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Nepal's Monetary Policy FY 2025/26: Macroeconomic Analysis and Trends

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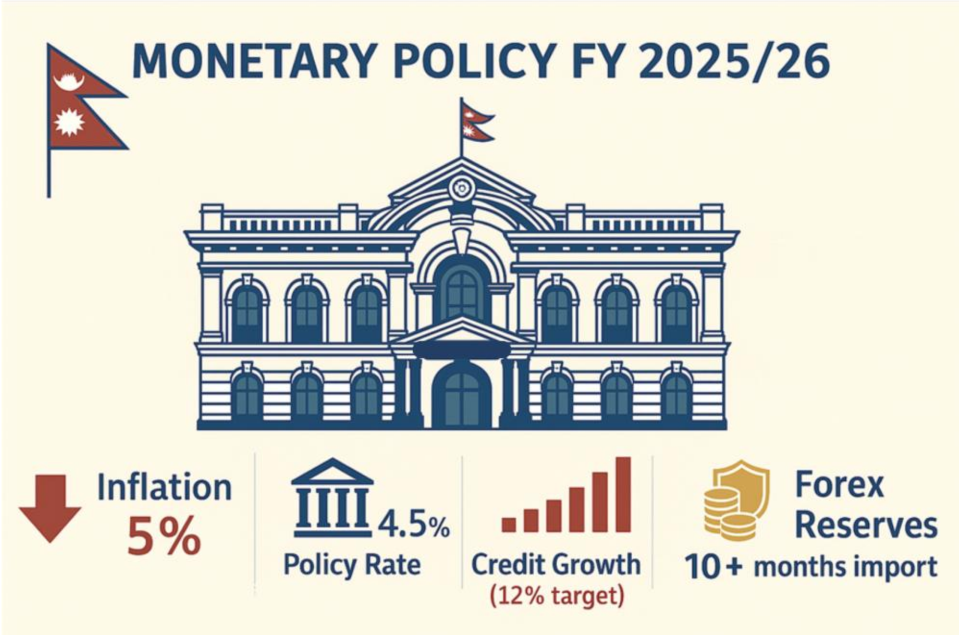
Macroeconomic Context and Recent Trends

Nepal's recent macroeconomic trajectory has been marked by a post-pandemic recovery tempered by inflationary pressures and external sector volatility. During FY 2021/22 and FY 2022/23, expansionary policies adopted to spur recovery (following the COVID-19 lockdowns) which contributed to rising inflation and a widening trade deficit. Year-on-year consumer price inflation peaked at about 8.6% in mid-2022, up from around 4.4% a year prior. Average inflation for FY 2021/22 reached 6.1% exceeding initial projections, prompting policymakers to shift toward contractionary measures. Broad money and private sector credit growth were reined in sharply as the monetary policy for 2022/23 targeted just 12% broad money growth (down from 18% earlier) and 12.6% private sector credit growth, recognizing that credit expansion had fuelled import consumption and external imbalances. In fact, actual private growth fell well below targets as in FY 2022/23 it was only about 3% year-on-year by mid-June 2023, versus a targeted 12.6%, reflecting tight liquidity and policy restrictions.



The external sector experiences significant stress in 2021/22. A surge in imports of up to 25% led to a record trade deficit of NPR 1.577 trillion, which strained the balance of payments. Foreign exchange reserves dropped to around NPR 1,176 billion (US 9.2 billion) by mid-2022, which was only sufficient to cover less than 6.6 months of imports, below the central bank's target of 7 months. In response, Nepal Rastra Bank (NRB) adopted a **cautiously contractionary stance** in FY 2022/23 to restore stability. Key policy rates were raised substantially as the repo rate was increased from 5.5% to 7.0% and the upper bound bank rate from 7.0% to 8.5% with the interest rate corridor floor (deposit collection rate) rising from 4.0% to 5.5%. NRB also hiked the Cash Reserve Ratio (CRR) from 3% to 4% deposits and the Statutory Liquidity Ratio (SLR) to 12% for commercial banks (10% for other banks) to tighten liquidity. These measures, combined with import control effects, helped cool domestic demand and ease external pressures. By mid-2023, inflation has moderating, averaging around 6.8% in FY 2022/23, close to the 7% targets and the current account deficit began to improve.

Entering FY 2023/24, the macroeconomic situation showed signs of stabilization and recovery. Inflation continued to ease, average inflation in the first half of FY 2023.24 was around 6.5% which then decline to around 5% by mid-2024. By mid-June 2024, year-on-year inflation stood at only 4.17% which was well within NRB's target of 6.5% for that year. **Economic growth** has resumed, albeit modestly as real GDP was estimated to have grown about 4% in FY 2023.24, up from 3.9% the year prior. Meanwhile, a collapse in import demand alongside booming remittance inflows had swung the external sector into surplus. Remittances surged by 19.3% in terms of NPR in the first 11 months of FY 2023/24, as Nepalese migrant labour outflows rebounded after the pandemic. This coupled with import compression, led Nepal to record a **current account surplus of roughly 4% of GDP in FY 2023/24**, reversing the deficits of earlier years. Gross foreign exchange reserves jumped from 25.7% year-on-year to USD 14.7 billion by mid-June 2024, sufficient to cover about 12-13 months of imports. The Nepalese rupee's **exchange rate** remained fixed at NPR 1.6 per Indian Rupee (a peg maintained since 1993), and reserve accumulation reinforced confidence in the peg's sustainability in the near term.

