March 2000

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Nepal: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of Nepal on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with Nepal, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of Nepal; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports allows for the deletion of market sensitive information.

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NEPAL

Staff Report for the 1999 Article IV Consultation

Prepared by the Staff Representatives for the 1999 Consultation with Nepal

Approved by Mario I. Blejer and Thomas Leddy

February 3, 2000

- Discussions for the 1999 Article IV consultation were held in Kathmandu during November 22–December 3, 1999. The Nepalese representatives included: Finance Minister Acharya; National Planning Commission Vice Chairman Ligal; and Governor Shrestha of the Nepal Rastra Bank. Discussions were also held with leaders of the major opposition political parties, donors, and private sector groups.

- Discussions were also held on a Technical Assistance Consultation.

- The team comprising Mr. Carter (Head), Ms. Abdelati, Messrs. Sidgwick, Nagaoka (all APD), Mr. Lönnberg (MAE) and Ms. George (Staff Assistant, APD) was assisted by Messrs. DeMilner (Resident Representative) and Zveglich (AsDB). Mr. Harinowo, Alternate Executive Director, participated in the discussions, as did Mr. Rothenbühler, World Bank Country Director.

- Nepal accepted the obligations of Article VIII, Sections 2, 3, and 4 in May 1994, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

- Nepal is participating in the pilot scheme for publication of staff reports.

- The principal authors of the staff report are Mr. Carter and Ms. Abdelati.

Contents

I. Introduction and Political Setting

1. **At the conclusion of the last Article IV consultation in February 1999, Executive Directors emphasized that the stable macroeconomic conditions should provide a platform for accelerating structural reforms to improve Nepal's development prospects and to reduce poverty**. In recent years, efforts to advance structural reform had little result. Nepal's earlier ESAF expired in October 1995 and discussions for a successor ESAF stalled. Successive coalition governments were unable to formulate a comprehensive reform package. Over the past year, the authorities have maintained macroeconomic stability and there has been an improvement in the external position. However, structural reforms remain delayed, pervasive fiscal weaknesses impair development efforts, and financial sector distortions impede the efficient allocation of resources. The 1999 Article IV consultation focused on these issues, and discussed how they could be addressed in the context of a growth-oriented program of reforms. The authorities wished that such a program could eventually be supported by a Poverty Reduction and Growth Facility (PRGF) arrangement.

2. **The new government has an opportunity to pursue a stronger reform program**. The Congress Party won a clear majority in the May general elections. The July Budget Speech highlighted the priorities of raising growth levels, promoting employment generation, and reducing poverty across all regions. However, strong internal conflicts within the Congress Party exist and continued perceptions of mismanagement and corruption together with the lack of improvement of economic conditions have led to strikes and further problems with the Maoist insurgency. Following a disagreement with the Prime Minister, Minister Acharya resigned on January 31 and was succeeded by Foreign Minister, Dr. Mahat (Finance Minister 1997–98).

3. **In the mission's view, without a substantial reduction in the structural impediments to private sector-led growth, poverty would not decline**. Only a dramatic increase in spending on education and infrastructure and significant inflows of foreign capital over the long term could tap into the country's potential and eventually permit sufficiently fast growth.[1] Critical to these objectives would be a reduction in low priority spending and increases in fiscal revenue to raise public savings to finance higher public investment while maintaining macroeconomic stability.

II. Recent Economic and Policy Developments

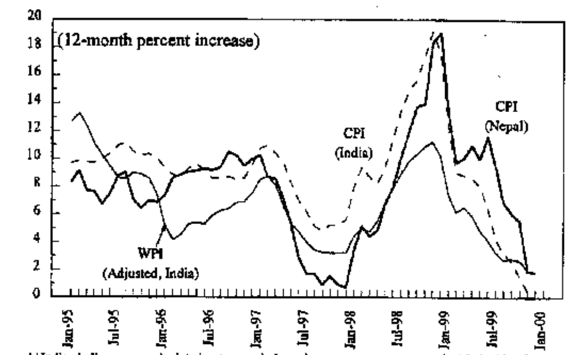
4. **Growth has picked up and inflation steadied**. Real GDP growth improved marginally to 3½ percent in 1998/99 led by increases in exports, manufacturing (carpets and garments) and financial services (Table 1).[2] Although agricultural GDP increased, its gains were modest because of fertilizer supply problems and adverse weather. Per capita GNP remains very low in dollar terms (US$220). Inflation has recently come down, similar to developments in India. After accelerating to nearly 20 percent in 1998 because of temporary food shortages, the 12-month rate of inflation declined to 2 percent by December 1999, as

[1]However, it would still take Nepal 20 years of 10 percent (7–8 percent per capita) growth to reach US$900 per capita income, the current IDA threshold.

[2]The fiscal year ends July 15.

food prices fell.[3] The inflation differential with India, which widened in 1999, has disappeared (Figure 1).

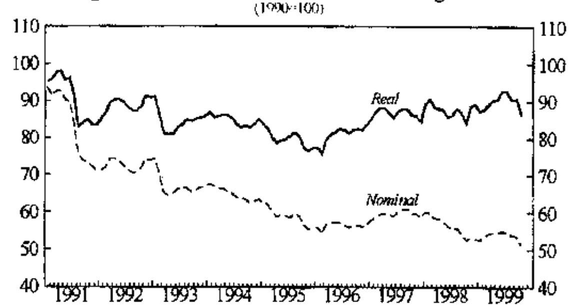
Figure 1. Inflation, 1995-2000 1/



1/ Indian indices are recalculated as two-period moving averages to correspond with the Nepalese month. WPI for India is re-weighted using food and nonfood shares from Nepal's consumption basket.

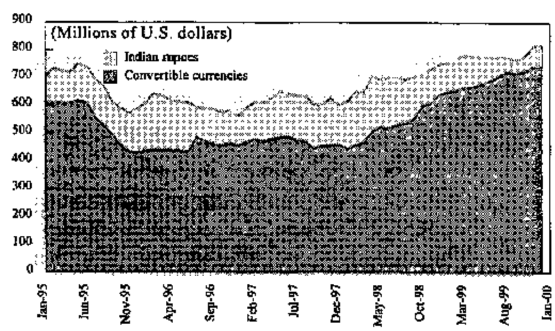
5. **External developments have been broadly favorable, allowing for sizeable reserve accumulation and a stable exchange rate** (Figures 2 and 3). Pegged to the Indian rupee, the Nepalese rupee broadly maintained its nominal rate with respect to the U.S. dollar, appreciating in real effective terms by about 7 percent for 1998/99. Nevertheless, the current account balance improved dramatically, shifting by 6 percent of GDP to a surplus (excluding grants) because of low recorded imports and increased remittances following the global recovery (Table 2 and Figure 4). Exports, excluding gold, increased by 21 percent in dollar terms, following a 12 percent increase in the previous year, mainly on account of rising sales of ready-made garments and increased trade with India. Total imports declined, with delays in capital spending and lower gold imports (mainly for re-export to India) following liberalization of gold imports in India.[4] Estimated total private remittances also increased sharply following the recovery in Asian economies and increases in pensions of retired Gurkhas.[5] Official loan disbursements declined in line with imports of capital goods, and foreign direct investment remained insignificant. In the first half of 1999/2000, the appreciation of the real

Figure 2. Real and Nominal Effective Exchange Rates
(1990=100)



Sources: International Financial Statistics; and Information Notice System: IMF.

Figure 3. Gross Official Reserves, 1995-2000

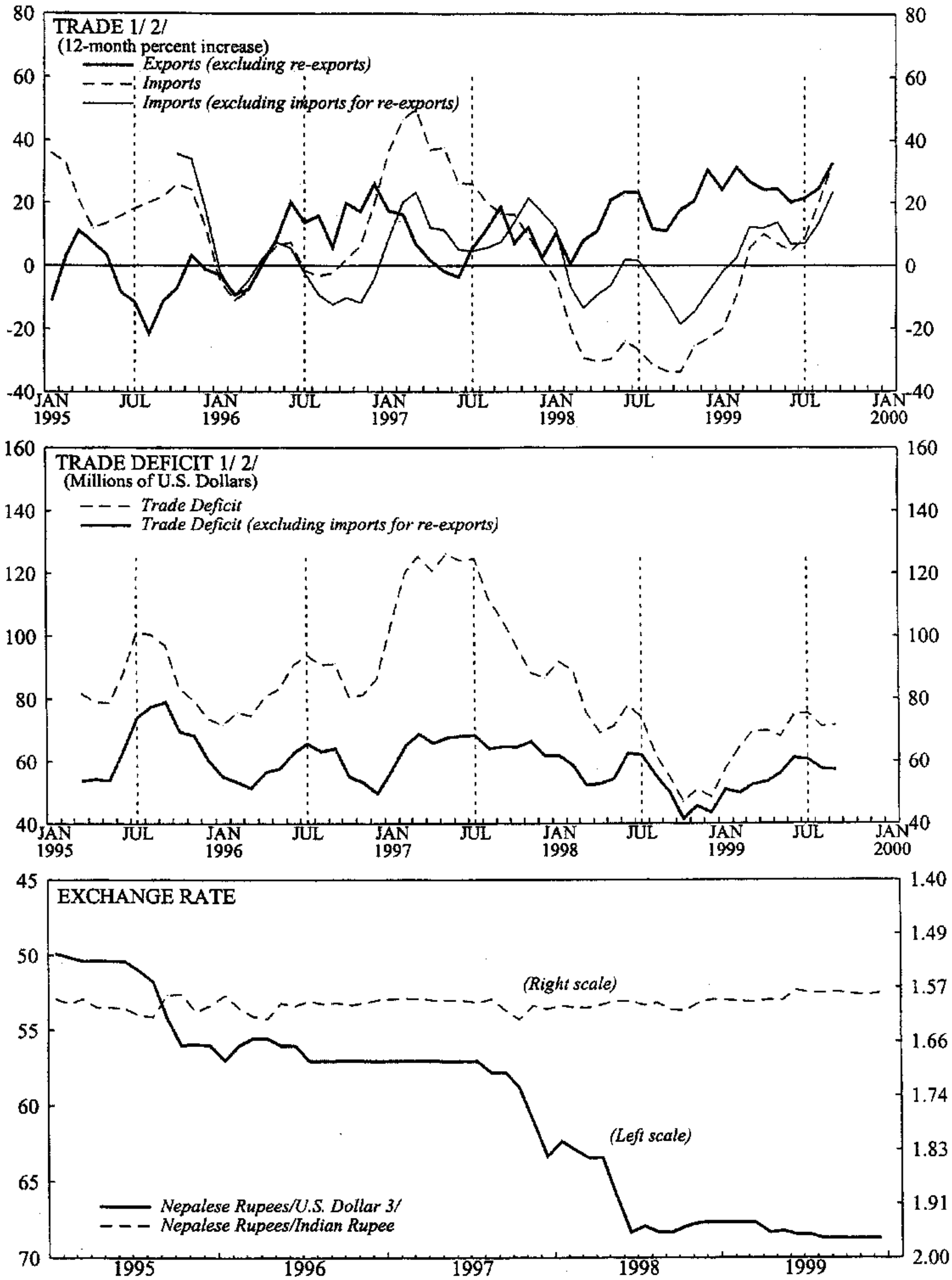


[3]The annual rate of price increases of nonfood items has been much more stable during recent years (in the range 4–8 percent). This was in part because of lack of adjustment of administered prices until the changes of November 1999 (see paragraph 9).

[4]The illegal gold trade picked up when India raised the import duty on gold in January 1999.

[5]In the staff's view, the improvement in the current account is somewhat overstated because of continued data problems, including in the recording of imports, as reflected in large negative errors and omissions. Data on gold exports and worker's remittances are rough estimates.

Figure 4. Nepal: Selected External Indicators, 1995-99 1/



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

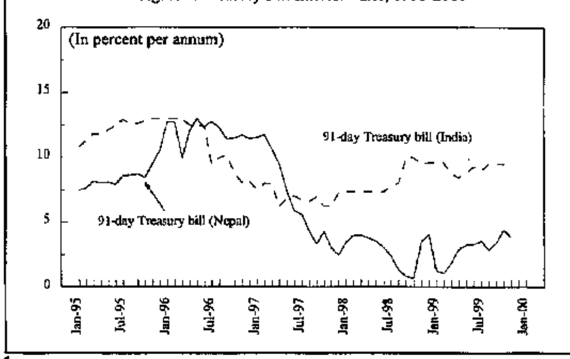
1/ Beginning of fiscal year is indicated by a dotted line.
2/ Three-month moving average.
3/ End of period.

effective exchange rate in 1998/99 has been reversed and the level is close to that of early 1997, before the Asian crisis. Official reserves have remained stable, standing at 4¾ months of imports or 35 percent of broad money.

6. **A passive monetary policy, intended to foster private sector growth, led to accommodation of higher budget financing and some overshooting of the monetary targets**. Under pressure from the Nepal Rastra Bank (NRB), commercial banks reduced nominal interest rates and broad money growth accelerated, peaking in February 1999 at 26 percent (on a 12-month basis), before slowing in recent months to 21 percent in November (Table 3 and Figures 5 and 6). As reserves built up, the NRB did not sterilize their foreign exchange purchases. However, faced by limited domestic lending opportunities, and a short supply of treasury bills, excess liquidity in the commercial banks continued to build up. Banks were forced to place their surplus funds abroad or in excess reserves held at the NRB. Although bank financing of the budget has been higher than projected, such financing was mainly through the NRB overdraft facility.

7. **The interest rate on treasury bills remained considerably lower than in India and has been negative in real terms since December 1997** (Figure 7).[6] The government had been reluctant to allow treasury bill rates to rise substantially because of the impact on debt service. The NRB converted the accumulated Government overdraft (Nrs 6 billion) into one-year treasury bills in March 1999, to be sold to mop up the excess liquidity in the commercial banks. However, so far only half of these securities have been sold.

Figure 7. Treasury Bill Interest Rates, 1995-2000



8. **While the overall budget deficit remained sustainable, financed primarily by foreign aid, fiscal performance was disappointing in 1998/99 as revenue and development spending were below target**. The deficit (before grants) was 6¼ percent of GDP, unchanged from the previous year (Table 4). Total revenue amounted to 10 percent of GDP; lower than budgeted and than in the previous two years—receipts from the recently introduced VAT were below expectation because of the resistance of the business community. Current expenditures were contained at just below budgeted levels, as increases in spending on law and order and election-related activities offset underspending by other ministries. Development expenditures, however, were substantially below budgeted amounts because of delays in project implementation. As in previous years, domestic bank financing of the deficit was considerably higher than budgeted and foreign financing (closely tied to project implementation) was less than anticipated. In the first four months of the current fiscal year, faster development spending and an increase in civil service allowances have led to further domestic financing needs and the government's central bank overdraft has increased sharply (Figure 8). VAT receipts have been less than targeted, with problems processing tax returns.

