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Nepal: 2002 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Nepal

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Nepal, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 3, 2002,** with the officials of Nepal on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 19, 2002**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its September 4, 2002 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Nepal.

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

Selected Issues and Statistical Appendix

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

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NEPAL

Staff Report for the 2002 Article IV Consultation

Prepared by Staff Representatives for the 2002 Consultation with Nepal

Approved by Wanda Tseng and Michael T. Hadjimichael

August 19, 2002

- Discussions for the 2002 Article IV consultation were held in Kathmandu during May 20-June 3, 2002. The staff team comprised Mr. Shishido (head), Ms. Abdelati, Messrs. J. S. Lee and Schellekens (all APD), Ms. Rahman (PDR), and Mr. Mahar (Administrative Assistant, APD). Mr. DeMilner (Resident Representative) assisted the mission. Mr. Bhatta, Advisor to the Executive Director, joined key meetings and Messrs. Bajacharya (IBRD) and Tuladhar (AsDB) took part in selected meetings.

- The team met with Prime Minister (and Finance Minister) Deuba, ex-Finance Minister Mahat (who resigned during the mission's visit), National Planning Commission Vice Chairman Khadka, Nepal Rastra Bank Governor Rawal, Finance Secretary Koirala, other senior government officials and representatives of private business, foreign investors, trade unions, opposition parties, and donors.

- Nepal accepted the obligations of Article VIII, Sections 2, 3, and 4 in May 1994. There are restrictions on payments for personal travel.

- The authorities have consented to the publication of the staff report.

- The principal author of the staff report is Hisanobu Shishido.

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Executive Summary

Nepal's main economic problem is poverty reflecting low growth, and the economy has paid a high economic and social price over the years. Pervasive poverty is considered to be among key causes of the six-year old Maoist insurgency. Violence has recently intensified resulting in high human and economic costs. The political environment has also deteriorated as debates on security turned into leadership disputes within the ruling party and resulted in the dissolution of Parliament, a split of the party, and the scheduling of general elections for November. The current government became a caretaker in the interim.

The insurgency and adverse external developments have slowed growth and complicated economic management. Social instability together with the global economic slowdown lowered exports and tourism receipts. GDP growth in 2001/02 slowed to less than 1 percent from about 5 percent a year earlier. The insurgency has also required higher security spending and reduced tax collection. While capital spending was cut back sharply to contain the deficit, domestic financing of the budget was higher than budgeted as foreign financing also declined.

Given the uncertainties related to the security situation and the need to contain domestic financing, the key challenge for fiscal policy is to prioritize spending. Spending needs to be channeled into improvements in basic infrastructure and social service provisions and focus on projects that can be completed so as to enhance growth and reduce poverty. The government is committed to this course of action in its 2002/03 budget. Its efforts need to be accompanied by higher revenue mobilization in the medium run.

The currency's peg to the Indian rupee has served Nepal well given its close ties with India. To protect the peg, monetary policy should be consistent with a domestic inflation rate similar to that in India.

Structural reforms should focus on financial and public sector reforms. Priority financial sector reforms are to address the weaknesses of the two largest and insolvent commercial banks and strengthen the supervisory capacity of the Nepal Rastra Bank (NRB). Public sector reforms include civil service and public enterprise reforms. Specifically, stronger efforts are needed to reduce overstaffing among lower skill workers and enhance performance incentives for professional staff. The process of privatization of public enterprises, which has stalled for the last three years, needs to be revived.

The authorities have expressed their interest in a PRGF-supported program. The staff has indicated that a more settled political and security situation and satisfactory implementation of the policies outlined above are needed to lay the basis for a new PRGF arrangement. The staff is maintaining a close dialogue with the authorities.

I. Introduction

1. **Despite decades of development efforts supported by substantial foreign aid, Nepal remains among the poorest countries in the world**. Forty percent of the population lives in poverty. Slow growth (especially of agriculture, which employs 80 percent of labor force) and poor infrastructure and social service delivery reflecting a weak and inefficient public sector are widely recognized as key causes of poverty. In concluding the last Article IV consultation in August 2001, Executive Directors agreed that the primary economic policy challenge was to achieve sustainable strong growth in order to reduce poverty through the adoption of a reform agenda focusing on removing structural impediments to growth while maintaining macroeconomic stability. Directors looked forward to seeing this agenda addressed in a full Poverty Reduction Strategy Paper (PRSP)—expected to be finalized in August—that could be supported by a Poverty Reduction and Growth Facility (PRGF) program.

2. **An already difficult economic situation has been complicated in recent months by an intensification of the Maoist insurgency, adverse external developments, and political uncertainties**. The insurgency, which started six years ago against the constitutional monarchy, has intensified. Poverty, inequitable access to economic opportunities, and a perception of widespread corruption are considered to be among the root causes of the insurgency (Box 1). Violence has intensified since November 2001 when the insurgents walked away from peace talks and a state of emergency was declared. The economy was further affected by the events of September 11 and the global economic slowdown. Near-term political uncertainty has risen as leadership disputes within the ruling party resulted in the dissolution of Parliament on May 22 and a split of the party. The government has assumed caretaker status pending general elections scheduled for November.

3. **Nepal's deteriorating security situation is attracting international attention**. The United States and India are offering limited military assistance. The World Bank and Asian Development Bank (AsDB) together with some bilateral donors are considering budget support to encourage improved governance and service delivery to the poor, although the exact timing of such assistance has not been decided.[1] The United Kingdom organized a workshop in June among donors and strategic neighbors (India, China and Russia) to discuss linkages between economic and political developments and security.

II. Recent Economic and Policy Developments

4. **Real GDP growth is estimated to have slowed to 0.8 percent in 2001/02** from 5 percent in the previous year due to the deteriorating security situation and adverse

[1] Measures to be supported by this prospective program aid are described in the "Immediate Action Plan" approved by the cabinet in June and focus on spending prioritization, decentralization of social service provision, and an increase in government accountability.

Box 1. Poverty and the Maoist Insurgency[1/]

Pervasive poverty and a perception of unfairness are considered to be among the root causes of the six-year old Maoist conflict. The population living in poverty increased from 5.7 million in 1976 to an estimated 9.2 million in 1996 accounting for 40 percent of the total population—unchanged during the last two decades. Most of the poor live in rural area—many based on subsistence agriculture—and income disparities between them and those in Katmandu valley are large and widening. Within the rest of the country, mid- and far-western hills/mountains regions fare much worse in terms of poverty and illiteracy, the same regions where Maoist presence is the strongest (where poverty incidence is 72 percent as compared with Kathmandu Valley's 4 percent). The poor feel disillusioned particularly by failure of development efforts to make headway against poverty, perceived widespread corruption in the government and among elites, and the entrenched inequalities across caste, ethnic, and gender lines in terms of access to social services and economic opportunities—making them more susceptible to Maoist influence.

Development efforts have been ineffective in reducing poverty. Failure to sustain high growth in general and in agriculture in particular has been a major reason for persistent poverty. While the government has tried to provide agricultural credit and subsidized inputs and services to the poor, the very poor seem to have been largely left out of the process. Only 8 percent of the poor borrow from formal and semi-formal institutions, half the rate for other households while fertilizer, veterinary, and other subsidies disproportionately benefit large and rich farmers. Similarly, past attempts at land reform were mostly unsuccessful as large landowners were able to parcel off ownership to relatives and land redistributed to the landless ended up in the hands of the non-poor as the poor are often forced to sell the land to pay off past debts.

The protracted insurgency has also hurt the poor. It accelerates outflow of resources and rural elites along with their assets from the affected areas—further reducing economic opportunities for the poor who remain in the areas. The conflict has also caused a deterioration in transportation services. The Maoists demand higher donations from those making profits reducing incentives to produce for profit. These developments are forcing the rural poor to depend on subsistence agriculture. Implementation of development projects and service delivery have also suffered in these areas as numerous donors have closed down or moved projects to district centers due to increased security risks and Maoists' demand for closure or forced donations. (But the Maoists are allowing projects that have local people's support and where project managers are willing to cooperate through providing donations.) Given that as of November 2001, the Maoists had a presence in 60 out of 75 districts and in many places were the only form of government, the poverty consequences could be alarming.

Economic policy can contribute to resolution of the conflict by focusing on its root causes. Measures to improve the poor's access to social services and economic opportunities are critical as well as overall economic policy that is geared to support higher growth through sustained macroeconomic stability and better private investment climate. Finally, improving governance and transparency in economic decision making are an important part of the envisaged reform process.

[1/] Based on background papers prepared for the London Meeting of donors on security and development held on June 19-20, 2002, and "Nepal: Poverty at the Turn of the Twenty-First Century" World Bank (1998).

exogenous shocks (fiscal year ending mid-July). Agricultural growth slowed to less than 2 percent from over 4 percent, reflecting irregular rainfall. The output of nonagricultural sectors was largely stagnant, down from 5 percent last year. Manufacturing and tourism have been particularly hit hard by the insurgency as well as the global slowdown. Inflation was subdued at around 3 percent (12-month basis), reflecting weak domestic demand and stable Indian prices for most of the year. But with slightly higher food prices in India towards the end of the fiscal year, inflation has recently edged up close to 4 percent by July (Box 2).

5. **Notwithstanding slowing exports and tourist receipts, the external current account surplus remained at 1 percent of GDP**. Exports are estimated to have declined by 15 percent (excluding re-exports) in 2001/02 after growing by 21 percent on average during the last three years. Sales to countries outside India fell by more than 40 percent as garment, carpet and pashmina exports plunged largely because of the global economic slowdown and supply disruptions caused by the insurgency (see forthcoming Selected Issues Paper). Exports to India slowed recently due to a revised bilateral trade treaty signed in March which introduced nontariff barriers on Nepalese exports (Box 3). Tourist receipts are estimated to have declined by 34 percent due to the internal security situation and September 11. Nevertheless, a drop in imports and expanding remittances from Nepalese working abroad maintained a current account surplus. Imports have declined by 11 percent due to a weaker economy and smaller aid disbursements. Remittances are estimated to have risen by 8 percent—and now exceed merchandise exports—reflecting a rapid increase in the number of workers in Malaysia and the Middle East. Nevertheless, foreign aid flows declined and contributed to turning the overall balance to a deficit of $77 million from a surplus of $38 million in 2000/01. Gross official reserves stood at over $1 billion, covering 6½ months of imports, 4½ months of which in convertible currencies. Reflecting the concessional nature of the external debt and high remittances, the debt service ratio remains at about 5 percent of current receipts.

Nepal: Summary of Fiscal Indicators

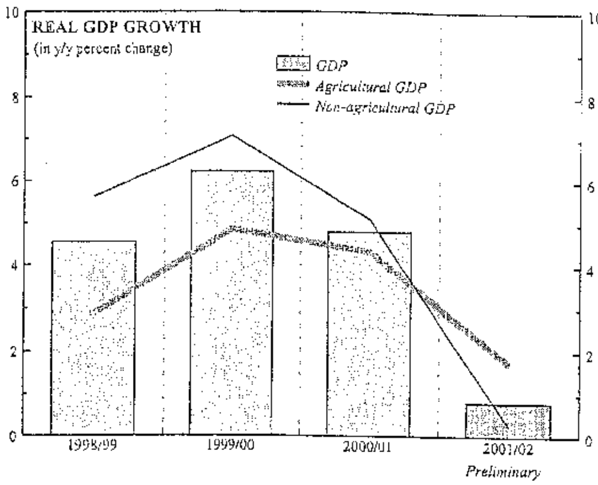
	2000/01	2001/02		2002/03
	Actual	Budget	Est. 1/	Budget
	(In percent of GDP)			
Total revenue	11.4	12.8	11.4	11.9
Grants	1.6	3.1	2.0	3.1
Current expenditure	11.2	11.6	12.3	13.0
Capital expenditure 2/	6.4	8.1	5.0	5.4
Overall balance before grants	-6.2	-7.0	-6.0	-6.5
Overall balance after grants	-4.5	-3.9	-4.0	-3.4
Net foreign financing	1.8	2.3	1.4	1.4
Net domestic financing	2.7	1.6	2.6	2.1
o/w Banking sector	2.5	...	1.8	...

1/ Revised estimate in 2002/03 Budget.
2/ Includes net lending.

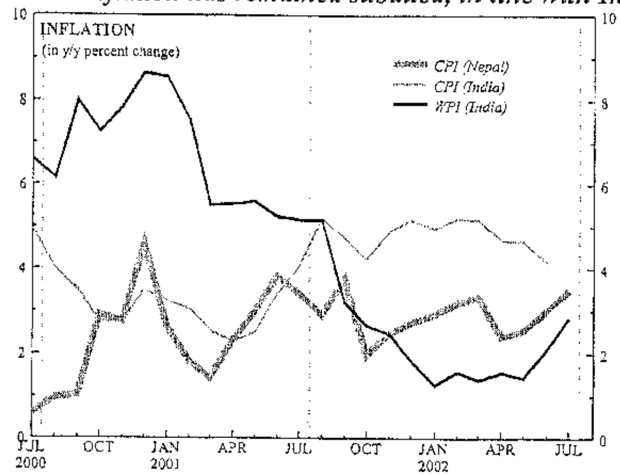
6. **The fiscal deficit (after grants) was contained to 4 percent of GDP, but domestic financing was higher than budgeted**. The insurgency and a weak economy contributed to a revenue shortfall of about 1½ percent of GDP. Revenues would have been even lower had it not been for the intensified collection efforts through a voluntary disclosure of income scheme (VDIS) and

Box 2. Nepal-Recent Economic Challenges and Risks, 1998/99 - 2001/02

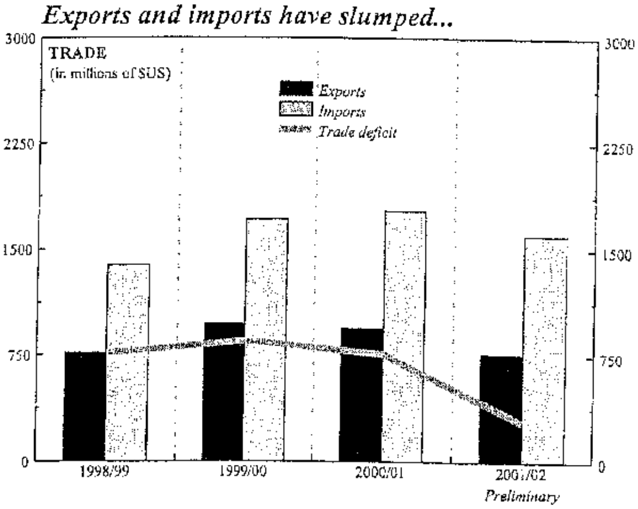
Growth has slowed...



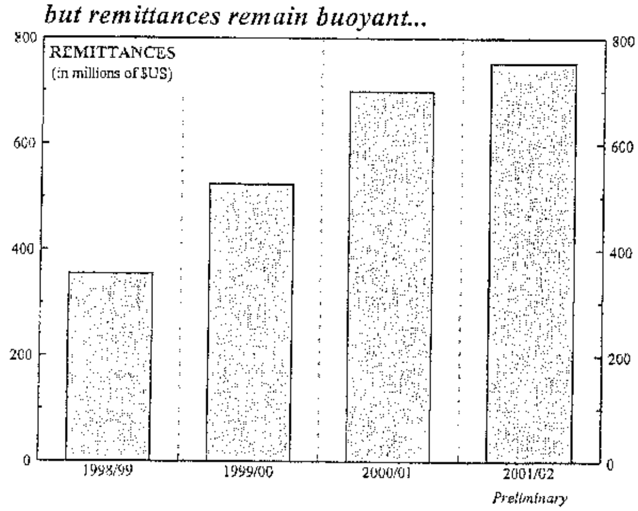
and inflation has remained subdued, in line with India.



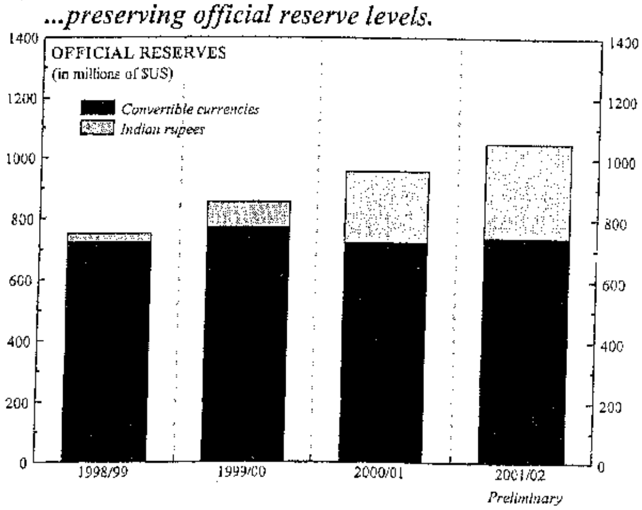
Exports and imports have slumped...



