June 2007
IMF Country Report No. 07/204

Nepal: Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Requests for Waiver and Modification 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 fourth review under the Stand-By Arrangement and request for a waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Requests for Waiver and Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on February 15, 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 May 30, 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 June 13, 2007 discussion of the staff report that completed the review; and

- a statement by the Executive Director for Nepal.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Nepal*
Memorandum of Economic and Financial Policies by the authorities of Nepal*
Technical Memorandum of Understanding by the authorities for 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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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

NEPAL

Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, and Requests for Waiver and Modification of Performance Criteria

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

Approved by Kalpana Kochhar and Matthew Fisher

May 30, 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.

- Discussions on the fourth review were held in Kathmandu during February 2–15. The staff team comprised Messrs. Kalra (Head) and Ginting, Ms. Duma and Ms. Jotikasthira (Administrative Assistant) (all APD), assisted by Mr. Pitt, Resident Representative. The mission coordinated with the resident AsDB and World Bank offices. Ms. Phang (Executive Director) and Mr. Acharya (Senior Advisor to Executive Director) participated in the discussions.

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

- In completing the second and third reviews, Directors commended the authorities' efforts in maintaining macroeconomic stability and advancing the reform agenda in a challenging political environment. Directors noted that durable peace and political stability remain critical to improving economic prospects. Directors encouraged the authorities to pursue structural reforms in key areas, including the fiscal sector, financial sector, and public enterprises. Several directors also asked staff to initiate work on a successor arrangement at an early date.

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EXECUTIVE SUMMARY

Significant political developments have taken place since the November 10, 2006 Executive Board meeting. The seven party alliance (SPA) government and the Communist Party of Nepal (Maoist, CPN-M) signed a Comprehensive Peace Accord; in January 2007, the interim constitution became effective, and the CPN(M) joined the interim parliament; and on April 1, the CPN-M joined the SPA alliance to form an interim government. The interim government has expressed a commitment to continued reform implementation.

Economic outcomes have been in line with the program, macroeconomic policies have remained sound, and the PRGF-supported program is broadly on track. All quantitative performance criteria for the fourth review were met. A number of structural performance criteria and benchmarks have been implemented, albeit with delays. For those that have not been completed, substantial progress has been made, and understandings have been reached on a revised timeframe for implementation. With this, the authorities have requested waivers for four structural performance criteria and completion of the fourth review, as well as modification of performance criteria for the fifth (and final) review.

Nepal's economic prospects have improved; however, risks remain. Real GDP growth could rise to 3−3½ percent in 2006/07 from under 2 percent in 2005/06. Over the medium term, growth could be higher if key structural reforms are implemented. With the exchange rate peg, underlying inflation should remain comparable to Indian levels. Continued strong remittances and higher aid flows are projected to help maintain adequate reserves. Risks to growth and program implementation stem from the still unsettled political environment, constrained space for policy implementation in the run-up to the constituent assembly elections, and unrest in the southern Terai.

Going forward, the program is geared to maintaining macroeconomic stability and furthering structural reforms. It envisages prudent macroeconomic policies, with adjustments to accommodate the evolving financing needs to further the peace process. To meet these needs, a modest increase in domestic financing of ¼ percent of GDP (to 1¾ percent of GDP) is required. The exchange rate peg to the India rupee will help maintain inflation close to levels in India. Structural reforms cover three macrocritical areas—tax administration and fiscal transparency; financial sector reforms; and Nepal Oil Corporation and the oil sector. Beyond the program period, the authorities have expressed interest in a successor arrangement to support a three-year interim plan focused on rehabilitation, reconstruction, and recovery from the 11-year insurgency.

The authorities' efforts and achievements—continued macroeconomic stability and further progress in structural reforms under trying circumstances—merit international support. Staff recommends approval of the authorities' request for waivers for nonobservance of performance criteria and completion of fourth review under the arrangement, and modification of performance criteria for the fifth review.

I. INTRODUCTION

1. **Significant political developments have taken place since the November 10, 2006 Executive Board meeting**. On November 21, the seven party alliance (SPA) government and the Communist Party of Nepal (Maoist, CPN-M) signed a Comprehensive Peace Accord. The Accord marked the official end of the 11-year insurgency, laid the basis for the formation of an interim parliament and government with participation of CPN-M, and for constituent assembly elections to be held in June 2007. In January 2007, the interim constitution became effective, and the CPN(M) joined the interim parliament. On April 1, the CPN-M joined the SPA alliance to form an interim government.

2. **Even as the peace process moves forward, the political situation remains complicated**. Constituent assembly elections are unlikely to take place as scheduled in June 2007 as considerable groundwork remains to be done on the electoral framework; they will most likely be held in November. Financing needs and logistics of the peace process—maintenance of camps for former Maoist combatants, preparations for constituent assembly elections (including security arrangements), and the fair conduct of the elections—pose continuing challenges. In addition, public agitations by various regional and ethnic groups—such as those by *Madhesis* in the southern Terai region and by indigenous groups which began in January—have a strong potential for further political and economic disruptions. These agitations, often violent, seek greater representation for the aggrieved groups in the interim constitution and constituent assembly elections.[1]

3. **The interim government has reaffirmed its commitment to the Fund-supported program to help maintain macroeconomic stability and advance reforms in key areas**. The government views the direction of reforms underlying Nepal's PRSP and PRGF arrangement as appropriate for achieving key objectives—sound economic management, better expenditure prioritization, structural reform in major economic sectors, and improved governance to deliver conditions for sustained growth and poverty reduction.[2] The CPN-M's declared economic agenda is centered on land reforms (especially redistribution) in the agricultural sector and on protection for Nepali business; however, it has expressed a willingness to work with multilaterals and bilateral donors, and sensible compromises are possible with its agenda. In addition, the CPN-M is supportive of a number of PRSP policies,

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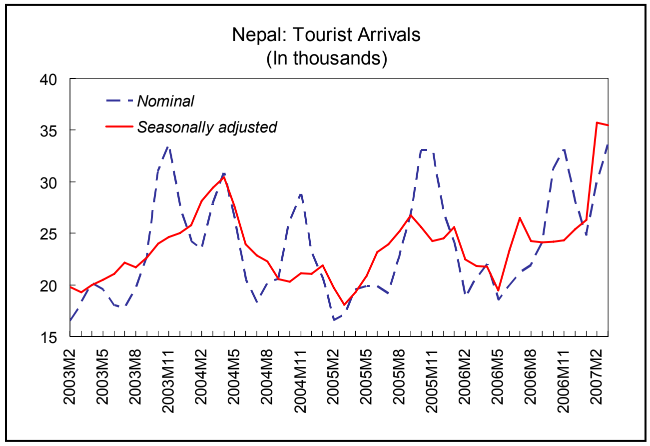
[1] For this, the interim constitution is to be amended to set up federal governance structures; ensure proportional representation for *Madhesis*, "backward classes" ethnic and other groups in state organs; and revise electoral constituencies.

[2] A progress report on Tenth Plan/PRSP implementation in 2004/05 was completed in June 2006, and a Joint Staff Advisory Note was circulated to World Bank/IMF Executive Boards in December 2006.

including higher social sector spending, transparency, and actions against large willful defaulters.

II. Economic Developments and Performance Under the Arrangement

4. **Economic outcomes were broadly in line with the program during the first half of 2006/07.**[3] Real GDP growth is on an upward trajectory, notwithstanding poor weather conditions which affected paddy production adversely and political uncertainties which continued to constrain budgetary capital spending. Tourism, transportation, and services also appear to be reviving. Activity remains dependent on consumption (driven by strong remittances) and public spending. Private investment remains dampened by an unfavorable investment climate, including labor demands, power shortages, and work disruptions. In mid-March, underlying CPI inflation was 5½ percent, broadly in line with price developments in India. Supported by robust private remittances, international reserves rose from US$1¾ billion at end-2005/06 to US$2 billion in March 2007 (Table 1).



5. **Macroeconomic policies remained sound**. Revenue grew strongly (by 20 percent during Q1-Q3 of 2006/07 compared to the same period in 2005/06), aided by a strong tax administration effort, higher customs duty rates on selected imports, and a broadening of the excise tax base. With development spending still constrained by implementation capacity at the local level, the budget made a net repayment to the domestic banking system of Nrs. 6 billion (1 percent of GDP). Monetary policy of Nepal Rastra Bank (NRB) remained geared to maintaining the exchange rate peg to the Indian rupee.

6. **The PRGF-supported program is broadly on track**. All quantitative performance criteria and indicative targets for review (test date was January 14, 2007) were met, with significant margins. A number of structural performance criteria and benchmarks have been implemented, albeit with delays (Table 6). In this context, the authorities have requested waivers for nonobservance of four structural performance criteria. These are:

[3] Fiscal year begins mid-July.

(i) Large Taxpayer Office (LTO) to conduct a comprehensive audit of at least 30 large taxpayers by mid-January 2007. This was completed around mid-May and thus the nonobservance of the performance criterion was temporary;[4]

(ii) Customs Department to establish a wide-area network (WAN) for headquarters and at least five large customs offices by mid-March 2007. Significant progress has been made and the WAN is expected to be established in the near future;

(iii) Nepal Rastra Bank to divest its shareholding in the Non-Life Insurance Division of Rastriya Beema Sansthan (NIRBS) and Citizen Investment Trust (CIT) by mid-February 2007. The NRB has divested its shareholding in the CIT. The NRB Board has decided to divest its shareholding in NIRBS. However, the bids received were insufficient to extinguish the NRB's total shareholding, and the NRB is engaged in efforts to divest the remainder. As a sign of its commitment, the NRB has also divested its shareholding in a rural development bank (which was scheduled for July 2007); and

(iv) Nepal Oil Corporation (NOC) to finalize audit of its 2005/06 accounts in accordance with international standards by mid-March 2007. After some delay, an auditor was appointed in February 2007 and work on the audit is underway.

7. The authorities have requested that test dates for performance criteria (ii), (iii) and (iv) be modified to July 15, 2007 and that the fourth review under the arrangement be completed.[5]

III. Report on the Discussions

8. **The authorities expressed commitment to reform implementation during the remainder of the program period and interest in a successor arrangement**. The program is geared to maintaining macroeconomic stability through prudent policies, with adjustments to accommodate the evolving financing needs of the peace process. It also aims to continue structural reforms in three macrocritical areas—tax administration and fiscal transparency; financial sector reforms; and NOC and the oil sector. Beyond the program period, the

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[4] The LTO has conducted audits of 2005/06 income tax, VAT returns, and excise declarations of 30 large taxpayers. It has also cross-checked these returns against customs declarations by the taxpayers, as appropriate.

[5] As for structural benchmarks, two (out of six) were observed. Of the remaining four, cabinet approved a new Customs Act, with delay; a draft Anti-Money Laundering Act is in cabinet committee; the Nepal Industrial Development Corporation (NIDC) Board has approved divestment of its shareholding in a commercial bank, and is considering an offer from another financial institution; and NRB guidelines for mergers and acquisitions are to be issued in the context of a revised Banking and Financial Institutions Act during the program period.

authorities expressed interest in a successor arrangement to support a three-year interim plan which would focus on rehabilitation, reconstruction, and recovery from the 11-year insurgency.

A. Macroeconomic Outlook and Risks

9. **The authorities expect Nepal's economic prospects to improve**. On balance, real GDP growth could rise to 3−3½ percent in 2006/07 from under 2 percent in 2005/06. Government spending could provide greater support for economic activity as budgetary capital spending picks up (especially on rural infrastructure) in the remainder of 2006/07. Manufacturing activity may struggle to recover until input supplies, labor disputes, and political uncertainties are resolved to create an environment for higher investment. Over the medium term, growth could be higher if key structural reforms are implemented. With the exchange rate peg, underlying inflation should remain in the 5−6 percent range, comparable to Indian levels. As regards the balance of payments, continued strong remittances and higher aid flows are projected to offset trade deficits (in part due to higher imports as growth recovers) and help maintain reserve cover at 6 months of goods and services imports over the medium term.

10. **Risks to growth and program implementation arise principally from the still unsettled political environment**. Risks from the insurgency have receded significantly as the peace process moves forward. Political risks will subside somewhat after constituent assembly elections have been held and the results are broadly accepted. In the run-up to the elections, the space for policy implementation will remain constrained in some areas. For example, the stance of the CPN-M on areas such labor market reforms and privatization/liquidation of insolvent state-owned enterprises will be a deterrent to far reaching reforms. In addition, there are risks to growth and the fiscal position if demands for greater representation by *Madhesis* in the Terai and indigenous groups cannot be satisfactorily accommodated politically and continue to disrupt economic activity for an extended period. In addition, the authorities' medium-term economic plans are in a flux. In particular, the interim plan provides only an indication of the spending pressures going forward, and is yet to be firmly grounded in a realistic macroeconomic and fiscal framework.

B. Fiscal Policy

11. **The 2006/07 budget, adopted in mid-July 2006, was focused on increasing the level and improving the quality of public spending and raising the revenue-to-GDP ratio**. On the expenditure side, the budget made provisions for a significant scaling up of social sector and public investment programs on health, education, and rural infrastructure, prioritized along the lines of the Medium Term Expenditure Framework (Table 2). The allocation for security-related spending was reduced by ½ percent of GDP to 2¾ percent. On the revenue side, a rebound in activity and reduced supply disruptions were projected to boost revenue from 12¼ percent of GDP in 2005/06 to 13 percent of GDP in 2006/07. Also

contributing to the increase in revenue were higher customs duty rates on selected imports and higher excise taxes on alcohol, beer, and cigarettes. With the sharp rise in spending to meet development needs only partly offset by revenue increases, the overall deficit (before grants) was expected to rise to 6¾ percent of GDP. With grants projected to rise to 3¾ percent of GDP, the overall deficit (after grants) was to be limited to 3 percent of GDP of which the domestically financed deficit was set at 1½ percent of GDP. Notwithstanding the higher overall deficit compared to 2005/06, the public debt-to-GDP ratio was projected to decline.

12. **Since the adoption of the budget, the peace process has moved forward quickly, requiring adjustments for the remainder of the fiscal year**. The additional spending needs for peace-related activities, including the upkeep of Maoist camps, security arrangements and preparations for constituent assembly elections, and rehabilitation of internally dislocated persons are high. To meet these needs, a revised fiscal framework for 2006/07 is required. The revised framework comprises a modest increase in domestic financing of ¼ percent of GDP (to 1¾ percent of GDP) and a reallocation from capital spending (from projects which are unlikely to be implemented) to current spending. The authorities also intend to tighten revenue administration to raise collections. With lower external financing projected for the remainder of the fiscal year, the overall deficit (after grants) for 2006/07 would remain at 3 percent of GDP. To raise external resources for peace-related activities, the GON has also set up a Peace Fund to attract donor and other financing.[6] Donor contributions to the Fund have so far been limited.

Nepal: Government Operations, 2006/07

	Budget	Program Revised
	(In percent of GDP)	
Total revenue	13.1	13.2
Tax revenue	10.9	10.9
Nontax revenue	2.3	2.3
Grants	3.7	3.0
Total expenditure	19.9	19.3
Current	13.0	13.6
Capital and net lending	6.8	5.7
Overall balance after grants	-3.0	-3.1
Net foreign loans	1.5	1.2
Net domestic financing	1.6	1.8

Sources: Nepalese authorities; and staff estimates.

13. **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**. The revenue-to-GDP ratio is targeted to increase to 13½ percent by 2008/09 through further improvements in administration and base broadening, including elimination of VAT exemptions and reducing customs and excise leakages. On the spending side, the priorities include rehabilitation, reconstruction, and recovery. In addition, higher spending is required on key social sector and infrastructure projects, especially in the rural areas where the bulk of

[6] 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.

the poor live. These priorities are outlined in the National Planning Commission's three-year draft interim plan. The plan is expected to be finalized by mid-July 2007, and the 2007/08 budget will provide an opportunity to hold fuller discussions with the interim government on the medium term fiscal framework. This framework would need to hold the overall and domestically financed deficits at levels that maintain fiscal sustainability, while allowing adequate room to accommodate the costs of reforms in the financial sector and public enterprises.[7] Staff projections suggest that overall deficits in the range of 3−4 percent of GDP can maintain the public debt-to-GDP ratio on a downward trajectory in a baseline scenario (excluding liabilities from financial sector and public enterprise reforms which are expected to be in the range of 7−8 percent of GDP).[8] This scenario is, however, subject to vulnerabilities, especially from export shocks and a large depreciation in the exchange rate, as noted in the LIC-DSA. In this context, potential debt relief from participation in the HIPC-MDRI initiatives provides an opportunity to reduce vulnerabilities, although the authorities indicated that they are still weighing the relative merits of participating in the initiatives.

C. Monetary and Exchange Rate Policies

14. **The NRB intends to maintain the exchange rate peg to the Indian rupee**. Reserve money growth is projected at 15¼ percent as NRB net foreign assets rise by US$110 million in 2006/07. Broad money growth is projected at around 16 percent, assuming a small decline in velocity as confidence in the banking system improves and real GDP growth picks up to 3−3½ percent. This would allow for real private credit growth of 8−9 percent, while accommodating the financing needs of the budget (Table 3). As to the exchange rate peg, the authorities view the level of the peg as broadly appropriate.[9] In this context, structural reforms and infrastructure investments to reduce transportation and transactions costs are key to improving external competitiveness while the peg helps to anchor inflation expectations given the substantial (and increasing) volume of current account transactions with India.

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[7] The bulk of these costs 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. These costs are expected to be in the range of ¼–¾ percent of GDP.

[8] In a baseline scenario, public debt is projected to decline from 56¾ percent at end-2005/06 to around 50 percent by 2009/10. These projections are presented in the Appendix (LIC-DSA). Most external debt indicators remain below the policy-dependent indicative thresholds in this scenario, except the NPV of debt-to-exports ratio (estimated at 163 percent at end-2005/06).

[9] The real exchange rate has remained broadly stable around its average value since 2003. Staff's analysis suggests that changes in the level of the peg have only a transitory effect on the real exchange rate.

15. **Substantial liquidity in the financial system from continued strong remittances needs to be managed**. Net foreign currency purchases to ease upward pressure on the exchange rate amounted to around US$200 million until mid-March 2007, with a substantial reduction in NRB T-bill holdings. Given the limited stock of T-bills remaining at the NRB's disposal, continued strong remittances and a pickup in aid inflows continue to pose a significant challenge for liquidity management. The mission suggested that the NRB could acquire an additional stock of T-bills from the Ministry of Finance to assist with liquidity management, and engage in repo operations with the newly finalized Master Repurchase Agreement.

D. Structural Reforms

Fiscal Sector

16. **Fiscal sector reforms are centered on tax administration and fiscal transparency**. The LTO has conducted comprehensive audits of large taxpayers to strengthen enforcement, and these are to be further intensified. The Inland Revenue Department has reduced the ratio of VAT nonfilers to registered taxpayers, and is engaged in automation to improve taxpayer service and increase collections. The cabinet has approved a new, overhauled Customs Act (as against the commitment to make amendments to the existing act) to facilitate trade, consistent with WTO and other international commitments. The Customs Office is nearing completion of the WAN, and plans to install the ASYCUDA system thereafter. For the remainder of the program period, these initiatives are to be carried forward. As regards fiscal transparency, the government is committed to implementing recommendations made in the fiscal transparency module of the draft *Report on Standards and Codes* and those that arise from ongoing IMF technical assistance.

