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Nepal: 2003 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Nepal

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Nepal, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 13, 2003**, with the officials of Nepal on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 5, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its August 22, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Nepal.

The document(s) listed below have been or will be separately released.

Statistical Appendix

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NEPAL

Staff Report for the 2003 Article IV Consultation

Prepared by Staff Representatives for the 2003 Consultation with Nepal

Approved by Wanda Tseng and Anthony Boote

August 5, 2003

- The 2003 Article IV consultation was held in Kathmandu during April 24–May 13, 2003. The staff team comprised Messrs. Shishido (head), Kalra (APD), Hallaert (PDR), Zhan (EP, FIN), and Mahar (Administrative Assistant, APD). Mr. Singh (Resident Representative) assisted the mission. Mr. Karki, Assistant to the Executive Director, joined key meetings and Messrs. Ahsan and Bajracharya (World Bank) and Tuladhar (AsDB) took part in selected meetings. Subsequently, discussions were continued during June 28-July 3 with the newly appointed government of Prime Minister Thapa.

- During the April/May mission, the team met then Finance Minister Shrestha, National Planning Commission Vice Chairman Sharma, Nepal Rastra Bank Governor Rawal, Chief Cabinet Secretary Koirala, Finance Secretary Acharya, other senior officials and representatives of private business, trade unions, political parties, and donors. During the June/July mission, the staff met with Finance Minister Lohani and senior Ministry of Finance officials.

- The 2002 Article IV consultation was concluded by the Executive Board on September 4, 2002. Executive Directors called on the authorities to demonstrate a firm commitment to macroeconomic stability and structural reforms to reinvigorate growth and reduce poverty. Directors noted that internal and external difficulties, including the insurgency, had contributed to economic weakness, and stressed that increased revenue mobilization was needed to maintain fiscal balance and generate resources for poverty alleviation. Directors also emphasized the need for improved governance.

- Nepal accepted the obligations of Article VIII, Sections 2, 3, and 4 in May 1994. The authorities have agreed to allow all payments for personal travel for bona fide reasons.

- The authorities agreed to publication of the staff report.

- The principal authors of this staff report are Sanjay Kalra and Hisanobu Shishido.

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Executive Summary

Poverty in Nepal remains pervasive due to insufficient growth and inadequate targeting under poverty alleviation programs. While macroeconomic conditions remained broadly stable in the 1990s, growth was constrained by financial sector weaknesses, weak public sector management, poor governance, and low agricultural productivity. More recently, security problems and adverse external developments contributed to lower growth.

Talks with the insurgents have raised hopes for peace and the reform momentum is being sustained, but political uncertainties remain. The ceasefire has started to restore normality in economic activities. However, key political parties continue to protest the appointment of governments by the King since the dissolution of parliament as unconstitutional. These protests forced the resignation of Prime Minister Chand and his replacement by Mr. Thapa in early June. Amidst the political uncertainty, senior officials have attempted to maintain the reform momentum.

A modest recovery is under way, but risks remain. GDP growth is expected to be 2 percent in 2002/03 and is projected to rise to 5–6 percent over the medium term, if the security situation remains stable and structural reforms are implemented. While manufacturing and tourism are expected to be the main sources of growth, a significant contribution from agriculture is also envisaged. Inflation is expected to remain below 5 percent. The current account deficit is projected to increase, but higher aid, remittances, and other inflows should allow international reserves to be maintained at 6 months of imports of goods and services.

Key fiscal policy challenges are to improve revenue mobilization, prioritize spending and contain domestic borrowing over the medium term. To raise revenues, policy measures are needed, including increases in the VAT rate. Significant reform measures are also required to streamline the tax system and strengthen administration, especially customs. Spending needs to be directed toward priority social and infrastructure sectors to help reduce poverty. Reductions in domestic borrowing will help maintain fiscal sustainability.

Monetary policy needs to support the peg to the Indian rupee which has served Nepal well given close ties with India. However, the level of the peg should remain under review to maintain competitiveness in the face of potentially reduced access to export markets from phasing out of Multi-Fibre Agreement and impending WTO accession. Meanwhile, competitiveness needs to be raised by labor reforms, investment in human capital to improve skills, and improved infrastructure to lower transportation costs.

Vigorous structural reform implementation is critical to restoring growth and reducing poverty. Financial sector reforms—improved financial sector legislation and loan recovery, central bank strengthening, and restructuring of insolvent commercial and development banks—would help spur private sector growth by improving intermediation. Significant progress is also required in public spending prioritization, and public enterprise and governance reforms to improve resource allocation.

I. Introduction

1. **Nepal remains among the poorest countries in the world due to insufficient growth and inadequate targeting under poverty reduction programs.** Around 40 percent of the population lives below the poverty line (roughly unchanged for more than a decade). Health, education, and other development indicators also remain low compared to other South Asian countries. Poverty is more intense in the distant mid- and far-western regions of the country and among female-headed households. Growth during the 1990s—modest but insufficient for poverty reduction—remained constrained by financial sector weaknesses, weak public sector management, and poor governance. During 2000/01–2001/02, growth fell due to the intensification of the seven–year old insurgency and adverse external developments.[1] Furthermore, the effects of modest growth on the rural poor have been limited, as it has been relatively rapid in the nonagricultural sector and centered in urban areas. Agricultural growth itself has been constrained by low productivity gains due to poor irrigation and infrastructure. Moreover, social and poverty alleviation programs have had limited impact on the poor due to insufficient targeting and weak implementation.

Nepal: Growth Rates

(Annual average, in percent)

	Real GDP	GDP Per Capita
1990/91-1994/95	5.2	2.6
1995/96-1999/00	4.8	2.4
2000/01-2001/02	2.1	-0.3

Source: WEO; and staff estimates.

2. **The ceasefire agreed in January 2003 has renewed hopes for peace and efforts have been made to sustain the reform momentum.** Progress in achieving lasting peace would facilitate more effective implementation of policies contained in the recently issued Poverty Reduction Strategy Paper (PRSP) with senior officials intent on furthering the reform agenda. Donors have expressed their support for the peace process and their readiness to increase aid to help implement the PRSP agenda. The World Bank and AsDB are preparing adjustment operations, in addition to their project loans. The authorities have expressed a strong interest in a Fund supported program, and PRGF negotiations were resumed in April. The government has agreed to posting the PRSP on the IMF's external website. A Joint Staff Assessment of the PRSP was initiated in June.

3. **However, political uncertainties persist.** Key political parties continue to maintain that the appointment of Prime Minister Thapa by King Gyanendra in early June was a continuation of his earlier unconstitutional moves.[2] The political parties have also refused to

[1] The Nepalese fiscal year begins mid–July.

[2] King Gyanendra dismissed the previous elected government after parliament was dissolved and appointed Prime Minister Chand in October 2002. Political parties took the position that (continued…)

join the peace talks which were initiated by the previous government—two rounds of peace talks were held, with some success. While the new government intends to continue the peace talks, the timeframe and modalities remain uncertain. It is also unclear what role the insurgents may seek to play in future governments.

II. STOCKTAKING

4. **During the 1990s, the fiscal position was manageable and macroeconomic conditions were broadly stable**. In the first half of the decade, current spending was limited to domestic revenue collection, and capital spending was kept at levels financed by foreign aid, the current surplus, and limited domestic borrowing. In the second half of the decade, as the amount of external loans declined, this decline was more than offset by expenditure cuts and an increase in the revenue-to-GDP ratio (due to introduction of the VAT and improved tax administration). As a result, the domestically financed deficit relative to GDP declined.

Nepal: Government Operations
(Annual average, percent of GDP)

	1990/91-1994/95	1995/96-1999/00	2000/01-2001/02
Revenue and grants	10.8	12.2	13.0
Of which: Revenue	9.1	10.5	11.5
Expenditure & Net lending	16.5	16.2	17.5
Deficit	5.7	4.0	4.5
Foreign financed	3.7	2.6	1.6
Domestically financed	2.0	1.4	2.8

Sources: GFS, IFS; and staff estimates.

5. **Since 2000/01, the fiscal position has deteriorated partly due to higher security spending, and budgetary pressures are rising**. During 2000/01–2001/02, the domestically financed deficit doubled to 2¾ percent of GDP with the escalation of security-related expenditures, a wage adjustment in the context of civil service reform, further declines in external financing, and less-than-targeted revenue collection. The fiscal pressures were reflected in debt service payments (domestic and external) which absorbed a fourth of revenues. Looking forward, the persistence of low growth, unchanged fiscal policies, and the potentially large contingent liabilities from financial sector and public enterprise reforms could lead to rising public debt levels over the medium term.[3]

6. **The factors behind slow growth—inefficient resource allocation and weak governance—are related to continued structural problems in key sectors.**

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this move was unconstitutional and increasingly sharpened their protests. Partly in response to these pressures, a new Prime Minister, Mr. Thapa, was appointed on June 4.

[3] At end-2001/02, domestic public debt had risen to 17¼ percent of GDP and external debt was 48¼ percent of GDP. Almost all of the external debt is on concessional terms.

- **In the financial sector, NRB oversight is weak, and intermediation is inadequate despite the proliferation of institutions largely due to a banking environment in which loan default is endemic.**[4] Currently, the NRB is overstaffed at lower levels, understaffed in key areas, and its pay structure makes it difficult to attract qualified personnel. The two largest commercial banks—the Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL)—are now insolvent with large nonperforming assets.[5] This is a result mainly of a culture of nonrepayment of bank loans, especially by well-connected borrowers. These banks are also overstaffed. Similar problems exist at the two large development banks—Agricultural Development Bank of Nepal and the Nepal Industrial Development Corporation.[6] In addition, NRB directives related to commercial banks' operations restrict banks' ability to price credit risk and limit profit opportunities.[7]

- **In the public sector, investment has been spread thinly over projects—without prioritization and with low completion rates—and enterprises suffer from weak management and accountability**. A number of public enterprises are potentially

[4] Currently, Nepal has 17 commercial banks, 11 development banks, 11 regional rural development banks, 1 postal savings bank, 56 finance companies, 34 nongovernment micro-credit institutions, and 38 nongovernment cooperative societies.

[5] Donor financed external management teams are now in place at the banks (see below). The NBL external management team has been in place since July 2002; the external management team at the RBB took over in January 2003. External managers of NBL estimate that the bank's NPLs amounted to Nrs 10¾ billion (53 percent of the loan portfolio) at end–2001/02. Preliminary data suggest that RBB's NPLs amounted to Nrs 14½ billion at end–2001/02 (55 percent of the loan portfolio).

[6] Preliminary results of AsDB-financed external audits suggest that a large share of the banks' portfolio is nonperforming.

[7] The commercial banks are permitted only a ±½ percentage point band around their published lending rates and a 1 percent spread between their foreign exchange buy/sell rates; they are also barred from investing in Indian T-Bills. Moreover, commercial banks are required to make 9 percent of their loans to "priority" sectors and an additional 3 percent to "deprived" sectors. Currently, the "priority" sector lending requirement is to be phased out over five years.

unviable, make losses and have accumulated large contingent liabilities (including debt service arrears to the budget).[8]

- **Poor governance reflects corruption, incentive problems and weak accountability in the public sector**. Some of these problems are being addressed by decentralization and increased local involvement in policymaking and implementation.[9]

7. **Other structural impediments reduce labor market flexibility, prevent orderly exit, and raise export costs.** A number of regulations restrict labor shedding and deficiencies in bankruptcy procedures prevent orderly and timely production cuts or shutdown of unviable firms. Also, despite low wages and a liberal trade regime, administrative procedures and supply constraints impede export growth (see box).[10]

Structural Impediments to Export Growth

Structural impediments contribute to higher export costs. Unit labor costs are higher than in competitor countries, with low labor productivity more than offsetting low wage levels. Other costs, including transportation and transaction costs, are also estimated to be high.

- **Labor market**. Current labor legislation makes it difficult to retrench permanent workers if needed, impedes a supply response, and raises incentives to hire temporary, unskilled workers. As a result, labor productivity and product quality are low.
- **Infrastructure.** Transportation costs for exports are high due to Nepal's landlocked location and poor roads and railway infrastructure. Import costs of inputs for garment industry are also significantly higher than for competitors in India or Bangladesh. Electricity and water costs are higher than in many other Asian countries.
- **Trade regime**. Customs procedures are cumbersome, export taxation distorts production incentives, and duty drawback procedures are inefficient.

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[8] Thirty seven public enterprises were under full government ownership at end–2000/01 (*Targets and Performances of Public Enterprises, 2002*). Their total loss amounted to Nrs 1.4 billion (0.3 percent of GDP). Only fourteen had audited accounts, of varying quality.

[9] The Local Self Governance Act was passed in 1999. Progress in devolving key services (primary education, agricultural extension, and health services) to local bodies stalled as the tenure of the locally elected bodies expired in mid–2002 and village development committees' offices had to be shut down in insurgency-affected areas.

[10] Nepal liberalized its trade regime during the first half of the 1990s reducing the average tariff on imports to 10–15 percent and largely eliminated nontariff barriers. In the Fund's 10-point trade restrictiveness index, Nepal has an overall rating of 2.

8. **In the past, the authorities have been receptive to Fund policy recommendations, although structural reform implementation has been delayed by political uncertainties:**[11]

- **Macroeconomic policies have generally been in line with Fund advice**. The authorities implemented a number of Fund tax policy recommendations. In particular, a VAT was introduced in 1997 at the rate of 10 percent and the Income Tax Act has been amended as suggested by Fund staff. Some measures were also taken to strengthen tax and customs administration, but significant weaknesses persist. The Fund staff has endorsed the exchange rate peg to the Indian rupee as a nominal anchor.

- **Structural reform implementation was slow in the latter half of the 1990s because of political uncertainties related to successive coalition governments.** Although understandings were reached on the elements of a possible PRGF-supported program in 2001, the program was not finalized as some prior actions, especially installation of external managers at financially-troubled commercial banks, could not be undertaken. These actions were taken in 2002/03—with donor financial support—providing a basis for resumption of PRGF negotiations.

III. Recent Economic Developments

9. **A modest economic recovery is underway**. The ceasefire has helped restore some normality in agriculture, transport and service sectors. There are signs that some exports and manufacturing production are rebounding and the decline in tourism may have halted. Overall, staff expects real GDP growth of 2 percent in 2002/03 (Table 1 and Figure 1).

10. **Inflation rose due to price developments in India, administrative price changes and supply shortfalls, but can be expected to moderate**. CPI inflation rose to about 7½ percent in mid–May (12–month basis) reflecting wholesale price rises in India, shortfalls of agricultural commodities and upward adjustments in administered prices (educational fees and petroleum products). As the pass-through effect of these price increases fades and the recent decline in international and domestic fuel prices takes effect, inflation should settle down to modest levels by early 2003/04.

11. **The 2002/03 budget is estimated to have met revised targets set in a mid-term review with better-than-expected revenue performance**. The 2002/03 budget aimed to reduce the overall and domestically financed deficit to 3½ and 2 percent of GDP, respectively

[11] In the absence of a Fund arrangement since 1995, policy advice has been provided through Article IV consultations and technical assistance. Nepal's last arrangement, an ESAF, started in October 1992 and expired in 1995.

(Table 2). Based on weak revenue performance due to lower activity during the first half of the year and external aid shortfalls relative to budget targets, the authorities took compensatory measures, in consultation with staff. Specifically, the tax revenue target and external financing were revised down. To compensate for these shortfalls, total expenditure was also revised down with significant cuts in capital expenditure; current spending was also reduced while making room for additional security personnel and clearance of pension and utility arrears. The revised budget set a net domestic financing target of Nrs 8¾ billion (2 percent of GDP).[12] In the event, activity picked up after the announcement of the ceasefire and the revenue performance improved. However, capital spending is estimated to have been below the revised budget, reflecting continued implementation constraints at the local level. As a result, domestic financing was around 1¾ percent of GDP.

12. **Monetary policy has been accommodative and the real exchange rate has depreciated**. To help spur the recovery, the NRB lowered cash reserve requirements by 1 percentage point in August 2002. The NRB has also continued to extend refinancing to commercial banks for onlending to "sick" industries in the hotel and garment sectors.[13] Partly, as a result of these measures, private sector credit growth appears to have revived (Table 3). At the same time, higher remittances and a positive cross rate differential between the Nepalese rupee and the Indian rupee against the U.S. dollar (see box)

The Cross Differential and Reserve Accumulation

Since mid–2002, the Nepalese rupee has appreciated less than the Indian rupee relative to the U.S. dollar. At the official exchange rate of Nrs 1.6/Irs, this led to the cross differential,[1] which had been negative earlier, turning positive and becoming greater than 2 percent at times (without taking into account the NRB's service fee for U.S. dollar purchases). The differential was possibly sustained by capital controls and commercial banks' intention to accumulate foreign assets. The differential also helped the NRB to accumulate reserves. To reduce arbitrage opportunities, the NRB raised the service fee charges for U.S. dollar purchases by 1 percentage point to 2 percent in February 2003 and tried to persuade the Foreign Exchange Dealers Association of Nepal to appreciate their Nrs buy/sell rates relative to the U.S. dollar to close the differential. The differential has since moderated.