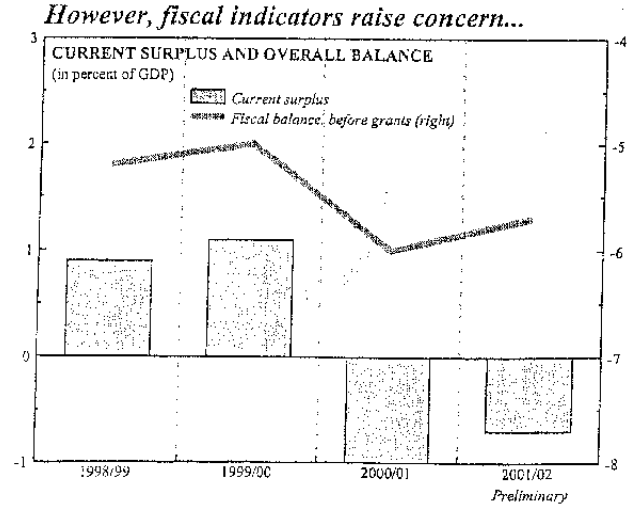
but remittances remain buoyant...



...preserving official reserve levels.

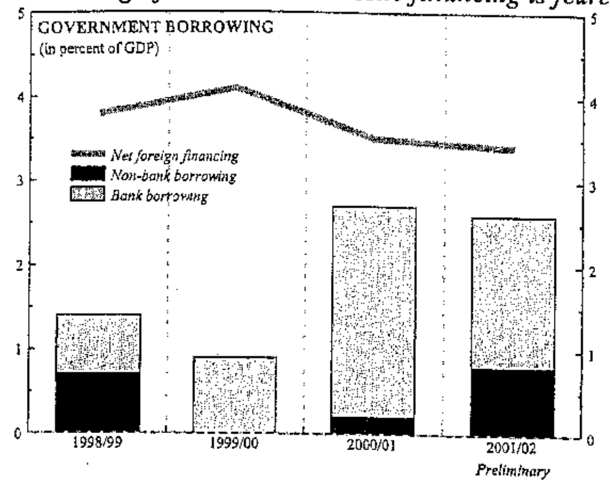


However, fiscal indicators raise concern...

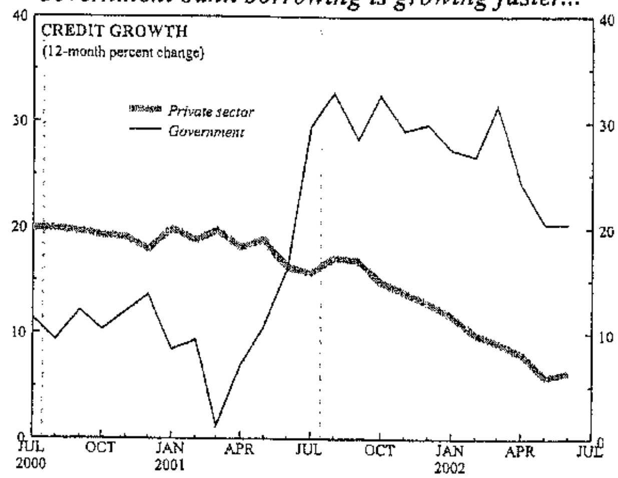


Box 2 (Concluded). Nepal-Recent Economic Challenges and Risks, 1998/99 - 2001/02

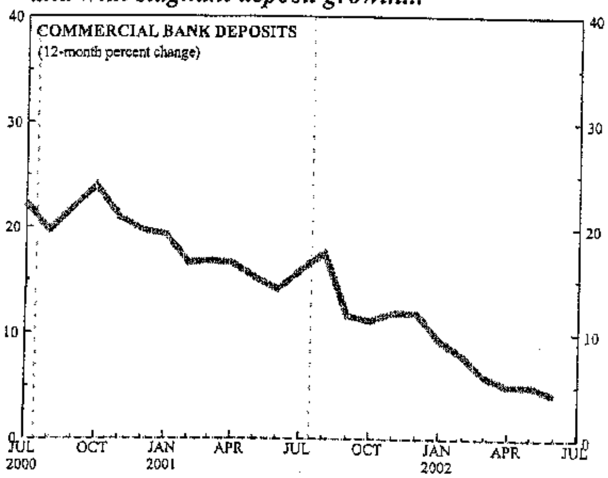
and a significant rise in domestic financing is feared.



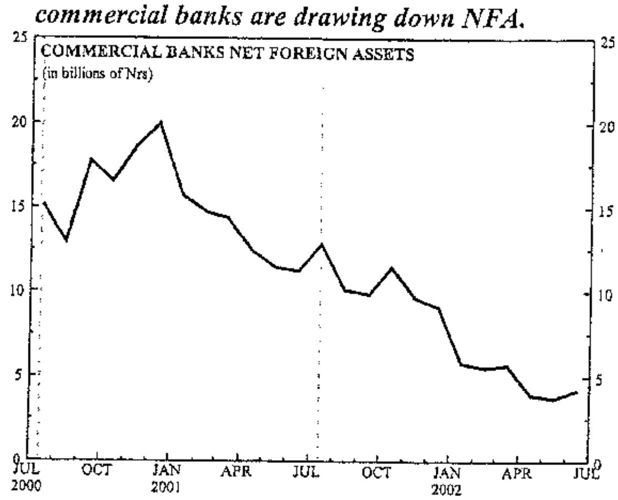
Government bank borrowing is growing faster...



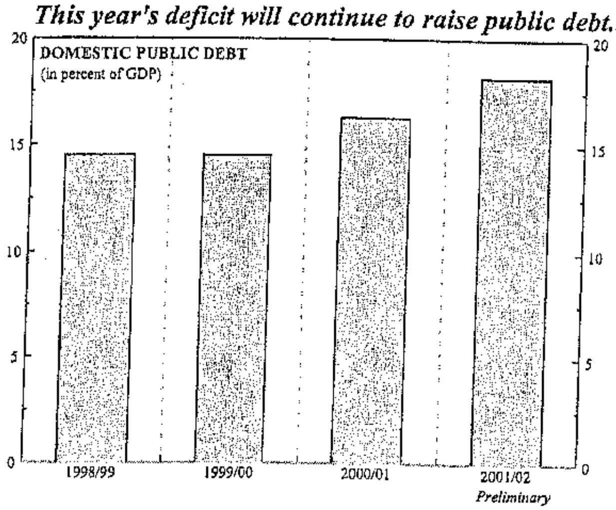
and with stagnant deposit growth...



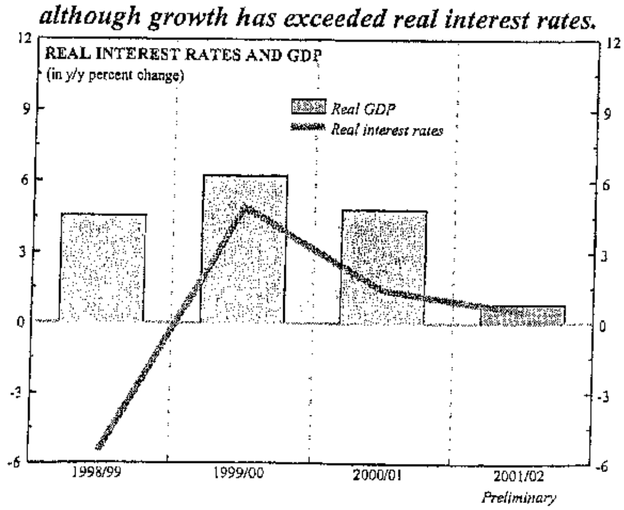
commercial banks are drawing down NFA.



This year's deficit will continue to raise public debt...



although growth has exceeded real interest rates.



Box 3. Export Prospects, 2002/03-2004/05

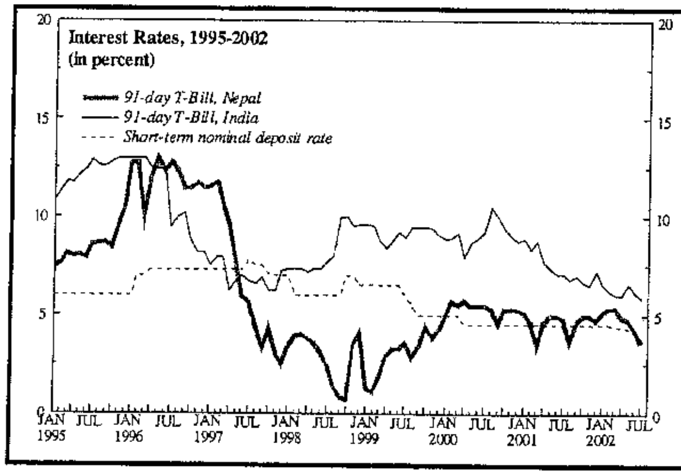
Nepal's export markets are limited. About half of its total exports, consisting of diverse products, are sold in India. The United States (apparel and pashmina products) and Germany (woolen carpets) absorb 75 percent of exports outside India. In the recent past, overall performance has deteriorated due to a rapid decline in exports to outside India. While economic recovery of major markets outside India offers some prospect for future exports, considerable challenges lie ahead with restricted access to India for some exports under the recently renewed trade treaty and intensified competition in the United States.

Exports to India, after growing at an average rate of 42 percent during the last 4 years, are expected to slow down in coming years. A five-year old bilateral trade treaty, whereby Nepali goods were allowed into India essentially duty- and quota-free expired last year. The renewed treaty, signed in March 2002, imposes quantitative restrictions on four of Nepal's export items: vegetable fats (vanaspati, 100,000 tons), acrylic yarn (10,000 tons), copper products (7,500 tons) and zinc oxide (2,500 tons). The quotas are significantly below last year's export levels. These products represented around 25 percent of Nepal's exports to India last year. Nepalese exporters are not allowed to carry forward the unutilized quota while exports in excess of the quota are permitted under normal MFN rates. A special addition duty of 4 percent is levied on these products. India has also granted rights to Central Warehousing Corporation (CWC) for buying all vegetable fats from Nepal. CWC is currently negotiating with Nepal monopsony prices. Exports are allowed by the Indian customs authorities on the basis of a Certificate of Origin showing a minimum value addition of 25 percent in the first year and 30 percent thereafter. Exports to India are as a result expected to decline by 4 percent in 2002/03. However, as Nepal diversifies and moves away from the quota-restricted products, growth of exports to India could recover to 8-10 percent in subsequent years.

Exports to third countries are likely to grow only modestly in the range of 5-8 percent during 2002/03-2004/05, after an initial decline of more than 40 percent this year. Apparel exports to the United States decreased by 15 percent in 2001 after increasing by 30 percent the previous year. While production disruption caused by Maoist activities contributed to this decline, slow U.S. growth also played a role. Nepalese exporters will likely continue to face difficulties with internal violence and increased international competition in the near future. The industry, however, stands a chance if the insurgency is brought under control, demand picks up in the United States and aggressive marketing efforts are undertaken. Prospects for carpet and pashmina exports are more uncertain due to market saturation, absence, so far, of product diversification, and strong competition from lower cost producers. Without aggressive marketing and flexibility in responding to ever-changing consumer tastes, these industries face tough survival battles.

special revenue measures to fund security spending, which together raised ½ percent of GDP.[2] Security spending (Nr 13 billion, or 3 percent of GDP) is estimated to be 1 percent of GDP higher than the budget. The authorities cut back capital spending by 3 percent of GDP relative to the budget. However, this also affected foreign aid disbursements and financing. As a result, while the overall deficit was contained to budgeted levels, domestic financing amounted to nearly 3 percent of GDP, 1 percent of GDP higher than budgeted. Public debt rose to 66 percent of GDP of which 18 percent is domestic debt. All of the foreign debt is on highly concessionary terms.

7. **Monetary policy has accommodated fiscal needs and the authorities' desire to bail out depressed industries**. Net claims on government rose by 19 percent in 2001/02. Private sector credit grew by 8 percent compared with 16 percent a year earlier. While the weak economy kept demand for new credit down, there was sizeable demand for refinancing loans to troubled borrowers. Domestic credit grew by 10 percent which, combined with stagnant deposits (see below), created a liquidity shortage at some commercial banks. This prompted the NRB to lower cash reserve requirements (CRR) by 1.2 percentage points on average to around 9 percent in January 2002.[3] Refinancing rates were also lowered by 100–200 basis points to 2-5 percent at the same time. In addition, from February 2002, the NRB provided a special refinancing facility at 3 percent interest to encourage commercial banks to provide concessional loans to "sick" industries (mostly hotels and garment industry).



8. **The growth of monetary aggregates slowed sharply**. Broad money growth in 2001/02 slowed to 6 percent from 15 percent a year earlier. This is because of a weaker economy and stagnant deposits linked to the VDIS and other asset verification efforts, which prompted withdrawals by depositors who feared that tax and anti-corruption authorities could trace their undeclared income by examining bank deposits. Interest rates on deposits and treasury bills (91 days) declined during 2001/02 to around 4 percent, which are about 200 basis points lower than those in India reflecting limited investment opportunities in Nepal. The heavy

[2] Special measures introduced in January included: raising special fees on imports and surcharges to income tax (both initiated in the 2001/02 budget) from 1 percent to 3 percent; imposing surcharge of Nr 1 per liter on petroleum products; raising some export duties; and raising excise rates on tobacco, alcohol products, and soft drinks.

[3] This include the requirement that 3 percent of deposits needs to be in cash-in-vault.

domestic borrowing by the government has so far not raised interest rates, because of the weak economy, but in the context of decelerating money demand, resulted in a decline in the NFA of the banking system.

9. **The peg of the Nepalese rupee to the Indian currency has provided a suitable nominal anchor and enabled Nepal to benefit from the close economic ties with India.** The real effective exchange rate has been relatively stable, and the informal market premium has been minimal. Exporters also report that they do not face significant wage pressure.

10. **Structural reform has advanced in the financial sector.** To provide a sound basis for strengthening the NRB's regulatory and supervisory capacities, new banking regulations were issued and a new NRB Act was enacted in 2002, that granted the central bank greater autonomy. The authorities are preparing an action plan to "re-engineer" the NRB through reorganization, strengthening of supervision, and human resource enhancement based on stronger performance incentives for the professional staff. These efforts are supported by Fund and World Bank technical assistance. The two largest commercial banks, Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL), accounting for over 40 percent of the banking sector assets, have a negative net worth amounting to 7-9 percent of GDP (an estimate based on 1998 data, which is the most recent study) because of large nonperforming assets. To address this issue, external managers for the two banks were selected in early 2002, with funding from the World Bank and the United Kingdom. Because lending by these banks was often politically-motivated or involved insider dealing, reform initiatives were resisted not only by the banks' boards (and employee unions) but also by many well-connected borrowers. To take over management of the majority privately-owned NBL, the NRB invoked provisions of the new NRB Act and suspended its board. However, an international management firm that signed a contract in January to manage the RBB has decided to pull out, citing security risks and ambiguities in the contract.

11. **Progress was uneven in public sector reforms.** Among the positives, fiscal transparency has been improved through greater coverage, timeliness, and detail in budget reporting. Another important reform was the introduction of a medium term expenditure framework (MTEF) with assistance from the World Bank—in which fiscal resources are allocated to programs in accordance with national and sector priorities in a three-year rolling framework and a realistic revenue forecast considered as a hard budget constraint. To reduce overstaffing among lower-level employees[4] and improve performance incentives for professional staff, the authorities introduced a hiring freeze, completed a civil service census, increased relative wages of higher level staff, started to eliminate temporary and vacant posts at lower levels, and implemented the first phase of a voluntary retirement scheme. Nevertheless, out of about 106,000 core civil service positions (of which 17,000 are vacant), only 1,100 temporary and 300 vacant positions have been eliminated so far and the

[4] Over 80 percent of the core civil service is either "nongazetted" (48 percent) or "classless" (33 percent).

retirement scheme resulted in about 2,000 approved separations. Finally, there has been little visible progress in public enterprise reform. Public enterprise finances continue to deteriorate but poor accounting practices prevent accurate measurement of the size of the problem (Box 4). No public enterprises were privatized during the last three years.