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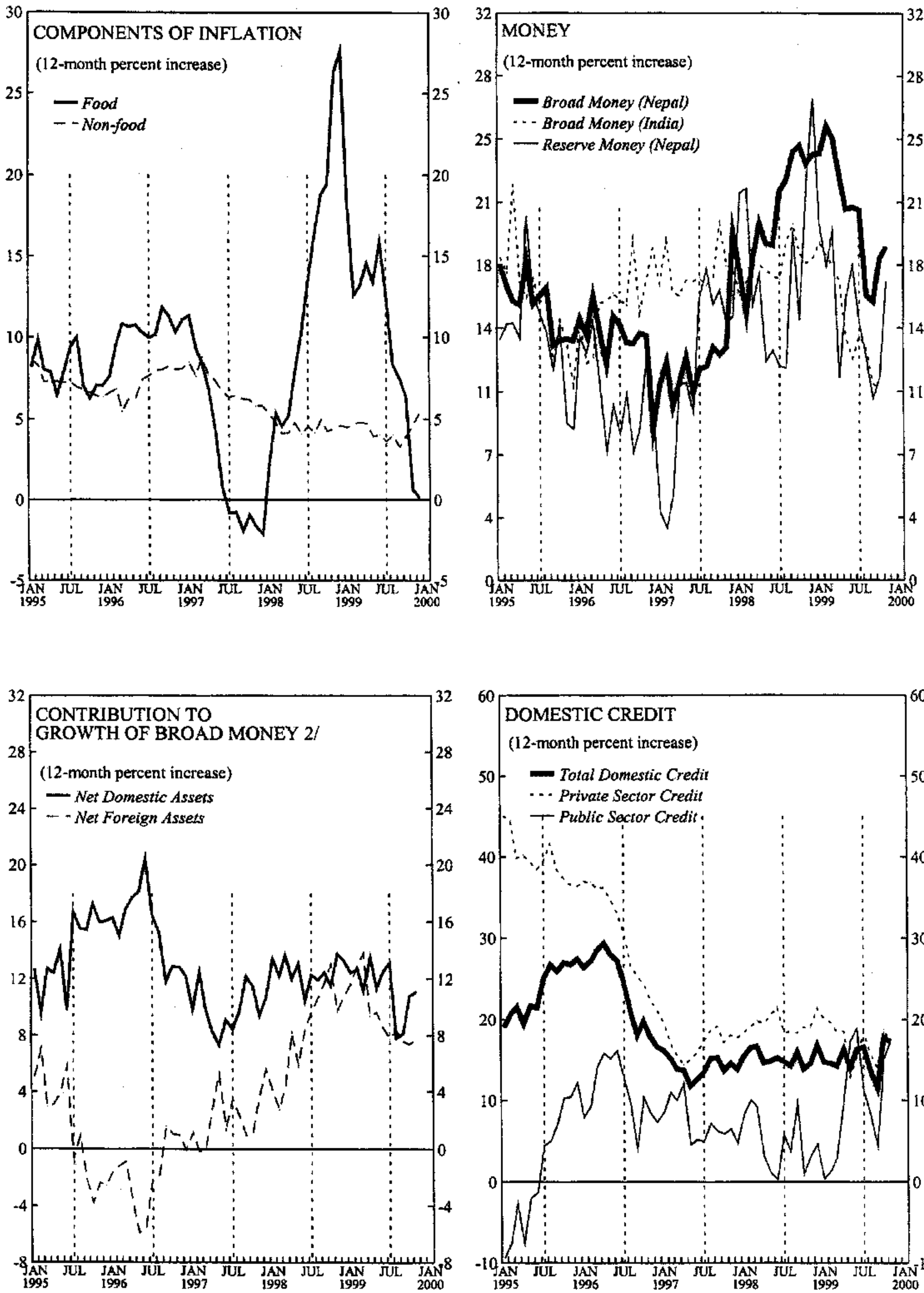
[6] Though significantly less so in recent months because of the sharp decline in inflation.

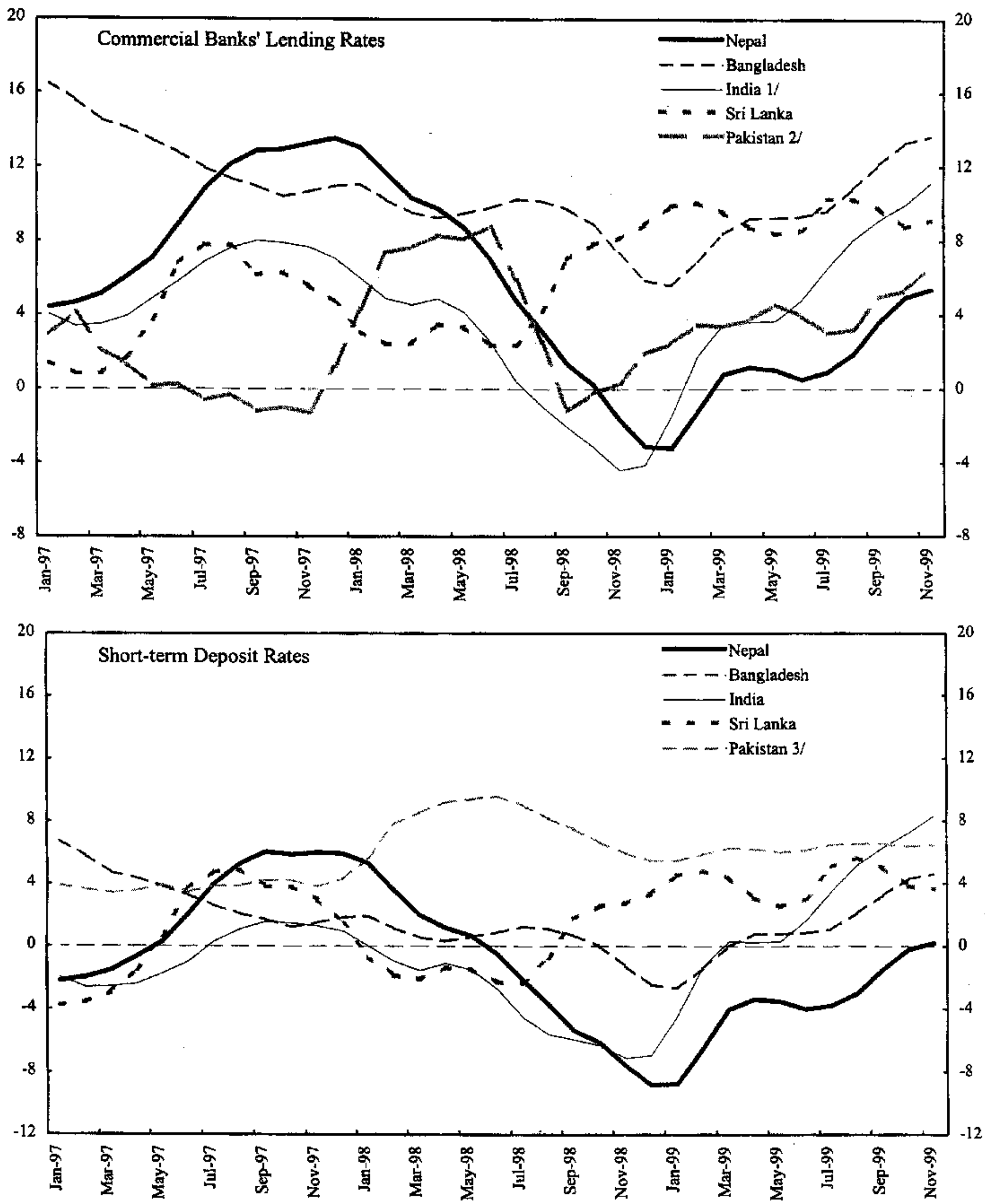
Figure 5. Nepal: Selected Financial Indicators, 1995-99 1/



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

1/ Beginning of fiscal year is indicated by a dotted line.
2/ Adjusted for valuation effects of exchange rate changes; in percent of broad money at beginning of period.

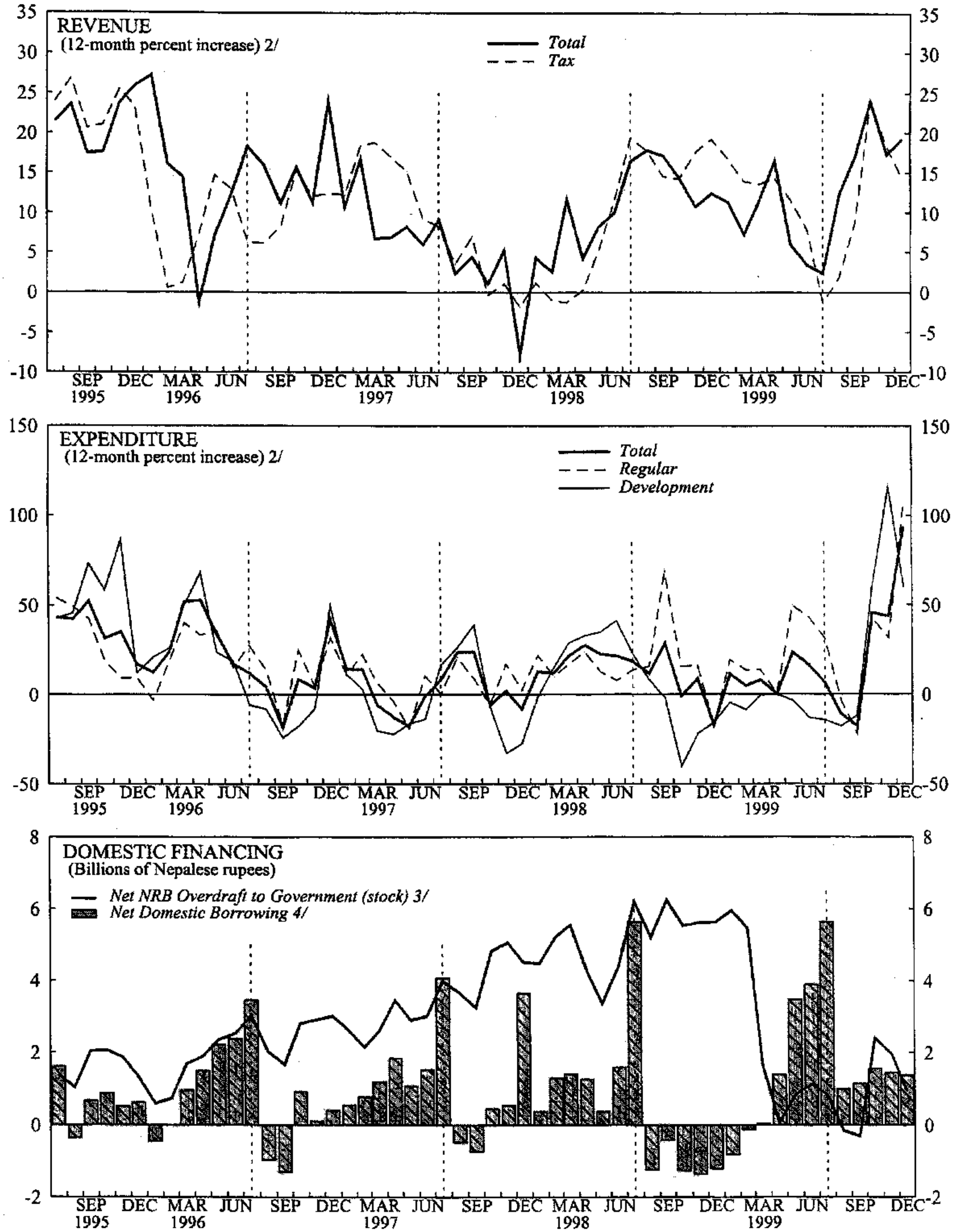
Figure 6. Nepal: Real Interest Rate Comparisons, 1997-99
(In percent per annum, three-month moving average)



Source: IMF, Economist Information System.

1/ For India, the WPI is used as the primary measure of inflation.
2/ Call rate.
3/ 6-month short-term federal bond rate.

Figure 8. Nepal: Selected Fiscal Indicators, 1995-99 1/



Source: Data provided by the Nepalese authorities.

1/ Beginning of fiscal year is indicated by a dotted line.
2/ Three-period moving average.
3/ The government's central bank overdraft balance was converted to treasury bonds in March 1999.
4/ Cumulative from start of fiscal year.

9. **Little concrete progress was achieved on structural reform, although some steps have been taken that could bode well for the pace of reforms to come:**

- Assisted by the World Bank, Fund, and Asian Development Bank (AsDB), the NRB has started its financial sector reform, with consultants in place reviewing the operations of the main financial institutions and supervision requirements.
- Progress in privatization has been slow. However, the sale of the tea company is now in the final stages and bids have been submitted for Butwal Power Company.[7]
- As part of the program to improve fertilizer distribution through greater private sector participation, agreed with the AsDB, fertilizer subsidies have been reduced.
- As part of public enterprise restructuring, electricity prices were raised in November to improve the finances of Nepal Electricity Authority (NEA).[8]

III. Short-Term Prospects and Risks

10. **Prospects remain uncertain in the current economic and political environment, but a pick-up in growth is projected in 1999/2000, possibly reaching 6 percent**, based primarily on good weather, better fertilizer distribution, and an export recovery. Inflation is expected to average 5–6 percent for 1999/2000 as a drop in agricultural prices would offset the rises in fuel and other utility prices.

11. **With a narrow export base and closely linked to the Indian economy, external developments remain subject to some risk.** Merchandise exports are projected to increase significantly but the current account is expected to worsen as imports rise sharply (by more than 30 percent) with the pick-up in economic activity, increased project-related imports, and higher oil costs. Nevertheless, the authorities expected foreign reserves would continue to increase, although at a slower rate, provided the outlook for India remains stable (also the staff's current assessment).[9]

12. **Foreign debt is not a pressing problem, but financial system weaknesses continue and foreign currency receipts are vulnerable to adverse regional developments** (Table 5). Public external debt is 50 percent of GDP and is almost entirely on concessional terms: the debt service ratio is below 6 percent. Nepal is not a HIPC-eligible country.

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[7]However, one bidder pulled out in December, complaining of irregular procedures.

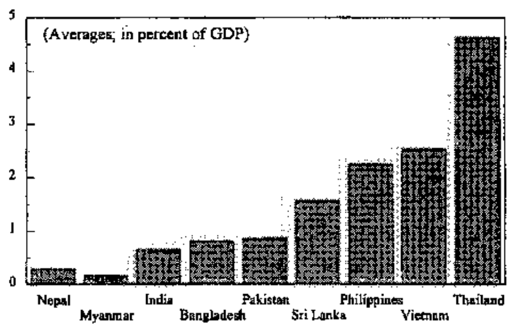
[8]The 30 percent electricity price increase, pushed by the AsDB, was criticized bitterly by the opposition and other groups, who complained that the NEA's financial difficulties resulted from its failure to collect arrears, technical and other electricity losses, and mismanagement. Complaints were also raised about fuel price increases, necessitated by higher world oil prices.

[9]India is growing at an annual rate of 5¾ percent.

IV. Policy Discussion

13. **Discussions focused on the steps needed to ensure macroeconomic stability while addressing the long-standing constraints to significantly higher growth.** Apart from the problems of a small domestic market and poor transport links, identified growth constraints include a weak financial sector and inefficient public expenditures and state enterprises. Compared with other Asian countries foreign direct investment remains negligible (Figure 9). Moreover, low agricultural productivity growth combines with a population growth rate of 2½ percent and high illiteracy to perpetuate widespread, especially rural, poverty (Box 1 and Table 6).

Figure 9. Foreign Direct Investment Inflows, 1997-1999

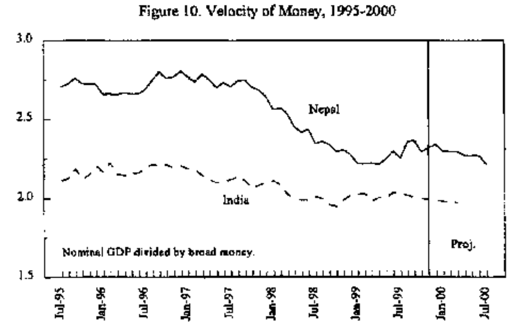


A. Exchange Rate and Monetary Policies

14. **The authorities noted that the exchange rate peg with the Indian rupee provided a useful anchor.** Formal and informal trade with India remained the cornerstone of the economy. The strong performance of exports—particularly non-traditional items—and tourism receipts, and the build-up in official reserves, suggest that the current exchange rate level is not out of line and competitiveness has been maintained.[10] In view of the low inflation and stable outlook in India, the mission supported the authorities' decision to maintain the current arrangement. However, the team cautioned the NRB to revisit the appropriateness of the peg regularly and urged them to enhance export competitiveness through structural reforms and improved infrastructure.