1/ The cross differential arises from the difference between the midpoint spot exchange rate for the Indian Rupee (Irs) and the U.S. dollar implied from their respective rates against the Nrs (i.e., the Nrs/U.S. dollar mid-rate quoted by the NRB, which is a simple average of the commercial banks' buy/sell rates and the official Nrs 1.6/Irs exchange rate) and the midpoint spot exchange rate for the Irs and the U.S. dollar in their principal markets. Staff examined whether this differential indicated a multiple currency practice (MCP) subject to Fund jurisdiction. Based on available evidence, staff did not determine the existence of an MCP since official action by the NRB causing this differential was uncertain.

[12] At the same time, domestic debt repayment to NRB was increased to reduce public debt taking advantage of savings on domestic interest payments (due to lower than anticipated interest rates) and external debt service payments (due to an appreciation of the Nepalese rupee against the U.S. dollar).

[13] Under the program, financing is provided for six months. Of the Nrs 1½ billion allocated for 2002/03, Nrs ½ billion has been provided to date.

contributed to a rise in banking system foreign assets, helping to improve banking sector liquidity. Lending, deposit and T-bill interest rates have all declined relative to 2001/02 levels reflecting easier liquidity conditions. Reflecting the Nepalese rupee's peg to the Indian rupee, which has appreciated only somewhat against the weakening U.S. dollar, the nominal and real effective exchange rates depreciated by 12½ percent and 6 percent, respectively, between January 2002 and April 2003 (Figure 2).

13. **Balance of payments developments turned favorable around mid–2002/03 and external reserves are adequate**. Large and increasing remittances—estimated at over 125 percent of merchandise exports—have helped to buoy the current account (see box, Table 4). Recorded exports to India declined reflecting the revised, more restrictive trade treaty with India in March 2002 and exports to other countries have been mixed. Garment exports began recovering in late 2002 while carpets and pashmina exports continue to stagnate. Notwithstanding the depreciation of the real effective exchange rate, export performance remained hampered by high unit costs, weak external demand, and supply constraints. Anecdotal evidence suggests that unrecorded exports may have increased recently. At the same time, the recovery raised imports. Overall, the staff expects that the current account (excluding official transfers) will move into a deficit of about ⅔ percent of GDP in 2002/03. Together with higher aid flows and unrecorded inflows, the overall balance of payments is expected to be in surplus and official foreign exchange reserves are expected to rise to over US$1 billion (6¼ months of imports of goods and services).

Remittances and Economic Management

Remittances are now likely the largest source of foreign exchange inflows. Recent estimates suggest that there are 3-3½ million Nepalese migrant workers (over 10 percent of population). Of these, 2½-3 million are in India, and the remainder in the Middle East, South East and East Asia.[1/] As a result of these substantial labor flows, remittances are now estimated to be larger than commodity exports or external aid. Owing to data weaknesses, including on account of informal transfer channels, estimates of remittances are subject to a wide margin of uncertainty. Nevertheless, evidence suggests that remittances have increased in recent years and NRB and commercial banks expect them to grow further.

Remittances have implications for economic management and policy:

- Remittances have contributed to external reserve accumulation, and more generally, supported Nepal's balance of payments in the face of an adverse external environment in recent years.
- Remittances help improve living standards. A large portion of the remittances is used to service loans (substantial amount of loans usually needed to finance the migration) and finance home construction.
- Remittances could impart pressures toward appreciation of the real exchange rate.
- Financial sector reform would help route remittances increasingly through formal channels.
- Labor market reforms related to overseas employment agencies and contractual arrangements would help protect migrants' interests and help ensure that remittance inflows are sustained.

1/ Seddon, D. (2003), Migration and Remittances, Report for the World Bank, *mimeo*.

14. **Significant progress was made in financial sector reform implementation, with Bank/Fund policy advice and financial assistance**. The NRB launched a voluntary retirement scheme (VRS) in March to reduce overstaffing at the nonofficer level.[14] In addition, the Banking and Nonbank Financial Intermediaries Regulation Departments were merged. Progress was also made in NBL and RBB restructuring. The external managers prepared management plans for the banks, made progress in assessing their financial status, and proposed VRSs to reduce overstaffing. Financial performance has also improved somewhat with better loan recovery and branch rationalization. However, loan recovery from well-connected defaulters continues to be difficult. It is expected that the Debt Recovery Tribunal, which was operationalized in mid–July under the Debt Recovery Act, should aid loan recovery, although much would depend on effective enforcement of the tribunal's rulings, with NRB and government support.

15. **Prioritization of budgetary spending improved and public enterprise reform implementation progressed**. To improve prioritization, a medium term expenditure framework (MTEF) was introduced with World Bank assistance to help align development spending with national and sectoral priorities. As regards public enterprises, administered price increases for petroleum products were announced in March 2003 to stem losses of the state-owned Nepal Oil Corporation (NOC), although some price increases were partially rolled back in April under public pressure.[15] [16] Liquidation procedures were initiated for four enterprises under the AsDB-supported Public Sector Management Program (PSMP); preparations for the privatization of one enterprise were brought to an advanced stage. The Country Financial Accountability Assessment was conducted, jointly with the World Bank, to strengthen accounting practices.

16. **Governance reforms progressed and anti-corruption efforts were boosted**. The cabinet approved in September 2002 the elimination of 7,500 vacant civil service positions.[17] The cabinet also issued an order freezing new recruitment for other vacant positions in the

[14] Prior to the VRS, NRB staffing was 2,152. Of this, 19 percent were at the officer level. The scheme resulted in a staff reduction of 15 percent, mostly nonofficers.

[15] During the first eight months of 2002/2003, NOC suffered losses of Nrs 4 billion (1 percent of GDP). The price changes also aimed to eliminate distortions in prices in Nepal relative to India and across product types.

[16] The World Bank's impact analysis suggested that the price changes would not hurt the poor as petroleum products constitute a small portion of their total consumption. To reduce the impact on the poor, dual pricing for kerosene was introduced.

[17] The number of government positions (core civil service, police, army and teachers) is estimated at over 385 thousand.

context of the AsDB-supported Governance Reform Program and the PSMP. To tackle corruption in public life, the Commission for Investigation of Abuse of Authority (CIAA) initiated investigations against politicians and revenue officials perceived to have accumulated unaccountable assets. Similarly, a Judicial Commission to investigate assets holdings of politicians and senior government officials was established, and the Anti-Corruption Strategy was adopted.

IV. Policy Discussions

17. **The policy discussions focused on PRSP policies to generate high, sustainable growth and alleviate poverty**. The PRSP's strategy, which is based on the Tenth Plan (2002/03–2007/08), consists of four pillars: broad-based economic growth; social sector development; targeted programs for the poor and deprived groups; and good governance. The authorities believe that the growth strategy should be rooted in macroeconomic stability and that a reduction in the domestically financed deficit over the medium term would help achieve this goal. The authorities have plans for financial sector, public sector, and governance reforms to improve intermediation, create room for the private sector, and generate efficiency gains to improve growth prospects. Legal and trade policy reforms are also envisaged. Among the priority social sectors, the PRSP places special emphasis on health and education where decentralization could help enhance service delivery without undue increases in spending. Within these sectors, interventions are to be targeted at vulnerable and deprived groups through the proposed Poverty Alleviation Fund.

A. Medium-Term Outlook and Risks

18. **The authorities' objectives are to raise GDP growth to 5–6 percent over the medium term, keep inflation low, and maintain a manageable balance of payments position**. If peace talks progress and the security situation do not deteriorate, the economic recovery could gather momentum, and growth could rise to 3¾ percent in 2003/04. Beyond 2003/04, growth rates could rise further if a strong program of structural reforms can be implemented. The authorities recognize that their medium term objective for growth is ambitious, but maintain that it is feasible in light of the annual average growth rate of 5 percent experienced during the 1990s. In particular, they recognize that strong agricultural growth is a prerequisite for broad-based growth and poverty reduction by 5–8 percentage points over the medium term.[18] With the exchange rate peg, inflation is expected to follow price developments in India. The current account deficit is projected to increase, but higher aid, remittances, and other inflows should allow international reserves to be maintained at six months of imports of goods and services.

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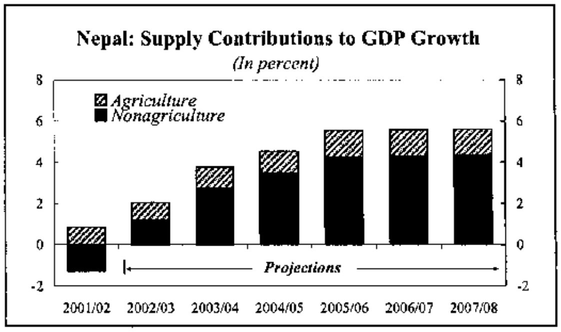
[18] World Bank estimates suggest that with sustained 5–6 percent real GDP growth and better targeting, the PRSP poverty reduction targets are achievable (See G. Pernnushi (1999), *Nepal: Poverty at the Turn of the Twenty-First Century*, World Bank Report No. IDP 174).

Sources of Growth[1/]

In the latter half of the 1990s, real GDP growth fell to an annual average of 4¾ percent (from 5¼ percent in the first half). In this period, average annual agricultural and nonagricultural sector growth rates were 3½ percent and 6 percent, respectively. The intensification of security problems in 2000/01–2001/02 had a significant impact on the nonagricultural sector where growth fell to around 1 percent. The manufacturing and tourism sectors were especially hard hit with average annual declines of 3 percent and 4½ percent, respectively (these sectors had average annual growth rates of 6½ percent and 5 percent, respectively, during 1995/96–1999/00).

Looking forward, real GDP growth could rise to 3¾ percent of GDP in 2003/04 with a pickup to the trend growth rate of 5–6 percent over the medium term. Underlying these growth rates, agricultural growth is projected to increase steadily through implementation of the Agricultural Perspective Plan—higher utilization of fertilizers, expansion of year-round irrigation, extension of the road network, diversification into cash crop and livestock production in the hill areas, and credit availability—which could help raise productivity.[2/] As a result of these productivity gains, average annual agricultural growth is projected to be about 3¼ percent during 2003/04–2005/06. Manufacturing and tourism are expected to experience a rebound. In addition, with higher donor aid and infrastructure spending, construction, water, electricity, and gas sectors would also grow. Overall, nonagricultural growth is projected to average 6 percent during 2003/04–2005/06.



1/ Significant deficiencies in national accounts data preclude a comprehensive analysis of growth sources. GDP data by industry of origin are available for supply side analysis, albeit with significant shortcomings. However, constant price expenditure data and saving-investment balances are not available. A decomposition analysis into factor accumulation and total factor productivity is also not possible due to absence of data on factors of production.

2/ See Koeva, P. (2002), "The Determinants of Agricultural Productivity," IMF Country Report No. 02/206.

19. **The authorities are aware that the economy faces downside risks.**

- Failure of peace talks and resumption of violence would mire the country in low growth with continued pervasive poverty. Moreover, although some of the insurgents' basic goals—provision of better social and economic services and representation for the poor—are consistent with the PRSP, it is still uncertain how specific demands will be incorporated into future policies. In addition, uncertainties remain on how the standoff between the new government and major political parties would be resolved.

- It may be difficult to sustain the fiscal framework if there is strong resistance to revenue mobilization measures and tax administration cannot be strengthened adequately. External aid shortfalls would also make fiscal management difficult.

- An adverse external environment would dampen growth prospects. The key risks include an increase in oil prices, reduction in remittances and tourism, and a prolonged global slump.

- Weak implementation capacity and governance pose continuing constraints to full utilization of development budgets and poverty alleviation.

B. Macroeconomic Policies

Fiscal Policy

20. **The medium term fiscal strategy is to boost revenue performance, reorient and reprioritize social and infrastructure spending, and reduce domestic financing.** By 2005/06, revenue is targeted to increase by 1¼ percentage points to 13½ percent of GDP, based on revenue administration reforms, a 2 percentage point increase in the VAT rate, and rationalization of VAT and customs exemptions. Reduction in current spending could be achieved through demobilization of security forces and downsizing of the civil service. Capital spending could rise to 6 percent of GDP in a prioritized manner stipulated in the medium term expenditure framework (MTEF). To improve resource allocation, the MTEF is to be extended to regular expenditure.[19] As a result, spending on key sectors—agriculture, irrigation, roads, electricity, health, education, drinking water, and local development—will account for 75 percent of total spending (roughly 11–13 percent of GDP). With aid disbursements averaging 4¼ percent of GDP, domestic financing could be reduced to ½ percent of GDP. The authorities noted that further increases in the VAT rate could be considered or spending cuts undertaken to sustain the framework in the event of revenue shortfalls or lower aid inflows.

21. **The 2003/04 budget has been formulated in line with the medium term fiscal strategy**. Compared to 2002/03, revenue is projected to rise slightly to 12⅓ percent of GDP based on a long overdue increase in a wide range of charges and fees. The increase in current spending reflects a combination of higher wage allocation for security personnel and larger health and education spending, mostly under donor funded programs to decentralize service provision.[20] Capital expenditure is projected to rise on the assumption that improvements in the security situation would permit higher spending. The development budget is fully prioritized in line with the MTEF. Poverty-related spending is to increase by 5 percentage

[19] The budget classifies spending into "regular" and "development." While the bulk of regular expenditure (9–10 percent of GDP) is for current spending, the development budget (6-8 percent of GDP) includes both current (roughly ⅓ of total development expenditure) and capital spending. Currently, all development expenditures are prioritized in the MTEF.

[20] Other factors for higher current spending include allocations for clearance of utility arrears and contingent liabilities of public enterprises to be liquidated/divested; integration into the budget of Roads Board, Health Fund, and Poverty Alleviation Fund expenditures recommended by Fund staff as part of public expenditure management reforms; and a contingency allocation for national elections.

points to 45 percent of the development expenditure budget. Despite higher spending needs, domestic financing is to be limited to 1¾ percent of GDP, thanks to higher revenue mobilization and aid commitment by multilaterals and bilateral donors. Staff stressed that achieving the budget targets would require a determined effort to reach the revenue target and to keep spending within stipulated limits.

22. **A significant tax reform effort would underpin the 2003/04 budget**. The staff welcomed measure to streamline the tax system, promote exports, and reduce the personal income tax burden at lower income levels, based on the government's Fiscal Reform Task Force and Fund technical assistance recommendations. These measures include: (i) removal of export service charges and significant reduction in export taxes; (ii) elimination of one-half of the special security levy by integrating it into customs duties and excises; (iii) reduction in import duty rates (consistent with WTO accession requirements) offset by increases in excises; (iv) an increase in the income tax threshold together with a widening of the lowest tax bracket; and (v) elimination of VAT exemption for edible oils. This package of measures is expected to be broadly revenue neutral. To strengthen revenue administration, the authorities have requested further FAD technical assistance to expand an existing unit in the Inland Revenue Department into a full service large taxpayer unit and to improve customs administration.

23. **The medium term framework will help maintain fiscal sustainability, although some risks remain**. The debt-to-GDP ratio—without accounting for contingent liabilities—is projected to stabilize around 55 percent of GDP in a baseline scenario. Stress tests suggest that public debt dynamics would remain manageable under this framework. Under a combination of plausible shocks to growth, interest rates, and the primary balance (or a 10 percent increase in debt creating flows, for example, to meet contingent liabilities from financial sector and public enterprise reforms), the debt-to-GDP ratio is projected to remain around 60 percent of GDP by 2006/07. Along similar lines, a smaller reduction in the domestically financed deficit (for example, to ¾ percent of GDP) would not jeopardize fiscal sustainability (Table 5). As regards external debt, preliminary computations suggest that the net present value of public debt at end–2002/03 was relatively low (22 percent of GDP), reflecting its concessional nature. However, given the large proportion of external financing, the debt profile is vulnerable to large exchange rate depreciations and to low export growth. Moreover, the full extent of contingent liabilities will only be revealed as financial and public enterprise reforms unfold.

Monetary and Exchange Rate Policy

24. **The authorities believe that the exchange rate peg to the Indian rupee continues to be appropriate and that policies should be geared to supporting the peg**. The peg has enabled the economy to benefit from close economic ties with India and helped keep inflation at low levels. Looking forward, this requires monetary growth that is consistent with domestic inflation broadly in line with prospective price developments in India. With this in mind, broad money growth should be contained to 11–12 percent in 2003/04, assuming a

continued small decline in velocity and a targeted real GDP growth rate of 3¾ percent. This growth in broad money could accommodate domestic financing needs of the budget while allowing real private credit growth of about 9–10 percent. With limited NRB financing of the budget, reserve money growth was projected at around 7 percent.

25. **The authorities agreed that the level of the peg would have to be kept under review in light of prospective external sector developments.** The removal of protected access to advanced country markets in the context of phasing out of the MFA quotas by January 2005 could affect exports adversely. Similarly, while the pending WTO accession could confer benefits through expanded access to overseas markets, it could also generate balance of payments pressures due to opening up of domestic markets. The authorities agreed that the likely impact of these developments and their implication for the level of the exchange rate peg need to be assessed with a view to maintaining competitiveness. In this context, staff suggested that the pace of structural reforms could be accelerated to raise manufacturing productivity and constraints associated with transportation and other infrastructure facilities alleviated to reduce costs and improve competitiveness.