With external stability restored and inflation subdued, domestic financial conditions loosened significantly in FY 2023/24. Nepal's banking system moved from a liquidity crunch to a state of **excess liquidity** by mid-2024. Deposit growth (12.6% y-o-y in mid-2024) outpaced the sluggish credit expansion, aided by remittance-driven inflows. This pushed **interest rates** down as the weighted average interbank rate fell to around 3.36% in FY 2023/24, within the lower half of the NRB's operating target range (3.0-7.0%). Commercial bank's lending rates, which had spiked above 15% during the tight liquidity period, declined markedly to multi-year lows by mid-2024. Despite low interest rates, however, **private sector credit growth remained anaemic** at 5.6% (y-o-y) in June 2024 which was far below the 11.5% target for that year. Businesses were hesitant to borrow amid weak demand, and banks grew cautious as non-performing loans (NPLs) climbed. The banking sector's gross NPL ratio rose from 3.0% to 4.0% over FY 2023/24, reflecting stress in industries like real estate and trading due to the economic slowdown. Nonetheless, banks remained well-capitalized on average, and NRB even reduced the countercyclical capital buffer to 0% (from 0.5%) in FY 2023/24 to support lending.

In summary, by mid-2025 Nepal's macroeconomy was characterized by **low inflation, a stable currency peg with strong reserves, and a banking system flush with liquidity but facing weak credit demand and rising asset quality concerns.** This context set the stage for the Monetary Policy of FY 2025.26 announced in July 2025, which aims to stimulate economic activity while safeguarding financial and external stability.

Monetary Policy Objectives and Stance for FY 2025/26

Nepal Rastra Bank unveiled the monetary policy for FY 2025/26 on July 11, 2024, adopting a **"flexible and accommodative" stance** to reinvigorate the sluggish economy. Governor Dr. Biswo Nath Poudel emphasized **cautiously expansionary measures** to support growth, marking a notable shift from the prior year's carefully balanced approach. The overarching objectives of the FY 2025/26 policy are to **boost credit flows, lower borrowing costs, and support the government's economic growth target of 6%**, all while keeping inflation contained and maintaining financial stability.

The monetary policy has et an **Inflation containment goal** 5.0% for FY 2025/26. This is slightly more conservative than the Ministry of Finance target of 5.5% announced in the budget, indicating NRB's intent to anchor inflation expectations on the lower side. The 5% inflation target aligns with expectations that price pressures will remain moderate, given easing global commodity prices and Nepal's currency peg to India (where inflation has been on the downward trends). By choosing a tighter inflation ceiling than the fiscal authorities, NRB signals its commitment to price stability, even as it pursues growth-friendly policies. This approach is akin to an informal **inflation targeting** framework, though not a formal one as NRB aims to balance the inflation goal with other objectives like external balance rather than single-mindedly focusing on CPI.

Similarly supporting the government's **6% real GDP growth** ambition for FY 2025/26 is a core theme of the policy. Given recent growth around 4%, achieving 6% will require rejuvenating private sector activity. To this end, NRB projects **private sector credit expansion of about 12%** in the year. This marks a substantial increase from the mere 5-6% credit growth realised in the prior two years, effectively doubling the pace of lending. The broad money (M2) supply is likewise forecast to grow by around 13% in FY 2025/26. These projections reflect an accommodative monetary environment intended to **remove financing constraints** on businesses and consumers. NRB's stance is that with inflation low and reserve ample, the economy has room for credit-fuelled expansion without jeopardizing stability in the short term. Indeed, the policy statement notes that further loosening is signalled such that market interest rates may remain **below the policy rate** for some time which is an indication that the central bank is comfortable with **easy liquidity** conditions to spur lending.

Even as the economy leans towards growth, the FY 2025/26 policy underscores continued vigilance on external sector health and banking stability. One objective is to maintain **sufficient foreign exchange reserves and a stable exchange** against the Indian rupee. The policy implicitly continues the commitment to the NPR-INR peg, which has long anchored Nepal's external stability. Given recent build-up of reserves (USD 13-15 billion) covering over a year's imports, NRB's baseline is that external buffers will remain adequate. However, it does caution that a rebound in import demand (as the economy accelerates and as delayed government capital spending is implemented) could erode the pace of reserve accumulation. The central bank projects the balance of payments to stay in **surplus for FY 2025/26** nonetheless, assuming steady remittances and foreign aid inflows. On the financial stability front, NRB explicitly identifies challenges such as rising NPLs, over-leveraged borrowers, and stress in certain financial institutions. The policy's stance is to address these via regulatory reforms and supervisory vigilance, not by tightening monetary policy per as this juncture. In essence, the central bank is attempting a **delicate balancing act:** it aims to catalyse credit growth and economic activity *(a Keynesian-style stimulus)* while employing prudential tools to contain any resulting risks to inflation, the currency, or the banking sector.

In summary, the monetary policy for FY 2025/26 is **expansionary in intent**, prioritizing revival of lending and investment. It aligns with a pro-growth, counter-cyclical stance given Nepal's context of low inflation and slack economic performance. At the same time, NRB's stated inflation target (5%) and emphasis on maintaining reserve adequacy signal that it remains mindful of its core mandate for price and external stability. The following sections detail the key policy measures and directives announced, which illustrate how NRB intends to operationalize this accommodative yet prudent stance.