Financial Sector

17. **The authorities are making progress on their financial sector reform agenda 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. As part of this effort, the NRB's licensing policy has been tightened to check the proliferation of financial institutions, steps are in train to eliminate regulatory obstacles to mergers and acquisitions of weak entities, and an Anti-Money Laundering legislation is being finalized for parliamentary approval. An overhaul of the Banking and Financial Institutions Act (BAFIA) will also be completed during the program period, including changes to strengthen NRB supervision over the financial system, improvements in licensing policies, and steps to promote financial sector consolidation.

- To strengthen the NRB, the supervision department has completed a self-assessment against Basle Core Principles for Effective Bank Supervision, with IMF technical assistance. This self-assessment had yielded a roadmap and timeframe for addressing weaknesses in the NRB's supervisory framework (Box 1). In addition, NRB "reengineering" plans are focused on eliminating noncore functions. As part of this effort, the NRB has divested its shareholdings in two financial institutions, and intends to do so for another two during the remainder of the program period.

- 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] A key element of these efforts is a reduction in nonperforming loans. While the GON and NRB remain committed to restructuring of the banks, envisioning a timeframe and modalities for the exit of these teams is becoming difficult. The management teams are operating in an environment of greater labor assertiveness which, together with political developments, is making planning for eventual privatization of the banks difficult.

- The GON and NRB acted in mid-February on their public commitment to take strong action to further loan recovery by annulling the passports of over eighty large, willful defaulters. In addition, their bank accounts were frozen, and restrictions were placed on asset sales by them except for the purpose of loan repayments. Loan recovery from these defaulters remain difficult due to their ability to manipulate the judicial process.

Nepal Oil Corporation and the Oil Sector

18. **Further steps are envisaged in the program to address NOC losses**.[11] While lower international oil prices have provided some respite from flow losses to the NOC, accumulated losses with the Indian Oil Corporation are disrupting supplies. The NOC also suffers from operational inefficiencies. To address these issues, the Petroleum Sales and Distribution Act to liberalize the oil sector and further increase private sector participation was submitted for parliamentary approval. However, private sector participation is likely to

[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-January 2007 was Nrs. 6 billion (1 percent of GDP) and Nrs. 16½ billion (2¾ percent of GDP), respectively.

[11] In February 2007, these accumulated losses stood at Nrs. 13½ billion (2 percent of GDP).

Box 1. Nepal Rastra Bank Self-Assessment Against Basle Core Principles

An assessment of bank supervision at Nepal Rastra Bank (NRB) using the Basle Core Principles (2006) was conducted in January 2007. The areas needing the most attention for Nepal to comply more fully with Core Principles included:

- Reinforcing the autonomy of the NRB by setting precise objectives for supervision, and reporting on their achievement annually; strengthening governance by reserving the Board's role to that of policy setting and review of the NRB's operational decisions.
- Strengthening licensing requirements and 'fit and proper' criteria to ensure that new banks are viable and have effective, experienced management. Improving corporate governance at banks and highlighting the formal responsibility of Boards of Directors for approving banks' risk management policies, procedures, internal systems, and controls.
- Developing further the NRB's risk based approach to supervision and conducting quality assurance of supervision function at reasonable intervals.
- Enhancing the framework for consolidated supervision and establishing formal relationships with home country supervisors for information exchange.
- Facilitating bank resolution outcomes by providing a legal framework for the acquisition of one bank by another, subject to approval by NRB.

Based on this assessment, an action plan going forward includes:

- Revising the licensing procedure to ensure that licenses are issued on the basis of a viable business plan and that directors and managers have appropriate skills and experience; improving supervisory capacity to identify beneficiary owners of shares.
- Strengthening legal ability to define and approve transfers of beneficiary interest in shares and to identify related and connected lending.
- Strengthening prudential regulation by enforcing existing minimum capital requirements; expanding classification and provisioning requirements to cover off-balance sheet exposures; introducing capital requirements for market risk; revising guidelines to ensure banks have comprehensive, Board approved risk management policies, including on country, foreign exchange and other market risks and operational risk; and reinforcing the use of international accounting standards in published financial statements.
- Requiring banks to notify the NRB of any material adverse development or matter of supervisory interest or breach of compliance.
- Strengthening the capacity of the Credit Information Bureau.
- Implementing regulations on consolidated supervision, including risks emanating from parallel shareholding structures with industrial and financial companies.
- Issuing revised NRB regulations on mergers and acquisitions.

be limited until an appropriate pricing mechanism is in place. For this, staff discussed with the authorities the introduction of an automatic pricing mechanism within the remainder of the program period (Box 2). In the meantime, the government is to cover any additional flow losses transparently until such time as prices are raised to break even levels.

IV. Program Monitoring

19. **The program will be monitored through quantitative and structural performance criteria proposed for the fifth (and final) review**. The authorities are requesting completion of the fourth review at this time (Tables 5 and 6), and modification of performance criteria for the fifth review under the arrangement.

V. Staff Appraisal

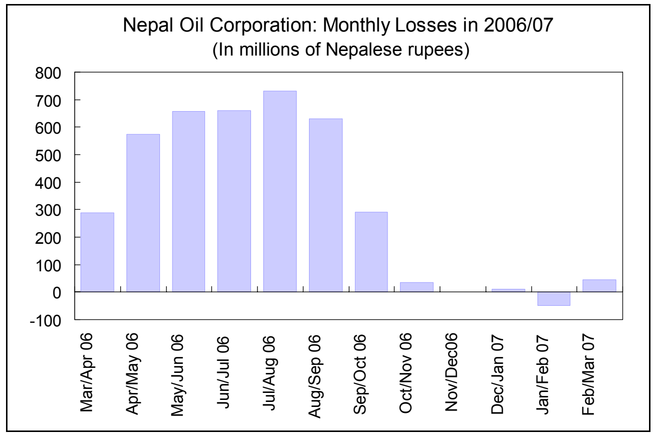
20. **Durable peace in Nepal remains key to higher, sustained growth and poverty reduction**. While risks to growth from the insurgency have receded considerably, demand for greater representation from various sections of society have added to unrest. Meeting these demands is likely to engage the national effort over an extended period, in which the successful conduct of constituent assembly elections is a key step. Meanwhile, the law and order situation will pose a continued challenge to economic activity. Restoration of law and order for the conduct of widely acceptable constituent assembly elections will be a test of the interim government.

21. **Against this background, Nepal's economy continues to be resilient**. Macroeconomic stability has been maintained. In 2006/07, a modest increase in real GDP growth can be expected, especially as tourism rebounds and government spending picks up. In addition, manufacturing could revive if the cost of doing business can be reduced by resolving labor disputes early and effectively. Over the medium term, growth rates upwards of 5 percent are achievable if macroeconomic stability can be maintained and structural reforms are implemented in key areas, including the financial sector, public enterprises, and governance.

22. **Maintaining macroeconomic stability requires continued prudent fiscal policies with adjustments for evolving needs**. In this context, the 2006/07 budget—with its focus on social sectors and infrastructure spending in rural areas, a higher targeted revenue-to-GDP ratio, and low domestic financing—struck the appropriate balance between being fiscally responsible while being responsive to development needs. On the revenue front, the achievements in tax administration, especially at the Large Taxpayer Office, are especially noteworthy. Efforts to plug leakages, broaden the tax base, and improve taxpayer services already appear to be paying dividends. Spending pressures to meet peacekeeping needs,

Box 2. Nepal Oil Corporation and Fuel Price Adjustment

NOC's financial position improved following the softening of international fuel prices and policy action to raise the price of aviation fuel. The flow losses have declined substantially from Nrs. 730 million in mid-2006 (1¾ percent of GDP on annualized basis) to Nrs. 59 million in mid-April 2007. However, LPG remains a major source of losses for NOC as its price has been relatively unchanged since early 2004. As a result, profits generated from the sales of other petrol products are offset by the losses from LPG sales.



Nepal Oil Corporation: Monthly Losses in 2006/07
(In millions of Nepalese rupees)

Nepal: Pricing of Petroleum Products and NOC Losses1/

Product	NOC Sales Price /IOC Price	NOC Sales Price/ BEP Price	Monthly Loss (Nrs. millions)
Petrol	1.62	0.95	-27.5
Diesel	1.26	0.96	-49.3
Kerosene	1.15	1.03	24.7
LPG 2/	0.97	0.74	-139.6
Avation fuel	1.69	1.50	146.0
Total	…	…	-45.7

Sources: Nepal Oil Corporation; and staff estimates.

1/ For March 16, 2007.
2/ IOC price is based on Haldia price.

To ensure future supply of fuel products, NOC recently renewed its supply agreement with Indian Oil Corporation (IOC). Among others, the new agreement allows NOC to procure fuel products from third countries. It also includes provision for customs duty drawback and a discount on marketing fees which are expected to reduce border prices of petrol products. However, NOC's accumulated obligations to IOC pose continuing problems for the supply of petroleum products to Nepal.

NOC will need to generate sufficient profits to meet its obligation to make timely payments on suppliers' credits while maintaining supplies at adequate levels. This will require a robust price adjustment mechanism going forward. International experience suggests that automatic pricing mechanisms which link domestic prices to international levels work better than ad hoc adjustments. The automatic price adjustment could substantially depoliticize domestic fuel price setting and could be adapted to local circumstances. Such an automatic pricing mechanism for Nepal should include the following important features:

- Adjustment of LPG price to break-even level, which would then be linked to international price.
- An automatic pricing mechanism for other fuel products with margins sufficient to cover payment of suppliers' credits. Initially, the budget may need to provide temporary financial support to repay suppliers' credits.
- The mechanism should be fully documented and clearly explained to the public. To limit instances of large discrete price adjustments, petroleum product prices should be adjusted on a monthly basis. To ensure broad acceptance, the package would include measures to mitigate the impact on the poor.

In the long run, it is essential to improve the operational efficiency of NOC. The passage of the Petroleum Sales and Distribution Act and implementation of the proposed pipeline from IOC's Raxaul depot to Amlekhganj depot in Nepal would help in this regard.

maintain law and order, and integrate the former Maoist combatants into the mainstream will remain high. The donor community will need to help defray part of these costs. Over the medium term, the budget should remain focused on raising revenue and mobilizing adequate external assistance, especially grants and concessional loans, to step up expenditure on social sectors and infrastructure, while reducing the public debt-to-GDP ratio. The interim plan would need to remain mindful of the need to maintain macroeconomic stability, even as it addresses development, reconstruction, and rehabilitation priorities. External assistance is required to finance liabilities arising from financial sector and public enterprise reforms. The GON's commitment to increase fiscal transparency is welcome.

23. **Maintaining the exchange rate peg is appropriate and policies are geared to supporting this arrangement**. Coordinated efforts by the NRB and the MOF to place additional T-bills are required to aid the central bank in managing banking system liquidity.

24. **Financial sector reforms are advancing, although much remains to be accomplished**. Improvements in the legal framework, especially an overhaul of the BAFIA, would set the stage for meeting WTO commitments on financial liberalization by 2010, and facilitating consolidation and raising financial sector integrity. Other changes to merger and acquisition provisions, higher capital requirements for banks, and improved NRB supervision over the financial sector would facilitate much needed consolidation in the financial sector. With its planned divestment in financial institutions, the NRB will be better placed to concentrate on its core functions. A determined effort is still required to improve the financial condition of NBL and RBB, especially through substantial loan recovery from large, willful defaulters which has remained elusive. After almost four years of restructuring by external managers, the authorities need to focus on further steps, including privatization of the two banks.

25. **Greater efficiency in NOC operations and the oil sector is possible with the proposed reform measures**. In this context, staff welcome the Petroleum Sales and Distribution Act. The increment in the public debt-to-GDP ratio from flow losses covered by the budget would be manageable over the medium term. Staff recommends the introduction of an automatic pricing mechanism for petroleum products at an early date.

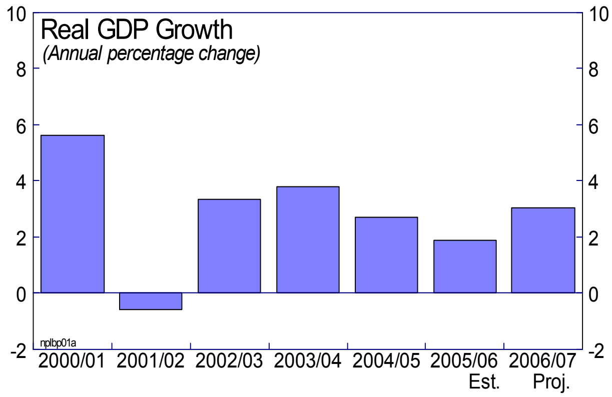
26. **Going forward, prospects for policy implementation during the remainder of the program are subject to risks which should be manageable**. The SPA coalition already consisted of parties that have steered PRSP reforms in the past; the CPN-M's participation in the government allows an important avenue for persuading it that the PRSP reform agenda is in the best interest of Nepal. With the program crafted to address macrocritical issues, the subscription of the full interim government to the PRGF reform agenda is already an important step. Risks to implementation of program measures come from possible delays owing to difficulties in reaching a political consensus within the interim government. In addition, political developments in the Terai and preparations for constituent assembly elections will likely consume a large share of the government's attention in the coming

months. Staff considers these risks to program implementation manageable and acceptable in view of the authorities' demonstrated commitment to reforms, and encourages them to persevere with their efforts.

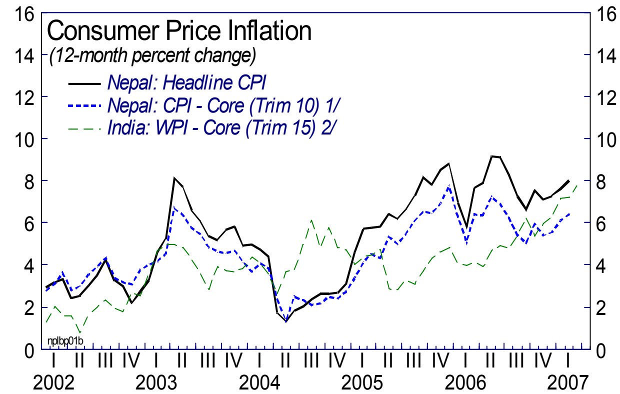
27. **The authorities' efforts and achievements—continued macroeconomic stability and further progress in structural reforms in 2006/07 under trying circumstances—merit international support**. With respect to the waivers requested for completion of the review, the nonobservance of one structural performance criteria (audit of large taxpayers by the LTO) was temporary. For the remaining three structural performance criterion (establishment of a WAN by the Customs Department; divestment by NRB in NIRBS and CIT; and audit of the NOC's 2005/06 accounts), progress has been made by the authorities, corrective actions are being taken, and understandings have been reached that these actions be completed by July 15, 2007. With this, staff recommends approval of the authorities' request for waivers for nonobservance of performance criteria, completion of fourth review under the arrangement, and modification of performance criteria.

Figure 1. Nepal: Economic Developments and Prospects

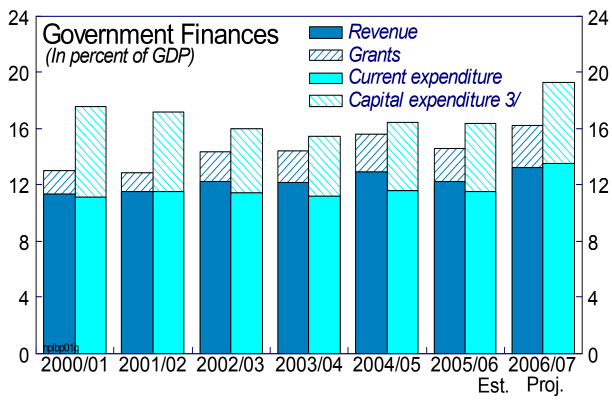
Nepal's growth prospects are expected to improve...



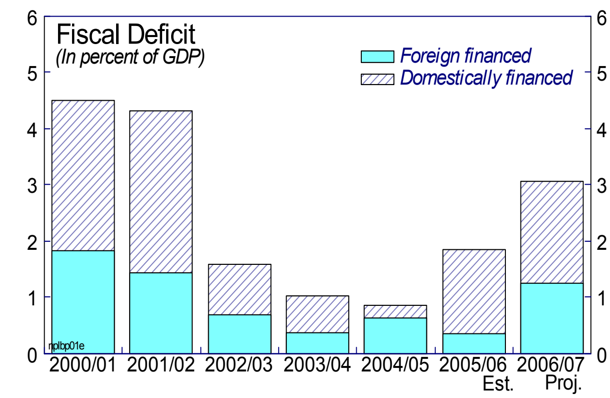
... and inflation remains in line with price developments in India.



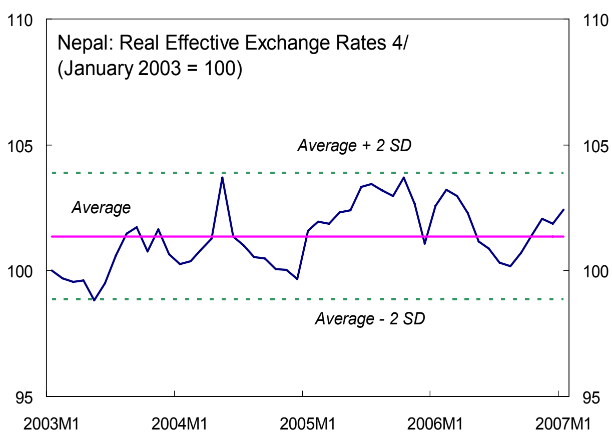
Revenue mobilization and development spending are expected to increase...



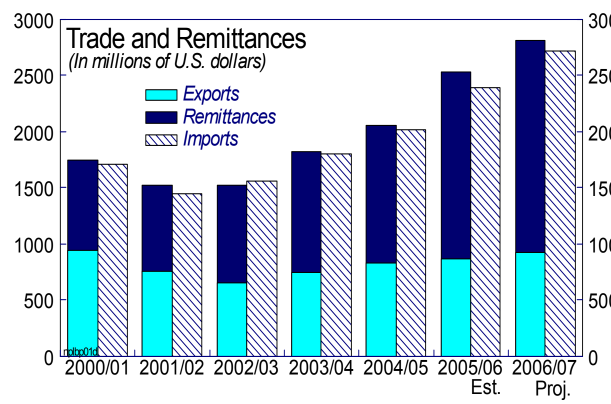
... and the overall and domestically financed deficits should remain contained.



The real effective exchange rate has remained broadly stable.



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 20 and 10 percent on the left and right end of the distribution
3/ Includes net lending.
4/ Using DOTS trade weights for 2003 to 2006.