C. Structural Reforms

Financial Sector Reforms

26. **The authorities outlined next steps to strengthen the NRB, restructure insolvent commercial and development banks, and to improve the banking environment.**

- The **NRB** noted that beyond the separations under the current voluntary retirement scheme (VRS), further downsizing would be undertaken by outsourcing general services, reducing the number of departments, and possibly privatizing payments system operations. The NRB intends to strengthen financial sector supervision. Adoption of the Banking and Financial Institution Ordinance, prepared with Fund technical assistance, would help achieve this objective. The NRB also intends to improve performance incentives by introducing decompressed and merit-based pay scales, and strengthen internal audit and accounting practices, based on World Bank-financed external consultants' recommendations.

- On **commercial bank restructuring**, the staff suggested that NRB facilitate early initiation of VRSs at NBL and RBB to reduce overstaffing by providing financial backing.[21] The NRB noted that it could provide only partial financing and that banks should make use of their own resources until donor financing comes through. The staff welcomed NRB efforts to strengthen the blacklisting mechanism against loan

[21] External managers estimated that VRSs for NBL and RBB could cost US$21 million and US$26 million, respectively. The schemes could be implemented in phases.

defaulters (and their connected parties) and greater disclosure requirements by the Credit Information Bureau to facilitate **loan recovery by the banks**. The staff also underlined the need for effective implementation of the Debt Recovery Tribunal's rulings to achieve this goal. On **development banks**, the staff urged the government to finalize AsDB-funded audits of the Agriculture Development Bank of Nepal and Nepal Industrial Development Corporation and begin preparing restructuring plans to address the banks' weakening financial condition.

- The NRB agreed to consider modification of its **directives related to commercial banks' operations**. The "priority" sector lending requirement could be eliminated within three years (instead of the currently planned five years) but this timetable is subject to political constraints. In addition, the NRB agreed, in principle, that "deprived" sector lending should be channeled through microcredit institutions which are better placed than commercial banks to conduct these operations. The NRB also agreed to review restrictions on commercial banks' lending rates and foreign exchange buy/sell spreads. On the investment ban in Indian T-bills, the NRB responded that easing would loosen capital controls and could diminish its ability to set interest rates in line with domestic economic conditions.

Public Sector and Governance Reforms

27. **Public sector ownership needs to be reduced and accountability and governance of public enterprises improved**. The staff urged the authorities to make rapid progress on liquidation/privatization of public enterprises as envisaged under the AsDB's Public Sector Management Program. As regards other large public enterprises, updated audits should be completed soon to international accounting and auditing standards. After these audits have been completed, strategic decisions are required to restructure viable enterprises, liquidate those that are unlikely to be turned around, and privatize those which can be better managed by the private sector.

28. **Civil service reform and decentralization need to be accelerated to reduce budgetary pressures and improve effectiveness of policy implementation**. The staff noted that, as a first step, the cabinet's decision of September 2002 to eliminate 7,500 vacant positions needs to be implemented in full soon. In addition, the authorities indicated (and staff agreed) that a substantial number of other remaining vacant positions could be eliminated. The staff welcomed these plans as well as others to maintain a hiring freeze, expand outsourcing, introduce merit-based recruitment and promotion systems, and to decompress the wage scale. Early amendment of Civil Service Act would facilitate increased transparency in civil service personnel policies and insulate civil servants from political interference. The authorities agreed that a strong effort is required over the medium term to reduce wage and pension payments, especially in the education sector. This could be achieved through devolution of schools to local management committees which are better placed to identify staffing needs and ensure service delivery, in consultation with the World Bank.

29. **The staff urged the authorities to sharpen their anti-corruption efforts, with AsDB and World Bank assistance**. The staff noted that the Anti-Corruption Strategy needed to be made more effective by focusing on ways to secure prosecutions. The staff was encouraged by strong efforts of the CIAA to initiate investigations against former ministers and revenue officials, and looked forward to these investigations leading to expeditious court ruling against offenders. The authorities noted their intent to follow through on the Country Procurement Assessment Report, prepared with World Bank assistance, to increase transparency and reduce leakages in public procurement through passage and implementation of a new law based on international standards.

Legal and Trade Policy Reforms

30. **Legal reforms are to be undertaken to improve labor market flexibility and to improve the business climate**. Given political sensitivities, the authorities are designing a strategy to ease inflexibilities in labor retrenchment, in consultation with business groups and labor unions. Other ongoing legal reforms, including amendments of the Company and Insolvency Acts (with AsDB technical assistance), should help improve the regulatory framework for private sector activity.

31. **Nepal maintains an open trade regime but further reforms are planned to improve transparency and help prepare for WTO accession**. The staff supported the authorities' plans to reduce high tariff rates and to integrate the security levy into the custom duty. The authorities agreed that it would be desirable to consolidate all import levies into a single customs duty to enhance transparency and that customs administration should be reformed to reduce administrative barriers to trade, with Fund and donor technical assistance. Moreover, substantial legislative reforms are required, including in intellectual property rights and customs valuation.

D. Other Issues

32. **The Auditor General agreed to address NRB safeguards issues**. Specifically, a foreign auditing firm experienced in central bank audits is expected to be appointed, jointly with a local firm, to conduct an audit of the NRB's 2002/03 financial accounts.

33. **Nepal accepted the obligations of Article VIII, Sections 2, 3, and 4 in May 1994**. It maintains an exchange restriction arising from quantitative limits on foreign exchange availability for travel abroad. The NRB informed staff that it would waive these limits for bona fide requests.

34. **The staff recommended improvements in statistics to enhance policy formulation and monitoring**. The staff welcomed the NRB's decision to publish the balance of payments in the format recommended by Fund technical assistance, but noted that some other recommendations were yet to be fully implemented. The staff also urged the authorities to implement fully existing and future STA technical assistance recommendations.

V. STAFF APPRAISAL

35. **Poverty in Nepal remains pervasive due to insufficient growth and inadequate targeting under poverty alleviation programs**. While macroeconomic conditions remained broadly stable during the 1990s, growth remained constrained by inefficient resource allocation linked to structural weaknesses in key sectors and poor governance. More recently, intensification of security problems and adverse external conditions reduced economic growth significantly. Insufficient growth, inadequate investment in health and education, and lack of income generation opportunities for the poor, have limited poverty reduction in Nepal.

36. **Progress in the peace talks is essential to sustain the nascent economic recovery currently under way**. The effects of a ceasefire agreed with the insurgents in early 2003 are already evident in higher economic activity. Continued peace will help sustain the recovery, including through effective implementation of priority social and infrastructure projects. A buildup of confidence should also help relieve budgetary pressures for security spending.

37. **The staff looks forward to implementation of the recently issued PRSP**. The PRSP's strategy to alleviate poverty—broad-based growth, social sector development, targeted programs for the poor and deprived groups, and improved governance—is appropriate. Progress in these areas is critical for poverty reduction. Staff underscores the need for a determined effort to mobilize revenue and resist spending pressures, including in fiscal year 2003/04. The staff looks forward to discussing with the authorities an economic program based on their medium term fiscal framework that could be supported by the Poverty Reduction and Growth Facility to help implement the PRSP strategy.

38. **Prudent fiscal policies will help maintain macroeconomic stability**. Revenue should be mobilized through tax policy measures including changes in the VAT rate and reduced exemptions. Tax administration, especially customs administration, needs to be strengthened significantly. On expenditure, the staff welcomes plans to prioritize all spending by extending the medium term expenditure framework (MTEF), raise allocations for priority sectors and increase poverty-related development spending. A strong effort is required to ensure higher development spending through enhanced local level implementation capacity, but the authorities need to be prepared to cut back spending in line with the MTEF to cover revenue and external aid shortfalls. Over the medium term, reductions in domestic borrowing will help maintain fiscal sustainability. Contingent liabilities from banking and public enterprise reforms should be addressed early with donor support.

39. **Monetary and exchange rate policies should remain geared to supporting the exchange rate peg to the Indian rupee**. The peg has served Nepal well given its close ties to India and helped keep inflation at low levels. However, prospective external developments, such as loss of protected access to overseas markets due to the phasing out of the MFA by 2005, pose challenges for export growth and will likely have implications for the appropriate level of the peg. These challenges can also be addressed by measures to reduce

labor and nonlabor inputs costs and make Nepal's exports more competitive and by infrastructure investment to alleviate supply bottlenecks.

40. **Financial sector reforms have progressed, but much remains to be done**. The NRB itself needs to be strengthened and its supervision of the financial sector enhanced significantly. External managers at the two largest and insolvent commercial banks have started to improve the financial condition of the banks. However, their efforts—in particular, at loan recovery and to reduce staffing through voluntary retirement schemes—require strong NRB and government support. Specifically, loan recovery requires that the strengthened criteria for blacklisting loan defaulters and the Debt Recovery Tribunal's rulings be implemented effectively and on a timely basis.

41. **Public enterprise and governance reforms will help improve public sector resource allocation**. Public enterprise reforms would strengthen the budgetary contribution of viable enterprises through improved management accountability, restructuring, and privatization. Unviable enterprises should be liquidated to reduce resource drain. Better governance—through civil service reforms, steps to curb corruption, and decentralization—will improve policy implementation through greater accountability and enhanced implementation capacity at the local level would help improve service delivery.

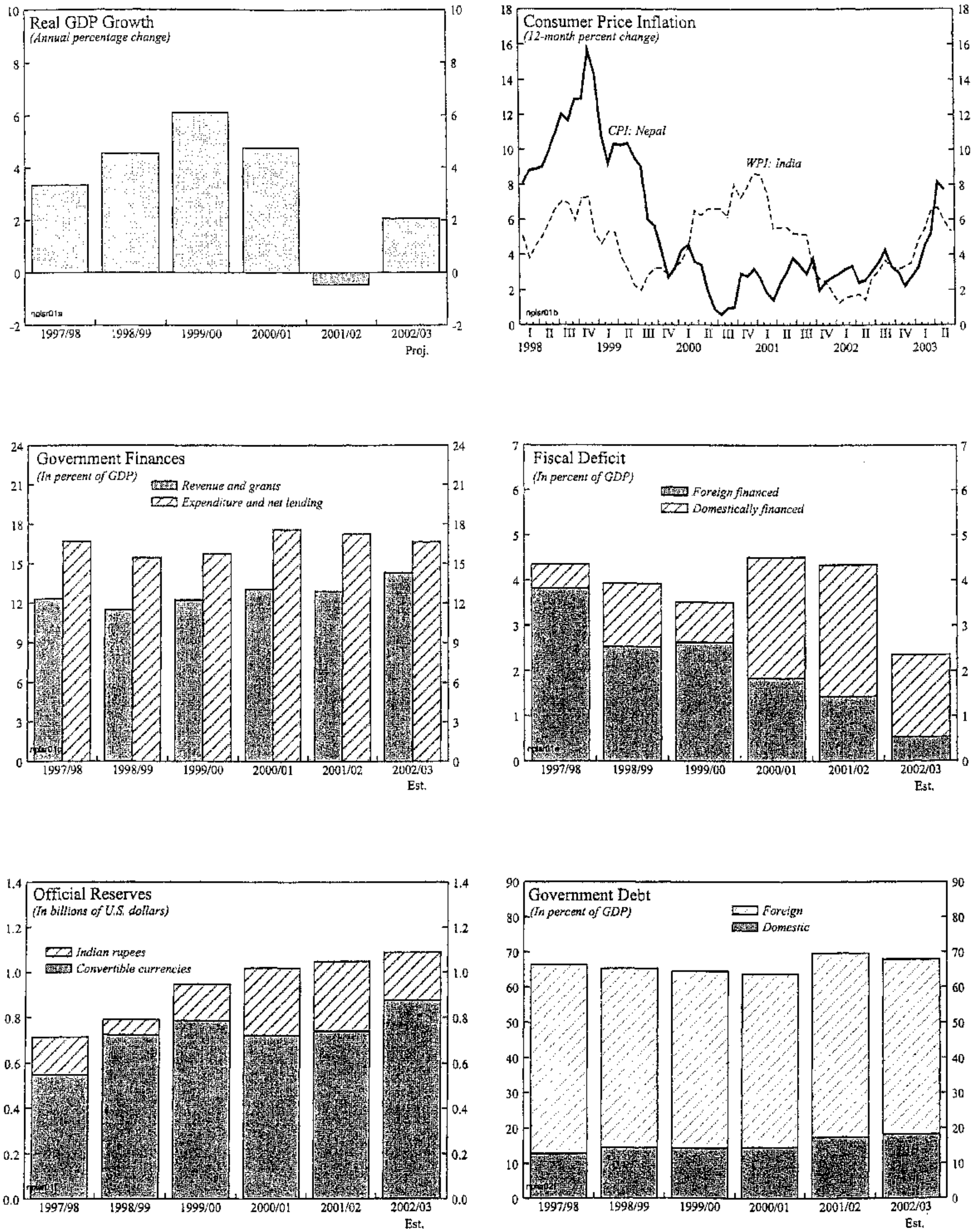
42. **Legal and trade policy reforms can improve the business climate for private sector development.** Labor legislation needs to be revised to make labor hiring more flexible; modifications of the Company and Insolvency Acts can make exit of unviable firms more orderly and timely. The authorities' efforts to gain early WTO accession are commendable. Accession would increase credibility and predictability of the trade regime and help secure access to foreign markets.

43. **Data deficiencies need to be addressed to improve policy formulation and monitoring**. Data provision to the Fund is adequate for policy surveillance. While the authorities' efforts to improve statistics are noted, key gaps remain and the staff encourages full implementation of STA technical assistance recommendations.

44. **The staff urges the NRB to eliminate the exchange restriction arising from quantitative limits on payments for personal travel for bona fide reasons**. Board approval is not recommended.

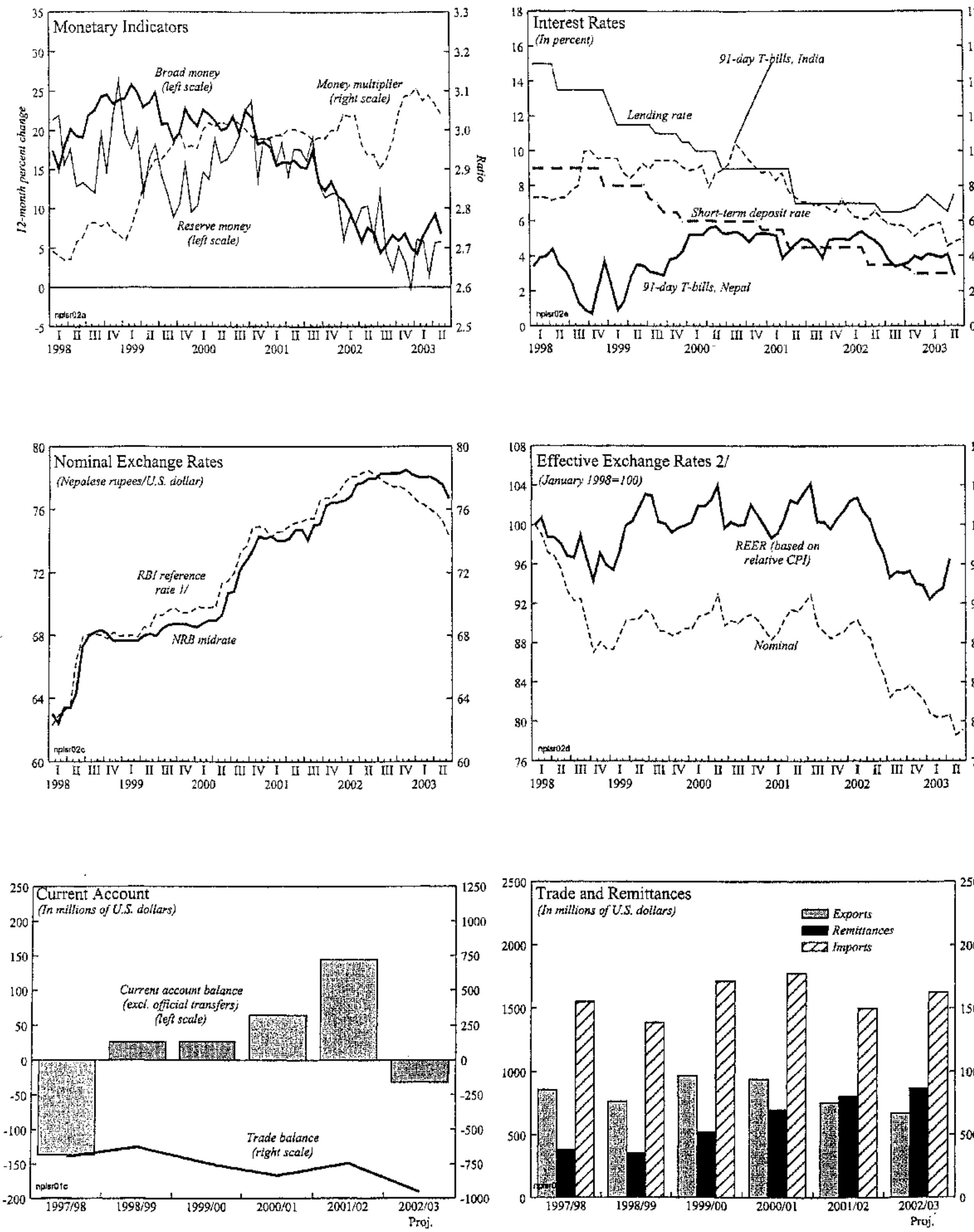
45. It is recommended that Nepal remain on the 12–month consultation cycle.

