. High outmigration further erodes the domestic talent pool. Structural inequalities persist, with a 32 percent urban-rural gap in internet usage and a 19 percent gender gap in mobile ownership, while institutional capacity remains weak with limited integration of universities into national research networks and the absence of a comprehensive digital skills framework.

06

E-Commerce Expansion Constrained by Informality and Limited MSME Integration

While e-commerce is expanding, participation remains shallow, with most MSMEs—representing over 90 percent of Nepal's 923,000 registered businesses—operating through informal social media channels rather than formal platforms. The introduction of the E-Commerce Act has created a regulatory framework, but compliance capacity remains limited, raising concerns that formalization requirements may outpace the ability of small enterprises to adapt.

P. GEOPOLITICS

The twenty-first century is widely described as the Asian Century, reflecting the rapid economic ascent of China and India, two economies that historically dominated global output prior to the Industrial Revolution. China is now the world's second-largest economy, while India is on track to become the third-largest by the end of this decade. With sustained high growth averaging approximately 8.7 percent for China since the late 1970s and over 6 percent for India since the 1990s, the global economic center of gravity is shifting eastward, geographically converging around Nepal. Yet proximity has not translated into economic convergence.

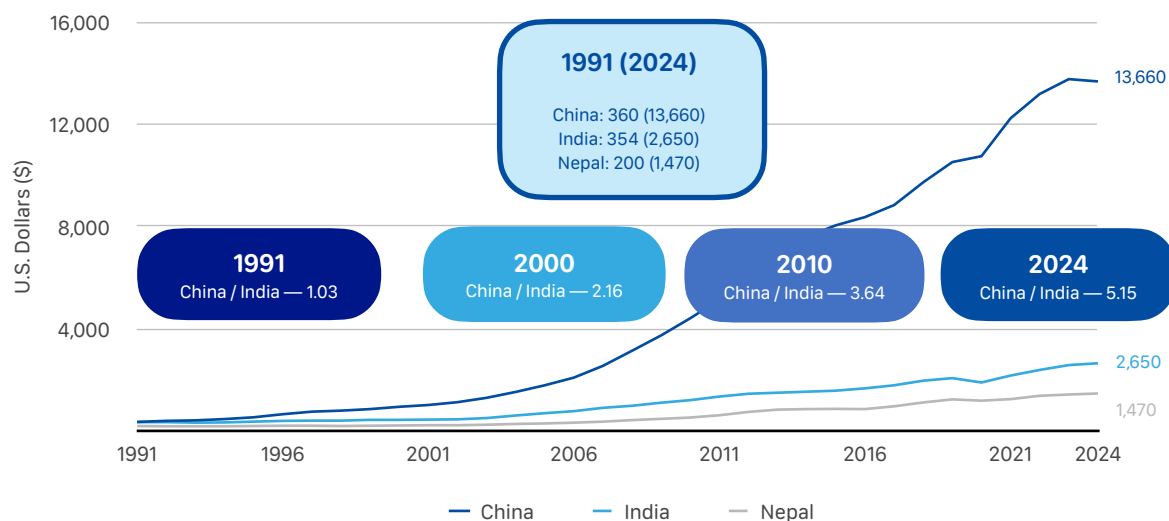
01

Limited Growth Spillovers from India and China

According to the World Bank's World Development Indicators, China's GNI per capita (USD 360) slightly exceeded India's (USD 354) in 1991. Over the subsequent three decades, China's per capita income surged to over USD 13,600 in 2024, approaching high-income status, while India's reached just under USD 2,650. Currency dynamics further widened the income gap: the Chinese CNY depreciated modestly against the US dollar by an annual average of 0.91 percent, supported by large foreign exchange reserves and trade surpluses, whereas the Indian rupee weakened by an average of 4.02 percent per year. During the same period, Nepal's per capita income rose from USD 200 to USD 1,470. Despite being geographically positioned between these rapidly growing economies, Nepal has experienced minimal spillover benefits, suggesting the presence of structural barriers that prevent effective integration into regional growth dynamics.

Figure 40 — Gross National Income (GNI) Per Capita: Nepal vs. Neighboring Economies

Source: The World Bank



02

Nepal Faces Persistent Triple Imbalances with India and China on Trade, Remittance, and Capital

The trade deficit with India peaked at over NPR 1.04 trillion in FY 2021/22, while the deficit with China reached NPR 338 billion in FY 2024/25, the highest on record. Nepal exports less than 1 percent of what it imports from China despite preferential access to more than 8,000 products, and exports to India account for only around 14 percent of imports, largely concentrated in primary or low-value-added goods. Structurally, Nepal remains heavily import-dependent even in agriculture, where the deficit exceeds NPR 200 billion annually. These patterns indicate structural import dependency and weak export competitiveness.