Table 1. Nepal: Selected Economic Indicators, 2001/02–2008/09 1/

Nominal GDP (2004/05): US$7,391 million
Population (2004/05): 25.2 million
GDP per capita (2004/05): US$293.3
Poverty rate: 31 percent (2003/04)
Main exports: Textiles and clothing
Quota: SDR 71.3 million

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
					Est.		Proj.	
			(Percent change)					
Real GDP at market prices	-0.6	3.3	3.8	2.7	1.9	3.0	4.5	5.0
CPI (12-month change)	3.5	6.1	2.0	6.6	8.3	8.0	5.3	5.3
CPI (period average)	2.9	4.7	4.0	4.5	8.0	7.2	5.9	5.3
GDP deflator	3.4	4.5	4.8	4.6	7.2	7.2	6.0	5.5
Fiscal indicators			(In percent of GDP)					
Total revenue	11.5	12.3	12.2	12.9	12.2	13.2	13.4	13.6
Total expenditure	17.2	16.0	15.5	16.5	16.4	19.3	19.3	19.6
Current expenditure	11.5	11.4	11.2	11.6	11.5	13.6	12.8	12.6
Capital expenditure and net lending	5.6	4.6	4.3	4.9	4.9	5.7	6.5	7.0
Overall deficit before grants	5.7	3.7	3.3	3.5	4.2	6.0	5.9	6.0
Overall deficit after grants	4.3	1.6	1.0	0.8	1.8	3.1	3.1	3.2
Domestic financing (net)	2.9	0.9	0.6	0.2	1.5	1.8	1.4	1.3
Public debt	69.5	67.2	65.4	59.5	56.7	54.7	53.8	52.5
Money and credit			(Percent change, end-of-period)					
Broad money	4.4	9.8	12.8	8.3	15.4	15.9	…	…
Domestic credit	8.7	12.0	9.8	13.9	16.3	9.9	…	…
Velocity	1.9	1.9	1.8	1.8	1.7	1.6	…	…
Interest rates			(In percent)					
91-day treasury bill (end-of-period) 2/	3.8	3.0	1.5	3.9	3.3	2.4	…	…
Central bank refinancing 2/	2–5½	2–5½	2–5½	1½–5½	1½–6¼	1½–6¼	…	…
Loans to industry 2/	7–14½	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)	106	16	59	-19	48	-22	-81	-128
In percent of GDP	1.9	0.3	0.9	-0.3	0.6	-0.2	-0.9	-1.2
Trade balance	-694	-904	-1,053	-1,190	-1,527	-1,797	-2,036	-2,240
In percent of GDP	-12.6	-15.4	-15.6	-16.1	-19.0	-20.4	-21.6	-21.9
Foreign direct investment	-3.7	12.4	1.9	1.9	-6.5	3.0	15.0	25.0
In percent of GDP	-0.1	0.2	0.0	0.0	-0.1	0.0	0.2	0.2
Net official reserves (end-of-period)	1,048	1,178	1,457	1,478	1,774	1,920	2,015	2,088
In months of imports of goods and services	7.0	6.6	7.3	6.2	6.5	6.4	6.1	5.8
Export value growth 3/	-18.4	5.6	14.7	11.2	4.0	7.0	11.1	11.8
Import value growth	-15.3	7.5	15.8	12.3	18.3	13.8	12.6	10.6
External debt/GDP (in percent) 4/	53.4	52.6	51.2	46.2	43.3	41.1	40.6	39.6
Debt service 5/	4.9	5.0	4.5	4.5	4.0	3.4	3.4	3.4
Exchange rate (Nrs./U.S. dollar, end-of-period)	78.3	75.1	74.5	70.7	74.4	...	...	...
REER (end-of-period; percent change; negative = depreciation)	-6.5	2.7	-2.6	7.4	-0.2	...	...	...
NEER (end-of-period; percent change)	-8.4	-1.2	-0.6	3.3	-5.5	...	...	...
Fund operations (outstanding loans at end-of-period; SDR millions)								
SAF/ESAF/PRGF 6/	4.5	1.7	7.1	14.3	14.3	28.5	...	...
Nominal GDP at market prices (Nrs. billions)	422.8	456.7	496.7	533.5	582.9	643.9	713.1	790.2

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

1/ Fiscal year begins mid-July.
2/ Mid-March 2007 for 2006/07.
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.
6/ End-November 2006 for 2006/07.

Table 2. Nepal: Summary of Government Operations, 2004/05–2008/09 1/

	2004/05			2005/06		2006/07				2007/08	2008/09
	Budget/ program	Revised budget	Outcome	Budget	Est.	Budget	Program	Q1 est.	Q2 est.	Proj.	
	(In billions of Nepalese rupees)										
Total revenue and grants	83.7	87.3	83.3	98.9	84.8	108.2	104.5	17.4	47.9	115.5	129.1
Total revenue	68.3	71.9	68.9	80.3	71.2	84.5	85.3	14.3	37.5	95.5	107.6
Tax revenue	53.8	56.0	54.1	63.9	58.2	69.9	70.4	12.2	31.6	78.4	87.9
Nontax revenue 2/	14.6	16.0	14.8	16.4	13.1	14.5	15.0	2.1	5.9	17.1	19.7
Grants	15.4	15.4	14.4	18.7	13.6	23.7	19.2	3.1	10.4	20.0	21.5
Total expenditure	97.2	100.8	87.8	111.5	95.5	127.8	124.2	16.9	41.2	137.8	154.7
Current	67.6	70.1	61.7	75.9	67.0	83.8	87.3	15.7	32.8	91.5	99.5
Of which: interest payments	7.6	7.6	6.2	7.4	6.2	7.9	7.2	1.2	2.2	8.5	9.5
Capital and net lending	29.6	30.7	26.1	35.7	28.6	44.1	36.9	1.2	8.4	46.3	55.2
Overall balance before grants	-28.9	-28.9	-18.9	-31.3	-24.3	-43.4	-38.9	-2.6	-3.7	-42.3	-47.1
Overall balance after grants	-13.5	-13.5	-4.5	-12.6	-10.7	-19.6	-19.7	0.5	6.7	-22.3	-25.6
Financing	13.5	13.5	4.5	12.6	10.7	19.6	19.7	-0.5	-6.7	22.3	25.6
Net foreign loans	10.0	10.0	3.3	8.0	2.0	9.4	8.0	0.3	-0.6	12.1	15.1
Gross disbursements	17.0	17.0	9.3	14.5	9.0	16.9	15.0	0.6	3.2	20.0	23.5
Amortization	7.0	7.0	6.0	6.5	7.0	7.5	7.0	0.3	3.8	7.9	8.4
Net domestic financing	3.5	3.5	1.2	4.6	8.7	10.2	11.7	-0.8	-6.1	10.2	10.6
Central bank financing	0.5	...	1.7	...	-0.1	...	...	3.9	-3.7	...	...
Commercial bank financing	2.5	...	4.8	...	10.3	...	...	-4.8	-2.2	...	...
Nonbank financing	0.5	...	-5.3	...	-1.5	...	...	0.1	-0.1	...	...
	(In percent of GDP)										
Total revenue	12.7	13.3	12.9	13.6	12.2	13.1	13.2	2.2	5.8	13.4	13.6
Tax revenue	10.0	10.4	10.1	10.8	10.0	10.9	10.9	1.9	4.9	11.0	11.1
Nontax revenue 2/	2.7	3.0	2.8	2.8	2.2	2.3	2.3	0.3	0.9	2.4	2.5
Grants	2.8	2.8	2.7	3.2	2.3	3.7	3.0	0.5	1.6	2.8	2.7
Total expenditure	18.0	18.7	16.5	18.9	16.4	19.9	19.3	2.6	6.4	19.3	19.6
Current	12.5	13.0	11.6	12.8	11.5	13.0	13.6	2.4	5.1	12.8	12.6
Of which: interest payments	1.4	1.4	1.2	1.3	1.1	1.2	1.1	0.2	0.3	1.2	1.2
Capital and net lending	5.5	5.7	4.9	6.0	4.9	6.8	5.7	0.2	1.3	6.5	7.0
Overall balance before grants	-5.3	-5.3	-3.5	-5.3	-4.2	-6.7	-6.0	-0.4	-0.6	-5.9	-6.0
Overall balance after grants	-2.5	-2.5	-0.8	-2.1	-1.8	-3.0	-3.1	0.1	1.0	-3.1	-3.2
Financing	2.5	2.5	0.8	2.1	1.8	3.0	3.1	-0.1	-1.0	3.1	3.2
Net foreign loans	1.8	1.8	0.6	1.4	0.3	1.5	1.2	0.0	-0.1	1.7	1.9
Gross disbursements	3.1	3.1	1.7	2.5	1.5	2.6	2.3	0.1	0.5	2.8	3.0
Amortization	1.3	1.3	1.1	1.1	1.2	1.2	1.1	0.0	0.6	1.1	1.1
Net domestic financing	0.7	0.7	0.2	0.8	1.5	1.6	1.8	-0.1	-0.9	1.4	1.3
Central bank financing	0.1	...	0.3	...	0.0	...	...	0.6	-0.6	...	...
Commercial bank financing	0.5	...	0.9	...	1.8	...	...	-0.7	-0.3	...	...
Nonbank financing	0.1	...	-1.0	...	-0.3	...	...	0.0	0.0	...	...
Memorandum items:											
Public savings	0.1	0.3	1.3	0.7	0.7	0.1	-0.3	-0.2	0.7	0.6	1.0
Primary balance	-1.1	-1.1	0.3	-0.9	-0.8	-1.8	-1.9	0.3	1.4	-1.9	-2.0
Debt service	3.7	3.7	3.7	3.6	3.5	3.6	3.4	0.2	1.1	3.4	3.4
Domestic	1.9	1.9	2.2	2.1	1.9	1.9	1.9	0.1	0.4	1.8	1.8
Foreign	1.8	1.8	1.5	1.5	1.6	1.7	1.5	0.1	0.7	1.6	1.6
Public debt	60.0	60.0	59.5	59.2	56.7	54.8	54.7	...	...	53.8	52.5
Domestic	15.6	15.6	16.1	15.1	16.3	16.3	16.5	...	...	16.4	16.1
External	44.3	44.3	43.4	44.1	40.4	38.5	38.1	...	...	37.5	36.3
Education expenditure	3.3	3.3	3.2	3.6	3.3	3.5	...	0.6	1.3	...	...
Health expenditure	1.2	1.2	0.9	1.3	1.0	1.4	...	0.1	0.4	...	...
Nominal GDP (Nrs. billions)	539.9	539.9	533.5	590.8	582.9	643.9	643.9	643.9	643.9	713.1	790.2

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, 2003/04–2006/07

	2003/04	2004/05	2005/06	2006/07			
	Jul.	Jul.	Jul.	Oct.	Jan.	Apr. Proj.	Jul. Proj.
Monetary authorities	(In billions of Nepalese rupees)						
Reserve money	94.4	96.5	110.7	115.9	110.8	117.8	127.7
Net foreign assets	108.2	103.9	131.6	130.2	135.0	136.1	137.6
Net domestic assets	-13.8	-7.3	-20.8	-14.3	-24.2	-18.4	-9.9
	(Annual percentage change)						
Reserve money	16.6	2.2	14.7	23.9	15.5	18.3	15.3
	(Change in percent of reserve money at start of period)						
Reserve money	16.6	2.2	14.7	4.7	0.1	6.3	15.3
Net foreign assets	25.4	-4.6	28.7	-1.2	3.1	4.1	5.5
Net domestic assets	-8.8	6.9	-14.0	5.9	-3.1	2.2	9.8
Monetary survey	(In billions of Nepalese rupees)						
Broad money	277.3	300.4	346.7	360.4	367.7	380.0	401.8
Narrow money	94.0	100.2	112.9	114.9	118.2	119.2	129.4
Quasi money 1/	183.3	200.2	233.8	245.5	249.6	260.8	272.4
Net foreign assets	108.8	107.7	139.5	137.7	140.7	143.9	145.5
Net domestic assets	168.5	192.7	207.1	222.7	227.0	236.1	256.3
Domestic credit 1/	246.0	280.2	325.8	333.9	327.6	337.1	358.0
Public sector	60.3	70.5	78.7	77.8	73.2	78.2	90.5
Government 2/	57.4	63.9	74.1	73.3	68.2	73.2	85.5
Public enterprises	2.9	6.6	4.6	4.6	5.0	5.0	5.0
Private sector 3/	185.7	209.7	247.1	256.0	254.3	258.9	267.5
Other items, net	-77.5	-87.5	-118.7	-111.1	-100.5	-101.0	-101.7
	(Annual percentage change)						
Broad money	12.8	8.3	15.4	16.7	14.8	15.3	15.9
Narrow money	12.2	6.6	12.7	12.4	14.1	9.8	14.6
Quasi money	13.1	9.2	16.7	18.8	15.1	18.1	16.5
Domestic credit	9.8	13.9	16.3	15.7	11.4	10.2	9.9
Public sector	-1.6	16.8	11.7	10.1	6.7	9.5	15.0
Government 2/	-1.8	11.3	16.0	13.0	7.8	12.0	15.3
Private sector credit 3/	14.2	12.9	17.8	17.5	12.8	10.3	8.3
	(Change in percent of broad money at start of period)						
Broad money	12.8	8.3	15.4	4.0	6.1	9.6	15.9
Net foreign assets	7.1	-0.4	10.6	-0.5	0.3	1.2	1.7
Net domestic assets	5.7	8.7	4.8	4.5	5.7	8.4	14.2
Domestic credit	9.0	12.3	15.2	2.3	0.5	3.3	9.3
Private sector	9.4	8.7	12.4	2.6	2.1	3.4	5.9
Memorandum items:							
Velocity of broad money	1.79	1.78	1.68	…	…	…	1.60
Broad money multiplier	2.94	3.11	3.13	3.11	3.32	3.23	3.15

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. Adjusting for the write-off, real private sector credit growth in 2006/07 is around 8–9 percent.

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

	2002/03	2003/04	2004/05	2005/06 Est.	2006/07	2007/08	2008/09 Projection	2009/10	2010/11
	(In millions of U.S. dollars, unless otherwise stated)								
Current account	150	200	160	193	241	183	151	51	-43
Current account (excluding official transfers)	16	59	-19	48	-22	-81	-128	-242	-350
Trade balance	-904	-1,053	-1,190	-1,527	-1,797	-2,036	-2,240	-2,421	-2,612
Exports, f.o.b.	653	748	832	865	926	1,028	1,150	1,286	1,431
Merchandise exports	653	748	832	865	926	1,028	1,150	1,286	1,431
Imports, f.o.b.	1,556	1,801	2,022	2,392	2,722	3,064	3,390	3,706	4,043
Oil products	242	273	370	465	458	521	556	582	614
Other imports	1,314	1,528	1,652	1,926	2,265	2,544	2,834	3,124	3,429
Services (net)	93	125	-28	-91	-127	-82	-77	-77	-56
Receipts	341	465	361	366	446	476	511	548	589
Of which : tourism	151	246	145	132	192	212	235	260	288
Payments	248	340	389	457	573	559	588	625	645
Income	-10	-23	23	68	86	96	106	115	125
Credit	58	52	108	158	175	189	204	220	238
Debit	68	75	85	90	89	93	99	105	114
Current transfers	971	1,151	1,356	1,742	2,079	2,205	2,363	2,433	2,501
Credit, *of which:*	1,000	1,209	1,405	1,807	2,152	2,285	2,451	2,530	2,608
General government 1/	135	141	180	145	263	264	279	293	306
Workers remittances	697	795	910	1,349	1,568	1,702	1,849	1,911	1,974
Recorded	234	381	607	1,177	1,395	1,545	1,712	1,807	1,906
Estimated	463	414	302	172	173	157	136	104	68
Debit	29	58	48	65	73	80	88	97	107
Capital account	69	20	22	43	47	50	55	59	65
Capital transfers	69	20	22	43	47	50	55	59	65
Of which : official grants	42	20	22	43	47	50	55	59	65
Financial account	-172	-298	-431	-365	-186	-238	-204	-92	-17
Direct investment	12	2	2	-7	3	15	25	29	33
Portfolio investment	0	0	0	0	0	0	0	0	0
Other investment (net) 2/	-184	-300	-433	-358	-189	-253	-229	-120	-50
Of which : loans	40	37	46	28	109	160	195	243	288
Disbursements	111	115	128	124	205	264	305	360	412
Amortization	71	78	82	97	96	105	109	117	124
Errors and omissions 2/	84	285	259	427	0	0	0	0	0
Overall balance	132	206	10	298	102	-5	1	18	4
Financing	-132	-206	-10	-298	-146	-95	-75	-65	-50
Change in reserve assets (-=increase)	-129	-279	-21	-296	-146	-95	-73	-61	-46
PRGF Loans (net)	-4	8	11	0	0	0	-2	-4	-4
Other liabilities	1	65	0	0	0	0	0	0	0
Exceptional financing	0.3	0.3	0.5	-1.7	...	...	...	...	...
Arrears to Austria (+ increase)	0.3	0.3	0.3	-1.5	...	...	...	...	...
Arrears to Belgium (+ increase)	0.0	0.0	0.2	-0.2	...	...	...	...	...
Financing gap 3/	…	…	…	...	44	100	74	47	46
Of which:									
IMF (current PRGF arrangement)	…	…	…	…	36	15	0	0	0
	(In percent of GDP, unless otherwise stated)								
Memorandum items:									
Trade balance	-15.4	-15.6	-16.1	-19.0	-20.4	-21.6	-21.9	-21.7	-21.6
Current account (excluding official transfers)	0.3	0.9	-0.3	0.6	-0.2	-0.9	-1.2	-2.2	-2.9
Current account (including official transfers)	2.6	3.0	2.2	2.4	2.7	1.9	1.5	0.5	-0.4
Total external debt 4/	52.6	51.2	46.2	43.3	41.1	40.6	39.6	38.9	38.5
Total PPG external debt	49.3	48.3	43.4	40.4	38.1	37.5	36.3	35.6	35.2
PPG debt service 5/	9.6	9.7	9.4	9.0	9.1	8.7	8.5	8.4	8.1
Debt service 6/	5.0	4.5	4.5	4.0	3.4	3.4	3.4	3.5	3.5
Stock of arrears (in millions of U.S. dollars)	1	1	2	...	...	...	...	...	...
Gross foreign assets (end of period)	1,462	1,772	1,853	2,205	2,400	2,515	2,598	2,669	2,724
Of which : central bank	1,178	1,457	1,478	1,774	1,920	2,015	2,088	2,148	2,194
(In months of imports of goods and services)	6.6	7.3	6.2	6.5	6.4	6.1	5.8	5.4	5.2
Nominal GDP (in millions of U.S. dollars)	5,870	6,732	7,391	8,052	8,826	9,421	10,248	11,143	12,118