Figure 1. Nepal: Real and Fiscal Sector Developments



Sources: Data provided by the Nepalese authorities; IMF, International Financial Statistics; and staff estimates.

Figure 2. Nepal: Monetary and External Sector Developments



Sources: Data provided by the Nepalese authorities; and IMF staff calculations.

1/ Indian rupees per U.S. dollar reference rate at the official exchange rate of 1.6 Nrs per Indian rupee.
2/ An increase indicates an appreciation.

Table 1. Nepal: Selected Economic Indicators, 2000/01–2005/06 1/

Nominal GDP (2001/02): US$5,549 million
Population (2001/02): 23.2 million

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
			Est.		Proj.	
			(Percent change)			
Real GDP at market prices	4.8	-0.5	2.0	3.8	4.5	5.5
CPI (12-month change)	3.4	3.5	7.5	4.8	4.5	4.0
CPI (period average)	2.4	2.9	5.0	4.5	4.5	4.2
GDP deflator	3.2	3.2	4.2	4.9	5.2	4.7
Fiscal indicators			(In percent of GDP)			
Total revenue	11.4	11.5	12.0	12.3	12.7	13.4
Total expenditure	17.6	17.2	16.7	18.6	18.3	17.8
Current expenditure	11.2	11.6	12.4	13.0	12.5	11.9
Capital expenditure and net lending	6.4	5.7	4.2	5.6	5.8	5.9
Overall deficit after grants	4.5	4.3	2.4	3.1	2.6	1.9
Overall deficit before grants	6.2	5.7	4.6	6.3	5.5	4.4
Domestic financing (net)	2.7	2.9	1.8	1.7	1.2	0.6
Money and credit			(Percent change, end-of-period)			
Broad money	15.2	4.4	8.1	11.0	...	...
Domestic credit	18.8	9.2	12.4	13.4	...	...
Interest rates			(In percent)			
91-day treasury bill (end-of-period)	5.0	3.6	2.1 2/	...	...	...
Central bank refinancing	6½–7½	2–5½	2–5½ 2/	...	...	...
Loans to industry	9½–15	7–14½	7–14½ 2/	...	...	...
Balance of payments			(In millions of U.S. dollars)			
Current account balance (excluding grants)	65	144	-32	-45	-93	-118
(In percent of GDP)	1.2	2.6	-0.6	-0.7	-1.4	-1.6
Trade balance	-831	-742	-953	-1,023	-1,092	-1,144
(In percent of GDP)	-14.9	-13.4	-16.6	-16.5	-16.4	-15.9
Gross official reserves (end-of-period)	1,020	1,048	1,088	1,133	1,183	1,238
(In months of imports of goods and services)	7.0	6.7	6.2	6.1	6.0	5.9
Export value growth 3/	4.6	-18.1	-1.0	4.8	7.7	8.1
Import value growth 4/	6.6	-12.7	8.5	12.2	6.9	6.0
External debt/GDP (in percent) 5/	49.9	52.9	51.7	48.4	45.7	42.9
Debt service 6/	6.0	7.5	7.8	7.7	7.5	7.2
Exchange rate (Nrs per U.S. dollar, end-of-period)	74.7	78.0	...	...	...	...
REER (end-of-period; percent change; - = depreciation)	4.3	-9.1	...	...	...	...
NEER (end-of-period; percent change)	2.9	-11.2	...	...	...	...
Fund operations (outstanding loans at end-of-period; SDR million)						
SAF/ESAF	6.6	3.2	1.7	...	...	...
Nominal GDP at market prices (Nrs billion)	410.3	421.3	448.0	487.6	536.0	592.2

Sources: Data provided by the Nepalese authorities; and Fund staff estimates and projections.

1/ Fiscal year ends mid-July.
2/ As of May 2003.
3/ Cumulative, excluding re-exports.
4/ Cumulative, excluding gold.
5/ Includes estimated private sector debt and short-term trade credits.
6/ In percent of exports of goods, services, and private transfers; including debt service to the Fund.

Table 2. Nepal: Summary of Government Operations 1/

	2000/01 Actual	2001/02 Estimate	2002/03 Budget	2002/03 Budget Revised	2002/03 Estimate	2003/04 Budget	2004/05 Projection	2005/06 Projection
				(In billions of Nepalese rupees)				
Total revenue and grants	53.6	54.4	70.2	62.2	64.1	75.7	84.1	94.2
Total revenue	46.8	48.6	55.6	53.0	53.9	60.2	68.3	79.3
Tax revenue	38.9	39.3	45.9	42.3	42.6	48.2	58.3	67.5
Nontax revenue 2/	8.0	9.2	9.7	10.7	11.3	12.0	10.1	11.8
Grants	6.8	5.8	14.6	9.2	10.2	15.5	15.8	14.9
Total expenditure	72.1	72.6	86.3	76.7	74.6	90.7	98.1	105.4
Current 3/	45.8	48.7	61.1	56.1	55.8	63.5	67.2	70.3
Of which: Interest payment	4.7	5.8	8.0	7.2	7.2	7.9	8.5	9.4
Capital and net lending 3/	26.3	23.9	25.1	20.6	18.9	27.2	30.9	35.1
Overall balance before grants	-25.3	-24.0	-30.7	-23.7	-20.7	-30.5	-29.7	-26.1
Overall balance after grants	-18.5	-18.2	-16.1	-14.5	-10.5	-15.0	-13.9	-11.2
Financing	18.5	18.2	16.1	14.5	10.5	15.0	13.9	11.2
Net foreign loans	7.5	6.0	6.4	5.6	2.4	6.7	7.3	7.8
Gross disbursements	12.0	10.8	12.4	11.3	8.1	12.8	13.6	14.7
Amortization	4.5	4.8	6.0	5.6	5.6	6.1	6.3	6.9
Net domestic financing	11.0	12.2	9.7	8.8	8.1	8.4	6.7	3.5
Net NRB financing	3.0	6.3	...	...	1.5	2.0	1.0	0.0
Net commercial bank	7.2	4.0	...	...	6.0	6.0	4.5	2.0
Net nonbank	0.7	1.9	...	...	0.6	0.4	1.2	1.5
				(In percent of GDP)				
Total revenue	11.4	11.5	11.9	12.0	12.0	12.3	12.7	13.4
Tax revenue	9.5	9.3	9.8	9.5	9.5	9.9	10.9	11.4
Nontax revenue 2/	1.9	2.2	2.1	2.4	2.5	2.5	1.9	2.0
Grants	1.6	1.4	3.1	2.1	2.3	3.2	2.9	2.5
Total expenditure	17.6	17.2	18.4	17.3	16.7	18.6	18.3	17.8
Current 3/	11.2	11.6	13.0	12.7	12.4	13.0	12.5	11.9
Of which: Interest payment	1.1	1.4	1.7	1.6	1.6	1.6	1.6	1.6
Capital and net lending 3/	6.4	5.7	5.4	4.6	4.2	5.6	5.8	5.9
Overall balance before grants	-6.2	-5.7	-6.5	-5.3	-4.6	-6.3	-5.5	-4.4
Overall balance after grants	-4.5	-4.3	-3.4	-3.3	-2.4	-3.1	-2.6	-1.9
Financing	4.5	4.3	3.4	3.3	2.4	3.1	2.6	1.9
Net foreign loans	1.8	1.4	1.4	1.3	0.5	1.4	1.4	1.3
Gross disbursements	2.9	2.6	2.6	2.5	1.8	2.6	2.5	2.5
Amortization	1.1	1.1	1.3	1.3	1.3	1.3	1.2	1.2
Net domestic financing	2.7	2.9	2.1	2.0	1.8	1.7	1.2	0.6
Central bank financing	0.7	1.5	...	...	0.3	0.4	0.2	0.0
Commercial Bank financing	1.8	0.9	...	...	1.3	1.2	0.8	0.3
Nonbank financing	0.2	0.5	...	...	0.1	0.1	0.2	0.2
Memorandum items:								
Public savings	0.2	0.0	-1.2	-0.7	-0.4	-0.7	0.2	1.5
Primary balance	-3.4	-3.0	-1.7	-1.6	-0.7	-1.5	-1.0	-0.3
Debt service	2.5	2.9	3.5	3.7	0.0	0.0	0.0	0.0
Domestic	1.0	1.3	1.6	1.9	0.0	0.0	0.0	0.0
Foreign	1.5	1.6	1.8	1.8	0.0	0.0	0.0	0.0
Public debt	63.8	69.7	66.1	69.5	67.9	65.5	62.2	58.2
Domestic	14.6	17.5	17.8	18.6	18.2	18.5	18.1	16.9
External	49.1	52.2	48.3	50.9	49.7	47.0	44.1	41.2
Regular expenditure 3/	9.0	9.8	10.5	10.8	10.8	10.4	9.8	9.3
Development expenditure 3/	8.5	5.0	7.9	6.5	6.0	8.2	8.5	8.5
Education expenditure 4/	2.7	3.1	3.0	3.1	...	3.0	...	...
Health expenditure 4/	0.9	0.9	1.0	0.9	...	1.0	...	...
Nominal GDP (in billions Nrs)	410.3	421.3	468.8	443.4	448.0	487.6	536.0	592.2

Sources: Data provided by the Nepalese authorities; and Fund staff estimates and projections.

1/ Fiscal years start mid-July. Table confined to central government operations as contained in the budget.
2/ Includes privatization receipts.
3/ Current and capital and net lending expenditures are based on new economic classification provided by the authorities and staff estimates. The traditional presentation is in terms of regular and development expenditures (using Fund definitions).
4/ Provisional.

Table 3. Nepal: Monetary Accounts, 2001-2004

	2001	2002	2003		2004
	Jul	Jul	May	Jul	Jul
			Prov.	Est.	Proj.
Monetary authorities			(In billions of Nepalese rupees)		
Reserve money	70.6	79.0	81.6	83.5	89.3
Net foreign assets	75.0	81.1	86.4	85.1	89.9
Net domestic assets	-4.4	-2.1	-4.7	-1.6	-0.6
Net credit to government	19.4	26.3	24.9	27.8	29.8
			(Annual percentage change)		
Reserve money	15.7	11.9	5.8	5.7	6.9
			(12-month change in percent of reserve money at start of period)		
Reserve money	15.7	11.9	3.4	5.7	6.9
Net foreign assets	15.9	8.7	6.7	5.1	5.7
Net domestic assets	-0.2	3.2	-3.3	0.6	1.2
Net credit to government	4.9	9.8	-7.3	1.9	2.4
Monetary survey			(In billions of Nepalese rupees)		
Broad money	214.5	224.0	240.3	242.2	268.8
Narrow money	70.6	77.2	80.6	82.1	89.0
Quasi money 1/	143.9	146.8	159.6	160.0	179.8
Net foreign assets	87.8	88.4	93.3	91.9	100.6
Net domestic assets	126.7	135.6	147.0	150.3	168.2
Domestic credit 1/	183.4	200.3	217.2	225.1	255.3
Public sector	47.0	58.6	61.3	66.9	74.9
Government	44.8	55.5	58.1	63.0	71.0
Public enterprises	2.2	3.1	3.2	3.9	3.9
Private sector	136.4	141.7	156.0	158.2	180.5
Other items, net	-56.8	-64.7	-70.2	-74.8	-87.1
			(Annual percentage change)		
Broad money	15.2	4.4	7.5	8.1	11.0
Narrow money	15.7	9.3	2.5	6.4	8.4
Quasi money	15.0	2.1	10.2	9.0	12.3
Domestic credit	18.8	9.2	12.8	12.4	13.4
Public sector	29.1	24.7	22.1	14.2	12.0
Government	29.4	24.0	22.2	13.5	12.7
Private sector credit	15.7	3.9	9.5	11.6	14.1
			(12-month change in percent of broad money at start of period)		
Broad money	15.2	4.4	7.3	8.1	11.0
Net foreign assets	3.9	0.3	2.2	1.5	3.6
Net domestic assets	11.3	4.2	5.1	6.6	7.4
Domestic credit	15.6	7.9	7.5	11.1	12.5
Private sector	9.9	2.5	6.4	7.4	9.2

Sources: Data provided by the Nepalese authorities; and Fund staff estimates and projections.

1/ Commercial bank data are subject to revisions due to reporting lags.

Table 4. Nepal: Balance of Payments, 2000/01–2007/08

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
			Est.			Proj.		
	(In millions of U.S. dollars, unless otherwise stated)							
Current account balance (excl. official transfers)	65	144	-32	-45	-93	-118	-147	-170
Trade balance	-831	-742	-953	-1,023	-1,092	-1,144	-1,200	-1,257
Exports, f.o.b.	942	754	670	797	854	919	989	1,066
Merchandise exports	755	618	612	642	691	747	808	875
Re-exports	187	136	58	156	163	172	181	191
Imports, c.i.f.	1,773	1,496	1,623	1,820	1,945	2,063	2,189	2,323
Oil products	338	275	241	307	303	305	314	330
Other imports	1,435	1,221	1,382	1,513	1,643	1,758	1,875	1,993
Services (net)	216	108	87	104	102	109	114	122
Receipts	477	362	346	378	397	418	439	463
Of which:								
Tourism	159	113	101	111	125	140	156	174
Payments	262	254	259	275	294	309	325	341
Private Transfers (net)	680	778	834	875	897	917	938	965
Remittances receipts	699	803	866	908	932	954	978	1,006
Recorded	290	316	325	354	389	430	453	487
Estimated	409	487	541	555	543	524	524	519
Payments	19	25	32	33	35	37	39	41
Current Official Transfers 1/	94	143	160	236	235	218	214	209
Capital Transfers	78	74	78	120	118	109	95	78
Of which:								
Official grants 1/	18	48	68	110	108	99	85	68
Net official disbursements	103	39	31	29	32	25	31	35
Disbursements	164	105	103	108	110	104	110	116
Amortization	61	66	72	78	78	79	80	81
Foreign direct investment	6	-4	5	10	15	17	19	20
Net other investment 2/	...	...	-215	-366	-320	-254	-216	-174
Errors and omissions 2/	-307	-427	0	0	0	0	0	0
Overall balance	38	-31	27	-16	-13	-3	-5	-2
Financing	-38	31	-27	16	13	3	5	2
Change in reserves (-=increase)	-75	40	-45	-85	-90	-100	-85	-73
IMF purchases (net)	-5	-4	-4	-2	0	0	0	0
Other liabilities	42	-5	22	10	10	10	10	10
Financing gap 3/	0	0	0	93	93	93	80	65
Memorandum items:				(In pecent of GDP)				
Current account (excl. official transfers)	1.2	2.6	-0.6	-0.7	-1.4	-1.6	-1.9	-2.0
Current account (incl. official transfers)	2.8	5.2	2.2	3.1	2.1	1.4	0.9	0.5
Total external debt 4/	49.9	52.9	51.7	48.4	45.7	42.9	40.3	38.1
Debt service 5/	6.1	7.5	7.8	7.7	7.5	7.2	6.9	6.7
Gross foreign assets (end of period)	1,423	1,371	1,417	1,502	1,592	1,692	1,777	1,850
Of which: Central Bank	1,020	1,048	1,088	1,133	1,183	1,238	1,293	1,358
(In months of imports of goods and services)	7.0	6.7	6.2	6.1	6.0	5.9	5.8	5.8
Nominal GDP (in million U.S. dollars)	5,582	5,549	5,739	6,219	6,673	7,199	7,762	8,356

Sources: Data provided by the Nepalese authorities; and Fund staff estimates and projections.

1/ Includes official transfers that are channeled through the budget only.

2/ Large net other investments and errors and omissions reflect data weaknesses in capital account, unreported remittances and large informal trade.

3/ Provisional. The financing gap is expected to be filled by bilateral and multilateral donors.

4/ Includes estimated private sector debt and short-term trade credits.

5/ Public sector debt service only, as a ratio of exports of goods and services (excluding reexports of oil) and private transfer receipts.

