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Nepal: Fifth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waivers for Nonobservance of Performance Criteria—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Nepal

In the context of the fifth review under the three-year arrangement under the Poverty Reduction and Growth Facility, and a request for waivers for nonobservance of performance criteria, the following documents have been released and are included in this package:

- The staff report for the Fifth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waivers for Nonobservance of Performance Criteria prepared by a staff team of the IMF, following discussions that ended on September 30, 2007 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 October 31, 2007. 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 Press Release summarizing the views of the Executive Board as expressed during its November 9, 2007 discussion of the staff report that completed the review and request.

- A statement by the Executive Director for Nepal.

The document listed below has been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Nepal*

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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NEPAL

Fifth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waivers for Nonobservance of Performance Criteria

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by Steven Dunaway and Matthew Fisher

October 31, 2007

- A three–year PRGF arrangement (for an amount equivalent to SDR 49.9 million, 70 percent of quota) was approved by the Executive Board on November 19, 2003. The first review was completed on October 20, 2004. The second and third reviews were completed on November 10, 2006; the PRGF arrangement was extended to November 18, 2007, and reviews and disbursements under the arrangement were rephased. The fourth review was completed on June 13, 2007.

- Discussions on the fifth (and final) review were held in Kathmandu during September 19–30. The staff team comprised Messrs. Kalra (Head), Aisen, and Ginting (all APD), Ms. Khemani (PDR) assisted by Mr. Pitt, Resident Representative. The mission coordinated with the resident AsDB and World Bank offices. Mr. Acharya (Senior Advisor to Executive Director) participated in the discussions.

- The mission met with Finance Minister Mahat, Nepal Rastra Bank Acting Governor Manandhar, National Planning Commission Vice Chairman Pokharel, senior government and Nepal Rastra Bank officials, and donor and civil society representatives.

- In completing the fourth review, Directors commended the Nepalese authorities for keeping the program broadly on track in the difficult political environment. Directors noted that peace and political stability remain critical to Nepal's long-term economic prospects. Going forward, significant challenges and risks remain, underscoring the need for the authorities to press ahead with implementation of the economic reform agenda in key areas, including the fiscal sector, financial sector, and public enterprises.

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EXECUTIVE SUMMARY

The political situation is in flux and significant risks remain. Following demands from the Communist Party of Nepal (Maoist, CPN-M) for declaration of a republic and for changes in the electoral system, the constituent assemby elections have been postponed from November 22; a new date has not yet been announced. Financing needs and logistics of the peace process—maintenance of camps for former Maoist combatants, their integration into the Nepal Army, preparations for the elections, and maintaining law and order—pose continuing challenges.

Economic outcomes have been broadly in line with the program, and macroeconomic policies have remained sound. Real GDP growth rose to 2½ percent in 2006/07 from under 2 percent in 2005/06. With the exchange rate pegged to the Indian rupee, underlying inflation returned to 5 percent by year end. The 2006/07 budget exceeded its revenue target, aided by a strong tax administration effort, and domestic financing was lower-than-programmed. Monetary management by Nepal Rastra Bank (NRB) remained geared to maintaining the exchange rate peg to the Indian rupee.

As the PRGF-supported program draws to a close, macroeconomic stability remains intact but the speed of structural reform implementation has been slow. All quantitative performance criteria for the review (test date was July 15, 2007) were met, with significant margins. While nonobservance for most structural performance criteria (SPC) was minor or temporary, implementation of measures related to the PCs was delayed.

Going forward, macroeconomic policies remain anchored and the authorities are aware of the need for further structural reforms. The 2007/08 budget is appropriately focused on social sectors and infrastructure spending in rural areas, a higher targeted revenue-to-GDP ratio, and limited domestic financing. The exchange rate peg to the India rupee should help maintain inflation close to levels in India. Structural reforms in the fiscal, financial, and public enterprise sectors are key for sustained growth and poverty reduction. Fiscal reforms should be geared to improving tax administration to reduce leakages and broaden the tax base. Financial sector reforms can help improve intermediation and financial stability. Price adjustments and the timely introduction of an automatic pricing mechanism for petroleum products are needed to put Nepal Oil Corporation finances on a sustainable footing.

The authorities' efforts and achievements—sustained macroeconomic stability and progress on the structural reform front under trying political circumstances—merit international support. Staff recommends approval of the authorities' request for waivers for nonobservance of performance criteria and completion of the fifth (and final) review under the arrangement.

I. INTRODUCTION

1. **As the PRGF-supported program draws to a close, macroeconomic stability remains intact but the difficult political environment continues to weigh on the speed of structural reform implementation**. For the near term, macroeconomic policies are anchored by the 2007/08 budget and the exchange rate peg to the India rupee. At the same time, the authorities' focus remains on consolidating the peace process, including the rehabilitation of Maoists combatants into the mainstream, recuperation of civil society from the 11-year old insurgency, and building inclusive political and social institutions. However, the scope for extensive structural reforms remains circumscribed until the political environment has settled. Incremental reforms should still be possible, as has been the case since late 2003.

2. **The political situation is in flux and significant risks remain**. Maoist ministers resigned from the interim government in late September to press their party's demands for declaration of a republic and for changes in the electoral system. With this, constituent assembly elections have been postponed from November 22; a new date for the elections has not yet been announced. Nevertheless, the Communist Party of Nepal (Maoist, CPN-M) remains a part of the seven party alliance.[1] Financing needs and logistics of the peace process—maintenance of camps for former Maoist combatants, their integration into the Nepal Army, preparations for the elections, and maintaining law and order—pose continuing challenges.

II. ECONOMIC DEVELOPMENTS AND PERFORMANCE UNDER THE ARRANGEMENT

3. **Economic outcomes were broadly satisfactory during 2006/07**.[2] Real GDP rose by 2½ percent, notwithstanding poor weather conditions which affected paddy production and political uncertainties which continued to dampen nonagricultural activity (Table 1). Tourism, transportation, construction, and services contributed to growth. On the demand side, activity remained dependent on consumption (driven by strong remittances) and public spending, while private investment remained dampened by the unfavorable investment climate, including power shortages and work disruptions. With the exchange rate peg to the Indian rupee, headline inflation in mid-August 2007 was 6¼ percent, broadly in line with price developments in India. Supported by robust remittances, international reserves stood at around US$2 billion (6½ months of goods and services imports).

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[1] With the reunification of two factions of the Nepali Congress in late September, the eight party alliance is now an alliance of seven parties.

[2] Fiscal year begins mid-July.

4. **Macroeconomic policies remained sound**.

- The 2006/07 budget provided for higher customs duty rates on selected imports, and a broadening of the income and excise tax bases. In the event, the budget exceeded its revenue target, aided by a strong tax administration effort. Current spending was lower-than-budgeted, reflecting savings from the postponement of elections to the next fiscal year. Capital spending picked up with a real increase of around 20 percent over 2005/06. While external aid fell short of the budgeted amount, at under 1 percent of GDP domestic financing was lower-than-programmed (1½ percent of GDP).

- Monetary management by Nepal Rastra Bank (NRB) remained geared to maintaining the exchange rate peg to the Indian rupee.

- All quantitative performance criteria for the review (test date was July 15, 2007) were met, with significant margins. All indicative targets (test date was April 13, 2007), with the exception of the floor on government revenue, were also met.

5. **Implementation of a number of measures related to structural performance criteria was delayed**. The authorities have requested waivers for nonobservance of six structural performance criteria (SPCs).

- For five PCs, the nonobservance was minor or temporary:

  - Inland Revenue Department (IRD) to reduce VAT nonfilers to 12½ percent or less of registered VAT taxpayers. The average of nonfilers over the filing months April/May and May/June was 12.7 percent;[3]

  - Customs Department to establish a wide-area network (WAN) for headquarters and at least five large customs offices (July 15). The WAN was established on July 19;

  - NRB to divest its shareholding in Non-Life Insurance Division of Rastriya Beema Sansthan July 15. The divestment was completed on October 8;

  - NRB to divest its shareholding in at least two rural development banks (July 15). The NRB divested its shareholding in the Eastern Rural Development Bank before July 15; divestment in the Central Rural Development Bank was completed on August 23; and

[3] Computation of the nonfiler rate excludes suspended VAT taxpayer IDs. The IRD has issued instructions to revenue offices that arrears of suspended taxpayer ID numbers be reviewed with a view to deregistering those that have minor repayments due and to pursue larger offenders for collections.

- Nepal Oil Corporation to finalize audit of its 2005/06 accounts in accordance with international standards (July 15). The audit was finalized on October 17.[4]

- Cabinet approval of a revised Banking and Financial Institutions Act (BAFIA) has not been received. However, the NRB has made significant progress on revising the BAFIA, and the revised draft has been finalized and submitted to the cabinet. The authorities have requested a waiver for nonobservance of the SPC, with the commitment that cabinet approval (and submission to parliament which was a structural benchmark for September 30) should be possible at an early date.

III. Report on the Discussions

6. **The interim government expressed a commitment to maintaining macroeconomic stability and advancing reforms in key areas**. The government's objectives remain sound economic management, expenditure prioritization, structural reform in major economic sectors, and improved governance to deliver conditions for sustained growth and poverty reduction.[5] Beyond the program period, the authorities remain interested in a successor arrangement to support a three-year interim plan which is being finalized, and to further implement structural reforms. The plan's focus is on rehabilitation, reconstruction, and recovery from the insurgency.

A. Macroeconomic Outlook and Risks

7. **Nepal's economic prospects can improve with normalization of the political situation and reform implementation**. On balance, real GDP growth could rise to 4 percent in 2007/08, subject to favorable agricultural performance, and continued strength in tourist arrivals with a knock on effect on the service sector more generally. A continuation of the pickup in budgetary capital spending (especially on rural infrastructure) could provide a welcome stimulus to economic activity. Manufacturing activity is likely to remain sub par until input (including petroleum products) supply disruptions are fully overcome and political uncertainties are resolved to create an environment for higher investment. Over the medium term, growth could rise gradually to historical levels of 5−5½ percent if structural reforms are implemented. With the exchange rate peg, underlying inflation should remain in the 5−6 percent range, comparable to Indian levels. On the balance of payments, continued strong remittances and higher aid flows could offset trade deficits (in part due to higher

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[4] Four structural benchmarks (out of six) were observed. With the delay in cabinet approval of BAFIA, the submission to parliament of the revised BAFIA and NRB issuance of guidelines for mergers and acquisitions (M&A) of banks and financial institutions were not implemented. Submission of BAFIA to parliament can be done after cabinet approval and M&A provisions are part of the revised BAFIA.

[5] A progress report on Tenth Plan/PRSP implementation in 2004/05 was completed in June 2006, and circulated to the Executive Board in October 2006. A Joint Staff Advisory Note was circulated to World Bank/IMF Executive Boards in December 2006. A progress report on Tenth Plan/PRSP implementation in 2005/06 was completed in December 2006, and circulated to the Board in May 2007.

imports as growth recovers) and help maintain reserves at 5½ months of goods and services imports.

8. **The unsettled political environment poses the most immediate risks to growth**. Progress on the peace process and rehabilitation of Maoist combatants has been slow. Risks from the slow pace of progress on this front, and from the political situation more generally will subside only after the constituent assembly elections have been held and the results are broadly accepted. Meanwhile, with the intense focus on the political front, the space for structural reforms implementation remains constrained in the near term.

B. Fiscal Policy

9. **The 2007/08 budget adopted in mid-July was broadly in line with the authorities' medium-term fiscal objectives**. The budget targets an increase in the revenue-to-GDP ratio of about ¾ percentage point to 12¾ percent, the bulk of the increase coming from the sale of shares in Nepal Telecommunications Corporation (⅔ percent of GDP) and further improvement in tax administration (especially excises). On the expenditure side, the budget provides for an increase in civil service wages, election-related spending, maintenance of Maoists cantonments, and a step up in capital spending. External aid (net loans and grants) are projected to increase from 2¾ percent of GDP in 2006/07 to 4¼ percent of GDP. With this, the overall and domestically financed deficits are targeted at 2¾ percent and 2 percent of GDP, respectively (Table 2).

10. **The medium-term fiscal objectives are to raise resources to finance the peace process, infrastructure, and structural reforms while lowering the public debt-to-GDP ratio**. Staff proposed that overall and domestically financed deficits be held at levels that maintain fiscal sustainability, while allowing adequate room to accommodate the costs of reforms in the financial sector and public enterprises. In this framework, the revenue-to-GDP ratio is targeted to increase to at least 13 percent by 2010/11 through further improvements in administration and base broadening, including reductions in customs and excise leakages. On the spending side, the priorities include rehabilitation, reconstruction, and recovery.[6] In addition, higher spending is required on key social sector and infrastructure projects, especially in the rural areas where the bulk of the poor live. Staff projections suggest that overall deficits in the range of 2½−3 percent of GDP can maintain the public debt-to-GDP ratio on a downward trajectory in a baseline scenario. The priorities of the interim plan are broadly consistent with this framework. In the baseline scenario, public debt is projected to

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[6] To raise external resources for peace-related activities, the GON set up a Peace Fund to attract donor and other financing. The Peace Fund was set up as an off-budget fund, with its own regulations and reporting requirements, to assure donors that their contributions would be earmarked for the designated purposes. Donor contributions to the fund have so far been limited.

decline from 48 percent at end-2006/07 to 44 percent by 2010/11.[7] [8] Relatedly, the authorities remain ambivalent about participation in the HIPC/MDRI initiatives, with their concerns about the potential impact on net inflows in the aftermath of debt relief, and reputation effects given their strong record of debt service payments.