III. Outlook and Risks

12. **Near- and medium-term prospects depend critically on how the security and political situations evolve.** Discussions with the authorities have been based on a scenario and policy implementation consistent with that used in the PRSP (base case) including a return in the security threat to the level prevailing before July 2001, a move toward a negotiated solution, and the emergence of a relatively stable government after the November elections. Under such a scenario and assuming normal weather, real GDP growth of 3½-4 percent could resume in this fiscal year on account of recovery of agricultural growth to about 3⅓ percent and nonagricultural to 4 percent. Furthermore, medium-term growth could exceed 5 percent, making it possible to achieve sustained poverty reduction.

13. **International reserves are expected to remain adequate in this scenario.** Overall merchandise exports are expected to recover slowly as exports to outside India will continue to face challenges; garment exports will face growing international competition. In addition, as stated above, various nontariff barriers introduced by India under the India-Nepal trade treaty will have negative short-run consequences. But the current account is projected to remain in broad balance as import growth will also be slow and a modest recovery in tourist receipts is expected.[5] Inward remittances are expected to grow steadily. With improved aid disbursements, the overall balance could turn positive from 2002/03 and gross official reserves would be around 6¼ months of imports. The debt service ratio is projected to stay at a sustainable level of 5-6 percent, assuming that future external debt will continue to be concessionary.

14. **The economy, however, remains highly vulnerable to various downside risks** stemming from continued intense civil conflict, adverse external developments, poor weather, and slippages in reform implementation. The irregular monsoon of this year may have already affected agricultural production negatively, especially in western regions. An additional scenario was thus discussed with the authorities to illustrate the possible macroeconomic effects of absence of early progress on the security front (Table 5 and Annex V). In such a scenario, growth would be lower, exports and tourism would stagnate, reforms would be more difficult to implement, and poverty would likely remain pervasive further complicating achievement of a negotiated solution to the insurgency. While large

[5] Nepal may also benefit from a limited increase in Chinese tourists under the recently signed tourism treaty.

Box 4. Public Enterprises—Performance and Contingent Fiscal Liabilities

Public enterprises were established in the 1960s with the aim of building industrial and manufacturing base. To date, there are 7 financial and 36 nonfinancial public enterprises (covering industrial and trading sector, service sector, and public utility sector).

The sector's contribution to GDP, estimated by the CBS, is around 2 percent in 1999/2000 as most public enterprises are ailing with some large ones suffering from negative value added. Budgetary transfers to them (including on-lending) average 1.8 percent of GDP for the last three years. Net profits have plummeted from about Nr 3 billion in 1998/99 to Nr 240 million in 2000/01 despite continued government transfers and investment. Although the sector's capital stock is hard to assess accurately, these profit levels indicate that return on capital has come down to less than 1 percent from around 6 percent in 1998/99. This poor performance can be attributed to lack of commercial orientation, poor management, and overstaffing with an inappropriate skill mix.

Summary Indicators of Public Enterprise Performance, 1998/99—2000/01

(In millions of Nepalese rupees)

	1998/99	1999/00	2000/01
Net profits (39 enterprises) 1/	3,026	2,397	241
Of which:			
Financial PE's (7)	175	-106	14
Utility PE's (3)	2,377	2,797	2,536
Others (29)	474	660	-2,308
Government investment 2/	5,510	7,369	7,749
Share investment	1,420	1,276	1,089
Loan investment	4,090	6,093	6,660
Dividend payments 2/	327	372	336

1/ *Targets and Performances of Public Enterprises, 2001*, Ministry of Finance.
2/ Based on the fiscal account of the Financial Controller General's Office, excluding NRB dividend.

Restructuring and privatization has been limited, with only four small enterprises privatized since 1990 and little progress since 1996. In the meantime, contingent fiscal liabilities are accumulating and these would have to be cleared prior to privatization.[1/] The known liabilities include:

- *Wage arrear* have been reported but consistent records are not available. For example, wage arrears reached 16 months for the Agriculture Tools Factory, and 4 months for the Lumbini Sugar Factory.
- *Other arrears to employees.* According to a recent report on eight industrial public enterprises, about Nr 15.2 billion (3-4 percent of GDP) is due for gratuity, sick and home leaves allowance, medical allowance, and insurance premium.
- *Arrears to banks and suppliers* exist, but no monitoring mechanism is in place.

[1/] Public enterprise accounts are of poor quality, and often inconsistent with reported fiscal transactions. This makes it extremely difficult to identify the size and nature of potential fiscal liabilities.

uncertainties surround these projections, and the two scenarios are illustrative, it is clear that, as more time passes without progress toward internal peace, the likelihood that the lower case scenario will prevail increases.

IV. Policy Discussions

A. Medium-Term Policy Framework

15. **The discussion focused on the policies needed to maintain macroeconomic stability in the immediate future and foster growth and poverty reduction over the medium term.** There was broad agreement on the assessment of the economic situation and required reform steps. The authorities acknowledged that despite the ongoing political problems and a weak economy, they needed to move ahead with implementation of reforms that would lead to efficient financial intermediation and restructuring of the public sector. In some cases, however, the authorities preferred a slower pace of implementation than recommended by the team given the current fragile political situation. The team stressed that establishment of a stable political environment and improvements in internal security would be prerequisites for sustained implementation of necessary reforms. The main elements of the discussion included:

- **Maintaining macroeconomic balance.** This requires limiting bank financing of the budget to less than 1½ percent of GDP in 2002/03 and to no more than ½ percent of GDP in the medium term; maintaining reserve cover of about 6 months of imports; and keeping annual inflation to about 4½ percent consistent with projected Indian inflation;[6]
- **Improving private sector resource allocation** through reforms in the financial sector, and establishment of an enabling business climate conducive to private investment;
- **Improving public sector resource allocation** through streamlining and prioritizing government expenditures (especially to improve social services and promote agricultural growth), enhancing revenue collection, improving the civil service, and reforming public enterprises; and
- **Strengthening governance and institutional capacity.**

B. Macroeconomic Policy for 2002/03

Fiscal Policy

16. **In discussing the 2002/03 budget prior to its finalization, the team stressed the needs to improve revenue mobilization, prioritize spending, and contain domestic borrowing.** The authorities in the past avoided domestic debt problems by raising enough

[6] The reserve cover needs to be relatively high reflecting Nepal's volatile export earnings and its land-locked position, which can make import costs high and variable.

revenue to cover current spending (and even generating a small current surplus) and adjusting the size of development expenditure in line with available concessionary foreign aid. Nepal has a relatively efficient tax system for its income level based on low income tax rates and a VAT. With the increased security spending, however, the current balance has turned to a deficit and domestic borrowing is on the rise. There was thus increased need to raise revenues and streamline spending. In particular, the team emphasized that the following aspects needed to be incorporated in the budget:

- **Strong efforts to improve tax and customs administration should be made** to raise revenue by at least ¼ percent of GDP to reach 11.6 percent of GDP. There was agreement that the authorities needed to increase regular and field audits of large taxpayers, strengthen customs valuation of imported goods (including seizures if needed), and enhance the number and quality of staff assigned to the tax office. The team also welcomed the authorities' plan to reduce the VAT exemption list and convert the special security surcharge on petroleum products to a permanent excise tax;

- **Spending in 2002/03 needs to be prioritized**. The team stressed that the authorities should include only the highest priority projects in the capital budget to ensure that spending would be streamlined and contribute to growth and poverty alleviation. The team indicated that the authorities should move away from the practice of overestimating development spending. Given a realistic estimate of available foreign financing, the authorities' implementation capacity, and the size of currently identified priority activities, the team suggested that capital spending should be kept at around 5 percent of GDP. While current spending depends on the security situation, it should be contained at 12½ percent of GDP under the base case/PRSP scenario. Saving due to continued civil service reform implementation and streamlined allowances would partially offset additional demand for security-related outlays and the cost of the national elections; and

- **Domestic borrowing needs to be contained to about 2⅓ percent of GDP to sustain macroeconomic stability**—of which bank financing should be 1⅓ percent of GDP. The team recommended that if more budget support became available, it should be used to reduce domestic borrowing rather than expand lower priority spending. While the domestic debt to GDP ratio was still low, it could increase if the low growth scenario became a reality especially as the government was burdened with large contingent liabilities associated with nonperforming assets of the banking sector and wage and other liabilities of public enterprises slated for privatization.

17. **While agreeing that the fiscal framework outlined by the mission was appropriate, the authorities stated that spending would have to be larger**. They believed that a significant contingency provision was needed given that uncertainties existed regarding the security situation. In addition, while prioritization of development projects would be undertaken, some staff assigned to projects now classified as lower priority could not be immediately removed from the payroll. They also agreed that contingent fiscal

liabilities associated with banks and public enterprises were large, but hoped that a significant part of the liabilities would be covered by donor aid.

18. **In the event, the 2002/03 budget announced on July 8 aimed to reduce the overall deficit (after grants) to 3½ percent of GDP**. Compared with the framework discussed with the team, the budget contained nearly 1 percentage point of GDP higher spending due in part to higher contingency for security outlays. As revenues and foreign aid flows were similarly higher, domestic financing was to be contained to 2 percent of GDP. While budgeted spending was higher than the levels discussed with the team, the authorities hoped that the security contingency would not need to be fully utilized and also said that funds for high priority projects would be released first to ensure their rapid completion. With nearly a third of 550 existing projects having been canceled, the team noted that the budget was more realistic than in the past. While not disagreeing with the strategy of making some spending contingent on the security situation, the team cautioned against the diversion of these funds to other lower priority activities—a particular risk in an election year.

19. **There are significant downside risks to the revenue and foreign financing forecasts in the budget**. The authorities aimed to mobilize revenues amounting to nearly 12 percent of GDP based largely on intensified collection efforts—implying that buoyancy will rise to 1½ from last year's near unitary level. This target appears optimistic given that economic recovery is expected to be modest, that the security situation is assumed to improve only slowly, and that the authorities are not modifying the tax structure to any significant extent.[7] The authorities also assumed higher foreign aid inflows in the budget than discussed during the mission's visit. In particular, projected grant disbursements of above 3 percent of GDP were significantly above the past trend. The team was concerned that if revenue and foreign aid were lower than budget targets, domestic borrowing could be substantially higher. The authorities responded that they were aware that if these targets did not materialize, they would have to prioritize spending further and make cuts rather than expand domestic borrowing.

Monetary and Exchange Rate Policy

20. **Looking ahead, monetary policy should continue to be geared towards supporting the exchange rate peg**. This requires monetary growth that is consistent with a domestic inflation rate broadly in line with that in India. With this in mind, broad money growth should be contained to 11-12 percent, assuming real GDP growth of 3.8 percent and a slowing of the downward trend in velocity.[8] Net claims to government should be limited to

[7] The government proposed only one modification of the tax structure in this budget: elimination of VAT exemption on metal products.

[8] The VDIS that contributed to lower deposit growth in 2001/02 will not be repeated in 2002/03.

11 percent, while allowing private credit growth of around 12 percent and an NFA increase of 8 percent. The team also noted that the monetary program would need to be reviewed with the progress in restructuring of the RBB and NBL as it could affect the behavior of monetary aggregates given the large size of assets and liabilities of these banks.

21. **The authorities need to remain vigilant about the quality of new credit.** In August, the authorities lowered CRR further by 1 percentage point. Given the weak economy and limited investment opportunities, such an easing raises concerns that the increased liquidity could be used for refinancing existing loans, many of which are nonperforming. It is thus important that the NRB enforce newly issued prudential regulations vigorously and urge financial institutions to reschedule loans only after borrowers submit viable restructuring plans.

C. Structural Reforms

22. **The structural reform agenda aims at improving allocation of resources in both private and public sectors.** This involves continued financial sector reforms, notably restructuring key commercial and development banks and strengthening the supervisory capacity of the NRB (Box 5). Trade and legal reforms are also needed to improve the overall business environment. Public sector reform includes reforms of public expenditure management, civil service and public enterprises. In addition, there is a strong need to strengthen governance and institutional capacity.

Financial Sector Reforms

23. **Addressing the problems of RBB and NBL tops the authorities' agenda.** With the assistance of the World Bank, the authorities are forming a new team of qualified international experts that will replace the management team for the RBB that earlier withdrew. The external managers for the banks are to prepare plans within 1-2 months which would lay out the process of (i) reviewing the banks' assets and liabilities within six months, and (ii) preparing the banks for divesting their state assets within two years.

24. **With regard to the divestment strategy, the team urged the authorities to consider all restructuring alternatives proposed by the external managers**, including the banks' liquidation or sales to strategic investors. It was also important that recapitalization of these banks should be considered only after their viable restructuring plans have been put in place. The authorities hoped that these two banks could be strengthened under external management and privatized rather than liquidated. They nonetheless stated that they would be open to all options recommended by the external managers.

25. **Another focus of financial sector reforms is the restructuring of the two government-owned development banks**—the Agricultural Development Bank of Nepal (ADBN) and the Nepal Industrial Development Corporation (NIDC). The AsDB is currently financing their external audits, and restructuring strategies should be adopted based on these

Box 5. Status of Key Financial Sector Reforms

The government's Financial Sector Strategy Statement—published in December 2000—focuses on:

- **Restructuring the two largest and insolvent commercial banks**, the state-owned RBB and the majority privately-owned NBL. Based on 1998 data (most recent study available), these two banks are estimated to have negative net worth of 7-9 percent of GDP. The restructuring would entail addressing the issue of nonperforming loans, reducing overstaffing, rationalizing branches, improving control mechanisms and risk assessment, and improving record-keeping. Possibilities of liquidation, merger, or sale to a strategic investor have not been ruled out. **Status**: Contracts have been signed with management teams for both banks. Managers for NBL took over management in July 2002. RBB managers withdrew from the contract they signed in January 2002, and a new team of experts is being assembled.

- **Identifying restructuring strategies for the two development banks**, ADBN and NIDC. **Status**: As a first step, AsDB is funding their audits.

- **Strengthening banking sector regulation and accounting and auditing standards** through introduction of internationally accepted standards and practices, including new bank prudential regulations. Also establishing regulation and supervision for nonbank deposit taking institutions. **Status**: New prudential regulations became effective July 2001, covering loan loss provisioning, capital adequacy, and code of ethics. Extension of the regulations to nonbanks is in progress.

- **Strengthening the central bank's supervisory capacities and its ability to enforce compliance with prudential regulations.** New NRB Act aims to enhance its autonomy, limit its role to central banking, terminate other current functions and provide legal powers to implement effective bank supervision. On-site and offsite supervision capacities are being improved by recruiting more qualified accountants, training, introducing a risk rating system, and expanding supervision to cover other financial institutions, especially development banks. **Status**: New NRB Act became effective February 2002. New financial reporting requirements are to be introduced and to take effect with the banks' 2001/02 accounts, allowing for more effective supervision. Supervision staff has increased and undertaking training. An action plan to "re-engineer" the NRB is being prepared.

- **Modernizing the legislative framework** to reduce the overlap and segmentation of institutions as well as strengthening corporate governance and the framework for loan recovery. **Status**: The new legislation (BFI Act) governing all deposit taking institutions would replace existing and overlapping laws and is expected to be submitted to Parliament's next session. A new insolvency act is under preparation.

- **Removing NRB and commercial banks from priority lending activity**. The NRB intends to divest its equity participation in microfinance institutions and development banks, and to phase out the role of commercial banks in poverty-oriented lending (priority and deprived sectors). **Status**: The NRB plans to gradually phase out priority sector lending requirement (which has been broadened and largely lost its original purpose), and to eliminate penalty for non-compliance. A framework for development of micro-finance is under consideration.

audits—the restructuring options include rationalizing the ADBN and closing the NIDC. These banks are known to be suffering from large amounts of nonperforming loans but because they are legally established under their own statutes, the NRB had not been able to assess the exact size of the problems nor take effective measures to address them. In the immediate future, the team stressed that ADBN and NIDC needed to be brought under direct NRB supervision by enacting the Banks and Financial Institutions (BFI) Act[9] as soon as a new parliamentary session was held. This Act would help the NRB to effectively oversee all banks and a wide range of financial institutions.

26. **The authorities confirmed that an action plan to restructure these banks would be prepared once AsDB-funded audits were completed later this fiscal year.** The authorities were also reviewing MAE comments on the draft BFI Act, and plan to submit it to parliament after the November elections. In the meantime, the NRB had already started to examine the two development banks and indicated that it would be able to supervise them fully as soon as the BFI Act was enacted.

27. **The NRB needs to be strengthened urgently.** The team stressed that the NRB needed to be better equipped to supervise not only the largest institutions but also 11 other commercial banks as well as smaller development banks. In this regard, the team welcomed the authorities' efforts to "re-engineer" the central bank to enhance its supervisory, accounting and auditing, and research capacities. The team encouraged early introduction of reform in human resource management which includes reorganization, a voluntary retirement scheme, a revised incentive structure, and a comprehensive training program. The authorities indicated their interest in continued Fund technical assistance in this area.