Table 5. Nepal: Public Sector Debt Sustainability Framework, 1992-2007

(In percent of GDP, unless otherwise indicated)

	Actual											Est.	Proj.			
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
							I. Baseline Medium-Term Projections									
Public sector debt 1/	63.0	65.5	66.5	66.3	65.3	59.9	66.4	64.1	64.6	63.8	69.7	67.9	65.5	62.2	58.2	54.3
Of which: Foreign-currency denominated 1/	46.6	49.3	52.0	51.0	50.9	47.2	52.2	51.7	49.9	49.6	53.7	50.9	47.9	44.7	41.3	38.5
Change in public sector debt	-3.8	2.5	1.1	-0.2	-1.0	-5.4	6.5	-2.3	0.5	-0.8	6.0	-1.8	-2.4	-3.3	-4.0	-3.9
Identified debt-creating flows (4+7+12)	-5.6	3.5	-4.9	3.4	-0.8	1.6	3.6	-3.4	1.0	1.0	3.0	0.0	-0.8	-1.7	-2.5	-2.5
Primary deficit	5.4	3.8	2.3	1.9	4.7	2.4	3.2	2.1	2.3	3.4	3.0	0.7	1.5	1.0	0.3	0.0
Revenue and grants	12.1	12.4	13.7	12.5	11.3	12.7	12.4	11.6	12.2	13.1	12.9	14.3	15.5	15.7	15.9	15.9
Primary (noninterest) expenditure	17.5	16.3	16.0	14.4	16.0	15.1	15.6	13.7	14.5	16.4	15.9	15.0	17.0	16.7	16.2	15.9
Automatic debt dynamics 2/	-11.0	-0.4	-7.2	1.5	-5.5	-0.8	0.3	-5.5	-1.3	-2.3	0.0	-0.7	-2.2	-2.8	-2.8	-2.5
Contribution from interest rate/growth differential 3/	-11.5	-6.3	-7.8	-4.4	-6.4	-6.0	-2.8	-6.3	-5.0	-3.7	-0.3	-2.5	-3.9	-4.3	-4.3	-3.9
Of which: Contribution from real interest rate	-9.3	-4.4	-2.9	-2.4	-3.3	-2.9	-1.2	-3.6	-1.5	-0.8	-0.6	-1.2	-1.6	-1.7	-1.2	-1.0
Of which: contribution from real GDP growth	-2.2	-1.9	-4.8	-2.0	-3.1	-3.1	-1.6	-2.7	-3.5	-2.9	0.3	-1.3	-2.4	-2.7	-3.1	-2.9
Contribution from exchange rate depreciation 4/	0.5	6.0	0.6	5.9	0.9	5.1	3.1	0.8	3.7	1.4	0.4	1.8	1.7	1.6	1.5	1.4
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	1.9	-1.0	6.0	-3.7	-0.2	-7.0	2.9	1.1	-0.5	-1.9	3.0	-1.8	-1.7	-1.6	-1.5	-1.4
Public sector debt-to-revenue ratio 1/	520.0	526.3	485.7	531.3	576.9	473.2	535.4	554.3	528.1	488.1	540.0	474.6	421.7	396.2	365.7	341.3
Gross financing need 5/	8.2	6.8	5.3	4.9	7.7	5.2	5.9	5.3	4.9	5.6	5.5	3.6	4.3	3.8	3.1	3.0
In billions of U.S. dollars	0.3	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.3	0.2	0.2	0.2
Key macroeconomic and fiscal assumptions																
Real GDP growth (in percent)	4.1	3.5	8.6	3.3	5.3	5.3	2.9	4.6	6.1	4.8	-0.5	2.0	3.8	4.5	5.5	5.5
Average nominal interest rate on public debt (in percent) 6/	2.8	2.8	2.8	2.6	2.7	2.5	2.3	3.1	2.2	1.9	2.2	2.5	2.6	2.7	2.8	3.3
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-16.5	-7.6	-4.6	-3.7	-5.2	-4.7	-2.0	-5.7	-2.3	-1.2	-1.0	-1.7	-2.3	-2.5	-1.9	-1.7
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-1.2	-12.3	-1.3	-10.9	-1.8	-9.9	-6.5	-1.5	-7.5	-2.8	-0.7	-3.5	-3.5	-3.5	-3.5	-3.5
Inflation rate (GDP deflator, in percent)	19.3	10.5	7.4	6.3	7.8	7.2	4.2	8.8	4.5	3.2	3.2	4.2	4.9	5.2	4.7	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	4.0	-3.8	6.6	-6.8	17.1	-0.8	6.5	-8.6	12.5	18.8	-3.8	-3.4	17.1	2.9	2.3	3.7
							II. Stress Tests for Public Debt Ratio									
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007											69.7	66.1	62.9	60.0	57.4	55.0
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004											69.7	71.4	72.6	69.0	64.7	60.5
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004											69.7	68.2	67.3	63.9	59.9	55.9
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004											69.7	72.7	74.2	70.5	66.1	61.9
5. Combination of 2-4 using one standard deviation shocks											69.7	71.2	72.9	69.4	65.1	61.0
6. One time 30 percent real depreciation in 2003 7/											69.7	92.3	89.0	84.7	79.7	74.9
7. 10 percent of GDP increase in other debt-creating flows in 2003											69.7	77.9	75.1	71.4	67.0	62.7
Historical statistics for key variables (past 10 years)							Historical Average		Standard Deviation				Average 2002-07			
Primary deficit							3.2		1.2				1.1			
Real GDP growth (in percent)							4.9		1.7				3.5			
Nominal interest rate (in percent) 6/							2.6		0.3				2.7			
Real interest rate (in percent)							-5.4		4.4				-1.9			
Inflation rate (GDP deflator, in percent)							7.9		4.6				4.5			
Revenue to GDP ratio							12.4		0.7				15.0			

Sources: Data provided by the Nepalese authorities; and Fund staff estimates and projections.

1/ Central government gross debt as reported in IFS. Differences between this external debt data series and staff estimates are attributable to differences in coverage and valuation.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 5 . Nepal: Public Sector Debt Sustainability Framework, 1997-2007 (Concluded)

(In percent of GDP, unless otherwise indicated)

	Actual						Est.	Proj.			
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Projections											
Gross financing need 1/	5.2	5.9	5.3	4.9	5.6	5.5	3.6	4.3	3.8	3.1	3.0
In billions of U.S. dollars	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.3	0.2	0.2	0.2
II. Stress Tests											
Gross financing need 2/											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007						5.5	3.6	4.1	4.2	4.0	4.2
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						5.5	7.0	8.3	4.1	3.4	3.3
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						5.5	3.6	4.4	3.9	3.1	3.1
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						5.5	8.5	8.7	4.2	3.4	3.4
5. Combination of 2-4 using one standard deviation shocks						5.5	7.7	8.3	4.2	3.5	3.5
6. One time 30 percent real depreciation in 2003 3/						5.5	4.0	5.4	4.8	4.1	4.1
7. 10 percent of GDP increase in other debt-creating flows in 2003						5.5	3.8	4.7	4.2	3.5	3.5
8. Revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						5.5	6.9	9.0	4.1	3.4	3.4
Gross financing need (in billions of U.S. dollars) 2/											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007						0.3	0.2	0.3	0.3	0.3	0.3
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						0.3	0.4	0.5	0.3	0.2	0.2
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						0.3	0.2	0.3	0.2	0.2	0.2
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						0.3	0.5	0.5	0.3	0.2	0.2
5. Combination of 2-4 using one standard deviation shocks						0.3	0.4	0.5	0.3	0.2	0.2
6. One time 30 percent real depreciation in 2003 3/						0.3	0.2	0.2	0.2	0.2	0.2
7. 10 percent of GDP increase in other debt-creating flows in 2003						0.3	0.2	0.3	0.3	0.2	0.2
8. Revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						0.3	0.4	0.5	0.3	0.2	0.2

Sources: Data provided by the Nepalese authorities; and Fund staff estimates and projections.

1/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
2/ Gross financing under the stress test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 6. Nepal: Vulnerability Indicators, 1997/98–2003/04

(In percent of GDP, unless otherwise indicated)

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03 Est.	2003/04 Proj.
Official risk indicators							
Share of nonperforming loans (as percent of total loans)							
Rastriya Banjiya Bank	36–45 1/	...	...	...	55.0 2/	...	...
Nepal Bank Ltd.	28–34 1/	...	...	...	53.0 2/	...	...
Financial sector risk indicators							
Public and public guaranteed debt 3/	64.6	64.8	62.7	63.8	69.7	67.9	71.1
Broad money (percent change, 12-month basis)	21.9	20.8	21.8	15.2	4.4	8.1	11.0
Private sector credit (percent change, 12-month basis) 4/	18.4	18.5	19.9	15.7	3.9	11.6	14.1
Share of deposits in broad money (percent)	81.0	83.0	83.0	84.4	82.0	..	...
Share of foreign currency deposits in total deposits (percent)	8.3	8.7	8.4	9.5	9.6	...	...
Market assessment indicators							
91-day Treasury bill yield (real, percent)	-9.6	-5.5	4.9	1.4	0.6	-2.0 10/	...
Stock market index (NEPSE Index, Feb. 12, 1994=100)	163.4	216.9	360.7	348.4	227.5	...	...
External indicators							
Exports (percent change, 12-month basis in US$) 5/	-26.2	-10.8	27.3	-3.0	-19.9	-11.2	19.0
Imports (percent change, 12-month basis in US$) 6/	-11.3	-10.4	23.3	3.5	-15.6	8.5	12.2
Current account balance (excluding grants)	-2.8	0.5	0.5	1.2	2.6	-0.6	-0.7
Capital and financial account balance	7.4	3.8	2.2	0.3	-0.6	-1.1	-3.2
Of which : Inward foreign direct investment	0.2	0.2	0.1	0.1	-0.1	0.1	0.2
Gross foreign assets (in millions of US$)	973	1,145	1,385	1,423	1,371	1,417	1,502
Central Bank short-term foreign liabilities (in millions of US$) 7/	3.4	2.3	4.9	7.1	5.8	1.8 10/	...
Central Bank foreign currency exposure 8/	0.5	0.3	0.5	0.7	0.6	0.2 10/	...
Short-term foreign assets of commercial banks (in millions of US$)	262	343	399	403	323	347 10/	...
Short-term foreign liabilities of commercial banks (in millions of US$)	126	161	184	231	229	258 10/	...
Foreign currency exposure of commercial banks 8/	48.0	47.1	46.2	57.3	70.9	74.3 10/	...
Gross official international reserves (in months of imports of goods and services)	5.3	4.9	5.6	7.0	6.7	6.2	6.1
Gross official international reserves (as percent of broad money)	52.0	51.3	52.6	49.5	47.7	45.7	44.8
Short-term debt 9/	3.0	3.4	3.4	2.8	2.3	2.3	2.2
Short-term debt to gross official international reserves 9/	15.1	15.0	13.0	15.3	11.9	12.0	12.3
Total external debt	52.7	53.7	51.6	49.9	52.9	51.7	48.4
Of which : Public sector debt	49.7	50.3	48.5	47.1	50.6	49.5	46.1
Total external debt (as percent of exports of goods and services)	198.3	206.4	191.2	196.3	262.8	292.2	255.9
External interest payments (as percent of exports of goods and services)	1.8	1.9	1.7	1.5	2.1	2.5	2.6
External amortization payments (as percent of exports of goods and services)	4.8	4.5	3.9	4.4	5.8	6.9	7.2
Exchange rate (NR per US$, end of period)	67.9	68.5	70.4	74.7	78.0	78.1	80.2

Sources: Data provided by the Nepalese authorities; and Fund staff estimates and projections.

1/ From Special Audit Report by an accounting firm, R. Bajracharya & Company.
2/ External managers of RBB and NBL.
3/ Consists of public and public guaranteed external debt, domestic claims on government by banking sector, and domestic credits to the central government by nonbanking sector.
4/ Including private sector credit by NRB.
5/ Including re-exports.
6/ Including gold.
7/ Excluding SAF and ESAF.
8/ Foreign currency liabilities as a percent of foreign currency assets.
9/ Short-term debt in the form of outstanding trade credits and amortizations due in the following year.
10/ As of mid-May 2003.

Table 7. Nepal: Social Indicators

	Latest Single Year			Same Region/Income Group		
	1970–75	1980–85	1994–00	India	South Asia	Low Income
Total population, mid-year (millions)	13.1	16.2	23.0	1,015.9	1,355.1	2,459.8
Growth rate (percent annual average)	2.0	2.1	2.4	1.8	1.9	2.0
Urban population (percent of population)	5.0	7.8	11.9	28.4	28.4	31.9
Total fertility rate (births per woman)	6.2	5.9	4.3	3.1	3.3	3.6
Total labor force (millions)	...	7	11	439	585	1,085
Females in labor force (percent)	...	39	40	32	33	38
Labor force participation rate	...	48	48	43	43	50
Poverty (percent of population)						
National headcount index	...	...	42.0	35.0	...	...
Urban headcount index	...	...	23.0	30.5	...	...
Rural headcount index	...	...	44.0	36.7	...	...
Income						
GNP per capita (U.S. dollars)	120	170	240	450	440	410
Consumer price index (1995=100)	17	35	137	144	142	140
Food price index (1995=100)	...	33	144	137	...	...
Income/consumption distribution						
Gini index	...	...	36.7	37.8	...	...
Lowest quintile (percent of income or consumption)	...	...	7.6	8.1	...	...
Highest quintile (percent of income or consumption)	...	...	44.8	46.1	...	...
Public expenditure						
Health (percent of GDP)	...	...	1.3	0.8	0.9	1.2
Education (percent of GDP)	1.5	2.6	2.5	2.9	3.0	3.4
Social security and welfare (percent of GDP)	0.1	0.1	0.4	...	...	...
Net primary school enrollment rate (percent of age group)						
Total	...	60	78	77	77	86
Male	...	80	93	83	83	89
Female	...	37	63	71	70	82
Gross secondary school enrollment						
Total	12	27	32	49	...	...
Male	19	39	45	59	...	...
Female	4	14	18	39	...	...
Adult literacy (percent)	...	22	58	68	66	71
Female literacy	...	...	33	45	42	52
Access to an improved water source (percent of population)						
Total	...	...	81	88	87	76
Urban	...	...	85	92	92	88
Rural	...	...	80	86	85	70
Access to electricity (percent)	...	...	15	54	...	...
Population per physician	...	30,221	13,617	2,459	2,500	...
Population per hospital bed	...	5,719	4,308	1,503	1,429	1,152
Immunization rate (percent under 12 months)						
Measles	...	34	73	50	53	57
DPT	...	32	76	55	57	57
Child malnutrition (percent under 5 years)	69	...	47	47	49	...
Life expectancy at birth (in years)						
Total	45	51	59	63	62	59
Male	46	52	59	62	62	58
Female	44	50	59	63	63	60
Mortality						
Infant (per thousand live births)	160	115	74	69	73	76
Under 5 (per thousand live births)	234	180	105	88	96	115
Adult (15–59)						
Male (per 1,000 population)	482	376	260	222	227	294
Female (per 1,000 population)	476	395	265	209	212	261
Maternal (per 100,000 live births)	...	...	830	440	...	...

Sources: Staff reports; EDSS; and World Bank 2002 World Development Indicators.

Nepal—Fund Relations

(As of April 30, 2003)

I. **Membership Status**: Joined 9/06/61; Article VIII, Sections 2, 3, and 4 in May 1994

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	71.30	100.00
Fund holdings of currency	65.56	91.95
Reserve position in Fund	5.75	8.06

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	8.10	100.0
Holdings	0.04	0.54

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**% Quota**
ESAF arrangements	1.68	2.35

V. **Financial Arrangements**:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
ESAF	10/05/92	10/04/95	33.57	16.79
SAF	10/14/87	10/13/90	26.11	26.11
Stand-By	12/23/85	4/22/87	18.65	18.65

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	**Forthcoming**				
	04/30/03	2003	2004	2005	2006	2007
Principal	--	1.12	0.56			
Charges/Interest	--	0.11	0.14	0.14	0.14	0.14
Total	--	1.23	0.70	0.14	0.14	0.14

VII. **Exchange Rate Arrangement**

In February 1993, Nepal unified its exchange rate and eliminated the multiple currency practice associated with the previous dual exchange rate arrangement. In October 1997, the exchange arrangement of Nepal was reclassified as that pegged to a single currency unit from pegged to a currency composite. Currently, all merchandise imports (except for a few goods restricted for security or related reasons) are freely available through an open general license system, with foreign exchange provided through the banking system at the market exchange rate. Nepal's exchange system is presently free of restrictions on the making of payments and transfers for current international transactions except for restrictions on payments for personal travel. These payments are limited to $2,000 per fiscal year per person for North America, Western Europe, Australia, and Japan, and $1,000 for all other areas. The Executive Board did not grant or extend approval of this restriction at the time of Nepal's 2002 Article IV consultation. As of April 30, 2003, the exchange rate was US$1=Nrs 77.27.

VIII. Safeguards Assessments

Under the Fund's safeguards assessment policy, Nepal Rastra Bank (NRB) is subject to an assessment with respect to the prospective new arrangement. A safeguards assessment of the NRB was completed on September 03, 2002. The assessment concluded that substantial risks may exist in the area of external and internal audits, and the internal control system of the NRB. Staff findings and recommendations were reported in SM/02/270. Implementation of the measures by the NRB needs to be monitored by staff.

IX. Last Article IV Consultations

Staff discussions were held in Kathmandu in May–June 2002. The Executive Board discussed the staff report (SM/02/270) on September 4, 2002. Nepal is on the standard 12-month consultation cycle.

X. Technical Assistance Since 1996

Department		Purpose	Date
MFD	-	Debt management and monetary operations.	10/96
	-	Bank supervision and compliance with Basel guidelines.	6/99
	-	Central bank and banking reform	12/01–3/02
	-	Monetary Policy	6/03
MFD/ LEG	-	Reform of Central Bank and Depository Institutions Legislation.	7/00
FAD	-	Review of Tax policy and VAT administration.	1/98, 3/98 5/03
LEG	-	Redrafting of income tax laws.	3/00, 7/01
STA	-	Improving the compilation and reporting of the monetary statistics.	11/97, 4/99, 3/00
	-	Long-term residential advice on coverage and classification of balance of payments statistics.	11/97–5/98
	-	Multisector statistics mission	1/01
	-	Balance of payments statistics advisor	4/02, 12/02
	-	Producer price statistics	1/02, 1/03
	-	Monetary Statistics	7/03

XI. Resident Representative/Advisor

The Fund has provided staff members as resident representatives since 1977. Mr. Sukhwinder Singh began his term in October 2002.

