November 2003
IMF Country Report No. 03/360

Nepal: Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility—Staff Report; Staff Supplement; and Press Release on the Executive Board Discussion

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

- the staff report for the request for a three-year arrangement under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on **September 17, 2003,** with the officials of Nepal on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on October 31, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **November 13, 2003** updating information on recent developments.

- a Press Release summarizing the **views of the Executive Board as expressed during its November 14, 2003 discussion** of the staff report that completed the request.

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

Poverty Reduction Strategy Paper
Joint Staff Assessment of the Poverty Reduction Strategy Paper
Letter of Intent sent to the IMF by the authorities of Nepal*
Memorandum of Economic and Financial Policies by the authorities of Nepal*
Technical Memorandum of Understanding*

*May also be included in the Staff Report

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

NEPAL

Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility

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

Approved by Wanda Tseng and Matthew Fisher

October 31, 2003

- Discussions on a program to be supported by a three-year PRGF arrangement were completed in Kathmandu during September 8–17, 2003. The staff team comprised Messrs. Shishido (head), Kalra (both APD), Hallaert (PDR), Zhan (EP, FIN), Ms. Yelten (EP, APD) and Ms. Abraham (Administrative Assistant, APD). Mr. Singh (Resident Representative) assisted the mission. Messrs. Karki (Advisor, Executive Director), Ahsan (World Bank) and Tuladhar (AsDB) took part in selected meetings.

- The team met Finance Minister Lohani, National Planning Commission Vice Chairman Sharma, Nepal Rastra Bank Governor Rawal, Chief Cabinet Secretary Koirala, Finance Secretary Acharya, other senior officials and representatives of private business, political parties, and donors.

- The 2003 Article IV consultation was concluded by the Executive Board on August 22, 2003. Executive Directors noted that to address poverty in Nepal, growth needs to be raised significantly over the medium term through vigorous implementation of structural reforms, particularly in the financial and public sectors. They underlined that continued peace was essential to improve growth prospects. Directors also emphasized governance reforms. Directors welcomed finalization of the PRSP and encouraged the authorities to reach early understandings on a program that could be supported by an arrangement under the PRGF to help achieve PRSP goals.

- The authorities agreed to publication of the staff report.

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

Contents Page

Executive Summary

The Nepalese authorities are seeking to break a vicious cycle of low growth, pervasive poverty, and insurgency. To this end, they intend to implement a comprehensive reform agenda outlined in their Poverty Reduction Strategy Paper (PRSP). The PRSP strategy is focused on broad-based growth, social sector development, targeted programs for the poor and deprived groups, and improved governance.

To support their efforts, the authorities have requested a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF). In support of their request, they have established a track record of policy implementation, and have completed all prior actions for the PRGF-supported program.

The key elements of the proposed PRGF-supported program are in line with the PRSP.

- The fiscal strategy is to improve revenue mobilization, prioritize spending, and contain domestic borrowing over the medium term. To raise revenues, policy measures would be taken, including increases in the VAT rate and strengthening revenue administration. Spending would be directed toward priority social and infrastructure sectors to help reduce poverty. Reductions in domestic borrowing will help maintain fiscal sustainability.
- Monetary policy would remain geared to supporting the peg to the Indian rupee which has served Nepal well given close ties with India. However, the level of the peg would be kept under review in light of prospective external developments (such as phasing out of Multi-Fibre Arrangement by 2005) while competitiveness is to be enhanced by reforms to reduce labor and nonlabor input costs.
- Financial sector reforms involve central bank strengthening, improved legislation and loan recovery, and restructuring of commercial and development banks.
- Public sector reforms include civil service reforms; privatization/liquidation of unviable enterprises and divestment from profitable ones to enhance their efficiency.
- Governance reforms involve steps to combat corruption and decentralize policy making and implementation authority to local levels to improve accountability and service delivery.

Risks to the program stem from an unsettled security and political situation. Resolving these uncertainties would obviously provide for a firmer basis for achieving the program's objectives. Nevertheless, the program contains some cushions to deal with fiscal contingencies. Moreover, the authorities have established a track record of policy implementation under difficult circumstances and the PRSP reform agenda resulted from wide consultations and has broad political support. The authorities' reform efforts are also being supported by the World Bank, AsDB, and donor community.

I. Introduction and Recent Developments

1. **In the attached Letter of Intent and Memorandum on Economic and Financial policies, the Nepalese authorities request a three-year arrangement under the IMF's Poverty Reduction and Growth Facility.**[1] The arrangement is to support implementation of the authorities' reform strategy, described in their Poverty Reduction Strategy Paper (PRSP, Box 1), which aims to break a vicious cycle of low growth, poverty, and insurgency. The PRGF-supported program would also help catalyze external financial support for the authorities' policies. A Joint Staff Assessment (JSA) of the PRSP (EBD/03/86) is concurrently under consideration by the Executive Board of the World Bank, along with the authorities' request for a Poverty Reduction Support Credit (PRSC). The AsDB approved a Public Sector Management Loan in July and is considering further adjustment operations.

2. **The authorities' request comes against the backdrop of an unsettled security and political environment**. After the insurgents' unilateral declaration in late August of an end to the January 2003 ceasefire, peace talks stalled, and incidents of sporadic violence occurred, including in the Kathmandu area. A key issue is the insurgents' demand for a constituent assembly to rewrite the constitution. The Thapa government is open to amending the current constitution but wants the insurgents to disarm. The insurgents called for a temporary ceasefire in early October. In the meantime, key political parties continue to maintain that appointment of Prime Minister Thapa by King Gyanendra was unconstitutional and are pressing for the establishment of an all-party government, an idea that is gaining ground. The government has also stepped up development activities, especially in the conflict affected regions of the country, through higher budget allocations and targeted programs. The international community is broadly supportive of this approach, while encouraging a negotiated settlement of the insurgency.

3. **Despite the political uncertainty, the PRSP reform agenda has broad support across the political spectrum**. The PRSP has been in preparation since 2000 under a series of governments. As noted in the JSA, the PRSP was finalized in May 2003 after an extensive consultative process. A key event in the process was the February 2002 Nepal Development Forum which was held when parliament was in session. The forum presented Nepal's reform agenda, including the Tenth Five Year Plan, for public debate and to the international community. The Tenth Plan forms the basis of the PRSP. Subsequently, key figures from major parties have indicated their continued support of the reform agenda, including in discussions with staff.

4. **Notwithstanding the difficult security and political environment, the authorities have taken policy actions and established a track record of reform implementation to lay the groundwork for a PRGF-supported program.**

---

[1] Nepal's last Fund arrangement, an ESAF, started in October 1992 and expired in 1995.

Box 1. Nepal: Poverty Reduction Strategy Paper

A. Objectives and Strategy

Objectives. The PRSP policy measures aim to push up the real GDP growth rate to 5–6 percent over the medium term and reduce the poverty rate by 8–10 percentage points (from around 40 percent) in five years. The PRSP also aims at significant improvements in human development indicators.

Strategy. The PRSP strategy consists of four pillars: broad-based economic growth; social sector development; targeted programs for the poor and deprived groups; and good governance. The PRSP notes that the growth strategy should be rooted in macroeconomic stability and that a reduction in the domestically financed budget deficit over the medium term would help achieve this goal. The PRSP outlines plans for financial sector, public sector, and governance reforms to improve growth prospects.

B. Macroeconomic Scenarios

Growth. The PRSP acknowledges that achievement of the targeted growth rates would depend on progress in the peace process, implementation of structural reforms, and a favorable external environment. With these factors in mind, in the PRSP's **base case scenario**, resolution of political uncertainties and speedy implementation of reforms are projected to generate average annual growth of 6¼ percent over 2002/03-2006/07. In the **lower case scenario**, continued political difficulties and delays in reforms would limit average annual growth rate to 4¼ percent over this period. **Inflation** is projected to remain around 4½-5 percent.

C. Policy Actions

Policy actions to achieve its goals are outlined in the PRSP matrix:[1]

- **Macroeconomic stability**: Prudent fiscal policies (1.A. mobilize revenue and reduce domestic budget financing; 1.B. prioritize public spending through the Medium-Term Expenditure Framework); 1.C. conduct monetary and exchange rate policy to support the exchange rate peg and keep inflation low; and 1.D. maintain favorable balance of payments and international reserve position.
- **Structural reforms**: Financial sector reforms, including to "reengineer" NRB; restructure state-owned commercial and development banks; and improve loan recovery); Public enterprise reforms (1.F. privatize, corporatize, or liquidate SOEs); Civil service reforms (14. "rightsize" employment; operationalize Personnel Information System); Governance (15, 16. implement anti-corruption strategy; provide active role for the Commission for Investigation of Abuse of Authority; decentralize education and health services, rural roads, and small irrigation facilities); Trade (4. WTO accession).
- **Sectoral policies**: Agriculture (2, 3. improve provision and use of inputs—irrigation, fertilizer, and credit;diversify into cash crop production); Industry (8. reform foreign investment policy, introduce exit policy; amend of Labor and Company Laws); Infrastructure (6. operationalize Roads Board; corporatize NTC and allow private sector participation in telecom; operationalize Power Development Fund, unbundle Nepal Energy Authority, establish independent regulatory body for power sector, and expand rural electrification).
- **Social sectors**: Education (10. decentralize school management; train teachers;); Health (11. promote local management of health facilities; reduce absenteeism; expand health services to remote areas).
- **Targeted poverty alleviation**: (13. establish Poverty Alleviation Fund; increase budget allocation for deprived communities and areas; improve poverty monitoring; increase scholarships; mainstream deprived groups through credit delivery and asset creation).