Key Policy Measures in FY 2025/26

Interest Rate Corridor and Liquidity Management

A centrepiece of the FY 2025/26 policy is the **reduction of key policy rates** to lower the cost of funds in the economy. NRB eased its **interest rate corridor (IRC)** by 50-75 basis points. The upper bound **Bank Rate** (the rate for Standing Liquidity Facility) was cut from 6.5% to **6.0%** and the **policy rate** (repo rate, the mid-point target) from 5.0% to **4.5%**. The lower bound **Standing Deposit Facility (SDF)** rate, the interest floor for excess liquidity parked at the central bank was also reduced from 3.0% to **2.75%**. This adjustment narrows the IRC to a 2.75%-6.0% range, signalling an overt easing bias. By comparison, during the tightening phase of 2022, the corridor stood much higher at 5.5%-8.5%.

Lowering all three corridor rates sends a clear signal that **monetary policy is in easing mode** and the NRB is comfortable if market rates decline further. In fact, Governor Poudel indicated that the weighted interbank rate will be guided to stay below the 4.5% policy rate for some time. This implies the central bank is content with excess liquidity conditions, where banks have more funds than credit demand, pushing short-term rates to the floor of the corridor. The policy thus accommodates the prevailing surplus liquidity rather than aggressively mopping it up.

However, NRD did preserve some tools for liquidity management to prevent volatility or overshooting. Notably, it announced plans to issue **NRB bonds as needed to manage structural liquidity** imbalances. This is a departure from relying solely on short-term deposit auctions; longer-term NRB bonds can help soak up persistent excess liquidity in a ore controlled manner, should that excess threaten inflation or exchange rate stability. Additionally, the **Cash Reserve Ratio** (CRR), the fraction of deposits banks must hold as reserves is **unchanged at 4%**. By maintaining the CRR, the central bank ensures that banks continue to hold a basic liquidity buffer, but it refrained from increasing CRR further, which would have tightened liquidity. The **Statutory Liquidity Ratio (SLR)** also remains at prior levels (around 12% for commercial banks), with no new increase, indicating a neutral stance on this front.

Moreover, the policy continues the provision of Standing Liquidity Facility (SLF) and other refinancing facilities on more flexible terms. By committing to readily supply liquidity to banks (through SLF repo operations) when needed, NRB reassures the market that interest rates will remain low and stable. The combined effect of these measures is that banks have ample access to funding at cheaper rates, which they can pass on as lower lending rates to borrowers. Indeed, by July 2025, commercial bank prime lending rates in Nepal had already fallen to around 10% or lower, a multi-year low, reflecting the cumulative 200 bps reduction in the policy rate since early 2023.

One potential risk of lowering interest rates in a small, open economy like Nepal is **capital flight** as if Nepalese interest rates drop significantly below rates in India, investors could shift funds to higher-yielding INR assets. NRB has acknowledged such concerns but judged the risk to be manageable. As of mid-2025, India's repo rate was about 6.5%, only modestly above Nepal's 4.5% policy rate. Furthermore, capital controls on limited convertibility of NPR to INR for investment purposes insulate Nepal to a degree. Nevertheless, Governor Poudel has addressed the issue by tightening regulatory oversight on foreign exchange to pre-empt undue outflows. The modest narrowing of the interest differential, couples with Nepal's strong reserve positions, suggests that the **peg can be maintained** without aggressive rate hikes. In theory, under the **Mundell-Fleming Framework** (with a pegged exchange rate and not fully open capital account), Nepal has some room for independent monetary policy, the trade-off being that being if capital outflows did surge, NRB would need to intervene or adjust rates to defend the peg. The policy stance implies confidence that current easing will not destabilize the currency peg in the near term, thanks to adequate reserves and partial capital controls.

Finally, NRB is moving toward more sophisticated liquidity risk management in line with global standards. The policy announced plans to implement **Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) regulations** for banks. These Basel III metrics will require banks to hold high quality liquid assets and maintain stable funding profiles, respectively, which should fortify the banking system's resilience to shocks. In short, the interest rate and liquidity measures for FY 2025/26 demonstrate a careful calibration with **monetary easing** to encourage lending and growth complemented by **liquidity monitoring tools** (like NRB bonds, LCR/NSFR) to curb any excesses and maintain confidence in the financial system.

Credit Expansion and Sectoral Lending Directives

In order to translate lower interest rates into actual economic activity, the monetary policy introduced several **credit policy measures and directives** aimed at boosting lending to the private sector. A significant more is the **relaxation of loan limits and collateral requirements** in key areas, to encourage both consumer and business credit growth.

Regarding **housing loans**, the cap on banks loans for purchasing or constructing a private residence has been raised from NPR 20 million to **NPR 30 million**. This increase in the loan limit it significant in the context of Nepal's urban housing market, where property prices have historically risen and previous limits were seen as restrictive for mid-range homes. Furthermore, the **loan-to-value (LTV) ratio** allowed for home loans was liberalized as first-time homebuyers can now borrow up to **80% of the property value** (up from 70%), while for others the LTV cap is at 70% (up from 50%). By reducing down-payment requirements, these measures aim to stimulate the housing sector and associated industries (cement, steel, construction jobs), which can have large multiplier effects on the economy. The higher LTV for first-time buyers is a nod to social policy aiming to promote home ownership. This added leverage can unlock mid-range properties for salaried households and revive construction jobs. Yet, the higher borrowing can also amplify risks as if supply lags, easier credit can inflate prices and push household debt-service burdens even further. The policy's net impact hinges on execution, as if macro-prudential guard-rails of LCR, NSFR and forthcoming ILAAP works, new loans can translate into growth else, if may simply fuel another price spiral and take us back to 2022.