Nepal—Relations with the World Bank Group

(As of June 13, 2003)

A. Partnership in Nepal's Development Strategy

Since the late 1990s, Nepal's poverty reduction agenda has been held back by formidable challenges—the persistent political instability leading to the October 2002 dismissal of the Cabinet by the King, the escalation of the Maoist insurgency resulting in heightened security concerns and the global economic slowdown bringing about a precipitous decline of exports and economic activity. Amidst the turbulence, a small but growing group of committed, reform-minded Government officials and technocrats began implementing reforms in earnest in late 2001. These initiatives formed the basis for the Immediate Action Plan (IAP) adopted by the Government in June 2002. As a result, reform efforts intensified in the following areas—financial sector, public expenditures, the fight against corruption, infrastructure regulatory environment and decentralized delivery of public services.

The reform group has been building on the successful experience with the IAP in moving the reform process forward. In developing the new Poverty Reduction Strategy (PRS), the Government has essentially broadened the scope of the reforms and adopted a more integrated approach within a medium-term perspective. The PRS spells out specific development targets, foremost among which is the reduction of the overall poverty ratio from about 40 to 30 percent by the end of FY07. The strategy revolves around four key pillars: (i) achieving sustainable and broad-based economic growth with an emphasis on the rural economy; (ii) accelerating human development through improved delivery of basic social services and economic infrastructure; (iii) ensuring social and economic inclusion of the poor, marginalized groups and less developed regions; and (iv) vigorously pursuing good governance to achieve better development results and ensure social and economic justice.

Having received Cabinet endorsement in May 2003, the PRS is expected to be formally sent to the World Bank and the IMF in June 2003 and to be discussed by the Boards around the fall of 2003. The two institutions will carry out a joint staff assessment over the summer of 2003. Meanwhile, the Government has requested assistance from the Bank and the IMF in implementing the IAP/PRS. The IMF is in the lead in assisting Nepal maintain macroeconomic stability. In April–May 2003, an IMF mission conducted Article IV consultations and worked together with the Government towards developing a medium-term macroeconomic framework. The latter will form the basis for a proposed three-year Poverty Reduction and Growth Facility (PRGF) the IMF is preparing in support of the reform program. The PRGF—envisaged for IMF Board presentation in the fall of 2003—would focus on medium-term fiscal consolidation as well as structural reforms related to the financial system, public sector management, and government revenue mobilization.

In implementing the 1998 Country Assistance Strategy (CAS) and the 2002 CAS Progress Report, the Bank is in the lead with the policy dialogue in the structural and institutional areas. The Bank has been conducting intensive dialogue with the Government in the formulation of recent reforms towards rationalization of public expenditures, establishment of a framework conducive to private sector growth, decentralization for better service delivery, targeted assistance to vulnerable groups and improving governance. To support these measures, a Bank-financed Programmatic Structural Adjustment Credit (PSAC) is currently under preparation. The Bank's future engagement is envisioned to be complemented by a program of financial assistance articulated in the new Country Assistance Strategy (CAS). Bank Board discussions on the PRSP and the CAS as well as presentation of the PSAC are planned for October 2003.

B. IMF-World Bank Collaboration in Specific Areas

Areas in which the Bank leads and there is no direct IMF involvement

The areas in which the Bank leads the policy dialogue and there is no direct IMF involvement are the social sectors, infrastructure, and environment. In the social sphere, the Bank continues to assist Nepal in poverty analysis as a follow-on to the 1999 study, ***Poverty at the Turn of the Twenty-First Century***. The Bank is currently providing technical assistance (TA) to the Government in conducting the Nepal Living Standards Survey II (NLSS II) during 2003/04 aimed at updating household level information on trends in consumption, poverty, and their determinants. The Bank's TA also seeks to strengthen Nepal's capacity to undertake regular household surveys that will facilitate poverty comparisons over time and to conduct social impact analyses. The NLSS II will provide a key input into the Government's first annual progress report on the PRS as well as the Bank's planned comprehensive Poverty Report (FY05).

In ***education***, the Bank and other donors (including Denmark, the European Union, Finland, Japan and Norway) are actively supporting the Government's well-formulated ten–year sectoral program. The Bank is providing phased support to the program in the form of an adaptable program loan (APL). Together they are financing the ongoing ***Basic and Primary Education II*** project with a view to strengthening institutional capacities at national, district, and local levels to plan and deliver more efficient and better quality education services. With the project making modest but steady progress, the Bank and donor community intend to continue their joint financing of the next phase of the program.

The Bank has vigorously encouraged Nepal's decentralization efforts towards more efficient delivery of public services. It has played a pivotal role in supporting the transfer of public schools to community management. The Bank's dialogue will be accompanied by financing in the form of the ***Community School Support*** Learning and Innovation Loan (LIL)—to be approved in June 2003—to improve accountability of primary schools, build capacity of communities to manage schools and develop the roles of teachers, local officials and education offices within the devolved framework.

In ***health***, the Bank has been supporting the devolution of sub-health posts to local communities, a measure included in the Immediate Action Plan (IAP), and the development of a sector-wide reform strategy. A ***Health Sector Operation*** currently under preparation is envisaged to support the sector-wide program. Key reform priorities in the sector include addressing the problems of inadequate financing and inefficient public spending, weak institutional capacity and over-centralized planning and management, weak delivery mechanisms and inequitable access to services.

To help generate broad-based growth, the Bank supports investments in key ***infrastructure*** sectors by financing projects in ***Rural Infrastructure, Road Maintenance and Development, Rural Water Supply and Sanitation, Irrigation Sector Development, Power Sector Development, Telecommunications Sector Reform and Multimodal Trade and Transit*** projects. At the same time, project finance is supporting decentralization to improve service delivery in most of these sectors by promoting grassroots-driven, bottom-up planning and community-based management. The Rural Infrastructure Learning and Innovation Loan, for instance, is helping strengthen the institutional capacity of a decentralized governance structure to enhance the quality, efficiency and sustainability of rural roads. Communities, district committees and civil society organizations are active implementation partners.

The Road Maintenance and Development project supports key sectoral policy reforms by establishing a Roads Board and Road Fund to assure a stable source of funding for maintenance expenditures, while also promoting motorable access to isolated regions. Similarly, the Rural Water Supply and Sanitation project relies on a semi-independent management Board to ensure that rural water and sanitation services are provided in a sustainable, reliable, cost-effective and demand-led manner with an emphasis on community-based methods. The Irrigation Sector Development project is helping to increase productivity and sustainability of irrigation systems in the western and eastern regions. The recently approved Power Sector Development project will help with the development of the country's hydropower potential to meet electricity demand, improve access of rural areas to electricity services and promote private sector participation. The Telecommunications Sector Reform Project supports sectoral policy reforms in addition to the provision of greater rural access to telecommunications services through the introduction of a private operator. The Multimodal Trade and Transit project is helping to reduce international trade-related transport costs, streamline trade and transit procedures and improve the efficiency of transit trade documentation.

While Bank financing of investment and sector operations also supports ***social inclusion,*** the Bank is assisting in the design, implementation and evaluation of a Poverty Alleviation Fund (PAF) instrument. The policy dialogue has been articulated in the FY03 PAF Policy Note. If successful, the envisaged PAF would channel resources to grassroots levels, complement decentralization, and create a mechanism for continuity and coordination of donor programs for poverty reduction. In addition, the Bank is assisting Nepal in gaining a better understanding of the institutional underpinnings of caste, ethnic and gender-based social and economic exclusion and how these affect poverty outcomes and the options for policy and institutional reform. To this end, a Social and Gender Analysis will be carried out. The Bank along with ILO and UNICEF will continue to build on the work of the 2003 Nepal Understanding Child Labor Project towards a comprehensive framework for addressing child labor issues.

In responding to ***environmental management***, Bank assistance is focused on helping Nepal articulate an effective strategy for environmental conservation, management and capacity building. More recently, emphasis has been placed on capacity building for carrying out environmental impact assessments in line with newly implemented institutional and legislative framework. In addition, plans have been developed for implementing the convention on Biological Diversity and the Sustainable Development Agenda.

Areas in which the Bank leads and its analysis serves as input into the IMF program

The Bank takes the lead in assisting the Government with ***public expenditure analysis***. The Bank's FY00 Public Expenditure Review (PER) provided analytical support for developing the strategy on public expenditure reform. Together with the U.K. Department for International Development (DfID), the Bank's intensive dialogue and technical assistance have been supportive to the Government as it has carried out reforms, including the development of a credible Medium Term Expenditure Framework (MTEF). In FY03, this framework was applied to the prioritization of the development budget to ensure efficient budget allocations in the coming fiscal year for priority projects, and in FY04, it will be applied to all expenditures. As the Government begins to implement its PRS, the MTEF will help the Government translate the PRS priorities into fiscal realities.

As further reforms proceed, public expenditure analysis will remain an integral part of the Bank's analytical and advisory (AAA) work program with two proposed PERs—an evaluation of the MTEF and an analysis of the state-owned enterprise (SOE) sector. To complement the economic analysis, studies on the public sector's framework for financial accountability and procurement—the Country Procurement Assessment Review (CPAR) and the Country Financial Accountability Assessment (CFAA)—were conducted jointly by the Bank and the Government. Additionally, in response to technical assistance and training needs on public expenditure management, decentralization and enhancement of financial accountability, the Bank is providing support through Institutional Development Fund (IDF) grants or the Bank's budget.

On the financing side, future Bank support is likely to include a PSAC envisaged as a forerunner to a series of possible fiscal support operations in line with the programmatic approach articulated in the 2002 CAS Progress Report. The proposed PSAC would support the implementation of the PRS by expanding the fiscal space to increase priority spending. The PSAC would also assist in refining the MTEF, improving the efficiency of key parastatals, removing impediments to broad-based growth (through improvements in the effectiveness of irrigation, rural transport and power sector investments and reforms of the labor market, the financial system and the telecommunications sector). In line with the programmatic support, the Bank's AAA program places emphasis on the need to address the challenges and bottlenecks to broad-based growth. A Development Policy Review and key studies on agriculture and labor remittances are envisioned to help prioritize future policy reforms.

With respect to ***governance***, the Bank has consistently and firmly implemented the strategy of the 1998 CAS as well as the 2002 CAS Progress Report for helping address Nepal's fundamental constraint to development—poor governance. The Bank's strong stance manifested in the restricted new lending during FY99–FY02—albeit accompanied by intensive dialogue—may have provided some impetus to the wave of recent reforms. The public expenditure reform program which has benefited from the Bank's analytical work and policy dialogue is facing up to the challenge of improving not only efficiency but also governance. The program includes measures to fight corruption, ensure civil service accountability and enhance transparency of public financial management and procurement framework. Bank support on decentralization includes analytical assistance on the fiscal decentralization framework and promotion of the expanded roles of local governments, e.g., the ***Rural Infrastructure*** project. Following the completion of the CPAR and CFAA, IDF grants will provide the means for strengthening relevant public sector institutions and implementing main policy recommendations.

Areas of shared responsibility

The Bank and the IMF, in conjunction with other external development partners, have provided assistance in the preparation of the PRS which will likely be discussed at the Bank and IMF Boards in October 2003. The two institutions will carry out the Joint Staff Assessment (JSA) in the summer of 2003. In addressing the PRS pillar on achieving good governance, the Bank and the IMF are assisting in the area of ***civil service reform*** through policy dialogue and technical assistance towards ensuring an autonomous and professional civil service as well as fiscal sustainability.

The Bank and the IMF are partners in providing analytical support to the Government on ***international trade*** which is key to attaining broad-based growth. The Bank leads in carrying out the Trade and Competitiveness Study to help identify major constraints to Nepal's further integration into the multilateral trading system in a manner that is supportive of the PRS. The IMF contributed to the study by assessing the Government's macroeconomic policy and its potential impact on trade performance. In turn, the study is helping the IMF design its technical assistance program on tax policy, including import tariffs taking into account Nepal's current negotiations towards WTO accession.

Financial sector reform is a prerequisite for successful implementation of the IAP and PRS. Since the mismanagement of key financial institutions was a major element of poor governance, the progress on financial sector reform has been the litmus test of political commitment to government reform. The Bank and the IMF are helping to strengthen the Central Bank's authority and regulatory capacity, improve the financial health of the two largest banks, restructure the state banks and upgrade the legislative and institutional framework for the financial sector. The Bank financed the comprehensive assessment of the two largest banks and undertook a comprehensive Financial Sector Study in 2002. The ongoing ***Financial Sector Technical Assistance*** project supports the restructuring and reengineering of the Central Bank, introduction of professional management teams into the two large ailing commercial banks (the first step toward eventual restructuring of those banks), capacity building towards enhanced credit information, improved public awareness of financial sector issues and upgrading of staff training in financial institutions.

Areas in which the IMF leads and its analysis serves as input into the Bank program

The IMF leads the policy dialogue on maintaining sound macroeconomic policies as is the case with most Bank/IMF member countries. The possible PRGF-supported program under negotiation will serve as the macroeconomic policy anchor for ensuring successful implementation of the IAP/PRS and the Bank's program of support.

The IMF leads in encouraging reforms that are critical to the maintenance of macroeconomic stability, primarily on fiscal matters, such as maintaining sustainable domestic borrowing while allocating resources to priority sectors. Also, the IMF is taking the lead on the revenue side by setting realistic targets for increasing domestic revenues and advising on tax policy and administration.

Areas in which the IMF leads and there is no direct Bank involvement

The areas in which the IMF leads and the Bank is not directly involved are monetary policy, the exchange rate regime, the balance of payments and related statistical and measurement issues.

C. World Bank Group Strategy and Lending Operations

The Country Assistance Strategy (CAS). In December 2002, the Board considered the Country Assistance Strategy Progress Report (CAS PR) which discussed the rationale for implementing the Low Case lending program since the 1998 CAS. Between December 1998 and December 2002, the Bank approved only four credits for a total of US$94.6 million. Consistent with the Low Case scenario, the Bank placed stronger emphasis on helping to build the agenda and the needed consensus for reform through policy dialogue, technical assistance and the AAA program (as discussed above). The CAS PR confirmed that the major challenge for Nepal presented in the 1998 CAS—governance—and the approach to tackle it—bringing resources to the grassroots level and improving development effectiveness—remain valid. Also, the 1998 CAS will continue to guide the Bank's strategy into FY04 when the new CAS will be presented on the basis of the PRS. Given the nature of ongoing reforms, the CAS PR presented the rationale for moving to a Base Case scenario and developing a programmatic approach to financial assistance.

The Base Case Lending Program. The FY04 Base Case program is anchored by the PSAC cast in the context of a medium-term reform program. Programmatic support, through financial assistance to the fiscal cost of reforms, is being complemented by investment and technical assistance credits. In FY03, credit approvals included the Financial Sector Technical Assistance and Power Sector Development and approval of the Community School Support LIL is forthcoming (June 2003). Future Bank credits are likely to be provided for the following projects—Poverty Alleviation Fund, Second Rural Water Supply and Sanitation and Basic and Primary Education II (the second phase of the APL).

Bank Assistance Program in Nepal. As of May 30, 2003, the active IDA lending portfolio consisted of nine projects with a total commitment of US$273 million and a total undisbursed balance of US$147 million (Table 1). As previously mentioned, two projects have been approved in FY03 and three operations are at an advanced stage of preparation—Community School Support LIL, Poverty Alleviation Fund project and PSAC.

Table 1: World Bank Operations
(As of May 30, 2003)

(In millions of U.S. dollars, net of cancellations)

	IDA Amount	Undisbursed 1/	Board Date
Multimodal Transit	23.5	4.3	1998
Rural Water Supply and Sanitation	16.7	1.6	1997
Irrigation Sector Development	71.8	7.9	1998
Basic & Primary Education II	12.5	5.3	1999
Rural Infrastructure Learning and Innovation Loan	5.0	0.8	1999
Road Maintenance and Development	54.5	36.1	2000
Telecommunications Sector Reform	22.6	23.3	2002
Financial Sector Technical Assistance	16.0	17.5	2003
Power Development 2/	50.4	50.4	2003
Total	273.0	147.0	

1/ Credit accounting is in SDRs. As these figures are in US$, exchange rate fluctuations may result in undisbursed balances greater than the principal amounts.
2/ The Power Development project approved in FY03 is not yet effective.

Economic and Sector Work. The *CAS Progress Report* (Report No. 24170–NEP, 11/18/2002) was discussed by the Bank's Board in December 2002. Recently completed core diagnostic work includes *Nepal: Financial Sector Study* (Report No. 24959–NEP, 10/16/2002), *Nepal: Towards a Sustainable Approach for Poverty Reduction and Decentralization: A Note on Nepal's Proposed Poverty Alleviation Fund* (Report No. 25019-NEP, 11/20/2002), *Nepal: Country Procurement Assessment Report* (Report No. 23917-NEP, 4/11/2002) and *Financial Accountability in Nepal: A Country Assessment* (Report No. 25833–NEP, 3/31/2003). At an advanced stage of preparation is the *Trade and Competitiveness Study.*

IFC's Activities in Nepal. As of April 30, 2003, IFC-held portfolio in Nepal was US$79.9 million (US$53 million from IFC's own account and US$26.9 million in B-loans) in two power generation projects, one tourism project and one leasing company.