---

[1] The numbered references are to the PRSP policy matrix in IMF Country Report No. 03/305.

- The **2003/04 budget** was passed in July to implement a fiscal strategy focused on revenue mobilization, prioritized spending, and reduction in domestic borrowing.[2] Earlier, the 2002/03 budget was revised in December 2002 on a timely basis to take account of macroeconomic developments.

- In the **financial sector**, actions were taken in three critical areas: strengthening the central bank; addressing endemic loan default; and restructuring of commercial and development banks.

  - The NRB has formulated plans to "reengineer" itself and strengthen supervision over the financial system, with donor financed external consultants. As part of this effort, a voluntary retirement scheme (VRS) was launched in March to reduce overstaffing at the nonofficer level. In addition, all nonofficer vacancies have been eliminated. Performance incentives are expected to improve as the remuneration decompression scheme, which was passed by the NRB Executive Board in October, becomes effective. A long-awaited step was taken in late September with cabinet approval of the Banking and Financial Institutions Ordinance to strengthen financial sector oversight.[3]
  - A Debt Recovery Tribunal (DRT) was set up in July under the Debt Recovery Act. In particular, the DRT provides for a time-bound resolution of cases involving loan defaults, and has already received cases from banks and district courts for its consideration. In addition, a strengthened blacklisting mechanism for loan defaulters was issued in September.
  - Donor financed external management teams have been placed at financially troubled Nepal Bank Limited (NBL) since July 2002 and at Rastriya Banijya Bank (RBB) since January 2003. The external managers have made progress in restructuring these banks that together account for over 50 percent of banking system assets. The managers have made progress in assessing the banks' financial position and announced VRSs to reduce overstaffing. Financial performance has also improved somewhat with better loan recovery and branch rationalization. Loan recovery from well-connected defaulters continues to be difficult, but the DRT and the strengthened blacklisting mechanism are expected to aid the banks' efforts and spur the process.

- **Public sector and governance reforms** progressed, supported by the AsDB's Governance Reform (GRP) and Public Sector Management (PSMP) Programs. The authorities have maintained a civil service hiring freeze and eliminated over

---

[2] The fiscal year begins mid-July.

[3] The BFI Ordinance replaces five acts—Commercial Bank Act, Development Bank Act, Finance Company Act, Agricultural Development Bank Act, and Nepal Industrial Development Corporation Act—governing financial institutions.

6,000 vacant positions (out of the 7,500 positions approved by cabinet in September 2002).[4] They also initiated irrevocable liquidation/privatization of five state-owned enterprises (SOEs) and approved divestiture plans for four others. A highly visible anti-corruption drive was launched by the Commission for Investigation of Abuse of Authority (CIAA) against politicians and revenue officials perceived to have accumulated unaccountable assets; a Special Court to handle corruption cases was established; and the Anti-Corruption Strategy was adopted.

- **Trade regime**. Nepal completed negotiations in September to join the WTO.

5. **Macroeconomic outcomes for 2002/03 were broadly as envisaged in the 2003 Article IV consultations staff report (SM/03/275) discussed by the Board in August**. The modest economic recovery made possible by the ceasefire helped restore some normality in economic activity and growth recovered to just over 2 percent; CPI inflation moderated as the pass-through effect of administered price adjustments and shortfalls in agricultural commodities faded (Table 1 and Figure 1). By end-year, private sector credit growth had picked up while interest rates edged down during the course of the year reflecting liquidity conditions in the banking system and lower government borrowing. The current account (excluding official transfers) slipped into a deficit of about 1 percent of GDP. However, together with higher remittances, aid, and unrecorded inflows, the overall balance of payments remained in surplus, and official foreign exchange reserves rose to over US$1 billion (6¾ months of imports of goods and services).

II. The Medium-term Framework and PRGF-Supported Program

6. **The PRGF-supported program focuses on**: (i) higher growth to help reduce poverty; (ii) implementing a medium-term fiscal strategy to mobilize revenue, prioritize expenditure, and reduce domestic financing; (iii) reforming the financial and public sectors to improve intermediation and resource allocation; and (iv) improving governance to reduce corruption, increase accountability, and enhance implementation capacity.

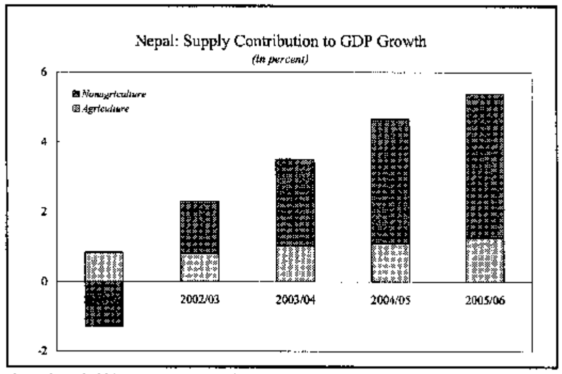
7. **The medium-term framework of the PRGF-supported program is based on a more realistic scenario set out in the PRSP, i.e., the "lower case" PRSP scenario**. This reflects the authorities' acknowledgement that the "base case" scenario is an "aspirations" scenario. In the PRGF framework, real GDP growth could rise to 3½ percent in 2003/04 (Table 5). There are downside risks if the security environment worsens and upside potential if peace talks resume in the coming months. Beyond 2003/04, growth rates could rise further to 5–6 percent if peace could be achieved and a strong program of structural reforms can be implemented (Box 2). With the exchange rate peg and prudent macroeconomic policies, inflation is expected to follow price developments in India. The current account deficit is projected to increase, but higher aid and remittances should allow official reserves to be maintained at around six months of imports of goods and services.

[4] Prior to this, the number of vacant positions was estimated at 17,000.

Box 2. Growth: Can the Economy Rebound?

A. Sources of Growth

In 2003/04, real GDP growth is expected to rise to 3½ percent. Agriculture growth is projected to rise from 2 percent in 2002/03 to 2¾ percent on the back of a favorable monsoon during the first half of the year. Nonagricultural growth is projected at 3–5 percent, from a low base. While tourist arrivals fell during the peak season (September/October) after the end of the ceasefire in August, preliminary indicators and anecdotal evidence suggest that manufacturing activity has remained relatively unscathed. In addition, the external environment is projected to turn around and help boost exports.

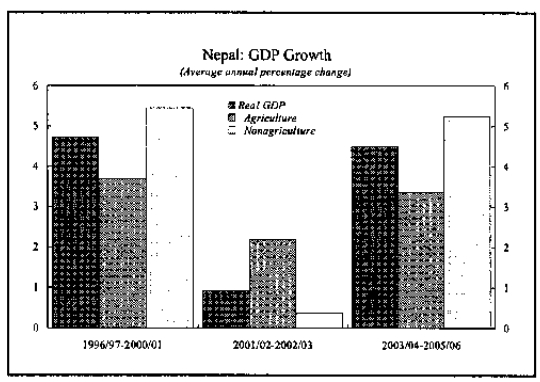


Over the medium term, growth is projected to pick-up to the trend growth rate of 5–5½ percent. Underlying these growth rates, agricultural growth is projected to increase steadily (average annual growth of 3¼ percent) through implementation of the Agricultural Perspective Plan (APP)—higher utilization of fertilizers, expansion of year-round irrigation, extension of the road network, diversification into cash crop and livestock production in the hill areas, and credit availability—which could help raise productivity. With the expectation that the security environment would have settled by then, nonagricultural growth, especially tourism and related sectors, can be expected to experience a rebound. Overall, nonagricultural growth is projected to average 6¼ percent.

B. Growth Prospects in Historical Perspective

Against the background of the unsettled security environment, an important consideration looking forward is whether the program growth targets are achievable. The historical experience from the eight-year old insurgency suggests that the growth assumptions of the program (average annual growth of 4½ percent during 2003/04-2005/06) are not out of line with past experience.

- During the latter half of the 1990s, real GDP growth slowed down but remained a robust annual average of 4¾ percent. Two factors contributed to this outcome. First, the impact of the insurgency on agriculture appears to have been small, as weather conditions remained a principal determinant of agricultural output. Second, reflecting the lagged effects of a strong program of reform implementation during the first half of the 1990s, especially trade liberalization, nonagricultural growth also remained relatively high. Within nonagriculture, manufacturing and tourism grew strongly.