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. 06/407 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	…	…
3. Actual 4/	1,843.1	1,865.2	1,952.0	…	…
II. Ceiling on net domestic assets of the NRB					
1. IMF Country Report No. 06/407 5/	-28.1	-26.1	-23.8	-25.7	-18.8
2. Adjusted 6/	...	-25.7	-23.5	…	…
3. Actual 7/	110.7	-24.0	-35.6	…	…
III. Ceiling on change in net domestic financing of central government budget. Cumulative from July 17, 2006					
1. IMF Country Report No. 06/407 8/	...	2.0	4.7	7.4	11.7
2. Adjusted 9/	…	2.3	5.0	…	…
3. Actual	…	-0.8	-6.1	…	…
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. 06/407	...	0.0	0.0	0.0	0.0
2. Adjusted	…	0.0	0.0	…	…
3. Actual	…	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. 06/407	0.0	0.0	0.0	0.0	0.0
2. Adjusted	…	0.0	0.0	…	…
3. Actual	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. 06/407	0.0	0.0	0.0	0.0	0.0
2. Adjusted	…	0.0	0.0	…	…
3. Actual	0.0	0.0	0.0	…	…
Indicative targets (IT)					
VII. Ceiling on reserve money					
1. IMF Country Report No. 06/407	110.1	112.9	117.4	117.8	127.7
2. Actual	110.7	115.9	110.8	…	…
VIII. Floor on central government revenue. Cumulative from July 17, 2006					
1. IMF Country Report No. 06/407 11/	...	14.7	36.9	57.4	85.3
2. Adjusted 12/	…	14.7	36.9	…	…
3. Actual	…	16.1	36.9	…	…

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: Structural Performance Criteria and Benchmarks for Fourth 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/	January 15, 2007	Not observed/May 11, 2006
2.	Inland Revenue Department (IRD) to reduce VAT nonfilers to 15 percent or less of registered VAT taxpayers 2/	January 15, 2007	Observed/January 15, 2007
3.	Customs Department to establish Wide Area Network (WAN) for headquarters and at least five large customs offices	March 15, 2007	Not observed/ Rescheduling proposed to July 15, 2007
B.	Financial Sector Reforms		
1.	NRB to divest all of its shareholding in Non-Life Insurance Division of Rastriya Beema Sansthan and Citizen Investment Trust	February 15, 2007	Not observed/Rescheduling proposed to July 15, 2007
2.	NRB to conduct a self-assessment of compliance with the updated Basel Core Principles for Effective Supervision	January 15, 2007	Observed/January 14, 2007
3.	Auditor General to appoint an international auditor for NRB 2005/06 accounts	January 31, 2007	Observed/January 21, 2007
C.	Nepal Oil Corporation and Public Enterprises		
1.	Finalize audit of NOC 2005/06 accounts in accordance with international standards	March 15, 2007	Not observed/Rescheduling proposed to July 15, 2007
Structural Benchmarks			
1.	IRD to make compulsory electronic tax deduction at source (ETDS) and fiscal printer for all large taxpayers	January 15, 2007	Observed/December 1, 2006
2.	Submission to Parliament of draft Petroleum Sales and Distribution Act	January 15, 2007	Observed/November 5, 2006
3.	Submission to Parliament of draft Anti-Money Laundering Act	January 15, 2007	Not observed/Rescheduling proposed to July 15, 2007
4.	Cabinet approval of Customs Act amendments prepared by the Customs Department	January 15, 2007	Not observed/April 12, 2007
5.	NIDC to implement rationalization and divestment instructions of MOF	January 15, 2007	Not observed/Rescheduling proposed to July 15, 2007
6.	NRB to issue guidelines for mergers and acquisitions of banks and financial institutions 3/	January 15, 2007	Not observed/Rescheduling proposed to July 15, 2007

1/ LTO to conduct audit of income tax and VAT returns, and customs and excise declarations of 2005/06 for at least 30 large taxpayers. LTO to conduct quarterly audit of excises for large taxpayers (mid-October filing).
2/ For the filing month November/December 2006.
3/ 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 Est.	2005/06 Est.	2006/07 Projection	2007/08	2008/09	2009/10	2010/11
Real sector							
Real GDP growth (percent change)	2.7	1.9	3.0	4.5	5.0	5.5	5.5
Agriculture	3.0	1.7	0.7	3.5	4.0	4.5	4.5
Nonagriculture	2.1	2.8	4.2	5.0	5.6	6.1	6.1
GDP deflator (percent change)	4.6	7.2	7.2	6.0	5.5	5.0	5.0
Saving-investment balance							
Gross fixed investment	18.9	18.5	20.5	22.0	23.5	24.0	25.3
Public 1/	5.8	6.1	7.2	8.3	9.0	9.1	9.5
Private	13.2	12.4	13.3	13.7	14.5	14.9	15.8
Gross national savings (incl. income and transfers from abroad)	26.7	27.9	28.5	29.7	30.7	31.4	32.8
Fiscal sector							
Total revenue	12.9	12.2	13.2	13.4	13.6	13.8	13.9
Grants	2.7	2.3	3.0	2.8	2.7	2.6	2.5
Current expenditure	11.6	11.5	13.6	12.8	12.6	12.6	12.6
Capital expenditure and net lending	4.9	4.9	5.7	6.5	7.0	7.1	7.3
Overall balance after grants	-0.8	-1.8	-3.1	-3.1	-3.2	-3.3	-3.5
External sector							
Export value (percent change) 2/	11.2	4.0	7.0	11.1	11.8	11.8	11.3
Import value (percent change)	12.3	18.3	13.8	12.6	10.6	9.3	9.1
Current account balance (excl. official transfers)/GDP	-0.3	0.6	-0.2	-0.9	-1.2	-2.2	-2.9
Overall balance/GDP	0.1	3.7	1.2	-0.1	0.0	0.2	0.0
Financing gap (in millions of U.S. dollars)	…	…	44	100	74	47	46
Change in reserves (in millions of U.S. dollars)	-21	-296	-146	-95	-73	-61	-46
External debt/GDP (in percent)	46.2	43.3	41.1	40.6	39.6	38.9	38.5
Debt service ratio	4.5	4.0	3.4	3.4	3.4	3.5	3.5
Monetary sector							
Broad money (percent change)	8.3	15.4	15.9	...	...	...	...
Private sector credit (percent change)	12.9	17.8	8.3	...	...	...	...
Memorandum item:							
Nominal GDP (Nrs. billions)	533.5	582.9	643.9	713.1	790.2	875.4	969.8

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: 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 17, 2006	Disbursed.
SDR 10.69 million (15 percent of quota)	June 13, 2007	Observance of the mid-January 2007, end-January 2007, mid-February 2007 and mid-March 2007 performance criteria and completion of the fourth review.
SDR 10.69 million (15 percent of quota)	October 15, 2007	Observance of the mid-July 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	0.3	0.7	0.8	0.7	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: External Financing Needs and Sources, 2005/06–2010/11

(In millions of U.S. dollars)

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
	Est.	Projection				
Gross financing needs	347	263	280	312	425	524
External current account deficit (excl. official transfers)	-48	22	81	128	242	350
Debt amortization	97	96	105	109	117	124
Repayments of arrears	1.7	0.0	0.0	0.0	0.0	0.0
Reserves accumulation	296	146	95	73	61	46
IMF repurchases and repayments	0	0	0	2	4	4
Financing sources	347	219	181	238	378	478
Foreign direct investment (net)	-7	3	15	25	29	33
Official creditors 1/	312	515	579	638	712	783
Other flows 2/	41	-299	-413	-425	-364	-338
Accumulation of arrears (exceptional)	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap 3/	...	44	100	74	47	46

1/ Includes both loans and grants.
2/ Includes all other net financial flows, and errors and omissions.
3/ Includes prospective IMF disbursements.

Table 11. 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.

APPENDIX I: NEPAL—DEBT SUSTAINABILITY ANALYSIS

Public debt dynamics are assessed using the Low-Income Country Debt Sustainability Analysis (LIC-DSA) framework, which was jointly prepared with the World Bank. Based on the external LIC-DSA, Nepal's external debt dynamics are subject to a high risk of debt distress. This assessment is broadly the same as in the LIC-DSA conducted in 2006; the baseline scenario is also roughly the same as in the previous DSA. The initial net present value of debt is slightly lower than in the previous DSA due to lower than projected disbursements in the interim.

VI. LOW-INCOME COUNTRY DEBT SUSTAINABILITY ANALYSIS (LIC-DSA)[1]

A. Recent Debt Developments

1. **Nepal's total debt stock is estimated at 59½ percent of GDP at end-2005 (in nominal terms)**. External debt is estimated at US$3½ billion (46 percent of GDP) of which about US$3 billion was owed to multilateral institutions, mostly IDA and the AsDB. Bilateral debt stock is estimated at about US$270 million, with Japan being the largest creditors accounting for more than half of the bilateral debt. After remaining fairly constant at a little over 50 percent as a share of GDP since 1995, the external debt stock as share of GDP dipped somewhat in 2005. External loan disbursements in recent years have been relatively low. Domestic debt also declined somewhat in 2005 by about 1 percent of GDP.

B. Assumptions

2. **Baseline projections of PPG debt are based on the following key assumptions**:

- **Real sector**: Real GDP growth is projected to rise gradually from 2 percent in 2005/06 and stabilize at 5½ percent after 2009/10, in line with growth rates observed in the early 1990s and supported by structural reforms and sound macroeconomic policies. Inflation is assumed to decline from about 8 percent in 2005/06 to 5 percent in the medium term as supply bottlenecks are gradually alleviated. The nominal interest rate on domestic debt is expected to average 6¼ percent during 2006/07−2009/10 and 6 percent thereafter. The exchange rate is projected to depreciate against the dollar, in line with projected movements in the Indian rupee to which the Nepalese rupee is pegged.

- **Fiscal sector**: The revenue-to-GDP ratio is projected to rise from 12¼ percent in 2005/06 to 13½ percent by 2008/09, assuming a rebound in economic activity and

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[1] Following *Operational Framework for Debt Sustainability Assessments in Low-Income Countries—Further Considerations* (SM/05/109 and IDA/R2005–0056).

improved tax collection from a broadening of the tax base. The expenditure-to-GDP ratio rises from 16½ percent in 2005/06 to 19½ percent in 2008/09 as development spending picks up, and stabilizes thereafter. Growth of real primary spending averages 7½ percent in 2006/07−2010/11 (5½ percent in 2011/12−2025/26), with domestic financing of 1−1⅓ percent of GDP and official grants around 3 percent of GDP in 2006/07–2010/11(around 1½ percent of GDP in 2011/12−2025/26).

- **External sector**: Exports of goods and services are projected to grow at an average 8½ percent over the projection period supported by tourism and strong growth in partner countries. Imports of goods and services are expected to rebound in line with economic activity, with growth averaging 7 percent. The noninterest current account balance is projected to deteriorate from a surplus of 2½ percent of GDP in 2004/05 to a deficit of 2¼ percent of GDP by 2025/26, with remittances declining gradually as a share of GDP. Scheduled debt service on existing external debt increases from around US$110 million in 2005/06 to US$125 million in 2025/26. New financing is assumed to be moderate during the next three years, but rising gradually from about US$200 million in 2006/07 to US$350 million by 2009/10. The grant element of new borrowing is assumed to average about 44 percent in 2006/07 and about 40 percent in the projection period.

C. Baseline

PPG External Debt

3. **A key feature of the LIC−DSA framework is that it compares debt burden indicators to indicative policy-based thresholds**. The thresholds are based on the empirical finding that low-income countries with stronger policies and institutions tend to have a higher debt carrying capacity.[2] Nepal is classified as a medium performer. At end 2006, Nepal's NPV of public debt-to-exports ratio is estimated at 163 percent (the relevant policy based indicative threshold is 150 percent). The ratio is projected to fall to 137 percent by 2010/11 and 87 percent by 2025/26. Other indicators remain below the policy-based indicative thresholds throughout the projection period.

Nepal: Indicative External Debt Burden Indicators

	Indicative Thresholds 1/	Nepal 2004/05 2/	Nepal 2005/06	Nepal Average 2006/07–2025/26
NPV of debt, in percent of				
Exports	150	172	163	120
GDP	40	28	25	20
Revenues	250	213	211	164
Debt service, in percent of				
Exports	20	9	9	9
Revenues	30	12	12	13

1/ Shows indicative policy dependent thresholds under the joint IMF-World Bank low-income country debt sustainability framework for a medium policy performer.
2. Appendix II, IMF Country Report No. 06/44, *Nepal–Staff Report for the 2005 Article IV Consultation*.

[2] See IDA/R2005–0056 and SM/05/109.

4. **In the baseline scenario, debt burden ratios are projected to fall between 2005/06 and 2025/26** (Table I.1). The NPV of external public debt-to-GDP (25 percent to 16 percent) NPV of external public debt-to-exports (163 percent to 87 percent); external public debt service-to-exports ratio (9 percent to 8 percent).[3]

Total Public Debt

5. **Domestic debt accounts for about 28½ percent of total public debt**. For the baseline scenario, the NPV of public debt-to-GDP ratio declines from 44 percent at end 2005/06 to 34 percent by 2025/26 (Table I.4, Figure I.2). Over the same period, the NPV of public debt to-revenue ratio falls from 303 percent to 209 percent, and the public debt service-to revenue ratio decreases from 25 percent to 16 percent.

D. Sensitivity Analysis

6. **Stress tests and alternative scenarios suggest susceptibility to shocks**.

- **Total public debt**: Following an extreme shock—a one-time 30 percent real depreciation in 2006/07 which leads to the highest level of NPV of debt-to-GDP 10 years after the shock—the NPV ratio peaks at around 55 percent in 2006/07 and falls to about 40 percent in 2025/26. The debt service to revenue ratio peaks in 2005/06 at 25 percent declining to 19 percent in 2025/26. These scenarios are especially sensitive to GDP projections, including the prospects for the peace process in the near term. Over the medium term, the effectiveness of public investment the availability of external financing, and fiscal risks such as those from contingent liabilities in the financial and public enterprise sectors are key.[4]

- **External debt**: Following an export shock—defined as export value growth at historical levels minus one standard deviation in the first two years of the shock—the NPV of debt-to-exports ratio increases significantly, peaking at a little over 330 percent in the near term, but quickly dissipates thereafter. The debt service-to-exports ratio peaks at 19 percent in 2015/16. These results are driven by Nepal's volatile export performance in the historical period. The combined shocks scenario has a similar effect, primarily based on the export component of the shock. If financing is available only at less favorable terms, debt indicators would remain

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[3] Given the high concessionality of external debt, the debt service-to-exports ratio is low, and at levels similar or lower than to most HIPCs after full HIPC debt relief. The ratio reflects debt service on existing debt and debt service on projected disbursements.

[4] Liabilities from financial sector and public enterprise reforms are expected to be 7–8 percent of GDP, with annual carrying costs of ¼–¾ percent of GDP.

higher than in the baseline and the debt service ratio would start to rise. While debt indicators go below the baseline in the historical scenario toward the end of the projections, it reflects the effect of extremely low current account deficits and even surpluses in the historical period that cannot be expected to persist.[5]

E. Staff Assessment

7. **Based on the LIC-DSA, staffs conclude that Nepal's external debt dynamics are subject to a high risk of distress**. The external debt-to-export ratio is above the indicative threshold in 2005 and could remain so under various scenarios, especially if growth is low, donor grant support inadequate, and contingent liabilities high. The sensitivity analyses underscore the need to implement sound macroeconomic policies and reforms, including toward achieving higher export growth, while maintaining efforts to raise revenue. These factors combined with foreign financing at favorable terms—preferably through grants—would help Nepal make progress toward achieving its MDG targets while containing risks to debt sustainability.

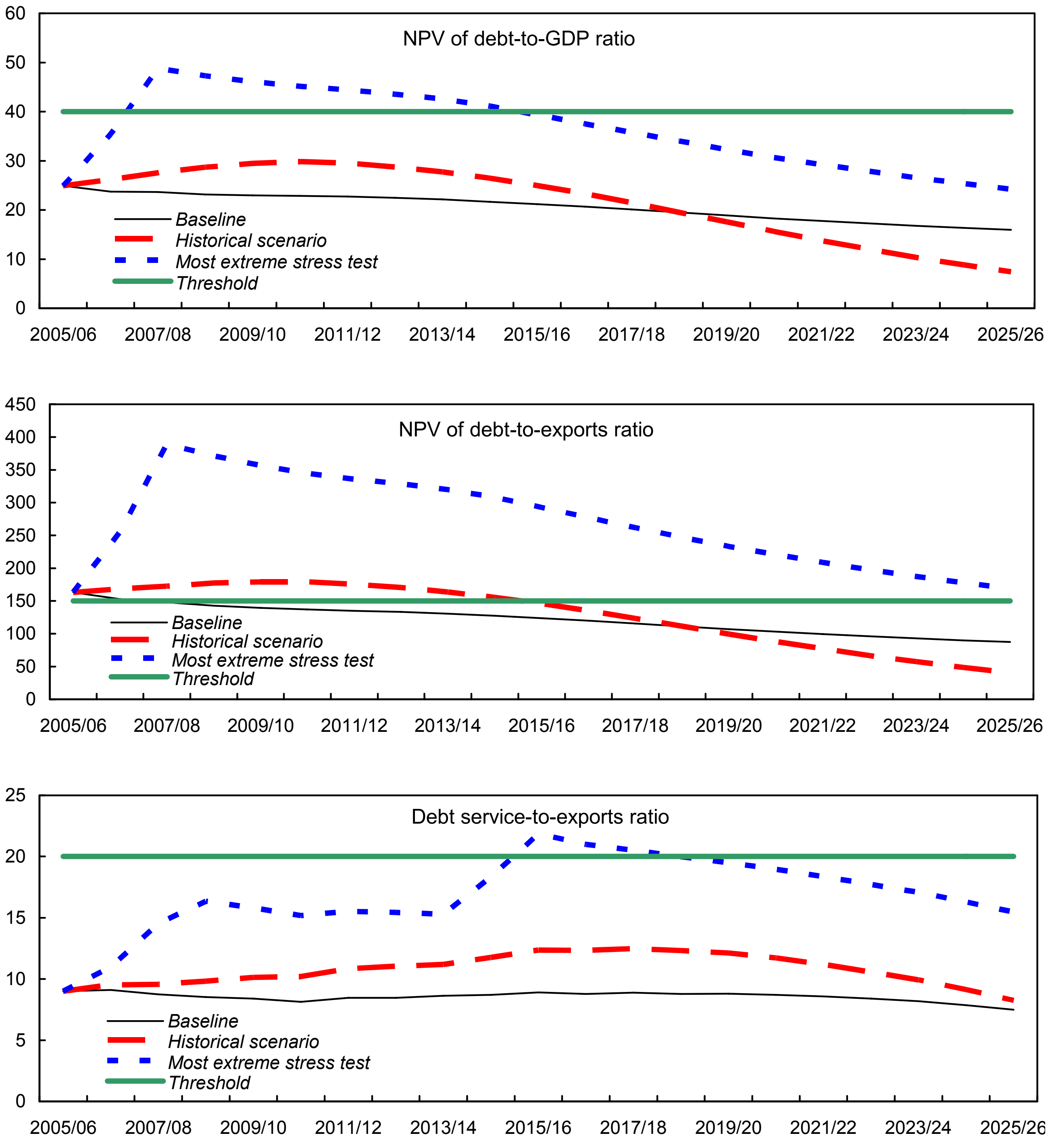
VII. Enhanced HIPC and Multilateral Debt Relief (MDR) Initiatives

8. **Nepal was recently deemed potentially eligible for HIPC relief under the extended sunset clause**. This determination was based on an estimated end 2004 NPV of debt-to-exports ratio (around 200 percent after traditional debt relief; the enhanced HIPC threshold is 150 percent). If Nepal's eligibility is confirmed at the appropriate time, it could receive substantial relief under the enhanced HIPC Initiative and MDRI.