28. **The authorities intend to further liberalize the financial sector by reducing administrative control.** The 5 percent interest spread limit was eliminated last year. The team welcomed this action and encouraged the authorities to eliminate requirements that commercial banks extend concessional lending to support the government's priority sectors.[10] With the significant broadening of the definition of priority sectors, the requirement was no longer serving the original purpose of poverty reduction, but it still imposed administrative costs on a number of commercial banks. The authorities agreed with the team in principle but wanted to phase out the requirements over a number of years. As a first step, they agreed to remove the penalty for a quarter of the priority sector lending requirement early in 2002/03. This action *de facto* lowers the priority sector lending requirement to below 7 percent. Finally, the team recommended that the public sector withdraw from equity participation and representation at the boards of financial institutions.

[9] Previously called Deposit-Taking Institutions Act.

[10] Commercial banks are required to lend 9 percent of their total lending to "priority" sectors and additional 3 percent to "deprived" sectors. Failure to comply with these is subject to a penalty.

The NRB responded that it was already in the process of doing so but the Ministry of Finance presented no immediate plan to reverse the recent expansion of its appointees to joint venture commercial bank boards.

Trade Policy and Legal Reforms

29. **The authorities intend to further rationalize the import tariff structure and expedite WTO accession.** Import tariffs would be further restructured from the current five standard rates to four rates with a lower maximum rate of 30–35 percent. The exceptional tariff rates on vehicles (80 percent and 130 percent) would be converted into excises as recommended by this and previous Fund missions. The authorities, however, gave no firm time schedule to implement these reforms. The team also noted that new or additional trade taxes had been levied to finance security spending, and urged the authorities to rescind them as soon as the security situation improved. On WTO accession, negotiations with trade partners were ongoing. The authorities were waiting for responses from some of their key trade partners including India, their largest trade partner.

30. **There was agreement on the need for continued legal reforms to improve private business environment.** The authorities had already drafted an amended Companies' Act to separate ownership and management, better protect small shareholders, and mandate accounting and auditing based on international standards with AsDB technical assistance. Furthermore, preparations were underway to introduce an efficient insolvency law and a dispute resolution mechanism by establishing, inter alia, a commercial bench in the High Court. The team also pointed out that the Labor Act needed to be amended to allow firms to reduce labor employment in response to market forces.

Public Sector Reforms

31. **The team welcomed progress in public expenditure management reform.** The development budget for 2002/03 was prepared using a medium term expenditure framework (MTEF)—introduced with assistance from the World Bank—in which fiscal resources are allocated to programs in accordance with national and sector priorities. This exercise has kept the authorities focused on high priority activities and prevented them from overly inflating the budget.

32. **The civil service skill mix needed to be adjusted to realize efficient public service delivery.** The measures include (i) reducing the size of the lower-level nonprofessional cadre; (ii) contracting out some services to the private sector; (iii) removing duplication of functions; and (iv) introducing wages and incentives that reward performance. The authorities had maintained the hiring freeze without filling vacant posts—critical action for controlling wage growth and allowing room for future reorganization. In addition, the Ministries of Finance and General Administration contracted out some of their service work. The authorities had also nearly completed a new personnel information system based on the civil service census. This system allowed identification of some 17,000 vacant positions, and the administration proposed that the cabinet eliminate 7,500 of these positions. The team

strongly urged the cabinet to act on this proposal and also pointed out that an amendment to the Civil Service Act was needed to provide a framework that allowed for the elimination of positions including those made redundant by outsourcing service work. The authorities agreed that these steps were critical to improving the public sector and announced elimination of the 7,500 vacant positions by October. They, however, stated that the amendment of the Civil Service Act needed preparation and would have to wait until the November elections.

33. **Implementation of public enterprise reforms had stalled and needed to be reinvigorated**. It was important that the authorities move ahead with privatizing seven public enterprises included in the "active" list as enterprise finances were deteriorating and liabilities growing rapidly. Overdue workers' allowances for five closed (but not liquidated) small enterprises suggested that these liabilities could be substantial. The authorities responded that they could not resolve these liabilities due to the tight fiscal situation unless donors came forward with financial support. The team suggested the use of government bonds to clear these liabilities and incorporate these bonds in the fiscal planning. For all other public enterprises, there was need to assess the size of liabilities to workers, banks, and suppliers in coming months. Larger firms that were to remain in the public sector for the immediate future, such as Nepal Oil Corporation, Agricultural Inputs Corporation, Nepal Electricity Authority, Nepal Telecommunication Corporation, and Royal Nepal Airlines, should be required to adopt internationally accepted accounting standards, issue annual reports, and be subject to more extensive audits.

34. **The authorities have decided to promote decentralization to improve service delivery**. The team agreed that this was an important move toward effective poverty alleviation but stressed that decentralization could succeed only if administrative capacity existed and there was adequate monitoring and accountability. There was agreement that a move towards decentralization should focus on monitorable and well-defined activities—as seen in the ongoing efforts to transfer a limited number of primary schools and sub-health posts to local communities. The central government has, however, recently decided to appoint local government leaders until nationwide local elections, postponed earlier due to fighting in some districts, could be held. This action will likely reduce the effectiveness of the ongoing decentralization process significantly.

35. **The team welcomed the increased attention given to improving governance.** Improved availability of information would be one of key prerequisites for strengthening governance. In this regard, the authorities acknowledged the need to enhance central and local government reporting and introduce international accounting and auditing practices at not only public enterprises but also large private firms (e.g., those listed at the stock exchange). The team also welcomed the quick passage of the four anti-corruption bills by

Parliament in April.[11] It was important that these acts are translated into effective preventive, control, and enforcement mechanisms, and address major corruption issues on the ground. There was agreement on the need to sequence measures so as not to overload the new institutions and spread their resources too thinly as was the case with the Asset Investigation Commission—it was given a broad mandate to investigate 80,000 present and previous officials. Anti-corruption measures would be much more effective if investigation began with a narrower and more visible group of senior officials.

Poverty Reduction

36. **The content of the final draft of the full PRSP was discussed**. The authorities are aiming to finalize the draft in August. The main elements of the poverty alleviation strategy in the draft are to: (i) achieve high rates of growth; (ii) improve agricultural productivity; (iii) promote private sector development based on improved governance; (iv) invest in and maintain priority infrastructure; (v) improve the quality of and access to education and health services; and (vi) design targeted programs for the particularly disadvantaged. The team agreed with the authorities that the PRSP would form the basis for a prospective PRGF program.

37. **The PRSP objectives have guided the authorities' public expenditure prioritization**. Greater emphasis has been placed on projects that will reap the highest return for agricultural productivity and promote private sector development. The authorities have increased per capita social sector spending emphasizing primary education and basic health care, although the recent increase in security spending has made this task a challenge. A number of programs provide income transfers targeted to the very poor, often with donor assistance, and encourage the use of micro credits to fund livestock and cash crop activities in the hill regions. The recently established Poverty Alleviation Fund (PAF), to be funded by government and donor resources, is expected to coordinate these efforts and provide grants for targeted income transfers and human capital development. It would also extend the reach of micro credit to remote areas. The PAF is, however, not yet operational pending further parliamentary approval and commitments of donor resources. The team stressed the need for accountability and transparency in the operation of the PAF, which is independent of annual budgets, and emphasized that it should be incorporated into the budget process as soon as necessary capacity is developed within the government.

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[11] They were: the Anti-Corruption Act (requiring disclosure of assets of public servants); the Committee for Investigating Abuse of Authority (CIAA) Act (broadening its mandate); the Special Courts Act; and the Impeachment Act.

D. Other Issues

PRGF Process

38. **While the policies described above provide a possible framework for a PRGF program, the team stated that a more settled political and security environment was needed before concluding negotiations on a program.** The staff stressed that continued implementation of strong structural reforms and maintenance of macroeconomic stability between now and the November election and movement toward a greater internal security would contribute to early completion of PRGF negotiations. The authorities responded that, even though the current government was a caretaker, its commitment to the reform program and implementation capacity had not been compromised. Furthermore, they stressed that the general thrust of economic policy of all mainstream political parties was similar.

Safeguards Assessment

39. **The NRB is subject to a full safeguards assessment with respect to any new prospective PRGF arrangement.** The assessment was conducted during July 3-16, 2002. A draft report, submitted to the authorities for their comments, recommends the adoption of a strong external audit mechanism, preparation of financial statements in accordance with International Accounting Standards, strengthening of the internal audit function, and improvement of the internal control structure at the NRB. Based on these recommendations, specific measures will be proposed for inclusion under the prospective new PRGF program. The final safeguards assessment report is expected to be submitted to the authorities later in August 2002.

Foreign Exchange Restrictions

40. **Nepal accepted the obligations of Article VIII, Sections 2, 3 and 4 in May 1994.** It maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions with the following exception. There are quantitative limits on the availability of foreign exchange for personal travel abroad and bona fide requests for amounts in excess of these limits are not granted, which constitutes a restriction subject to Fund jurisdiction under Article VIII. These limits are set at $2000 per fiscal year per person for North America, Western Europe, Australia and Japan and $1000 per fiscal year per person for all other destinations. The authorities note that these limits have been in place since Nepal accepted Article VIII status in 1994, that they increased these limits in 2001, and that all other current payments and transfers based on bona fide requests are permitted without limits. They also believe that these limits are high in light of Nepal's low per capita income and are concerned that these payments have often been a conduit for capital flight. Nevertheless, the staff urged the authorities to remove these restrictions as soon as possible.

Data Issues

41. **Severe weaknesses remain in economic statistics that impair effective policy formulation and monitoring.** Particularly problematic are coverage and estimation of balance of payments data given large informal trade and unreported workers' remittances as well as inadequate and late reporting by commercial banks and other financial institutions. The staff urged the authorities to continue to make efforts to implement recommendations of past STA missions and, in particular, ongoing STA technical assistance on compilation of balance of payments data. The team also encouraged the authorities to disseminate debt and international liquidity information as per the Fund's benchmarks. Further improvements in fiscal data and strengthening in general of the statistical office with donor support would be needed in the medium term. It was hoped that the ongoing reform in the NRB and the commercial banking sector would also improve timely availability of accurate financial and monetary statistics.

V. Staff Appraisal

42. **Despite several decades of development efforts assisted by significant foreign aid, income per capita in Nepal remains among the lowest in the world and poverty is pervasive.** The full PRSP being finalized by the authorities in partnership with civil society and the donor community recognizes that the alleviation of poverty requires the maintenance of macroeconomic stability and the implementation of a comprehensive reform program to lay the foundations for sustained growth. The program appropriately focuses on improving agricultural productivity, promoting more efficient resource allocation, especially in the financial sector and public service delivery, and strengthening governance. The next challenge is implementation, which requires a more settled political and security environment.

43. **Despite a deterioration in the political and security situation, the authorities have made good efforts at maintaining relatively low inflation and pushing forward with structural reforms.** However, economic activity has been severely disrupted by the internal security situation, which was exacerbated by external shocks. Looking ahead, the near-term prospects for growth are vulnerable to downside risks: the impact of the insurgency on production, exports, and tourism; a weaker than expected global recovery; and the bilateral trade treaty with India which is expected to slow exports to Nepal's key market.

44. **The authorities are encouraged to build on the PRSP process to push forward the program for growth and poverty reduction.** In implementing the 2002/03 budget, the focus should be on containing domestic borrowing, prioritizing spending, and mobilizing revenue. Given resource constraints, spending should be allocated to activities that contribute to enhancing growth and improving access of the poor to social services. Strict expenditure control is also needed, through linking fund release with monitoring performance. Strong collection efforts would be needed to realize the optimistic revenue forecast in the budget. Furthermore, in the event that revenue and foreign financing assumed in the budget are not

realized, lower priority spending will need to be cut further rather than relying on increased domestic borrowing.

45. **In the medium term, revenue mobilization needs to be strengthened further.** Nepal has a relatively robust tax system for its income level but collection is low. The focus should be on improving tax and customs administration, particularly enforcing invoicing requirements, increasing the frequency and quality of audits for large taxpayers, tighter check on import valuation, and raising the number and quality of staff assigned to the tax office.

46. **The staff continues to support the peg of the Nepalese rupee to the Indian currency, given Nepal's close economic links with India.** Although export performance was weak this year, this was mainly due to supply disruptions and weak external demand, and the exchange rate remains broadly appropriate. The authorities' monetary policy for 2002/03, which targets monetary growth consistent with a domestic inflation rate broadly in line with that in India, is appropriate.

47. **Notwithstanding strong resistance, the authorities have made significant progress in financial sector reform.** The highest priority remains addressing the problems of the two largest and insolvent commercial banks by having external managers review existing portfolios and prepare the banks for divesting all state assets within two years. A new external management team needs to be selected expeditiously to replace the consultants who withdrew from the RBB contract. It is important for the authorities to consider all restructuring alternatives proposed by the external managers. The restructuring of the two large development banks is also a priority. The restructuring options should include rationalization of ADBN and closure of NIDC. In addition, the staff calls for vigilance about the quality of bank lending and strengthening of the central bank's supervisory capacity.

48. **The staff commends the maintenance of Nepal's open trade and investment regime under difficult conditions.** In this regard, the authorities' plan to further reduce the maximum tariff rate is welcome, and the staff urges the conversion into excises of the exceptionally high tariff on vehicles imposed two years ago.

49. **Implementation of public sector reforms needs to be strengthened.** A good start was made in reducing the overemployment of lower-level civil servants—including maintaining the hiring freeze, contracting out some service work, implementing an early retirement scheme, and identifying vacant positions to be eliminated. These efforts need to be followed through and incentives for professional staff should be improved. Efforts to privatize public enterprises slated for early sale need to be revived, and the financial situation of other public enterprises assessed with a view to making decisions on future privatization.

50. **The authorities' efforts to improve governance and implement anti-corruption measures are welcome.** Better monitoring of central and local government activities is critical for improved fiscal transparency. Improved corporate governance would be facilitated by the adoption of internationally accepted accounting and auditing standards at large private and public firms. The staff welcomes the authorities' more directed anti-

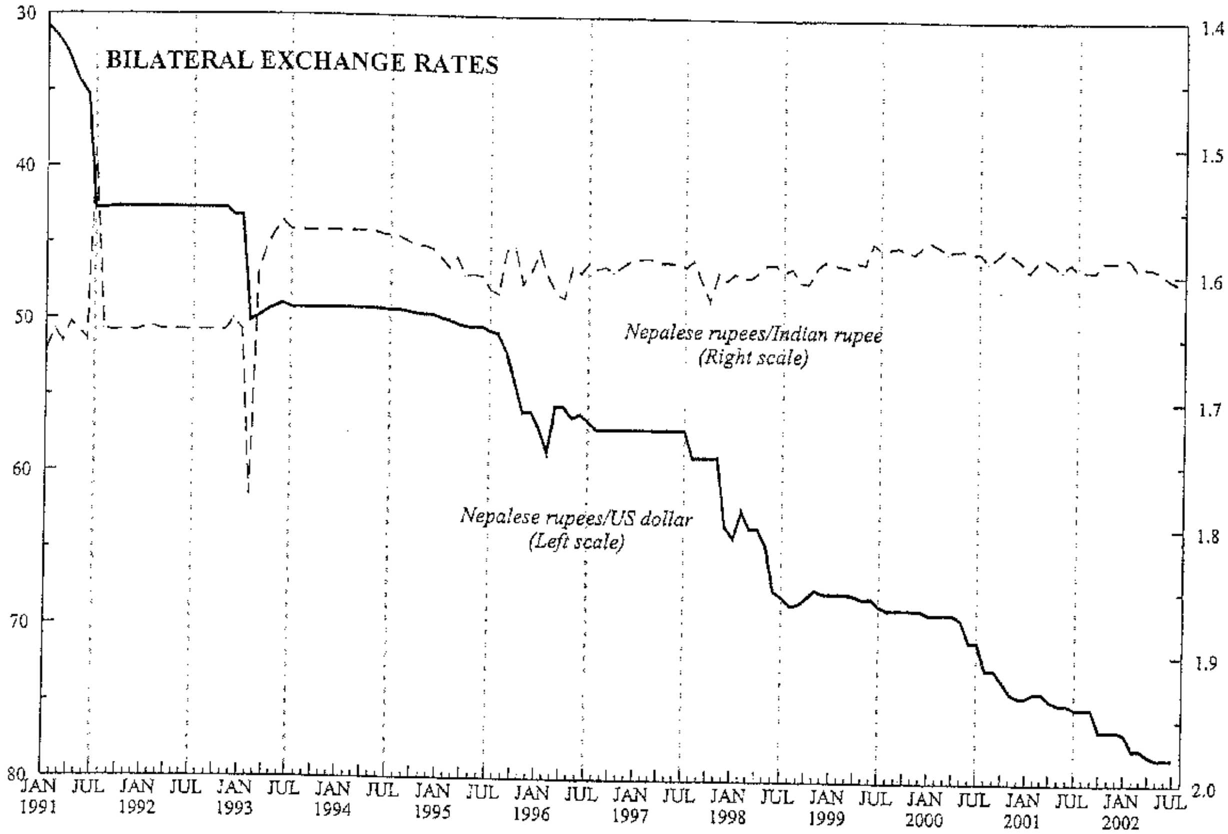
corruption efforts that will focus on largest loan defaulters and those responsible for misuses of largest public funds.