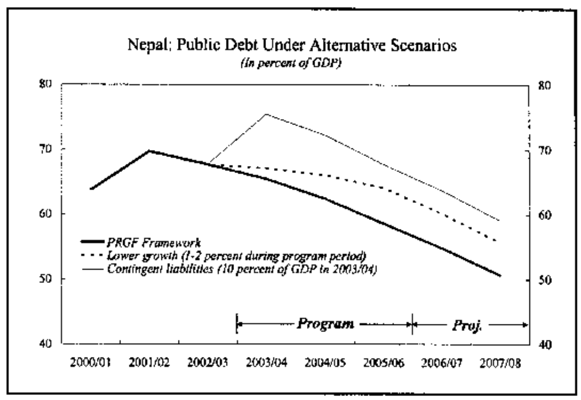
- During 2001/02-2002/03, the insurgency intensified after November 2001 and affected economic growth. However, economic performance was also set back by a number of other factors. Two consecutive years of poor rains affected agriculture adversely. Among the nonagricultural sectors, the impact of the insurgency on manufacturing was exacerbated by the weak external environment, since the global slowdown after September 11, 2001. Tourism was already being affected by the negative press following the palace massacre earlier in June 2001, with spillovers into related sectors. Overall, real GDP growth fell to 1 percent per year.

A. Macroeconomic Policies

Fiscal Policy

8. **The authorities' medium-term fiscal strategy is geared to help maintain sustainability**. This strategy consists of boosting revenue and reducing domestic financing while redirecting spending to social and key infrastructure sectors. By 2005/06, revenue would be targeted to increase by 1¼ percentage points to 13½ percent of GDP, based on revenue administration reforms, increases in the VAT rate, and rationalization of VAT and customs exemptions (MEFP ¶11, 13). Over 2003/04–2005/06, reduction in current spending could be achieved through reductions in security-related spending, as circumstances permit, and downsizing the civil service.[5, 6] Capital spending would rise to 6 percent of GDP in a prioritized manner stipulated in the Medium-Term Expenditure Framework (MTEF). With foreign grants and loans rising to 4¼ percent of GDP, domestic financing would be reduced to ½ percent of GDP in 2005/06.

9. **Nepal's public debt-to-GDP ratio is set to decline over the medium term from 68 percent of GDP at end-2002/03**. Stress tests suggest that public debt dynamics would remain manageable in the PRGF framework.[7] The debt-to-GDP ratio—without accounting for contingent liabilities—is projected to decline to around 50 percent of GDP by 2007/08 in a baseline scenario. Under a combination of plausible shocks to growth, interest rates, and the primary balance (or a 10 percent increase in debt creating flows, for example, to meet contingent liabilities from financial sector and public enterprise reforms), the debt-to-GDP ratio is projected to remain around



[5] Inefficiencies in the education sector—from an allegedly large number of "ghost" teachers—and rising pension payments are a source of concern. Some of these problems are to be addressed under a World Bank-supported program to devolve schools to local management committees which are better placed to identify staffing needs.

[6] After the intensification of the insurgency, security-related expenditures (defense and police spending) rose to an annual average of 2¾ percent of GDP during 2001/02–2002/03 (from annual average of 1¾ percent during the latter half of the 1990s). Following this build-up, defense and security-related spending is projected to decline slightly from these levels during 2003/04–2005/06.

[7] Interest payments in 2002/03 were 1½ percent of GDP.

60 percent of GDP by 2007/08 (Table 6). Similarly, even if growth fails to pick up, and remains for example at 1–2 percent per year during the program period, the public debt ratio would be only 5 percentage points of GDP higher than in the baseline scenario. As regards external debt, preliminary estimates suggest that the net present value of public debt at end–2002/03 was relatively low (22 percent of GDP), reflecting its concessional nature. However, given the large proportion of external financing, the debt profile is vulnerable to large exchange rate depreciations and to low export growth. Moreover, the full extent of contingent liabilities will only be revealed as financial and public enterprise reforms unfold.

Box 3. Fiscal Cost of Reforms

Contingent liabilities for the budget from financial and public sector reforms are currently estimated at 8½–10 percent of GDP. The bulk of these liabilities will arise from financial sector reforms to recapitalize insolvent banks (7–8 percent of GDP). The remainder are expected from public enterprise and civil service reforms (¾ percent of GDP each), and a limited amount from implementation of voluntary retirement schemes at NBL and RBB.

The estimates are, however, subject to large uncertainties. Specifically, liabilities from financial sector reforms would depend on decisions on privatization/merger/liquidation of NBL and RBB, the capital injection that may be required, progress made in resolving nonperforming loans (NPLs) and improvement in the financial condition of the banks under external managers in the meantime. Similarly, the net liabilities of SOEs would depend on the recovered value of assets during privatization/liquidation which are, *ex ante*, difficult to determine, including on account of weak financial information on the enterprises.

The carrying cost of the reforms (defined as cash payments and interest costs in the event of bond financing) would be provided for in annual budgets. These cost are estimated at ¼–1 percent of GDP per year over 2003/04–2005/06, depending on the phasing of the reforms. The 2003/04 budget provides for Nrs 1 billion (¼ percent of GDP) for public enterprise reforms envisaged during the first year program of the PRGF arrangement. The costs of VRS schemes at NBL and RBB are expected to be largely met from the banks' own resources, with some on-lending of budgetary external assistance. Beyond 2003/04, the carrying costs can be accommodated in annual budgets within the proposed framework using contingency margins in the fiscal projections and concessional external assistance which should be available if reform implementation remains on track.

10. **The 2003/04 budget makes a start in implementing the medium-term fiscal strategy**. The budget includes a significant tax reform effort which should yield results over time (Box 4). To strengthen revenue administration, an existing unit in the Inland Revenue Department will be expanded into a full service large taxpayer unit by mid-January 2004 (MEFP ¶15), with IMF and donor technical assistance. Steps to strengthen customs

Box 4. Key Elements of the 2003/04 Budget

A. Revenue, Expenditure, and Financing

Revenue. Compared to 2002/03, revenue is projected to rise by ¼ percentage points of GDP to 12½ percent of GDP. Tax revenue is to rise from 9½ percent of GDP in 2002/03 to around 10 percent of GDP as a part of the special security levy (until now a part of nontax revenue) is to be integrated into customs duties and excises. The decline in nontax revenue is to be offset by an increase in a wide range of charges and fees.

Expenditure. Total expenditure is set to increase by around 2½ percentage points of GDP to 18¾ percent of GDP. The budget provides for an increase in **current spending** by 1½ percentage point of GDP to 13 percent of GDP, reflecting a combination of higher wage allocation for security personnel and larger health and education spending, mostly under donor funded programs to decentralize service provision. Other factors for higher current spending include allocations for clearance of utility arrears and contingent liabilities of public enterprises to be liquidated/divested; integration into the budget of Roads Board, Health Fund, and Poverty Alleviation Fund expenditures recommended by Fund staff as part of public expenditure management reforms; and a contingency allocation for national elections. The budget does not envisage an increase in civil service wage scales. **Capital expenditure** is to rise from the depressed levels of 2002/03 by 1 percentage points of GDP to 5½ percent on the assumption that the security situation would permit higher spending.

Financing. Domestic financing is to be limited to 1¾ percent of GDP, thanks to higher revenue mobilization and aid commitments by multilaterals and bilateral donors. Foreign grants and loans are projected to increase significantly by 1¾ percentage points of GDP to 4½ percent of GDP.

B. Tax Reform

The budget includes a significant tax reform effort, based on FAD and the government's Fiscal Reform Task Force recommendations to streamline the tax system, promote exports, and reduce the personal income tax burden at lower income levels. These measures include: (i) removal of export service charges and reduction in export taxes on a number of items by 25 percent; (ii) elimination of one-half of the special security levy by integrating it into customs duties and excises; (iii) reduction in import duty rates (in line with WTO accession agreements, e.g., on vehicles from 130/80 percent to 80/40 percent offset by increases in excises); (iv) an increase in the income tax threshold; and (v) elimination of VAT exemption for edible oils. This package of measures is expected to be revenue neutral.

C. Prioritization and the Medium Term Expenditure Framework

The Medium-Term Expenditure Framework provides the basis for expenditure prioritization. Development expenditure is fully prioritized in line with the MTEF.[1] Under the framework, expenditures are prioritized in three categories (P1, P2, and P3). Over 60 percent of the development budget is allocated to P1 projects with assured funding. To facilitate implementation of priority activities, budget allocations for agriculture/rural and human development/social service delivery are protected under alternative growth scenarios. A performance-based fund release mechanism is being implemented for projects.

---

[1] The budget classifies spending into "regular" and "development." The bulk of regular expenditure (9-10 percent of GDP) is current spending. Development expenditure (6-8 percent of GDP) includes current (one-third of development expenditure) and capital spending.

administration will also be identified and implemented by end-2003/04.[8] In addition, reforms are envisaged to improve the transparency of Nepal's already open trade regime and help meet WTO accession requirements. The development budget is fully prioritized in line with the MTEF. Domestic financing is to be contained to 1¾ percent of GDP.