IFC will continue to support export-oriented manufacturing, private investment in telecommunications and power generation and distribution, financial market development and the growth of small and medium enterprises (SMEs). Due to the still weak security situation and political uncertainties, currently there are few investment opportunities in Nepal large enough for direct financing, so the IFC does not expect to make many new investments during the CAS period. Instead, IFC will focus on technical assistance for SMEs through the regional multi-donor technical assistance facility for SME development—the Small Enterprise Development Facility (SEDF)—based in Dhaka. This facility—funded by IFC in partnership with Canada, Netherlands, Norway, United Kingdom, ADB and the European Union (EU)—will deliver technical assistance programs in Nepal to increase SMEs' access to financing and business development services, improve the business environment for SMEs and develop linkages with larger enterprises. SEDF intends to locate a staff member within the Kathmandu office to manage these programs.

Questions may be referred to Ms. Dado (32545).

Nepal—Relations with the Asian Development Bank

Lending Program

As of December 31, 2002, total commitments by the Asian Development Bank (AsDB) consisted of 99 loans amounting to $1.96 billion covering projects in agriculture (including forestry), energy, transport, industry, social infrastructure, and tourism. Undisbursed funds of $442.5 million represent about 59 percent of the total net loan amount as of December 31, 2002. For the period 2003–05, 15 projects amounting to $305 million are tentatively programmed.

Loans by the Asian Development Bank, 1969– 2002

(As of December 31, 2002)

	1969–1999 Approved	2000 Approved	2001 Approved	2002 Approved
	(In millions of U.S. dollars)			
Agriculture and natural resources	748.4	11.0	--	--
Energy	364.4	--	--	--
Finance and Industry	130.7	7.3	--	--
Social Infrastructure	137.1	155.0	19.6	60.0
Transport and communications	224.7	--	46.0	--
Others	27.6	--	30.0	--
Total commitments	1,632.9	173.3	95.6	60.0
Gross Disbursements	1,120.9	99.7	57.3	28.2
Technical Assistance Projects				
Total commitments	89.3	7.3	4.0	3.9
Gross Disbursements	50.6	3.5	5.0	3.9

Source: Data provided by the Asian Development Bank.

Technical Assistance

Since 1968, the AsDB has provided Nepal with technical assistance in most sectors. Recent assistance includes Support for Financial Sector Reforms, Community-based Water Supply and Sanitation, Teacher Education, Empowerment of Women, Privatization/Liquidation of Public Enterprises, Commercial Agriculture Development, Skills for Employment, Public Debt Management, and Community Livestock Development. As of December 31, 2002, total technical assistance commitments consisted of 228 projects—89 of which were in preparation for loans—for a total of $104.5 million.

Private Sector Operations

As of December 31, 2002, the AsDB has provided five private-sector loans in Nepal: two in industry, two in hydropower and one in tourism. Direct investment has involved $49.5 million in loans and $3.3 million in equity for a total of $52.8 million. Moreover, the AsDB has been working through its lending and technical assistance program to create a policy and legal environment in Nepal that promotes private sector development.

Nepal—Statistical Issues

Lack of consistent and timely data hamper effective analysis and policy implementation. A multi-sector statistics mission (January 2001) prepared recommendations and an action plan to upgrade Nepal's statistics to international standards. Nepal provides core data to the Fund and releases data in government and central bank publications. Nepal has participated in the GDDS since May 2001 and its metadata are posted on the Dissemination Standards Bulletin Board.

Real Sector

The Central Bureau of Statistics (CBS) compiles **national accounts statistics** using the *1968 SNA*. These statistics include GDP by industry of origin (current and constant prices) and by expenditure categories (current prices), and gross national income and savings (current prices). The statistics are deficient due to lack of comprehensive and regular data sources. The limited source data suffer from inconsistencies, lags in availability, and insufficient detail. There are shortcomings in record-keeping by agencies and access to records is not timely due to processing lags. Reflecting source data problems, compilation methods rely heavily on fixed ratios derived from past surveys or *ad hoc* assumptions.

The **consumer price index** (CPI) was recently revised following completion of the 1995/96 household expenditure survey. The weights used for calculation of the CPI were updated and the revised series were published in May 2000. However, the revised CPI covers only urban areas and the consumption basket refers only to a sub-set of the population. The **wholesale price index** (WPI) was developed by the NRB and first published in July 2001. The weights for the WPI, based on 1999/2000 data, were derived using a commodity flow approach and the prices related to the first commercial transaction point. However, the compilation method needs to be improved to implement weekly or bi-weekly price collection; the number of price quotations need to be increased; and procedures for adjusting for quality differences implemented. The CBS, with STA assistance, is developing a monthly **producer price index** (PPI) series, to replace the manufacturing price index which is based on a biased unit values rather than actual transaction prices. The new index is expected to provide better deflation of national accounts data and a more accurate measure of industrial sector inflation.

Fiscal Sector

The new **budget classification** system introduced in 1996/97 and since refined, has substantially improved fiscal statistics, in particular the division between current and capital spending. However, fiscal data by functional and economic classification is only provided on an irregular basis with varying degree of coverage, large amounts are still attributed to the contingency account, and monthly reporting of development spending excludes amounts directly paid for by donors. Moreover, a number of fees are collected outside the budget and the operations of local governments are not reported in the annual budget.

More timely data on **revenue and expenditure** are needed for effective fiscal control. A financial management project is under way and a system of 'flash' reporting covering selected districts that account for the bulk of expenditure is being developed. Further progress is needed in improving data collected by the Financial Comptroller General's Office to allow the MOF to effectively monitor actual revenue collections and expenditures, and to provide assessments during the course of the fiscal year. This will require additional donor funding of technical assistance and further computerization in the MOF regional offices.

Consolidated accounts for the **public enterprise sector** are not compiled on a regular basis, and financial reporting by many individual enterprises is subject to long delays. Fund staff have assisted the authorities in processing surveys of public enterprises. However, further assistance in survey design and processing may be needed.

Monetary Sector

Monetary data provided by the NRB have been subject to revisions with a substantial lag (up to 12 months), making program monitoring difficult. A **money and banking statistics** technical assistance mission visited Nepal during April/May 1999 and again during March 2000 to assist in improving timeliness, compilation procedures, and the coverage of the financial system. The 2001 multi-sector mission recommended implementation of the residency criterion, instead of the currency basis, to distinguish foreign and domestic accounts. The mission also encouraged the NRB to improve procedures for grossing-up balance sheet data to account for late reporting by commercial bank branches, which had led to the consistent underestimation of broad money. In August 2002, the NRB's Research Department informed STA about the introduction of new reporting forms for commercial banks, the implementation of which initially resulted in delayed transmissions of aggregated data on banks to STA. Beginning May2 003 , STA received revised and new data on commercial banks for the period August2 001 through April2 003. Nepal's country page in the June 2003 edition of *IFS* shows data for the monetary authorities, deposit money banks, and interest rates through March2 003 . However, some components of data on deposit money banks are still not reported such that important aggregates like claims on private sector and demand deposit liabilities are not shown in *IFS*. Consequently, the monetary survey section in *IFS* also does not show data for these aggregates.

Balance of Payments

Despite improvements, **balance of payments accounts** continue to exhibit large and volatile net errors and omissions. An advisor was stationed in Kathmandu for a six-month period in 1997–98 to provide technical assistance and help implement previous recommendations. As a result, methodologies were developed to improve recording of grants, workers' remittances, and re-exports. These revised estimates were presented in the 1998 staff report and substantially amended the current account balance and reduced net errors and omissions. However, further work is needed to improve recording of oil transactions, remittances, grants, foreign direct investment, short-term inflows, and other private capital flows. A peripatetic Statistical Adviser conducted the second of a series of four missions during November/December 2002. The authorities have recently agreed to publish the balance of payments in the format recommended by Fund technical assistance, but some other recommendations are yet to be fully implemented.

Exports and imports data are compiled by the NRB, the Customs Department, and the Trade Promotion Center (overseas trade only). There are discrepancies among them. Export and import price indices are not compiled, and information on trade volumes is unavailable.

Incomplete and conflicting data on government **external grants and loans** make it difficult to estimate foreign financing. The NRB monitors cash disbursements and repayments, but most commodity aid and direct payment is excluded. MOF reporting is also incomplete and not timely. With technical assistance from DfID, a new database providing comprehensive account of disbursements, payments, and the stock of outstanding government debt has been developed and is currently being refined. However, reporting of direct external grants remains a problem.

Nepal—Core Statistical Indicators

(As of July 15, 2003)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	External Current Account Balance	Central Government Balance	GDP/ GNP	External Debt
Date of Latest Observation	6/27/03	6/13/03	5/15/03	5/15/03	5/15/03	6/24/03	5/03	5/03	3/03	6/13/03	2001/02	2001/02
Date Received	6/30/03	6/30/03	6/15/03	6/15/03	6/15/03	6/30/03	6/15/03	6/30/03	6/30/03	6/30/03	8/02	8/02
Frequency of Data 1/	D	W	W	W	M	W	M	M	M	W	A	A
Frequency of Reporting 1/	W	W	W	W	M	W	M	M	M	W	A	A
Source of Data 2/	A	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting 3/	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C
Confidentiality 4/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	M	M	M	M	W	M	M	Q	Q	A	A

1/ D-daily; W-weekly; M-monthly; Q-quarterly; or A-annually.
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700 19th Street, NW
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IMF Concludes 2003 Article IV Consultation with Nepal

On August 22, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Nepal.[1]

Background

Nepal remains among the poorest countries in the world with almost 40 percent of the population living in poverty due to insufficient growth and inadequate targeting of the poor. During the 1990s, macroeconomic conditions remained broadly stable and the fiscal position was manageable, but growth was constrained by financial sector weaknesses, weak public sector management, and poor governance. In the financial sector, Nepal Rastra Bank (NRB) oversight is still weak, and intermediation is inadequate largely due to a banking environment in which loan default is endemic, especially by well-connected borrowers. Partly as a result of this, the two largest commercial banks now have large nonperforming assets. Similar problems exist at two large development banks. In the public sector, investment has been spread thinly over projects and enterprises suffer from weak management and accountability. More recently, intensified security problems and adverse external developments contributed to lower growth and the fiscal position has deteriorated since 2000/01.

The ceasefire agreed in January 2003 with the insurgents has renewed hopes for peace and efforts have been made to sustain the reform momentum. Progress in achieving lasting peace would facilitate poverty reduction and implementation of policies contained in the government's

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Poverty Reduction Strategy Paper (PRSP). However, political uncertainties persist as major political parties continue to maintain that the appointment of governments by the King since the dissolution of parliament is unconstitutional. The parties have also refused to join the peace talks.

GDP growth is estimated to be 2 percent in 2002/03. The ceasefire has helped restore some normality in the transport and service sectors and the decline in tourism may have halted. There are also signs that some exports and manufacturing production are rebounding. Inflation, which rose to about 7½ percent in mid–May (12–month basis) reflecting price developments in India, administrative price changes, and supply factors, is expected to moderate by early 2003/04.

The 2002/03 budget met revised targets set in a mid-term review. Based on weak revenue performance due to lower activity during the first half of the year and external aid shortfalls relative to the initial budget targets, the authorities revised the budget at mid–year. Specifically, the tax revenue target and external financing were revised down. To compensate for these shortfalls, total expenditure was also revised down and the revised budget set a net domestic financing target of 2 percent of GDP. Following the announcement of the ceasefire, economic activity picked up and revenue performance improved. However, capital spending was below the revised budget, reflecting continued implementation constraints at the local level. As a result, domestic financing was around 1¾ percent of GDP.

Monetary policy has been accommodative and the real effective exchange rate has depreciated. To help economic recovery, the NRB lowered cash reserve requirements by 1 percentage point in August 2002 and maintained a refinancing facility for lending to "sick" industries. Aided by the recovery in activity and monetary easing, private credit appears to have revived and higher remittances contributed to a rise in banking system foreign assets. However, reserve money growth has been curtailed, due largely to lower net credit to the government. Lending and deposit rates have declined somewhat. The Nepalese rupee has depreciated in real effective terms since early 2002, reflecting the peg to the Indian currency which has appreciated only somewhat against the weakening US dollar.

Balance of payments developments turned favorable in mid–2002/03 and external reserves are adequate. Large and increasing remittances helped buoy the current account. Garment exports began recovering in late 2002, while recorded exports to India declined, carpets and pashmina exports continued to stagnate, and imports increased with the recovery. The current account (excluding official transfers) is expected to move into a deficit of about ⅔ percent of GDP, but with higher aid and other inflows official foreign exchange reserves are expected to rise to US$1 billion (6¼ months of imports of goods and services).

In 2002/03, significant progress was made in financial sector reform implementation. The NRB took steps to reduce staffing through a voluntary retirement scheme (VRS). Progress was made in restructuring the two largest commercial banks, which had external management teams installed. The teams have prepared management plans, made progress in assessing the banks' financial status, and proposed VRSs to reduce overstaffing. Some improvements have already taken place with success in loan recovery and branch rationalization, although loan recovery from well-connected borrowers continues to be difficult. Prioritization of budgetary spending improved, anti-corruption efforts were boosted, and public enterprise reform implementation and governance reforms progressed. To improve prioritization, a Medium Term Expenditure Framework was introduced with World Bank assistance to help align development spending with national and sectoral priorities. Administered price increases for petroleum products were announced in March 2003, although some price increases were rolled back under public pressure. Liquidation procedures were initiated for four public enterprises; preparations for the privatization of one enterprise were brought to an advanced stage.

Governance reforms progressed and anti-corruption efforts were boosted. The cabinet approved in September 2002 the elimination of 7,500 vacant civil service positions. To tackle corruption in public life, the Commission for Investigation of Abuse of Authority and a newly established Judicial Commission initiated investigations against politicians and revenue officials perceived to have accumulated unaccountable assets. The Anti-Corruption Strategy was adopted.

Executive Board Assessment

Executive Directors stressed that to address the pervasive level of poverty in Nepal, growth needs to be raised significantly over the medium term through vigorous implementation of structural reforms, particularly in the financial and public sectors. In this regard, Directors welcomed the authorities' Poverty Reduction Strategy Paper (PRSP), which is founded on broad-based growth, social sector development, targeted programs for the poor and deprived groups, and improved governance. Directors looked forward to considering a Joint Staff Assessment of the PRSP in the near future. They encouraged the authorities to reach early agreement on a program that could be supported by the Poverty Reduction and Growth Facility to help achieve PRSP goals.

Directors welcomed the ceasefire agreement with the insurgents reached in January 2003. They underlined that continued peace was essential to help sustain the economic recovery currently under way. Directors also noted that progress in the peace talks and the build up of confidence should help relieve budgetary pressures for security spending.

Directors commended the authorities' for maintaining broad fiscal stability to create conditions to support economic growth. Looking forward, Directors endorsed the authorities' fiscal strategy based on revenue mobilization, expenditure prioritization, and a reduction in domestic borrowing. They welcomed the 2003/04 budget as the first step in implementing this strategy. However, Directors called for a determined effort to meet the revenue targets and to resist spending pressures. To raise revenue over the medium term, Directors suggested cuts in exemptions, improvements in tax and customs administration, and increases in the VAT rate. Directors welcomed the steps taken to prioritize development spending to help achieve poverty reduction goals, including the introduction of a medium-term expenditure framework, and encouraged the extension of such efforts to all expenditures. Directors noted that the envisaged reductions in domestic borrowing would help maintain fiscal sustainability over the medium term, especially in view of potentially large contingent liabilities from financial sector and public enterprise reforms. Continued technical assistance in the fiscal area will help address capacity constraints.

Directors agreed that monetary and exchange rate policies should remain geared to supporting the exchange rate peg to the Indian rupee, stressing that the peg had served Nepal well given its close links with India. Looking forward, they noted that prospective external developments, such as the phasing out of the Multi-Fiber Agreement, would likely have implications for external competitiveness and the appropriate choice and level of the peg. Directors pointed to the need for policy measures to ensure that remittances are sustained, as well as for efforts to diversify Nepal's export base. They also noted that external competitiveness could be enhanced by measures to raise labor productivity and lower transport costs.

Directors commended the authorities for progress in financial sector reforms, but noted that much remained to be done. They stressed the need for strengthening Nepal Rastra Bank (NRB) supervision of the financial sector. The NRB should also improve performance incentives for skilled personnel, while encouraging separations at lower levels. Directors welcomed the appointment of external managers at the two largest insolvent commercial banks, and noted recent steps taken by the new managers to improve the financial condition of the banks. To help support these efforts and, more generally, to create a sound banking environment, Directors noted the authorities' intention to phase out priority sector lending requirements, and emphasized the effective implementation of recently adopted debt recovery mechanisms, including the Debt Recovery Tribunal and blacklisting of loan defaulters.