Figure 41 — Trade Deficit in NPR Billion (Average of 3 Years: FY 2022/23 - FY 2024/25)

Source: Nepal Rastra Bank (NRB)

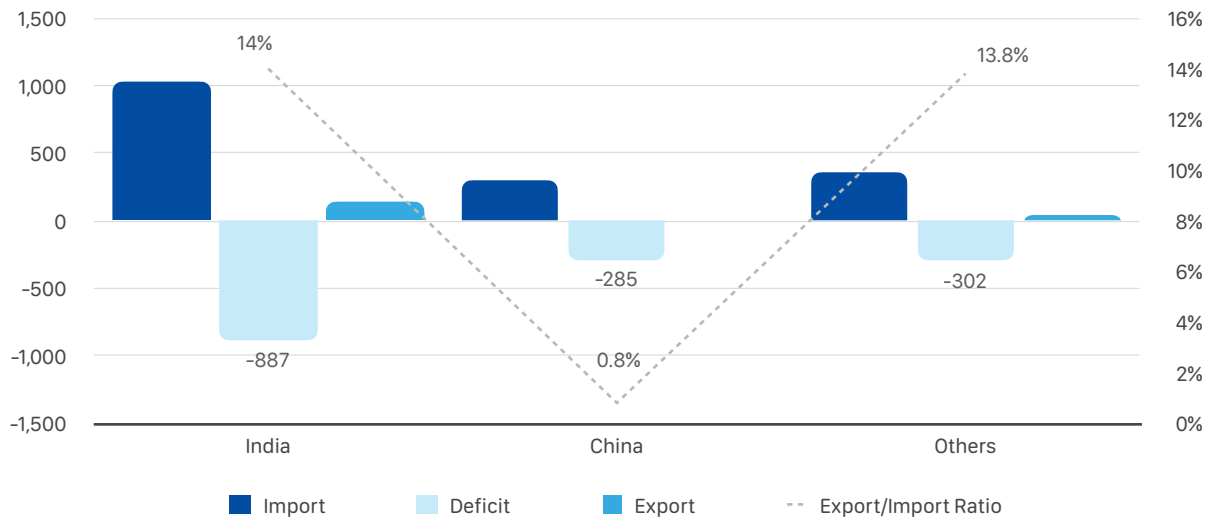
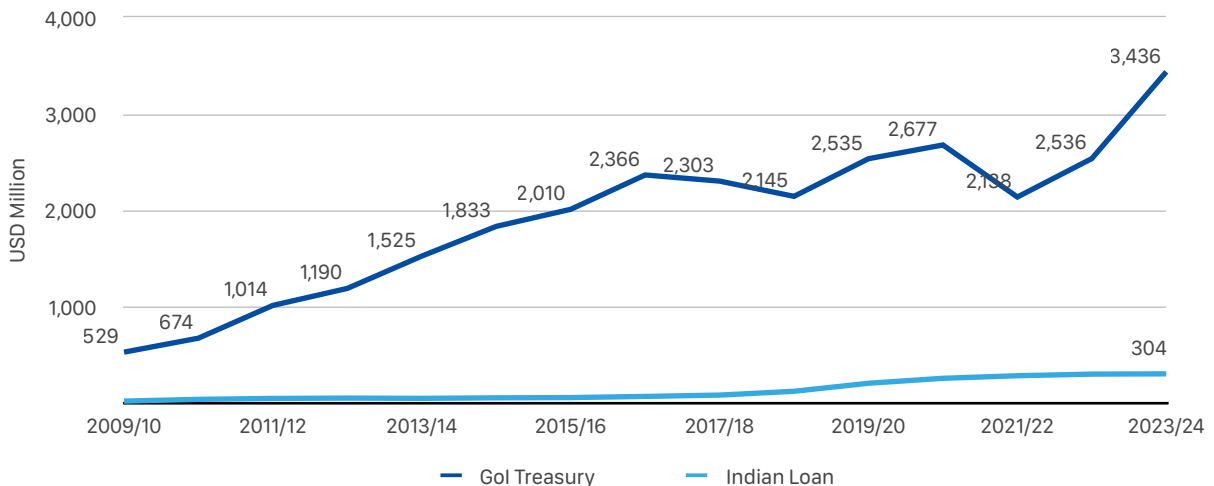