[5] In the baseline projections, current account surpluses are initially larger than the average in the historical scenario. The historical scenario uses average of the late 1990s, a more appropriate reference period.

Figure I.1. Nepal: Indicators of Public and Publicly Guaranteed External Debt
Under Alternative Scenarios, 2005/06–2025/26

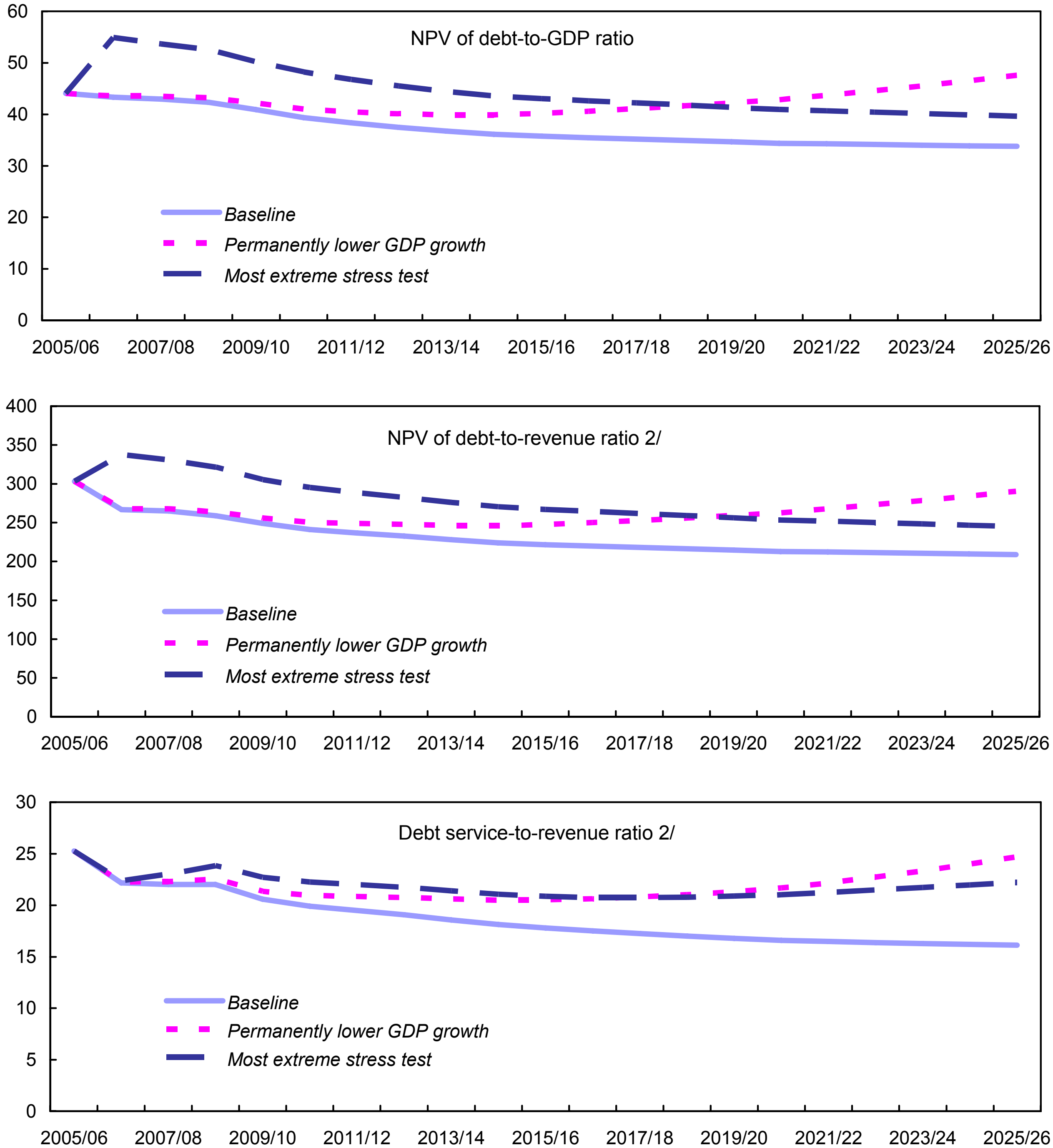
(In percent)



Source: Staff projections and simulations.

Figure I.2. Nepal: Indicators of Public Debt Under Alternative Scenarios, 2005/06–2025/26 1/ 2/

(In percent)



Source: Staff projections and simulations.

1/ Most extreme stress test is test that yields highest ratio in 2016.
2/ 2005 refers to fiscal year 2004/05.
3/ Revenue including grants.

Table I.1. Nepal: External Debt Sustainability Framework, Baseline Scenario, 2002/03– 2025/26 1/

(In percent of GDP, unless otherwise indicated)

						Estimate	Projections					Average			Average
	2002/03	2003/04	2004/05	Average 6/	Deviation 6/	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2006/07–2010/11	2015/16	2025/26	2011/12–2025/26
External debt (nominal) 1/	52.6	51.2	46.2			43.3	41.1	40.6	39.6	38.9	38.5		35.1	28.1	
Of which : public and publicly guaranteed (PPG)	49.3	48.3	43.4			40.4	38.1	37.5	36.3	35.6	35.2		31.6	24.5	
Change in external debt	-0.8	-1.4	-4.9			-2.9	-2.2	-0.5	-1.0	-0.7	-0.4		-0.8	-0.4	
Identified net debt-creating flows	-6.1	-9.7	-6.8			-3.1	-3.9	-3.8	-3.6	-2.7	-1.9		-0.2	0.2	
Non-interest current account deficit	-3.0	-3.4	-2.6	-2.2	3.1	-2.7	-3.0	-2.2	-1.8	-0.8	0.0	-1.8	1.6	2.2	1.8
Deficit in balance of goods and services	13.8	13.8	16.5			20.1	21.8	22.5	22.6	22.4	22.0		20.0	16.7	
Exports	16.9	18.0	16.1			15.3	15.5	16.0	16.2	16.5	16.7		17.1	18.3	
Imports	30.7	31.8	32.6			35.4	37.4	38.5	38.8	38.9	38.7		37.1	34.9	
Net current transfers (negative = inflow)	-16.5	-17.1	-18.3	-13.5	4.0	-21.6	-23.6	-23.4	-23.1	-21.8	-20.6	-22.4	-17.3	-13.7	-16.1
Other current account flows (negative = net inflow)	-0.3	-0.1	-0.7			-1.2	-1.3	-1.3	-1.4	-1.4	-1.4		-1.1	-0.7	
Net FDI (negative = inflow)	-0.2	0.0	0.0	-0.1	0.1	0.1	0.0	-0.2	-0.2	-0.3	-0.3	-0.1	-0.4	-0.8	-0.5
Endogenous debt dynamics 2/	-2.9	-6.3	-4.2			-0.4	-0.9	-1.4	-1.6	-1.7	-1.6		-1.5	-1.2	
Contribution from nominal interest rate	0.4	0.5	0.4			0.4	0.3	0.3	0.3	0.3	0.4		0.4	0.3	
Contribution from real GDP growth	-1.7	-1.7	-1.3			-0.8	-1.2	-1.7	-1.9	-2.0	-2.0		-1.8	-1.5	
Contribution from price and exchange rate changes	-1.7	-5.0	-3.3			…	…	…	…	…	…		…	…	
Residual (3–4) 3/	5.3	8.3	1.8			0.2	1.8	3.3	2.6	2.0	1.5		-0.6	-0.7	
Of which : exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
NPV of external debt 4/	...	...	29.3			27.8	26.8	26.8	26.4	26.3	26.2		24.7	19.5	
In percent of exports	...	...	181.6			181.9	172.3	167.7	163.0	159.7	157.4		144.0	106.8	
NPV of PPG external debt	...	...	26.4			24.9	23.7	23.6	23.2	23.0	22.9		21.2	15.9	
In percent of exports	...	...	163.8			162.9	152.8	147.9	143.0	139.5	137.2		123.8	87.3	
Debt service-to-exports ratio (in percent)	9.6	9.7	9.4			9.0	9.1	8.7	8.5	8.4	8.1		8.9	7.5	
PPG debt service-to-exports ratio (in percent)	9.6	9.7	9.4			9.0	9.1	8.7	8.5	8.4	8.1		8.9	7.5	
Total gross financing need (in billions of U.S. dollars)	-0.1	-0.1	-0.1			-0.1	-0.1	-0.1	-0.1	0.0	0.1		0.5	0.9	
Non-interest current account deficit that stabilizes debt ratio	-2.2	-2.0	2.4			0.2	-0.9	-1.7	-0.8	-0.1	0.4		2.5	2.7	
Key macroeconomic assumptions															
Real GDP growth (in percent)	3.3	3.8	2.7	3.9	2.0	1.9	3.0	4.5	5.0	5.5	5.5	4.2	5.5	5.5	5.5
GDP deflator in US dollar terms (change in percent)	3.3	10.5	6.9	1.5	4.9	6.9	5.9	2.2	3.6	3.1	3.1	4.1	1.2	0.7	1.1
Effective interest rate (percent) 5/	0.9	1.0	0.9	1.0	0.2	0.8	0.8	0.8	0.9	0.9	1.0	0.9	1.2	1.2	1.2
Growth of exports of G&S (U.S. dollar terms, in percent)	6.0	22.2	-1.7	1.9	19.0	3.2	11.4	9.7	10.3	10.4	10.1	9.2	7.5	6.8	7.4
Growth of imports of G&S (U.S. dollar terms, in percent)	6.0	18.7	12.6	5.4	14.6	18.1	15.8	10.0	9.8	8.9	8.2	11.8	5.9	5.6	6.0
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	50.6	43.8	40.6	41.6	39.1	40.1	42.7	39.3	44.3	41.4
Memorandym item:															
Nominal GDP (billions of U.S. dollars)	5.9	6.7	7.4			8.1	8.8	9.4	10.2	11.1	12.1		17.1	32.1	

Source: Staff simulations.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - r(1+g)]/(1+g+r+gr) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Current-year interest payments devided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table I.2. Nepal: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2005/06–2025/26

(In percent)

	Estimate	Projections						
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2015/16	2025/26
				NPV of debt-to-GDP ratio				
Baseline	25	24	24	23	23	23	21	16
A. Alternative scenarios								
A1. Key variables at their historical averages in 2007–26 1/	25	26	28	29	29	30	25	7
A2. New public sector loans on less favorable terms in 2007–26 2/	25	24	25	25	26	26	27	26
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	25	24	24	24	24	24	22	17
B2. Export value growth at historical average minus one standard deviation in 2007–08 3/	25	26	30	29	29	28	26	18
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007–08	25	26	27	27	27	26	25	19
B4. Net nondebt creating flows at historical average minus one standard deviation in 2007–08 4/	25	32	40	39	38	38	33	21
B5. Combination of B1-B4 using one-half standard deviation shocks	25	35	49	47	46	45	39	24
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	25	33	33	32	32	32	30	22
				NPV of debt-to-exports ratio				
Baseline	163	153	148	143	140	137	124	87
A. Alternative scenarios								
A1. Key variables at their historical averages in 2007–26 1/	163	169	172	177	179	179	146	41
A2. New public sector loans on less favorable terms in 2007–26 2/	163	157	156	155	156	158	160	142
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	163	152	147	142	139	137	123	87
B2. Export value growth at historical average minus one standard deviation in 2007–08 3/	163	225	334	321	311	303	266	173
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007–08	163	152	147	142	139	137	123	87
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007–08 4/	163	207	252	241	232	224	191	113
B5. Combination of B1-B4 using one-half standard deviation shocks	163	256	389	372	357	345	293	169
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	163	152	147	142	139	137	123	87
				Debt service ratio				
Baseline	9	9	9	9	8	8	9	8
A. Alternative scenarios								
A1. Key variables at their historical averages in 2007–26 1/	9	10	10	10	10	10	12	8
A2. New public sector loans on less favorable terms in 2007–26 2/	9	9	9	9	9	9	10	10
B. Bound tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	9	9	9	9	8	8	9	7
B2. Export value growth at historical average minus one standard deviation in 2007–08 3/	9	12	16	17	16	16	19	15
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007–08	9	9	9	9	8	8	9	7
B4. Net nondebt creating flows at historical average minus one standard deviation in 2007–08 4/	9	9	10	11	11	10	14	10
B5. Combination of B1-B4 using one-half standard deviation shocks	9	11	15	16	16	15	22	15
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	9	9	9	9	8	8	9	7
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	40	40	40	40	40	40	40	40

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and nondebt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers, FDI and capital flows in the financial account.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table I.3. Nepal: Public Sector Debt Sustainability Framework, Baseline Scenario, 2002/03–2025/26

(In percent of GDP, unless otherwise indicated)

	Actual			Historical	Standard	Estimate	Projections					2006/07–	Projections		2011/12–
	2002/03	2003/04	2004/05	Average 2/	Deviation 2/	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2010/11 Average	2015/16	2025/26	2025/26 Average
Public sector debt 1/	67.2	65.4	59.5			56.7	54.7	53.8	52.5	50.4	48.5		42.8	38.9	
Of which : foreign-currency denominated	49.3	48.3	43.4			40.4	38.1	37.5	36.3	35.6	35.2		31.6	24.5	
Change in public sector debt	-0.7	-1.8	-5.9			-2.8	-2.0	-0.8	-1.4	-2.0	-1.9		-0.8	-0.2	
Identified debt-creating flows	-5.4	-4.8	-6.0			-0.9	-1.7	-1.6	-0.7	-2.0	-0.7		-0.1	0.4	
Primary deficit	0.1	-0.3	-0.3	2.1	1.7	0.6	1.7	1.8	1.8	1.8	1.8	1.6	1.8	2.0	1.9
Revenue and grants	14.4	14.4	15.6			14.5	16.2	16.2	16.3	16.4	16.3		16.1	16.2	
Of which : grants	2.1	2.3	2.7			2.3	3.0	2.8	2.7	2.6	2.5		2.3	2.3	
Primary (noninterest) expenditure	14.5	14.1	15.3			15.2	18.0	18.0	18.2	18.2	18.1		18.0	18.2	
Automatic debt dynamics	-5.6	-4.5	-5.7			-1.5	-3.5	-3.4	-2.6	-3.8	-2.5		-1.9	-1.6	
Contribution from interest rate/growth differential	-2.4	-2.9	-1.7			-1.3	-1.8	-2.2	-2.3	-2.5	-2.4		-1.9	-1.7	
Of which : contribution from average real interest rate	-0.2	-0.8	0.0			-0.2	-0.1	0.1	0.2	0.2	0.2		0.4	0.4	
Of which : contribution from real GDP growth	-2.2	-2.2	-1.6			-1.1	-1.7	-2.3	-2.6	-2.7	-2.6		-2.3	-2.0	
Contribution from real exchange rate depreciation	-3.1	-1.5	-4.0			-0.2	-1.7	-1.2	-0.2	-1.3	-0.1		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	4.7	3.0	0.1			-1.9	-0.3	0.8	-0.6	0.0	-1.2		-0.7	-0.5	
Other Sustainability Indicators															
NPV of public sector debt	17.9	46.6	45.5			44.1	43.3	43.2	42.5	41.1	39.5		35.9	33.9	35.4
o/w foreign-currency denominated	0.0	29.5	29.3			27.8	26.8	26.8	26.4	26.3	26.2		24.7	19.5	22.9
o/w external	...	29.5	29.3			27.8	26.8	26.8	26.4	26.3	26.2		24.7	19.5	22.9
NPV of contingent liabilities (not included in public sector debt)	0.0	0.0	0.0			...	...	...	...	...	...		...	...	
Gross financing need 2/	3.7	3.2	3.4			4.3	5.3	5.4	5.5	5.2	5.0		4.7	4.6	4.7
NPV of public sector debt-to-revenue ratio (in percent) 3/	124.3	322.8	291.4			302.9	266.8	266.5	260.3	250.1	242.1		222.4	209.3	219.1
o/w external	...	204.4	187.8			191.2	164.9	165.4	161.7	159.9	160.6		152.9	120.6	142.1
Debt service-to-revenue ratio (in percent) 3/ 4/	24.6	24.2	23.7			25.3	22.2	22.0	22.1	20.6	19.9		17.8	16.1	17.3
Primary deficit that stabilizes the debt-to-GDP ratio	0.9	1.5	5.5			3.5	3.8	2.6	3.2	3.8	3.7		2.6	2.1	2.5
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	3.4	3.4	2.5	3.9	2.0	1.9	3.0	4.5	5.0	5.5	5.5	4.2	5.5	5.5	5.5
Average nominal interest rate on forex debt (in percent)	0.9	1.0	0.9	1.1	0.2	1.0	1.0	1.1	1.1	1.2	1.2	1.1	1.4	1.3	1.4
Average real interest rate on domestic currency debt (in percent)	2.0	-0.1	0.0	0.8	1.9	-1.6	-0.7	0.4	1.3	1.0	1.1	0.2	2.8	2.1	2.4
Real exchange rate depreciation (in percent, + indicates depreciation)	-6.4	-3.3	-8.5	0.1	7.4	-0.4	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	4.5	5.2	4.8	5.3	2.0	7.2	7.2	6.0	5.5	5.0	5.0	6.0	3.5	3.0	3.5
Growth of real primary spending (deflated by GDP deflator, in percent)	-5.0	0.7	10.8	4.8	8.9	1.0	22.1	4.6	6.1	5.8	4.6	7.4	5.7	5.6	5.5

Sources: Nepalese authorities; and Fund staff estimates and projections.

1/ Public and publicly guaranteed debt.

2/ Historical averages and standard deviations are derived over the past 10 years.

Table I.4. Nepal: Sensitivity Analysis for Key Indicators of Public Debt, 2005/06–2025/26

	Projections							
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2015/16	2025/26
	NPV of debt-to-GDP ratio							
Baseline	44	43	43	43	41	40	36	34
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	44	43	44	44	43	42	42	44
A2. Primary balance is unchanged from 2006	44	42	41	39	37	34	26	15
A3. Permanently lower GDP growth 1/	44	44	44	43	42	41	40	48
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007–2008	44	44	45	45	44	43	41	43
B2. Primary balance is at historical average minus one standard deviations in 2007–2008	44	45	47	46	44	43	39	36
B3. Combination of B1-B2 using one half standard deviation shocks	44	45	46	45	44	42	38	35
B4. One-time 30 percent real depreciation in 2007	44	55	54	53	50	48	43	40
B5. 10 percent of GDP increase in other debt-creating flows in 2007	44	53	52	51	49	48	43	39
	NPV of debt-to-revenue ratio 2/							
Baseline	303	267	267	260	250	242	222	209
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	303	267	270	268	262	258	258	261
A2. Primary balance is unchanged from 2006	303	260	254	241	225	211	163	93
A3. Permanently lower GDP growth 1/	303	268	269	265	257	251	248	291
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007–2008	303	270	279	275	267	262	254	263
B2. Primary balance is at historical average minus one standard deviations in 2007–2008	303	279	289	282	271	262	241	224
B3. Combination of B1-B2 using one half standard deviation shocks	303	274	284	276	265	256	233	214
B4. One-time 30 percent real depreciation in 2007	303	338	333	323	306	296	268	246
B5. 10 percent of GDP increase in other debt-creating flows in 2007	303	324	321	313	300	291	266	244
	Debt service-to-revenue ratio 2/							
Baseline	25	22	22	22	21	20	18	16
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	25	22	23	23	22	22	21	20
A2. Primary balance is unchanged from 2006	25	22	20	19	17	16	12	2
A3. Permanently lower GDP growth 1/	25	22	22	23	21	21	21	25
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007–2008	25	22	23	24	23	22	21	22
B2. Primary balance is at historical average minus one standard deviations in 2007–2008	25	22	26	28	23	21	19	18
B3. Combination of B1-B2 using one half standard deviation shocks	25	22	25	26	22	21	18	17
B4. One-time 30 percent real depreciation in 2007	25	23	23	23	22	22	20	19
B5. 10 percent of GDP increase in other debt-creating flows in 2007	25	22	42	30	25	23	20	22

Sources: Nepalese authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).
2/ Revenues are defined inclusive of grants.