The individual borrow limit on **loans against shares** (stock market margin lending) was increased from NPR 150 million to **NPR 250 million**. This is a raise responding to longstanding requests from investors and broker communities to loosen margin financing constraints. Additionally, banks can now lend up to **70% of the average share price** (or the last 180-days average, whichever is lower) as collateral value. These steps inject liquidity into the stock market by allowing larger and easier credit against equity holdings. The policy explicitly mentions this as supporting **"greater market participation"**.

Likewise, the monetary policy introduces or expands several schemes to facilitate **small and medium enterprise (SME)** and **agricultural loans** which is critical for inclusive growth. For instance, banks and financial institutions (BFIs) can now **self-assess the value of agricultural land and structures and extend loans up to NPR 1 million** against such collateral without external valuations. This simplifies and speeds up the lending process to farmers. Grace period loans of up to NPR 1 million will have reduced provisioning requirements, which incentivized banks to lend to small enterprises with flexible repayment schedules. Credit products will be tailored to the production and harvest cycles in farming, livestock and fisheries, meaning repayment terms can match income seasonality. Moreover, NRB is encouraging loans for specific **priority crops** as the policy states that loans will be promoted for agricultural commodities **recommended by the Nepal Agricultural Research Council (NARC)**. This likely means banks will get positive regulatory treatment (such as priority sector lending credit) for financing crops identified as high-value or import-substituting by NARC. These measures align with a development or **Keynesian supply-side** approach i.e. channelling credit into sector that can generate jobs and output, thus boosting aggregate supply and long-term growth potential.

As part of inclusive lending, the policy brings certain loans under the mandatory **deprived sector lending** category. Loans up to **NPR 300,00** for youth going abroad for employment will count toward banks' deprived sector lending quota as will loans up to **NPR 500,000** for women entrepreneurs. By reclassifying these as deprived sector loans, NRB essentially forces banks to direct a portion of their portfolio to such segments. This reflects a social objective to ensure access to finance for vulnerable cohorts as youth might need financing to migrate with the expectation, they send remittances back and women-led business.

Beyond stimulating new credit, NRB also addressed **existing loans under stress** to prevent a credit crunch. Notably, the policy offers a **loan restructuring window for real estate developers** and other businesses affected by shocks. Banks are now allowed to **restructure or reschedule loans to real estate companies** that are struggling to repay on time, by providing revised repayment schedules. This temporary forbearance is intended to support the liquidity of the housing and construction sector, which faced a downturn in recent years. By preventing fire sales or insolvencies of developers, NRB hopes to stabilize property markets and preserve collateral values, which in turn upholds banking sector health. Similarly, **borrowers in districts hit by natural disasters (like earthquakes)** will be eligible for easier restructuring of their loans. Banks can restructure such loans if the borrower pays at least 10% of the accrued interest and based on analysis of their cash flow situation. This acknowledges the exogenous shocks faced by certain regions and provides relief that can avert defaults.

In aggregate, the credit-related directives of the 2025/26 policy embody a **pro-growth, counter-cyclical credit policy**. They remove bottlenecks for borrowers (higher limits, higher LTVs, simplified processes) and provide targeted incentives for sectors with high economic impact. This is consistent with a **Keynesian view of using credit policy** as a tool for macroeconomic management by directing financial resources to spur demand (housing, consumption via remittance loans) and to support supply (agriculture, SMEs). At the same time, NRB has tried to calibrate risk, for example, the margin loan LTV rule uses average prices to avoid bubbles, and restructured loans still require partial interest payment to instil discipline. If successful, these measures could help achieve the targeted 12% credit growth, which in turn would feed into higher investment and GDP growth. However, their effectiveness will depend on borrower confidence and the overall economic climate, despite easier credit conditions in 2024, many firms were reluctant to borrow due to weak demand and existing debt overhang. The hope is that by FY

2025/26, with improved sentiment and supportive policies, credit flows will normalize towards the double-digit growth path.

External Sector and Exchange Rate Management

Nepal's monetary policy for 2025/26 continues to place strong emphasis on external sector stability, a necessity for a small economy with a fixed exchange rate regime. **Exchange rate management** in Nepal is primarily about maintaining the longstanding peg of NPR to the Indian Rupee at 1.6 NPR/INR. The monetary policy does not announce any change to this regime, on the contrary, by ensuring low inflation and robust reserves, NRB reinforces the credibility of the peg. A stable exchange rate provides a nominal anchor for the economy, helping to contain imported inflation (given large imports from India) and fostering predictability in trade and remittances. The policy thus implicitly aligns with a **monetarist view** that controlling money supply growth (projected at 13%) and inflation will keep the external balance in check, since excessive monetary expansion could undermine the peg via inflation differentials or import surges.