C. Monetary and Exchange Rate Policies

11. **The authorities intend to maintain the exchange rate peg to the Indian rupee which has served Nepal well**. The peg has helped to anchor inflation expectations given the substantial volume of current account transactions with India, and possibly unrecorded capital account movements given the large and porous border and close, informal ties between Nepalese and Indian businesses. With this, for 2007/08, reserve money growth is projected at 11 percent with NRB net foreign assets accumulation of US$120 million. Broad money growth is projected at around 15½ percent, assuming a small decline in velocity and a pickup in real GDP growth to 4 percent. This would accommodate the financing needs of the budget while allowing real private sector credit growth of 10 percent (Table 3). As regards external competitiveness, along with the nominal appreciation (of the Indian and Nepalese rupees) vis-à-vis the dollar, the real exchange rate has appreciated by about 7½ percent since end-2006.[9]

D. Structural Reforms

Fiscal Sector

12. **Fiscal sector reforms are to remain centered on tax administration, with added emphasis on public financial management and fiscal transparency**. The LTO intends to further improve its operations by adopting a risk-based methodology for audit. Parliament has approved a new, overhauled Customs Act to facilitate trade, consistent with WTO and other international commitments. With the installation of the WAN, the focus of the Customs Department would be on installation of the ASYCUDA system and improvements in management practices and procedures. As regards fiscal transparency, the government is

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[7] This excludes liabilities from financial sector and public enterprise reforms which are expected to be in the range of 7−8 percent of GDP. The bulk of the carrying cost associated with these liabilities would be interest payments on recapitalization of insolvent commercial banks (the banks would be recapitalized with external assistance, most likely from the World Bank). In addition, the budget needs to provide for resolving outstanding liabilities of ailing state-owned enterprises. The carrying cost is expected to be ¼–¾ percent of GDP.

[8] LIC-DSA public and external debt projections, prepared jointly with the World Bank, were presented in IMF Country Report 07/204. The main elements of these projections and the staffs' assessment that Nepal's external debt dynamics are subject to a high risk of debt distress remain valid. The main vulnerabilities relate to export shocks and a large depreciation in the exchange rate. Overall, the debt ratio are lower relative to the LIC-DSA due to the upward revision of GDP data for 2000/01 onwards by the Central Bureau of Statistics.

[9] The appropriate response to this appreciation and exchange rate policy issues will be taken up during the forthcoming Article IV consultation discussions, bearing in mind that over the medium term structural reforms and infrastructure investments remain critical to improving competitiveness.

committed to implementing recommendations made recently as part of IMF technical assistance to improve public financial management and in the fiscal transparency module of the draft *Report on Standards and Codes*. These include broadening the coverage of fiscal reporting to general government, progressive reduction in off-budget funds, and improvements in cash management through the introduction of a treasury single account.

Financial Sector

13. **The authorities agree that progress is required on financial sector reforms in four broad areas**.

- Gaps in the regulatory and legal framework, which compromise the overall soundness of financial institutions, are being addressed by the NRB. The revised BAFIA provides for clearer incorporation principles for various categories of banks, improved loan recovery provisions, strengthened procedures for voluntary and involuntary liquidation of financial institutions, and clear guidelines for mergers and acquisitions. Following consultations with key stakeholders (including the Nepal Bankers' Association), the draft has been submitted for cabinet consideration. Anti-Money Laundering legislation has been submitted for parliamentary approval.

- To strengthen the NRB, the supervision department is implementing a time bound action plan to remedy gaps identified in its self-assessment against Basle Core Principles for Effective Bank Supervision, with IMF technical assistance. In addition, NRB "reengineering" plans are focused on eliminating noncore functions. NRB divestment of its shareholdings in two financial institutions is part of these efforts. The NRB is also taking steps to strengthen its financial safeguards, building on the findings of the 2004 safeguards assessment and external audits by an international audit firm.

- External management teams are making progress in reducing balance sheet weaknesses in two large state owned/controlled banks (Nepal Bank Limited and Rastriya Banijya Bank).[10] In late July, the management contract for the external management team for NBL expired, under contentious circumstances, and management of the bank was taken over by the NRB. Since then, the authorities and the World Bank have been in negotiations to agree on a management arrangement for the bank. The external management contract for the RBB currently ends in early 2008. While the GON and NRB remain committed to restructuring of the banks, the current political environment has made it difficult to map out a clear strategy for further steps, including in the context of the World Bank-supported Financial Sector

[10] NBL and RBB represent more than half of banking system assets, and half of their loan portfolio is nonperforming. The negative net worth of NBL and RBB in mid-July 2007 was Nrs. 6 billion (¾ percent of GDP) and Nrs. 17 billion (2½ percent of GDP), respectively.

Reform Program. As regards other banks, progress is being made by NRB-appointed management teams in two other financially troubled banks.

- The GON and NRB seized the passports of 32 large, willful defaulters in July, in addition to the passports of 80 defaulters that were impounded in February. In addition, their bank accounts were frozen, and restrictions were placed on asset sales by them except for the purpose of loan repayments. Notwithstanding these measures, loan recovery from these defaulters have been limited, in part due to insufficient enforcement mechanisms available to commercial banks, including recourse to the judicial system. Strengthening these mechanisms remains an important task.

Nepal Oil Corporation and the Oil Sector

14. **The government has been unable to raise prices of petroleum products to address NOC losses**.[11] Accumulated losses and suppliers' credits with the Indian Oil Corporation have disrupted supplies for an extended period now and generated long queues at fueling stations. Despite calls from consumer groups that supplies be normalized even if it requires price increases and their own full recognition of the need to adjust prices, the authorities remain concerned about political agitations. With this, the authorities indicated their readiness to adjust prices at the earliest possible opportunity. Staff urged the authorities to aim for early price adjustments, for introduction of an automatic pricing mechanism in mid-2008 at the time of the 2008/09 budget. In the meantime, the budget should cover all NOC flow losses in a transparent manner and lending for this purpose should be reflected in public debt. Price adjustments would also facilitate private sector participation, with parliamentary approval of Petroleum Sales and Distribution Act to liberalize the oil sector.

IV. Staff Appraisal

15. **As the peace process inches forward, resolution of political uncertainties remains critical to an improvement in Nepal's prospects**. In the meantime, the interim government remains subject to public and international scrutiny on its ability to negotiate demands from various groups, restoration of durable law and order, and conduct of widely acceptable constituent assembly elections.

16. **The economy has been resilient**. In 2006/07, real GDP registered modest growth. In 2007/08, growth could be higher if the tourism rebound continues, the political situation normalizes, and government spending picks up. There are also some indications that labor disputes have simmered down, allowing for a small pick up in manufacturing. Over the medium term, growth rates upwards of 5 percent are achievable if macroeconomic stability

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[11] In August 2007, these accumulated losses stood at Nrs. 13¾ billion (1¾ percent of GDP). The bulk of the ongoing losses of the NOC are on LPG which is mostly consumed by the middle income earners in urban areas. World Bank Poverty and Social Impact Analysis suggest that the impact of the prices increases on the poor would be limited given the small share of expenditure on petroleum products in their consumption basket.

can be maintained and structural reforms are implemented in key areas, including the financial sector, public enterprises, and governance.

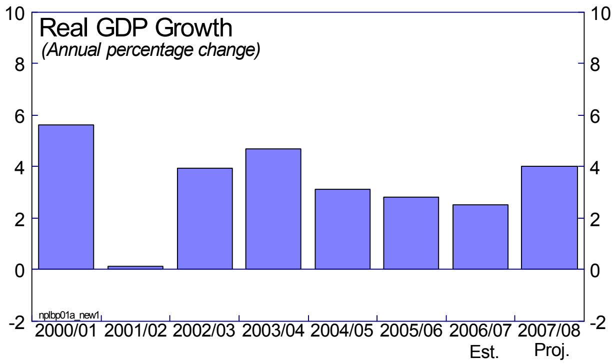
17. **Continued macroeconomic stability is contingent on prudent fiscal policies while accommodating the changing needs of the peace process**. The 2007/08 budget is appropriately focused on social sectors and infrastructure spending in rural areas, a higher targeted revenue-to-GDP ratio, and limited domestic financing. On the revenue front, progress has been made in improving tax administration, especially at the Large Taxpayer Office. The medium term budget priorities remain raising revenue and adequate concessional external assistance to increase social sector and infrastructure spending, while reducing the public debt-to-GDP ratio. External assistance will be required to finance liabilities arising from financial sector and public enterprise reforms. The GON's commitment to improve public expenditure management and increase fiscal transparency is welcome.

18. **Much remains to be accomplished on financial sector and public enterprise reforms**. The revised BAFIA would provide a strengthened framework for financial sector activity, facilitate consolidation and raise financial sector integrity. For its part, the NRB needs to fully remedy gaps identified in its supervisory framework. Substantial loan recovery from large, willful defaulters, which has been elusive, remains key to improving the financial condition of NBL and RBB. The authorities also need to agree on (and implement) a strategy for concluding the restructuring of the two banks. As regards the NOC, while the increment in public debt-to-GDP ratio from flow losses covered by the budget would be manageable over the medium term, staff recommends adjustments in the petroleum products prices at an early date to allow introduction of an automatic pricing mechanism.

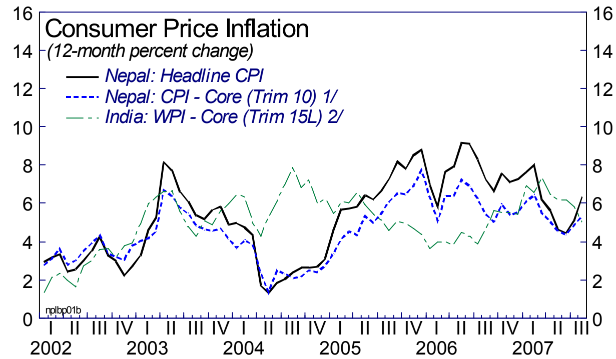
19. **The authorities continue to maintain macroeconomic stability and make some headway on implementation of structural reforms under trying circumstances**. The commitment to prudent macroeconomic policies is reflected in the strong revenue performance of the 2006/07 budget, maintenance of the exchange rate peg to the Indian rupee, and observance of all quantitative performance criteria for the fifth review. Overall, the authorities' efforts to maintain macroeconomic stability over the course of the arrangement in a difficult environment are commendable. In addition, delays in implementation notwithstanding, a strong effort has been made to implement structural reform measures envisaged under the program. With respect to the waivers requested for completion of the review, the nonobservance of five structural performance criteria was minor or temporary. For cabinet approval of BAFIA, significant progress has been made in completing the technical work reflecting the commitment of the GON and NRB to implementation. With this, staff recommends approval of the authorities' request for waivers for nonobservance of performance criteria, and completion of the fifth (and final) review under the arrangement.

Figure 1. Nepal: Economic Developments and Prospects

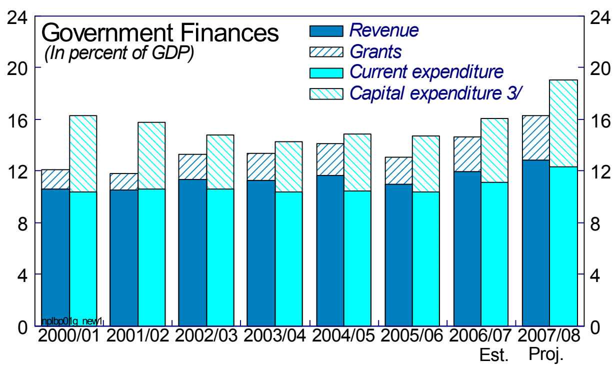
Nepal's growth prospects are expected to improve...



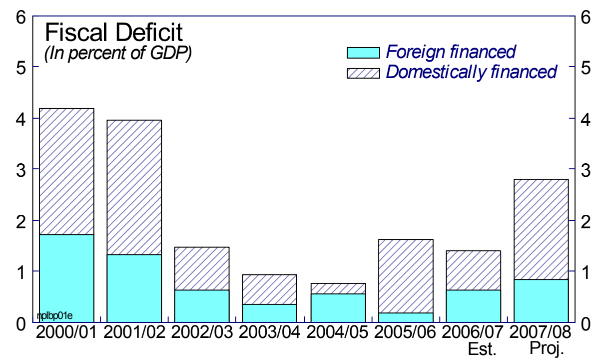
... and inflation remains in line with price developments in India.



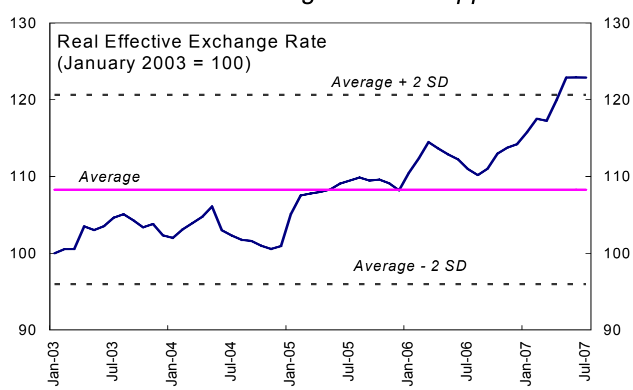
Revenue mobilization and development spending are expected to increase...



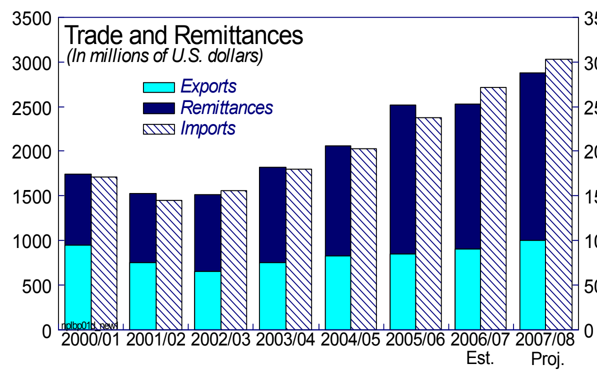
... and the overall and domestically financed deficits should remain contained.