15. **With a fixed exchange rate regime, inflation in Nepal is closely linked to price development in India. Thus, the focus of monetary policy is the control of credit expansion consistent with a satisfactory evolution of international reserves and projected money demand.** Achieving the targeted build up in international reserves will require prudent monetary conditions. The mission discussed an indicative financial program for 1999/2000, with an inflation target for 1999/2000 of 5–6 percent, similar to projections for India. The NRB noted that the focus had been on targeting narrow money because of the impact of increased monetization on the growth of bank deposits (Figure 10). However, in response to the

Figure 10. Velocity of Money, 1995-2000



[10]Data limitations and ongoing structural changes in the economy preclude estimation of an equilibrium exchange rate against which to assess the current level of the exchange rate and competitiveness. For a fuller discussion of competitiveness using the summary indicators available, see the accompanying 1999 *Recent Economic Developments* paper.

Box 1. The Challenge of Overcoming Deep-Rooted Poverty

Overcoming widespread and deep-rooted poverty is Nepal's greatest challenge. Recent estimates suggest that the proportion of the population living below the nutrition-based poverty line (defined at somewhat less than \$1 per day in PPP terms) is 42 percent and that 70 percent have incomes less than 1½ times the poverty line. As would be expected, income inequality is low, but disparities do exist, particularly in terms of access to health services and basic infrastructure, and with respect to education and income opportunities. Female literacy is less than half that of men, and primary school enrollment for girls less than half that of boys. As seen in Table 6, virtually all Nepal's social indicators are well below those of neighboring and other Asian countries.

Poverty is more acute and pervasive in rural areas and varies across regions. Regionally, the Mid and Far Western Development Regions, and the Mountain Belt are much poorer than the Eastern Region. Around 80 percent of the poor farm small and dispersed plots of low-quality land. Many must seek scarce low-wage agricultural employment to supplement their income. Limited work opportunities have maintained underemployment at around 50 percent. Many poor struggle as bonded laborers to pay off debts and the caste system constrains prospects for labor mobility. Health services are less accessible and more costly in rural areas. Eight percent of Nepali households have access to piped water, 9 percent are connected to sanitary drains, 15 percent have electricity access, and 24 percent live within a half hour of a paved road.

Lack of broad-based sustained growth is the primary factor behind Nepal's failure to reduce poverty in recent decades. Growth has averaged less than 4 percent with population growth exceeding 2½ percent over the past 25 years; employment has grown at a slower pace than the labor force. Much of the employment opportunities stem from banking, real estate, trade and services—with stagnating agriculture and few jobs in rural areas. The low domestic savings rate leaves Nepal highly dependent on foreign aid.

Additionally, political instability and corruption has slowed the pace of economic reform and wasted scarce economic resources and foreign aid. The low-paid bureaucracy has become increasingly more politicized with frequent allegations of corruption at all levels of government. Waste through weak governance and corruption has limited the effectiveness of fiscal policies and of poverty alleviation programs. Recognizing this problem, government initiatives and donor projects increasingly incorporate steps that involve local stakeholders in the design and implementation of projects and a comprehensive reform of civil service is to be undertaken.

The Ninth Plan (1997–2002) specifically aims to improve access to basic infrastructure and social services in deprived areas with specific targets, similar to the International Development Goals adopted by the OECD. Public spending on social and poverty alleviation programs is constrained by the low level of public revenues and its composition determined by donor assistance programs. Nepal cannot afford to significantly expand social safety net through domestic resources. Although social expenditure has increased from 3½ percent of GDP in the mid-eighties to nearly 6 percent of GDP, the allocation remains inadequate, particularly with respect to funding of priority areas.

Grass-roots ownership and participation are being enhanced by decentralizing development spending and project management to the district, municipality, and village level. Several participatory poverty assessments were recently carried out by local and international NGOs (e.g., Action Aid Nepal, Plan International Nepal, New Era, and part of the 1995/96 Nepal Living Standard Survey (NLSS)). A National Workshop on Poverty was hosted by NPC in January 1998. Government initiatives are widely discussed in committees and public debate. A Poverty Alleviation Fund has been created to facilitate program design and implementation. Projects with successful community participation include community forestry, farmer managed irrigation and the Food for Work program in the Churia region, as well as a number of UNDP and GTZ sponsored projects. However, it is doubtful that community mobilization efforts can be effectively replicated in more remote areas. There is also a risk that decentralization and revenue sharing arrangements could weaken overall resource mobilization and budgetary control.

Sources: World Bank Poverty Assessment, 1998 and UNDP Human Development Report, 1999 based on NLSS.

greater stability now exhibited by broad money velocity, it was agreed that the NRB would also monitor closely broad money developments. With projected GDP growth of 6 percent and a decline in velocity, the program would be based on broad money growth in the range of 15–16 percent. The mission stressed the need to restrict bank financing of the budget to enable room for reasonable growth of credit to the private sector.

16. **The authorities recognize the need to reduce the excess liquidity in the banking system.** To help mop up this excess liquidity (estimated at Nrs 4 billion, 2½ percent of M2), the mission recommended further sales of the central bank's treasury bill holdings. The NRB and Ministry of Finance accepted the proposal (the NRB does not have full independence on monetary policy), which would also correct the negative real interest rate on treasury bills. However, there were still legal and operational problems to selling the securities.[11] The NRB was not contemplating any adjustment of the reserve requirements.

17. **Given the decline in inflation, NRB officials were in favor of a reduction in commercial bank lending rates**. However, the mission argued that interest rates would need to remain near to their current levels to be consistent with a cautious monetary stance. Moreover, the mission noted that there was little room to reduce deposit rates, given the rates prevailing in India and the need to avoid capital flight. The spread between deposit and lending interest rates would remain high until the problems of the large banks were resolved.[12]

B. Fiscal Policy

18. **There was agreement that fiscal policy should be directed at raising revenues, reducing low-priority spending, and providing for higher and more effective development and social spending**. Thus, the key focus was not only the size of the overall deficit, which might increase in the short term, but on the structure of the budget. The aim was to increase public savings and lower domestic financing requirements, combined with efforts to improve project implementation so as to take advantage of the available investment financing. For the current year, discussions focused on efforts to realize the Budget goals announced in July—an increase in public savings of ½ percent of GDP and an increase in tax revenue to 9 percent of GDP mainly through improved VAT implementation.[13]

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[11]There are legal restrictions on selling in the primary market the 1-year bills acquired from converting the overdraft and limits on the level of gross sales of treasury bills.

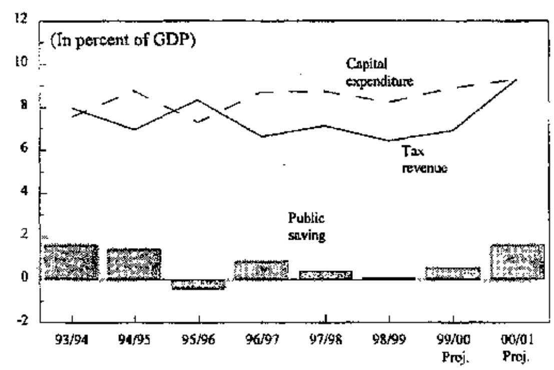
[12]The commercial banks expected to keep their interest rate spread within 5 percentage points, as required by the NRB, although the leading banks reported that this was not a major issue.

[13]The increase in tax revenues was expected from the extension of the VAT base through a lowering of the threshold from Nrs 4½ million to Nrs 2 million, implemented in July 1999 to capture many retailers, and administrative improvements. However, these and other changes prompted a sharp increase in the number of registrants, many of who will not be significant taxpayers, overloading the administration of the tax.

19. **On the revenue side, there was concern that the pace of receipts was starting to lag.** The authorities were optimistic that the budget targets could be reached, with income tax receipts on track, but noted that both VAT and customs duty collection needed to be strengthened. The mission stressed that for VAT to become the primary tax substantial efforts were needed to improve the administration, clear the filing backlog, collect arrears and intensify audit activity. In that regard, the authorities explained that they would fill most of the key vacancies in the VAT department as soon as possible and not transfer out existing personnel. Another major area of concern was customs receipts, where problems with the introduction of the invoice valuation system, combined with growing problems of barter trade from Tibet, seemed to have undermined the anticipated collection improvement. The authorities intended to conduct post-clearance audits soon to help resolve these difficulties, though the problems of monitoring the long borders with India and China would continue.

20. **The mission recommended that additional measures be taken to ensure that the revenue targets in the 1999/2000 budget are achieved and to set the stage for a further increase in public savings in 2000/2001.** In particular, administrative measures should include improved taxpayer registration, collection enforcement and audit. Performance should be reviewed at mid-term (in mid-February 2000). The government should take further action, as needed, at that time. For 2000/2001 there was discussion (but no final agreement) on revocation of exemptions on import duties; extension of excises to petroleum products, other than kerosene; and major revisions of the income tax law (LEG providing TA) (Figure 11).

Figure 11. Fiscal Indicators, 1993/94-2000/01



21. **The authorities believed that current spending was under control.**[14] The increase in allowances granted in August should be accommodated in the overall budget target for current expenditure, offset by normal underspending and some likely savings on interest payments. However, there was pressure for further security-related spending. The mission noted the authorities' resolve not to implement any further general pay rise in advance of the proposed civil service reform (see para. 31). The authorities explained that some populist expenditure measures mentioned in the Budget Speech had not been funded and might not take place. The mission stressed that other nonessential spending should be eliminated. There was also discussion of the payments of arrears to the NEA. The Ministry of Finance acknowledged that such arrears exceeded Nrs 700 million for the central government and local municipalities.

22. **The expansion of development spending envisioned by the authorities was seen as appropriate and the mission supported the resulting increase in the overall deficit to 7 percent of GDP, primarily foreign-financed.** However, efforts must be made to improve

[14]However, the economic composition of expenditure for 1998/99 was still not available.

the absorptive capacity of the government. Although the current pace of development spending was well above that of the previous year, aid financing was lower, and donors noted concerns about implementation of several key projects. Moreover, the authorities anticipated the need to increase net lending to some public corporations in order to cover government guarantees on earlier bank loans.

23. **The mission emphasized the importance of improving overall budgetary management and fiscal transparency**. The authorities indicated that they planned to present the budget one month earlier than previously and prepare the development budget within a 3-year rolling investment framework. Early preparation of next year's budget would allow sufficient time to incorporate meaningful revenue and expenditure measures. To improve transparency, the mission proposed that the authorities avoid shifting taxes and expenditure out of the budget. The mission suggested they develop more comprehensive fiscal accounts that include the local municipalities and other offbudget funds.[15]

C. Medium-Term Macroeconomic Framework

24. **Significantly reducing poverty in Nepal will require decades of high economic growth**. Nepal's comparative advantage lies with tourism and hydropower potential, while the fertile lowlands could support much larger agricultural production and exports. With a low-wage workforce, there are also opportunities to increase exports of goods and services to India. The staff discussed two medium-term scenarios to illustrate the possible impact of reform on growth (Annex V). In the current policy scenario, the failure to put into effect a strong structural program would limit growth prospects to the current annual trend of about 3½ percent. Aid would be expected to diminish, though there is still a considerable pipeline of projects to be completed. The fiscal position could become less sustainable in the longer term and poverty would likely not decline.

25. **An ambitious high-growth reform scenario, in addition to macroeconomic stability, would require rising agricultural output (through higher fertilizer usage and road construction) and a take-off in non-agricultural output, including manufacturing, tourism and power generation.**[16] Much higher levels of investment would need to be financed, including from domestic savings. Thus, the key fiscal objective would be to reduce spending in nonpriority areas and increase revenue mobilization significantly to raise public savings (to 4 percent of GDP), while allowing higher expenditures on health, education, and capital investment. Fiscal decentralization will also pose a challenge to ensure gains not losses of revenue and efficiency. Foreign aid levels would be expected to increase, but not sharply, focussing on implementing the key public investment projects. Equally important,

[15]Revenue from certain taxes, such as the hotel tax and the airport fees, has been earmarked in recent years to cover offbudget expenditure.

[16]Both the NEA and the private sector are undertaking small/medium-sized projects to increase hydropower capacity for domestic use. The projects designed to provide large-scale exports of electricity to India remain only in the planning stage and are not expected to affect the investment program significantly until 2004 at the earliest. Such exports would then provide the resources to finance broad-based expansion.

Nepal would need to improve dramatically the environment for foreign investment to support the expansion envisaged of the private sector.

26. **Achievement of the high-growth scenario would require a major change by the authorities, both in commitment to structural change and improved implementation.** If implementation problems continue, donors and foreign investors would be more cautious in their support and the envisaged increase in investment and growth would be delayed.

D. Poverty Reduction Strategy

27. **The authorities reviewed measures being taken to address poverty and other social problems.** They were considering the steps needed to adopt a Poverty Reduction Strategy Paper (PRSP), including key goals and policy measures and possible outcome based monitoring indicators (see Box 2). This work would be combined with the AsDB's poverty reduction strategy project. The mission encouraged early elaboration of a timeline for civil society and donor participation. These issues will be the focus of the next Nepal Development Forum, hosted by the World Bank in Paris on March 15–17, 2000. The authorities and donors are also reviewing the effectiveness of aid-financed projects—there has been much public debate about the high cost of such projects and the lack of ownership by the community.

E. Financial Sector

28. **The financial sector is weak, leading to high intermediation costs and inefficient allocation of resources.** The central bank has limited operational independence. After much discussion, the authorities have agreed with the World Bank and the AsDB a program of bank restructuring and reform of financial sector regulation and supervision. The strategy, reflected in their Financial Sector Strategy Statement, involves:

- Restructuring plans for Rastriya Banijya Bank (RBB), Nepal Bank Limited (NBL), the Agricultural Development Bank (ADBN), and the National Industrial Development Corporation (NIDC), with changed management, branch rationalization, and improved control mechanisms.[17]

- Improved prudential regulation, accounting, and auditing practices.

- Strengthened regulatory and oversight functions of the central bank and the phasing out of directed lending.

- Strengthened legislative and institutional framework for loan recovery.

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[17]The structure of the state-owned and largest bank, RBB, remains weak and nonperforming loans are over 30 percent. Studies suggest significant negative net worth (estimated at $40 million in 1997/98), weak internal systems, and poor operating methods. The other large bank, NBL, though majority privately owned since 1998, has similar problems.

Box 2. Elements of a Possible Poverty Reduction Strategy

The authorities welcomed the PRSP approach and indicated their willingness to take immediate steps for its development, including through broad-based consultation. Although there is no detailed and integrated "poverty reduction strategy" as such, elements of such a strategy are apparent in a number of documents developed by the authorities, IFIs and local groups and are summarized below.

- Accelerating broad-based economic growth through sound macroeconomic policies and accelerated structural reforms.
- Improving governance and removing waste through civil service reform aimed at transforming the public administration into a service and result-oriented system and strengthening the capacity of civil servants at the local level to improve service provision and respond to local demands.
- Increasing community consultation and involvement in poverty programs. For example, the Food for Work project in the Churia area is based on adopting local norms for payment of workers, an "open books" accounting system and community involvement, helping limit leakage.
- Improving institutional delivery mechanisms for programs that target the poor and improve the effectiveness of public expenditure. A World Bank Public Expenditure Review (PER), soon to be completed, identified the following recommendations:
    - Implementation of the Agriculture Perspective Plan (1997–2017), including more effective public expenditure in agriculture and greater efforts to ensure that public spending (on fertilizer distribution, irrigation, extension services and credit) actually reaches the poor.
    - Expansion of the rural road network to facilitate access to markets and agricultural inputs, and making public health and education services more accessible to the poor.
    - Shift of public resources from post-primary to primary education, which more effectively reaches the poor. Providing incentives for parents to send children to schools, (including feeding programs for children in remote areas). Increasing the number of female teachers and improving teacher attendance.
    - Shift from building hospitals to increasing the number of lower-level health posts. Improving incentives for doctors to work in rural areas and increasing the number of paramedics to improve the poor's access to health services.
    - Public work schemes (e.g., the Food for Work Program) to be expanded if they can be done in such a way as to limit the possibilities for leakage, which are currently high.
    - No expansion of income transfer schemes (e.g., widow's pensions), which are very limited due to resource constraints and tend to reach the better off more than the poor.
- Improving data collection and analysis of poverty indicators and of the impact of national policies and local projects. Follow-ups to the 1995/96 Living Standards Survey are to be conducted every 4–5 years with shorter surveys in between—subject to financing. Improving information available at the local level, local capacity for policy formulation and implementation, such as under UNDP's Participatory District Development Program and the NPC's district-level poverty monitoring projects.
- An interim PRSP could be ready by end-June 2000 and a final draft available for Board discussion in early 2001.