51. **There are serious deficiencies in official statistics that impede effective policy formulation and monitoring.** The authorities are encouraged to implement recommendations made by past STA missions and the BOP expert currently working with them. Considerable donor support will continue to be needed to strengthen the limited capacity of the national statistics office in the medium run.

52. **Nepal maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions except for restrictions on payments for personal travel.** The staff urges the authorities to remove these restrictions as soon as possible.

53. It is proposed that the next Article IV consultation with Nepal take place on the standard 12-month cycle.

Figure 1. Nepal: Exchange Rates



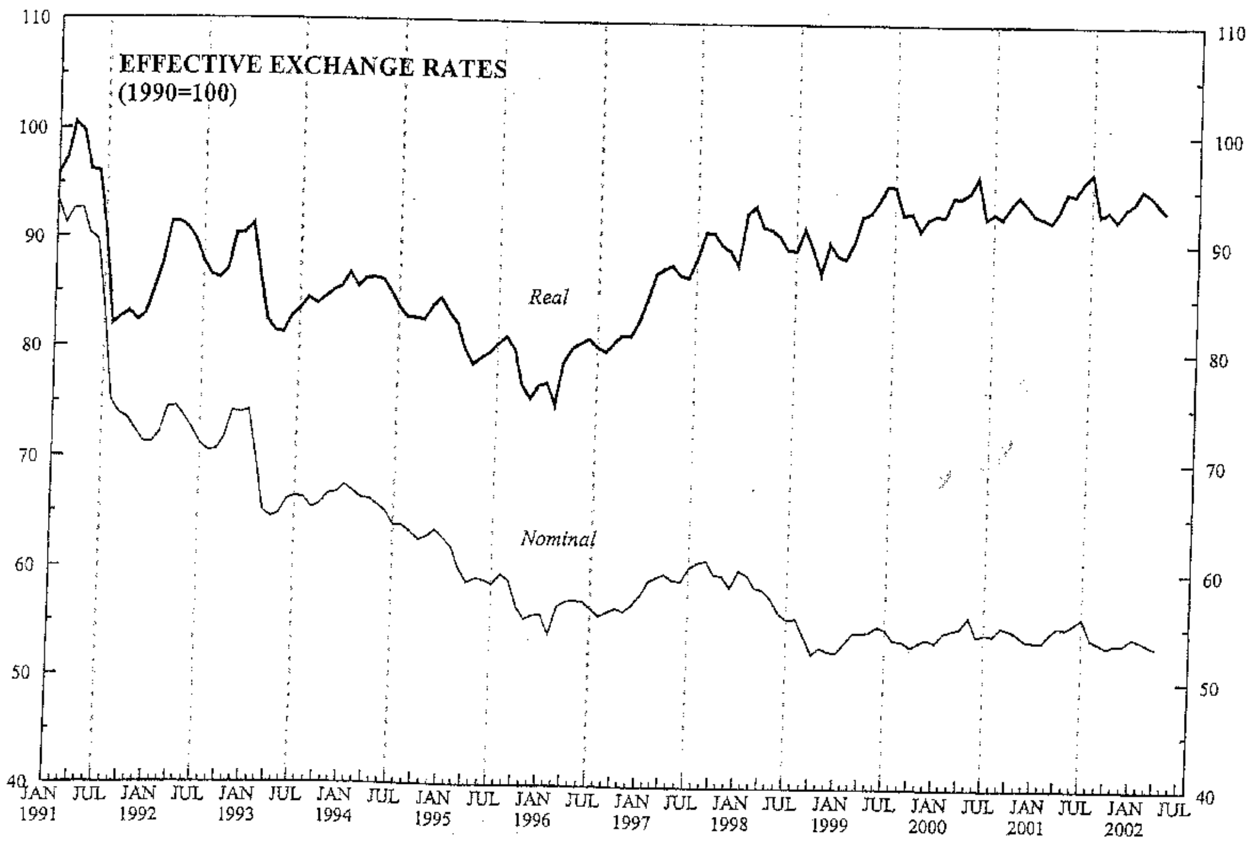


Table 1. Nepal: Selected Economic Indicators, 1997/98–2002/03 1/

Nominal GDP (2000/01): US$5,554 million
Population (2000/01): 23.2 million

	1997/98	1998/99	1999/00	2000/01	2001/02 Prel.	2002/03 Proj.
Real GDP at market prices	2.9	4.5	6.2	4.8	0.8	3.8
Savings and investment (percent of GDP)						
Gross investment	24.8	20.5	24.2	24.3	23.6	25.4
National savings	22.1	21.0	24.7	25.4	24.6	25.6
Of which: Public savings	1.3	0.9	1.1	0.2	-1.0	-0.9
Prices (percent change)						
Consumer prices (end-of-period/12-month)	12.0	9.0	0.6	3.4	3.5	4.3
CPI (average)	8.3	11.4	3.4	2.4	2.9	4.0
GDP deflator	4.2	8.8	4.4	3.1	3.5	4.3
Government budget (percent of GDP) 2/						
Total revenue	10.5	10.2	10.7	11.4	11.4	11.6
Total expenditure	16.8	15.4	15.7	17.6	17.4	17.5
Current expenditure	9.2	9.3	9.6	11.2	12.3	12.5
Capital expenditure and net lending	7.6	6.1	6.1	6.4	5.0	5.0
Overall deficit after grants	4.5	3.9	3.5	4.5	4.0	3.6
Overall deficit before grants	6.3	5.2	5.0	6.2	6.0	6.0
Domestic financing (net)	0.6	1.4	0.9	2.7	2.6	2.3
Money and credit (percent change; end-of-period)						
Broad money	21.9	20.8	21.8	15.3	6.2	11.5
Domestic credit	14.8	16.1	17.8	18.9	10.3	11.9
Interest rates						
91-day treasury bill (end-of-period) 3/	2.4	3.1	5.4	5.0	3.6	...
Central bank refinancing 3/	9.0	9.0	6½–7½	6½–7½	2–5½	...
Loans to industry 3/	13½–17	11½–17	10½–15½	7–15	7–17	...
External trade (percent change)						
Export value 4/	11.9	17.9	37.4	4.6	-15.0	-0.4
Import value 5/	7.1	-1.9	27.6	6.7	-9.9	6.6
Balance of payments (U.S. dollars million)						
Current account balance (excluding grants)	-135	24	28	64	54	13
(in percent of GDP)	-2.8	0.5	0.5	1.1	1.0	0.2
Overall balance	184	136	192	38	-77	60
Other external indicators						
Gross official reserves (U.S. dollars million; end-of-period)	716	795	946	1,021	1,056	1,101
In months of imports of goods and services 6/	5.3	4.9	5.6	6.7	6.5	6.3
Of which: In convertible currencies	4.1	4.4	4.6	4.8	4.5	4.4
Public and public guaranteed debt/GDP (in percent)	49.7	50.3	48.2	47.1	48.1	47.5
Debt service 7/	4.7	5.0	4.7	6.0	5.2	5.6
National currency per U.S. dollar (end-of-period)	67.9	68.5	70.8	74.7	78.3	...
REER (end-of-period; percent change; - = depreciation)	-1.0	7.3	-2.2	0.8	...	...
NEER (end-of-period; percent change)	-7.8	-1.5	-0.7	1.5	...	...
Fund operations (outstanding loans at end-of-period; SDR million)						
SAF/ESAF	19.6	14.7	10.6	6.6	3.2	0.4
Nominal GDP at market prices (Nrs billion)	301	342	380	410	428	463

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

1/ Fiscal year ends July 15.

2/ Staff estimate for 200203, not the budget target.

3/ Estimates for 2001/02 refer to June.

4/ Cumulative, excluding re-exports.

5/ Cumulative, excluding gold.

6/ Ratio is in terms of projected imports of goods and services.

7/ In percent of exports of goods, services, and private transfers; including debt service to the Fund.

Table 2. Nepal: Summary of Government Operations 1999/2000-2002/03 1/

	1999/00	2000/01		2001/02		2002/03
	Actual	Budget	Actual	Budget	Est. 2/	Budget 2/
	(In billions of Nepalese rupees)					
Total revenue and grants	46.4	62.3	53.6	72.2	57.3	70.2
Total revenue	40.7	50.4	46.8	58.1	48.6	55.6
Tax revenue	33.2	42.5	38.9	47.2	40.4	45.9
Nontax revenue	7.6	7.9	8.0	10.9	8.2	9.7
Grants	5.7	11.8	6.8	14.1	8.7	14.6
Total expenditure	59.8	82.4	72.1	90.1	74.3	86.2
Current 3/	36.5	47.7	45.8	53.0	52.7	61.1
Capital and net lending 3/	23.3	34.7	26.3	37.1	21.6	25.1
Overall balance before grants	-19.0	-32.0	-25.3	-32.0	-25.7	-30.6
Overall balance after grants	-13.3	-20.1	-18.5	-17.9	-17.0	-16.1
Financing	13.3	20.1	18.5	17.9	17.0	16.1
Net foreign loans	10.0	14.5	7.5	10.6	5.9	6.4
Gross disbursements	13.7	19.8	12.0	16.4	10.9	12.4
Amortization	3.7	5.3	4.5	5.8	5.0	6.0
Net domestic financing	3.4	5.6	11.0	7.3	11.1	9.7
Net NRB financing	-2.1	-0.3	3.0	...	2.3	...
Net commercial bank	5.5	2.5	7.2	...	5.4	...
Net nonbank	-0.1	3.4	0.7	...	3.4	...
	(In percent of GDP)					
Total revenue	10.7	12.0	11.4	12.8	11.4	11.9
Tax revenue	8.7	10.1	9.5	10.4	9.4	9.8
Nontax revenue	2.0	1.9	1.9	2.4	1.9	2.1
Grants	1.5	2.8	1.6	3.1	2.0	3.1
Total expenditure	15.7	19.5	17.6	19.8	17.4	18.4
Current 3/	9.6	11.3	11.2	11.6	12.3	13.0
Capital and net lending 3/	6.1	8.2	6.4	8.1	5.0	5.4
Overall balance before grants	-5.0	-7.6	-6.2	-7.0	-6.0	-6.5
Overall balance after grants	-3.5	-4.8	-4.5	-3.9	-4.0	-3.4
Financing	3.5	4.8	4.5	3.9	4.0	3.4
Net foreign loans	2.6	3.4	1.8	2.3	1.4	1.4
Gross disbursements	3.6	4.7	2.9	3.6	2.6	2.6
Amortization	1.0	1.3	1.1	1.3	1.2	1.3
Net domestic financing	0.9	1.3	2.7	1.6	2.6	2.1
Central bank financing	-0.6	-0.1	0.7	...	0.5	...
Commercial Bank financing	1.5	0.6	1.8	...	1.3	...
Nonbank financing	0.0	0.8	0.2	...	0.8	...
Memorandum items:						
Public savings (percent of GDP)	1.1	0.6	0.2	1.1	-1.0	-1.2
Regular expenditure (percent of GDP) 3/	7.7	8.7	9.0	9.2	10.3	10.5
Development expenditure (percent of GDP) 3/	8.0	11.4	8.5	10.6	7.1	7.9
Education expenditure (percent of GDP)	2.4	2.8	2.7	3.1	3.0	3.0
Health expenditure (percent of GDP)	0.9	1.1	0.9	1.1	1.0	1.0
Nominal GDP (billions Nrs)	380	422	410	455	428	469

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

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

2/ Based on the Budget Speech, delivered on July 8, 2002. However, expenditures in the estimate in 2001/02 reflects staff estimate as the detailed expenditure items were not available at the time of the 2002/03 budget speech.

3/ Current and capital and net lending expenditures are based on new economic classification provided by the authorities and staff estimates. The traditional presentation is in terms of regular and development expenditures.

Table 3. Nepal: Balance of Payments, 1997/98-2004/05

(In millions of U.S. dollars)

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	20004/05
					Prel.		Proj. 1/	
Exports, f.o.b.	856	763	971	942	762	782	836	902
Merchandise exports	445	525	722	755	642	639	685	743
Re-exports	411	238	250	187	121	143	150	159
Imports, c.i.f.	1,551	1,390	1,713	1,774	1,605	1,707	1,826	1,969
Oil products	259	219	276	338	268	317	315	332
Other imports	1,293	1,171	1,437	1,436	1,337	1,390	1,511	1,637
Trade balance	-695	-627	-742	-832	-843	-925	-990	-1,067
Services (net)	205	313	273	216	186	185	195	200
Receipts	436	545	513	477	419	432	457	484
Of which, tourism	160	179	175	159	105	110	123	138
Payments	231	232	240	261	234	247	262	284
Private Transfers (net)	355	338	497	680	711	752	796	846
Remittances receipts	383	354	524	699	753	797	842	895
Recorded	138	188	224	290	334	360	393	432
Estimated	245	166	300	409	420	436	449	463
Payments	28	16	27	19	42	44	46	49
Current account balance (excl. official transfers)	-135	24	28	64	54	13	0	-20
Official Transfers 2/	88	69	85	94	112	133	139	146
Current account balance (incl. official transfers)	-48	93	114	158	166	145	139	126
Capital grants	286	211	156	78	43	38	39	39
Of which, Official grants 2/	17	13	17	18	23	28	29	29
Net official disbursements	186	127	144	103	78	73	87	102
Disbursements	229	174	198	164	144	147	167	170
Amortization	44	47	53	61	66	73	81	67
Foreign direct investment	11	9	3	6	6	15	30	40
Net other investment 3/	-121	-157	-181	-169	-175	-165	-165	-165
Errors and omissions	-131	-146	-44	-138	-194	-47	-57	-67
Overall balance	184	136	192	38	-77	60	72	75
Financing	-184	-136	-192	-38	77	-60	-72	-75
Change in reserves (- increase)	-171	-160	-214	-76	85	-66	-80	-85
IMF purchases (net)	-7	-5	-5	-4	-4	-4	-2	0
Other liabilities	-6	29	21	42	-4	10	10	10
Financing gap	0	0	0	0	0	0	0	0
Memorandum items:								
Current account (excl. official transfers) 4/	-2.8	0.5	0.5	1.1	1.0	0.2	0.0	-0.3
Current account (incl. official transfers) 4/	-1.0	1.8	2.1	2.8	2.9	2.5	2.2	1.8
Gross foreign assets (end of period)	973	1,133	1,347	1,423	1,338	1,404	1,484	1,569
o/w: Central Bank	716	795	946	1,021	1,056	1,101	1,164	1,230
(in months of imports of g&s)	5.3	4.9	5.6	6.7	6.5	6.3	6.2	5.9
(o/w: in convertible currencies)	4.1	4.4	4.6	4.8	4.5	4.4	4.3	4.1
Short-term debt / Gross foreign assets of NRB 5/	29.0	28.8	26.1	21.8	20.2	20.4	19.1	21.8
Total debt 4/	52.8	53.7	51.6	49.9	50.6	50.0	47.9	46.0
Debt service 6/	4.7	5.0	4.7	6.0	5.2	5.6	5.6	4.8
Projected percentage change in oil price (U.S. dollars)	-18.1	-18.4	84.2	13.3	-18.2	11.6	-8.8	-3.6

1/ Reflects assumptions under the base-case scenario, i.e. improvement in the security situation in the second half of 2002/03.

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

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

4/ As percent of GDP

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

6/ As a ratio of exports of goods and services (excluding reexports of oil) and private transfer receipts.