The real effective exchange rate has appreciated.



Remittance inflows are expected to stay strong, offsetting weak export growth and higher imports.



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

1/ Trim 10 percent from both sides of the distribution of monthly price changes
2/ Asymmetric trim, respectively, excludes 15 and 20 percent on the left and right end of the distribution
3/ Includes net lending.

Table 1. Nepal: Selected Economic Indicators, 2002/03–2007/08 1/

Nominal GDP (2005/06): US$8,929 million
Population (2005/06): 25.9 million
GDP per capita (2004/05): US$345
Poverty rate: 31 percent (2003/04)
Main exports: Textiles and clothing
Quota: SDR 71.3 million

	2002/03	2003/04	2004/05	2005/06	2006/07 Est.	2007/08 Proj.
	(Percent change)					
Real GDP at market prices	3.9	4.7	3.1	2.8	2.5	4.0
CPI (12-month change)	6.1	2.0	6.6	8.3	5.1	6.4
CPI (period average)	4.7	4.0	4.5	8.0	6.4	6.5
GDP deflator	3.1	4.2	6.5	6.7	8.6	6.5
Fiscal indicators	(In percent of GDP)					
Total revenue	11.4	11.3	11.7	10.9	12.0	12.8
Total expenditure	14.8	14.3	14.9	14.7	15.7	19.1
Current expenditure	10.6	10.3	10.5	10.4	10.6	12.3
Capital expenditure and net lending	4.2	4.0	4.4	4.3	5.1	6.8
Overall deficit before grants	3.4	3.0	3.2	3.8	3.6	6.2
Overall deficit after grants	1.5	0.9	0.8	1.6	1.4	2.8
Domestic financing (net)	0.9	0.6	0.2	1.4	0.9	2.0
Public debt	62.4	59.8	53.9	51.1	48.0	47.4
Money and credit	(Percent change, end-of-period)					
Broad money	9.8	12.8	8.3	15.4	14.0	15.6
Domestic credit	12.0	9.8	13.9	16.3	12.1	16.2
Private sector credit 2/	14.8	14.2	12.9	17.8	12.1	16.0
Velocity	2.0	1.9	2.0	1.9	1.8	1.7
Interest rates	(In percent)					
91-day treasury bill (end-of-period) 3/	3.0	1.5	3.9	3.3	2.8	…
Central bank refinancing 3/	2–5½	2–5½	1½–5½	1½–6¼	1½–6¼	…
Loans to industry 3/	8½–14	8½–13½	8¼–13½	8–13½	8–13½	…
Balance of payments	(In millions of U.S. dollars)					
Current account balance (excluding official transfers)	16	59	-19	53	-146	-230
In percent of GDP	0.3	0.8	-0.2	0.6	-1.5	-2.2
Trade balance	-904	-1,053	-1,190	-1,521	-1,761	-2,023
In percent of GDP	-14.3	-14.5	-14.6	-17.0	-17.9	-19.2
Foreign direct investment	12.4	1.9	1.9	-6.5	5.1	15.0
In percent of GDP	0.2	0.0	0.0	-0.1	0.1	0.1
Gross official reserves (end-of-period)	1,178	1,457	1,501	1,797	2,008	2,144
In months of imports of goods and services	6.6	7.3	6.4	6.7	6.6	6.4
Export value growth 3/	5.6	14.7	11.2	2.2	4.9	10.8
Import value growth	7.5	15.8	12.2	17.3	11.9	13.5
External debt/GDP (in percent) 4/	48.8	47.4	41.9	38.9	36.2	35.1
Debt service 5/	5.0	4.5	4.5	4.0	3.6	3.4
Exchange rate (Nrs./U.S. dollar, end-of-period)	75.1	74.5	70.7	74.4	65.2	...
REER (end-of-period; percent change; negative = depreciation)	3.0	-2.2	7.0	1.4	10.7	...
NEER (end-of-period; percent change)	0.1	0.1	3.3	-2.9	8.3	...
Fund operations (outstanding loans at end-of-period; SDR millions)						
SAF/ESAF/PRGF	1.7	7.1	14.3	14.3	39.2	...
Nominal GDP at market prices (Nrs. billions)	492.2	536.7	589.4	646.5	719.5	796.8

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

1/ Fiscal year begins mid-July.
2/ Includes lending by the Agriculture Development Bank of Nepal (ABDN) since July 2006. Reflects loan write-off of Nrs. 16 billion during July to December 2006.
3/ Excluding re-exports.
4/ Includes estimated short-term trade credits.
5/ In percent of exports of goods, services, and private transfers and income receipts; including debt service to the Fund.

Table 2. Nepal: Summary of Government Operations, 2005/06–2010/11 1/

	2005/06		2006/07			2007/08	2008/09	2009/10	2010/11
	Budget	Outcome	Budget	Program	Estimate	Budget	Projection		
	(In billions of Nepalese rupees)								
Total revenue and grants	98.9	84.6	108.2	104.5	102.7	129.8	142.5	158.0	175.6
Total revenue	80.3	70.8	84.5	85.3	86.4	102.3	113.5	127.0	142.1
Tax revenue	63.9	57.4	69.9	70.4	71.2	81.0	90.5	101.7	114.1
Nontax revenue 2/	16.4	13.3	14.5	15.0	15.2	21.3	23.0	25.3	28.0
Grants	18.7	13.8	23.7	19.2	16.4	27.5	29.0	31.0	33.5
Total expenditure	111.5	95.1	127.8	124.2	112.6	152.1	167.2	185.7	206.1
Current	75.9	67.0	83.8	87.3	76.0	98.2	106.0	117.5	130.0
Of which: interest payments	7.4	6.2	7.9	7.2	6.2	7.4	7.8	8.1	8.4
Capital and net lending	35.7	28.1	44.1	36.9	36.7	53.9	61.2	68.2	76.1
Overall balance before grants	-31.3	-24.3	-43.4	-38.9	-26.3	-49.8	-53.7	-58.6	-64.0
Overall balance after grants	-12.6	-10.5	-19.6	-19.7	-9.9	-22.3	-24.7	-27.6	-30.5
Financing	12.6	10.5	19.6	19.7	9.9	22.3	24.7	27.6	30.5
Net foreign loans	8.0	1.2	9.4	8.0	3.4	6.6	9.2	12.2	15.2
Gross disbursements	14.5	8.2	16.9	15.0	10.9	14.9	17.6	20.6	23.6
Amortization	6.5	7.0	7.5	7.0	7.5	8.3	8.4	8.4	8.4
Net domestic financing	4.6	9.3	10.2	11.7	6.5	15.7	15.6	15.4	15.3
Central bank financing	...	-0.1	...	...	1.8	...	...	...	...
Commercial bank financing	...	10.3	...	...	7.0	...	...	...	...
Nonbank financing	...	-1.0	...	...	-2.2	...	...	...	...
	(In percent of GDP)								
Total revenue	12.4	10.9	11.7	11.9	12.0	12.8	12.9	13.0	13.1
Tax revenue	9.9	8.9	9.7	9.8	9.9	10.2	10.3	10.4	10.5
Nontax revenue 2/	2.5	2.1	2.0	2.1	2.1	2.7	2.6	2.6	2.6
Grants	2.9	2.1	3.3	2.7	2.3	3.4	3.3	3.2	3.1
Total expenditure	17.3	14.7	17.8	17.3	15.7	19.1	18.9	19.0	19.0
Current	11.7	10.4	11.6	12.1	10.6	12.3	12.0	12.0	12.0
Of which: interest payments	1.1	1.0	1.1	1.0	0.9	0.9	0.9	0.8	0.8
Capital and net lending	5.5	4.3	6.1	5.1	5.1	6.8	6.9	7.0	7.0
Overall balance before grants	-4.8	-3.8	-6.0	-5.4	-3.6	-6.2	-6.1	-6.0	-5.9
Overall balance after grants	-1.9	-1.6	-2.7	-2.7	-1.4	-2.8	-2.8	-2.8	-2.8
Financing	1.9	1.6	2.7	2.7	1.4	2.8	2.8	2.8	2.8
Net foreign loans	1.2	0.2	1.3	1.1	0.5	0.8	1.0	1.2	1.4
Gross disbursements	2.2	1.3	2.4	2.1	1.5	1.9	2.0	2.1	2.2
Amortization	1.0	1.1	1.0	1.0	1.0	1.0	1.0	0.9	0.8
Net domestic financing	0.7	1.4	1.4	1.6	0.9	2.0	1.8	1.6	1.4
Central bank financing	...	0.0	...	...	0.2	...	...	...	...
Commercial bank financing	...	1.6	...	...	1.0	...	...	...	...
Nonbank financing	...	-0.1	...	...	-0.3	...	...	...	...
Memorandum items:									
Public savings	0.7	0.6	0.1	-0.3	1.4	0.5	0.8	1.0	1.1
Primary balance	-0.8	-0.7	-1.6	-1.7	-0.5	-1.9	-1.9	-2.0	-2.0
Debt service	3.3	3.2	3.2	3.0	0.2	2.8	2.7	2.5	2.3
Domestic	1.9	1.7	1.7	1.7	0.2	1.4	1.4	1.3	1.2
Foreign	1.4	1.4	1.5	1.3	0.0	1.4	1.3	1.2	1.1
Public debt	50.1	51.1	48.5	48.7	48.0	47.4	46.2	45.0	43.8
Domestic	13.8	14.8	14.7	14.9	14.2	14.8	15.1	15.2	15.1
External	36.3	36.3	33.8	33.8	33.8	32.6	31.1	29.8	28.7
Education expenditure	3.3	3.0	3.2	...	3.2	3.5	...	...	...
Health expenditure	1.2	0.9	1.3	...	1.2	1.5	...	...	...
Nominal GDP (Nrs. billions)	646.5	646.5	719.5	719.5	719.5	796.8	883.0	978.1	1083.5

Sources: Data provided by Nepalese authorities; and 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.

Table 3. Nepal: Monetary Accounts, 2003/04–2007/08

	2003/04	2004/05	2005/06	2006/07				2007/08
	Jul.	Jul.	Jul.	Oct.	Jan.	Apr.	Jul. Est.	Jul. Proj.
Monetary authorities	(In billions of Nepalese rupees)							
Reserve money	94.4	96.5	110.7	115.9	110.8	113.5	119.3	132.5
Net foreign assets	108.2	103.9	131.6	130.2	135.0	135.0	126.3	134.0
Net domestic assets	-13.8	-7.3	-20.8	-14.3	-24.2	-21.5	-6.9	-1.6
	(Annual percentage change)							
Reserve money	16.6	2.2	14.7	23.9	15.5	14.0	7.8	11.0
	(Change in percent of reserve money at start of period)							
Reserve money	16.6	2.2	14.7	4.7	0.1	2.5	7.8	11.0
Net foreign assets	25.4	-4.6	28.7	-1.2	3.1	3.1	-4.8	6.5
Net domestic assets	-8.8	6.9	-14.0	5.9	-3.1	-0.6	12.5	4.5
Monetary survey	(In billions of Nepalese rupees)							
Broad money	277.3	300.4	346.7	360.4	367.7	380.2	395.3	457.0
Narrow money	94.0	100.2	112.9	114.9	118.2	120.3	126.7	145.3
Quasi money 1/	183.3	200.2	233.8	245.5	249.6	260.0	268.6	311.7
Net foreign assets	108.8	107.7	139.5	137.7	140.7	142.2	131.9	140.0
Net domestic assets	168.5	192.7	207.1	222.7	227.0	238.1	263.4	317.0
Domestic credit 1/	246.0	280.2	325.8	333.9	327.6	341.0	365.1	424.4
Public sector	60.3	70.5	78.7	77.8	73.2	69.2	88.0	103.0
Government 2/	57.4	63.9	74.1	73.3	68.2	64.1	82.9	97.9
Public enterprises	2.9	6.6	4.6	4.6	5.0	5.2	5.1	5.1
Private sector 3/	185.7	209.7	247.1	256.0	254.3	271.8	277.1	321.4
Other items, net	-77.5	-87.5	-118.7	-111.1	-100.5	-102.9	-101.6	-107.4
	(Annual percentage change)							
Broad money	12.8	8.3	15.4	16.7	14.8	15.4	14.0	15.6
Narrow money	12.2	6.6	12.7	12.4	14.1	10.8	12.2	14.7
Quasi money	13.1	9.2	16.7	18.8	15.1	17.7	14.9	16.0
Domestic credit	9.8	13.9	16.3	15.7	11.4	11.4	12.1	16.2
Public sector	-1.6	16.8	11.7	10.1	6.7	-3.1	11.8	17.0
Government 2/	-1.8	11.3	16.0	13.0	7.8	-2.0	11.8	18.1
Private sector credit 3/	14.2	12.9	17.8	17.5	12.8	15.8	12.1	16.0
	(Change in percent of broad money at start of period)							
Broad money	12.8	8.3	15.4	4.0	6.1	9.7	14.0	15.6
Net foreign assets	7.1	-0.4	10.6	-0.5	0.3	0.8	-2.2	2.1
Net domestic assets	5.7	8.7	4.8	4.5	5.7	8.9	16.2	13.5
Domestic credit	9.0	12.3	15.2	2.3	0.5	4.4	11.3	15.0
Private sector	9.4	8.7	12.4	2.6	2.1	7.1	8.6	11.2
Memorandum items:								
Velocity of broad money	1.94	1.96	1.86	…	…	…	1.82	1.74
Broad money multiplier	2.94	3.11	3.13	3.11	3.32	3.35	3.31	3.45

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

1/ Commercial bank data are subject to revisions due to reporting lags.
2/ Central Government, adjusted for local government deposits.
3/ Includes lending by the Agriculture Development Bank of Nepal (ABDN) since July 2006. Reflects loan write-off of Nrs. 16 billion during July to December 2006.