11. **The 2003/04 budget incorporates some cushions to deal with contingencies.** First, the revenue projections are based on conservative assumptions on buoyancy and the effect of improvements in tax administration reforms on collections.[9] Second, on the spending side, limited margins have been built in to allow for, for example, elections and security-related spending. Third, remedial measures are specified in the event of financing shortfalls.

12. **Government spending will be redirected to social sectors, for poverty alleviation, and be better prioritized.** Health and education expenditures are budgeted to increase by ¼ percentage point of GDP to 4 percent of GDP in 2003/04, and to 4½ percent of GDP by 2005/06. By 2005/06, poverty-related spending is to increase to 7½ percent of GDP from 6¼ percent of GDP in 2003/04 and is to be better targeted under the newly established Poverty Alleviation Fund.[10] The MTEF would also be extended to regular expenditure, as envisaged in the PRSP. In particular, the 2003/04 budget makes a provision for privatization/liquidation of public enterprises scheduled in the fiscal year.

Monetary and Exchange Rate Policy

13. **Monetary policy would remain geared to supporting the exchange rate peg to the Indian rupee (MEFP ¶16).** For 2003/04, this requires that broad money growth be contained to 11 percent, assuming a continued small decline in velocity and targeted real GDP growth of 3½ percent. This growth would accommodate domestic financing needs of the budget while allowing real private credit growth of about 9–10 percent. With the targeted increase in NRB foreign assets of US$60 million and limited NRB financing of the budget, reserve money growth would be limited to 10½ percent. However, the level of the peg is to be kept under review, given prospective external developments, such as loss of protected access to overseas markets due to the phasing out of the Multi-Fibre Arrangement by 2005 which could pose challenges for export growth. These challenges can be addressed over the medium term

---

[8] It is expected that some high tariff rates would be reduced and all import levies, including the security levy, would be consolidated into a single customs duty over the program period.

[9] With the nominal GDP growth assumptions of 8½ percent in 2003/04, the cushion is about 0.4 percent of GDP, using the estimated revenue buoyancy of 1½ during 1998/99-2002/03; the implied buoyancy in 2003/04 is 1¼.

[10] In the PRSP, poverty-related spending covers a number of spending heads, including basic health and primary education, drinking water and sanitation, rural infrastructure, agriculture, irrigation, local level grants, and targeted programs.

through steps to make Nepal's exports more competitive, through reduced labor and nonlabor inputs costs and by infrastructure investment to ease supply bottlenecks (see below).

14. **The NRB will take steps to foster development of money and foreign exchange markets**. In a significant move, the NRB intends to eliminate existing restrictions on commercial banks' lending rates and foreign exchange buy/sell rate spreads in the coming months (MEFP ¶18) to allow banks to better price credit risk and expand their profit opportunities. In addition, the "priority" sector lending requirement is to be phased out over the arrangement period. Financial sector reforms (see below), especially at insolvent commercial banks, would help improve monetary policy transmission and implementation.

B. Structural Reforms

15. **The structural reform agenda is focused on financial and public sector reforms, and improving governance**. Over the medium-term, reforms in these areas would create conditions for higher growth by improving intermediation and resource allocation, reducing corruption, and increasing accountability (MEFP ¶19, Table 2). A number of measures are to be taken in each of these areas in the first year of the program. These reforms are also supported by the World Bank (Financial Sector Technical Assistance Program and the proposed PRSC) and by AsDB's Governance Reform Program (2002–2005) and Public Sector Management Program (July 2002–December 2004).[11]

Financial Sector Reforms

16. **Further steps are envisaged to strengthen the NRB, improve the banking environment, and restructure commercial and development banks.**

- By end-2003/04, organization of the **NRB** will be streamlined, based on recommendations of the external consultants, with a view to focusing on core central banking functions. In this context, further downsizing will be undertaken by outsourcing general services and preparations made to privatize payments system operations. Improvements in performance incentives would be possible through a revision of human resources policies, including introduction of merit-based promotions. Supervision will be enhanced by upgrading manuals and retaining qualified staff.

- To create **a sound banking environment**, the Debt Recovery Tribunal will remain actively operative and the strengthened blacklisting provisions for loan defaulters

---

[11] The objectives of the GRP include improvements in civil service efficiency and governance and reduction in corruption in government. PSMP objectives include government disengagement from SOE management and ownership and strengthening public and corporate sector governance.

enforced, with NRB and government support. The BFI Ordinance will be amended to align its provisions with a revised Company Ordinance.

- **Commercial banks**—RBB and NBL—will continue loan recovery efforts, with NRB and government support. The banks would also complete phased implementation of their VRSs to reduce overstaffing.[12] The banks are also committed to preparing audited 2002/03 accounts to international accounting standards. As these steps are being taken and restructuring progresses, the authorities would develop a strategic plan towards recapitalization and final resolution of these banks, including decisions on the banks' merger, privatization, or liquidation over the course of the program period, in consultation with the World Bank.[13]

- **Development banks**—Agriculture Development Bank of Nepal and Nepal Industrial Development Corporation—are to undergo restructuring based on AsDB-funded audits to address the banks' financial condition.

Public Sector Reforms

17. **Public sector reforms aim to make the civil service more efficient, reduce government ownership and improve management and accountability of SOEs.**

- Further elimination of vacant positions and downsizing of civil service employment at lower levels will be undertaken. Over the medium term, reform efforts would focus on better incentives for professional staff and steps to increase their accountability to improve policy implementation. In these efforts, the authorities are committed to ensuring that the civil service wage bill is affordable and sustainable, while decompressing pay scales.

- Public enterprise reform efforts would lower government ownership in the economy, increase the SOEs' net budgetary contribution, and address contingent liabilities. Government ownership would be reduced through privatization and restructuring of viable enterprises and liquidation of unviable ones. The program will complement the authorities' strategy to improve management, accountability, and performance of

---

[12] External managers estimate that VRSs for NBL and RBB could cost US$24 million and US$26 million, respectively.

[13] At end–2001/02, NPLs at NBL and RBB were an estimated Nrs 10¾ billion (56 percent of the loan portfolio) and Nrs 15 billion (55 percent of the loan portfolio), respectively.

SOEs. More generally, boards and management of SOEs are to be professionalized, including by reducing government representation. Specifically,

- Privatization/liquidation of five enterprises will be completed by end-2003/04. Preparations for another four enterprises will be brought to an advanced stage.[14]
- The 2003/04 budget announced plans to initiate share sales in the profitable Nepal Telecommunications Corporation and National Life Insurance Corporation and an internal unbundling of the Nepal Electricity Authority.
- To assess its financial position, an audit of the Nepal Oil Corporation's 2002/03 accounts by an international firm is to be completed by end-2003/04.[15] The sector is also to be opened to private competition.

Governance Reforms

18. **The authorities' anti-corruption efforts will be intensified**. The institutional structure to tackle corruption—the CIAA and the Special Court—is to be strengthened through additional resource allocation. A time-bound plan to implement the Anti-Corruption Strategy will be formulated and efforts made to secure prosecutions and to expedite the judicial process. Technical assistance to support these efforts has been provided by AsDB, Denmark, and the United Kingdom. The authorities would follow through on the Country Procurement Assessment Report, prepared with World Bank assistance. To increase transparency and reduce leakages in public procurement, the Fiscal Transparency Ordinance is to be issued.

19. **The PRSP places special emphasis on decentralization—increased local involvement in policymaking and implementation—to improve service delivery and accountability**. In this context, a key component of the World Bank's PRSC is greater local

---

[14] Thirty eight public enterprises were under full government ownership at end–2001/02 with total employment of 43,500 (½ percent of the labor force). Excluding Nepal Telecommunication Corporation, the National Life Insurance Company, and a few small enterprises, other enterprises were loss makers with total losses estimated at Nrs 9 billion (2 percent of GDP). Severance payments and unfunded liabilities to staff retrenched during privatization/liquidation/restructuring are to be met with external financial assistance. Privatization/liquidation procedures are envisaged for Bhaktpur Brick Factory, Cottage and Handicrafts Limited, Nepal Coal Limited, Hetauda Textile Factory, Nepal Transport Corporation, Birjung Sugar Factory, Agriculture Tools Factory, Nepal Rosin and Terpentine Limited, and Himal Cement Company.

[15] At end-2002/03, only a few enterprises had updated audited accounts, of varying quality.

level management of schools and health posts. The authorities are taking steps to reactivate local level bodies to improve accountability and implementation capacity.[16]

Labor Market Reforms and Private Sector Development

20. **Legal reforms will be undertaken to improve labor market flexibility and the business climate.** Given current political sensitivities, the authorities intend to consult with business groups and labor unions and seek amendments to labor laws to improve flexibility in labor employment.[17] Other ongoing legal reforms include amendments of the Company and Insolvency Acts (with AsDB technical assistance) to improve the regulatory framework for private sector activity.