Figure 42 — Investment in Government of India (GoI) Treasury vs. Loan from India

Source: Ministry of Finance (MoF), Nepal Rastra Bank (NRB)



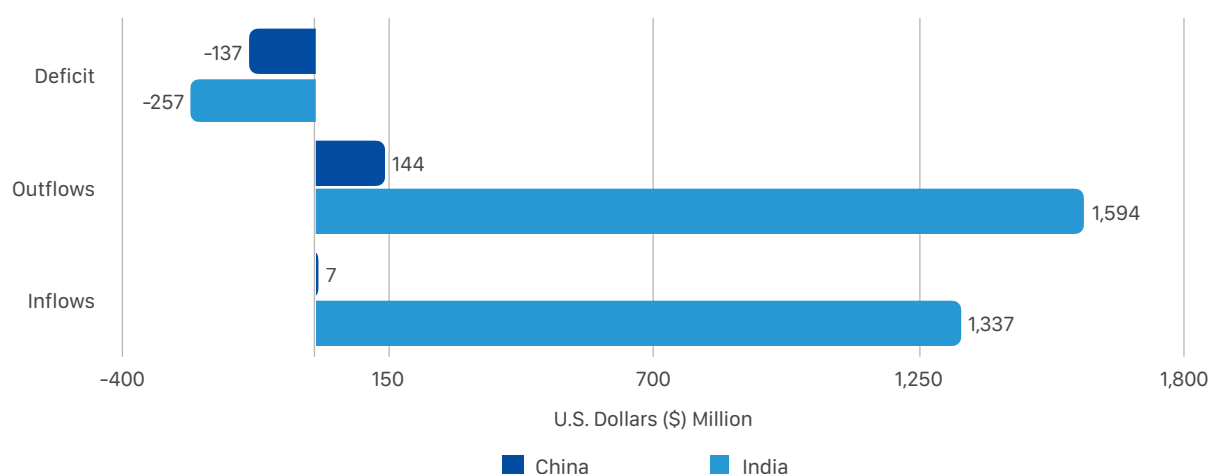
03

Contrary to popular perception, bilateral remittance data suggest Nepal runs a remittance deficit even with India.

Meanwhile, Nepal invests substantial portions of its foreign exchange reserves in Indian and Chinese government securities. As of FY 2023/24, approximately USD 3.436 billion (NPR 448 billion) was invested in Government of India treasury instruments compared to bilateral loan outstanding of about USD 304 million. Similarly, USD 718 million (NPR 96.4 billion) was invested in Government of China treasury instruments, with total exposure to CNY-denominated assets amounting to NPR 181.6 billion compared to bilateral loan outstanding of USD 265 million. These exposures far exceed Nepal’s bilateral loan liabilities to these countries, underscoring a paradoxical capital flow structure: Nepal borrows modestly while simultaneously investing reserves in their sovereign instruments. This is in spite of the fact that the currencies of both these countries are not reserve currencies.