Table 4. Nepal: Balance of Payments, 2002/03–2010/11

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
					Est.		Projection		
	(In millions of U.S. dollars, unless otherwise stated)								
Current account	150	200	161	197	58	133	67	-41	-125
Current account (excluding official transfers)	16	59	-19	53	-146	-230	-309	-435	-544
Trade balance	-904	-1053	-1190	-1521	-1761	-2023	-2236	-2411	-2596
Exports, f.o.b.	653	748	832	850	892	989	1,106	1,235	1,373
Merchandise exports	653	748	832	850	892	989	1,106	1,235	1,373
Imports, f.o.b.	1,556	1,801	2,022	2,372	2,653	3,011	3,342	3,646	3,969
Oil products	242	273	370	465	476	603	659	693	731
Other imports	1,314	1,528	1,652	1,906	2,177	2,409	2,682	2,954	3,238
Services (net)	93	125	-28	-94	-117	-145	-150	-149	-148
Receipts	341	465	361	366	455	508	537	577	618
Of which : tourism	151	246	145	132	144	186	209	234	259
Payments	248	340	389	460	572	653	687	726	766
Income	-10	-23	23	69	105	118	131	144	158
Credit	58	52	108	158	206	222	240	259	280
Debit	68	75	85	89	100	104	109	115	121
Current transfers	971	1,151	1,356	1,744	1,830	2,183	2,322	2,375	2,460
Credit, *of which:*	1,000	1,209	1,405	1,809	1,890	2,248	2,394	2,455	2,549
General government 1/	135	141	180	145	204	363	376	395	419
Workers remittances	697	795	910	1,351	1,421	1,576	1,711	1,761	1,819
Recorded	234	381	607	1,178	1,327	1,430	1,584	1,664	1,756
Estimated	463	414	302	172	94	146	127	97	64
Debit	29	58	48	65	60	66	72	79	88
Capital account	69	20	22	43	63	67	73	80	87
Capital transfers	69	20	22	43	63	67	73	80	87
Of which : official grants	42	20	22	43	63	67	73	80	87
Financial account	-172	-562	-431	-427	-178	-155	-148	-16	55
Direct investment	12	2	2	-6	5	15	25	29	33
Portfolio investment	0	0	0	0	0	0	0	0	0
Other investment (net) 2/	-184	-564	-433	-421	-183	-170	-173	-45	22
Of which : loans	40	47	18	10	31	88	122	150	178
Disbursements	111	125	101	106	137	197	228	262	294
Amortization	71	78	83	97	107	109	106	112	116
Errors and omissions 2/	85	627	267	482	233	0	0	0	0
Overall balance	133	284	19	295	176	45	-8	23	16
Financing	-133	-284	-19	-295	-176	-137	-78	-65	-45
Change in reserve assets (-=increase)	-129	-293	-30	-296	-211	-137	-76	-61	-41
PRGF Loans (net)	-4	8	11	0	36	0	-2	-4	-4
Other liabilities	1	1	0	1	-1	0	0	0	0
Exceptional financing	0.0	0.0	0.0	0.0	...	...	...	...	...
Arrears to Austria (+ increase)	0.0	0.0	0.0	0.0	...	...	...	...	...
Arrears to Belgium (+ increase)	0.0	0.0	0.0	0.0	...	...	...	...	...
Financing gap 3/	…	…	…	...	...	92	86	43	29
Of which:									
IMF (current PRGF arrangement)	…	…	…	…	...	15	...	...	...
	(In percent of GDP, unless otherwise stated)								
Memorandum items:									
Trade balance	-14.3	-14.5	-14.6	-17.0	-17.9	-19.2	-19.5	-19.4	-19.2
Current account (excluding official transfers)	0.3	0.8	-0.2	0.6	-1.5	-2.2	-2.7	-3.5	-4.0
Current account (including official transfers)	2.4	2.7	2.0	2.2	0.6	1.3	0.6	-0.3	-0.9
Total external debt 4/	48.8	47.4	41.9	38.9	36.2	35.1	33.7	32.5	31.5
Total PPG external debt	45.8	44.7	39.3	36.3	33.6	32.5	30.9	29.7	28.6
PPG debt service 5/	9.6	9.7	9.4	9.1	9.3	8.8	8.5	8.3	7.9
Debt service 6/	5.0	4.5	4.5	4.0	4.0	3.5	3.3	3.3	3.3
Stock of arrears (in millions of U.S. dollars)	0.0	0.0	0.0	...	...	...	...	...	...
Gross foreign assets (end of period)	1,462	1,772	1,863	2,243	2,555	2,792	2,708	2,778	2,829
Of which : central bank	1,178	1,471	1,501	1,797	2,008	2,144	2,220	2,281	2,322
(In months of imports of goods and services)	6.6	7.3	6.4	6.7	6.6	6.4	6.1	5.7	5.4
Nominal GDP (in millions of U.S. dollars)	6,327	7,274	8,165	8,929	9,861	10,527	11,451	12,451	13,539

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

1/ Includes estimated NGO transfers.
2/ Large other investments and errors and omissions reflect data weaknesses in capital account, unreported remittances and informal trade.
3/ The financing gap in 2006/07 is expected to be closed through PRGF resources and support by MDB's.
4/ Includes estimated private sector debt and short-term trade credits.
5/ As a ratio of exports of goods and services
6/ As a ratio of exports of goods and services, private transfer and income receipts; including debt service to the Fund.

Table 5. Status of Quantitative Performance Criteria and Indicative Targets

(In billions of Nepalese rupees; unless otherwise stated)

	Jul. 17, 2006	Oct. 17, 2006	Jan. 14, 2007 (PC)	Apr. 13, 2007 (IT)	Jul. 15, 2007 (PC)
Performance criteria (PC) and indicative targets (IT) 1/					
I. Floor on net foreign assets of the NRB			(In millions of U.S. dollars)		
1. IMF Country Report No. 07/204 2/	1,842.7	1,852.7	1,882.7	1,912.7	1,952.7
2. Adjusted 3/	...	1,848.6	1,878.4	1,909.5	1,926.9
3. Actual 4/	1,843.1	1,865.2	1,952.0	2,008.1	1,947.8
II. Ceiling on net domestic assets of the NRB					
1. IMF Country Report No. 07/204 5/	-28.1	-26.1	-23.8	-25.7	-18.8
2. Adjusted 6/	...	-25.7	-23.5	-25.4	-16.8
3. Actual 7/	110.7	-24.0	-35.6	-37.1	-26.7
III. Ceiling on change in net domestic financing of central government budget. Cumulative from July 17, 2006					
1. IMF Country Report No. 07/204 8/	...	2.0	4.7	7.4	11.7
2. Adjusted 9/	…	2.3	5.0	8.1	15.6
3. Actual	…	-0.8	-6.1	-8.3	6.5
IV. Ceiling on contracting or guaranteeing of new nonconcessional medium- and long-term external debt by the central government and NRB. Cumulative from July 17, 2006 10/			(In millions of U.S. dollars)		
1. IMF Country Report No. 07/204	...	0.0	0.0	0.0	0.0
2. Adjusted	…	0.0	0.0	0.0	0.0
3. Actual	…	0.0	0.0	0.0	0.0
V. Ceiling on short-term external debt contracted or guaranteed by the central government and NRB			(In millions of U.S. dollars)		
1. IMF Country Report No. 07/204	0.0	0.0	0.0	0.0	0.0
2. Adjusted	…	0.0	0.0	0.0	0.0
3. Actual	0.0	0.0	0.0	0.0	0.0
VI. Accumulation of external payments arrears. Continuous performance criterion during the program period.			(In millions of U.S. dollars)		
1. IMF Country Report No. 07/204	0.0	0.0	0.0	0.0	0.0
2. Adjusted	…	0.0	0.0	0.0	0.0
3. Actual	0.0	0.0	0.0	0.0	0.0
Indicative targets (IT)					
VII. Ceiling on reserve money					
1. IMF Country Report No. 07/204	110.1	112.9	117.4	117.8	127.7
2. Actual	110.7	115.9	110.8	113.5	119.3
VIII. Floor on central government revenue. Cumulative from July 17, 2006					
1. IMF Country Report No. 07/204 11/	...	14.7	36.9	57.4	85.3
2. Adjusted 12/	…	14.7	36.9	56.9	83.3
3. Actual	…	16.1	36.9	55.9	86.4

1/ Mid-January 2007 and mid-July 2007 are performance criteria test dates. Figures for mid-April 2007 are indicative targets.
2/ Net Foreign Assets (NFA) as defined in the Technical Memorandum of Understanding (TMU). Valued at program exchange rates; monetary gold valued at US$600 per oz. Adjusted upward/downward by excess/shortfall of foreign program financing. Details specified in the TMU.
3/ Valued at program exchange rates; monetary gold valued at program price (US$600 per oz.). Adjusted upward/downward by excess/shortfall of foreign program financing.
4/ Valued at program exchange rates; monetary gold valued at program price (US$600 per oz.).
5/ Net domestic assets (NDA) as defined in the TMU. Calculated as the difference between reserve money (VI.1.) and NFA (I.1). Adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign financing. Details specified in the TMU.
6/ Calculated as the difference between reserve money (V1.1) and NFA (I.2). Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing.
7/ Calculated as the difference between reserve money (VI.2.) and NFA (I.3).
8/ Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing. Adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the TMU.
9/ Adjusted upward/downward by shortfall/excess of privatization receipts. Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing. Details specified in the TMU.
10/ External debt as in the TMU.
11/ Adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the TMU.
12/ Adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the TMU.

Table 6. Nepal: Proposed Structural Performance Criteria and Benchmarks for Fifth Review of the PRGF Arrangement

Measures	Timing	Status/Implementation Date
Structural Performance Criteria		
A. Fiscal Sector Reforms		
1. Large Taxpayer Office (LTO) to conduct comprehensive audit of large taxpayers 1/	July 15, 2007	Observed/July 15, 2007
2. Inland Revenue Department (IRD) to reduce VAT nonfilers to 12.5 percent or less of registered VAT taxpayers 2/	July 15, 2007	Not observed
3. Customs Department to streamline customs clearance at Birgunj customs office 3/	July 15, 2007	Observed/April 3, 2007
4. Customs Department to establish Wide-Area Network (WAN) for headquarters and at least five large customs offices	July 15, 2007	Not observed/July 19, 2007
B. Financial Sector Reforms		
1. Cabinet approval of revised Banking and Financial Institutions Act 4/	August 31, 2007	Not observed
2. NRB to divest all its shareholding in Non-Life Insurance Division of Rastriya Beema Sansthan	July 15, 2007	Not observed/October 8, 2007
3. NRB to divest all its shareholding in at least two rural development banks	July 15, 2007	Not observed/August 23, 2007
4. Finalize audit of NRB 2005/06 accounts by an international auditor	July 15, 2007	Observed/June 10, 2007
C. Nepal Oil Corporation		
1. Finalize audit of NOC 2005/06 accounts in accordance with international standards	July 15, 2007	Not observed/ October 17, 2007
Structural Benchmarks		
1. Submission to Parliament of amendments to Customs Act	April 15, 2007	Not observed/May 30, 2007
2. Submission to Parliament of draft Anti-Money Laundering Act	July 15, 2007	Not observed/August 20, 2007
3. Submission to Parliament of revised Banking and Financial Institutions Act	September 30, 2007	Not observed
4. IRD to make compulsory ETDS for Kathmandu-based government offices	July 15, 2007	Observed/December 1, 2006
5. NIDC to implement rationalization and divestment instructions of the MOF	July 15, 2007	Not observed/October 17, 2007
6. NRB to draft guidelines for mergers and acquisitions of banks and financial institutions 5/	August 31, 2007	Not observed

1/ LTO to conduct audit of income tax (including tax deduction at source) and VAT returns, and excise declarations of 2005/06 for a cumulative number of at least 50 large taxpayers. LTO to conduct quarterly audit of excises for large taxpayers (mid-January and mid-April filings).
2/ Averaged over the filing months April/May and May/June 2007. The computed nonfiler rate was 12.7 percent.
3/ The department will reduce the number of steps in the clearance process for imports from countries other than India to at most 10 steps.
4/ The revised act is expected to address gaps in the supervisory and regulatory frameworks identified by the assessment against the Basel Core Principles, ensure consistency with provisions of the Company Act, provide for a strengthened framework for mergers and acquisitions, and bring bank insolvency and resolution frameworks under the purview of the BFIA.
5/ The guidelines are expected to specify the regulatory framework, enabling procedures, conditions for approval, and actions in case of contravention.