To further ease foreign exchange usage for legitimate needs, the policy **raised the foreign currency cash carry limit for Nepali travellers abroad from $2,500 to $3,000 per person**. This 20% increase reflects the comfortable reserve position and is a goodwill measure to facilitate travel and small payments abroad by citizens. It indicates NRB's confidence that a moderate rise in personal forex allowances will not dent external stability. Indeed, remittance inflows (nearly 22–25% of GDP in recent years) far exceed such travel outflows, and the current account is in surplus. By liberalizing foreign exchange for travellers, NRB is also moving gradually toward capital account openness, albeit in a controlled manner which is consistent with Nepal's aim to eventually remove itself from the Financial Action Task Force (FATF) "grey list" by showing adherence to international norms on forex and AML/CFT (Anti-Money Laundering/Combating Financing of Terrorism).

On that note, a noteworthy aspect of the 2025/26 policy is the commitment **to strengthen AML/CFT measures** to protect the external financial integrity. The policy explicitly mentions an urgent, coordinated implementation of the FATF action plan to get Nepal delisted from the grey list. This includes enhanced monitoring, investigation, and prosecution of suspicious transactions through better interagency coordination. While not a traditional monetary policy item, this regulatory stance has important macro implications: compliance with FATF improves Nepal's global financial standing, helps safeguard remittance channels (so that foreign banks continue facilitating remittance flows), and by extension supports the balance of payments. Essentially, NRB is acknowledging that **external sector health is not only about exchange rates and reserves, but also about reputation and transparency** in financial flows which are factors that rating agencies and investors watch closely.

Another external indicator targeted by policy is the **foreign exchange reserve adequacy**. The government's budget had set a goal of at least 7 months import cover and as of mid-2025, NRB had achieved over 10–12 months cover. The 2025/26 monetary policy indicates that even if imports pick up due to higher growth, reserves are expected to stay above the 7-month threshold. The policy gives itself flexibility by planning to use open market operations and possibly direct FX intervention if needed to smooth out any BoP pressures. It's worth noting that in early 2022, when reserves fell to around 6 months import cover, NRB employed import restrictions and tight monetary policy to reverse the trend. In the current scenario, such drastic measures are not anticipated, instead, a moderate widening of the trade deficit is forecast as imports recover, but this is to be offset by sustained remittances (which are projected to remain steady or grow modestly after the 19% jump in 2023/24). The World Bank projects Nepal's current account surplus will narrow in the medium term as import demand returns and remittance growth stabilizes, potentially shifting back to a slight deficit. NRB's policy stance appears to be that a manageable deficit is acceptable as long as it is financed by stable inflows (remittances, tourism uptick, concessional loans) and does not draw reserves below comfort levels.

In conclusion, the monetary policy continues a strategy of **anchoring expectations of external stability**. By keeping the NPR pegged to INR, capping inflation, and cautiously liberalizing forex usage, NRB aligns with a **Mundell-Fleming fixed-exchange framework** where fiscal and other tools must carry more of the burden of adjustment. The central bank's actions on AML and reserve management further buttress external sector confidence. These measures reassure credit rating agencies and investors that Nepal, while easing monetary conditions, is not neglecting its external fundamentals. Fitch Ratings, for example, highlighted Nepal's strong external liquidity and net external creditor position as key strengths supporting its first-time sovereign rating of BB- (assigned in late 2024). The 2025/26 policy's external sector prudence aims to preserve those strengths going forward.

Banking Sector Stability and Regulatory Reforms

A critical component of the FY 2025/26 monetary policy is a suite of regulatory and supervisory measures to ensure **banking sector stability** even as monetary conditions loosen. NRB recognizes that rapid credit expansion and low interest rates could exacerbate financial vulnerabilities, so it has introduced or reiterated reforms to fortify banks' resilience and risk management.

Banks and financial institutions (BFIs) are encouraged and allowed **to raise fresh capital** as needed, subject to NRB approval. This implies that if banks wish to issue new equity or other capital instruments to bolster their capital base, the central bank will facilitate it. The timing is apt, as some banks have seen capital buffers pressured by rising NPLs and reduced profits. In fact, NRB temporarily reduced the countercyclical capital buffer to 0% in FY 2024 to ease capital strain. Now, by supporting capital raising, NRB is signalling that banks should proactively strengthen their Tier-1 and Tier-2 capital, which will ultimately improve their capacity to lend safely. Additionally, the policy proposes preparing draft legislation to establish **separate asset management companies** for managing non-performing loans and distressed assets. This suggests a move toward a structural solution for bad loans by possibly creating “bad bank” entities where banks can park or sell their bad assets. Such an approach, if implemented, could clean up bank balance sheets and resolve NPLs more efficiently, thereby improving overall banking sector health.

Recognizing that the NPL ratio has neared 5% (the highest in many years), NRB’s policy focuses on enhancing oversight. The policy calls for **asset quality reviews (AQR)** of commercial banks, with an independent third-party auditor to review loan portfolios. It also speaks of improving **property (collateral) valuation standards** to ensure loan quality. These steps align with international best practices and aim to identify any hidden credit risks or under-provisioning early. In addition, the policy maintains that **provisions like the 15% dividend cap on microfinance institutions** will be reviewed. Previously, microfinance companies were barred from distributing over 15% in dividends if they were highly profitable, as a prudential limit. Reviewing this could allow well-performing MFIs to raise investor confidence by paying more dividends, but NRB will likely ensure they meet stringent NPL and capital criteria first. Furthermore, NRB emphasizes it will revise borrower eligibility and standards for microfinance to ensure loans actually reach target low-income groups and are used productively, thereby indirectly safeguarding the asset quality in that segment.