Sources: Extracted from the Ninth Plan, Annual Budget Speeches, and World Bank Poverty Assessment.

29. **The mission strongly supported the position of the World Bank that large-scale financial support for the RBB should not be provided until the restructuring and other reforms are underway**. The extent of the fiscal costs of the various possible restructuring approaches will be determined, following the evaluation of RBB and NBL operations currently being conducted by the international audit firm KPMG (see also Annex VI).

30. **Nonbank financial institutions are playing an increasingly important role in the highly segmented financial sector, heightening the urgency of strengthening the regulatory and supervisory framework covering such institutions**. Technical assistance and extensive training are planned through World Bank and AsDB projects currently underway. The mission urged the authorities to press ahead with these reforms, which may also require organizational changes in the NRB and to the NRB Act, in parallel with measures to increase competition in the financial sector.

F. Other Structural Reforms

31. **Public sector reform would give priority to preparations for civil service reform, public enterprise restructuring and governance.**

- Assisted by the AsDB, the authorities are planning to streamline the civil service and then adjust the low level of public sector wages. There are proposals to reduce the number of ministries and the labor force—many services are now provided by the private sector or devolved to the regional councils. The mission suggested interim steps be taken during preparation of the reform, including continuing the hiring freeze, eliminating vacant positions, and early retirement programs.

- The mission urged the authorities to accelerate enterprise restructuring and privatization, continuing with divestiture of small enterprises while tackling the inefficient and loss-making public enterprises such as fertilizer distribution and commercial aviation.[18]

- Weak financial discipline and widespread corruption in both the public and private sectors drain economic resources. Anti-corruption agencies have been ineffective and unsupported by the courts. The mission supported the AsDB's governance initiative aimed at streamlining regulations, enforcing loan collection, and combating corruption.

32. **The authorities have proposals to simplify the legal framework affecting private sector activity and tackle environmental problems.**[19] In addition to the changes required in financial sector and tax legislation, the focus of legal reform was on resolving land right issues and removing impediments to entrepreneurship. The regulatory framework for foreign investment was a priority. The key environmental issues identified were unsustainable

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[18]Out of 34 nonfinancial public enterprises, employing 15,000 workers, 14 had operating losses in 1998/99, totaling 5 percent of GDP.

[19]The World Bank is providing technical assistance for legislative reform and together with the AsDB helping to formulate a private sector strategy.

utilization of natural resources in the countryside and air pollution in the urban areas. The authorities were now working with donors to address both problems.

33. **Nepal has a relatively open trade regime, when compared with regional partners.**[20] The authorities noted that the high tariff structure of India imposed constraints for tariff policy in Nepal. Nevertheless, over the medium term and with prospective membership of the World Trade Organization in mind, the mission encouraged the authorities to bring the simple average tariff from its current level of 12¼ percent to below 10 percent and to sharply reduce maximum tariff rates—replacing them, where appropriate, with excise duties.[21] These proposals, and elimination of export taxes, were being considered by the new Revenue Advisory Committee, which comprised representatives of the public and private sector.

34. **Nepal's capital account remains closely regulated, particularly with respect to short-term capital and foreign commercial borrowing**. The mission noted that phasing in more liberal rules for foreign borrowing should await the implementation of the reforms to the financial institutions and their supervision. The authorities were encouraged, however, to improve the scope and environment for foreign direct investment, including through amendment of relevant legislation.

V. Fund Financial Support

35. **The authorities indicated their desire to formulate a structural program that could be supported by the PRGF**. They saw such support as important in providing credibility for a more focused and integrated approach compared with the project-based measures taken in the past. It was agreed that they would be expected to take measures to ensure the realization of the 1999/2000 budget targets, prior to formal program discussions. A range of possible key actions for a PRGF-supported program was discussed during the mission.[22] A main component would be preparations for the 2000/2001 budget with measures to improve revenue performance and amend the allocation of expenditures in line with the PER. The mission indicated that the authorities could tailor the structural reform package in terms of its scope, so long as measures were included to reform the financial sector (with restructuring of RBB and ADBN and strengthening of the NRB) and to refocus, streamline and upgrade the public administration. A timetable for the PRSP would be set and broad-based discussion of priorities was encouraged to ensure effective implementation of all measures.

VI. Other Issues

36. **The mission reviewed efforts being made to improve the statistical database: the range of information produced is quite extensive but the authorities acknowledged the**

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[20]Nepal has five standard tariffs (highest 40 percent), and two surcharge rates. With no significant nontariff barriers, it has a ranking of 2 (open) in the Fund's trade restrictiveness index, compared to 4 for Sri Lanka, 7 for Bangladesh, 8 for Pakistan, and 10 for India.

[21]The shift to invoice valuations from July 1999 should increase effective tariff rates.

[22]A preliminary outline of key medium-term measures is shown in Annex VII.

need to improve quality and consistency. The mission encouraged the publication of the balance of payments statistics based on the revised coverage and classification proposed by STA. Work is underway to improve the presentation of the fiscal accounts and the coverage of data on the financial sector. The authorities also noted the need to improve the national accounts and savings/investment data and analysis.

37. **Discussions also included assessment of the effectiveness of past technical assistance provided by the Fund and possible future needs** (Annex VIII). Technical assistance from FAD was considered to have played an important role in the building of institutional capacity in the Ministry of Finance. In addition, advice from MAE and STA had helped improve the coverage and accuracy of money and banking statistics and balance of payments statistics, respectively. The mission considered that technical assistance has generally been well received and successfully implemented, though often after considerable delay. The authorities identified the following areas for future assistance: fiscal—income tax legislation, rules for indirect tax and its administration, customs administration, budget monitoring and management; financial sector—legislation on the central bank, insolvency and debt recovery; and statistics—national accounts, fiscal statistics, and balance of payments.

VII. Staff Appraisal

38. **The fundamental challenge for policy remains to achieve and sustain growth rates sufficient to make meaningful progress toward poverty alleviation**. While the overall fiscal deficit is currently sustainable, financed primarily by aid flows, the budget remains structurally unsound, with persistently low revenue receipts and delayed implementation of key development projects. The much-discussed overall reform agenda has yet to be put in motion. Without a significant shift in policies, it will be difficult to achieve the government's growth objectives while maintaining low inflation and a comfortable external position. Moreover, the economy is vulnerable to external shocks.

39. **However, despite little policy contribution, the Nepalese economy has performed reasonably well in the past 12 months and the near term outlook is broadly positive**. Growth is increasing and could be around 6 percent for 1999/2000. Inflation is expected to remain low. Although the current account (excluding grants) is projected to shift back into deficit in 1999/2000, aid inflows should sustain reserves.

40. **The government should move quickly to adopt a bold and comprehensive reform agenda supported by improved microeconomic management; one based on a PRSP and that could be supported by a PRGF arrangement**. The government is encouraged to continue the ongoing process of wide consultation in its preparation of the PRSP. Poverty reduction will be the central objective of the programs supported by the Fund and will guide the formulation of budgetary and other policies. A PRGF-supported policy package would be anchored by a front-loaded fiscal program based on reforms of the tax and expenditure systems. This would be accompanied by measures to improve both the effectiveness of foreign aid and the governance in public sector operations. Over the longer-term, only a dramatic and sustained increased in investment and infrastructure and large inflows of foreign capital could permit eventual annual growth rates sufficiently large to reduce significantly poverty across the country.

41. **The great advantages of close integration with India and the latter's stable outlook continue to argue strongly for maintaining a fixed exchange rate regime based on a peg to the Indian rupee, supported by consistent financial policies**. The strong performance of exports and the continued accumulation of official reserves suggest the level of the exchange rate remains broadly appropriate. The government should, however, continue to enhance export competitiveness.

42. **The fixed exchange rate requires that domestic monetary conditions be consistent with the peg and monetary policy be broadly harmonized with that of India.** The authorities are urged to target average inflation in the range 5–6 percent, in line with the rates currently projected for India. There is a need to lower domestic financing of the budget, particularly by the central bank, and make interest rates on treasury bills more competitive with Indian instruments. The sale of some of the central bank's holding of treasury bills would reduce the current excess liquidity in the banking system, without restricting availability of credit to the private sector.

43. **The staff supports the government's commitment to take measures to achieve the ambitious budget targets for 1999/2000 and to set the stage for an increase of public savings in 2000/2001**. On the revenue side, the key measures needed to establish VAT as an effective tax include increased staffing of the VAT office. The post-clearance audits should help to reduce the current problems with implementation of the new customs valuation system and undeclared imports. Current spending seems to be on track but there could be pressures on the wage bill. The proposed growth of capital spending is justified by the development needs and the resulting increase in the deficit should be primarily foreign-financed.

44. **Looking ahead, the broad fiscal strategy should aim to mobilize higher tax revenues and improve the quality of expenditures, providing scope for higher social spending**. The fiscal stance could be relaxed if additional foreign financing is secured and the feasibility of more enhanced social sector spending demonstrated. It is important that a comprehensive budget framework be developed, bringing together budget and nonbudget revenue items, to improve transparency and accountability. The staff supports the early preparation of next year's budget and consideration of measures to raise revenue.

45. **Spending in 2000/2001 should be based on established priorities, linked to the proposed 3-year rolling investment program**. Rural education and health and essential infrastructure will need increased provisions and improved targeting. Spending on some other items will have to be curtailed. The budget should also provide for clearing of government arrears, retrenchment schemes, and the fiscal costs of financial sector reform.

46. **The authorities are encouraged to press ahead with their financial sector strategy, taking steps also to increase the independence of the central bank**. Some form of recapitalization of RBB will be necessary, but should only be undertaken when the bank has been properly restructured and management improved. Of equal importance are the enhancement of accounting and auditing practices and strengthened regulatory and oversight functions of the central bank, including supervision of nonbank financial institutions. A complete overhaul of the NRB Act would aid these improvements.

47. **Public administration reform should focus on rationalizing the civil service, improving public enterprise operations, and privatization**. Once a retrenchment is achieved, the level and structure of wages should be corrected. The public debate about the recent price increases in utilities serve to highlight management problems that also exist in other public institutions. The government should accelerate divestiture of small institutions while tackling the inefficient and loss-making public enterprises.

48. **The staff supports the efforts to simplify the existing legal framework and encourage private sector investment and growth**. The staff welcomes the efforts to streamline regulations, enforce collection of delinquent loans, and combat corruption in the collection and expenditure of public resources.

49. **Although extensive data are compiled in a timely manner, there remain serious weaknesses in economic statistics that impair effective monitoring and policy formulation**. The authorities are urged to improve further the coverage and presentation of the balance of payments and the fiscal and monetary accounts. To facilitate these steps, the staff encourages requests for further technical assistance, as well as for help to improve the compilation of the national accounts.

50. **During the Technical Assistance Consultation, the usefulness of past assistance has been noted**. The Fund looks forward to providing further assistance where needed. The authorities are urged to ensure that such assistance is implemented in a timely manner.

51. **Finally, the government should continue to ensure an open trade and investment regime and access to world markets**. The authorities are encouraged to lower import tariff rates. Efforts to enhance the performance of the financial sector and strengthen supervision should be pursued before opening up the capital account. The government is urged, moreover, to improve the receptiveness for foreign direct investment.

52. **The staff recommends that the next Article IV consultation remain on the 12-month cycle.**

Table 1. Nepal: Selected Economic Indicators, 1995/96–1999/2000 1/

Nominal GDP (1998/99): US$ 4,590 million
Population (1998/99): 22 million

GNP per capita (1998/99): US$220
Quota: SDR 71.3 million

	1995/96	1996/97	1997/98	1998/99	1999/2000 Proj.
Growth (percent change)					
Real GDP at market prices	5.3	5.0	2.3	3.4	6.0
Savings and investment (percent of GDP)					
Gross investment	27.3	25.3	20.7	16.8	20.6
National savings	18.7	22.5	17.2	19.4	19.7
Of which : Public savings	-0.4	0.8	0.4	0.1	0.5
Prices (percent change)					
Consumer prices (end of period)	9.2	1.7	10.2	9.5	6.0
GDP deflator	7.8	7.3	3.3	12.5	7.0
Government budget (percent of GDP)					
Domestic revenue	10.8	10.5	10.7	10.1	10.7
Total expenditure	17.6	16.5	17.4	16.4	17.1
Regular expenditure	7.5	7.4	7.8	7.9	7.5
Development expenditure	10.0	9.2	9.6	8.6	9.6
Overall deficit after grants	4.8	3.9	4.9	4.6	4.3
Overall deficit before grants	6.8	6.0	6.7	6.3	6.4
Domestic financing (net)	2.0	1.4	1.9	1.3	1.1
Money and credit (percent change; end of period)					
Broad money	14.4	11.9	21.9	20.9	15.5
Domestic credit	24.5	13.4	14.8	16.6	15.7
Interest rates					
91-day treasury bill (end of period)	12.7	5.6	2.4	3.1	...
Central bank refinancing	11	11	9	9	...
Loans to industry	15–17½	15–17½	13½–17	11½–17	...
External trade (percent change)					
Export value 2/	1.9	10.4	11.9	20.3	20.0
Import value 3/	12.9	5.3	9.7	-3.1	29.4
Balance of payments (U.S. dollars million)					
Current account balance (excluding grants)	-390	-142	-168	131	-51
(in percent of GDP)	-8.6	-2.9	-3.5	2.6	-0.9
Official grants and loans (net)	271	241	294	247	334
Overall balance	-40	59	177	144	95
Other external indicators					
Gross official reserves (U.S. dollars million; end of period)	609	650	716	791	880
In months of imports of goods and services 4/	4.4	4.3	5.2	4.7	4.5
Of which : In convertible currencies	3.6	3.1	4.3	4.3	4.1
Public and public guaranteed debt/GDP (in percent)	51.3	48.0	50.5	49.9	47.5
Debt service 5/	6.8	5.0	5.7	5.2	5.2
National currency per U.S. dollar (end of period)	56.3	56.8	67.6	68.5	...
Real effective exchange rate (end of period; percent change) 6/	1.9	5.9	0.2	7.2	...
Nominal effective exchange rate (end of period; percent change) 6/	-3.6	6.8	-7.8	-1.5	...
Fund operations (outstanding loans at end of period; SDR million)					
SAF/ESAF	29.8	24.6	19.6	14.7	10.6

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

1/ The fiscal year starts on July 16.
2/ Cumulative, excluding re-exports.
3/ Cumulative, excluding gold.
4/ Ratio is in terms of projected imports of goods and services.
5/ In percent of exports of goods, services, and private transfers; including debt service to the Fund.
6/ Minus sign indicates depreciation of the Nepalese rupee.