C. Poverty and Social Impact of Reforms

21. **The overall impact of the proposed reforms on the poor is expected to be strongly positive.** Stable macroeconomic conditions are expected to generate higher growth rates which, together with better targeting of the poor, should help to reduce poverty by 8-10 percentage points from around 40 percent over the medium term.[18] Revenue mobilization, especially if there are significant improvements in tax and customs administration, could obviate the need for rate increases through base broadening.[19] Expenditure prioritization and increased spending on social and infrastructure sectors under the MTEF in particular can be expected to be pro-poor, provided monitoring mechanisms are strengthened. The impact of redundancies in the context of financial and public sector reforms, especially at lower grades, will be ameliorated by voluntary retirement schemes, severance packages, and training programs. Moreover, addressing contingent liabilities at an

[16] The Local Self Governance Act was passed in 1999. Progress in devolving key service (primary education, agricultural extension, and health services) stalled as the tenure of locally elected bodies expired in mid–2002 and village development committee offices had to be shut down in insurgency-affected areas. Since then, local bodies have been run by civil servants, with limited success. The government is now moving to constitute all-party committees to govern the local bodies.

[17] The official unemployment rate at end-2001/02 was 5 percent. However, underemployment was estimated at over 30 percent. These estimates are subject to significant margins.

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

[19] The impact of oil prices and subsidy changes has been investigated by the World Bank. Elimination of some tax exemptions, such as electricity, could lead to higher prices, although the direct impact on the poor may be limited due to low usage. The impact of these measures on prices can be phased in and ameliorated through targeted programs.

early stage would create room for higher prioritized spending in the coming years. The impact of proposed public sector reforms is judged to be positive by the AsDB. A fuller analysis of the proposed reforms will become available after the next round of the Nepal Living Standards Survey scheduled to be completed in March 2004.

III. Program Risks, Monitoring, and Safeguards

22. **The main risk to program implementation stems from the security and political situation**. An escalation of violence would disrupt activity, and jeopardize the implementation of development spending, including for infrastructure and poverty alleviation projects. Revenue collection could also be affected. In addition, weak implementation capacity and governance pose continuing constraints to full utilization of development budgets and poverty alleviation.

23. **Mitigating these risks is the authorities' demonstrated track record of policy implementation under difficult circumstances, as well as support for the reform agenda across the political spectrum**. The authorities have implemented reforms over a period of time, including at the height of the insurgency, to demonstrate their commitment to reforms. The Thapa government has asked all political parties to join it in the fight against the basis for the insurgency—pervasive poverty, corruption, and social exclusion. Indeed, higher spending for social sectors and deprived groups, governance reforms, and local level participation in social service delivery are key elements of the PRSP and the PRGF program. Finally, the risk of policy reversal is limited as the reform agenda enjoys political support, including from the parties opposed to the current government, as many of them were the initial architects of the PRSP.

24. **The proposed program will be monitored through semi-annual reviews.** Quantitative and structural performance criteria have been proposed through mid-July 2004 (MEFP ¶27). The test dates for these performance criteria during the first year of the arrangement are mid-January 2004 and mid-July 2004, respectively, and the first program review by the Board is tentatively scheduled for April 2004.

25. **Nepal should be able to meet its obligations to the Fund under the proposed PRGF arrangement**. The requested access in an amount equivalent to SDR 49.9 million (70 percent of quota) would yield a total projected disbursement of about US$70 million (Table 7), to be disbursed semi-annually in seven equal installments. For 2003/04, the projected financing gap of US$90 million is expected to be covered by PRGF disbursements (US$20 million) and the World Bank (US$70 million). The financing need over the remaining program period (2004/05-2005/06) is projected at US$180 million, and would be covered by further support from other international financial institutions, including adjustment operations, and by bilateral donors. Under the program, total use of Fund resources would peak at 70 percent of quota in 2006/07, and debt service to the Fund as a share of exports would remain below 0.1 percent during the arrangement period (Table 8).

26. **The Auditor General has agreed to address NRB safeguards issues.** An external auditing firm is expected to finalize NRB's 2002/03 financial accounts, to International Accounting Standards, by February 2004.

IV. Staff Appraisal

27. **Nepal needs to urgently address pervasive poverty related to insufficient growth and inadequate targeting under poverty alleviation programs.** Growth remains constrained by inefficient resource allocation linked to structural weaknesses in key sectors and poor governance. Intensified security problems and adverse external conditions added to these constraints in recent years. Insufficient growth, inadequate investment in health and education, and lack of income generation opportunities for the poor have limited poverty reduction in Nepal and fueled the eight-year old insurgency.

28. **The proposed PRGF-supported program—and the PRSP reform agenda on which it is based—seeks to reduce poverty through a comprehensive strategy to address constraints to growth.** The PRSP's strategy—focused on broad-based growth, social sector development, targeted programs for the poor and deprived groups, and improved governance builds on lessons from past experience. Progress in each of these areas is critical for poverty reduction. The proposed program is closely linked to the PRSP, and its elements—sound macroeconomic management, expenditure prioritization, structural reform implementation, and better governance—are geared to deliver conditions for high, sustained growth and increase the health, education, and pro-poor focus of budget spending.

29. **To demonstrate their commitment to reforms, the authorities have established a track record of policy implementation under difficult circumstances.** All prior actions for the PRGF-supported program have been completed. Looking forward, although the security and political situation remain unsettled, the risk of policy reversal is limited by the broad support across the political spectrum enjoyed by the PRSP reform agenda.

30. **To maintain macroeconomic stability, it will be important to implement the medium-term fiscal framework which focuses on raising revenue and reducing domestic financing while prioritizing spending.** Determined implementation of tax policy measures and strengthened administration will be needed to mobilize revenue. On expenditure, the extension of the MTEF to all spending will help raise allocations for priority sectors and increase poverty-related development spending. However, a strong effort is required to ensure higher development spending through enhanced local level implementation capacity. Should revenue or external aid fall short, cutbacks in spending in line with the MTEF will be required. Over the medium term, reductions in domestic borrowing will help maintain fiscal sustainability.

31. **Monetary and exchange rate policies are to remain geared to supporting the exchange rate peg to the Indian rupee.** The peg has served Nepal well given its close ties to India and helped keep inflation at low levels. However, the level of the peg is to be kept

under review, given prospective external developments while competitiveness will be enhanced by reduced labor and nonlabor input costs.

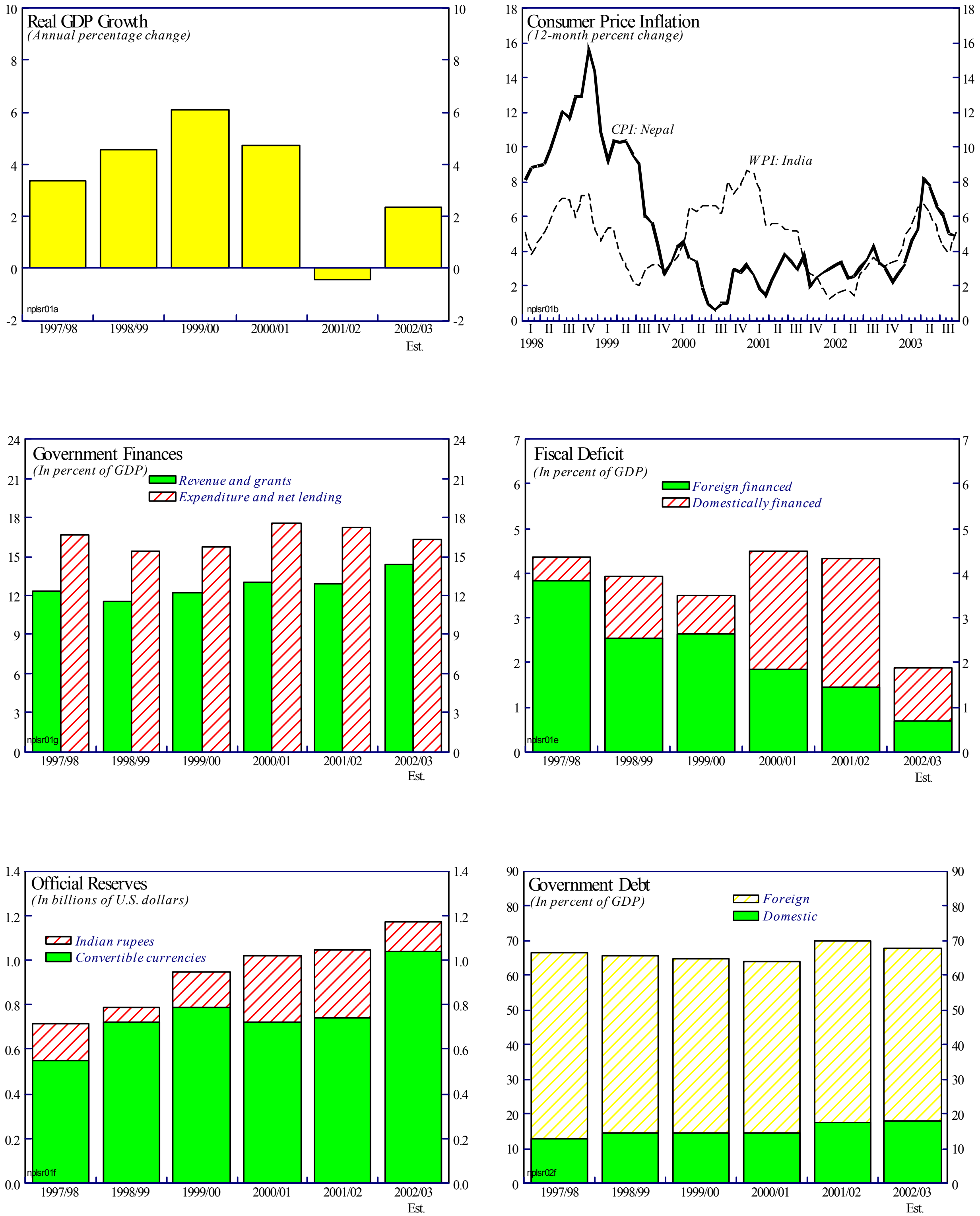
32. **An encouraging start has been made in financial sector reforms, but much remains to be done**. Reform actions and restructuring envisaged under the program should help transform the NRB into a modern and efficient central bank, with a stronger capacity to supervise the financial sector. With the strengthened criteria for blacklisting loan defaulters and the Debt Recovery Tribunal in place, the focus needs to be on effective and timely implementation, applied to all defaulters. This is essential to buttress the external managers' efforts at commercial banks to improve the banks' financial condition. Implementation of voluntary retirement schemes to reduce overstaffing and improved efficiency are key elements of these efforts.