Table 4. Nepal: Monetary Accounts, 1998-2001 and Targets for 2002-2003

	1998 July	1999 July	2000 July	2001 July Revised	2001 Oct Provisional 1/	2002 Jan	2002 Apr	2002 Jun	2002 Jul Projection	2003 Jul
Monetary authorities					(In billions of Nepalese rupees)					
Net foreign assets 2/	46.4	52.6	65.3	75.0	76.7	81.8	80.1	81.4	81.3	87.0
Net domestic assets	-0.4	-0.4	-4.3	-4.2	-3.8	-11.8	-6.0	-5.9	-5.8	-3.5
Net credit to government	18.5	18.4	16.4	19.4	23.2	13.6	18.3	19.8	22.9	22.9
Reserve money	46.0	52.2	61.0	70.8	72.9	70.0	74.1	75.5	75.5	83.5
					(12 month change in percent of reserve money at start of period)					
Net foreign assets	18.3	14.6	23.1	19.2	17.2	22.3	9.0	8.7	8.9	7.5
Net domestic assets	-6.2	-1.0	-6.3	-3.2	-5.7	-16.3	1.0	-2.5	-2.2	3.1
Net claims on government	-0.9	-0.2	-3.8	4.9	5.4	-8.2	-1.5	0.6	4.9	0.0
Reserve money	12.1	13.5	16.8	16.0	11.5	6.0	10.0	6.2	6.7	10.6
Monetary survey					(In billions of Nepalese rupees)					
Net foreign assets	55.6	65.0	80.5	87.8	88.2	87.6	84.0	85.5	85.3	92.2
Net domestic assets	70.9	87.8	105.7	126.9	127.3	133.6	137.4	140.7	142.8	162.0
Domestic credit	112.8	131.0	154.4	183.4	190.5	193.1	192.0	196.8	202.4	226.4
Public sector	29.8	32.6	36.4	47.0	48.5	46.8	49.1	55.7	55.5	61.8
Government	28.8	31.1	34.6	44.8	46.8	45.1	46.7	52.7	53.3	59.3
Public enterprises	1.1	1.6	1.8	2.2	1.7	1.7	2.4	3.0	2.3	2.5
Private sector	83.0	98.3	118.0	136.5	142.0	146.3	142.9	141.1	146.8	164.6
Other items, net	-41.9	-43.2	-48.7	-56.6	-63.2	-59.5	-54.6	-56.1	-59.6	-64.3
Broad money	126.5	152.8	186.1	214.7	215.5	221.2	221.4	226.2	228.0	254.3
Narrow money	45.2	51.1	61.0	70.8	71.6	74.4	76.5	77.5	77.9	86.0
Quasi money	81.3	101.7	125.1	143.9	143.9	146.8	144.9	148.7	150.2	168.2
					(Annual percentage change)					
Domestic credit	14.8	16.1	17.8	18.9	18.8	14.8	11.6	11.1	10.3	11.9
Public sector	5.8	9.4	11.6	29.1	32.1	25.6	23.4	28.8	18.2	11.3
Government	8.2	8.0	11.4	29.4	32.5	27.4	24.1	29.5	19.0	11.3
Private sector	18.4	18.5	19.9	15.7	14.9	11.7	8.1	5.4	7.6	12.1
Broad money	21.9	20.8	21.8	15.3	12.5	11.0	7.4	8.7	6.2	11.5
Narrow money	17.4	13.1	19.4	16.1	12.7	13.4	12.1	11.1	10.0	10.5
Quasi money	24.6	25.1	23.0	15.0	12.4	9.8	5.1	7.1	4.4	12.0
					(12 month change in percent of broad money at start of period)					
Net foreign assets	9.7	7.8	9.5	3.9	1.7	0.4	-1.2	-0.4	-1.2	3.1
Net domestic assets	12.3	13.1	12.3	11.4	10.8	10.6	8.6	8.0	7.4	8.4
Domestic credit	14.0	14.4	15.3	15.6	15.7	12.5	9.7	7.8	8.8	10.5
Public sector	1.6	2.2	2.5	5.7	6.2	4.8	4.5	3.8	4.0	2.8
Private sector	12.4	12.1	12.8	9.9	9.6	7.7	5.2	4.1	4.8	7.8
Memorandum items:										
Velocity of broad money	2.38	2.24	2.04	1.91	...	...	...	...	1.88	1.82
Percent change	-5.9	-8.9	-8.9	-6.3	...	...	...	...	-1.8	-2.9
Velocity (narrow money)	6.66	6.70	6.22	5.80	...	...	...	...	5.50	5.39
Money multiplier	2.75	2.93	3.05	3.03	2.96	3.16	2.99	2.99	3.02	3.04
Percent change		6.4	2.9	1.5	...	...	...	...	-0.4	0.8
Nominal GDP growth (%)	7.2	13.7	11.0	8.1	...	...	...	...	4.4	8.3
Currency/deposits (%)	32.3	29.7	29.3	29.2	31.1	31.3	33.4	...	...	...
Reserves/deposits (%)	14.3	13.1	11.6	12.3	11.3	8.5	10.5	...	...	...
Excess reserves/deposits (%)	4.3	3.1	1.6	3.2	1.9	0.3	2.2	...	...	...
Loan to deposit ratio (%)	86.5	83.7	82.0	81.5	87.3	87.5	86.1	...	...	...
Share of foreign currency deposits (%)	8.3	8.7	8.4	9.5	9.2	9.1	10.1	...	...	...

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

1/ Commercial banking deposit and lending data is typically subject to upward revision due to some reporting lags.
2/ Assumes increase in NRB's NFA of $38 million in 2001/02 and $45 million in 2002/03.

Table 5. Nepal: Medium-Term Scenarios, 1997/98–2004/05

(In percent of GDP, unless otherwise indicated)

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
							Projections	
				(Base Case Scenario)				
Real sector								
Real GDP growth (percent change)	2.9	4.5	6.2	4.8	0.8	3.8	5.5	6.0
Agriculture	0.9	2.9	4.9	4.3	1.7	3.3	4.0	4.0
Non-agriculture	5.0	5.6	7.1	5.1	0.2	4.1	6.4	7.2
GDP deflator (percent change)	4.2	8.8	4.4	3.1	3.5	4.3	4.5	4.7
Real per capita GDP (percent change)	0.5	2.1	3.6	2.1	-1.7	1.2	3.0	3.5
National savings	22.1	21.0	24.7	25.4	24.6	25.6	25.9	26.6
Public 1/	1.3	0.9	1.1	0.2	-1.0	-0.9	-0.4	0.2
Private	20.7	20.1	23.6	25.2	25.5	26.5	26.3	26.4
Gross investment 2/	24.8	20.5	24.2	24.3	23.6	25.4	25.9	26.9
Public 1/	7.6	6.1	6.1	6.4	5.0	5.0	5.3	5.5
Private 2/	17.2	14.4	18.0	17.8	18.6	20.4	20.6	21.4
Fiscal Sector 3/								
Total revenue	10.5	10.2	10.7	11.4	11.4	11.6	11.9	12.3
Grants	1.8	1.3	1.5	1.6	2.0	2.4	2.3	2.3
Current expenditure 4/	9.2	9.3	9.6	11.2	12.3	12.5	12.2	12.1
Capital expenditure & net lending 4/	7.6	6.1	6.1	6.4	5.0	5.0	5.3	5.5
Overall balance before grants	-6.3	-5.2	-5.0	-6.2	-6.0	-6.0	-5.6	-5.3
Overall balance after grants	-4.5	-3.9	-3.5	-4.5	-4.0	-3.6	-3.3	-3.0
Net foreign financing (including grants)	5.6	3.8	4.1	3.5	3.4	3.6	4.5	4.8
Net domestic debt financing	0.6	1.4	0.9	2.7	2.6	2.3	1.1	0.5
External sector								
Export value (percent change) 5/	11.9	17.9	37.4	4.6	-15.0	-0.4	7.2	8.4
Import value (percent change) 6/	7.1	-1.9	27.6	6.7	-9.9	6.6	7.2	8.1
External current account balance	-2.8	0.5	0.5	1.1	1.0	0.2	0.0	-0.3
Overall balance	3.8	2.7	3.5	0.7	-1.4	1.0	1.1	1.1
Financing gap (million US$)	...	...	...	...	0	0	0	0
Gross official reserves (millions US$)	716	795	946	1,021	1,056	1,101	1,164	1,230
(in months of imports of goods and services)	5.3	4.9	5.6	6.7	6.5	6.3	6.2	5.9
(*Of which*: in convertible currencies)	4.1	4.4	4.6	4.8	4.5	4.4	4.3	4.1
External public debt (millions US$)	2,415	2,533	2,651	2,630	2,714	2,792	2,880	2,989
External public debt	49.7	50.3	48.2	47.1	48.1	47.5	45.5	43.5
Debt service ratio	4.7	5.0	4.7	6.0	5.2	5.6	5.6	4.8
Monetary sector 7/								
Broad money (percent change)	21.9	20.8	21.8	15.3	6.2	11.5	15.0	16.5
Private sector credit (percent change)	18.4	18.5	19.9	15.7	7.6	12.1	6.5	20.1
				(Low Case Scenario)				
Real sector								
Real GDP growth (percent change)	2.9	4.5	6.2	4.8	0.8	2.5	2.8	2.8
Agriculture	0.9	2.9	4.9	4.3	1.7	2.8	2.9	2.9
Non-agriculture	5.0	5.6	7.1	5.1	0.2	2.3	2.7	2.7
Real per capita GDP (percent change)	0.5	2.1	3.6	2.1	-1.7	0.1	0.3	0.3
Gross investment 2/	24.8	20.5	24.2	24.3	24.0	23.0	21.0	21.0
Fiscal Sector								
Total revenue	10.5	10.2	10.7	11.4	11.4	11.0	11.0	11.0
Current expenditure 4/	9.2	9.3	9.6	11.2	12.3	12.5	12.8	13.0
Public savings 1/	1.3	0.9	1.1	0.2	-1.0	-1.5	-1.8	-2.0
Overall fiscal balance before grants	-6.3	-5.2	-5.0	-6.2	-6.0	-7.0	-7.2	-7.0
Net domestic financing	0.6	1.4	0.9	2.7	2.6	3.9	4.2	4.2
Net foreign financing (including grants)	5.6	3.8	4.1	3.5	3.4	3.1	3.0	2.8
External sector								
External current account balance	-2.8	0.5	0.5	1.1	1.0	-3.2	-3.4	-3.6
Gross official reserves (millions US$)	716	795	946	1,021	1,056	998	1,003	979
(in months of imports of goods and services)	5.3	4.9	5.6	6.7	6.5	4.8	4.6	4.0
(*Of which*: in convertible currencies)	4.1	4.4	4.6	4.8	4.5	3.9	3.7	3.2
External public debt (millions US$)	49.7	50.3	48.2	47.1	48.1	50.1	52.1	54.1
Debt service ratio	4.7	5.0	4.7	6.0	5.2	6.0	6.4	6.8

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

1/ Public savings and investment estimate derived from fiscal accounts. Gross investment derived from national income accounts.

2/ Historical totals include changes in stocks.

3/ Staff estimate for 2002/03, not the budget target.

4/ From 2002/03, current includes interest cost of restructuring bonds.

5/ Excluding re-exports.

6/ Excluding gold.

7/ Excludes possible balance sheet impact of restructuring RBB and NBL, but included in fiscal projection.

Table 6. Nepal: Vulnerability Indicators, 1995/96–2000/2001

(In percent of GDP, unless otherwise indicated)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01
Official risk indicators						
Share of nonperforming loans (as percent of total loans)						
Rastriya Banjiya Bank 1/ 2/	31.0	40.0	36-45	...	...	...
Nepal Bank Ltd.	17.5	24.6	28-34	...	...	...
Financial sector risk indicators						
Public and public guaranteed debt 3/	65.9	62.2	64.6	64.8	62.7	63.4
Broad money (percent change, 12-month basis)	14.4	11.9	21.9	20.8	21.8	15.3
Private sector credit (percent change, 12-month basis) 4/	30.6	17.3	18.4	18.5	19.9	15.7
Share of deposits in broad money (percent)	76.9	78.6	81.0	83.0	83.0	84.4
Share of foreign currency deposits in total deposits (percent)	6.7	8.3	8.3	8.7	8.4	9.5
Market assessment indicators						
91-day Treasury bill yield (real, percent)	2.8	-0.1	-9.6	-5.5	4.9	1.4
Stock market index (NEPSE Index, Feb. 12, 1994=100)	185.6	176.3	163.4	216.9	360.7	327.3
External indicators						
Exports (percent change, 12-month basis in US$) 5/	-8.8	92.9	-26.2	-10.9	27.3	-3.0
Imports (percent change, 12-month basis in US$) 6/	5.8	29.6	-11.3	-10.4	23.3	3.6
Current account balance (excluding grants)	-8.4	-2.8	-2.8	0.5	0.5	1.1
Capital and financial account balance	3.1	3.1	6.0	2.0	0.9	0.1
Of which: Inward foreign direct investment	0.2	0.6	0.2	0.2	0.1	0.1
Gross foreign assets (in millions of US$)	805	870	973	1,133	1,347	1,423
Central Bank short-term foreign liabilities (in millions of US$) 7/	3.7	8.1	3.4	2.3	4.9	7.1
Central Bank foreign currency exposure 8/	0.9	1.2	0.5	0.3	0.5	0.7
Short-term foreign assets of commercial banks (in millions of US$)	196	220	262	343	399	403
Short-term foreign liabilities of commercial banks (in millions of US$)	85	119	126	161	184	231
Foreign currency exposure of commercial banks 8/	43.5	54.1	48.0	47.1	46.2	57.3
Gross official international reserves (in months of imports of goods and services	3.7	4.4	5.3	4.9	5.6	6.7
Gross official international reserves (as percent of broad money)	48.9	47.6	52.0	50.8	51.2	49.5
Short-term debt 9/	2.2	3.6	4.3	4.5	4.5	4.2
Short-term debt to gross official international reserves 9/	16.0	27.2	29.0	28.8	26.1	21.8
Total external debt	52.4	50.5	52.8	53.7	51.6	49.9
Of which: Public sector debt	51.5	48.0	49.7	50.3	48.2	47.1
Total external debt (as percent of exports of goods and services)	223.0	161.1	198.3	206.7	191.1	196.3
External interest payments (as percent of exports of goods and services)	2.2	1.8	1.8	1.9	1.7	2.0
External amortization payments (as percent of exports of goods and services)	5.6	3.6	4.8	4.5	3.9	4.9
Exchange rate (NR per US$, end of period)	56.3	56.8	67.6	68.5	70.8	74.7

Sources: Data provided by the Nepalese authorities.

1/ Fund staff estimates.

2/ From *Special Audit Report* by an accounting firm, R. Bajracharya & Company.

3/ Consists of public and public guaranteed external debt, domestic claims on government by banking sector, and domestic credits to the central government by non-banking 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 7. Nepal: Social Indicators

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

Sources: Staff reports, EDSS, World Bank 2002 World Development Indicators CD-ROM.

Nepal—Relations with the Fund

(As of June 30, 2002)

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

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

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	8.10	100.0
Holdings	0.01	0.09

IV. **Outstanding Purchases and Loans**:	**SDR Million**	**% Quota**
ESAF arrangements	4.48	6.28

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				
	06/30/02	2002	2003	2004	2005	2006
Principal	--	1.7	2.2	0.6		
Charges/Interest	--	0.1	0.2	0.2	0.2	0.2
Total	--	1.8	2.4	0.8	0.2	0.2

VII. Exchange Rate Arrangement:

In February 1993, Nepal unified its exchange rate and eliminated the multiple currency practice associated with the previous dual exchange rate arrangement. In October 1997, the exchange arrangement of Nepal was reclassified as that pegged to a single currency unit from pegged to a currency composite. Currently, all merchandise imports (except for a few goods restricted for security or related reasons) are freely available through an open general license system, with foreign exchange provided through the banking system at the market exchange rate. Nepal's exchange system is free of restrictions on the making of payments and transfers for current international transactions except for restrictions on payments for personal travel. These payments are limited to $2,000 per fiscal year per person for North America, Western Europe, Australia, and Japan, and $1,000 for all other areas and bona fide requests for amounts in excess of these limits are not granted.

Exchange rate: $1=78.30 Nepalese rupees (as of July 15, 2002).

VIII. Safeguards Assessments:

Under the Fund's safeguards assessment policy, Nepal Rastra Bank (NRB) is subject to a full safeguards assessment with respect to the PRGF Fund arrangement. On-site assessment was conducted during July 3-16, 2002.

IX. Last Article IV Consultation:

(a) Staff discussions were held in Kathmandu in April-May 2001.

(b) The Executive Board discussed the staff report (SM/01/22) on August 31, 2001.

X. Consultation Cycle:

Nepal is on the standard 12-month consultation cycle.