ATTACHMENT I

May 30, 2007

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. de Rato:

The Government of Nepal held discussions with IMF staff during February 2–15, 2007 on the program supported by the Poverty Reduction and Growth Facility (PRGF). The purpose of this letter and the attached Memorandum of Economic and Financial Policies (MEFP) is to inform you of the progress in implementing the program and set out the policies for the period ahead. In addition, we request waivers for the nonobservance of performance criteria and completion of fourth review under the arrangement.

Despite the difficult political environment, Nepal has maintained macroeconomic stability and all quantitative performance criteria (QPCs) for the fourth review were met. However, some structural reform measures were delayed beyond target dates. In this regard, we request waivers for nonobservance of four structural performance criteria (SPCs) related to: (i) conduct of comprehensive audit of large taxpayers by the Large Taxpayer Office; (ii) establishment of a wide area network (WAN) by the Customs Office for headquarters and (at least) five large customs offices; (iii) divestment by NRB of its shareholding in Non-Life Insurance Division of Rastriya Beema Sansthan and Citizen Investment Trust; and (iv) finalization of NOC's 2005/06 accounts to international standards. Of these, (i) has been completed. Significant progress has been made towards completion of measures related to (ii)–(iv), and we request that the test date for completion of the remaining steps be moved to July 15, 2007.

The government is fully committed to the reform agenda detailed in the 10th Plan/PRSP, which aims to reduce poverty through private-sector led growth and social inclusion. We believe that the policies and measures described in the MEFP are adequate to achieve the objectives of the program, but the government stands ready to take any additional measures that may become appropriate for this purpose. The government will consult with the IMF on the adoption of any such measures, and in advance of revisions to the policies contained in the MEFP in accordance with the IMF's policies on such consultations. It will also provide the IMF with information required to assess progress in implementing the program. The government intends to make this letter, the MEFP, and the staff report on the reviews available to the public and authorize their posting on the IMF website subsequent to Board completion of the reviews.

Sincerely yours,

/s/	/s/
Ram Sharan Mahat Minister of Finance	Bijaya Nath Bhattarai Governor, Nepal Rastra Bank

Attachments
Memorandum on Economic and Financial Policies
Technical Memorandum of Understanding

NEPAL—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES UNDER THE PRGF ARRANGEMENT

1. **Nepal is in a defining moment since the people's movement of April 2006**. On the political front, the Government of Nepal (GON) is making a determined effort to further the peace process and restore participatory democracy. In January 2007, the interim parliament was expanded to include the Communist Party of Nepal (Maoist) to further cement the ceasefire, and an interim constitution was adopted, along the lines agreed in the 12-point Comprehensive Peace Accord signed by the seven party alliance (SPA) and the CPN(M) in November 2006. Also in January 2007, at the request of Prime Minister Koirala and Mr. Prachanda (Chairman, CPN(M)), the United Nations began operations to assist with monitoring human rights and the ceasefire, management of combatants and arms, and fair conduct of constituent assembly elections. The process of combatants and arms management started in February, after which the CPN(M) joined the government on April 1 and paved the way for the formation of representative institutions at the central and local levels. This interim government is charged with the conduct of constituent assembly elections.

2. **On the economic front**, **expectations for growth and an improvement in living standards are running high**. The GON remains committed to achieving the goals of Nepal's 10th Plan/Poverty Reduction Strategy Paper (PRSP), which remain appropriate. The PRSP which was finalized in July 2003 lays out Nepal's objectives and policy agenda for 2002−07 and will continue to guide the policies of the interim government. This agenda has been supported by the Poverty Reduction and Growth Facility (PRGF) arrangement which was approved by the IMF's Executive Board in November 2003.

3. **The GON remains committed to implementing policy understandings reached under the PRGF arrangement**. This memorandum reviews progress achieved under the PRGF arrangement since the completion of the second and third reviews in November 2006. Progress on the broader objectives of the PRSP for 2005/06 was most recently reviewed in the "Assessment of the Implementation of the Tenth Plan/PRSP" which was finalized in December 2006. Looking forward, this memorandum outlines economic and financial policies for the remainder of 2006/07 in support of which the GON is requesting completion of the fourth review. All quantitative performance criteria (QPCs) and indicative targets (ITs) for review were met, with significant margins. A number of structural performance criteria (SPCs) and structural benchmarks (SBs) have been implemented, albeit with delays. However, finalization of Nepal Oil Corporation (NOC) 2005/06 accounts has not been possible due to delays in the appointment of an auditor. This has now been done and a revised timeframe for completion of the audit has been agreed. For SPCs that were completed with a delay or for which revised understanding have been reached, the GON is requesting waivers from the IMF's Executive Board.

4. **Going forward, the National Planning Commission (NPC) has begun the preparation of a three-year interim plan**. This plan is focused on rehabilitation, reconstruction, and recovery to provide a medium term focus to economic policies after mid-July 2007. The GON intends to engage all stakeholders and donors in the preparation of the three-year plan, which is expected to be finalized by mid-July 2007. The GON will also

formulate the 2007/08 budget by mid-July, on which discussions with the IMF will provide an opportunity to update the medium-term macroeconomic framework and the Medium-Term Expenditure Framework.

A. Macroeconomic Developments and Policies

5. **Macroeconomic stability has been maintained and policies remained appropriate in the first half of 2006/07**. Notwithstanding political uncertainties and poor weather conditions, real GDP growth is on an upward trajectory. Underlying CPI inflation was 6 percent, broadly in line with price developments in India. International reserves rose from US$1¾ billion at end-2005/06 to over US$2 billion in mid-January 2007, supported by robust private remittances and foreign aid inflows. The overall and domestically financed deficits were lower than programmed. Revenues have grown strongly, aided by a strong tax administration effort, higher customs duty rates on selected imports, a broadening of the excise tax base. With development spending still constrained by implementation capacity at the local level, the budget made a net repayment to the domestic banking system of Nrs. 6 billion (1 percent of GDP). Monetary and exchange rate policies of the Nepal Rastra Bank (NRB) remained firmly geared to maintaining the exchange rate peg to the Indian rupee.

B. Structural Reforms

6. **The GON and NRB have completed implementation reform actions agreed for the fourth review (except finalization of audit of NOC 2005/06 accounts)**.

Fiscal Reforms

- **Tax administration**: With the introduction of performance indicators and performance-based incentive schemes in the Large Taxpayer Office (LTO) and the model customs office, tax administration and revenue collection has improved. The LTO has conducted comprehensive audit of tax return of 30 large taxpayers. In addition, to assess the extent of excise leakages, the LTO has conducted audits of excise returns of large taxpayers for mid-October 2006. Based on its study of VAT nonfilers, the Internal Revenue Department (IRD) has reduced the proportion of nonfilers to lower than 15 percent through deregistration of dormant VAT taxpayers. As regards income tax, the IRD made compulsory electronic tax deduction at source (ETDS) for all large taxpayers after January 15, 2007, and introduced the fiscal printer to improve recordkeeping and reduce tax evasion. In addition, the IRD will make mandatory the installation of excise sticker machines in all cigarette and beer factories by April 15, 2007. The new sticker regime will be fully operational by July 15, 2007. The Customs Department is implementing its three-year reform program. As part of this action plan, and in line with IMF recommendations, the department has made significant progress in establishing a wide-area network (WAN) between the headquarters in Kathmandu and the five largest customs offices to improve information sharing among the offices. This WAN will facilitate greater ASYCUDA functionality, with AsDB and UNCTAD assistance. To improve customs administration, the cabinet has approved a new Customs Act, which has been submitted to parliament.

Financial Sector

- **NRB "re-engineering**:**"** To address the qualified opinion on 2003/04 and 2004/05 NRB account by international accounting firms, make further progress towards meetings IFRS standards, and spur improvements in the Internal Audit and Financial Management Departments, the Auditor General appointed an international accounting firm for NRB's 2005/06 accounts in January 2007. Also, to focus the NRB on its core functions and to address noncompliance with IFRS standards, the NRB has divested its shareholding in the Citizen Investment Trust, the Eastern Rural Development Bank, and a portion of its shareholding in the Non-Life Insurance Division of Rastriya Beema Sansthan. To strengthen NRB supervisory capacity and to ensure that the central bank is well placed to meet the challenges of financial sector liberalization as part of WTO commitment in 2010, the NRB conducted a self-assessment of its compliance with Basle Core Principles for Effective Banking Supervision, with IMF technical assistance. With this self-assessment, the NRB supervision department has prepared a time-bound action plan to address the identified gaps in its supervisory framework. To enhance off-site supervision, the NRB has developed a manual for analyzing data submission by development banks and finance companies. Also, the supervision department is developing an early warning system based on off-site data for effective communication of risks to senior management.

- **Legal framework**. A draft Anti-Money Laundering Bill to strengthen the integrity of the financial system is to be presented to Parliament in 2007. In addition, the NRB is drafting guidelines to clarify the procedure for mergers and acquisitions to facilitate consolidation among financial sector institutions, along with a revised BAFIA. To strengthen the basis for repo operations, the NRB Board has approved a Master Repo Agreement for the NRB and commercial banks.

- **Loan recovery**: The GON has taken action against a number of large, willful defaulters and annulled their passports, frozen their bank accounts, and placed restrictions on their asset sales.

- **Restructuring of commercial and development banks**: The commercial banks under external managers (Nepal Bank Limited and Rastriya Banijya Bank; NBL and RBB, respectively), made operating profits in the first half of 2006/07, reduced their NPLs, improved lending practices, and made substantial progress in computerization of their branches. Restructuring of Nepal Industrial Development Corporation (NIDC) is progressing with efforts underway to divest its shares in a commercial bank. Earlier in late 2006, the NRB intervened to stem a bank run on a troubled private sector bank. The NRB took over management of the bank, the board was dissolved, and management dismissed. The takeover restored confidence in the bank as deposit withdrawals ceased immediately. Moreover, NRB management subsequently was able to partially restore the deposit base and recover a significant amount of nonperforming and connected loans.

Public Sector Reforms

The decline in international oil prices, and price increases on some petroleum products have provided a much needed respite to the loss-making NOC which is operating broadly at break-even levels. However, the accumulated suppliers' credits to Indian Oil Corporation, NOC's sole supplier continue to constrain supplies. To address these credits, the NOC has discussed options with IOC to schedule and settle the accumulated credits. Meanwhile, the draft Petroleum Sale and Distribution Act to liberalize the oil sector and further increase private sector participation was submitted to Parliament in November 2006.

VIII. Macroeconomic Objectives and Policies

A. Macroeconomic Objectives

7. **Economic activity is expected to recover somewhat in 2006/07**. Real GDP growth is expected to increase to 3−4 percent. While agriculture output growth is likely to remain dampened due to erratic weather conditions and manufacturing may still take some time to recover from unsettled labor market conditions, tourism and construction appear to be making a strong rebound. Underlying CPI inflation is projected to remain around 5−6 percent, in line with price developments in India. The current account is projected to remain in surplus with continued strong remittance inflows.

B. Fiscal Policies

8. **The 2006/07 budget aimed to raise and improve the quality of public spending, raise the revenue-to-GDP ratio, and limit domestic borrowing**. On the revenue side, a rebound in activity and reduced supply disruptions are expected to help revive revenue performance, and the targeted increase to 13⅓ percent of GDP is expected to be met. The budget makes provisions for a significant scaling up of social sector and public investment programs on health, education, and rural infrastructure, prioritized along the lines of the Medium-Term Expenditure Framework. The allocation for security-related spending was reduced by ½ percent of GDP to 2¾ percent. Implementation capacity for increased local level investment remains weak but is expected to be overcome partially by scaled-up grants for village development committees, where past experience with community and user groups' participation in project implementation has been favorable. With the rise in spending to meet development needs, the overall deficit (after grants) is expected to rise to 5½ percent of GDP. External aid is projected to increase from 3¾ percent of GDP in 2005/06 to 6¼ percent, and the gross domestically financed deficit would be limited to Nrs. 18 billion (2¾ percent of GDP).

9. **Since the adoption of the budget in mid-July 2007, the peace process has moved forward quickly, requiring adjustments in the budget**. The additional spending needs for peace-related activities, including the upkeep of Maoist cantonments, security arrangements and preparations for constituent assembly elections, and other rehabilitation needs for internally dislocated persons are high. Nevertheless, to maintain fiscal balance, the GON will aim to meet these needs with only a limited increase in domestic financing through a reallocation from capital spending (where projects are unlikely to take off in this fiscal year

due to technical problems) or low priority spending to peace-related spending and will aim to achieve a modest increase in the revenue target. The GON has also set up a Peace Fund for which is hopes to attract donor and other financing. Expenditures from the Fund will be undertaken in a transparent manner, and supporting regulations have been finalized.

10. **Beyond 2006/07, the GON intends to remain focused on its medium-term objectives of raising resources to finance infrastructure and needed structural reforms while lowering the public debt-to-GDP ratio**. A further increase in the revenue-to-GDP ratio should be possible from tighter administration and base broadening, including elimination of VAT exemptions and reducing customs and excise leakages. As implementation capacity improves, it would be possible to raise spending on much needed social sector and infrastructure projects, mainly through higher external aid while further reducing security-related spending to lower levels as the peace is firmly reestablished. The overall deficit (after grants) and domestic financing would be limited. This would leave room to meet the costs of further reforms in the financial and public enterprise sectors. Discussion with the IMF in the context of the 2007/08 budget would provide an opportunity to specify the medium-term fiscal framework, taking into account the evolving needs for rehabilitation, reconstruction, and recovery.

C. Monetary and Exchange Rate Policies

11. **The NRB's monetary and exchange rate policy will remain geared toward maintaining the peg to the Indian rupee**. The peg has served Nepal well given close ties with India. In addition, the level of the exchange rate peg is appropriate. Consistent with this objective, broad money growth is projected at around 16 percent in 2006/07, assuming real GDP growth of 3−4 percent and a small decline in velocity. This would accommodate the projected domestic financing needs of the budget while allowing real private sector credit growth of 8−9 percent. Reserve money growth is projected around 15 percent, with a targeted increase in the NRB's net foreign assets (NFA) of US$110 million.

12. **The NRB will take steps to further improve monetary operations and its internal processes**. To address excess liquidity in the financial system, the NRB has expanded the list of imports from India eligible for payment in convertible currencies, and will explore options to further extend the range of transactions with India suppliers in convertible currencies, including those conducted by the NOC. The MOF has also agreed to issue a stock of T-bills (which could be placed in a separate government account at the NRB) to assist with liquidity management.

D. Structural Reforms

13. **The GON and NRB are determined to press ahead with structural reforms in three macrocritical areas in the context of the PRGF arrangement**. More broadly, the GON is committed to improving service delivery to the public and to improve governance, consistent with the overall objectives of Nepal's PRSP. To this end, the GON intends to maintain a continuous dialogue with all stakeholders to ensure that these objectives are met.

Fiscal Reforms

- **Tax administration**: The GON will make a strong effort to further reforms to raise revenue collection, reduce leakages, enhance audit, and improve taxpayer services in the Inland Revenue and Customs Departments. To help improve revenue administration, the MOF has requested further IMF and donor assistance. To make the audit of large taxpayers more effective, starting 2007/08, the responsibility to audit tax deduction at source (TDS) will be shifted to the LTO. The IRD will make compulsory ETDS for Kathmandu-based government offices after July 15, 2007, design a strategy for ETDS implementation, and extend computerization significantly at the large taxpayer and retail levels to reduce underinvoicing. In addition, the IRD will make a strong effort to ascertain whether VAT taxpayers with suspended PANs are still trading with a view to prosecuting tax evaders and recover tax arrears. The Customs Department will streamline clearance procedures at the largest customs point in Birgunj. Steps will be taken to gain parliamentary passage of an amended Customs Act in time for inclusion in the 2007/08 budget.

- **Fiscal transparency**. The GON is committed to significantly improving transparency as envisaged in fiscal ROSC that it conducted with IMF collaboration.

E. Financial Sector

14. **Steps will be taken to improve the banking framework and loan recovery, further NRB re-engineering, and help restructure troubled commercial and development banks**.

- **Legal framework**: To improve the legal framework for financial sector activity, a revised Banking and Financial Institutions Act (BFIA) will be finalized. Cabinet approval for the act will be sought by August 31, 2007. In view of the proliferation of financial institutions relative to market size, the NRB has raised the minimum capital requirements for commercial banks, and tightened licensing criteria.

- **NRB "re-engineering:"** In the remainder of 2006/07, the NRB intends to address gaps in the supervisory framework identified in the self-assessment against the Basle Core Principles.

- **Commercial banks**: With restructuring of NBL and RBB by external managers in its third year under the Financial Sector Reform Program with assistance from the World Bank, the GON is now looking ahead to the next phase.

F. Nepal Oil Corporation

15. **To address NOC losses, the GON will gradually adjust upwards prices of oil products** with the objective of introducing an automatic pricing mechanism for oil products at that time. In the meantime, suitable measures to finance flow losses have been devised.

IX. Program Monitoring

16. **The program will be monitored using the definitions, data sources, and frequency of monitoring set out in the attached Technical Memorandum of Understanding (TMU)**. The government will make available to Fund staff all core data, appropriately reconciled and on a timely basis, as specified in the TMU.

17. **Performance criteria**. Table 1 shows quantitative performance criteria and benchmarks until mid-July 2007. In addition, the nonaccumulation of external payment arrears will constitute a continuous performance criterion, as will the standard injunctions against overdue financial obligations to the IMF, imposition or intensification of restrictions on current payments, introducing or modifying multiple currency practices, conclusion of bilateral payments agreements inconsistent with Article VIII, and imposition or intensification of import restrictions for balance of payments purposes. Structural performance criteria and benchmarks for the fifth review are identified in Table 2.

18. **Program review**. The fifth and final review of the program under the PRGF arrangement is expected to be completed by mid-October 2007. This review will focus on: (i) the implementation of administration reforms at the Inland Revenue and Customs Departments; (ii) financial sector reform; (iii) safeguards issues; and (iv) progress in oil sector and SOE reform.