33. **Implementation of public enterprise and governance reforms is essential to create conditions for higher growth over the medium term.** The privatization/liquidation of unviable enterprises needs to be completed as envisaged and divestment of state ownership in profitable entities undertaken to further enhance their efficiency. Other reform measures, including the preparation of updated audited accounts, would improve management accountability, including through a better assessment of the financial condition of SOEs. Civil service reforms and decentralization need to be carried out to improve service delivery, and forceful steps need to be taken to curb corruption to improve governance.

34. **Trade policy and legal reforms can improve the business climate for private sector development**. With the negotiations completed, Nepal's WTO accession will make history but steps will need to be taken, including liberalization of trade in services which would reduce business costs, to implement accession commitments. Looking forward, it will be important for the authorities to build social consensus to amend legislation to make labor markets more flexible and make exit of unviable firms more orderly and timely.

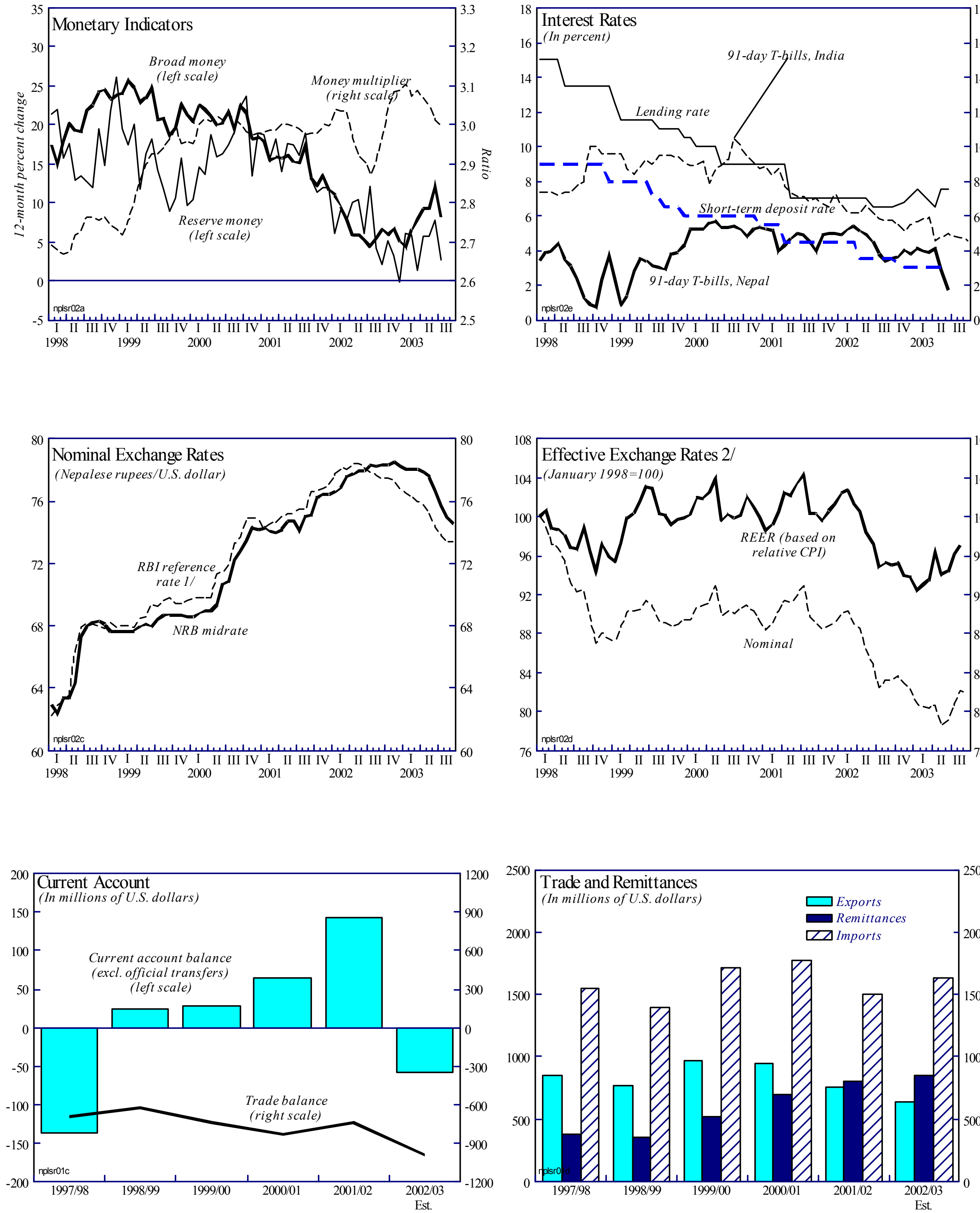
35. **The staff considers the proposed program to be appropriately comprehensive and realistic for achieving the program's objectives**. While there are risks to policy implementation arising from the unsettled security and political situation, the staff considers these risks to be acceptable in view of the authorities' demonstrated commitment to the reform program, and the broad consultation and support for the PRSP strategy that underpins the program. Furthermore, the program aims to break the vicious cycle of low growth, poverty, and insurgency by revitalizing development efforts, improving implementation capacity, and strengthening local level participation. In addition, the government continues to seek peace negotiations with the insurgents, including through informal channels, and remains open to the idea of an all-party government. The staff encourages the authorities to persevere with their efforts. The authorities' reform program merits the support of the international community, and therefore, the staff recommends Executive Board approval of the authorities' request for an arrangement under the PRGF.