Table 7. Nepal: Medium-Term Macroeconomic Framework, 2004/05–2010/11

(In percent of GDP, unless otherwise indicated)

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
			Projection				
Real sector							
Real GDP growth (percent change)	3.1	2.8	2.5	4.0	4.5	5.0	5.5
Agriculture	3.5	1.1	0.7	3.0	3.5	4.0	4.5
Nonagriculture	2.7	4.6	3.6	4.6	5.1	5.6	6.0
GDP deflator (percent change)	6.5	6.7	8.6	6.5	6.0	5.5	5.0
Saving-investment balance							
Gross fixed investment	19.9	20.9	20.3	21.8	23.3	24.3	25.0
Public 1/	4.4	4.3	5.1	6.8	6.9	7.0	7.0
Private	15.5	16.6	15.2	15.1	16.4	17.3	18.0
Gross national savings (incl. income and transfers from abroad)	28.4	28.2	28.6	27.6	28.0	27.7	27.4
Fiscal sector							
Total revenue	11.7	10.9	12.0	12.8	12.9	13.0	13.1
Grants	2.4	2.1	2.3	3.4	3.3	3.2	3.1
Current expenditure	10.5	10.4	10.6	12.3	12.0	12.0	12.0
Capital expenditure and net lending	4.4	4.3	5.1	6.8	6.9	7.0	7.0
External sector							
Export value (percent change) 2/	11.2	2.2	4.9	10.8	11.8	11.7	11.2
Import value (percent change)	12.2	17.3	11.9	13.5	11.0	9.1	8.9
Current account balance (excl. official transfers)/GDP	-0.2	0.6	-1.5	-2.2	-2.7	-3.5	-4.0
Overall balance/GDP	0.2	3.3	1.8	0.4	-0.1	0.2	0.1
Financing gap (in millions of U.S. dollars)	…	…	44	100	74	47	46
Change in reserves (in millions of U.S. dollars)	-30	-296	-211	-137	-76	-61	-41
External debt/GDP (in percent)	39.3	36.3	33.8	32.6	31.1	29.8	28.7
Debt service ratio	4.5	4.0	3.6	3.4	3.4	3.5	3.5
Monetary sector							
Broad money (percent change)	8.3	15.4	14.0	15.6	...	...	...
Private sector credit (percent change)	12.9	17.8	12.1	16.0	...	...	...
Memorandum item:							
Nominal GDP (Nrs. billions)	589.4	646.5	719.5	796.8	883.0	978.1	1083.5

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

1/ Public savings and investment estimate derived from fiscal accounts.
2/ Excluding re-exports.

Table 8. Nepal: Actual and Proposed Schedule of Disbursements Under the PRGF Arrangement

Amount	Available Date	Conditions for Disbursement
SDR 7.13 million (10 percent of quota)	November 19, 2003	Disbursed.
SDR 7.13 million (10 percent of quota)	October 20, 2004	Disbursed.
SDR 14.26 million (20 percent of quota)	November 10, 2006	Disbursed.
SDR 10.69 million (15 percent of quota)	June 13, 2007	Disbursed.
SDR 10.69 million (15 percent of quota)	November 12, 2007	Observance of the mid-July and end-August 2007 performance criteria and completion of the fifth review.

Table 9. Nepal: Projected Fund Transactions Under the PRGF, 2005/06–2010/11

(In millions of SDRs)

	2005/06	2006/07	2007/08	2007/08	2008/09	2009/10	2010/11
	Est.	Projections					
Total use of fund resources (UFR) outstanding	14.3	39.2	49.9	48.5	45.6	42.8	36.0
PRGF	14.3	39.2	49.9	48.5	45.6	42.8	36.0
PRGF							
Disbursements	0.0	25.0	10.7	0.0	0.0	0.0	0.0
Debt service	0.2	0.2	0.2	1.7	3.1	3.1	7.0
Repayments	0.0	0.0	0.0	1.4	2.9	2.9	6.8
Interest	0.2	0.2	0.2	0.3	0.2	0.2	0.2
Total debt service to the Fund	0.3	0.3	0.3	1.8	3.2	3.2	7.1
PRGF	0.2	0.2	0.2	1.7	3.1	3.1	7.0
Principal	0.0	0.0	0.0	1.4	2.9	2.9	6.8
Interest	0.2	0.2	0.2	0.3	0.2	0.2	0.2
Other SDR charges	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Memorandum items:							
Total UFR as a percentage of quota	20.0	55.0	70.0	68.0	64.0	60.0	50.5
Total UFR as a percentage of GDP	0.2	0.6	0.7	0.6	0.6	0.5	0.4
Debt service to the Fund as a percentage of exports of goods and services 1/	0.0	0.0	0.0	0.2	0.3	0.2	0.5

Sources: Fund staff estimates.

1/ Excluding re-exports of oil.

Table 10. Nepal: Millennium Development Goals, 1990–2015

	1990	1995	2001	2002	2003	2015
Eradicate extreme poverty and hunger	(2015 target = halve 1990 $1 a day poverty and malnutrition rates)					
Population below $1 per day (in percent)	...	37.7	...	...	...	18.9
Poverty gap at $1 per day (in percent)	...	9.7	...	...	...	...
Percentage share of income or consumption held by poorest 20 percent	...	7.6	...	...	...	...
Prevalence of child malnutrition (in percent of children under 5)	...	48.5	48.3	...	...	24.3
Population below minimum level of dietary energy consumption (in percent)	18.0	24.0	17.0	...	17.0	...
Achieve universal primary education	(2015 target = net enrollment to 100)					
Net primary enrollment ratio (in percent of relevant age group)	...	...	70.5	...	...	100
Percentage of cohort reaching grade 5 (in percent)	52.0	...	62.1	...	...	...
Youth literacy rate (in percent of ages 15–24)	46.6	54.6	61.6	62.7	...	...
Promote gender equality	(2005 target = education rate to 100)					
Ratio of girls to boys in primary and secondary education (in percent)	56.6	69.7	83.4	...	85.4	100
Ratio of young literate females to males (in percent of ages 15–24)	40.7	48.2	57.3	58.9	...	...
Share of women employed in the nonagricultural sector (in percent)	11.7	...	...	...	...	...
Proportion of seats held by women in national parliament (in percent)	6.0	3.0	6.0	6.0	6.0	...
Reduce child mortality	(2015 target = reduce 1990 under 5 motality by two thirds)					
Under 5 mortality rate (per 1,000)	143.0	114.0	91.0	83.0	82.0	47.7
Infant mortality rate (per 1,000 live births)	99.0	81.0	67.0	62.0	61.0	...
Immunization, measles (in percent of children under 12 months)	57.0	56.0	71.0	71.0	75.0	...
Improved maternal health	(2015 target = reduce 1990 maternal mortality by three fourths)					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	830.0	740.0	...	...	207.5
Births attended by skilled health staff (in percent of total)	7.4	9.0	10.9	...	...	...
Combat HIV/AIDS, malaria, and other diseases	(2015 target = halt, and begin to reverse, AIDS, etc.)					
Prevalence of HIV, female (in percent of ages 15–24)	...	...	0.3	...	0.5	0.2
Contraceptive prevalence rate (in percent of women ages 15–49)	...	28.5	39.3	...	...	...
Number of children orphaned by HIV/AIDS	...	...	13,000.0	...	...	...
Incidence of tuberculosis (per 100,000 people)	...	...	201.0	189.8	211.2	150
Tuberculosis cases detected under DOTS (in percent)	...	6.0	60.0	63.6	60.3	...
Ensure environmental sustainability	(2015 target = various 1/)					
Forest area (in percent of total land area)	32.7	...	27.3	...	...	30
Nationally protected areas (in percent of total land area)	...	7.8	7.8	8.9	8.9	10
GDP per unit of energy use (PPP$ per kg. oil equivalent)	2.6	3.3	3.9	...	3.8	...
CO2 emissions (metric tons per capita)	0.0	0.1	0.1	...	...	...
Access to an improved water source (in percent of population)	67.0	...	88.0	...	84.0	83.5
Access to improved sanitation (in percent of population)	20.0	...	28.0	...	27.0	...
Access to secure tenure (in percent of population)	...	...	...	...	...	...
Develop a global partnership for development	(2015 target = various 2/)					
Youth unemployment rate (in percent of total labor force ages 15–24)	...	...	...	...	...	...
Fixed line and mobile telephones (per 1,000 people)	3.2	4.1	13.9	15.1	17.8	...
Personal computers (per 1,000 people)	...	1.2	3.5	3.7	3.7	...
General indicators						
Population (in millions)	18.1	20.4	23.6	24.1	24.7	...
Gross national income (in billions of U.S. dollars)	3.9	4.4	5.6	5.5	5.9	...
GNI per capita (in U.S. dollars)	220.0	220.0	240.0	230.0	240.0	...
Adult literacy rate (in percent of people ages 15 and over)	30.4	36.0	42.9	44.0	...	...
Total fertility rate (births per woman)	5.3	4.6	4.3	4.2	4.1	...
Life expectancy at birth (in years)	53.6	56.3	58.9	59.9	60.2	...
Aid (in percent of GNI)	11.6	9.8	7.0	6.6	...	...
External debt (in percent of GNI)	45.1	54.9	48.2	53.3	...	...
Investment (in percent of GDP)	18.1	25.2	24.0	24.6	25.8	...
Trade (in percent of GDP)	32.2	59.5	53.8	44.9	45.4	...

Source: *World Development Indicators* database.

1/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environment resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking.

2/ Develop further an open, rule-based, predictable, nondiscriminatory trading and financial system. Address the special needs of the least developed countries. Address the special needs of landlocked countries and small island developing states.

Attachment I

October 31, 2007

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street, NW
Washington, DC 20431

Dear Mr. de Rato:

The Government of Nepal held discussions with IMF staff during September 19–30, 2007 on the program supported by the Poverty Reduction and Growth Facility (PRGF). The purpose of this letter is to inform you of the progress made in implementing the program, request waivers for the nonobservance of structural performance criteria, and request completion of the fifth (and final) review under the arrangement.

Despite a difficult political situation, Nepal has maintained macroeconomic stability and all quantitative performance criteria for the review were observed. The Government of Nepal has also made a considerable effort to implement measures related to structural reform criteria (SPCs) and benchmarks (SBs).

Of the structural reform measures related to SPCs, three measures were implemented on or before envisaged dates (conduct of comprehensive audits of large taxpayers by the Large Taxpayer Office; streamlining of the customs clearance at the Birgunj customs office; and finalization of the audit of the NRB 2005/06 accounts by an international auditor).

However, given the difficult operating circumstances, there was nonbservance of six SPCs. For four PCs, the delay in implementation was temporary (the establishment of a Wide-Area Network by the Customs Department for headquarters and at least five large customs offices; divestment of all NRB shareholdings in the Non-Life Insurance Division of the Rastriya Beema Sansthan; divestment of all NRB shareholding in at least two rural development banks; and finalization of NOC 2005/06 accounts in accordance with international standards). For one PC, the nonbservance was minor (reduction of VAT nonfilers by the Inland Revenue Department to 12.5 percent or less of registered VAT taxpayers). For the sixth PC (the cabinet approval of a revised Banking and Financial Institutions Act), all technical work has been completed, and the revised act has been submitted for cabinet approval. On this basis, we request waivers for the six structural performance criteria.

Going forward, the Government of Nepal is firmly committed to maintaining macroeconomic stability and furthering structural reforms. A good basis for this has been laid with the

2007/08 budget which is consistent with the medium term objectives of raising resources to finance the peace process, infrastructure, and structural reforms while lowering the public debt-to-GDP ratio. To put these objectives in a medium term perspective, the Government of Nepal has started implementing its three-year interim plan, with an emphasis on rehabilitation, reconstruction, and recovery from the 11-year insurgency. The government is also fully cognizant of the need for further structural reforms in key sector to lay a sound basis for sustained growth and poverty alleviation.

The government intends to make public this letter and the staff report for this review under the PRGF arrangement. Accordingly, the Government of Nepal authorizes the IMF to arrange for these documents to be posted on the Fund's website once the Executive Board has completed the review.

Yours sincerely,

/s/	/s/
Ram Sharan Mahat Minister of Finance Government of Nepal	Krishna Bahadur Manandhar Acting Governor Nepal Rastra Bank

INTERNATIONAL MONETARY FUND

NEPAL

Fifth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Request for Waivers for Nonobservance of Performance Criteria—Informational Annex

Prepared by the Asia and Pacific Department

October 31, 2007

Contents Page

Annex I: Nepal—Fund Relations
(As of September 30, 2007)

I. Membership Status: Joined 9/06/61; Article VIII, Sections 2, 3, and 4 on May 30, 1994.

II. **General Resources Account**:	**SDR Million**	**Percent Quota**
Quota	71.30	100.00
Fund holdings of currency	71.31	100.02
Reserve position in Fund	0.00	0.00

III. **SDR Department**:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	8.10	100.00
Holdings	5.86	72.29

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**Percent Quota**
PRGF arrangements	39.21	54.99

V. Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
PRGF	11/19/03	11/18/07	49.90	39.21
PRGF	10/05/92	10/04/95	33.57	16.79
SAF	10/14/87	10/13/90	26.11	26.11

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

	Forthcoming				
	2007	2008	2009	2010	2011
Principal			1.43	2.85	2.85
Charges/interest	0.12	0.28	0.28	0.27	0.25
Total	0.12	0.28	1.71	3.12	3.11

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 free of restrictions on the making of payments and transfers for current international transactions. As of August 31, 2007, the exchange rate for the Nepalese rupee (Nr) was US$1=Nrs. 66.0.

VIII. Safeguards Assessments

A safeguards assessment of the Nepal Rastra Bank (NRB) was completed on September 2, 2002. The assessment concluded that substantial risks exist in the area of external and internal audits, and the internal control system of the NRB. A safeguards monitoring assessment was completed in October 2004. Staff findings and recommendations were reported in IMF Country Report No. 02/205. The NRB is making progress in the implementation of these recommendations, which is being monitored under the current PRGF arrangement.