Table 2. Nepal: Balance of Payments, 1995/96–1999/2000 1/

(In millions of U.S. dollars, unless otherwise indicated)

	1995/96	1996/97	1997/98	1998/99	1999/2000 Proj.
Exports, f.o.b.	**602**	**1,160**	**855**	**752**	**891**
Merchandise exports	360	397	445	535	642
Re-exports 2/	242	763	411	217	249
Imports, c.i.f.	**1,350**	**1,750**	**1,582**	**1,405**	**1,793**
Aid-related	110	137	190	215	249
Non-aid	1,240	1,612	1,392	1,190	1,544
Of which: Gold and silver	212	551	267	130	143
Trade balance	**-748**	**-589**	**-727**	**-653**	**-902**
Services (net)	167	139	204	314	334
Receipts	461	381	435	546	581
Payments	294	241	232	232	247
Transfers (net)	192	309	355	470	517
Recorded private transfers	78	117	138	172	189
Estimated private remittances	125	213	245	315	346
Payments	10	21	29	17	18
Current account balance	**-390**	**-142**	**-168**	**131**	**-51**
Official current transfers	137	93	119	107	118
Current account balance (including grants)	**-253**	**-49**	**-50**	**238**	**67**
Capital transfers	0	147	255	137	150
Official and private loans (net)	134	149	175	140	216
Disbursements	186	197	230	195	287
Amortization	52	48	55	55	70
Foreign direct investment	7	29	11	9	20
Other investment, net	0	-173	-144	-256	-332
Errors and omissions	72	-44	-71	-122	-28
Overall balance	**-40**	**59**	**177**	**144**	**95**
Financing	40	-59	-177	-144	-95
Change in reserves (- increase) 3/	34	-86	-171	-172	-89
IMF purchases (net)	-8	-7	-7	-7	-6
Other liabilities, net 3/	13	35	1	34	0
Memorandum items:					
Current account (excluding grants; percent of GDP)	-8.6	-2.9	-3.5	2.6	-0.9
Current account (excluding gold trade)	-9.3	-4.4	-4.3	2.6	-1.1
Imports (percent of GDP)	29.9	35.6	33.1	27.7	31.1
Current account (including grants; percent of GDP)	-5.6	-1.0	-1.0	4.7	1.2
Gross foreign assets (at current rates)	805	870	978	1,133	1,222
Of which: Central bank	609	650	716	791	880
(in months of imports of goods and services)	4.4	4.3	5.2	4.7	4.5
Of which: In convertible currencies	3.6	3.1	4.3	4.3	4.1
Short-term debt as percent of gross official reserves 4/	16.2	27.0	35.2	33.8	32.8
Gross foreign assets of banking system as percent of reserve money	128	120	144	147	140
Debt service ratio 5/	6.8	5.0	5.7	5.2	5.2

Sources: Data provided by the Nepal Rastra Bank; and staff estimates.

1/ Beginning in 1996/97, the presentation incorporates improved coverage of the re-export trade, and more accurate accounting of private remittances and official transfers. As a result, errors and omissions are sharply lower than in previous presentations.

2/ Includes re-exports of oil beginning in 1996/97.

3/ NRB assets and liabilities are calculated at constant exchange rates beginning in 1996/97.

4/ Short-term debt in the form of outstanding trade credits and amortization due the following year.

5/ In percent of current account receipts excluding Indian excise refund.

Table 3. Nepal: Monetary Accounts, 1996–2000

	1996 July	1997 July	1998 July	1999 April	1999 July	1999 Nov. Est. 1/	2000 July Staff Proj. 2/
Monetary authorities	(In billions of Nepalese rupees)						
Net foreign assets	31.5	34.5	46.4	51.8	52.6	54.6	59.1
Net domestic assets	3.9	6.6	-0.4	-1.8	0.1	2.9	0.8
Of which: Net credit to central government	17.3	18.8	18.5	17.9	18.8	21.0	14.8
Reserve money	35.4	41.0	46.0	50.0	52.7	57.5	59.9
	(12 month change in percent of reserve money at start of period)						
Net foreign assets (excluding exchange valuation) 3/	-7.8	10.7	18.3	14.9	14.6	11.2	12.4
Net domestic assets (excluding exchange valuation) 3/	16.1	5.2	-6.2	-3.4	0.0	5.7	1.3
Reserve money	8.3	15.9	12.1	11.4	14.5	16.9	13.7
Monetary survey	(In billions of Nepalese rupees)						
Net foreign assets	37.7	40.2	55.6	64.8	65.0	66.6	71.5
Net domestic assets	55.0	63.5	70.9	82.4	87.9	93.1	105.1
Domestic credit	86.6	98.3	112.8	125.4	131.5	137.5	152.2
Public sector	26.8	28.2	29.8	31.6	33.2	34.3	36.2
Government	24.9	26.6	28.8	30.2	31.6	32.8	34.4
Public enterprises	2.0	1.6	1.1	1.5	1.6	1.5	1.8
Private sector	59.8	70.1	83.0	93.8	98.3	103.2	116.0
Other items, net	-31.7	-34.7	-41.9	-43.1	-43.6	-44.4	-47.1
Broad money	92.7	103.7	126.5	147.2	152.9	159.7	176.6
Narrow money	36.5	38.5	45.2	49.3	51.2	54.7	57.0
Quasi money	56.2	65.3	81.3	97.9	101.7	105.0	119.6
	(Annual percentage change)						
Domestic credit	24.5	13.4	14.8	16.2	16.6	18.7	15.7
Public sector	12.6	5.0	5.8	10.0	11.2	17.3	9.1
Government	10.1	6.8	8.2	10.9	9.9	16.8	8.9
Private sector	30.6	17.3	18.4	18.5	18.5	19.2	17.9
Broad money	14.4	11.9	21.9	22.9	20.9	20.8	15.5
Narrow money	10.6	5.4	17.4	12.5	13.3	23.6	11.5
Quasi money	17.0	16.2	24.6	28.8	25.1	19.4	17.5
	(12 month change in percent of broad money at start of period)						
Net foreign assets (excluding exchange valuation) 3/	-2.1	3.5	9.7	9.3	7.8	6.5	4.3
Net domestic assets (excluding exchange valuation) 3/	16.5	8.5	12.3	13.6	13.1	14.3	11.2
Domestic credit	21.0	12.6	14.0	10.0	14.8	16.4	13.5
Public sector	3.7	1.4	1.6	1.4	2.6	3.8	2.0
Private sector	17.3	11.1	12.4	8.5	12.1	12.6	11.5
Memorandum items:							
Velocity	2.69	2.70	2.34	...	2.26	...	2.22
Velocity (narrow money)	6.82	7.29	6.57	....	6.74	...	6.86
Money multiplier	2.62	2.53	2.75	2.94	2.90	2.78	2.95
Currency/deposits (in percent)	37.0	35.8	32.3	30.9	29.7	31.1	...
Reserves/deposits (in percent)	13.8	16.2	14.3	12.1	13.4	13.7	...
Excess reserves/deposits (in percent)	1.8	4.2	4.3	2.1	3.4	3.7	...

Sources: Data provided by the Nepalese authorities; and staff estimates and projections.
1/ Estimated figures adjusted for sample bias.
2/ A projection based on a stable exchange rate against U.S. dollar, and a nominal GDP growth of 13½ percent.
3/ Adjusted for the impact of exchange rate changes on the value of net foreign assets and other items, net.

Table 4. Nepal: Summary of Government Operations, 1995/96–1999/2000 1/

	1995/96	1996/97		1997/98		1998/99		1999/2000		
		Budget	Actual	Budget	Actual	Budget	Actual	Budget	Without Measures 3/	With Revenue Measures
	(In billions of Nepalese rupees)									
Total revenue and grants	31.6	39.3	35.5	41.5	37.1	46.2	40.8	50.9	48.3	50.0
Total revenue	26.8	32.9	29.5	35.5	31.7	38.4	34.9	42.2	40.3	42.0
Tax revenue	21.7	26.8	24.4	29.3	25.9	30.9	28.4	34.7	33.0	34.8
Nontax revenue	5.1	6.1	5.1	6.1	5.7	7.5	6.5	7.5	7.2	7.2
Grants	4.8	6.4	6.0	6.0	5.4	7.8	5.9	8.7	8.0	8.0
Total expenditure	43.7	52.7	46.4	56.9	51.6	63.7	56.7	68.9	67.0	66.9
Regular expenditure	18.7	21.4	20.7	24.2	23.0	27.1	27.1	29.4	29.4	29.4
Development expenditure	25.0	31.2	25.7	32.7	28.6	36.6	29.6	39.5	37.6	37.6
Overall balance before grants	-16.9	-19.8	-16.9	-21.4	-20.0	-25.3	-21.8	-26.8	-26.7	-24.9
Overall balance after grants	-12.0	-13.4	-10.9	-15.4	-14.6	-17.6	-15.9	-18.1	-18.7	-16.9
Financing	12.0	13.4	10.9	15.4	14.6	17.6	15.9	18.1	18.7	16.9
Net foreign loans	7.1	11.7	6.9	13.1	9.0	14.5	11.4	14.1	12.6	12.6
Gross disbursements	9.5	13.9	9.0	15.5	11.1	17.7	14.6	18.6	16.7	16.7
Amortization	2.4	2.2	2.1	2.5	2.1	3.2	3.2	4.4	4.1	4.1
Net domestic financing	5.0	1.7	4.0	2.3	5.6	3.1	4.5	3.9	6.2	4.4
Bank financing	2.2	...	2.0	0.2	2.2	1.5	2.8	2.5	2.8	2.8
Nonbank financing	2.8	...	2.0	2.1	3.4	1.6	1.7	1.4	3.4	1.6
Of which: Privatization proceeds									0.7	0.5
	(In percent of GDP)									
Total revenue	10.8	11.7	10.5	12.1	10.7	11.8	10.1	11.1	10.3	10.7
Tax revenue	8.7	9.5	8.7	10.0	8.7	9.5	8.2	9.1	8.4	8.9
Nontax revenue	2.1	2.2	1.8	2.1	1.9	2.3	1.9	2.0	1.9	1.9
Grants	1.9	2.3	2.1	2.1	1.8	2.4	1.7	2.3	2.0	2.0
Total expenditure	17.6	18.8	16.5	19.4	17.4	19.6	16.4	18.1	17.1	17.1
Regular expenditure	7.5	7.6	7.4	8.2	7.8	8.3	7.9	7.7	7.5	7.5
Development expenditure	10.0	11.1	9.2	11.2	9.6	11.3	8.6	10.4	9.6	9.6
Overall balance before grants	-6.8	-7.1	-6.0	-7.3	-6.7	-7.8	-6.3	-7.0	-6.8	-6.4
Overall balance after grants	-4.8	-4.8	-3.9	-5.2	-4.9	-5.4	-4.6	-4.7	-4.8	-4.3
Financing	4.8	4.8	3.9	5.2	4.9	5.4	4.6	4.7	4.8	4.3
Net foreign loans	2.8	4.2	2.5	4.5	3.0	4.5	3.3	3.7	3.2	3.2
Gross disbursements	3.8	5.0	3.2	5.3	3.7	5.4	4.2	4.9	4.3	4.3
Amortization	1.0	0.8	0.7	0.8	0.7	1.0	0.9	1.2	1.0	1.0
Net domestic financing	2.0	0.6	1.4	0.8	1.9	0.9	1.3	1.0	1.6	1.1
Bank financing	0.9	...	0.7	0.1	0.7	0.4	0.8	0.7	0.7	0.7
Nonbank financing	1.1	...	0.7	0.7	1.2	0.5	0.5	0.4	0.9	0.4
Of which: Privatization proceeds									0.2	0.1
Memorandum items:										
Public savings (percent of GDP) 2/	1.6	1.3	0.8	1.1	0.4	0.6	0.1	0.6	0.1	0.5
Nominal GDP (billions Nrs)	248.9	280.6	280.5	293.5	296.5	325.1	344.9	381.4	391.2	391.2

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

1/ Fiscal years start on July 16. Table confined to central government operations as contained in the budget.

2/ Public savings are adjusted for the recurrent component of development expenditure.

3/ Conservative estimate highlighting the risks to revenue collection stemming from administration problems.

Table 5. Nepal: Vulnerability Indicators, 1995/96–1998/99

(In percent of GDP, unless otherwise indicated)

	1995/96	1996/97	1997/98	1998/99
Official risk indicators				
Share of nonperforming loans (as percent of total loans)				
Rastriya Banjiya Bank 1/	31.0	40.0	35.0	...
Nepal Bank Ltd.	17.5	24.6	24.4	...
Risk-based capital asset ratio (capital over risk-weighted assets)				
Rastriya Banjiya Bank 2/	8.0	5.6	6.0	...
Of which: Core capital	-6.3	-6.9	-6.2	...
Nepal Bank Ltd.	8.7	9.5	10.7	...
Financial sector risk indicators				
Public and public guaranteed debt 3/	...	61.8	63.5	63.8
Broad money (percent change, 12-month basis)	14.4	11.9	21.9	20.9
Private sector credit (percent change, 12-month basis) 4/	30.6	17.3	18.4	18.5
Share of deposits in broad money (percent)	76.9	78.6	81.0	82.9
Share of foreign currency deposits in total deposits (percent)	6.7	8.3	8.3	8.7
Market assessment indicators				
91-day treasury bill yield (real, percent)	2.8	2.4	-0.5	-10.4
Stock market index (NEPSE Index, Feb. 12, 1994=100)	185.6	176.3	163.4	216.9
External indicators				
Exports (percent change, 12-month basis in U.S. dollars) 5/	-8.8	92.8	-26.3	-12.0
Imports (percent change, 12-month basis in U.S. dollars) 6/	5.8	29.6	-9.6	-11.2
Current account balance (excluding grants)	-8.6	-2.9	-3.5	2.6
Capital and financial account balance	4.6	2.0	4.2	-2.4
Of which: Inward foreign direct investment	0.2	0.6	0.2	0.2
Gross official reserves (in millions of U.S. dollars)	609	650	716	791
Central Bank short-term foreign liabilities (in millions of U.S. dollars) 7/	5.4	8.1	3.4	2.3
Central Bank foreign currency exposure 8/	0.9	1.2	0.5	0.3
Short-term foreign assets of commercial banks (in millions of U.S. dollars)	196	220	262	343
Short-term foreign liabilities of commercial banks (in millions of U.S. dollars)	85	119	126	161
Foreign currency exposure of commercial banks 8/	43.5	54.1	48.0	47.1
Gross official international reserves (as percent of imports of goods and services)	37.0	32.7	39.5	48.3
Gross official international reserves (as percent of broad money)	36.9	35.6	38.3	35.4
Short-term debt 9/	2.2	3.6	5.3	5.3
Short-term debt to gross official international reserves 9/	16.2	27.0	35.2	33.8
Total external debt	52.4	50.5	54.6	53.8
Of which: Public sector debt	51.3	48.0	50.5	49.9
Total external debt to exports of goods and services	223	161	202	210
External interest payments (as percent of exports goods and services)	3.1	1.9	1.9	2.1
External amortization payments (as percent of exports goods and services)	4.9	3.1	4.2	4.3
Exchange rate (NR per U.S. dollars, end of period)	56.3	56.8	67.6	68.5

Sources: Data provided by the Nepalese authorities; Special Audit Report by R. Bajracharya & Company; and staff estimates.

1/ Staff estimates.

2/ From Special Audit Report by an accounting firm, R. Bajracharya & Company. Capital comprises core capital and supplementary capital, including provision for loss, redeemable preference shares and other reserves.

3/ Consists of public and public guaranteed external debt, domestic claims on public sector by banking sector, and domestic credits to the central government by non-financial sector.

4/ Including private sector credit by NRB.

5/ Including re-exports.

6/ Including gold.

7/ Excluding SAF and ESAF.

8/ Foreign currency liabilities as a percent of foreign currency assets.

9/ Short-term debt in the form of outstanding trade credits and amortizations due in the following year.