Figure 43. Bilateral Remittance Matrix between Nepal vs. India and China in 2018

Source: The World Bank



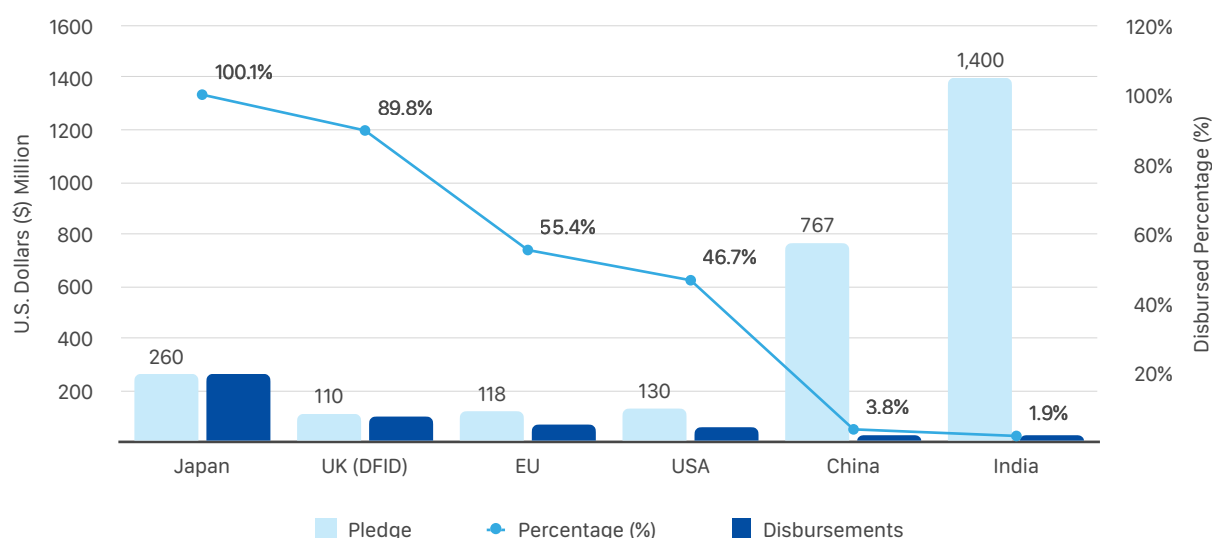
04

Despite their economic size and growing global influence, development assistance from India and China remains modest relative to Nepal’s structural exposure to them.

Between FY 2016/17 and FY 2021/22, India and China accounted for about 2.6 percent and 1.5 percent of total development assistance respectively, with annual averages of USD 58 million and USD 33 million. Even for 2015 post-earthquake reconstruction support, actual disbursement remained extremely low compared to pledges: by FY 2022/23, India had disbursed only USD 26.5 million (less than 2 percent of its USD 1.4 billion pledge) and China USD 29.3 million (less than 4 percent of its USD 767 million pledge). This suggests that economic interdependence is asymmetric and the physical proximity has not been translated into proportionate development finance support.

Figure 44. Post-Earthquake Reconstruction Pledge vs. Disbursement

Source: Ministry of Finance (MoF)



05

Foreign Direct Investment (FDI) from Nepal's two immediate neighbors constitutes a significant share of total investments but remains modest relative to the size, proximity, and economic linkages with these economies.

As of the first eleven months of FY 2024/25, cumulative FDI commitment from China stood at NPR 255 billion across 2,913 projects, accounting for 44.8 percent of total FDI of NPR 570 billion, while India's commitments amounted to NPR 111 billion across 874 projects, representing 19.6 percent of the total. Chinese investments are concentrated primarily in hydropower, manufacturing industries, and tourism, whereas Indian investments are largely directed toward manufacturing, hydropower, and the financial sector. Despite Nepal's fixed exchange rate regime with the Indian rupee, absence of currency risk in bilateral transactions, open border arrangements, and deep historical, cultural, and socio-economic ties, Indian FDI remains relatively low in proportion to potential. While the concentration of FDI from the two neighbors reflects geographic realities, its overall scale remains insufficient to materially transform Nepal's economic potential.

06

Recent developments surrounding the U.S.-funded Millennium Challenge Corporation (MCC) Compact and the Chinese-financed Pokhara International Airport illustrate how infrastructure and development initiatives in Nepal have become embedded in broader geopolitical narratives.

Projects that are fundamentally economic in nature have been interpreted through geo-strategic lenses, generating domestic political polarization and external sensitivities.

07

The economic viability of Pokhara International Airport, for instance, remains contingent upon securing direct connectivity with major regional markets, particularly Indian cities, without which traffic volume and revenue projections may remain constrained.

These episodes highlight the growing entanglement between development finance and geopolitics, where project implementation, market access, and economic returns are influenced by geopolitical considerations.

08

India remains the primary and virtually sole large-scale market for Nepal's electricity exports, creating concentration risk.

Nepal began exporting electricity to India in FY 2018/19, and exports have expanded rapidly, reaching a record NPR 17.5 billion in FY 2024/25, generating a trade surplus of NPR 6.4 billion in electricity for the first time. While this demonstrates significant commercial potential and validates hydropower as a strategic sector, over dependence on a single external market exposes Nepal to economic and geopolitical vulnerabilities.

09

Regional integration in South Asia remains limited, with intra-regional trade among member states remaining one of the lowest relative to other regional blocs.

Persistent geopolitical tensions and asymmetrical economic structures have constrained deeper cooperation. India records high trade surpluses with most neighboring countries, including Nepal, reflecting structural imbalances in production capacity and competitiveness. In practical terms, Nepal has functioned primarily as an end-market for imports rather than as a value-added participant within regional supply chains. This pattern reinforces structural dependence rather than reciprocal integration.