Directors welcomed ongoing public sector reforms, including the elimination of vacant positions, the introduction of merit-based promotions, the decompression of the wage scale, as well as improvements in the public procurement process. Looking forward, Directors recommended the adoption of civil service accountability in order to improve policy implementation. They welcomed the public enterprise reform efforts that would lower government ownership in the economy and increase the enterprises' net budgetary contribution—through privatization and restructuring of viable enterprises and liquidation of unviable ones. Several Directors stressed that due regard should be paid to the pace and sequencing of these reforms. Also, an appropriate compensation scheme could help smooth implementation of workforce reductions. Directors welcomed recent efforts to combat corruption, but emphasized the need to pursue forcefully those responsible for the misuse of public funds. Directors supported the authorities' plans to increase decentralization to enhance service delivery. However, they noted that the implementation of these measures should be accompanied by improved public sector governance and capacity building at the local level.

Directors supported measures to improve the business climate for private sector development through legal reforms and streamlining of administrative procedures to facilitate trade. They recommended revisions to labor legislation to make labor hiring more flexible and modifications to the Company and Insolvency Acts to allow more orderly and timely exit of unviable firms.

Directors commended Nepal for its open trade regime, and welcomed the authorities' efforts to gain early World Trade Organization (WTO) accession. Directors welcomed the elimination of the exchange restriction arising from quantitative limits on payments for personal travel. Directors encouraged the authorities to further improve statistics to enhance policy formulation and monitoring. They urged full implementation of Fund technical assistance recommendations.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Nepal is also available.

Nepal: Selected Economic Indicators, 1998/99–2002/03 1/

	1998/99	1999/00	2000/01	2001/02	2002/03 Est. 2/
			(Percent change)		
Output and prices					
Change in real GDP	4.5	6.1	4.8	-0.5	2.0
Change in CPI (end–period)	9.0	0.6	3.4	3.5	7.5 3/
			(Percent of GDP)		
Budgetary operations					
Total revenue	10.2	10.7	11.4	11.5	12.0
Total expenditure	15.4	15.7	17.6	17.2	16.7
Current expenditure	9.3	9.6	11.2	11.6	12.4
Capital expenditure and net lending	6.1	6.1	6.4	5.7	4.2
Overall deficit 4/	3.9	3.5	4.5	4.3	2.4
			(Percent change)		
Money and credit					
Domestic credit	16.1	17.8	18.8	9.2	12.4
Broad money	20.8	21.8	15.2	4.4	8.1
	(In millions of U.S. dollars, unless otherwise indicated)				
External sector					
Exports , f.o.b. 5/	763	971	942	754	670
Imports, c.i.f.	1,390	1,713	1,773	1,496	1,623
Current account 6/	24	28	65	144	-32
(In percent of GDP) 6/	0.5	0.5	1.2	2.6	-0.6
Overall balance	136	192	38	-31	27
Gross foreign assets	795	946	1,020	1,048	1,088
Rupees per U.S. dollar (end–period)	68.5	70.8	74.7	78.0	75.1

Sources: Nepalese authorities; and IMF staff estimates.

1/ Fiscal year ending July 15.
2/ As of July 25, 2003.
3/ Mid–May.
4/ After grants.
5/ Includes re–exports.
6/ Before grants.

Statement by Sri Mulyani Indrawati, Executive Director for Nepal and Rewat Karki, Assistant to Executive Director
August 22, 2003

We, on behalf of our Nepalese authorities, would like to thank the staff for preparing a comprehensive and analytical report on Nepal's recent economic situation. The overall observations and suggestions put forth by the staff are commendable and should certainly be useful in the authorities' endeavors aimed at tackling the current socio-economic problems and addressing the structural development challenges of Nepal.

Development Challenges

Nepal's past development outcomes being only modest, the development challenges are hence daunting. The Ninth Development Plan (1997-2002) achieved an annual average GDP growth of 3.2 percent as against the targeted growth of 6 percent, with the respective growth of agricultural and non-agricultural sectors at 3.9 percent and 3.6 percent compared to the Plan targets at 4.0 percent and 7.3 percent respectively. Accordingly, the per capita GDP during the Plan period increased by an annual average of 0.9 percent, and the ratio of the population below the poverty line could fall only by 4 percentage points to 38 percent compared to the target of reducing it by 10 percentage points. Total investment as percent of GDP during the Plan period averaged 23.6 percent vis-a-vis the Plan target of 25.0 percent. Inflation averaged 5.7 percent vis-a-vis the Plan estimate of 6.5 percent. Macroeconomic stability in terms of the containment of inflation, balance of payments (BOP) surplus, exchange rate stability and competitive interest rate levels clearly depicted a mixed economic scenario during the Plan period.

Expediting economic development and reducing poverty through employment generation in the productive pursuits of the economy and providing access to productive resources for the poverty-stricken and marginalized sections of the population as well as the underdeveloped geographical regions thus become major challenges for the Nepalese authorities. The insurgency intensified as the situation of development outcomes falling below the expectations provided the insurgency the fertile ground and the fillip for its growth. In such a backdrop, the Tenth Development Plan (2002-2007) has now been under implementation. The Plan targets poverty reduction by 8 percentage points to 30 percent. The economic growth target is 6.2 percent with agriculture 4.1 percent and non-agriculture 7.5 percent. Total investment/GDP ratio is targeted at 25.9 percent. A total of 57.5 percent of the development expenditure would be financed through the foreign assistance (grants 23 percent and loans 34.5 percent).

Macroeconomic Developments

Despite the insurgency, macroeconomic developments in Nepal remained broadly satisfactory until 2000/01 as a result of the adoption of liberal economic policies. However, the Nepalese economy, for the first time in the last two decades, declined by 0.5 percent in 2001/02 due to the intense internal security problem emanating from the escalation of the insurgency together with the adverse external developments. The first year of the 10th Plan i.e. 2002/03, witnessed some positive outcomes, though quite modest from the perspective of the Plan targets. A positive growth in non-agriculture sector at 2.5 percent with the agricultural growth at 2.2 percent contributed to the overall growth rate of 2.4 percent in 2002/03. Though consumer price index (CPI) inflation increased by 4.8 percent in 2002/03 following the hike in administered prices of petroleum products, supply shortfalls, and price developments attributed to contraction in agricultural output in India, the inflation rate remained within the 5 percent target of the 10th Plan.

The external sector too recorded some improvements in 2002/03. Exports increased by 4.9 percent in 2002/03 as against a decline of 15.6 percent in 2001/02. Despite a decline of exports to India following the quantitative restrictions in the renewed trade treaty in 2002, a strong acceleration in garment exports contributed to the growth of overall exports in 2002/03. The import demand for both consumer and capital goods resulted in a 16.9 percent increase in import in 2002/03 as against a decline of 7.2 percent in the preceding year. Significant increase in the remittances resulted in a BOP surplus of US$ 66.7 million in 2002/03 from a deficit of US$ 42.7 million in the preceding year. As a result, the existing gross official international reserves at US$ 1.5 billion are sufficient to finance 11 months of merchandise imports.

The fiscal deficit narrowed down due mainly to the decline in development expenditure in conjunction with the satisfactory performance of revenue collection. In 2002/03, revenue grew by 11.5 percent compared to the 3.2 percent growth in 2001/02. As such, the budget deficit narrowed down to 4.7 percent of GDP in 2002/03 from 5.4 percent of GDP in 2001/02. Foreign assistance (grants and loans) rose by 20.4 percent in 2002/03 compared to 23.5 percent decline in 2001/02. Domestic loans, which had increased by 14.4 percent in 2001/02, declined by 46.6 percent in 2002/03. The treasury position at the end of 2002/03 showed the cash balance of His Majesty's Government (HMG) at US$ 17.7 million in sharp contrast to the overdraft of US$ 75.3 million at the end of the previous fiscal year.

Monetary Policy

The broad objectives of monetary policy in Nepal are to attain domestic price stability, maintain comfortable level of international reserves and make provision of adequate level of liquidity to facilitate the sustained level of economic growth. In the face of economic contraction, accommodative policy stance was adopted for 2002/03. Accordingly, CRR was cut by one percentage point. Monetary authorities sterilized foreign inflows by selling HMG securities nearly to the extent at which foreign exchange accretion took place at Nepal Rastra Bank (NRB). As a result of this, reserve money increased by less than one percent in 2002/03 compared to the significant rise of 11.9 percent in the preceding year. Similarly, narrow money growth was estimated at 7.5 percent in 2002/03 compared to the 9.3 percent rise in the preceding year. The major contributory factors for monetary growth were net foreign assets and the bank credit to the private sector with the negligible role of the banking sector's loans to HMG.

NRB unveiled its new monetary policy for 2003/04 on July 24, 2003. The new monetary policy has supported the current exchange rate peg regime with the Indian currency as the nominal anchor to ensure domestic price stability and, at the same time, to prevent real appreciation or depreciation of the Nepalese rupee. The new monetary policy has abolished the vault cash CRR of 2 percent and also simplified the CRR into a uniform rate of 6 percent. The policy is directed at domestic stability as well as reducing the external vulnerability by avoiding the unnecessary depletion of the nation's international reserves.

Financial Sector Reform

Under the World Bank-supported financial sector reform, the management of the two largest public sector commercial banks and the reengineering work of NRB have been contracted out to internationally recognized management groups: the management of Nepal Bank Limited (NBL) to the Bank of Scotland (Ireland) ICC consulting group, while that of Rastriya Banijya Bank (RBB), following the unilateral breach of agreement by the Deloitte Touche Tohmatsu, to a group of experts led by an American consultant. Similarly, the reengineering process of NRB has been entrusted to the IOS Partners, an American consultancy agency. In order to reduce the overstaffing especially at the non-officer level, NRB also launched a voluntary retirement scheme (VRS), which reduced 17 per cent staff mostly from the non-officer layers. The Debt Recovery Tribunal under the Debt Recovery Act has been constituted. HMG has reiterated its commitment to legal reforms including enacting the proposed legislation on Secured Transaction, Insolvency and Anti-money Laundering. In addition, with the view to reducing the non-performing assets (NPA) of the banking sector, HMG is going to introduce an ordinance to set up an Assets Management Company (AMC) within the first six months of the current fiscal year, and has earmarked US$ 2 million in the 2003/04 budget for this purpose. Credit Information Center with legal entity, in the form of public limited company, is also being established to cater the credit information needs of all the commercial banks and financial institutions. The structural reform of the rural development banks and the transfer to the private sector of the NRB-held shares in one of these banks are under implementation. The supervision system is being improved through the implementation of international standards of supervision. The central bank is committed to discharge its duties and responsibilities for the implementation of all the measures required toward loan recovery and reducing the ratio of NPA.

Since Nepal has accepted the obligations of Article VIII, it has not yet pursued capital account convertibility. Accordingly, commercial banks are not permitted to invest in Indian T-Bills. Moreover, trade deficit with India during 2002/03 has risen by 80.7 percent, resulting in the substantial decline in the Indian currency reserve to US$ 1.3 million in mid-July 2003 from US$ 3.2 million in mid-July 2002. In such a situation also, it would not be desirable to allow commercial banks invest in Indian T-Bills. The provisions with respect to the interest rates and foreign exchange rates are also aimed at stabilizing the financial markets. NRB directives for commercial banks, one of the focal points of the financial sector reform strategy, have been instrumental in improving the financial condition of the commercial banks besides enhancing the confidence of the public in the financial system. In the process of phasing out the priority sector credit requirement other than the deprived sector credit requirement of 3 percent of the total outstanding credit by 2007/08, the ratio for 2003/04 has been brought down to 6 percent. These directives and measures have also enhanced commercial banks' ability to price credit risk and expand profit opportunities even in the prevailing difficult economic situation of the country.

Fiscal Reform

In line with the Tenth Plan with single objective of poverty reduction, the budget for the current fiscal year has clearly visualized the multi-dimensions of the nature of poverty in terms of income poverty, human poverty and social exclusion as the cause of social conflict and unrest. The budget has also addressed programs and policies for poverty reduction and economic reform. They include regional balance, employment promotion, social justice within the framework of the Tenth Plan's growth target, fiscal balance, collaboration and partnership among the public and private sectors, transfer of ownership of State-owned enterprises through stock market, performance evaluation based on the prescribed criteria of the top management in public sector enterprises, strict financial discipline, anti-corruption drive, transparency in the financial decisions, etc. Efforts are also being made to reorganize programs within the framework of PRSP/Tenth Plan.

Expenditure and Revenue Reform

Though the recurrent expenditure comprising the debt servicing, salaries and allowances is not amenable to reduction at a single go, the authorities have expressed their long-term commitments to its reduction. On the development expenditure front, programs and projects are being prioritized and fund availability to higher priority projects has been ensured in conformity with the Medium-term Expenditure Framework (MTEF). To avoid the possibility of construction works turning out to be substandard and that of financial misappropriation due to the bulk expenditure incurred at the end of the fiscal year, the budget will be released only for the contracts awarded by the second week of February. Similarly, budget transfer or additional budget release for development programs would not be allowed after the second week of May in order to discourage the demand for development budget toward the end of the fiscal year. The authorities have continued to encourage higher community participation in the areas of education and health services through transferring these services to the Local Management Committees. An arrangement has also been made to launch special program to reconstruct infrastructures destroyed by the insurgents.

The thrust of the tax policy as spelt out in the budget is to enhance effectiveness and elasticity of the tax system by broadening the tax base with the reduction and adjustment in the tax rates. Efforts are underway to make the Income Tax Act, 2002 simple and understandable to tax payers. Similarly, broadening the VAT base, increasing the tax payers' awareness, auditing, improvement in customs valuation, tax payer registration campaign, Gift Lottery Program in Kathmandu Valley for encouraging billing practices, etc., have been initiated. In order to make Revenue Investigation Department more effective, additional legal provisions have been introduced. A cut in the personal income tax burden at lower income level has helped this group in easing their livelihood.

Corruption Control

To control the corruption at political level and to make donations more transparent, an arrangement has been made for providing the nationally recognized political parties grants at a rate of Rs 20 for each vote polled in the immediately preceding election for the House of Representatives. Based on the report of Property Investigation Commission as well as its own investigation, the Commission for the Investigation of the Abuse of Authority (CIAA) has been taking actions against civil service officials and politicians.

External Reforms

In the context of phasing-out of the MFA quotas in the near future and the WTO Working Party's recent recommendation to the Ministerial Conference to be held in Cancun, Mexico, during September 10-14, 2003 for Nepal's accession to WTO, it is but natural that Nepal pursue and be supported to expand access to overseas markets. Nepal has fulfilled the obligations under Article VIII and has further liberalized foreign exchange facility through the current fiscal year's monetary policy. As Nepal has open border and free convertibility of Indian rupee into Nepalese rupee, it would be more feasible and practical to move ahead a bit cautiously towards extending unlimited foreign exchange facility for personal travel even for bona fide reasons. As a step towards this, the recently announced monetary policy has unified and upgraded the foreign exchange passport facility at US$ 2000 for all countries, and NRB has also made arrangements to provide exchange facility exceeding the above amount based on the reasonable ground.

Additional items will be included in the list that can be imported from India through the payment of convertible currency. The provision of making exports through the cash against document (CAD) mechanism has been further liberalized up to US$ 100,000 by maintaining 10 percent bank guarantee replacing the existing amount of US$ 50,000 at 25 percent bank guarantee. The amount of imports from third countries through the draft/TT has been raised from the existing US$ 3,000 to US$ 30,000. The facility of opening usance letter of credit, which has so far been extended to the industrial importers, has also been allowed for other importers. Commercial banks are allowed to make inter-bank transactions of the Indian currency among themselves.

Statistical Issues

Our authorities would like to acknowledge the technical assistance in the areas of monetary and banking, foreign exchange and BOP, multi-sector data dissemination and management. Nepal has benefited greatly from such technical assistance and has implemented a number of recommendations in different statistical areas. The NRB is to incorporate the major deposit-taking institutions through the compilation of the banking survey within the current fiscal year. The multi-sector statistics mission has been very useful and Nepal has been participating in the GDDS framework for compiling and disseminating macroeconomic and socio-demographic data. The authorities are looking forward to receiving further support in the future.

PRGF Issues

As a result of positive impacts of policy reform measures in various sectors of the economy, the World Bank upgraded Nepal's status in its funding program from that of the low case to the base case level. The financial sector reform program is being implemented with the highest priority. The MTEF and the Tenth Plan are also under implementation. Macroeconomic indicators are broadly on the right track. The successful conclusion of the ongoing dialogue with the insurgents along with the macroeconomic policies and developments as outlined above are expected to pave the way for a conducive environment to give a big push to the Nepalese economy. Against this backdrop, the Nepalese authorities would like to enter into PRGF arrangement with the IMF.

Conclusion

The current challenge facing Nepal is the restoration of peace and security towards which HMG has been committed and is also ushering in a positive environment for this purpose. Since some normalcy has returned following the announcement of the ceasefire for the last 6-7 months, a rebound of economic activities is in the offing. The third-round of talks between HMG and the insurgents was held during August 17-20, 2003. With the ongoing peace talks, the implementation of some of the key reform programs and the sustenance of the overall macroeconomic stability, the Nepalese authorities are eagerly looking forward to entering into the PRGF program. The program would go a long way in assisting Nepal in its task of expediting the much-needed economic development by building on the intensified economic reform endeavors and the improvements in the overall macroeconomic management. Obviously, domestic efforts alone would not be adequate to provide the necessary wherewithal for Nepal to spur economic growth and combat poverty. Hence, Nepal seeks and looks forward to financial and technical support from the international community.