The policy announces that NRB will **review the Credit-to-Deposit** ratio regime after implementing global liquidity standards (LCR/NSFR). Currently, Nepali banks must maintain a CD ratio (often 90%) which means that loans cannot exceed 90% of deposits (plus core capital). This rule was a simple liquidity risk proxy. With LCR and NSFR in place, NRB might relax or replace the CD ratio, which could free some banks to lend more if they have excess deposits. However, NRB’s caution is clear, any change will occur only after robust liquidity risk measures are confirmed, **ensuring no compromise on stability**. Additionally, NRB will issue **Internal Liquidity Adequacy Assessment Process (ILAAP)** guidelines for banks. ILAAP requires banks to assess their own liquidity needs under stress scenarios which is another layer of risk management. By institutionalizing ILAAP, NRB is effectively compelling banks to self-regulate liquidity risk in parallel to the central regulations. Once these global liquidity safeguards are embedded, the CD metric will be relaxed, but measures of asset guard rails, sectoral lending quotas, tight real-estate LTV caps and exposure ceiling will be in force, so that lending is steered towards agriculture, energy and MSMEs rather than the repeat 2022 property boom.

Table 1: Funding-Side Liquidity Safeguards Under NRB's FY 2025/26 Monetary Policy

Funding-side rules (liquidity/funding risk)	**Current calibration (2025/26)**	**Implementation trigger**
Liquidity Coverage Ratio (LCR)	≥ 100 % stock of high-quality liquid assets vs. 30-day net cash outflow	Basel III circular, Feb 2025
Net Stable Funding Ratio (NSFR)	≥ 100 % available stable funding vs. required stable funding	Same Basel III circular
Internal Liquidity Adequacy Assessment Process (ILAAP)	Bank-run quarterly stress tests, reviewed by NRB	New guideline announced in Monetary Policy 2082/83 (
CD-ratio review	Present ceiling 90 % (loans ≤ 90 % of deposits + core capital) stays **until** all banks meet LCR/NSFR/ILAAP; may be lowered or scrapped thereafter	Monetary Policy 2082/83 clause on liquidity metrics

Table 2: Asset-Side Credit Allocation Tools to Promote Productive Lending and Limit Real-Estate Exposure

Asset-side steering tools (credit allocation & risk)	**Rule & level**	**How it favours productive sectors**
Priority/ "productive-sector" quota	Agri + energy + MSME loans ≥ 25 % of total by FY 2027/28; deadline just extended one year	Forces banks to reallocate away from low-productivity real estate
Risk-weight on land-plotting & margin loans	150 % capital weight (vs. 50–100 % for agriculture & hydro)	Makes speculative loans capital-expensive
Real-estate LTV caps	40 % within Kathmandu, 50 % elsewhere	Limits leverage in property purchases
Exposure ceilings	Housing + real estate ≤ 25 % of total loans; land development ≤ 10 %	Automatic brake on property concentration
Sectoral credit reporting & stress tests	Monthly granular returns; NRB stress tests downgrade scenarios (FSR 2024)	Enables swift enforcement & higher Pillar-2 buffers if property risk surges

Overall, the regulatory measures in the 2025/26 monetary policy illustrate a **macroprudential approach** accompanying the macroeconomic stimulus. By shoring up bank capital, tightening supervision (AQRs, new guidelines), and improving the credit ecosystem (better credit information, AML enforcement), NRB is aligning with a **"twin goals" framework i.e. promoting growth while preserving financial stability**. This approach resonates with modern central banking that uses a combination of interest rate policy and prudential policies (sometimes termed "leaning against the wind" in credit markets). It also reflects lessons learned from the credit boom and bust cycle Nepal saw around 2020–2022, unchecked credit growth, especially to unproductive sectors, can lead to crises. The current measures attempt to ensure that the targeted 12% credit expansion will be of **high quality** where credit will flow to productive uses and backed by robust risk management.

Notably, these actions address some concerns cited by credit rating agencies. When Fitch Ratings assigned Nepal a **BB- sovereign rating** in late 2024 (Nepal's first global rating), it pointed to **banking sector stability and regulatory improvements as a factor supporting the rating.** Fitch noted that private sector credit had reached about 86% of GDP, fuelled by remittance-fed deposits, and that regulatory enhancements were underway to mitigate risks from non-bank financial institutions. The FY 2025/26 policy's focus on asset quality, NPL resolution, and integrating cooperatives/finance companies into stricter norms (e.g., removing the 15x deposit mobilization limit for finance companies) directly aligns with those enhancements. Thus, NRB is addressing structural issues in tandem with cyclical easing, which should reassure observers that Nepal is not trading short-term growth for long-term instability.