10

Shifts in global trade and foreign policy, including rising protectionism, strategic supply-chain reconfiguration, and increased defense expenditures among major powers, have further complicated the external environment facing developing economies.

As advanced economies recalibrate fiscal priorities toward security and industrial policy, concessional development assistance flows may face downward pressure. At the same time, while globalization has expanded trade volumes it has coincided with Nepal's deepening import dependence and widening trade imbalances rather than productive integration into global value chains. These trends heighten uncertainty for aid-dependent and import-reliant economies, underscoring the need for careful external engagement, diversified partnerships, and prudent management of development finance.

11

Despite decades of rapid economic expansion in both neighboring economies, Nepal has not experienced commensurate economic spillover benefits.

The aspiration that Nepal could serve as a bridge between India and China remains largely rhetorical rather than grounded in geopolitical realities. Nepal's geopolitical positioning between two rising giants presents structural asymmetries rather than automatic advantages. Without strategic integration into global value chains, diversification of markets, and strengthening of domestic productive capacity, proximity alone will not ensure shared prosperity.

The long-held notion that geography is destiny has largely held true for Nepal.

There is a fundamental distinction between landlocked economies in South Asia and those in Europe. European landlocked countries rank among the world's richest economies, reflecting deep market integration, institutional strength, and effective connectivity, unlike those in South Asia.

Q. CONCLUDING DIAGNOSTIC SUMMARY

Nepal stands at a historic juncture. The current “New Normal,” defined by the paradox of record external sector strength alongside deep internal structural fragility, has created a rare, time-bound opportunity to reset the foundations of the economy. Strong foreign exchange reserves and a sustained Balance of Payments surplus provide temporary stability, but more importantly, they offer the fiscal and monetary space to undertake a decisive structural pivot. This moment is further reinforced by a historic political mandate: in the national elections held in early March this year, the people of Nepal delivered a decisive verdict, granting a near two-thirds majority to a new political force led largely by a younger generation of representatives. This convergence of economic necessity and political renewal creates an unprecedented window for reform. This is not a moment for incremental adjustment; it is a moment for fundamental recalibration of an economy that has long relied on exporting labor to finance domestic consumption.

01

Core Binding Constraints: Structural Barriers to Transformation

Nepal’s transition to a sustainable, high-growth economy is constrained by three reinforcing structural bottlenecks: premature welfarism, premature depopulation, and premature financialization.

Premature welfarism has locked the state into a cycle of fiscally unsustainable, unproductive expenditures, where rising debt-servicing obligations increasingly crowd out capital investment. This has weakened the state’s ability to build the physical and institutional foundations required for long-term growth.

Premature depopulation reflects a deep structural imbalance in the labor market. Annual outmigration for work and education is now approaching the scale of new labor force entrants, creating a “replacement trap.” This has effectively liquidated Nepal’s demographic dividend at an early stage of development, leaving behind acute skill shortages while over 57 percent of the domestic workforce remains concentrated in low-productivity agriculture.

Premature financialization has further distorted the economy. Despite a private sector credit-to-GDP ratio approaching 100 percent, capital remains disproportionately allocated toward land, real estate, and consumption rather than productive sectors. The result is a credit-consumption loop where liquidity is abundant, but productive investment remains constrained.

Together, these forces have created a self-reinforcing cycle of remittance-dependent stability and structural stagnation, an economy that remains externally stable but internally hollowed out. Without a long-term strategic pivot toward productive capital

formation, Nepal risks remaining trapped in a model of “stabilized decline.”

02

Key Warning Signals: The Inversion of Stability

The current phase of macroeconomic stability masks several underlying risks that signal deep structural stress:

Demographic Replacement Trap: Outmigration has exceeded both the birth rate and the rate of labor force entry, eroding the current workforce and weakening the future domestic demand base. Nepal risks aging before achieving middle-income stability.

The Liquidity-Productivity Disconnect: Despite record reserves exceeding USD 22 billion and liquidity conditions remaining accommodative, credit growth has slowed sharply while non-performing loans have risen above 5 percent. This decoupling reflects weakening transmission from finance to real economic activity.