Table 6. Nepal: Social Indicators

	Latest single year			Same region/income group		
	1970–75	1980–85	1992–97	India	South Asia	Low income
Total population, mid-year (millions)	12.8	16.5	22.3	945.0	1,281.3	2,035.6
Growth rate (percent annual average)	2.4	2.6	2.0	1.7	1.5	1.7
Urban population (percent of population)	5.0	7.8	10.9	27.0	27.0	28.4
Total fertility rate (births per woman)	6.3	6.1	4.4	2.6	3.5	4.0
Total labor force (millions)	...	8	12	400	546	...
Females in labor force (percent)	...	39	40	32	33	41
Labor force participation rate	...	48	48	43	43	50
Poverty						
National headcount index	...	...	42	35	...	...
Urban headcount index	...	...	23	31	...	...
Rural headcount index	...	...	44	37	...	...
Income						
GNP per capita (U.S. dollars)	120	170	220	340	380	350
Consumer price index (1995=100)	17	35	114	117	117	122
Food price index (1995=100)	...	33	111	...	...	...
Income/consumption distribution						
Gini index	...	...	36.7	29.7	...	...
Lowest quintile (percent of income or consumption)	...	...	7.6	9	...	...
Highest quintile (percent of income or consumption)	...	...	44.8	39	...	...
Public expenditure						
Health (percent of GDP)	...	...	1.2	0.7	0.8	1.0
Education (percent of GNP)	1.5	2.6	2.8	3.5	3.0	5.5
Social security and welfare (percent of GDP)	0.1	0.1	...	...	...	...
Net primary school enrollment rate (percent of age group)						
Total	...	58	...	...	99	95
Male	...	79	...	...	...	...
Female	...	36	...	...	...	...
Gross secondary school enrollment						
Total	12	27	32	49	...	...
Male	19	39	45	59	...	...
Female	4	14	18	39	...	...
Adult literacy (percent)	...	22	27	51	51	54
Female literacy	...	...	20	38	36	35
Access to safe water (percent of population)						
Total	8	24	59	81	81	69
Urban	85	78	61	85	84	80
Rural	5	20	59	79	80	66
Access to electricity (percent)	...	...	15	54	...	...
Population per physician	...	30,221	13,617	2,459	2,500	...
Population per hospital bed	...	5,719	4,308	1,503	1,429	1,152
Immunization rate (percent under 12 months)						
Measles	...	34	85	89	81	74
DPT	...	32	78	92	87	76
Child malnutrition (percent under 5 years)	69	...	47	39	53	...
Life expectancy at birth (in years)						
Total	43	49	57	63	62	59
Male	44	50	58	62	62	58
Female	43	48	57	63	63	60
Mortality						
Infant (per thousand live births)	160	125	83	65	77	82
Under 5 (per thousand live births)	234	180	117	85	100	118
Adult (15–59)						
Male (per 1,000 population)	482	376	274	212	219	274
Female (per 1,000 population)	476	395	314	203	212	255
Maternal (per 100,000 live births)	...	...	1,500	437	...	...

Sources: Staff reports, EDSS, World Bank 1999 World Development Indicators CD-ROM.

NEPAL: Fund Relations

(As of December 31, 1999)

I. Membership Status: Joined 9/06/61; Article VIII

II. General Resources Account:	SDR Million	% Quota
Quota	71.30	100.0
Fund holdings of currency	65.58	92.0
Reserve position in Fund	5.73	8.0

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	8.10	100.0
Holdings	0.04	0.2

IV. Outstanding Purchases and Loans:	SDR Million	% Quota
ESAF arrangements	12.87	18.0

V. Financial Arrangements:

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

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

	Overdue	Forthcoming				
	12/31/99	2000	2001	2002	2003	2004
Principal	--	3.4	3.4	3.4	2.2	0.6
Charges/Interest	--	0.4	0.3	0.3	0.3	0.3
Total	--	3.8	3.7	3.7	2.5	0.9

VII. Exchange Rate Arrangement

In February 1993, Nepal unified its exchange rate and eliminated the multiple currency practice associated with the previous dual exchange rate arrangement. In October 1997, the exchange arrangement of Nepal was reclassified as that pegged to a single currency unit from pegged to a currency composite. Currently, all merchandise imports (except for a few goods restricted for security or related reasons) are freely available through an open general license system, with foreign exchange provided through the banking system at the market exchange rate. Nepal's exchange system is presently free of restrictions on the making of payments and transfers for current international transactions.

Exchange rate: $1=68.73 Nepalese rupees (as of December 31, 1999).

VIII. Last Article IV Consultation

(a) Staff discussions were held in Kathmandu in November 1998.

(b) The Executive Board discussed the staff report (SM/99/17) on February 10, 1999.

IX. Consultation Cycle

Nepal is on the standard 12-month consultation cycle.

X. Technical assistance since 1996

Department	Purpose	Date
MAE -	Technical assistance in debt management and monetary operations.	10/96
-	Assistance on bank supervision and compliance with Basel guidelines	6/99
FAD -	Technical assistance in VAT administration.	1/98, 3/98
STA -	Assistance in improving the compilation and reporting of the monetary statistics.	11/97,4/99
-	Long-term residential advice on coverage and classification of balance of payments statistics.	11/97–5/98

XI. Resident Representative/Advisor

The Fund has provided staff members as resident representatives since 1977. Mr. Lawrence DeMilner began his term in August 1999.

Nepal: Relations with the World Bank Group

The World Bank's strategy is designed to assist Nepal in making progress towards poverty alleviation. The Country Assistance Strategy (CAS) of December 1998 aims at (a) bringing resources closer to the beneficiaries, where they are most likely to be productively used and (b) collective donor action to foster the stronger governance needed to reduce waste and mismanagement, while (c) further improving economic and fiscal management. The level of future assistance will be determined by progress in overall economic management and institutional reform. The Bank's current dialogue with the Government is focused on public resource management issues, governance and financial sector reform.

As of December 31,1999, the Bank's portfolio in Nepal included 72 IDA credits of which 10 are active (see table). Of the closed credits, two were Structural Adjustment Credits (approved in March 1987 and June 1989) which supported policy reforms in trade, finance and agriculture. In FY1999, two new projects were approved: Basic and Primary Education II (March 1999) and Rural Infrastructure (May 1999). The latter is a Learning and Innovative Lending operation (LIL). A Road Maintenance and Development project was approved in November 1999. Projects in the telecommunications, finance, power, urban and rural water, and health sectors are at various stages of preparation and discussion with Government.

As of December 31, 1999, IFC's commitments in Nepal included U.S.$49 million in loans, concentrated in the power sector. MIGA's portfolio in Nepal consists of three guarantee contracts with a net exposure of U.S.$18.2 million, mainly in the infrastructure sector.

Lending by the World Bank Group, FY 1994–2000

(In millions of U.S. dollars)

	1994	1995	1996	1997	1998	1999	2000 Est.
IDA (net)	64.5	71.8	75.1	50.0	43.3	47.6	41.6
Disbursements	69.1	78.6	82.4	58.4	52.5	59.9	56.5
Amortization	4.6	6.8	7.3	8.4	9.6	12.3	14.9
IFC							
Disbursements	14.9	0.0	8.2	0.0	1.0	0.0	...
Total loans	84.0	78.6	90.6	58.4	53.5	59.9	56.5

Source: Data provided by the World Bank.

The Bank has been providing technical assistance in energy planning, road infrastructure, irrigation, industrial finance, cottage industry and municipal development, planning and financial management, and remote area access. Nonlending activities of the Bank include preparation of a CAS (12/98), a Poverty Assessment Report (8/98), a Country Economic Memorandum (11/97), and a Health Sector Report (1999). A Public Expenditure Review is scheduled for completion in FY2000.

Nepal: Relations with the Asian Development Bank

Lending Program

As of December 31, 1999, total commitments by the Asian Development Bank (AsDB) consisted of 90 loans amounting to U.S.$1.7 billion covering projects in agriculture (including forestry), energy, transport, industry, social infrastructure, and tourism. Undisbursed funds of U.S.$302 million represent about 21 percent of the total net loan amount as of end-December 1999. For the period 2000–2002, 11 projects amounting to U.S.$340 million are tentatively programmed.

Loans by the Asian Development Bank, 1969–1999
(as of December 31, 1999)
(In millions of U.S. dollars)

	1969–1997 Approved	1998 Approved	1999 Approved
Agriculture and natural resources	677.5	100.0	--
Energy	345.9	--	50.0
Finance and industry	70.1	--	--
Social infrastructure	132.1	5.0	--
Transport and communications	224.7	--	--
Others	27.6	--	--
Total commitments	1,582.8	105.0	50.0
Gross disbursements	936.9	105.3	70.5
Technical Assistance Projects			
Total commitments	81.1	4.4	4.5
Gross disbursements	45.5	9.7	14.3

Source: Data provided by the Asian Development Bank.

Technical Assistance

Since 1968, the AsDB has provided Nepal with technical assistance in most sectors. Recent assistance includes support for the implementation and monitoring of the Agriculture Perspective Plan, developing a Power System Masterplan, capacity building for rural and urban water supply, and formulating an action plan for civil service reform. As of December 31, 1999, total technical assistance commitments consisted of 209 projects—80 of which were in preparation for loans—for a total of U.S.$90 million.

Private Sector Operations

The AsDB has five private-sector projects in Nepal: two in industry, two in hydropower, and one in tourism. Direct investments have involved U.S.$52.8 million in loans and U.S.$3.3 million in equity. Moreover, the AsDB has worked through its lending and technical assistance program to create a policy environment in Nepal that encourages private sector development.

Nepal: Statistical Issues

The authorities provide the core minimum data to the Fund (attached table) and release data through government and central bank publications. At present, however, the lack of consistent data reporting hampers effective economic analysis and policy implementation in a number of areas. In appropriate instances, and in consultation with the authorities, the staff has made its own estimates of key data where official statistics are judged to be deficient (see below on balance of payments and fiscal data).

1. In the past, **balance of payments accounts** consistently exhibited large and volatile entries under net errors and omissions (as much as 5 percent of GDP). As a follow-up to the 1995 Fund mission in balance of payments statistics, a statistical advisor was stationed in Kathmandu for a six-month period in 1997–98 to provide further technical assistance in compiling balance of payments statistics, including implementation of the recommendations of previous technical assistance. As a result, methodologies were developed to improve the recording of grants, workers' remittances, and re-exports. These revised estimates were presented in the 1998 staff report and have substantially amended the current account balance and reduced net errors and omissions. The staff team encouraged the authorities to also use the new coverage of the balance of payments when reporting official data to the Fund, and in publications. Further efforts are also needed to improve estimates of foreign direct investment and other private capital flows.

2. Data on **exports and imports** are compiled by the central bank, the Customs Department, and the Trade Promotion Center (overseas trade only), and there are discrepancies among them. Price indices for exports and imports are not compiled.

3. Incomplete and conflicting data on **external grants and loans** to the government make it difficult to anticipate trends in the availability of foreign financing. Data collected by the central bank monitor trends in cash disbursements and repayments, but exclude most commodity aid, while the Ministry of Finance (MOF) reporting is incomplete and often not timely. With technical assistance from DFID, a new database providing comprehensive account of disbursements, payments, and the stock of outstanding government debt has been developed and is currently being refined.

4. **Monetary data** provided by the central bank have been subject to revision with a substantial lag (up to 12 months), making timely program monitoring difficult. Monetary data reported by the commercial banks and the central bank on commercial banks' reserve holdings with the central bank show substantial discrepancies. A **money and banking statistics** technical assistance mission visited Nepal during April/May 1999 and assisted the authorities in improving data timeliness, compilation procedures, and the coverage of the financial system. Methodological issues were also reviewed. Progress by the authorities in implementing the recommendations, and expected improvements in the monetary data, are being monitored. Further technical assistance in money and banking statistics is anticipated during the current Fund fiscal year.

5. The new **budget classification** system introduced in 1996/97 should provide an adequate economic classification in a timely manner. Nevertheless, Nepal's budget data still

do not provide an accurate division between current and capital spending. For example, substantial recurrent spending on wages, subsidies, and transfers continues to be included in the development budget and completed development projects are not systematically transferred to the regular budget. As a result, the budget definitions of regular and development spending do not provide a good basis for analyzing trends in public savings and investment. Additionally, a number of fees are collected outside the budget and the operations of local governments are not reported in the annual budget. For analytical purposes, staff has made its own estimates.

6. More timely data on **revenue and expenditure** developments are needed for effective fiscal control. A financial management project is under way and a system of 'flash' reporting covering selected districts that account for the bulk of expenditure is being developed. At present, financial management information is provided only by the central bank, and this is at a very aggregated level. It is critical that financial information currently collected by the Financial Comptroller General's Office be organized in a manner that will allow the MOF to effectively monitor actual expenditures and revenue collections and provide assessments during the course of a fiscal year.

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

8. The Central Bureau of Statistics (CBS) compiles **national accounts statistics** following the 1968 version of the System of National Accounts. These statistics cover estimates of gross domestic product (GDP) by industry of origin at current and constant prices, estimates of GDP by expenditure categories at current prices, and current price estimates of gross national income and savings. However, questions remain about their reliability. The accuracy of these data are hampered by the lack of sufficient primary statistics in several areas, including the important agricultural sector. Current statistics on many service activities are virtually nonexistent. In addition, there is an urgent need for a survey of construction activity. A comprehensive census of manufacturing establishments is normally conducted every five years, but the latest available census is for 1991/92. Although sample surveys covering manufacturing establishments with 10 or more persons are conducted annually, the survey results are not satisfactory due to a lack of procedures to update the sample frame which is usually based on the latest census. The estimates of household consumption expenditures are derived residually. The CBS conducted a household budget survey in 1995/96, and the result of this survey could be used to compile household consumption expenditure.

9. The current weights used for calculation of the consumer price index (CPI) are based on a household expenditure survey of 1984/85. The index covers urban areas only. The central bank conducted a household budget survey in urban areas in 1995/96 for updating the weights for the CPI. The new index is expected to be introduced in early 2000.

Nepal: Core Statistical Indicators

(As of January 20, 2000)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	External Current Account Balance	Central Government Balance	GDP/ GNP	External Debt
Date of latest observation	1/19/00	12/31/99	11/15/99	11/15/99	11/15/99	1/18/00	12/99	9/99	9/99	12/15/99	1998/99	1998/99
Date received	1/20/00	1/20/00	1/6/00	1/6/00	1/6/00	1/20/00	1/11/00	1/20/00	1/20/00	1/6/00	9/99	9/99
Frequency of data 1/	D	W	W	W	M	W	M	M	M	W	A	A
Frequency of Reporting 1/	W	W	W	W	M	W	M	M	M	W	A	A
Source of data 2/	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting 3/	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C
Confidentiality 4/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of publication	D	M	M	M	M	W	M	M	Q	Q	A	A

1/ D-daily; W-weekly; M-monthly; Q-quarterly; or A-annually.

2/ A-direct reporting by central bank, ministry of finance, or other official agency (by Res. Rep, except Exchange Rates); N-official publication or press release; P-commercial publication; C-commercial electronic data provider; or E-EIS.

3/ E-electronic data transfer; C-cable or facsimile; T-telephone; M-mail; or V-staff visits.

4/ A-for use by the staff only; B-for use by the staff and the Executive Board; C-unrestricted use; or D-embargoed for a specific period and thereafter for unrestricted use.

Nepal: Illustrative Medium-Term Scenarios, 1999/2000–2004/05

1. **The Government's Ninth Plan (1998–2002) targets the eventual eradication of widespread poverty in Nepal by accelerating economic growth, including through enhancing the role of the private sector, and reducing population growth.** On this basis, the staff has prepared two medium-term scenarios. The "Current Policy Scenario," based on the continuation of existing policies without strong structural measures, illustrates the potential adverse implications for growth, macroeconomic stability, and above all, poverty reduction. The "High Growth Reform Scenario" is predicated on the maintenance of macroeconomic stability and early implementation of a bold program of measures to remove key structural impediments to high and sustained growth that would allow more rapid progress in reducing poverty.

2. **Achievement of the high growth scenario is not without risk. It will require a radical shift by the authorities, both in commitment to structural change and improvement in implementation.** Without these changes, some donors are likely to be more cautious in their support and the anticipated increase in investment and growth would be delayed. Moreover, even under the high growth scenario, significant strides in reducing poverty would be achievable only over the longer-term, once firm foundations—upon which sharply higher levels of economic growth can be generated—have been firmly established.[1]

Current Policy Scenario

3. **Without sustained macroeconomic stability and aggressive implementation of key structural reforms to boost economic growth above the annual trend of 3½ percent, the objectives of increasing per capita incomes and reducing poverty will remain elusive.** As illustrated in the "Current Policy Scenario" (Table 7 and Figure 12), failure to increase agricultural productivity would not only result in continued low and uneven agricultural output, but also act as a restraint on domestic demand and the growth of non-agricultural production. Moreover, even with expenditure restraint, the absence of measures to increase the tax effort in combination with dwindling donor assistance, would likely result in higher domestic bank financing of the overall fiscal deficit, higher inflation, and lower public savings. An increase in the inflation differential with India would, in turn, cause imports from India to increase, exports to India to decline, and the current account deficit to rise.