Theoretical Framework Alignment

Nepal's FY 2025/26 monetary policy can be analysed through various economic theoretical lenses, as it embodies elements of Keynesian stimulus, monetarist discipline, and open-economy considerations:

- **Keynesian Approach:** The policy's overall stance is counter-cyclical and growth-oriented, reflecting Keynesian demand management. By lowering interest rates and relaxing credit constraints, NRB is attempting to **stimulate aggregate demand** in the face of a sluggish economy. The emphasis on boosting credit to productive sectors (agriculture, SMEs) and supporting industries like housing and construction shows a belief in the fiscal-monetary multiplier effects which is a hallmark of Keynesian thinking. Moreover, the willingness to tolerate a modestly higher money supply growth and to intervene directly in credit allocation (through directives and refinancing schemes) aligns with a Keynesian view that active policy can steer the economy toward higher output and employment. The policy's flexibility and pragmatism, adjusting tools as per the situation (tightening in 2022, easing in 2025) also resonate with Keynes's advocacy for context-dependent policy rather than strict rules.

- **Monetarism and Inflation Targeting:** Despite its expansionary bent, the policy does not abandon monetarist principles of inflation control. By setting a **clear inflation target of 5%** and monitoring monetary aggregates (13% M2 growth projection), NRB is invoking elements of **monetarism** and inflation targeting. The NRB Act's focus on price stability is reflected in the cautious language about not letting demand-pull inflation re-emerge. The fact that NRB chose an inflation goal slightly below the fiscal authority's indicates a concern for maintaining credibility in fighting inflation. This is reminiscent of inflation targeting regimes where central banks often communicate a numeric target to anchor expectations. However, Nepal's approach is more eclectic than pure monetarism as there is no single intermediate target (like a strict money growth rule), and the central bank is also managing the exchange rate. Nonetheless, adherence to moderate money growth low inflation suggests the influence of monetarist thought that "**inflation is always and everywhere a monetary phenomenon"**, NRB clearly does not intend the credit easing to spill into runaway money expansion or prices. The successful curbing of inflation from 8% to 3% over 2022–2025 strengthens NRB's confidence in its ability to fine-tune money supply and use tools like the interest rate corridor to keep inflation in check, much like a light version of an inflation-targeting framework.

- **Mundell-Fleming and the Impossible Trinity**: Operating under a fixed exchange rate (peg to INR) with partial capital mobility, Nepal's monetary policy must respect the constraints described by the **Mundell-Fleming model**. In a classic Mundell-Fleming scenario, with a fixed exchange rate and high capital mobility, independent monetary policy is ineffective as the central bank would have to follow the base country's interest rates to maintain the peg. Nepal, however, has some capital controls and a financial system not fully open internationally, which gives NRB room to manoeuvre with interest rates. The 2025/26 policy in fact diverges somewhat from India's stance (India's policy rate remained higher). This reflects **limited capital mobility**, otherwise, arbitrage would force Nepal to match India's rates. NRB's careful reduction of rates and the continued build-up of reserves indicates that capital outflows have not overwhelmed the system, validating a semi-autonomous monetary policy. However, theoretical consistency requires caution, if interest differentials widen or if confidence in the peg falters, NRB would have to adjust. The policy's simultaneous attention to FX reserves and FATF compliance underscores an understanding of Mundell-Fleming trade-offs as NRB is buttressing the external side (via reserves, AML measures) to buy space for domestic monetary easing. In essence, Nepal is attempting to enjoy two sides of the "impossible trinity", a fixed exchange rate and an independent monetary policy by limiting the third (capital flows). The success of this approach aligns with the model’s implication that with controls on capital, some monetary autonomy is achievable.

- **Financial Sector (Macroprudential) Theories:** The policy also aligns with modern macroprudential theory and the concept of the **financial accelerator**. By implementing measures like countercyclical capital buffers (reduced in bad times), NPL resolution frameworks, and sectoral credit caps/ relaxations, NRB is invoking the idea that financial frictions can amplify economic cycles and must be addressed by policy. For example, the decision to allow loan restructuring for real estate firms reflects an understanding of the financial accelerator as if these firms default, it could tighten credit conditions economy-wide and by preventing that, NRB dampens a potentially negative feedback loop. This is consistent with **Bernanke-Gertler’s financial accelerator theory**, where central banks might act to prevent a credit crunch from deepening a downturn. Additionally, embracing **Basel III standards (LCR/NSFR)** is grounded in the theory of banking regulation that says adequate liquidity and stable funding reduce the probability of banking crises. By phasing in these standards, NRB follows the global post-2008 consensus on macroprudential policy.

Implications for Credit Ratings and Outlook

The measures in Nepal’s FY 2025/26 monetary policy carry important implications for how credit rating agencies view the country’s sovereign and financial institutions. Overall, the policy’s balanced approach providing stimulus while initiating structural reforms is likely to be **seen favourably, albeit with some caution**, by ratings analysts.