XI. Technical Assistance Since 1996:

Department		Purpose	Date
MAE	-	Debt management and monetary operations	10/96
	-	Bank supervision and compliance with Basel guidelines	6/99
	-	Central bank and banking reform	12/01-3/02
MAE	-	Reform of Central Bank and Depository Institutions	7/00
LEG	-	Legislation	
FAD	-	Technical assistance in VAT administration	1/98, 3/98
LEG	-	Redrafting of income tax laws	3/00, 7/01
STA	-	Assistance in improving the compilation and reporting of the monetary statistics	11/97, 4/99, 3/00
	-	Long-term residential advice on coverage and classification of balance of payments statistics	11/97–5/98
	-	Multisector statistics mission	1/01
	-	Database of macroeconomic statistics	7/01
	-	Production price statistics	1/02
	-	Balance of payments advisor	4/02

XII. 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

(As of July 24, 2002)

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 (i) bringing resources closer to the beneficiaries, where they are most likely to be productively used and (ii) collective donor action to foster the stronger governance needed to reduce waste and mismanagement, while (iii) 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 economic management issues (including public expenditures), governance and structural and financial sector reforms.

Since its first operation in Nepal in 1969, IDA has approved 74 credits for Nepal totaling over US$1.6 billion. In FY 00, a Road Maintenance and Development Project was approved, while in FY 01 there were no new operations. In FY 02, a Telecommunications Sector Reform Project was approved in December 2001 for US$22.6 million. The current IDA portfolio consists of eight credits for a total committed gross value of US$240.5 million. Projects in the financial, power, rural water and health sectors are at various stages of preparation and discussion with the Government.

As of May 31, 2002, IFC's commitments in Nepal included US$53.7 million in loans, concentrated primarily in the power sector. MIGA's portfolio in Nepal consists of four guarantee contracts with a net exposure of US$14.1 (as of June 30, 2002) million, mainly in the infrastructure sector.

The Bank has been providing technical assistance in energy planning, road infrastructure, irrigation, industrial finance, cottage industry, municipal development, and planning and financial management. Recent nonlending activities of the Bank in Nepal include a Private Sector Assessment (6/01), an Education Sector Strategy (4/01), and a Power Sector Development Strategy (3/01). In FY 02, an Economic Update was prepared for the Development Forum, that was prepared, managed and chaired by the government in accordance with CDF principles and held in Kathmandu in February 2002. In addition, a Country Procurement Assessment Report (CPAR) was completed in FY 01, a Country Financial Accountability Assessment (CFAA) in FY 02 and a Financial Sector Study will be completed in early FY 03. Work on growth and decentralization issues—including fiscal decentralization and an analysis of the proposed Poverty Alleviation Fund—has been initiated. It is anticipated that a CAS Progress Report will be presented to the Bank's Board in FY 03, along with the Financial Sector Technical Assistance Credit.

Lending by the World Bank Group, FY 1996–2002

(In millions of U.S. dollars, as of July 1, 2002)

	1996	1997	1997	1999	2000	2001	2002
IDA (net)	75.1	50.0	42.9	47.5	31.4	30.6	20.2
Disbursements	82.4	58.4	52.5	59.9	46.1	47.3	38.0
Amortization	7.3	8.4	9.6	12.3	14.7	16.7	17.8

Source: Data provided by the Controllers Department, the World Bank.

Nepal—Relations with the Asian Development Bank

As of December 31, 2001, total commitments by the Asian Development Bank (AsDB) consisted of 97 loans amounting to $1.9 billion covering projects in agriculture (including forestry), energy, transport, industry, social infrastructure, and tourism. Undisbursed funds of $386 million represent about 58 percent of the total net loan amount as of December 31, 2001. For the period 2002–04, 13 projects amounting to $380 million are tentatively programmed.

Loans by the Asian Development Bank, 1969–2001
(In millions of U.S. dollars, as of December 31, 2001)

	1969–1998	1999	2000	2001
Agriculture and natural resources	748.4	--	11.0	--
Energy	314.4	50.0	--	--
Finance and Industry	130.7	--	7.3	--
Social infrastructure	137.1	--	1,55.0	19.6
Transport and communications	224.7	--	--	46.0
Others	27.6	--	--	30.0
Total commitments	1,582.9	50.0	173.3	95.6
Gross disbursements	1,042.2	78.7	99.7	57.2
Technical Assistance Projects				
Total commitments	87.6	4.4	7.3	4.0
Gross disbursements	45.5	5.1	3.5	5.0

Source: Data provided by the Asian Development Bank.

Since 1968, the AsDB has provided Nepal with technical assistance in most sectors. Recent assistance includes support for Strengthening the National Statistical System, Company, Insolvency, and Secured Transactions Law Reform, Second Secondary Education Sector, Agriculture Sector Performance Review, Management Reform and Efficiency Improvement for the Nepal Electricity Authority, Corporate and Financial Governance, Institutional Support for Governance Reforms, Ecotourism, Capacity Building for the Accounting and Auditing Profession, Partnership Agreement on Poverty Reduction Between and AsDB and HMGN, Support for the Preparation of the Tenth Five-Year Plan, Optimizing Water Use in Kathmandu Valley, Support for the Focal Point for Financial Sector Reform, Community-Managed Irrigation (Central and Eastern Basins) Sector, and Second Rural Infrastructure Development. As of December 31, 2001, total technical assistance commitments consisted of 223 projects—84 of which were in preparation for loans—for a total of $101.3 million.

As of December 31, 2001, the AsDB has provided five private-sector loans for four projects in Nepal: two in industry, two in hydropower, and one in tourism. Direct investments have involved $49.5 million in loans and $3.3 million in equity for a total of $52.8 million. Moreover, the AsDB has been working through its lending and technical assistance program to create a policy and legal environment in Nepal that promotes private sector development.

Nepal—Statistical Issues

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 January 2001, a multi-sector statistics mission visited Kathmandu to conduct a comprehensive assessment, and prepared recommendations and an action plan to bring Nepal's macroeconomic statistics in line with international standards.

In the past, **balance of payments accounts** consistently exhibited large and volatile 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 substantially amended the current account balance and reduced net errors and omissions. However, further work is needed to improve recording of oil transactions, remittances, grants, foreign direct investment, short-term inflows, and other private capital flows. A peripatetic Statistical Adviser has been appointed for a term of 12 months beginning in March 2002 and is expected to provide technical assistance in the above areas.

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, and no information is available on trade volumes.

Incomplete and conflicting data on **external grants and loans** to the government make it difficult to anticipate trends in the availability of foreign financing. The central bank monitors trends in cash disbursements and repayments, and provides estimates of commodity aid and direct payment by donors based on incomplete Ministry of Finance (MOF) reporting that is often not timely. With technical assistance from Department for International Development, United Kingdom (DfID), a new database providing comprehensive account of cash disbursements, payments, and the stock of outstanding government debt has been developed and is currently being refined. However, reporting of grants and loans paid directly by donors, and of future financing, remains a problem.

Monetary data provided by the central bank have been subject to revisions with a substantial lag (up to 12 months), making timely program monitoring difficult. A **money and banking statistics** technical assistance mission visited Nepal during April/May 1999 and again during March 2000 to assist in improving data timeliness, compilation procedures, and the coverage of the financial system. Commercial bank reporting is particularly weak. The January 2001 multi-sector mission recommended to implement the residency criterion, instead of the currency basis, in distinguishing foreign from domestic accounts. The mission also encouraged the Nepal Rastra Bank (NRB) to improve the procedures for grossing-up balance sheet data to account for late reporting of commercial bank branches, which had led to the consistent underestimation of the broad money. Data on deposit money banks (DMBs) for the previous four reporting months, as provided by the NRB to STA, are incomplete, because the information excludes, important information on components of (i) DMBs' total claims on private sector, (ii) demand deposits, and (iii) other items (net). Consequently, data published for the DMB, in *IFS* are incomplete.

The new **budget classification** system introduced in 1996/97 and improved in the past two years, has substantially improved fiscal statistics, in particular the division between current and capital spending. However, fiscal data by functional and economic classification is only provided on an irregular basis with varying degree of coverage; some classification problems remain with large amounts attributed to the contingency account, and monthly reporting of development spending excludes amounts directly paid by donors (amounting to over 50 percent). Recent changes in line-item classifications complicates historical data comparisons. Additionally, a number of fees are collected outside the budget and the operations of local governments are not reported in the annual budget.

More detailed data on **revenue and expenditure** developments are needed on a timely basis for effective fiscal control. A financial management project is under way in the Financial Comptroller General's Office that so far covers selected districts that account for the bulk of expenditure. It is critical that further progress is made to effectively monitor actual expenditures and revenue collections and provide assessments during the course of a fiscal year. This will require additional donor funding of technical assistance and further computerization in the MOF regional offices.

Consolidated accounts for the **public enterprise sector** are not compiled on a regular basis, and financial reporting by many individual enterprises is subject to long delays. Individual company accounts are suspect given the lack of standard accounting procedures and known inconsistencies with budgetary transaction data. Donor assistance in survey design and processing may be needed.

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. These statistics are seriously deficient owing to the lack of comprehensive and regular data sources. The limited source data available suffer from inconsistencies, lags in data production, and unavailability of required details. Timely access to administrative records is limited due to shortcomings in record-keeping and processing by the respective agencies. Reflecting the inadequacy of current source data, compilation methods rely heavily on fixed ratios derived from outdated surveys or ad hoc assumptions.

The **consumer price index** (CPI) was revised following completion of the 1995/96 household expenditure survey. The weights used for calculation of the CPI were updated and the revised series were first published in May 2000, starting from the month of July 1999. However, the revised CPI's consumption basket refers only to the expenditures of a sub-set of urban population.

The **wholesale price index** (WPI) was developed by the NRB and first published in July 2001. The weights for the WPI, based on data for 1999/2000, were derived using a commodity flow approach and the prices related to the first commercial transaction point. However, the index compilation method should be improved to implement weekly or bi-weekly price collection; increase the number of price quotations; and implement adjustment procedures for quality difference.

The CBS, with the assistance of the STA, is in the process of developing monthly series of **producer price index** (PPI), replacing the current manufacturing price index which is based on a biased unit values rather than an actual transaction prices. The new index is expected to provide better deflation of components of national accounts and to be used as a measure of inflation in the industrial sector of the economy.

Nepal—Core Statistical Indicators

(As of July 20, 2002)

	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	7/19/02	5/15/02	7/05/02	5/15/02	5/15/02	7/16/02	5/02	6/02	03/02	7/5/02	2000/01	2000/01
Date received	7/19/02	6/25/02	7/19/02	6/25/02	7/19/02	7/19/02	6/25/02	7/17/02	7/05/02	7/15/02	11/01	8/01
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

The authorities continue to pursue a development strategy to enhance growth and thus reduce poverty, but their medium-term prospects will depend on how soon the problem of internal security could be addressed. The two scenarios shown in Table 5 illustrate the economic impact of the continued conflict. The base-case scenario is predicated on two assumptions: First, violence can be reduced shortly to the level seen early in 2001 (before fighting intensified); and second, the government implements a comprehensive program geared toward moving key structural impediments to high and sustained growth. It is also assumed that a stable government will emerge after the November election. The low-case scenario illustrates the impact of continued intense civil disturbances on macroeconomic stability and growth. The scenarios also underscore that even under the base-case scenario, significant strides in reducing poverty would be achieved only over the longer term.

The base-case scenario is consistent with the assumptions and principal elements of the PRSP (which forms the core of the government's 10th Plan). The PRSP targets include: (i) increasing annual economic growth to about 6 percent; (ii) containing inflation to below 5 percent; (iii) raising domestic savings; and (iv) maintaining reserves of at least 5 months of imports. Given the dominant role of the agricultural sector, sustained high growth would require higher utilization of fertilizers, expansion of year-round irrigation, improved agricultural extension services, and extension of the road network, as well as a take-off in nonagricultural activity. A significant increase in public and private gross investment (to near 27 percent) would result from several hydro-power and road construction projects, which would require mobilizing external resources, including in the form of private capital. To allow for private investment growth, and avoid unsustainable current account deficits, the public sector's contribution to domestic savings would need to increase significantly from the current negative levels.

The low-case scenario illustrates the impact of continued civil unrest on macroeconomic stability and growth. Economic growth could slow to at most 3 percent and the objective of reducing poverty would remain elusive. Continued civil unrest could result in lower manufacturing and export activities and reduced tourism receipts. At the same time, the spread of terror in the countryside would not only result in continued low and uneven agricultural output, but also hamper implementation of development projects and thus dampen domestic demand and the growth of nonagricultural production. Moreover, even with expenditure restraint, difficulties in tax collection due to security problem would likely result in higher domestic bank financing of the fiscal deficit and higher inflation. With lower exports and official capital inflows on account of slower implementation of foreign aid projects, gross official reserves would decline, and the sustainability of the exchange rate regime could be called into question. In addition, the debt service ratio would be higher than in the base 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, which would likely exacerbate the security problems.

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

IMF Concludes 2002 Article IV Consultation with Nepal

On September 4, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Nepal.[1]

Background

Despite decades of development efforts supported by substantial foreign aid, Nepal remains among the poorest countries in the world with 40 percent of the population living in poverty. The Poverty Reduction Strategy Paper, expected to be finalized soon, identifies slow growth (especially of agriculture) and poor infrastructure and social service delivery as key causes of poverty, and proposes an economic program that primarily aims at improving the financial sector and correcting public sector inefficiencies.

An already difficult economic situation has been complicated by an intensification of the Maoist insurgency, political uncertainties, and adverse external developments. Violence has intensified since November 2001 when the insurgents walked away from peace talks, and the economy was further affected by the events of September 11 and the global economic slowdown. Near-term political uncertainty has also risen as leadership disputes within the ruling party resulted in the dissolution of Parliament in May and the scheduling of general elections for November.

Reflecting these adverse internal and external developments, real GDP growth is estimated to have slowed to 0.8 percent in 2001/02 from 5 percent in the previous year (fiscal year ending mid-July). Agricultural growth slowed to less than 2 percent from over 4 percent, reflecting irregular rainfall. The output of nonagricultural sectors was largely stagnant, with manufacturing and tourism sectors particularly hit hard by the domestic security situation as well as the global

[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.

slowdown. Inflation was subdued at around 3 percent, reflecting weak domestic demand and stable Indian prices for most of the year.

Notwithstanding slowing exports and tourist receipts, the external current account surplus was maintained at 1 percent of GDP in 2001/02, reflecting a drop in imports and expanding remittances from Nepalese working abroad. Nevertheless, foreign aid flows declined and contributed to turning the overall balance to a small deficit. Gross official reserves stood at over $1billion, covering 6½ months of imports. Reflecting the concessional nature of the external debt and high remittances, the debt service ratio remains at about 5 percent of current receipts.

The fiscal deficit (after grants) was contained to 4 percent of GDP, but domestic financing was higher than budgeted. The revenue shortfall of 1½ percent of GDP would have been larger had it not been for the intensified collection efforts through a voluntary disclosure of income scheme and special revenue measures to fund higher security spending. To accommodate higher current expenditure, capital spending was cut back by 3 percent of GDP relative to the budget. However, this also affected foreign aid disbursements and financing. As a result, net domestic financing amounted to nearly 3 percent of GDP, 1 percentage point higher than budgeted.

Monetary aggregates grew slowly while monetary policy has accommodated fiscal needs and the need to bail out depressed industries. Broad money growth in 2001/02 slowed to 6 percent from 15 percent a year earlier due mainly to a weaker economy. Net claims on government rose by 19 percent, and domestic credit grew by 10 percent—reflecting sizable demand for refinancing loans to troubled borrowers. In response to a liquidity shortage at some commercial banks, the Nepal Rastra Bank (NRB) lowered cash reserve requirements by 1.2 percentage points on average to around 9 percent and also lowered refinancing rates by 100–200 basis points. In addition, from February 2002, the NRB provided a refinancing facility at 3 percent interest to encourage commercial banks to provide concessional loans to "sick" industries (mostly hotels and garment industry). Interest rates on deposits and treasury bills (91 days) declined during 2001/02 to around 4 percent.

The peg of the Nepalese rupee to the Indian currency has provided a suitable nominal anchor and enabled Nepal to benefit from the close ties with India. The real effective exchange rate has been relatively stable, and the informal market premium has been minimal. Exporters also report that they do not face significant wage pressure.

Structural reform has advanced in the financial sector. To provide a sound basis for strengthening the NRB's regulatory and supervisory capacities, new banking regulations were issued and the new NRB Act was enacted in 2002 that granted the central bank greater autonomy. The authorities are preparing an action plan to "re-engineer" the NRB through reorganization, strengthening of supervision, and human resource enhancement based on stronger performance incentives for the professional staff. External managers were selected in early 2002 for the two largest commercial banks, Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL), with funding from the World Bank and the United Kingdom. To take over management of the majority privately-owned NBL, the NRB invoked provisions of the new NRB Act and suspended its board. However, an international management firm that signed a contract in January to manage the RBB has decided to pull out, citing security risks and ambiguities in the contract.