4. **With lower official capital inflows, gross official reserves would be set on a declining path and the sustainability of the exchange rate regime would eventually be called into question.** In addition, while total external debt as a share of GDP would fall, in line with the likely decline in foreign financing, the debt service ratio would be higher than in the reform scenario, reflecting lower exports. Above all, the absence of high and sustained economic growth would result in even higher poverty levels over the medium-term.[2]

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[1] As an illustration, even with annual growth rates in per capita income of 5 percent from 2004/05 onward, it would take Nepal over 30 years to reach US$900, the current IDA threshold.

[2] In comparison with the high growth reform scenario, with annual per capita income growth of only 2 percent, it would take Nepal 70 years to reach the US$900 IDA threshold.

"High Growth" Reform scenario

5. **The high growth reform scenario is based on continued improvements in macroeconomic performance and early actions to remove structural impediments, to achieve high and sustained economic growth and meaningful progress toward poverty reduction.** The principal elements include: (i) increasing annual economic growth to 6–7 percent; (ii) reducing and maintaining inflation to 5 percent; (iii) raising domestic savings; and (iv) maintaining a comfortable level of reserves.

6. **High sustained growth will require a strong expansion of agricultural output and a take-off in non-agricultural production.** Higher utilization of fertilizers, expansion of year-round irrigation, and extension of the road network should increase agricultural output. Rising foreign investment and further liberalization in India are expected to spur a sharp sustained increase in non-agricultural production, principally from manufacturing. Higher growth will also require a significant increase in gross investment (to 30 percent) from last year's relatively low level, through several hydro-power and road construction projects, which will only be possible by mobilizing external savings, including private capital. In that connection, a central objective of the reform scenario is to increase the public sector's contribution to domestic savings (to at least 4 percent of GDP) to ensure that rising external current account deficits can be financed on a sustainable basis.[3]

7. **Higher public savings will require a sustained improvement in revenue mobilization and the continued containment of regular expenditures, including through the implementation of tax and expenditure reforms, and privatization.** There is considerable potential to reduce low-priority and wasted spending through reduced transfers to public corporations, tighter expenditure management and improved governance. This would also allow room for higher spending on health and education, and capital goods. Thus, total revenue is projected to rise to 14½ percent of GDP and current expenditures to be contained at around 7½ percent of GDP. Owing to the concessional nature of anticipated foreign inflows, the burden of debt service is projected to remain low (7½ percent of exports).

8. **Export growth is expected to decline to around 12 percent by 2001/02, as a result of the expiration of quotas for ready-made garments, but to recover robustly thereafter following increased diversification and rising tourism receipts.** Imports are projected to rise sharply in the initial years as a result of the need for imported capital goods, and to settle at a lower level towards the end of the period. Rising export growth and steady inflows of private remittances are expected to contain the external current account deficit to around 5½ percent of GDP by the end of the period. Foreign aid levels are expected to increase, but not dramatically, and the overall balance of payments is expected to remain in surplus. The import cover of gross official reserves is anticipated to remain at about 4 months.

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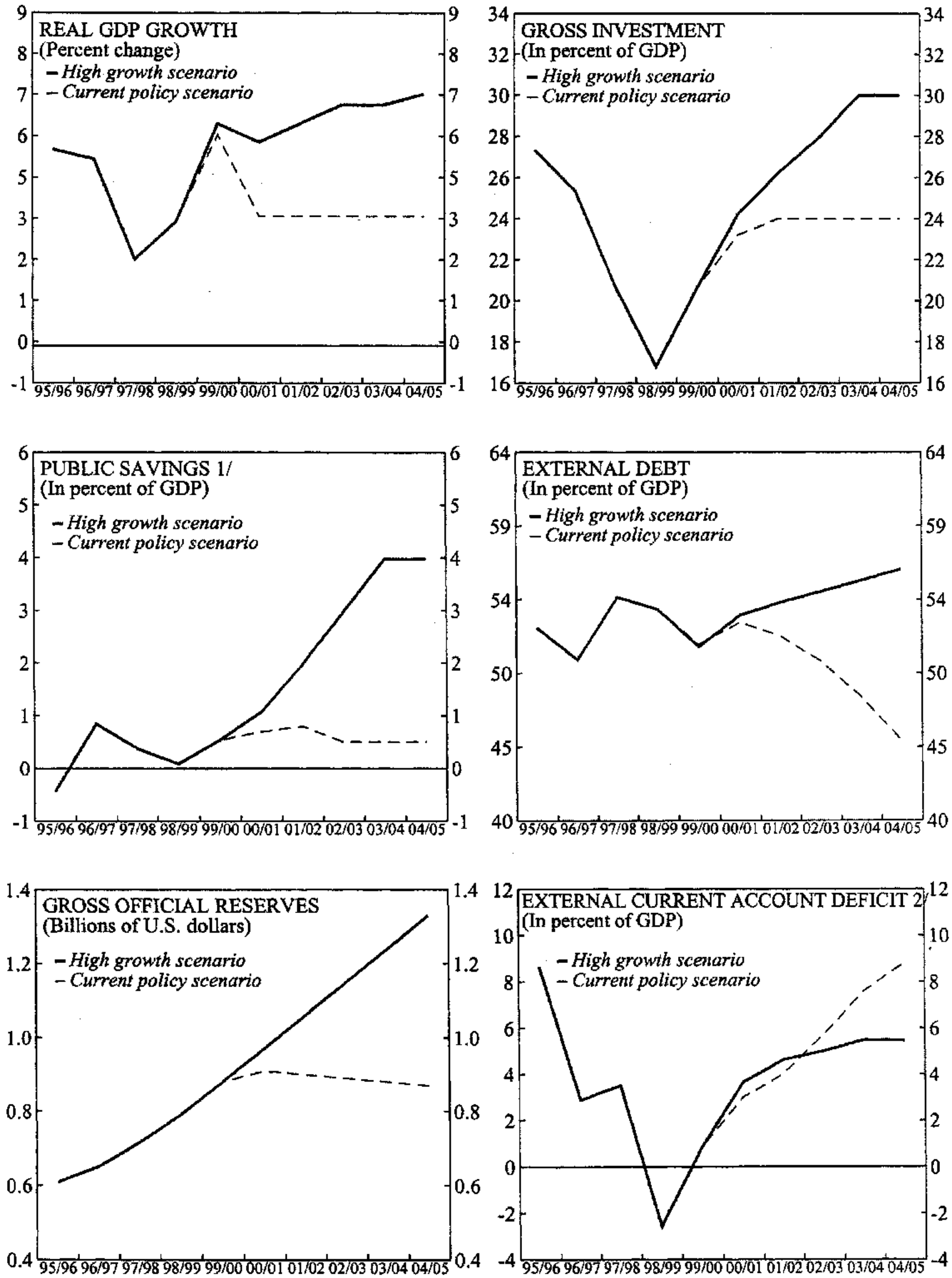
[3]Public savings are adjusted for the recurrent component of development expenditure, which is assumed to represent 3 percent of GDP by the end of the period.

Figure 12. Nepal: Medium-Term Macroeconomic Scenarios, 1995/96-2004/05



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

1/ Adjusted for the recurrent component of development expenditure.
2/ Excluding official transfers.

Table 7. Nepal: Illustrative Medium-Term Scenarios, 1996/97–2004/05

(In percent of GDP, except where indicated)

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
				Projections					
("High Growth" Reform Scenario)									
Real sector									
Real GDP growth (percent change)	5.0	2.3	3.4	6.0	5.5	6.0	6.5	6.5	6.8
Agriculture	4.1	1.0	2.4	4.0	3.0	3.5	3.5	4.0	4.0
Non-agriculture	5.2	3.9	4.1	7.2	7.0	7.5	8.2	7.8	8.2
Average CPI inflation (percent change)	7.3	3.3	12.5	6.0	6.0	5.0	5.0	5.0	5.0
Real per capita GDP (percent change)	2.6	0.0	0.9	3.6	3.1	3.7	4.3	4.4	4.8
National savings	22.5	17.2	19.4	19.7	20.6	21.6	22.9	24.5	24.5
Public 1/	0.8	0.4	0.1	0.5	1.1	2.0	3.0	4.0	4.0
Private	21.6	16.8	19.3	19.2	19.5	19.6	19.9	20.5	20.6
Gross investment 2/	25.3	20.7	16.8	20.6	24.2	26.2	27.9	30.0	30.0
Public 1/	6.9	6.7	5.9	6.9	8.8	9.4	9.4	9.4	9.4
Private	18.4	13.9	10.9	13.7	15.4	16.8	18.5	20.6	20.6
Fiscal Sector									
Total revenue	10.5	10.7	10.1	10.7	11.5	12.5	13.5	14.5	14.5
Regular expenditure	7.4	7.8	7.9	7.5	7.5	7.4	7.4	7.4	7.4
Development expenditure	9.2	9.6	8.6	9.6	11.7	12.5	12.5	12.5	12.5
Overall balance before grants	-6.0	-6.7	-6.3	-6.4	-7.7	-7.4	-6.4	-5.4	-5.4
Net foreign financing (including grants)	4.6	4.9	5.0	5.3	6.0	6.0	6.0	6.0	5.5
Net domestic financing	1.4	1.9	1.3	1.1	1.7	1.4	0.4	-0.6	-0.1
External sector									
Export value (percent change) 3/	10.4	11.9	20.3	20.0	15.0	12.0	15.0	16.5	18.0
Import value (percent change) 4/	5.3	9.7	-3.1	29.4	18.6	12.3	12.7	13.4	13.5
External current account balance	-2.9	-3.5	2.6	-0.9	-3.6	-4.6	-5.0	-5.5	-5.5
Overall balance	1.4	3.7	2.8	1.6	1.6	1.5	1.4	1.3	1.1
Gross official reserves (millions U.S. dollars)	650	716	791	880	970	1,060	1,150	1,240	1,330
(in months of imports of goods and services)	4.3	5.2	4.7	4.5	4.4	4.4	4.2	4.0	4.2
Total external debt	50.5	54.6	53.8	51.3	53.3	54.2	54.9	55.6	56.4
Debt service ratio	5.0	5.7	5.2	5.2	5.4	5.5	6.4	7.1	7.6
Monetary sector 5/									
Broad money (percent change)	11.9	21.9	20.9	15.5	13.8	13.3	14.0	13.8	14.2
Private sector credit (percent change)	17.3	18.4	18.5	17.9	15.8	15.1	15.8	15.4	16.0
(Current Policy Scenario)									
Real sector									
Real GDP growth (percent change)	5.0	2.3	3.4	5.7	3.5	3.5	3.5	3.5	3.5
Agriculture	4.1	1.0	2.4	3.9	3.0	3.0	3.0	3.5	3.5
Non-agriculture	5.2	3.9	4.1	6.8	3.8	3.8	3.8	3.5	3.5
Average CPI inflation (percent change)	7.3	3.3	12.5	6.0	10.0	10.0	10.0	10.0	10.0
Real per capita GDP (percent change)	2.6	0.0	0.9	3.3	1.2	1.2	1.2	1.2	1.2
Gross investment 2/	25.3	20.7	16.8	20.6	23.2	24.0	24.0	24.0	24.0
Fiscal Sector									
Public savings 1/	0.8	0.4	0.1	0.5	0.7	0.8	0.5	0.5	0.5
Overall fiscal balance before grants	-6.0	-6.7	-6.3	-6.4	-6.8	-6.7	-7.0	-7.0	-7.0
Net domestic financing	1.4	1.9	1.3	1.1	2.0	2.4	2.8	2.9	3.0
Net foreign financing (including grants)	4.6	4.9	5.0	5.3	4.8	4.3	4.2	4.1	4.0
External sector									
External current account balance	-2.9	-3.5	2.6	-0.9	-3.0	-4.0	-5.7	-7.6	-8.8
Gross official reserves (millions U.S. dollars)	650	716	791	880	910	900	890	880	870
(in months of imports of goods and services)	4.3	5.2	4.7	4.6	4.3	3.7	3.2	2.8	2.7
Total external debt	50.5	54.6	53.8	51.4	52.9	52.0	50.4	48.0	45.2
Debt service ratio	5.0	5.7	5.2	5.2	5.4	5.6	6.6	7.6	8.3

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

1/ From 1999/2000, projected public sector savings and investment are based on central government budget data after adjusting for the recurrent component of the development budget.

2/ Historical totals include changes in stocks.

3/ Excluding re-exports.

4/ Excluding gold.

5/ Excluding balance sheet impact of restructuring RBB.

Nepal: Elements of a Financial Sector Reform Strategy

Modernize financial sector legislation (Timing: 2000–01)

- Review current legislation and prepare a timetable of amendments with a view to reducing segmentation and fragmentation and stimulating competition.
- Prepare and adopt a new NRB Act allowing increased autonomy and accountability.
- Prepare and adopt a special Financial Institutions Insolvency Act.
- Amend the Income Tax Act with revisions for banks in line with best international practices on tax-deductibility for provisioning and harmonized tax rates.
- Phased introduction of internationally accepted accounting and auditing standards.

Deregulate financial sector to increase competition (Timing: End-2000)

- Until a comprehensive banking and financial institutions law is enacted, issue a regulation for licensing to ensure operation of adequately capitalized and prudentially managed banks.
- Allow mergers and acquisitions between financial institutions of different categories.
- Subsidies related to directed lending to be reflected in the budget.
- Phase-out directed/subsidized lending by the NRB and commercial banks.

Strengthen NRB, including supervision capacity (Timing: 2000–02)

- Limit the NRB's role to central banking, terminating other current functions.
- Reorganize the supervisory functions in an autonomous direction within the NRB.
- Establish functional collaboration between four regulatory/supervisory departments.
- Provide legal powers to implement the Core Principles for Effective Banking Supervision.
- Improve on-site supervision capacity by hiring more accountants and improving training.
- Develop the off-site supervision function and introduce a risk rating system.
- Expand supervision of nonbank financial institutions, especially development banks.

RBB restructuring (Timing: End-2000)

- Ensure periodic feed-in of findings from KPMG's current work on RBB.
- Prepare and implement a time-bound restructuring plan, with focus on improving management (possibly through a partnership with a foreign bank) and on Kathmandu Main Branch, to include staff retrenchment and changes to branching policy.
- Strengthen collection and enforcement procedures so as to improve loan recovery and reduce the nonperforming loan ratio (from estimated 35 percent)[1].
- Amend the special loan-loss provisioning and handling of accrued interest.
- Undertake audits for 1999 year-end accounts by an internationally recognized firm.

NBL restructuring (Timing: End-2000)

- Prepare and implement time-bound restructuring plan to (i) improve management (possibly through a partnership with foreign bank); (ii) reduce overstaffing; and (iii) merge/close branches.
- Implement internal regulations to ensure arm's length distance between running the bank and influence of shareholders, nonexecutive directors, and important clients.
- Improve recovery from nonperforming loans (now 18–20 percent).

Improve regulations governing other financial institutions (Timing: 2000–01)

- Announce specific time-bound plans to restructure Agricultural Development Bank.
- Privatize, merge or close the Nepal Industrial Development Corporation.

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[1] Nonperforming loans may initially increase due to improved classification following adoption of internationally accepted standards and strengthening of banking supervision.

Nepal: Medium-Term Structural Reform Policies

Financial Sector

- Modernize financial sector legislation to ensure adequate regulation and competition.
- Strengthen supervision capacity, including through adopting internationally accepted standards.
- Implement restructuring plans to improve loan recovery and reduce nonperforming loans of state banks and nonbank financial institutions.