IX. 2005 Article IV Consultation

The Executive Board discussed the staff report for the 2005 Article IV consultation (IMF Country Report No. 06/44) on January 18, 2006. Nepal is currently on a 24-month consultation cycle, subject to the provisions of the July 15, 2002 decision on consultation cycles (Decision No. 129794-(02/76) as amended).

X. Technical Assistance Since 2001

Department	Purpose	Date
MCM	- Accounting	10/04, 4/05, 9/05, 11/05, 7/06
	- Central bank and banking reform	12/01–3/02
	- Internal Audit	10/04, 1/05, 4/05, 9/05, 11/05, 7/06, 1/07, 7/07
	- Monetary policy	6/03
	- Monetary operations	Continuous
	- Strengthening central bank accounting and controls	4/05
	- Foreign exchange reserves management	5/03, 8/04, 10/04, 11/05, 7/06, 9/07
	- Financial Sector Supervision	12/06,1/07, 4/07
	- Liquidity management	6/03
FAD	- Implementation of a large tax payer unit	10/03
	- Review of tax policy and VAT administration	5/03
	- Tax and customs administration reform	7/04, 6/06, 6/07, 9/07
	- Follow up on the LTO and customs administration reform	8/04, 6/06, 4/07
	- Tax/customs policy (fiscal reform)	4/03
	- Revenue Administration	4/07
	- Fiscal Transparency Legislation	5/07
LEG	- Redrafting of income tax laws	3/00, 7/01, 1/07
	- Income Tax Act	4/03
	- Banking Law	6/04, 10/05
	- Fiscal Law	5/07
	- Fiscal Transparency	5/07
STA	- Multisector statistics	1/01, 7/03
	- Balance of payments statistics	4/02, 11/02, 5/03, 10/03, 4/04
	- Producer prices statistics	1/02, 1/03, 4/04, 1/05
	- Monetary statistics	7/03
	- National accounts	5/03, 4/05, 7/06

XI. Resident Representative/Advisor

Mr. Alexander Pitt has been the Resident Representative since August 2006.

ANNEX II: NEPAL—RELATIONS WITH THE WORLD BANK GROUP

(As of October 5, 2007)

A. Partnership in Nepal's Development Strategy

Since the late 1990s, Nepal's poverty reduction agenda has been held back by formidable challenges—that is, persistent political instability, the escalation of the Maoist insurgency and the global economic slowdown. Nevertheless, amidst the turbulence, a group of committed, reform-minded government officials and technocrats began implementing reforms in earnest in late 2001. These initiatives formed the basis for the first Immediate Action Plan (IAP) adopted by the Government in June 2002. For a while, reform efforts flourished in a number of areas, including the financial sector, public expenditures, the fight against corruption, infrastructure regulatory environment, and decentralized delivery of public services.

The reform group had been building on the successful experience with the IAP in moving the reform process forward. In developing the 2003 Poverty Reduction Strategy (PRS)—formally sent to the World Bank and IMF in July 2003—the scope of reform was broadened and a more integrated approach was adopted within a medium-term perspective.[12] The PRS spells out specific development targets, foremost among which is the reduction of the overall poverty ratio from about 40 percent to 30 percent by the end of FY07.[13] The PRS contains four 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) pursuing good governance to achieve better development results, and ensure social and economic justice. While there had been considerable progress towards implementing the PRS, the reform efforts and momentum have suffered greatly in recent years with the increased political instability.

In implementing the 2003 Country Assistance Strategy (CAS), the Bank is leading the policy dialogue in the structural and institutional areas. The Bank has been engaged in intensive dialogue in the formulation of reform efforts 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

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[12] The PRS was discussed by the Boards in November 2003 following a joint staff assessment carried out by the two institutions. Subsequently, four PRS Progress Reports have been issued by the authorities.

[13] This target has nearly been met with recent analysis showing that the incidence of poverty in Nepal fell from 42 percent (1995–96) to 31 percent (2003–04), with urban areas experiencing greater reductions than rural areas in the depth and severity of poverty.

support these measures, the Bank's Board approved the first Poverty Reduction Support Credit (PRSC I) along with the CAS and PRS. Although the Bank's strategy had envisioned a series of PRSCs, such support has not materialized given the developments, most notably the slowdown in the reform efforts.

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 provided technical assistance (TA) in conducting the Nepal Living Standards Survey II (NLSS II) during 2003/04 that updated household level information on trends in consumption, poverty, and their determinants. The TA also helped to strengthen the country's capacity to undertake regular household surveys that will facilitate poverty comparisons over time and to conduct social impact analyses. The NLSS II has been a key input into the three annual PRS progress reports, as well as the Bank's comprehensive poverty report—***Nepal: Resilience Amidst Conflict—An Assessment of Poverty in Nepal, 1995–96 and 2003–04***.

In ***education***, the Bank and numerous other donors are actively supporting Nepal's well-formulated, ten-year primary education reform program. IDA along with Denmark, Finland, Norway, and the United Kingdom have established a joint financing arrangement whereby donor funds are pooled with public sector budgetary resources to support implementation of the program. IDA resources are provided through the ***Education for All*** project—which employs a sector-wide approach ("SWAp")—and the ***Second Higher Education***.

The Bank has encouraged Nepal's decentralization efforts to achieve more effective delivery of public services and has played a pivotal role in supporting the transfer of public schools to community management. The Bank's dialogue is accompanied by financing in the form of the ***Community School Support*** Learning and Innovation Loan (LIL) 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, and the development of a sector-wide reform strategy. A ***Health Sector Operation*** supports the program. Key reform priorities 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 support both human health and animal health, an ***Avian Influenza Control Project*** was approved in early 2007.

To support broad-based growth, the Bank supports investments in key ***infrastructure*** sectors by financing projects in ***Rural Access Improvement and Decentralization*, *Power Development,*** **and *Telecommunications Sector Reform***. 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 Access Improvement and Decentralization Project*** (RAIDP) helps to improve governance and service delivery for rural infrastructure, while at the same time promoting agricultural and rural economic growth, and generating employment through direct project investments in rural transport infrastructure. The ***Power Development Project*** (PDP) is helping to develop 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.

While many of the Bank's investment/sector operations mentioned above also support ***social inclusion***, a more direct initiative in this area that received Bank support in recent years is the Poverty Alleviation Fund (PAF). PAF channels resources to the poorest groups in rural communities by creating infrastructure, employment and income-generating opportunities. Bank financing through the PAF project (approved in FY04 with a supplemental approved in FY07) supports implementation of the fund in 25 districts. 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 through a recently completed social and gender analysis: ***Unequal Citizens: Gender, Caste and Ethnic Exclusion in Nepal***.

In responding to ***environmental management,*** Bank assistance is focused on helping Nepal articulate an effective strategy for environmental conservation, management and capacity building. A ***Country Environmental Analysis*** was completed in FY07.

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

The Bank takes the lead in assisting Nepal 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 UK's Department for International Development (DfID), the Bank's intensive dialogue and technical assistance have been supporting the reforms, including the development of a credible Medium Term Expenditure Framework (MTEF). This framework has applied since FY04 to the prioritization of the development budget to ensure efficient budget allocations for priority projects. As Nepal implements its PRS, the MTEF will help the public sector translate the PRS priorities into fiscal realities.

Public expenditure analysis remains an integral part of the Bank's analytical and advisory (AAA) work program, consisting of an ongoing: (i) PER that focuses on evaluating the implementation of the MTEF; and (ii) Public Finance Management (PFM) Review that examines the fiscal space for development activities and cross-sectoral allocation of public spending and service delivery.

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 other sources.

In the future, the Bank could provide additional support through development policy lending linked to: (i) financing of a post-conflict program; (ii) supporting the transition to a more stable environment; or (iii) supporting reform implementation. In the meantime, to assist in the reform efforts the ***Economic Reform Technical Assistance (ERTA) Project*** is providing TA to help implement aspects of all the PRS pillars. The Bank's AAA program places emphasis on the need to address the challenges and bottlenecks to broad-based growth. In addition to the Development Policy Review: ***Restarting Growth and Poverty Reduction*** (completed in June 2004), key studies on rural sector development and labor are envisioned to help prioritize future policy reforms.

With respect to ***governance***, in implementing both the 1998 and 2003 CASes, the Bank has consistently and firmly focused on helping Nepal address its fundamental constraint to development—poor governance. Albeit accompanied by intensive dialogue, the Bank's strong limited lending stance during FY99–FY02 (less than US$25 million per year) may have provided some impetus to the wave of reforms initiated in the early 2000s. 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 the procurement framework. Bank support for decentralization includes analytical assistance on the fiscal decentralization framework and promotion of the expanded roles of local bodies. Following the completion of the CPAR and CFAA, IDF grants are providing the means for strengthening relevant public sector institutions and implementing main policy recommendations. The FY07 PFM Review contains a CPAR and a CFAA aimed at assessing the efficiency of public finance management practices for delivering value for money and accountability.

Areas of shared responsibility

The Bank and the IMF—together with other external development partners—provided assistance during the preparation of the PRS and the subsequent PRS Progress Reports. In addressing the PRS pillar on good governance, the Bank and the IMF are assisting in the area of ***civil service reform*** through policy dialogue and TA 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 Nepal on ***international trade***, which is key to attaining broad-based growth. The Bank leads the work with a Trade and Competitiveness Study that helped identify major constraints to further integrating the country into the multilateral trading system in a manner that is supportive of the PRS. The IMF contributed to the study by assessing 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 WTO accession.

Financial sector reform is a fundamental area for Bank/IMF involvement. Since the mismanagement of key financial institutions was a major element of poor governance, progress in implementing financial sector reform has been the litmus test of political commitment to governance reform. The Bank and the IMF are helping to strengthen the central bank's authority and regulatory capacity, improve the financial health and restructure of the two largest state banks, and upgrade the legislative and institutional framework for the financial sector. Building on a comprehensive Financial Sector Study carried out in 2002, the ***Financial Sector Technical Assistance*** project supports: (i) the restructuring and reengineering of the Central Bank; (ii) introduction of professional management teams into the two large ailing commercial banks (the first step toward eventual restructuring); (iii) capacity building towards enhanced credit information; and (iv) upgrading of staff training in financial institutions. The ***Financial Sector Restructuring*** project—for which financing was approved in FY04—supports further strengthening of the Central Bank and deepening the reform process within the two banks. In FY05, a Legal Financial Review was completed providing a snapshot of the legal and judicial environment for financial sector growth and development. In addition, a recently completed study on Access to Finance helps to gain a better understanding of (i) the financial performance of the microfinance sector; and (ii) whether the current legal and regulatory framework is an obstacle to the sector's growth.

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 PRGF-supported program serves 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.

C. World Bank Group Strategy and Lending Operations

The Country Assistance Strategy (CAS): In November 2003, a CAS was presented to the Bank's Board of Directors, which discussed the rationale for implementing a 'base case' lending program equivalent to approximately US$190 million annually. Given the nature of the country's ongoing reforms, the CAS Progress Report (CAS PR) prepared in 2002 had already presented the justification for moving to a base case scenario that included implementing a programmatic approach to financial assistance. However, given the slowdown in the reform efforts over the past couple of years, new commitments have been significantly below what was envisioned in the base case program. An Interim Strategy Note (ISN) was presented to the Board in February 2007 and a note on the implementation of the ISN was circulated in August 2007.

The Lending Program: New commitments in FY07 amounted to US$103.2 million for two projects—Second Higher Education and Avian Influenza Control Program—and one supplemental financing for the Poverty Alleviation Fund. A very strong lending program is envisioned for FY08.

Bank Assistance Program in Nepal: As of October 5, 2007, IDA's lending portfolio consisted of thirteen projects with a total commitment of US$470 million and a total undisbursed balance of US$284 million (Table 2.1).

Table 2.1. World Bank Operations

As of October 5, 2007

	IDA Amount	Undisbursed [1/]	Board Date
(In millions of U.S. dollars, net of cancellations)			
Telecommunications Sector Reform	20.4	9.0	2002
Financial Sector Technical Assistance	16.0	7.9	2003
Community School Support	5.0	0.8	2003
Power Development	74.8	68.4	2003
Poverty Alleviation Fund	40.0	24.7	2004
Financial Sector Restructuring (Phase II)	75.5	20.5	2004
Rural Water Supply and Sanitation II	25.3	14.1	2004
Health Sector Program	50.0	17.3	2005
Education for All	50.0	11.2	2005
Rural Access Improvement and Decentralization	32.0	28.4	2005
Economic Reform Technical Assistance	3.0	1.7	2005
Avian Flu	18.2	16.3	2007
Second Higher Education	60.0	63.7	2007
Total	470.2	284.2	

[1/] Credit accounting is in SDRs. As these figures are in U.S. dollar, exchange rate fluctuations may result in undisbursed balances greater than the principal amounts.

Economic and Sector Work: The 200*3 Country Assistance Strategy* (Report No. 26509—NEP, 11/24/2003) was discussed by the Bank's Board in November 2003. Recently completed economic and sector work includes *Nepal Development Policy Review: Restarting Growth and Poverty Reduction* (June 2004), *Unequal Citizens: Gender, Caste and Ethnic Exclusion in Nepal* (June 2005), *Nepal Decentralized Organizations Study* (March 2004), *Urbanization and Service Delivery in the Context of Decentralization: A Review of the Issues for the Kathmandu Valley* (December 2004), *Legal Financial Review* (February 2005), *North South Transport Corridor Options* (August 2004), *Nepal: Resilience Amidst Conflict: An Assessment of Poverty in Nepal, 1995–96 and 2003–04* (June 2006), *Nepal—Public sector accounting and auditing: a comparison to international standards* (May 2007*) and Managing Public Finances for a New Nepal* (June 2007).