19. **The NRB and GON are committed to accurate data reporting under the PRGF-supported program**. In this context, the NRB intends to follow through fully with IMF recommendations to improve its financial accounts, internal audit, and financial management made in the context of the Safeguards Assessment.

Table 1. Nepal: Quantitative Performance Criteria and Indicative Targets

(In billions of Nepalese rupees, unless otherwise stated)

	Jul. 17, 2006 Actual	Oct. 17, 2006 Actual	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) 2/ 3/	1,842.7	1,852.7	1,882.7	1,912.7	1,952.7
II. Ceiling on net domestic assets of the NRB 2/ 4/	-28.1	-26.1	-23.8	-25.7	-18.8
III. Ceiling on change in net domestic financing of central government budget 4/ 5/ Cumulative from July 17, 2006	...	2.0	4.7	7.4	11.7
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 (in millions of U.S. dollars) 6/	...	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) 6/	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)	0.0	0.0	0.0	0.0	0.0
Indicative targets (IT)					
I. Ceiling on reserve money	110.1	112.9	117.4	117.8	127.7
II. Floor on central government revenue 7/ Cumulative from July 17, 2006	...	14.7	36.9	57.4	85.3

1/ Mid-January 2007 and mid-July 2007 are performance criteria test dates. Figures for mid-April 2007 are indicative targets.
2/ Valued at the program exchange rates. Monetary gold valued at program prices (US$600 per oz.).
3/ Adjusted upward/downward by excess/shortfall of foreign program financing. Details specified in the Technical Memorandum of Understanding (TMU).
4/ Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing. Details specified in the TMU.
5/ Adjusted upward/downward by shortfall/excess of privatization receipts. Details specified in the TMU.
6/ External debt as in the TMU.
7/ Adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the TMU.

Table 2. Nepal: Proposed Structural Performance Criteria and Benchmarks for Fifth Review of the PRGF Arrangement

Measures		Timing
Structural Performance Criteria		
A.	Fiscal Sector Reforms	
1.	Large Taxpayer Office (LTO) to conduct comprehensive audit of large taxpayers 1/	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
3.	Customs Department to streamline customs clearance at Birgunj customs office 3/	July 15, 2007
4.	Customs Department to establish Wide-Area Network (WAN) for headquarters and at least five large customs offices	July 15, 2007
B.	Financial Sector Reforms	
1.	Cabinet approval of revised Banking and Financial Institutions Act 4/	August 31, 2007
2.	NRB to divest all its shareholding in Non-Life Insurance Division of Rastriya Beema Sansthan	July 15, 2007
3.	NRB to divest all its shareholding in at least two rural development banks	July 15, 2007
4.	Finalize audit of NRB 2005/06 accounts by an international auditor	July 15, 2007
C.	Nepal Oil Corporation	
1.	Finalize audit of NOC 2005/06 accounts in accordance with international standards	July 15, 2007
Structural Benchmarks		
1.	Submission to Parliament of amendments to Customs Act	April 15, 2007
2.	Submission to Parliament of draft Anti-Money Laundering Act	July 15, 2007
3.	Submission to Parliament of revised Banking and Financial Institutions Act	September 30, 2007
4.	IRD to make compulsory ETDS for Kathmandu-based government offices	July 15, 2007
5.	NIDC to implement rationalization and divestment instructions of the MOF	July 15, 2007
6.	NRB to draft guidelines for mergers and acquisitions of banks and financial institutions 5/	August 31, 2007

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.
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.

NEPAL—TECHNICAL MEMORANDUM OF UNDERSTANDING FOR PRGF ARRANGEMENT

May 30, 2007

This memorandum sets out the framework for monitoring the PRGF-supported program for 2006/07. It specifies quantitative performance criteria and indicative targets and the content and frequency of the data to be provided for monitoring the financial program. All foreign currency nondollar denominated quantities under the program will be converted into U.S. dollars at program exchange rates specified in Table 1.

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Net Foreign Assets of Nepal Rastra Bank

20. **Net foreign assets (NFA) of the Nepal Rastra Bank (NRB)** is defined as the difference between the market value of gross foreign assets and liabilities, at program exchange rates. Gross foreign assets of the NRB consist of monetary gold, foreign currency balances at the NRB, foreign exchange balances held outside Nepal, foreign securities (valued at market prices), foreign bills purchased and discounted, IMF reserve position and SDR holdings. Excluded from gross foreign assets will be participation in international financial institutions and holdings of precious metals other than monetary gold. Gross foreign liabilities are all foreign currency denominated liabilities and use of Fund credit.

21. **The NFA floor will be adjusted** downward/upward by the shortfall/excess of the identified foreign program financing as set out in Table 2. Foreign program financing is defined to include adjustment loans from multilateral creditors other than the Fund, budget support from bilateral creditors, loans (if any) from private creditors (including commercial banks) and rescheduling of medium- and long-term public and publicly-guaranteed debt (exceptional financing).

B. Net Domestic Assets of NRB

22. **Net domestic assets (NDA) of the NRB** is defined as the difference between reserve money and rupee value of NFA of the NRB, at program exchange rates. NFA of the NRB is defined in Section A above; reserve money is defined in Section C.

23. **The NDA ceiling** will be adjusted downward/upward by the excess/shortfall of the identified foreign program financing as set out in Table 2. External program financing received for financial and public sector reforms over the amounts identified in Table 2 would not lead to a downward adjustment of the NDA ceiling. The upward adjustment in the ceiling due to a shortfall in external program financing compared to Table 2 would be capped at Nrs. 5 billion (around 1 percent of GDP).

C. Reserve Money of the NRB

24. **Reserve Money (RM) of the NRB** consists of currency in circulation outside the NRB, deposits of commercial banks at the NRB, and other private sector deposits at NRB. As of July 17, 2006, RM stood at Nrs. 110.7 billion.

D. Net Domestic Financing of the Central Government Budget

25. **Net domestic financing (NDF) of the budget is defined as net credit to the central government (NCG) by the banking system (NRB), and deposit money banks (DMBs) and net change in holdings of treasury bills and other government securities by the nonbank sector**. The flow NDF of the budget would be the cumulative change in book value from July 17, 2006 in the sum of the following government debt instruments: (i) treasury bills; (ii) development bonds; (iii) national and citizen savings certificates; (iv) special bonds (including duty drawback bonds); and (iv) loans and advances from the NRB and deposit money banks (DMBs) *minus* government deposits with NRB and DMBs. This stock stood at Nrs. 94.2 billion at July 17, 2006. Central government is defined here to include line ministries, departments and public institutions.

26. **The ceiling on net domestic financing** will be adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign program financing as set out in Table 2. External program financing received for financial and public sector reforms over the amounts identified in Table 2 would not lead to a downward adjustment of the NDF ceiling. The upward adjustment in the ceiling due to a shortfall in external program financing compared to Table 2 would be capped at Nrs. 5 billion (around 1 percent of GDP). The ceiling on net domestic financing will be adjusted upward/downwards by 100 percent of the amount of any shortfall/excess in privatization receipts beyond the programmed amounts (Table 3). The ceiling on net domestic financing will be adjusted upward for onlending operations to cover flow losses of Nepal Oil Corporation. The ceiling on net domestic financing will not be adjusted down for external assistance received directly into the Peace Fund.

E. Central Government Revenue

27. **Central government revenue** is defined as reported in the treasury accounts (economic classification), excluding principal repayments to the budget by corporations and including privatization receipts. The floor on central government revenue is cumulative from the start of the fiscal year. The central government revenue benchmark will be adjusted upward/downward by 100 percent of the excess/shortfall in privatization receipts.

F. Contracting or Guaranteeing of New Nonconcessional External Debt

28. **Contracting or guaranteeing of new medium- and long-term nonconcessional external debt** is defined as contracting or guaranteeing new nonconcessional external debt by the central government and the NRB with an original maturity of more than one year (valued at program exchange rates as defined in Table 1). Nonconcessional debt is defined as borrowing containing a grant element of less than 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates (CIRR). For maturities of less than 15 years, the grant element would be calculated based on six-month CIRR averages, while for maturities longer than this, the grant element would be based on ten-year CIRR averages. This performance criterion applies not only to debt as defined in point No. 9 of the *Guidelines on Performance Criteria with Respect to Foreign Debt* (Decision No. 12274–(00/85), August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are credits extended by the IMF and financing from the World Bank and Asian Development

Bank (AsDB), and government counter guarantees on project loans from both the World Bank and AsDB, as well as changes in indebtedness resulting from rescheduling operations or rollovers. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee issued.

G. Contracting or Guaranteeing of Short-Term External Debt

29. **Stock of short-term external debt outstanding** is defined as debt with original maturity of up to one year owed or guaranteed by the NRB and central government (valued at program exchange rates as defined in Table 1). The term debt is defined as set forth in point No. 9 of the *Guidelines on Performance Criteria with Respect to Foreign Debt* (Decision No. 12274–(00/85), August 24, 2000), but excludes normal import-related credits.

H. Accumulation of External Payment Arrears

30. **The program's performance criterion on nonaccumulation of external payment arrears is continuous throughout the program period**. External payments arrears are defined as overdue payments (interest and principal payments) on short-term debt in foreign currencies with an original maturity of up to and including one year (spot, money market, letters of credit) and medium- and long-term debt contracted or guaranteed by the central government. As of May 15, 2007, there were no external payment arrears.

II. Data Reporting Requirements

31. For the purpose of monitoring the performance under the program, data will be provided in the format shown in Tables 4–9. Nepal shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Nepal in achieving the objectives and policies set forth in the letter. All the program monitoring data would be provided by the Ministry of Finance and the NRB. In addition, a written reconciliation of NRB program data (NFA, NDA and Reserve Money) with the accounting records will be prepared for all test dates under the PRGF arrangement. Data on gross foreign assets and gross foreign liabilities would be provided at market prices and program exchange rates. All the data relating to the above programmed targets will be furnished within eight weeks after the end of each test date.

- Table 4. Net Foreign Assets of Nepal Rastra Bank
- Table 5. Balance Sheet of Nepal Rastra Bank
- Table 6. Net Domestic Financing of Central Government Budget
- Table 7. Central Government Revenue
- Table 8. Contracting or Guaranteeing of New Medium- and Long-Term Nonconcessional External Debt by the Central Government and NRB
- Table 9. Contracting or Guaranteeing of Short-Term External Debt by the Central Government and NRB

Table 1. Program Exchange Rates and Gold Prices 1/	
Foreign currency	Foreign Currency/U.S. Dollar
Nepalese rupee	75.0
Indian rupee	46.45
SDR	0.68
Japanese yen	117.0
Euro	0.80
Pound sterling	0.55
Gold prices (U.S. dollars per ounce)	600.0

1/ Currencies not shown here will be converted first into U.S. dollars using official exchange rates used by the IMF's Finance Department on July 17, 2006.

Table 2. Program Foreign Financing, 2006/07
(In millions of U.S. dollars)

	Oct. 17, 2006 Actual	Jan. 14, 2007 Actual	Apr. 13, 2007	Jul. 15, 2007
Foreign financing (cumulative)	32.9	41.4	45.9	69.2

Table 3. Program Privatization Receipts, 2006/07
(In millions of Nepalese rupees)

	Oct. 17, 2006 Actual	Jan. 14, 2007 Actual	Apr. 13, 2007	Jul. 15, 2007
Privatization receipts (cumulative)	0.0	0.0	495	1,978

Table 4. Net Foreign Assets of the Nepal Rastra Bank, 2006/07

(In millions of U.S. dollars)

	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Net foreign assets 1/				
Assets				
Foreign exchange				
Monetary gold				
Reserve position in the Fund				
SDR holding				
Liabilities				
Deposits				
CSI credit accounts				
ESAF/PRGF				

1/ At program exchange rates and prices.

Table 5. Balance Sheet of the Nepal Rastra Bank, 2006/07 1/

(In billions of Nepalese rupees)

	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Net foreign assets				
Assets				
Liabilities				
Net domestic assets				
Claims on public sector				
Net credit to government				
Claims on government 2/				
Less: Deposits				
Claims on public enterprises				
Claims on private sector				
Claims on commercial banks				
Other items (net)				
Reserve money				
Currency outside banks				
Currency held by banks				
Bankers' deposits				
Private sector deposits				

1/ For program monitoring purposes.
2/ Excluding IMF promissory notes.

Table 6. Net domestic financing of the Budget, 2006/07
(In millions of Nepalese rupees)

	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Net claims on government (stock)				
Banks				
NRB (net)				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				
Loans and advance				
Less: Deposits				
DMBs				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				
Nonbanks				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				

Table 7. Central Government Revenue, 2006/07
(In millions of Nepalese rupees)

	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Total revenue (GON)				
Less: Principal repayment by corporations				
Total revenue 1/				
Tax revenue				
Taxes on goods and services				
VAT/sales tax				
Excise taxes				
Others				
Taxes on international trade				
Import taxes				
Indian excise refund				
Export taxes				
Agriculture reform fee and other				
Taxes on income and profits				
Taxes on property				
Nontax revenue 1/				
Charges, fees, and fines				
Sales of goods and services				
Dividends				
Royalty and fixed asset sales				
Interest receipts				
Other				

1/ Excluding principal repayments by corporations.

Table 8. Contracting or Guaranteeing of New Nonconcessional Medium- and Long-Term External Debt by the Central Government and the NRB (In millions of U.S. dollars)									
Date	Creditor	Project	Date of Agreement	Currency	Maturity Period	Grace Period	Interest Rate	Amount	Disbursement

Table 9. Contracting or Guaranteeing of New Short-Term External Debt by the Central Government and the NRB (In millions of U.S. dollars)									
Date	Creditor	Project	Date of Agreement	Currency	Maturity Period	Grace Period	Interest Rate	Amount	Disbursement

INTERNATIONAL MONETARY FUND

NEPAL

Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction And Growth Facility, and Requests for Waiver and Modification of Performance Criteria—Informational Annex

Prepared by the Asia and Pacific Department

May 30, 2007

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ANNEX I: NEPAL—FUND RELATIONS

(As of April 30, 2007)

I. Membership Status: Joined 9/06/61; Article VIII, Sections 2, 3, and 4 in May 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	5.98	73.73

IV. Outstanding Purchases and Loans:	**SDR Million**	**Percent Quota**
PRGF arrangements	28.52	40.00

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	28.52
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	0.21	0.23	0.23	0.22	0.21
Total	0.21	0.23	1.66	3.07	3.06

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 April 30, 2007, the exchange rate for the Nepalese rupee (Nr) was US$1=Nrs. 65.7.

VIII. Safeguards Assessments

A safeguards assessment of the 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
	- Monetary policy	6/03
	- Monetary operations	Continuous
	- Foreign exchange reserves management	5/03, 10/04, 11/05, 7/06
	- Financial Sector Supervision	1/07, 4/07
FAD	- Implementation of a large tax payer unit	10/03
	- Review of tax policy and VAT administration	5/03
	- Tax and customs administration reform	10/03
	- Follow up on the LTO and customs administration reform	8/04, 6/06, 4/07
LEG	- Redrafting of income tax laws	3/00, 7/01
STA	- Multisector statistics	1/01
	- Balance of payments statistics	4/02, 12/02, 10/03, 4/04
	- Producer price statistics	1/02, 1/03, 4/04, 1/05
	- Monetary statistics	7/03
	- National accounts	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

A. Partnership in Nepal's Development Strategy

Since the late 1990s, Nepal's poverty reduction agenda has been held back by formidable challenges—the persistent political instability, 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.[1] 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.[2] The strategy revolves around four key pillars: (i) achieving sustainable and broad-based economic growth with an emphasis on the rural economy; (ii) accelerating human development through improved delivery of basic social services and economic infrastructure; (iii) ensuring social and economic inclusion of the poor, marginalized groups and less developed regions; and (iv) vigorously pursuing good governance to achieve better development results, and ensure social and economic justice. While there had been considerable progress towards implementing the PRS, since February 2004, the reform efforts and momentum have suffered greatly.

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 support these measures, the Bank's Board approved the first Poverty Reduction Support

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[1]The PRS was discussed by the Boards in November 2003 following a joint staff assessment carried out by the two institutions. Subsequently, three PRS Progress Reports have been issued by the authorities—in May 2004, June 2005, and June 2006.

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

Credit I (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 UK have established a joint financing arrangement whereby donor funds are pooled with public sector budgetary resources to support implementation of the program. IDA support is provided through the *Education for All* project which employs a sector-wide approach (SWAp) and through the *Second Higher Education* that was approved in February 2007.

The Bank has encouraged Nepal's decentralization efforts to achieve more efficient delivery of public services. It has played a pivotal role in supporting the transfer of public schools to community management. The Bank's dialogue 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 recently approved in January 2007.

To help generate broad-based growth, the Bank supports investments in key ***infrastructure*** sectors by financing projects in *Road Maintenance and Development, 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 *Road Maintenance and Development Project* (RMDP) supports key sectoral policy reforms by establishing a Roads Board and Road Fund to assure a stable source of funding for maintenance expenditures, while also promoting motorable access to isolated regions. 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). The PAF channels resources to grassroots levels, creating a mechanism for continuity and coordination of donor programs for poverty reduction. Bank financing for the PAF project (approved in FY04 with a supplemental approved in FY07) is supporting the 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 is being carried out and will be 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 United Kingdom 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 (to be completed in FY07) that will examine 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.

Should there be a reinvigoration of the reform process, the Bank in the future would contemplate additional development policy lending linked to the government's short-term program. In the meantime, to assist in the reform effort 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 will also comprise 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 in the preparation of the PRS and subsequent three 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 lead the work with a Trade and Competitiveness Study which 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 prerequisite for successful implementation of the IAP and PRS. Since the mismanagement of key financial institutions was a major element of poor governance, the progress on financial sector reform has been the litmus test of political commitment to governance reform. The Bank and the IMF are helping to strengthen the Central Bank's authority and regulatory capacity, improve the financial health of the two largest banks, restructure the state banks, and upgrade the legislative and institutional framework for the financial sector. The Bank financed the comprehensive assessment of the two largest banks and undertook a comprehensive Financial Sector Study in 2002. The ***Financial Sector Technical Assistance*** project supports the restructuring and reengineering of the Central Bank, introduction of professional management teams into the two large ailing commercial banks (the first step toward eventual restructuring of those banks), capacity building towards enhanced credit information, improved public awareness of financial sector issues and upgrading of staff training in financial institutions. The ***Financial Sector Restructuring*** project—for which Bank financing was approved in FY04—supports further strengthening of the Central Bank and deepening the reform process within the two large ailing commercial 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, an on-going study on Access to Finance (to be completed in FY07) is helping to gain a better understanding of: (i) the financial performance of the micro-finance 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, the Board considered a new Country Assistance Strategy (CAS), 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) went to the Board in February 2007.

The Lending Program. In FY05, IDA financing was approved for the Education for All Project, the Health Sector Program, the Rural Access Improvement and Decentralization Project, and the Economic Reform Technical Assistance Project for total new commitments of US$135 million. Given the instabilities of the past year, no new commitments were entered into in FY06. To date, US$103.2 million has been approved in FY07 for two projects and one supplemental financing.