Nepal received its first sovereign credit rating in late 2024, when Fitch Ratings assigned Nepal received its first sovereign credit rating in late 2024, when Fitch Ratings assigned a **‘BB-’ with Stable outlook**. Fitch cited Nepal’s low public debt (about 44% of GDP) and strong external liquidity (current account surplus and rising reserves) as credit strengths, against weaknesses like low per-capita income and governance challenges. The 2025/26 monetary policy supports these credit strengths in several ways. By keeping inflation around 5% and maintaining a surplus in the balance of payments, NRB guards the value of the currency and ensures debt affordability remains high (interest payments were only arounf8% of revenue in FY 2024 due to low rates and concessional borrowing). The decision to not monetize debt (no drastic measures like deficit financing via money printing) and instead allow market-driven interest rates at low levels will help keep government borrowing costs down. This aids fiscal consolidation, which Fitch projected with the deficit narrowing to 4% of GDP by FY 2026. Indeed, in H1 FY 2025 the fiscal deficit was nearly balanced due to revenue growth outpacing spending, a positive sign for creditworthiness. However, rating agencies will also watch for **risks arising from the easier monetary stance**. One concern is that a rapid credit expansion (12% target) on top of an already high private credit-to-GDP ratio (108% including all sectors) could sow the seeds of future financial instability or require government intervention. If the stimulus leads to excessive import growth and the current account swings back to deficit significantly, it **could weaken Nepal's external metrics** which are key to the BB- rating. Fitch explicitly warned that "weakening external finances" or a drop in reserves could put downward pressure on the rating. In this regard, NRB's prudent moves (like modest rate cuts, raising the forex travel limit only marginally, and focusing on remittance and export promotion indirectly) should keep the external deficit moderate. The **grey-list FATF issue** is another factor –as successful removal from the grey list by tightening AML as planned would be a credit-positive development, improving Nepal's international financial standing. Conversely, any slip that risks capital flight or loss of correspondent banking relationships would be viewed negatively.

Local credit rating agencies in Nepal (e.g., Infomerics Nepal, ICRA Nepal, CARE Ratings Nepal) rate banks and corporate debt. From their perspective, the monetary policy's impact is mixed but largely positive. **For banks**, the flush liquidity and lower interest rates mean **narrower net interest margins** in the short term, which could constrain profitability. Many banks had enjoyed high lending rates during the tight policy phase; now with lending rates down and deposit rates also down, the net effect depends on each bank's asset-liability mix. However, the increase in credit growth should help banks earn more interest income volume, offsetting some margin compression. More importantly, the regulatory relaxations (e.g., allowing regulatory reserves on non-banking assets to count as supplementary capital for two years) provide capital relief. This specific measure, permitting banks to use reserves set aside for assets like land or unsold properties as capital boosts their capital adequacy in the short term. It is essentially a forbearance that rating analysts will note: it temporarily strengthens capital ratios, which is positive for solvency metrics, but it also hints that underlying asset quality issues (non-banking assets often result from bad loans) persist. Rating agencies will therefore appreciate NRB's moves to address NPLs (via asset management companies, AQRs) as they indicate a path to **resolve problem loans** rather than hide them.

Conclusion

Nepal's Monetary Policy for FY 2025/26 represents a strategic pivot toward supporting economic recovery, underpinned by the favourable macroeconomic conditions of low inflation and a fortified external sector. The policy delivers a comprehensive package**: it lowers interest rates** and eases liquidity to stimulate credit; it **relaxes credit controls** and boosts lending limits to channel funds into housing, stock markets, and productive sectors; and it undertakes **regulatory reforms and safeguards** to ensure that this credit uptick does not compromise financial stability. This dual-pronged approach, stimulus with prudence, reflects the central bank's broader commitment to its legally mandated objectives of price stability, balance of payments equilibrium, and financial sector soundness.

Comparatively, the 2025/26 policy marks a shift from the tighter, cautious policies of a few years prior. The trends are evident: **inflation** has been tamed from over 8% to around 3–5%, allowing a reduction in the policy rate from a peak of 7% in 2022 down to 4.5%. **Interest rate corridors** that were widened to combat overheating have now been narrowed to encourage borrowing**. Credit growth**, which stagnated in the low single digits amid deleveraging, is now poised for a revival with a 12% target albeit a level still below the heady 20% expansions seen pre-2020, indicating a measured approach. **Exchange rate management** remains steadfast, with the peg providing continuity and confidence, but NRB's toolkit has expanded (reserve accumulation, modest liberalization, AML measures) to manage the external side of a more open economy.

The policy also implicitly trusts that Nepal's economic agents, banks, borrowers and investors will respond positively. Much rides on improved sentiment: banks must be willing to utilize their ample liquidity to extend new loans, and creditworthy firms must be willing to invest and expand production. Early signs, such as a rising stock market and uptick in credit inquiries post-policy announcement, are encouraging. Remittance trends remain robust, suggesting continued support to domestic demand. Additionally, external factors like India's inflation and rate trajectory, global commodity prices, and tourism recovery will influence outcomes. NRB has left room to manoeuvre; it can tighten if inflation surprisingly jumps or if there is undue pressure on forex reserves, and conversely, it could ease further if growth disappoints and inflation stays below target.

In essence, Nepal Rastra Bank is charting a middle path with this monetary policy, **fostering growth while vigilantly guarding against risk**. The alignment with theoretical frameworks is pragmatic rather than dogmatic, which is appropriate for an economy in transition and recovering from shocks. As Nepal enters 2025/26, the policy stance projects optimism: that the country can seize the opportunity of stability to energize its economy. Should the policy succeed, Nepal could experience a virtuous cycle of moderate inflation, improved credit flows, higher growth, and strengthened financial stability indicators. That outcome would not only better the lives of Nepali citizens through more jobs and income, but also solidify Nepal's macroeconomic credentials on the world stage, potentially leading to improved credit ratings and greater investor confidence. The coming year will thus be a critical period of implementation, in which Nepal's policymakers must stay agile to ensure that the benefits of this accommodative monetary policy are fully realized, without letting the guard down on the hard-won stability gains of recent years.

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