Activities of the International Finance Corporation (IFC) in Nepal

IFC Investment Services

As of end September 2007, the IFC's outstanding balance portfolio in Nepal is US$32.771 million in two power generation projects and one tourism project. An equity investment made in 2001 in a local leasing company has failed. Given the security situation, opportunities for new investments have been limited. More recently, however, as the peace process continues and the security situation improves, IFC is considering new investment opportunities in cement, hydropower and the financial sector. In 2005, IFC launched the Global Trade Finance Program (GTFP) which offers confirming banks partial or full guarantees on issuing banks' payment risk. IFC has recently agreed GTFP financing with Bank of Kathmandu and Nepal Industrial and Commercial Bank. IFC is also considering equity financing and long-term credit lines to a few selected banks. IFC has several investment leads in the ICT, cement and financial services sectors. IFC recently signed a MoU to undertake a feasibility study for an Infrastructure Development Bank together with IDFC, Nepalese banks, AsDB, and DEG.

IFC Advisory Services

Privatization/Corporate Advisory Services: IFC has recently agreed on a mandate with the government to act as lead advisor on the restructuring of Nepal Airlines. Similar discussions with the government of Nepal on providing advisory services for a possible privatization/restructuring of Nepal Telecom are on-going, in close collaboration with the wider World Bank Group.

IFC's main delivery mechanism for technical assistance for small and medium enterprises (SMEs) in Nepal is through the Dhaka-based South Asia Enterprise Development Facility

(IFC-SEDF). This facility—funded by IFC in partnership with Canada, Netherlands, Norway, the United Kingdom, Asian Development Bank, and the European Union—delivers

TA programs to increase access for SMEs to financing and business development services, improve the business environment for SMEs and develop linkages with larger enterprises.

Access to Finance: IFC-SEDF has undertaken SME banking diagnostics with the Bank of Katmandu and Himalayan Bank using the IFC SME banking diagnostic toolkit. Following this IFC-SEDF has signed partner financial institution memorandum of understandings (MOUs) with Himalayan Bank and Bank of Kathmandu and hopes to sign an MOU with NIC Bank shortly. The MOUs outline specific programs to assist the banks with institutional capacity building that will help enhance the quality of service to the bank's SME clients. Future work includes a Credit Bureau Strengthening Project that will aim at making the newly privatized credit bureaus commercially viable.

Business Enabling Environment: At the request of the Ministry of Industry, Commerce, and Supplies (MoICS), IFC-SEDF and Foreign Investment Advisory Service (FIAS) jointly reviewed the draft Special Economic Zone (SEZ) legislation in September 2006. This was followed by an investment climate diagnostic study (February-March 2007) which uncovered constraints to investment. FIAS and IFC-SEDF are currently developing a four year US$6 million Nepal Investment Climate Reform Program (NICRP) focused on helping the SEZs meet international best practice.

Questions on IDA may be referred to Ms. Tinsley (458-4920) or on the IFC to Mr. Paul Barbour (473-7349).

ANNEX III: NEPAL—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Country Program

As of 30 September 2007, cumulative lending to Nepal was $2.25 billion, comprising 111 loans and four grant projects amounting to $83.9 million. Sectors covered through AsDB loans and grants are agriculture and natural resources, education, energy, finance, industry and trade, law, economic management and public policy, transport and communication, and water supply, sanitation, and waste management. AsDB's total country program for Nepal in 2007 amounts to $133 million—Rural Reconstruction and Rehabilitation Sector Development Program ($100 million), Improving ICT Accessibility for Public Service Delivery ($25 million), and Education Sector Cluster Program (subprogram 2, $8 million).

Undisbursed funds of $516 million represent 70 percent of the total portfolio amount as of September 30, 2007.

Loans and Grants by the Asian Development Bank, 1969–2007

(As of September 30, 2007)

	1968–2000	2001	2002	2003	2004	2005	2006	2007
Loans				(In millions of U.S. dollars)				
Agriculture and natural resources	656.23	0	0	20	70	0	0	
Education	61.1	19.6	30	0	20	0	30	
Energy	364.4	0	0	0	0	0	0	
Finance	7.3	0	0	0	0	0	56	
Industry and trade	129.18	0	0	0	0	0	0	
Law, economic and public policy		30		35	0	0	0	
Transport and communication	236.86	46	0	0	20	0	0	
Water supply, sanitation and waste management	224	0	0	39	0	0	0	
Multisector	127.06	0	30	0	0	0	0	
Grant								
Agriculture and natural resources							18	
Education							2	
Finance							8.7	
Transport and communication							55.2	
Total Grants							83.9	
Total approved (Loan and Grant)	1,806.13	95.6	60	94	110	0	169.9	
Gross disbursements	1,220.60	57.3	28.2	33.5	22	43.7	108.0	53.3
Technical Assistance								
Total approved	98.03	4.03	4.02	4.17	3.16	2.05	5.82	0.5
Gross disbursements	54.1	5	3.9	4.17	4.2	3.6	2.04	3.7

Technical Assistance

Since 1968, AsDB has provided Nepal with technical assistance in most sectors. As of September 30, 2007 total technical assistance consisted of 264 projects totaling $123.2 million. As of September 30, 2007, there were 29 ongoing TAs including two JFPR projects.

Private Sector Operations

Developing a strong and dynamic private sector is essential to the long-term economic growth of Nepal. AsDB aims to strengthen the role of the private sector in Nepal through prudent investments in its infrastructure sector. The AsDB's public sector lending and technical assistance program have also been helping Nepal to create a more conducive policy and legal environment for private sector development. At the end of 2006, cumulative approvals for four private sector projects in Nepal amounted to $58.64 million while AsDB's outstanding exposure to nonsovereign projects totaled $28 million, representing 1.1 percent of AsDB's total nonsovereign portfolio.

Currently AsDB is looking into the possibility of financing the proposed 750 MW West Seti Hydropower project.

ANNEX IV: NEPAL—STATISTICAL ISSUES

Economic and financial data are adequate for surveillance, although there is scope for improvement. Nepal provides core data to the Fund and releases data in government and central bank publications and has been a participant in the General Data Dissemination System (GDDS) since May 2001.

Real Sector

The Central Bureau of Statistics (CBS) compiles **national accounts** using the *1968 SNA*. These include GDP by industry (current and constant prices) and by expenditure categories (current prices), and gross national income and savings. There are shortcomings 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 surveys or ad hoc assumptions—i.e., household consumption expenditure estimates are based on the extrapolation of the 1995/96 benchmark living standard survey. STA missions in April 2005 and July 2006 provided support to the development of quarterly national accounts (QNA) and the rebasing of the annual national accounts to 2000/01 from 1994/95. These missions and other developments took place in the context of a broader Asian Development Bank (AsDB) project aimed at strengthening the national accounts.

The **consumer price index** (CPI) uses outdated weights from the 1995/96 household expenditure survey. The CPI covers only urban areas and the consumption basket refers only to a subset of the population as it excludes: the upper and lower two income deciles; single person households; households with more than eight persons; and households obtaining more than 50 percent of consumption from own production or less than 50 percent of their income in cash. The national index is obtained by aggregating regional indices using population weights instead of the recommended expenditure weights. The **wholesale price index** (WPI) was developed by the Nepal Rastra Bank (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, compilation methods need improvement to implement weekly or bi-weekly price collection; the number of price quotations should be increased; and procedures for adjusting for quality differences require implementation. The CBS, with STA assistance, is developing a monthly **producer price index** (PPI) series, to replace the manufacturing price index, based on unit values rather than actual transaction prices.

Fiscal Sector

A revised **budget classification** system, introduced in 1996/97 and subsequently refined, has substantially improved fiscal statistics, in particular the division between current and capital spending. However, fiscal data by functional and economic classification are provided on an irregular basis with varying degrees of coverage. In addition, large amounts are still allocated to the contingency account, and monthly reporting of development spending excludes amounts directly paid by donors. Moreover, a number of fees 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 underway and a system of 'flash' reporting covering selected districts that account for the bulk of expenditure is being developed. Further improvement of fiscal data collected by the Financial Comptroller General's Office would permit the Ministry of Finance (MoF) to monitor more effectively actual revenue collections and expenditures, and to provide assessments during the course of the fiscal year. Such improvements will require further computerization in MoF regional offices, as well as donor financing and additional TA.

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 has assisted the authorities in processing surveys of public enterprises.

The NRB reports data regularly for publication in the *Government Finance Statistics Yearbook.*

Monetary Sector

Monetary data provided by the NRB have been subject to revisions with a substantial lag (up to 12 months). The 2001 multisector 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 aggregating balance sheet data to account for late reporting by commercial bank branches, which had led to underestimations for broad money.

In mid-2003, a monetary and financial statistics mission noted that the NRB has implemented some key guidelines of the IMF's *Monetary and Financial Statistics Manual,* notably on the sectorization of the economy and categorization of financial assets and liabilities. The mission made high-priority recommendations to address the following important shortcomings: (1) inadequate staff and computer resources; (2) interdepartmental data discrepancies on foreign reserve data; (3) late reporting of commercial banks and other banking institutions; (4) inaccurate estimation for late reporting commercial bank branches; (5) large interbank discrepancies; and (6) incorrect recording of repurchase agreements. The mission also recommended that the authorities consider the establishment of a Statistics Department in the context of NRB's ongoing reorganization. The authorities and STA are working to complete the implementation of the Standardized Reporting Forms.

Balance of Payments

A peripatetic Statistical Adviser conducted a series of missions in recent years. Despite improvements, net errors and omissions remain relatively large. Work is underway to improve the estimation of workers' remittances, and the data sources for private financial flows. Further work is needed to improve the recording of oil transactions, grants, foreign direct investment, short-term, and other private financial flows. In September 2003, the authorities began publishing the balance of payments in the format recommended by Fund technical assistance, but some other recommendations have not yet been fully implemented. Staffing is being increased.

Exports and imports data compiled by the NRB, the Customs Department, and the Trade Promotion Center (overseas trade only) exhibit discrepancies. Export and import price indices are not compiled, information on trade volumes is unavailable, and the NRB continues to estimate unrecorded trade. Staffing in the Customs Department is being strengthened.

Incomplete and conflicting data on government **external grants and loans** complicate estimating foreign financing. The NRB monitors cash disbursements and repayments, but most commodity aid and direct payment are excluded. MoF reporting is also incomplete and not timely. With technical assistance from the United Kingdom's DFID, a new database with comprehensive data on disbursements, repayments, and the stock of outstanding government debt has been developed and is currently being refined. International investment position data are not reported.

Nepal—Table of Common Indicators Required for Surveillance

(As of October 11, 2007)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	Sep. 2007	Oct. 2007	D and M	W and M	D and M
International reserve assets and reserve liabilities of the Monetary Authorities[1]	Aug. 2007	Sep. 2007	W	W	M
Reserve/base money	Aug. 2007	Sep. 2007	M	M	M
Broad money	Jul. 2007	Sep. 2007	M	M	M
Central bank balance sheet	Jul. 2007	Sep. 2007	M	M	M
Consolidated balance sheet of the banking system	Jul. 2007	Sep. 2007	M	M	M
Interest rates[2]	Jul. 2007	Sep. 2007	W and M	W and M	W and M
Consumer price index	Aug. 2007	Oct. 2007	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Aug. 2007	Sep. 2007	W	W	W
Revenue, expenditure, balance and composition of financing[3] – central government	Aug. 2007	Sep. 2007	W	W	W
Stocks of central government and central government-guaranteed debt[5]	2004/05	Jun. 2006	A	A	A
External current account balance	2006/07	Jun. 2007	Q/A	Q/A	A
Exports and imports of goods and services	2006/07	Jun. 2007	M	M	M
GDP/GNP	2004/05	Jun. 2007	A	A	A
Gross external debt	2004/05	Jun. 2007	A	A	A

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

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November 9, 2007

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fifth Review Under the PRGF Arrangement with Nepal and Approves US$16.9 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fifth and final review of Nepal's economic performance under the Poverty Reduction and Growth Facility (PRGF) arrangement. The completion of the review makes SDR 10.69 million (about US$16.9 million) available to Nepal, which would bring the total amount drawn under the arrangement to SDR 49.9 million (about US$79.1 million).

The Executive Board also approved Nepal's request for waivers of the nonobservance of six structural performance criteria. Waivers were granted in light of the minor or temporary nature of the nonobservance of five of the performance criteria, and the corrective actions taken towards the completion of the sixth performance criterion on the revision of the Banking and Financial Institutions Act (BAFIA).

The three-year PRGF arrangement with Nepal was approved on November 19, 2003 (see Press Release No. 03/202) for an amount equivalent to SDR 49.9 million (about US$79.1 million). At the conclusion of the third review, the PRGF arrangement was extended to November 18, 2007.

Following today's Executive Board discussion of Nepal's economic performance, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"The Nepalese authorities are to be commended for implementing prudent macroeconomic policies and structural reforms under difficult political circumstances.

"As the peace process moves forward, achievement of sustained higher economic growth and poverty reduction rests on resolution of political uncertainties and continued implementation of key structural reforms in the fiscal, financial, and public enterprise sectors.

“Continued macroeconomic stability is contingent on prudent fiscal policies that take into account the changing needs of the peace process. The 2007/08 budget is appropriately focused on boosting social sector and infrastructure spending, raising the revenue to GDP ratio, and limiting domestic financing. For the medium term, fiscal policy should remain focused on increasing revenue, including through improvements in tax administration, and on securing adequate concessional external assistance to raise social and infrastructure spending while reducing the public debt-to-GDP ratio. The authorities’ commitment to enhancing fiscal transparency is welcome.