Progress was uneven in public sector reforms. A medium term expenditure framework was introduced, in which fiscal resources are allocated to programs in accordance with national and sector priorities in a three-year rolling framework and a realistic revenue forecast considered as a hard budget constraint. To reduce overstaffing among lower-level employees and improve performance incentives for professional staff, the authorities introduced a hiring freeze, completed a civil service census, increased relative wage of higher level staff, started to eliminate temporary and vacant posts at lower levels, and implemented the first phase of a voluntary retirement scheme. However, there has been little visible progress in public enterprise reform. Public enterprise finances continue to deteriorate but poor accounting practices prevent accurate measurement of the size of the wage and other liabilities of individual enterprises. No public enterprises were privatized during the last three years.

Executive Board Assessment

Noting that the deteriorating security situation and adverse external shocks had contributed to the recent weakness in growth, Executive Directors welcomed the authorities' efforts to maintain macroeconomic stability and to push ahead with structural reforms under difficult circumstances. However, Directors noted that the economy remained vulnerable to downside risks in the near term, including the impact of the insurgency on production, exports, and tourism, as well as a weaker than expected global recovery. In view of the widespread poverty, they called on the authorities to demonstrate a firm and sustained commitment to reforms in order to reinvigorate growth.

Directors agreed that sound fiscal management was key to maintaining macroeconomic stability, and stressed the need to contain domestic borrowing, prioritize spending, and mobilize revenue in implementing the 2002/03 budget. They welcomed the recent steps taken to prioritize development spending within a multiyear framework and to strengthen expenditure control. In light of the budget's optimistic revenue and foreign financing assumptions, the achievement of the targeted overall deficit will probably require additional efforts during the course of the fiscal year, focused on raising revenue and cutting low priority spending, so that domestic borrowing can be contained.

Over the medium term, Directors endorsed the authorities' intention to strengthen revenue mobilization further, with an emphasis on improving tax and customs administration through increasing the frequency of audits, raising staffing resources, and tightening enforcement. This would permit higher spending for poverty reduction and growth—and success in these areas could contribute to the resolution of the civil conflict.

Directors considered that the exchange rate peg to the Indian rupee remains broadly appropriate given Nepal's close economic links with India, and they endorsed the focus on maintaining monetary conditions consistent with the peg. They encouraged the authorities to maintain an open trade and investment regime, while noting the adverse effects of trade barriers on Nepal's exports. A few Directors drew attention to the need to remove the exchange restrictions that limit payments for personal travel.

Directors encouraged the authorities to remain vigilant about the quality of new bank credit at a time of weakening bank loan portfolios, and to build on the progress made in financial sector reform—especially by addressing the problems of the two largest commercial banks. They looked forward to the preparation and implementation of plans to divest these banks' state assets, and to recapitalize the banks after they had been appropriately restructured under new management. Directors also encouraged the authorities to proceed with the restructuring of the two large development banks. They welcomed the progress in strengthening the central bank, including the passage of the new central bank law that gives the bank greater autonomy, and the authorities' commitment to establish an anti-money laundering regime consistent with the recommendations of the Financial Action Task Force.

Directors urged the authorities to strengthen public sector reforms. They welcomed the initial steps to reduce the overemployment of lower-level civil servants, but said that further efforts will be needed to eliminate vacant positions and improve incentives for professional staff. Directors recommended that the authorities revive their efforts to privatize public enterprises listed for early sale and assess the financial position of other enterprises with a view to making decisions on future privatization.

Directors welcomed the recent efforts to improve governance and enforce anti-corruption policy, focused on those responsible for the misuse of public funds. They stressed the need to increase fiscal transparency by fully monitoring central and local government finances, as well as extrabudgetary activities, such as those of the Poverty Alleviation Fund. The importance of the adoption of international accounting and auditing standards for large private and public firms was also emphasized, as an element of progress toward legal, institutional, and administrative reforms that will foster an environment that is supportive of private sector activity.

Directors welcomed the government's commitment to a comprehensive reform program, as described in the government's Poverty Reduction Strategy Paper, to maintain macroeconomic stability and promote more efficient resource allocation in the financial sector and better public service delivery, especially in the rural areas, together with strengthened governance. Such a program would lay the foundation for sustained growth once a more stable political and security environment is established. They looked forward to Nepal making progress toward designing and implementing a program that could be supported by the Poverty Reduction and Growth Facility.

Directors encouraged the authorities to continue to improve the macroeconomic database to eliminate deficiencies in official statistics that currently impair effective monitoring and policy formulation. They stressed the importance of implementing past technical assistance recommendations on statistics.

Directors welcomed the authorities' support for international efforts to combat the financing of terrorism.

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.

Nepal: Selected Economic Indicators, 1997/98-2001/02 1/

	1997/98	1998/99	1999/00	2000/01	2001/02 Est. 2/
Output and prices			(Percent change)		
Change in real GDP	2.9	4.5	6.2	4.8	0.8
Change in CPI (end-period)	12.0	9.0	0.6	3.4	3.5
Budgetary operations			(Percent of GDP)		
Total revenue	10.5	10.2	10.7	11.4	11.4
Total expenditure	16.8	15.4	15.7	17.6	17.4
Current expenditure	9.2	9.3	9.6	11.2	12.3
Capital expenditure and net lending	7.6	6.1	6.1	6.4	5.0
Overall deficit 3/	4.5	3.9	3.5	4.5	4.0
Money and credit			(Percent change)		
Domestic credit	14.8	16.1	17.8	18.9	10.3
Broad money	21.9	20.8	21.8	15.3	6.2
External sector	(Millions of U.S. dollars, unless otherwise indicated)				
Exports , f.o.b. 4/	856	763	971	942	762
Imports, c.i.f.	1,551	1,390	1,713	1,774	1,605
Current account 5/	-135	24	28	64	54
(in percent of GDP) 5/	-2.8	0.5	0.5	1.1	1.0
Overall balance	184	136	192	38	-77
Gross official reserves	716	795	946	1,021	1,056
Rupees per US dollar (end-period)	67.9	68.5	70.8	74.7	78.3

Sources: Nepalese authorities and IMF staff estimates.

1/ Fiscal year ending July 15.
2/ Based on latest data as of August 20, 2002.
3/ After grants.
4/ Includes re-exports.
5/ Before grants.

Statement by Dono Iskandar Djojosubroto, Executive Director and Madhav Prasad Bhatta, Advisor to the Executive Director for Nepal
September 4, 2002

On behalf of the Nepalese authorities, we would like to thank staff for a comprehensive and analytical report on the recent economic developments in Nepal. The observations and suggestions put forward by the staff would be most useful in guiding the authorities' design of policy initiatives to meet the socioeconomic challenges faced by Nepal.

Macroeconomic Performance

The Nepalese economy, which had achieved encouraging macroeconomic performance during the last few years, faced a setback in fiscal year 2001/02 because of the adverse domestic and external situation. Real GDP growth is estimated to have declined to 0.8 percent in 2001/02 from 4.9 percent in the previous year. The poor economic performance is attributed to the deterioration in the peace and security situation in the country, coupled with the events of September 11 that had significantly affected the tourism and manufacturing sectors. In addition, the delayed arrival of the monsoon season and the fall in prices of agricultural products affected the performance of the agricultural sector. Growth of the non-agricultural sector was only marginal owing to the negative growth of the manufacturing, trading and tourism sectors.

The growth of monetary aggregates further decelerated in 2001/02 from the preceding year's level. The growth of broad money fell from 15.2 percent in 2000/2001 to 5.5 percent in 2001/02. Similarly, credit to the private sector increased by only 5.9 percent compared with 15.8 percent the year before. However, as in the last two fiscal years, inflation remained subdued with the consumer price index rising by 2.9 percent in 2001/02 compared with 2.4 percent in the previous year.

The external sector which was already weak with decelerating export growth and declining service receipts, continued to deteriorate in 2001/02. Exports declined by 14.6 percent in 2001/02 against a growth of 11.7 percent in 2000/01. This was largely attributed to a significant fall in garment and carpet exports as well as the introduction of non-tariff barriers on Nepal's concessional exports by India. At the same time, the slowdown in economic activities and weak export prospects suppressed the demand for both consumer and capital goods, resulting in a 7.7 percent decline in imports.

The overall balance of payments fell into a deficit of 0.6 percent of GDP in 2001/02 after registering surpluses in previous years owing to a sharp decline in services receipts and lower capital inflows. Despite this, gross official international reserves remained high, covering more than 8 months of imports.

Despite Nepal's high dependence on external resources to finance the government budget, its external debt remains manageable. Total external debt stood at 48.4 percent of GDP in 2001/02, approximately similar to the preceding year. However, due to limited domestic resources, the external debt servicing has increased to 13 percent of total revenue or 13.4 percent of regular government expenditures in 2001/02.

The fiscal situation continued to be under stress as a result of the high expenditure for security needs and the weaker revenue performance attributed to the economic slowdown. The budget deficit, however, narrowed to 5.4 percent of GDP in 2001/02 compared with 5.9 percent in the preceding year

Reform Initiatives

The Nepalese authorities have set "poverty reduction" as its foremost development objective. The Tenth Plan and the policies outlined in the budget speech for the current fiscal year will address this goal despite the emergence of obstacles in the areas of peace and security. The authorities' poverty alleviation programs for the current fiscal year have focused on achieving a broad-based, sustainable and high economic growth, improved quality of social services, development of infrastructure, population management and empowerment, and the protection and creation of income generating opportunities for people living below the poverty line as well as the disabled. The government is finalizing the Tenth Plan along with the Poverty Reduction Strategy Paper (PRSP).

Expenditure Reforms

A number of reform measures have been introduced towards fiscal consolidation. The Medium Term Expenditure Framework (MTEF) has been adopted to further rationalize resources and prioritize programs as reflected in the current year's budget. Despite resource constraints, the authorities have allocated necessary funds to programs for the priority sectors and those that will directly benefit the general population. The cabinet has also approved a new policy on foreign aid that sets out the objective of using foreign assistance mainly in the priority areas.

The authorities have also formulated an Immediate Action Plan (IAP) that will prioritize public resources to provide immediate relief to the population and reduce poverty. The IAP also aims to improve the quality of public services and enhance transparency and accountability. The government has also constituted a committee comprising representatives from the Ministry of Finance, the National Planning Commission, and the Office of the Prime Minister to monitor its implementation and to review progress on a regular basis.

To support the authorities' poverty reduction objectives, a poverty-based formula for allocation of block grants among the local bodies is being developed. The authorities have encouraged greater participation from the community in the areas of education and health services to improve the quality of service delivery. The authorities have also set aside resources to rehabilitate of ailing industries in order to revive the manufacturing sector. They have also decided to grant 10-year multiple entry visas to non-residents of Nepalese origin to attract foreign investments.

However, at the top of the authorities' agenda is the need to restore peace and security in the country. For this purpose, the security agencies have been provided with the required resources to conduct their operations effectively.

Revenue Reforms

A new Income Tax Act that would widen the income tax net has been introduced while the VAT has been made more effective through rationalization measures. With the widening of the income tax net, revenue administration has also been strengthened. In this regard, laws and by-laws governing revenue administration and its organizational structure have been reviewed and simplified. A code of conduct for revenue officials has been introduced. To enhance the integrity of revenue officials, a staff transfer policy has been worked out while guidelines for the entry into and exit from the tax collection service is being considered.

Civil Services Reforms

The civil service is being reformed to make it more result oriented with greater responsibility and accountability for policy formulation and program implementation. In this regard, necessary reform measures, including downsizing the civil service, outsourcing of support services and freezing of vacant positions are being implemented. In addition, the compensation policy, contributory pension system and voluntary retirement schemes are being revised.

Corruption Control

The authorities have introduced a new Anti-Corruption Act with enhanced powers being granted to the anti-corruption agency in order to curb corruption and promote good governance. Soon after the new Act came into effect, the Commission for the Investigation of the Abuse of Authority (CIAA) has begun investigating the sources of income of two dozen revenue officials. This was seen as a positive start towards the authorities' efforts to tackle corruption in the country. A high level Property Investigation Commission was also constituted a few months ago to scrutinize the assets of more than 30,000 existing and retired public officials.

Financial Sector Reforms

With the assistance from the World Bank, the authorities have proceeded to make progress in financial sector reforms to restructure the ailing public sector banks. The management of one of the two largest public sector commercial banks, the Nepal Bank Limited, has been transferred to an external management team while that of the other bank, the Rastriya Banijya Bank, will be transferred to a new management team within the first four months of the current fiscal year. Necessary amendments in the financial sector regulations have been made and the new Nepal Rastra Bank (the central bank) Act has come into effect from the beginning of 2002. The Act provides the central bank with greater autonomy for its operations, including the formulation and implementation of monetary and exchange rate policies. It also sets out a clear and transparent procedure for the appointment and dismissal of the Governor and Deputy Governors.

A new umbrella act for banks and financial institutions is in the process of being enacted to establish a uniform regulatory system for all deposit taking institutions and finance companies. Nepal Rastra Bank (NRB) will be establishing an Asset Management Company this fiscal year. It also plans to issue new directives to strengthen the Credit Information Bureau. Nepal has become a member of the Asia/Pacific Group (APG) on Money Laundering with effect from March1, 2002. An Anti Money Laundering Act has been drafted and will be submitted to the new parliament. As a member of the APG, Nepal is committed to establish an anti-money laundering regime that is consistent with the 40 recommendations of FATF.

The central bank has also initiated a number of other reforms like the withdrawal of NRB officials from the boards of commercial banks, phasing-out the priority sector credit program, and withdrawal of the maximum interest rate spread. The commercial banks' cash reserve requirements was also reduced to provide additional liquidity to the market to stimulate economic growth. All these reforms are expected to generate greater dynamism in the banking and financial sector and improve the investment climate in the country.

External Sector Reforms

Nepal is preparing for accession to the WTO and in this regard, its external sector is being liberalized further. The Foreign Exchange (Regulation) Act has been comprehensively amended to incorporate the liberalization measures introduced so far. Nepal adheres to the obligations of Article VIII and would further liberalize its foreign exchange regime as required. However, as convertibility of the capital account has not been established, it would not be feasible to allow unlimited access to foreign exchange, bearing in mind that there is already full convertibility of Nepalese rupees into Indian rupees. Given the low-income levels of the average Nepali, the existing limit on the foreign exchange facility for personal travel abroad (the so called Passport facility) has not been a hindrance to Nepalese traveling abroad. For those traveling for reasons such as business, education, training, medical treatment etc. are able to obtain the required amount of foreign exchange. Regarding the exchange rate regime, Nepal will continue to maintain a fixed exchange rate with the Indian currency, as the country has benefited from such an arrangement.

PRGF Issues

The Nepalese authorities have met most of the conditions for the proposed entry into a PRGF program with the Fund. The finalization of the Tenth Plan along with the Poverty Reduction Strategy Paper (PRSP) and the adoption of the Medium Term Expenditure Framework (MTEF) to further rationalize both resources and programs are the latest developments in this regard. Nepal's macro-economic indicators are also broadly on track. Despite its resource constraints, net domestic borrowing of the government has been maintained at about 2 percent of GDP. Monetary discipline has enforced, with money supply growth contained at the desired level. Inflation is well under control and despite the adverse external environment, foreign exchange reserves are at a comfortable level to absorb any external shocks. However, a number of unexpected obstacles, particularly due to the deteriorating peace and security situation and the unstable political environment, have delayed some of the structural reform efforts. The Nepalese authorities are making their best efforts to overcome these obstacles and expect to enter into the PRGF arrangement with the Fund as soon as possible.

Statistical Issues

The Nepalese authorities would like to acknowledge the technical assistance provided by the Fund in the various statistical areas. These had benefited the authorities greatly. Following the recommendations of the technical assistance missions, Nepal has introduced a large number of reforms in the area of money and banking and balance of payments statistics. The multi-sector statistics mission has also been useful and Nepal is already participating in the framework of the General Data Dissemination System (GDDS) for the compilation and dissemination of macroeconomic and socio-demographic data. The Nepalese authorities look forward to receiving continued technical assistance from the Fund in the future.

Conclusion

The major challenges facing Nepal are the issues of insecurity and poverty. Parliamentary elections will be held in November this year. The new government is expected to continue on the path of reforms and will expedite the reform efforts in order to reach an agreement with the Fund for a PRGF program that will address the challenges of poverty reduction. However, the authorities recognize that the challenge of reducing poverty in Nepal cannot be met solely by its own resources. Therefore, the authorities need the financial and technical support of the international community in their efforts to reduce poverty.