Figure 1. Nepal: Real and Fiscal Sector Developments



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

Figure 2. Nepal: Monetary and External Sector Developments



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

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

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

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

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
			Est.		Proj.	
			(Percent change)			
Real GDP at market prices	4.8	-0.5	2.3	3.5	4.6	5.4
CPI (12-month change)	3.4	3.5	6.1	4.5	4.2	4.0
CPI (period average)	2.4	2.9	4.7	5.3	4.3	4.1
GDP deflator	3.2	3.2	3.5	4.9	4.6	4.6
Fiscal indicators			(In percent of GDP)			
Total revenue	11.4	11.5	12.3	12.4	12.8	13.4
Total expenditure	17.6	17.2	16.3	18.7	18.5	18.2
Current expenditure	11.2	11.6	11.6	13.1	12.5	12.1
Capital expenditure and net lending	6.4	5.7	4.7	5.6	6.0	6.1
Overall deficit before grants	6.2	5.7	4.0	6.3	5.7	4.8
Overall deficit after grants	4.5	4.3	1.9	3.1	2.6	2.0
Domestic financing (net)	2.7	2.9	1.2	1.7	1.3	0.6
Public debt	63.8	69.7	67.7	65.5	62.4	58.7
Money and credit			(Percent change, end-of-period)			
Broad money	15.2	4.4	8.1	11.1	...	...
Domestic credit	18.8	9.2	11.2	13.7	...	...
Interest rates			(In percent)			
91-day treasury bill (end-of-period)	5.0	3.6	4.0	...	...	...
Central bank refinancing	6½–7½	2–5½	2–5½	...	...	...
Loans to industry	9½–15	7–14½	7–14½	...	...	...
Balance of payments			(In millions of U.S. dollars)			
Current account balance (excluding grants)	64	143	-59	-109	-123	-178
(In percent of GDP)	1.2	2.6	-1.0	-1.7	-1.8	-2.4
Trade balance	-831	-742	-997	-1,098	-1,141	-1,220
(In percent of GDP)	-14.9	-13.4	-17.4	-17.1	-16.7	-16.7
Gross official reserves (end-of-period)	1,020	1,048	1,173	1,233	1,288	1,343
(In months of imports of goods and services)	7.0	6.7	6.8	6.4	6.3	6.1
Export value growth 2/	4.6	-18.1	2.4	7.4	5.9	6.0
Import value growth	3.5	-15.6	9.0	9.0	13.9	6.5
External debt/GDP (in percent) 3/	49.9	52.9	52.2	47.2	44.8	42.4
Debt service 4/	4.7	5.3	5.6	6.0	6.3	6.7
Exchange rate (Nrs per U.S. dollar, end-of-period)	74.7	78.0	75.1	...	...	...
REER (end-of-period; percent change; -=depreciation)	3.8	-9.2	-7.3	...	...	...
NEER (end-of-period; percent change)	2.9	-11.2	-2.0	...	...	...
Fund operations (outstanding loans at end-of-period; SDR million)						
SAF/ESAF	6.6	3.2	1.7	...	...	...
Nominal GDP at market prices (Nrs billion)	410.3	421.3	446.2	484.3	530.0	584.1

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

1/ Fiscal year begins mid-July.
2/ Excluding re-exports.
3/ Includes estimated short-term trade credits.
4/ In percent of exports of goods, services, and private transfers; including debt service to the Fund.

Table 2. Nepal: Summary of Government Operations, 2001/02-2005/06 1/

	2001/02	2002/03			2003/04	2004/05	2005/06
	Estimate	Budget	Budget Revised	Estimate Sep-03	Budget	Projections	
			(In billions of Nepalese rupees)				
Total revenue and grants	54.4	70.2	62.2	64.3	75.7	84.2	94.6
Total revenue	48.6	55.6	53.0	54.7	60.2	67.7	78.1
Tax revenue	39.3	45.9	42.3	42.0	48.2	56.9	66.1
Nontax revenue 2/	9.2	9.7	10.7	12.7	12.0	10.8	12.0
Grants	5.8	14.6	9.2	9.6	15.5	16.5	16.5
Total expenditure	72.6	86.3	76.7	72.7	90.7	97.9	106.4
Current 3/	48.7	61.1	56.1	51.6	63.5	66.3	70.6
Of which: Interest payment	5.8	8.0	7.2	6.6	7.9	8.6	9.6
Capital and net lending 3/	23.9	25.1	20.6	21.1	27.2	31.7	35.8
Overall balance before grants	-24.0	-30.7	-23.7	-18.0	-30.5	-30.2	-28.3
Overall balance after grants	-18.2	-16.1	-14.5	-8.4	-15.0	-13.7	-11.8
Financing	18.2	16.1	14.5	8.4	15.0	13.7	11.8
Net foreign loans	6.0	6.4	5.6	3.1	6.7	6.9	8.0
Gross disbursements	10.8	12.4	11.3	8.6	12.8	14.2	16.0
Amortization	4.8	6.0	5.6	5.5	6.1	7.3	8.0
Net domestic financing	12.2	9.7	8.8	5.3	8.4	6.8	3.8
Net NRB financing	6.3	...	...	-7.1	1.0	0.5	0.0
Net commercial bank	4.0	...	...	10.1	7.0	5.5	2.5
Net nonbank	1.9	...	...	2.3	0.4	0.8	1.3
			(In percent of GDP)				
Total revenue	11.5	11.9	12.0	12.3	12.4	12.8	13.4
Tax revenue	9.3	9.8	9.5	9.4	9.9	10.7	11.3
Nontax revenue 2/	2.2	2.1	2.4	2.8	2.5	2.0	2.1
Grants	1.4	3.1	2.1	2.2	3.2	3.1	2.8
Total expenditure	17.2	18.4	17.3	16.3	18.7	18.5	18.2
Current 3/	11.6	13.0	12.7	11.6	13.1	12.5	12.1
Of which: Interest payment	1.4	1.7	1.6	1.5	1.6	1.6	1.6
Capital and net lending 3/	5.7	5.4	4.6	4.7	5.6	6.0	6.1
Overall balance before grants	-5.7	-6.5	-5.3	-4.0	-6.3	-5.7	-4.8
Overall balance after grants	-4.3	-3.4	-3.3	-1.9	-3.1	-2.6	-2.0
Financing	4.3	3.4	3.3	1.9	3.1	2.6	2.0
Net foreign loans	1.4	1.4	1.3	0.7	1.4	1.3	1.4
Gross disbursements	2.6	2.6	2.5	1.9	2.6	2.7	2.7
Amortization	1.1	1.3	1.3	1.2	1.3	1.4	1.4
Net domestic financing	2.9	2.1	2.0	1.2	1.7	1.3	0.6
Central bank financing	1.5	...	...	-1.6	0.2	0.1	0.0
Commercial bank financing	0.9	...	...	2.3	1.4	1.0	0.4
Nonbank financing	0.5	...	...	0.5	0.1	0.2	0.2
Memorandum items:							
Public savings	0.0	-1.2	-0.7	0.7	-0.7	0.3	1.3
Primary balance	-3.0	-1.7	-1.6	-0.4	-1.5	-1.0	-0.4
Debt service	2.9	3.5	3.7	3.6	3.6	3.7	3.7
Domestic	1.3	1.6	1.9	1.9	1.8	2.0	1.9
Foreign	1.6	1.8	1.8	1.7	1.8	1.7	1.8
Public debt	69.7	66.1	69.5	67.7	65.5	62.4	58.7
Domestic	17.5	17.8	18.6	17.7	18.0	17.7	16.8
External	52.2	48.3	50.9	50.0	47.5	44.7	41.9
Regular expenditure 3/	9.8	10.5	10.8	10.1	10.5	9.8	9.3
Development expenditure 3/	5.0	7.9	6.5	6.2	8.2	8.7	8.9
Education expenditure	3.1	3.0	3.1	...	3.4	3.5	3.6
Health expenditure	0.9	1.0	0.9	...	1.2	1.3	1.4
Nominal GDP (in billions Nrs)	421.3	468.8	443.4	446.2	484.3	530.0	584.1

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/ Includes privatization receipts.

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

Table 3. Nepal: Monetary Accounts, 2001-2004

	2001	2002	2003		2004		
	Jul	Jul	Jul Est.	Oct Proj.	Jan Proj.	Apr Proj.	Jul Proj.
Monetary authorities	(In billions of Nepalese rupees)						
Reserve money	70.6	79.0	81.0	83.0	86.6	86.5	89.5
Net foreign assets	75.0	81.1	87.7	88.4	90.6	91.4	92.1
Net domestic assets	-4.4	-2.1	-6.7	-5.3	-4.0	-4.8	-2.6
	(Annual percentage change)						
Reserve money	15.7	11.9	2.5	8.2	7.0	10.6	10.5
	(12-month change in percent of reserve money at start of period)						
Reserve money	15.7	11.9	2.5	2.5	7.0	6.9	10.5
Net foreign assets	15.9	8.7	8.3	0.9	3.6	4.6	5.5
Net domestic assets	-0.2	3.2	-5.8	1.7	3.4	2.3	5.1
Monetary survey	(In billions of Nepalese rupees)						
Broad money	214.5	224.0	242.2	246.8	251.9	261.9	269.1
Narrow money	70.6	77.2	81.4	82.5	83.7	86.5	88.3
Quasi money 1/	143.9	146.8	160.8	164.3	168.2	175.4	180.8
Net foreign assets	87.8	88.4	92.0	93.6	95.2	96.7	98.4
Net domestic assets	126.7	135.6	150.2	153.2	156.7	165.2	170.7
Domestic credit 1/	183.4	200.3	222.8	229.6	239.9	246.3	253.3
Public sector	47.0	58.6	61.6	64.6	67.6	68.6	69.6
Government	44.8	55.5	58.7	61.7	64.7	65.7	66.7
Public enterprises	2.2	3.1	2.9	2.9	2.9	2.9	2.9
Private sector	136.4	141.7	161.2	165.0	172.4	177.7	183.8
Other items, net	-56.8	-64.7	-72.6	-76.4	-83.2	-81.2	-82.6
	(Annual percentage change)						
Broad money	15.2	4.4	8.1	8.3	9.4	10.0	11.1
Narrow money	15.7	9.3	5.5	4.8	6.5	7.3	8.4
Quasi money	15.0	2.1	9.5	10.2	11.0	11.4	12.4
Domestic credit	18.8	9.2	11.2	10.2	12.1	14.6	13.7
Public sector	29.1	24.7	5.1	5.8	9.5	14.8	13.0
Government	29.4	24.0	5.7	4.9	10.3	16.2	13.6
Private sector credit	15.7	3.9	13.7	12.0	13.1	14.5	14.0
	(12-month change in percent of broad money at start of period)						
Broad money	15.2	4.4	8.1	1.9	4.0	8.1	11.1
Net foreign assets	3.9	0.3	1.6	0.6	1.3	1.9	2.6
Net domestic assets	11.3	4.2	6.5	1.3	2.7	6.2	8.5
Domestic credit	15.6	7.9	10.0	2.8	7.1	9.7	12.6
Private sector	9.9	2.5	8.7	1.6	4.6	6.8	9.3