“The exchange rate peg to the Indian rupee has served Nepal well in anchoring inflation. Improving external competitiveness requires efficiency-enhancing structural reforms and infrastructure investments.

“Further financial sector reform can help improve intermediation and secure stability. Key areas include early enactment of the revised Banking and Financial Institutions Act, improvements in the Nepal Rastra Bank’s supervisory framework, restructuring of the two largest commercial banks, and strong efforts to ensure loan recovery from large, willful defaulters.

“Recent adjustments to petroleum prices are a welcome step on the way to place the finances of the Nepal Oil Corporation on a sustainable footing,” Mr. Kato said.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies that are adopted in a participatory process involving civil society and development partners and articulated in the country's Poverty Reduction Strategy Paper. This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5½-year grace period on principal payments.

Statement by Perry Warjiyo, Executive Director for Nepal and Keshav Acharya, Senior Advisor to Executive Director November 9, 2007

1. On behalf of the Nepalese authorities, we wish to express our sincere gratitude and appreciation to Mr. Kalra and his team for very fruitful policy discussions on the fifth and final review of the PRGF arrangement held in Kathmandu during September 19–30, 2007. The staff report has eloquently encapsulated the economic and policy developments following the fourth review that was completed on June 13, 2007.

2. Our authorities are in general agreement with the staff's analysis and appraisal of the recent developments, issues and outlook of the Nepalese economy. In particular, the authorities wish to reiterate their strong commitment to maintaining macroeconomic stability and carrying forward structural reforms. As such, despite the difficult political environment, the overall economic performance have remained sound and the program has been broadly on track. We will briefly highlight the current political situation, economic developments, structural reforms and economic outlook, further reinforcing the staff's analysis and appraisal of the Nepalese economy.

Political Situation

3. Following the historic People's Movement of April 2006, the political transition in Nepal is still evolving. The constituent assembly (CA) election slated for November 22, 2007 has been postponed owing to demands from the Communist Party of Nepal-Maoists (CPN-M) for immediate declaration of a republic and an all out proportional electoral system as preconditions for going to the CA polls. Efforts are currently being made to address differences within the seven-party alliance (SPA) on this issue in order that a fresh new date for the CA election could be announced. Despite the current stalemate on this issue, all parties in the ruling alliance including the CPN-M have expressed their commitment to the comprehensive peace accord (CPA) reached on November 21, 2006 and to the continuation of the SPA.

4. In the meantime, the Maoist combatants are still in the cantonments. The United Nations' Mission to Nepal (UNMIN) is assisting Nepal in monitoring the peace process. The UNMIN is currently in the process of completing the second-round verification of arms and the combatants.

Recent Economic Performance

5. Despite the many unfavorable environment, the Nepalese economy in 2006/07 continued to secure growth albeit at a slower than expected pace. The end of insurgency and the restoration of peace were expected to facilitate growth. However, political uncertainties, load shedding, work disruptions, weak external

demand and unsatisfactory weather conditions belied the authorities' expectation of higher economic growth. As a result, the growth slowed to 2.5 percent in 2006/07 from 2.8 percent in 2005/06. Of the industrial origins, the growth was accounted for by the decline in the growth of agriculture and secondary sectors. On the demand side, the economic growth was mainly propped up by the increased private sector consumption on the back of the elevated level of workers' remittances and the rise in public spending.

6. The consumer price-based headline inflation moderated to 6.4 percent, on average, in 2006/07 from the level of 8.0 percent in 2005/06. With the exchange rate peg to the Indian rupee, the appreciation of Nepalese currency vis-a-vis the US dollar has suited well in containing inflationary pressures broadly in line with price development in India. In addition, the elapse of the base effect of the hike in prices of petroleum products in March 2006 helped moderate the inflation.

7. The overall balance of payments (BOP) remained in surplus on the back of the current account surplus, albeit lower than that of the preceding year, and the capital account transfers in 2006/07. Total merchandise exports recorded a growth of 0.9 percent in the domestic currency terms. The export of readymade garments and woolen carpet, the major exportable items to overseas, continued to decline, reflecting a lack of productivity gains. On account of the end of insurgency, the turnaround in tourism has taken place. However, the development of tourism to its potential of foreign exchange earnings and job creation has not taken place yet. Workers' inward remittances, which have emerged as the major source of foreign exchange earnings, remained at an elevated level, albeit the growth showed a marked decline in 2006/07.

Macroeconomic Outlook

8. Our authorities broadly concur with the staff's projection of the macroeconomic outlook for 2007/08. The authorities also expect a pick up in real GDP growth from 2.5 percent in the preceding year's level to around 4.0 percent. Improved weather condition this year is expected to drive up agricultural growth to around 3.0 percent. In addition, the major components of services sector such as tourism, transport, communication, and personal and community services are expected to contribute to a pick up in growth. However, as the staff report rightly points out, the performance of the industrial sector will remain at less than satisfactory level on account of weak external demand, load shedding and continuation of sporadic work disruptions.

9. The authorities had initially projected inflation in the range of 5–5.5 percent for 2007/08. With the very recent hike in petroleum prices, the authorities expect about a percentage point addition to the annual inflation at 6.5 percent in 2007/08. Pressure on overall prices is likely to arise from wage inflation on account of 17 percent effective hike in the salary of civil servants in this year's budget. Our authorities also feel that the upside risks to inflation outlook will emanate from the continuous rise in energy and food prices. Currency appreciation and lower import prices will have offsetting effect on overall prices. The authorities are committed to keep inflation low

through the appropriate monetary policy stance and prudent fiscal management. The NRB is committed to absorb liquidity through open market operations. The NRB will seek fiscal cooperation and request the government to continue to maintain fiscal discipline. A close coordination between monetary and fiscal policy will help keep inflation low.

10. On the external sector, even though trade deficit is expected to widen further owing to rise in imports relative to exports, the overall BOP is expected to remain in surplus on account of elevated level of workers' remittances and aid inflows. The authorities expect international reserves to remain at a level sufficient to cover about 6 months' imports of goods and services.

Fiscal Policy

11. Notwithstanding the difficult political environment, Nepal has maintained fiscal discipline, underpinning the overall macroeconomic stability. The overall fiscal deficit (after foreign grants) remained at 3.6 percent of GDP in 2006/07. The reform in tax administration, adjustment in customs duty on selected imports and enlargement of income and excise tax bases have succeeded in generating significant increase in fiscal revenues. As such, the revenue grew by 20.8 percent in 2006/07 compared to a growth of 3.1 percent in 2005/06. Revenue-to-GDP ratio also increased to 12.0 percent in 2006/07 from 11.0 percent in the preceding year.

12. A pick up in overall government expenditure as percent of GDP took place in 2006/07, reflecting a rise in recurrent expenditure and loans provided to ailing Nepal Oil Corporation (NOC). However, with the prudent fiscal management, the net domestic borrowing (net of overdraft position and excluding local authority balances) fell to 0.91 percent of GDP in 2006/07 from 1.35 percent in the preceding year. The prudent fiscal management also contributed to a decline in the public debt-to-GDP ratio in 2006/07. This reflects the responsible fiscal management and indicates the state of fiscal sustainability.

13. The budget for 2007/08 provides the fiscal policy framework, which is in line with the medium-term expenditure framework (MTEF) of the government. The budget aims to raise the revenue-to-GDP ratio further through the improvement in tax administration. The budget has also increased the overall expenditure on account of the increases in election and peace-related expenditure, programs for reconstruction, recovery and relief-related works, and wages of civil servants as enshrined in the three-year interim plan. Even though the budgetary data of the first quarter of 2007/08 show the significant increase in government expenditure in relation to government revenue, the rise in the overdraft has been contained within the ceilings prescribed by the NRB Act. The authorities have taken a note of it and are determined to rein in public expenditure and step up efforts to increase revenue.

Monetary and Exchange Rate Policies

14. In the face of the prevailing macroeconomic situation, the authorities feel that the management of monetary and exchange rate policies has been challenging. Workers' remittances continue to add liquidity. The credit off-take has increased but not to the extent at which it would absorb liquidity. As a result, real deposit rates are low. Obviously, excess liquidity has spillover effects on real estate and equity markets. This has also boosted private sector consumption. In the process, it has the potential to create pressure on overall prices.

15. The authorities are aware of this situation and are committed to initiate an appropriate policy response to maintain monetary and financial stability. Our authorities feel that the exchange rate peg to the Indian rupee provides a good framework to anchor inflation expectations and to keep inflation in check. The authorities broadly agree with the staff's monetary projection and appreciate the incorporation by the staff the authorities' assessment of likely higher growth of bank credit to the private sector. Two new commercial banks were established last year and three more have come into operation recently. The authorities are of the view that, besides capturing the market of other commercial banks, the new commercial banks are also likely to create additional businesses, leading to a rise in overall bank credit to the private sector.

16. The authorities are committed to use open market operations to keep monetary growth at an appropriate level. Open market operations like sale auction, purchase auction, repot auction and reverse repo auction will continue to work as the instrument for modulating liquidity. The liquidity monitoring and forecasting framework (LMFF) will continue to guide open market operations. Our authorities acknowledge the technical assistance provided by the Fund in developing the current monetary policy framework. The authorities continue to seek assistance from the Fund in developing and refining tools of monetary management.

Structural Reforms

17. During the program period, a number of structural reforms relating to the government finance, public enterprises and financial sector were introduced. The authorities feel that the continuation of structural reforms is crucial in accelerating economic growth and sustaining the process of sound economic management. Therefore, despite the difficult political environment, our authorities are committed to further reforms in key areas.

18. The authorities have attached priority to reforms in tax administration, public financial management and fiscal transparency. The authorities are planning to improve the operation of large tax office (LTO) by adopting the method of risk- based auditing of large taxpayers. The Parliament has already approved a new overhauled Customs Act to facilitate international trade. With a view to reform the Customs Department, wide area network (WAN) between headquarters and regional customs offices has been established. Plans are afoot to further expand the ASYCUDA

system. As for improving fiscal transparency, the authorities are committed to implement the recommendations of the draft Report on Standards and Codes.

19. With a view to improve the financial position of the loss-incurring NOC, the authorities increased prices of petroleum products on October 24, 2007. Given the continuous rise in energy prices at the global level, the present adjustment could still be inadequate. As the issue of energy prices is the sensitive one and the country is in political transition, the authorities view that it is rational to make a slow but a steady move on this. The authorities are committed to introduce an automatic pricing mechanism for oil and seek the private sector's participation in the importation and distribution of oil.

20. There has been a rapid expansion of the financial sector in terms of number and financial depth in recent years. The authorities are aware of the regulatory implication of this growth. In April 2007, the NRB raised paid-up capital and strengthened the "fit and proper test" for promoters in the new bank licensing policy. This reflects the authorities' commitment to the financial sector stability. In September this year, the NRB issued a directive on margin lending in share market to ensure an orderly development in the stock market. Likewise, with a view to remove distortions created by the system of cross-holdings of shares by the financial institutions, the NRB has issued a directive asking all banks and financial institutions to divest their promoter shares in other banks and financial institutions by mid-July 2008. A revised draft of the Banks and Financial Institutions Act (BAFIA), which incorporates 25 core principles of bank supervision, clear guidelines for mergers and acquisitions, and procedures for voluntary and involuntary liquidation, has been recently submitted for the Cabinet's approval.

21. The reengineering of the NRB continues with the focus on its core functions and the elimination of the non-core functions. The NRB is also reinforcing the financial safeguard measures developed with the technical assistance from the Fund. Of the external management teams placed in the two State owned banks, the management contract for five years in the NBL has expired and the NRB has temporarily taken over the management of the bank. The term of external management placed in the RBB expires in early 2008. The authorities are committed to continue the process of restructuring these two banks. The loan recovery from large willful defaulters has remained below the authorities' expectation. A number of measures including the seizure of passports of large willful defaulters, freezing the bank accounts of such defaulters and making restrictions on asset sales by such borrowers except for the purpose of loan repayments have been put in place.

Program Performances

22. Of the performance criteria, all quantitative performance criteria (QPCs) for the fifth and final review have been met with significant margins. As for structural performance criteria (SPCs), non-observance of five SPCs is minor or temporary. As for the Cabinet approval of the revised Banking and Financial Institutions Act

(BAFIA), the Cabinet has approved it on its November 5 Meeting and forwarded the draft to its Bill Committee for submission to the Parliament after looking into all the legal and constitutional provisions. The Nepalese authorities have shown their firm commitment to sound macroeconomic policies and reforms. They are aware of the high vulnerability of the Nepalese economy to the political developments. Our authorities also continue to count on timely donor support. Therefore, the Nepalese authorities have requested waivers for delayed and non-observance of SPCs as well as the completion of the fifth and final review of the PRGF arrangement.

Conclusion

23. Nepal has greatly benefited from the PRGF program put in place since 2003, the final review of which is taking place today. During most of this period, Nepal was in difficult situation on account of internal conflict and political instability. The authorities recognize the role of the Fund program in initiating economic and financial sector reforms under such difficult circumstances. Although economic growth remained sluggish due to insurgency, the consequent political instability, and poor weather conditions, the Fund program played a key role in assisting the authorities in maintaining macroeconomic stability. Recognizing the role of the Fund program and the donor support in accelerating structural reforms and maintaining macroeconomic stability even under trying circumstances, the Nepalese authorities are showing a keen interest in a successor Fund arrangement to support a three-year interim plan. The authorities are looking forward for the Article IV mission early next year, to deliberate on the most appropriate instrument.

24. The Nepalese authorities have consented to the publication of the letter of intent as well as the staff report.