Consumption-Driven Hollow Growth: A current account surplus of 6.7 percent reflects not structural strength but subdued domestic demand, driven by a contraction in imports and declining investment. With over 90 percent of GDP — driven by consumption and gross capital formation contracting — the economy is effectively substituting long-term asset creation with short-term consumption financed by external income.

These signals collectively point to an inversion of stability where macroeconomic indicators appear strong, but the underlying drivers of sustainable growth and job creation are weakening.

03

The Cost of Inaction: Entrenchment of Passive Deindustrialization

If the current trajectory persists, Nepal risks entering a phase of passive deindustrialization, where the economy gradually loses its productive base without a corresponding rise in high-value services or exports.

In such a scenario, the country’s graduation from Least Developed Country (LDC) status would be largely symbolic. While income thresholds may be met through remittance inflows, the economy would lack the structural resilience to compete without preferential trade access. Persistently low growth, combined with depopulation and a rising dependency ratio, would erode the tax base and strain public finances.

Over time, the continued outflow of youth and skills would deplete the very foundation of economic dynamism. Today's strong reserve position would gradually weaken as the demographic dividend is exhausted, leaving behind an aging population and an economy with limited capacity to generate domestic income, employment, or exports.

04

Resetting the Economic Structure: Aligning with Realities and Opportunities

The central challenge and opportunity for Nepal is to reset the structure of the economy in alignment with its fundamental realities: a small domestic market, a landlocked geography between India and China, high logistics costs, and limited scope for large-scale manufacturing. At the same time, Nepal possesses underleveraged strengths such as its global diaspora, growing digital capabilities, natural endowments, a youthful population, strong foreign exchange reserves, and a strategic geographic position between major economies.

The future growth model must; therefore, be anchored not in replication of traditional industrial pathways, but in selective specialization and global integration. The expanding global market for services particularly digital, knowledge-based, and remote services offers a pathway for Nepal to transition from exporting labor to exporting skills and services. The diaspora, already a central pillar of the economy through remittance, can play a catalytic role in connecting Nepal to global value chains, markets, capital, and technology.

Similarly, sectors such as tourism and hydropower, while not sufficient as standalone growth engines, remain critical components of a broader, integrated economic framework that strengthens domestic linkages and supports external earnings. In addition, Nepal has the potential to emerge as a regional hub for medical education and healthcare, where it holds a clear comparative advantage, provided appropriate policy alignment and strategic repositioning are undertaken to effectively tap this opportunity.

05

A Historic Political Moment: If Not Now, When?

This structural inflection point coincides with a rare and potentially transformative political moment. The emergence of a new political force with a near two-thirds majority in Parliament, combined with a new generation of leadership, provides an unprecedented mandate for reform. For the first time in over three decades, Nepal has the prospect of sustained political stability over a five-year horizon.

This convergence of economic urgency and political stability creates a narrow but powerful window for undertaking second-generation reforms. The cost of delay has already been high; the cost of inaction at this stage would be irreversible.

The reform agenda can no longer proceed in a gradual or fragmented manner. It must be executed in a mission mode, with clarity of purpose, institutional coordination, and accountability. The structural challenges identified in this report are not cyclical, they are systemic and demand a response of corresponding scale and urgency.

06

Why a Development Strategy for Vision 2100 is Indispensable

The scale and complexity of Nepal's structural challenges extend beyond the scope of conventional planning cycles. A long-term Development Strategy - Vision 2100 - is essential to anchor policy continuity and guide structural transformation.

Intergenerational Imperative: Nepal must transition from a remittance-consumption model to an investment- and production-driven economy within a narrowing demographic window.

Structural Re-engineering: Deep, sustained investments are required to reverse declining private investment and reorient capital toward productive sectors.

Policy Coherence and Continuity: A long-term national framework can ensure consistency across political cycles, transforming key sectors such as hydropower, tourism, and emerging services into integrated drivers of growth rather than isolated opportunities.

Global Integration: The strategy must position Nepal within evolving global economic structures, leveraging diaspora networks and digital transformation to overcome geographic constraints.

Nepal's current stability is both a shield and a signal: a shield that provides temporary protection and a signal that deeper structural weaknesses remain unresolved.

The choice ahead is stark: continue along a path of externally financed stability with internal decline, or undertake a decisive reset toward a resilient, productive, and globally integrated economy. The coming years will determine whether Nepal's transition is merely nominal or truly transformational. Vision 2100 is not just a strategic framework; it is the necessary foundation to ensure that Nepal's future is defined not by constraint, but by possibility.

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