Bank Assistance Program in Nepal. As of March 1, 2007, IDA's lending portfolio consisted of fourteen projects with a total commitment of US$524.7 million and a total undisbursed balance of US$332.3 million (Table 1), which includes the most recently approved Second Higher Education project approved in February 2007.

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), and *Nepal: Resilience Amidst Conflict: An Assessment of Poverty in Nepal, 1995−96 and 2003−04* (June 2006).

Table II.1. World Bank Operations

As of March 1, 2007

	IDA Amount	Undisbursed [1/]	Board Date
(In millions of U.S. dollars, net of cancellations)			
Road Maintenance and Development	54.5	6.7	2000
Telecommunications Sector Reform	20.4	8.9	2002
Financial Sector Technical Assistance	16.0	7.9	2003
Community School Support	5.0	2.1	2003
Power Development	74.8	70.1	2003
Poverty Alleviation Fund	40.0	31.8	2004
Financial Sector Restructuring (Phase II)	75.5	21.0	2004
Rural Water Supply and Sanitation II	25.3	13.9	2004
Health Sector Program	50.0	33.0	2005
Education for All	50.0	28.7	2005
Rural Access Improvement and Decentralization	32.0	28.2	2005
Economic Reform Technical Assistance	3.0	1.9	2005
Avian Flu	18.2	18.1	2007
Second Higher Education	60.0	60.0	2007
Total	524.7	332.3	

[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.

IFC's Activities in Nepal. As of end February 2007, the IFC outstanding balance portfolio in Nepal is US$39.93 million in two power generation projects, one tourism project and one leasing company. 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, infrastructure and the financial sector. The IFC has also begun to deliver technical assistance to facilitate SME access to finance through the South Asia Enterprise Development Facility (SEDF)—based in Dhaka. This facility—funded by IFC in partnership with Canada, Netherlands, Norway, United Kingdom, Asian Development Bank (ADB) and the European Union (EU)—will deliver TA programs in Nepal to increase SMEs' access to financing, improve the business environment for SMEs and develop supply chains involving SMEs. Recent scoping missions by IFC-SEDF and FIAS (a joint IFC and World Bank Facility) have investigated where the major investment climate constraints lie and where IFC-SEDF and FIAS interventions may add value.

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 December 31, 2006, cumulative lending to Nepal was $2.25 billion, comprising 111 loans and four grant projects amounting to $83.9 million. Sectors covered through ADB 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. ADB's total country program for Nepal in 2006 amounted to $169.9 million in 2006—Road Connectivity Sector I Project (Grant: $55.2 million), Rural Finance Sector Development Cluster Program I (Loan: $56 million; Grant: $8.7 million), Commercial Agriculture Development Project (Grant: $18 million), and Education Sector Cluster Program [subprogram 1 (Loan: $30 million; Grant: $2)] The proposed lending to Nepal in 2007 includes three firm projects totaling $129 million.

Undisbursed funds of $487.84 million represent 71 percent of the total net loan amount as of December 31, 2006.

Loans and Grants by the Asian Development Bank, 1969–2006

(As of December 31, 2006)

	1968–2000	2001	2002	2003	2004	2005	2006
Loans	(In millions of U.S. dollars)						
Agriculture and natural resources	656.23	0	0	20	70	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
Technical assistance							
Total approved	98.03	4.03	4.02	4.17	3.16	2.05	5.82
Gross disbursements	54.1	5	3.9	4.17	4.2	3.6	2.04

Technical Assistance

Since 1968, ADB has provided Nepal with technical assistance in most sectors. As of December 31, 2006, total technical assistance consisted of 260 projects totaling $121.28 million. At year-end 2006, there were 38 ongoing TAs including 3 JFPR projects.

Private Sector Operations

Developing a strong and dynamic private sector is essential to the long-term economic growth of Nepal. ADB aims to strengthen the role of the private sector in Nepal through prudent investments in its infrastructure sector. The ADB'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 2005, cumulative approvals for 4 private sector projects in Nepal amounted to $58.64 million. ADB's outstanding exposure for three private sector projects in Nepal amounted to $32.2 million as of December 31, 2005, representing approximately 1.9 percent of ADB's total private sector exposure. Currently ADB 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. Nepal has been a participant in the General Data Dissemination System (GDDS) since May 2001. Metadata were initially posted on the Dissemination Standards Bulletin Board in May 2001 and last updated in January 2007. A multisector statistics mission visited Katmandu in January 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 are within 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 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. The new price index is expected to provide better deflation of national accounts data and a more accurate measure of industrial sector inflation.

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 Nepal Rastra Bank (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), complicating program monitoring. **Money and banking statistics** missions visited Kathmandu during April/May 1999 and March 2000 to assist in improving timeliness, compilation procedures, and the coverage of the financial system. 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 2002, the NRB introduced new reporting forms for commercial banks. However, some components of data on deposit money banks are still not reported, preventing the publication in *IFS* of key aggregates such as claims on private sector, demand deposit liabilities, and money.

The July 2003 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 have started to report monetary data to STA using the new 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 large. Work is underway to improve the estimation of workers' remittances, and the data sources for private capital flows. Further work is needed to improve the recording of oil transactions, grants, foreign direct investment, short-term inflows, and other private capital 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, payments, and the stock of outstanding government debt has been developed and is currently being refined. However, reporting of direct external grants remains a problem.

Nepal—Table of Common Indicators Required for Surveillance

(As of April 17, 2007)

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

Press Release No. 07/131
FOR IMMEDIATE RELEASE
June 13, 2007

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Review Under Nepal's Three-Year PRGF Arrangement and Approves US$16 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the fourth review of Nepal's economic performance under the three-year Poverty Reduction and Growth Facility (PRGF) Arrangement, which enables Nepal to draw an amount equivalent to SDR 10.69 million (about US$16 million) under the arrangement. Completion of this review will bring total disbursements under the program to SDR 39.21 million (about US$59 million).

The Executive Board also approved a request for waivers for the non-observance of four structural performance criteria, including the audit of large taxpayers, the establishment of a wide-area network by the Customs Department; the divestment by Nepal Rastra Bank of its shareholdings in two financial institutions; and the audit of the Nepal Oil Corporation's 2005/06 accounts, in view of corrective actions taken by the authorities on these measures.

The Executive Board approved the three-year arrangement on November 19, 2003 (see Press Release No. 03/202) for an amount equivalent to SDR 49.9 million (about US$75 million). The first review was completed on October 20, 2004. The second and third reviews were completed on November 10, 2006, and the PRGF arrangement was extended to November 18, 2007.

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

"The Nepalese authorities are to be commended for their prudent macroeconomic policies and structural reforms, which have enhanced the resilience of the Nepalese economy. Fiscal, financial sector, and public enterprise reforms, together with durable peace, remain critical to sustained high growth and poverty reduction. The November 2006 Comprehensive Peace Accord is a welcome development that augurs well for the Nepalese economy.

"Going forward, sustaining macroeconomic stability will require continued prudent fiscal policies and reforms to increase government revenue, boost social sector and infrastructure spending, and limit domestically-financed budget deficits. The authorities are therefore appropriately focusing on improving tax administration, removing constraints on project implementation at the local level, and mobilizing adequate external assistance. The authorities also intend to enhance fiscal transparency.

"The pegged exchange rate to the Indian rupee has served Nepal well. Maintaining external competitiveness will require efficiency-enhancing structural reforms and infrastructure improvements. Monetary management would need to be strengthened by close coordination between Nepal Rastra Bank and the Ministry of Finance.

"Reforms are being implemented to develop and strengthen the financial sector. These include improvements in the legal and regulatory framework, strengthening of the central bank, restructuring of ailing commercial banks, and intensification of efforts to recover loans from large, willful defaulters.

"The enactment of the Petroleum Sales and Distribution Act will facilitate efforts to improve efficiency in the operations of the national oil company and the oil sector in general. Further actions are also needed, including introduction of an automatic price adjustment mechanism for petroleum products," 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 adopted in a participatory process involving civil society and development partners and articulated in the Poverty Reduction Strategy Paper (PRSP). 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 P. Acharya, Senior Advisor to Executive Director June 13, 2007

1. The Nepalese authorities would like to express their appreciation to the staff for the constructive discussions on fourth review of the three-year arrangement under the PRGF-supported program held in Kathmandu during February 2–15, 2007. My authorities broadly concur with staff's analysis, assessment and policy recommendations for macroeconomic management and structural reforms.

The Current Political Environment

2. The signing of the comprehensive peace accord between the seven party alliance (SPA) government and the Communist Party of Nepal (Maoist) (CPN/M) on November 21, 2006 culminated in the formal end of the 11-year insurgency. This facilitated the initiation of political measures aimed at cementing the peace process further. An interim constitution has come into effect since January 2007, which paved the way for the formation of an interim parliament inclusive of the CPN/M. An interim government of SPA and the CPN/M was formed on April 1, 2007. The United Nations' Mission to Nepal (UNIMIN) has already completed the first round of verification of the arms and the registration of combatants. The combatants have been relocated to the various cantonments under the supervision of the government, the CPN/M, and the UNIMIN. The process of registration of the combatants is going on for the second round verification.

3. The government has initiated dialogue with the Madeshi Janadhikar Forum, the newly formed Terai based political forum and with the indigenous groups, which have been in the agitation demanding greater share of political and economic power. This has eased tensions especially in the southern part of the country.

4. The constituent assembly (CA) election slated for June 2007 could not take place due to lack of preparedness especially of enactment of laws relating to elections and also unsatisfactory law and order situation especially from the Terai unrest**.** The eight political parties have recently agreed to hold CA election in November 2007.

Recent Economic Developments and Outlook

5. The most recent available indicators suggest that the real GDP at producers' price (recently compiled by the Central Bureau of Statistics on the basis of SNA 1993) is likely to slowdown to 2.5 percent in 2006/07 compared to 2.8 percent in 2005/06. This growth rate is far less than initially expected growth of 5 percent. Poor weather conditions, deterioration in industrial relations, public agitations in Terai, continued power disruptions and weak external demand accounted for lower-than-expected growth in 2006/07.

6. Consumer price inflation moderated to 5.6 percent, year-on-year (y-o-y) in mid-April 2007 compared to 7.9 percent a year ago. The moderate rate of inflation was on account of the elapse of the base effect of the hike in prices of petroleum products in February 2006. Price situation so far suggests that annual average consumer price inflation is likely to stand at 6.6 percent in 2006/07 compared to 8.0 percent in 2005/06.

7. The overall balance of payments (BOP) continues to be in a surplus. Elevated level of workers' remittances and the higher level of foreign aid flows have contributed to the surplus in country's BOP. International reserves are expected to remain at the targeted level in 2006/07. However, the decline in merchandise exports has been a matter of concern. The nominal appreciation of the Nepalese rupee against the US dollar is further aggravating the problem in merchandise exports. The currency appreciation is also likely to affect remittances.

Monetary and Exchange Rate Policies

8. The objective of both monetary and exchange rate policies has been to keep inflation low. Besides this, the objective of both the policies has also been to maintain the external sector stability. At the moment, the policy target is to maintain official international reserves at around 6 months' imports cover of goods and services. Currently, official reserves are sufficient to cover 7.5 months' imports of goods and services. The present exchange rate regime has significantly assisted in containing inflation. The Nepalese authorities are focusing on open market operations to modulate monetary liquidity. A significant amount of cash balances of the government with the central bank has also contributed to drain liquidity.

9. The prudent monetary management has helped defend the peg with the Indian rupee. However, recent rise in the value of Indian rupee has led to the nominal appreciation of the Nepalese rupee against the US dollar. As a result, the Nepalese rupee has appreciated in real terms as measured by the real effective exchange rate. Although the nominal appreciation has contributed to moderate inflation, the continuous appreciation of the currency has eroded the competitiveness of Nepalese exports particularly to countries other than India, reflecting the need to review the peg.

Fiscal Policy

10. The fiscal policy of 2006/07 was focused on increasing the level and improving the quality of government spending as well as raising the revenue-to-GDP ratio. As on June 1, 2007 (fiscal year ends in mid-July), the growth of total government expenditure, on cash basis, has been at about the preceding year's level. The lower than expected government expenditure has been on account of constrained capital spending at the local level. However, revenue growth has been significantly higher at 21 percent as against the negative growth of 0.2 percent last year. A strong tax administration effort, higher customs duty rates on selected imports and a broadening of the excise tax base have contributed to a higher rate of revenue growth. The revenue is expected to exceed the target set for 2006/07.

11. As a result, the magnitude of fiscal deficit is much lower this year compared to that of last year. The net domestic financing of the budget has been negative. As the government is maintaining cash balances with the central bank, the government recently retired treasury bills amounting to Rs 3.7 billion, which was not planned in the budget. So far, the government has made repayment of domestic debt amounting to Rs 6.7 billion, a 0.96 percent of GDP and the annual repayment of domestic debt would amount to Rs 11.4 billion. After the government raises the full amount of budgeted domestic borrowing of Rs 17.9 billion, the net domestic borrowing is likely to be much lower than initially projected.

Structural Reforms

12. The Nepalese authorities have expressed strong commitment to the Fund supported program. The authorities agree with the staff that both PRSP and PRGF arrangements are still appropriate and remain as the basic guidelines for maintaining macroeconomic stability, achieving a higher rate of economic growth and alleviating poverty. The authorities are also in agreement with the staff that besides prudent fiscal, monetary and foreign exchange policies, which are aimed at maintaining macroeconomic stability, structural reforms in fiscal, financial and oil sectors are crucial in accelerating growth and reducing poverty.

13. In this context, a number of reforms in the fiscal sector have been introduced. With a view to facilitate international trade and make tariff regime consistent with WTO and other international commitments, the Nepalese government has submitted a new Customs Act for Parliament's approval. The authorities are completing the wide-area network (WAN) for headquarters and five large customs offices. The authorities are also planning to install ASYCUDA in additional customs offices. With an objective of strengthening the tax administration and improving fiscal transparency, the Large Taxpayers' Office (LTO) has completed a comprehensive audit of 30 large taxpayers. The authorities have also expressed their commitment to improving fiscal transparency by way of implementing recommendations made in the draft Report on Standards and Codes.

14. On the financial sector reforms, the Nepal Rastra Bank (NRB) has introduced a new licensing policy for financial institutions. The objective of new licensing policy has been to help improve the overall soundness of financial institutions and tighten the proliferation of financial institutions. The new licensing policy is also aimed at consolidating the financial sector through mergers and acquisitions of weak institutions. Among others, the paid up capital for the establishment of financial institutions has been doubled.

15. The authorities are committed to overhaul the Banking and Financial Institutions Act (BAFIA) during the program period. The NRB has already submitted the draft of the BAFIA Act for its Board's approval, after which it will be sent to Ministry of Finance (MOF) for the Cabinet approval, latest by the end- June 2007. The proposed amendment is also aimed at strengthening NRB supervision over financial system and promoting financial sector consolidation. The Nepalese authorities have also finalized the Anti-Money Laundering legislation and Banking Fraud Act for parliamentary approval.

16. With the IMF technical assistance, the NRB has completed a self- assessment against Basle Core Principles for Effective Bank Supervision. With a view to focusing on core functions and eliminating non-core functions, the NRB has divested its shareholdings in two financial institutions, namely Western Rural Development Bank and Eastern Rural Development Bank, and is planning to divest its shares from other financial institutions. In this process, it has divested its shareholding from Citizen Investment Trust (CIT). Part of the NRB's shareholding in Non-life Insurance Division of the Rastriya Beema Sansthan (NLRBS) has already been divested, for the remainder the NRB is now negotiating with the Employees' Provident Fund (EPF), which has shown interest in buying it. It is expected to be completed before mid- July 2007.

17. External management teams placed in the two state-owned banks are making concerted efforts to improve financial health of these banks. The Nepalese authorities have expressed their commitment to restructure and rationalize these banks. In the present political context, because of likely spill over effects of labor unions' protest against privatization to a broader political horizon, the immediate privatization of these two large banks is somehow difficult. The authorities have taken strong measures such as publishing names, freezing of bank accounts, restricting the sale of assets except for the purpose of loan repayments and annulling the passports of over eighty large, willful defaulters. These measures are likely to help bring down the non-performing loans (NPL) especially in the two state owned banks. It is also expected to act as deterrence against further degeneration of banks' assets.

18. On divesting the share held by the Nepal Industrial Development Corporation (NIDC) in the joint venture Nepal Arab Bank Limited (NABIL), the NIDC has approached the Rastriya Beema Sansthan, and the two entities are negotiating on the price. Once the price is settled divestment will take place.

19. The significant amount of accumulated losses in Nepal Oil Corporation (NOC) is posing a risk to macroeconomic stability. The selling of petroleum products at lower-than-international prices and operational inefficiency have accounted for the accumulated losses in NOC. With a view to addressing the problem, the authorities have submitted the Petroleum Sales and Distribution Act for parliamentary approval. The objective of the Act is to liberalize the oil sector and pave the way for private sector participation in oil business.

Quantitative Performance Criteria (QPCs) and Structural Performance Criteria (SPCs)

20. Despite the difficult political and economic situation, all quantitative performance criteria (QPCs) and indicative targets for the fourth review have been met, with significant margins. Likewise, a number of structural performance criteria (SPCs) and benchmarks have been implemented. However, due to political transition, some SPCs were implemented with delays. In case of those SPCs which are not fully implemented, substantial progress have been made. We have also reached an understandings on a revised timeframe for implementation of those SPCs, which are not yet fully implemented.

21. The authorities have requested for waiver for nonobservance of four structural performance criteria (SPC), which were implemented with delay and for some of which understandings have reached for a revised time frame. Our authorities have also requested for the completion of the fourth review, as well as modification of test dates for performance criteria relating to WAN, divestment of NRB's shareholding in the Non-life Insurance Division of Rastriya Beema Sansthan (NLRBS) and finalization of NOC's audit of 2005/06 accounts to July 15, 2007. Office of the Auditor General has already appointed the auditor for NOC, and the audit work will be completed well within this fiscal year. The test date of mid-January 2007 set for LTO to conduct a comprehensive audit of at least 30 large taxpayers was missed. However, this was completed around mid May 2007.

22. As the country is still in political transition, the Nepalese authorities are in the process of preparing a three-year draft interim plan, focusing on rehabilitation, reconstruction and recovery from the 11-year insurgency. The three-year interim plan is slated to begin from 2007/08 through 2009/10. The interim government has reaffirmed its commitment and has felt a need for the Fund-support program to help maintain macro-economic stability and advance reforms in key areas. Our authorities have expressed an interest in a successor arrangement to support the interim plan.

Conclusion

23. Our authorities concur with the staff's assessment that durable peace remains the key to higher growth and poverty reduction. Therefore, risks to growth and reduction in poverty emanates from the still unsettled political environment. Authorities are supportive of the view that structural reforms are crucial in accelerating growth. For this, the Nepalese authorities solicit support from the international community.

The Nepalese authorities consent to the publication of the staff report, the LOI and the memorandum. My authorities have expressed sincere thanks to all directors for their constructive policy advice, and donor community for their continued assistance and support.