Legislative Reforms and Private Sector Environment

- Amend legislation pertaining to land, foreign direct investment, corporate governance and debt recovery, as well as financial sector legislation.

Fiscal Policy

- Improve revenue mobilization through: reduction of exemptions, improved VAT and customs reform implementation, introducing new excise taxes, revisions to the income tax law and improvements in tax administration. Tax revenue to reach 12 percent of GDP by 2004/5.
- Contain current expenditure by eliminating waste such as payments for ghost workers and use of public employment as a form of social assistance.
- Strengthen expenditure control through: more transparent and timely reporting, improved coverage, elimination of arrears, and mechanisms for maintaining budgetary control under decentralization.
- Ensure sufficient allocation for maintenance of past investments, project management and oversight, and improved pay incentives for rural posts.
- Include cost of interest subsidies, civil service reform, and financial sector restructuring.
- Implement mid-term reviews.
- Prepare annual investment program within 3-year rolling budget and in line with PER.

Public Sector Reform and Privatization

- Conduct civil service reform by: streamlining units and reducing civil service mandate; modifying the wage structure in line with job classifications, qualifications and functions; and improving the quality of public administration and service delivery.
- Strengthen domestic capacity for policy formulation and project implementation through intensified training programs.
- Devise framework for local government finance, authority and accountability.
- Reduce losses of public enterprises, eliminate bad debts to banking sector and phase out government support.
- Implement privatization program for nonfinancial and financial enterprises.

Poverty Reduction and Human Resource Development

- Prepare and implement poverty reduction strategy with broad-based participation. AsDB to assist in organizing public forums involving representatives of stakeholders in civil society.
- Increase the overall equity in resource allocation in favor of deprived rural areas.
- Improve public spending efficiency through local participation, project prioritization, and shifting of expenditure to programs more clearly identified as pro-poor and pro-growth (e.g. social spending to focus on primary education and basic health services while infrastructure spending would target fewer projects in power generation, rural roads, and drinking water).

Nepal: Review of Fund-Provided Technical Assistance

1. This annex presents an assessment of Fund technical assistance (TA) to Nepal.

Fiscal Area

2. **Past experience.** In November 1992, advice was provided on fundamental **reform of the tax system** with recommendations covering the areas of sales tax, excise duties, corporate income tax and taxes on land and buildings. A follow-up mission in June 1995 reported that some progress was achieved in sales tax reform, but little progress in the area of taxation of income and property. No further assistance was provided. On **public expenditure management**, a mission in January 1993 provided advice on fiscal reporting, expenditure control, and implementation of a system to monitor the fiscal impact of public enterprises. As the authorities were not ready to implement the recommendations made in 1993, no further assistance was provided. TA on **tax administration** focused on implementing a system to control the issuance of VAT refunds in conjunction with the introduction of VAT in February 1998, under the support of USAID and other agencies.

3. **Assessment.** FAD noted that recommendations related to tax policy reform and public expenditure control following TA provided during 1992-93 were generally not implemented. However, since then, there has been progress in implementing elements of FAD's recommendations both in the areas of taxation and in fiscal reporting and budgetary control. In the authorities' view, Fund TA has played an important role in the building of institutional capacity in the Ministry of Finance. Ministry officials indicated that in some cases weak administrative capacities constrain their ability to implement previous recommendations, particularly in the area of fiscal reporting and budget monitoring.

4. Regarding the continued assistance with VAT, one final Fund visit is planned to assist, in particular, with training in refund verification. FAD considered that the many problems facing tax administration in Nepal go far beyond those that can be addressed by the assignment of an IMF advisor in the area of VAT refund verification, and that the current situation calls for a comprehensive reform of tax administration which could be more appropriately supported by other agencies (USAID and the DanIDA).

5. **Future needs.** The mission and the authorities agreed that future TA is needed in three areas. Advice is needed (in conjunction with LEG) in drafting a new **Income Tax Act**, including harmonizing tax rates, rationalizing exemptions, providing tax-deductibility for financial institutions' special provisioning, and recommending new rules for general provisioning and for accrued interest not paid. For **indirect taxation**, advice is needed to improve tax policy and administration and to reduce system inefficiencies for the customs administration. In **budget monitoring and treasury management**, TA would be helpful in several areas: on procedures for monitoring of noncash grant and loan-financed development expenditure; developing procedures for reporting local government finances and extrabudgetary activities; regular reporting of the economic classification of the budget; effective use of computerized centralized treasury system currently being established; and improving capacity for developing deficit financing strategy, including the timing of debt issue, borrowing terms, and mix of instruments.

Monetary Area

6. **Past experience**. In October 1996, MAE provided TA on developing a market in government securities. In June 1999, an MAE mission undertook an assessment of the Core Principles for Effective Banking Supervision, in cooperation with the World Bank, which highlighted the need for comprehensive measures to strengthen supervision.

7. **Assessment**. The authorities considered the TA helpful and have requested assistance from the Fund to further strengthen banking supervision. MAE missions have found the authorities receptive to TA and implementation of past advice was judged to be generally good.

8. **Future needs**. For the near future, the highest priority was assigned to four areas of financial sector legislation. **Central bank legislation**: a new NRB Act is needed, paying special attention to modernizing the existing patchwork dating from 1955 (last revised in 1992), limiting NRB activities to traditional central banking operations, allowing for increased autonomy and accountability while reflecting international best practices with respect to central banking operations. Regarding **bank insolvency legislation**, a special Financial Institutions Insolvency Act should be drafted, reflecting international best practices with respect to the specific treatment of deposit-taking institutions. In addition, diagnostic and prescriptive assistance (in conjunction with LEG) related to modernizing laws and regulations to facilitate recovery of nonperforming assets should strengthen current **debt recovery legislation**. A follow-up to the 1996 MAE mission should assist in resolving legal and operational issues related to the **sale of government securities held by the NRB**.

Statistics

9. **Past experience**. Following a Fund TA mission in 1995, a long-term resident advisor was assigned in November 1997–May 1998 to review the coverage, classification and quality of the **balance of payments statistics**. The main issues addressed include: grants and transfers, which were determined to be incomplete; direct investment transactions, which were practically absent from BOP statistics compilation; accounting for transactions in nonmonetary gold and oil rexports; and estimates of worker remittances. Advice regarding **money and banking statistics** was provided in late 1997 and April/May 1999. The latter mission concluded that the framework for compiling monetary statistics broadly conforms with the Fund's methodology, but the coverage of monetary data is limited to the monetary survey. The mission assisted the authorities in expanding the institutional coverage of monetary statistics to include all banking institutions for the compilation of a banking survey.

10. **Assessment**. The authorities explained that Fund TA has helped improve the accuracy of balance of payments statistics, particularly with regard to the oil and gold trade and private remittances. However, published data do not yet conform to international guidelines. The authorities also noted that Fund advice on money and banking has improved the coverage and accuracy of money and banking statistics. In general, STA missions have found the authorities receptive to TA, demonstrating credible efforts to implement data improvements recommended by past missions.

11. **Future needs**. In addition to a follow-up money and banking statistics mission planned in FY2000, the authorities and Fund staff agreed that four areas deserve priority for future TA. On **statistics legislation**, visits by short-term experts should evaluate the need for a new Statistics Act to clarify reporting responsibilities. A follow-up to previous Fund advice on **balance of payments statistics** would be useful to further improve coverage, especially concerning volume and price indices, private remittances, and the capital account transactions. **National accounts statistics** also need to be improved, especially regarding quarterly expenditures, calculations of savings and investment balances, and changes in stocks. Finally, **fiscal statistics** should be enhanced with respect to classification, coverage, and timeliness to improve consistency of data between departments and government agencies, as well as between monetary and fiscal accounts.

INTERNATIONAL MONETARY FUND
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FOR IMMEDIATE RELEASE
March 14, 2000

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Nepal

On February 18, 2000, the Executive Board concluded the Article IV consultation with Nepal.[1]

Background

During the period since the last Article IV consultation, Nepal has maintained broad macroeconomic stability and there has been an improvement in the external position. However, in the absence of a strong political consensus, structural reforms remain delayed, pervasive weaknesses impair fiscal performance, and problems in the banking sector persist.

Real GDP growth improved to 3½ percent in 1998/99 (fiscal year ending July 15), led by growth in exports, manufacturing and finance sectors. Inflation has recently come down in a similar manner to developments in India. After accelerating to nearly 20 percent in 1998, the 12-month rate of inflation declined to 2 percent by December 1999, as food prices declined. As a result, the inflation differential with India, which widened in 1999, has disappeared. A pick-up in growth is projected in1999/2000 to around 6 percent of GDP based primarily on good weather, better fertilizer distribution and an export recovery.

External developments have been favorable, with the current account balance shifting by 6 percent of GDP to a surplus (excluding grants) in 1998/99. Pegged to the Indian rupee, the Nepalese rupee broadly maintained its dollar rate, and appreciated in real terms by about 7 percent for 1998/99 (before declining by December 1999 to the levels of early 1997, pre-Asian crisis). Aided by strong exports and increased remittances, gross official reserves increased in 1998/99 to nearly US$ 800 million, equivalent to 4¾ months of imports or

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

35 percent of broad money. In 1999/2000, merchandise exports are projected to increase significantly but the current account is expected to worsen as imports rise sharply with the pick up in economic activity, increased project-related imports, and higher oil costs. Nevertheless, foreign reserves are expected to continue to increase, although at a slower rate, provided the regional outlook remains stable.

A passive monetary policy led to excess liquidity in commercial banks, much of which has been placed in foreign currency assets. After converting the accumulated overdraft of the government into treasury bills, the Nepal Rastra Bank (NRB) has disposed of over half of these securities. Led by NFA accumulation, broad money expansion accelerated, peaking in February 1999 at about 26 percent, before slowing to 21 percent in November 1999. Reflecting the limited lending opportunities and excess liquidity, the interest rates on treasury bills have been negative in real terms since December 1997.

While the overall budget deficit remained stable, financed primarily by foreign aid, fiscal performance was disappointing in 1998/99 as revenue and development spending were below target. The overall deficit before grants was 6¼ percent of GDP. Total revenue amounted to 10 percent of GDP; lower than budgeted and than in the previous two years—receipts from the recently introduced VAT were below expectation because of the initial resistance of the business community. Current expenditures were contained at just below budgeted levels, as increases in spending on law and order and election-related activities offset underspending by other ministries. Development expenditures, however, were substantially below budgeted amounts because of delays in project implementation. In the first four months of the current fiscal year, faster development spending and an increase in civil service allowances have led to higher-than expected domestic financing.

The challenges facing Nepal relate to maintaining economic stability while addressing the long-standing constraints to significantly higher growth—the key to poverty reduction in Nepal. Identified growth constraints include a weak financial sector and inefficient public expenditures and state enterprises. Moreover, low agricultural productivity growth combines with a population growth rate of 2½ percent and high illiteracy to perpetuate widespread poverty.

Executive Board Assessment

Executive Directors regarded recent economic developments as broadly positive: international reserves had continued to increase, inflation was low, and the short-term growth outlook was encouraging. These improved macroeconomic conditions should give the authorities an opportunity to shift policies decisively. A front-loaded fiscal adjustment and a comprehensive package of structural reforms would be essential to realize Nepal's growth potential and provide a favorable basis for improving social indicators. Directors stressed that a substantial increase in per capita income would be required to achieve a meaningful reduction in poverty.

Directors emphasized the importance of maintaining an appropriately strong fiscal position. They welcomed the mid-term review of the budget and the recent steps to strengthen value-added tax and customs collections, and encouraged the authorities to take additional measures as needed to achieve the 1999/2000 budget targets. In the medium term, and notwithstanding the potentially important role of foreign financing, Nepal would have to raise its exceptionally low revenue-to-GDP ratio in order to finance necessary public expenditure—notably, on poverty reduction and other well targeted social programs, infrastructure, and bank restructuring. High priority should be given to broadening the tax base, especially by reducing tax concessions, and strengthening tax administration. At the same time, efforts to improve the efficiency of public spending should continue. In addition, Directors attached particular importance to increasing the transparency of fiscal operations. The formulation of fiscal policy would benefit from a more comprehensive budget framework incorporating all fiscal operations.

Directors noted that the exchange rate peg with India had so far served Nepal well and should continue to do so—as long as supported by appropriate financial policies. In this connection, they welcomed the recent move to positive real interest rates on treasury bills and encouraged the authorities to lower domestic budgetary financing, especially from the central bank.

Directors stressed the importance of providing greater autonomy to the central bank and encouraged efforts to strengthen regulation and supervision of the financial system. Concerted efforts would be needed to fully elaborate and implement the authorities' strategy to promote the efficiency and health of the banking system. The recapitalization and privatization of the troubled large state bank should be preceded by improved management and proper restructuring. Subsidized credit schemes should be funded transparently through the budget, not the banking system.

Regarding structural measures to promote broad-based growth, Directors considered that priority should be given to enhancing private and foreign investment, accelerating project implementation, and strengthening rural infrastructure. Wide-ranging reform of the public sector would be very important in this regard—to improve administration, promote good governance and accountability, streamline the civil service, and tackle the problems of inefficient and loss-making enterprises, including through privatization. Directors were encouraged by the recent policy initiatives to adjust public sector prices and tariffs, and by the authorities' commitment to an open trade and investment regime. They noted the desirability of diversifying exports, as well as the importance of productivity boosting reforms in promoting export competitiveness. While stressing the importance of a comprehensive development strategy, Directors noted Nepal's limited administrative capacity. Reform measures should therefore be well-sequenced and prioritized, and supported with adequate technical assistance from the donor community.

Directors encouraged the authorities to strengthen their efforts to eliminate significant weaknesses in the macroeconomic database that impair effective monitoring and policy formulation.

Directors welcomed the authorities' plan to adopt a broad and comprehensive agenda of structural reforms, which could be supported by a financial arrangement under the Poverty Reduction and Growth Facility (PRGF). The ongoing process of wide consultation in the preparation of a Poverty Reduction and Strategy Paper (PRSP)—together with planned and ongoing measures to reform the banking system, mobilize budgetary revenue, improve fiscal transparency, and tackle pervasive problems of governance and corruption—should create a favorable environment for mobilizing international support, including through a PRGF arrangement.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 1999 Article IV consultation with Nepal is also available on the IMF's website (http://www.imf.org).

Nepal: Selected Economic Indicators, 1995/96–1999/2000 1/

	1995/96	1996/97	1997/98	1998/99	Projection 1999/2000
			(Annual percent change)		
Output and prices					
Real GDP	5.3	5.0	2.3	3.4	6
Consumer prices (end-period)	9.2	1.7	10.2	9.5	5–6
			(As percent of GDP)		
Budgetary operations					
Domestic revenue	10.8	10.5	10.7	10.1	10.7
Total expenditure	17.6	16.5	17.4	16.4	17.1
Regular expenditure	7.5	7.4	7.8	7.9	7.5
Development expenditure	10.0	9.2	9.6	8.6	9.6
Overall balance	4.8	3.9	4.9	4.6	4.3
			(Annual percentage change)		
Money and credit (end of year)					
Total domestic credit	24.5	13.4	14.8	16.6	15.7
Claims on private sector	30.6	17.3	18.4	18.5	17.9
Broad money	14.4	11.9	21.9	20.9	15.5
			(In millions of U.S. dollars) 2/		
External sector					
Exports, f.o.b. 3/	602	1,160	855	752	891
Imports, c.i.f.	1,350	1,750	1,582	1,405	1,793
Current account 4/	-253	-49	-50	238	67
(In percent of GDP) 4/	-5.6	-1.0	-1.0	4.7	1.2
Overall balance	-40	59	177	144	95
Gross official reserves	609	650	716	791	880
Rupees per U.S. dollar (end-period)	56.0	56.8	67.6	68.5	...

Sources: Nepalese authorities and IMF staff estimates.

1/ Fiscal year ending July 15.

2/ Unless otherwise indicated.

3/ Includes re-exports.

4/ Includes grants.