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

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

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

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
			Est.			Proj.		
	(In millions of U.S. dollars, unless otherwise stated)							
Current account balance (excl. official transfers)	64	143	-59	-109	-123	-178	-224	-274
Trade balance	-831	-742	-997	-1,098	-1,141	-1,220	-1,285	-1,356
Exports, f.o.b.	942	754	633	680	883	935	1,006	1,086
Merchandise exports	755	618	633	680	720	763	825	895
Re-exports	187	136	0	0	163	172	181	191
Imports, c.i.f.	1,773	1,496	1,630	1,777	2,024	2,155	2,292	2,442
Oil products	338	275	214	219	326	322	326	339
Other imports	1,435	1,221	1,416	1,558	1,698	1,833	1,965	2,103
Services (net)	216	108	114	122	126	129	130	133
Receipts	477	362	372	400	422	447	475	505
Of which:								
Tourism	159	113	146	152	169	189	211	235
Payments	262	254	258	279	296	318	344	372
Private Transfers (net)	680	777	825	867	891	912	931	949
Remittances receipts	699	803	855	901	928	953	976	999
Recorded	290	316	318	346	378	417	440	473
Estimated	409	487	537	556	550	536	536	526
Payments	19	26	31	34	37	41	45	49
Current Official Transfers 1/	108	143	161	243	252	248	237	232
Capital Transfers	84	74	78	123	127	124	114	100
Of which:								
Official grants 1/	58	48	68	113	117	114	104	90
Net official disbursements	103	39	50	18	21	32	25	19
Disbursements	164	105	123	100	115	132	131	130
Amortization	61	66	73	81	94	100	106	111
Foreign direct investment	0	-4	-2	5	10	15	17	19
Net other investment 2/	...	...	...	-281	-297	-256	-175	-98
Errors and omissions 2/	-320	-420	-144	0	0	0	0	0
Overall balance	38	-25	83	-1	-10	-15	-5	-2
Financing	-38	25	-83	1	10	15	5	2
Change in reserves (-=increase)	-75	40	-114	-95	-90	-85	-85	-73
IMF purchases (net)	-5	-4	-4	-2	0	0	0	0
Other liabilities	42	-11	34	8	10	10	10	10
Financing gap 3/	0	0	0	90	90	90	80	65
Of which:								
IMF	...	...	...	20	20	20	10	...
	(In pecent of GDP)							
Memorandum items:								
Current account (excl. official transfers)	1.2	2.6	-1.0	-1.7	-1.8	-2.4	-2.8	-3.2
Current account (incl. official transfers)	3.1	5.2	1.8	2.1	1.9	1.0	0.2	-0.5
Total external debt 4/	49.9	52.9	52.2	47.2	44.8	42.4	39.8	37.3
Debt service 5/	4.7	5.3	5.6	6.0	6.3	6.7	7.1	7.4
Gross foreign assets (end of period)	1,423	1,371	1,485	1,580	1,670	1,755	1,840	1,913
Of which: Central Bank	1,020	1,048	1,173	1,233	1,288	1,343	1,398	1,458
(In months of imports of goods and services)	7.0	6.7	6.8	6.4	6.3	6.1	6.0	5.9
Nominal GDP (In millions of U.S. dollars)	5,582	5,549	5,738	6,408	6,813	7,311	7,879	8,487

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

1/ Includes official transfers that are channeled through the budget only.
2/ Large net other investments and errors and omissions reflect data weaknesses in capital account, unreported remittances and large informal trade.
3/ Provisional. The remaining financing gap will be filled by bilateral and multilateral donors.
4/ Includes estimated private sector debt and short-term trade credits.
5/ As a ratio of exports of goods and services (excluding reexports of oil) and private transfer receipts.

Table 5. Nepal: Medium-Term Macroeconomic Framework, 2001/02–2007/08

(In percent of GDP, unless otherwise indicated)

	2001/02	2002/03 Est.	2003/04	2004/05	2005/06 Projections	2006/07	2007/08
Real sector							
Real GDP growth (percent change)	-0.5	2.3	3.5	4.6	5.4	5.5	5.5
Agriculture	2.2	2.1	2.8	3.0	3.5	3.7	3.7
Non-agriculture	-2.1	2.5	3.9	5.7	6.5	6.6	6.7
GDP deflator (percent change)	3.2	3.5	4.9	4.6	4.6	4.6	4.5
Saving-investment balance							
Gross domestic savings	13.2	10.7	11.3	12.1	12.6	13.4	14.1
Public 1/	0.2	0.6	-0.6	0.4	1.4	2.1	2.7
Private	13.0	10.1	11.9	11.8	11.2	11.2	11.4
Gross fixed investment	19.3	19.2	20.0	20.5	21.5	22.5	23.5
Public 1/	7.6	7.0	7.5	7.9	8.1	8.2	8.4
Private	11.7	12.1	12.5	12.6	13.4	14.3	15.1
Fiscal sector							
Total revenue	11.5	12.3	12.4	12.8	13.4	13.8	14.0
Grants	1.4	2.2	3.2	3.1	2.8	2.5	2.5
Current expenditure	11.6	11.6	13.1	12.5	12.1	11.8	11.5
Capital expenditure & net lending	5.7	4.7	5.6	6.0	6.1	6.2	6.4
Overall balance before grants	-5.7	-4.0	-6.3	-5.7	-4.8	-4.2	-3.9
Overall balance after grants	-4.3	-1.9	-3.1	-2.6	-2.0	-1.7	-1.4
Net foreign financing	1.4	0.7	1.4	1.3	1.4	1.3	1.3
Net domestic debt financing	2.9	1.2	1.7	1.3	0.6	0.4	0.1
External sector							
Export value (percent change) 2/	-18.1	2.4	7.4	5.9	6.0	8.1	8.5
Import value (percent change)	-15.6	9.0	9.0	13.9	6.5	6.3	6.6
Current account balance (excluding official transfei	2.6	-1.0	-1.7	-1.8	-2.4	-2.8	-3.2
Overall balance	-0.4	1.5	0.0	-0.1	-0.2	-0.1	0.0
Financing gap (million U.S. dollars)	0	0	90	90	90	80	65
Change in reserves (million U.S. dollars)	-40	114	95	90	85	85	73
External debt/GDP (in percent)	52.9	52.2	47.2	44.8	42.4	39.8	37.3
Debt service ratio	5.3	5.6	6.0	6.3	6.7	7.1	7.4
Monetary sector							
Broad money (percent change)	4.4	8.1	11.1	...	...	...	...
Private sector credit (percent change)	3.9	13.7	14.0	...	...	...	...

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

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

2/ Excluding re-exports.

Table 6. Nepal: Public Sector Debt Sustainability Framework, 2001-2008

(In percent of GDP, unless otherwise indicated)

	Actual			Projections				
	2001	2002	2003	2004	2005	2006	2007	2008
				I. Baseline Medium-Term Projections				
1 Public sector debt 1/	63.8	69.7	67.7	65.5	62.4	58.7	54.9	51.0
Of which: Foreign-currency denominated 1/	49.6	53.7	50.7	48.4	45.3	42.0	39.2	36.6
2 Change in public sector debt	-0.8	6.0	-2.0	-2.2	-3.1	-3.8	-3.8	-3.9
3 Identified debt-creating flows (4+7+12)	2.8	5.1	-4.1	-2.1	0.4	-4.4	-1.0	-4.4
4 Primary deficit	3.4	3.0	0.4	1.5	1.0	0.4	-0.1	-0.5
5 Revenue and grants 2/	13.1	12.9	14.4	15.6	15.9	16.2	16.3	16.4
6 Primary (noninterest) expenditure	16.4	15.9	14.8	17.1	16.8	16.6	16.2	15.8
7 Automatic debt dynamics 3/	-0.5	2.1	-4.5	-3.6	-0.6	-4.7	-0.9	-3.8
8 Contribution from interest rate/growth differential 4/	-3.7	-0.3	-2.4	-3.7	-4.0	-4.2	-3.7	-3.3
9 *Of which:* Contribution from real interest rate	-0.8	-0.6	-0.9	-1.5	-1.3	-1.1	-0.8	-0.6
10 *Of which:* contribution from real GDP growth	-2.9	0.3	-1.5	-2.2	-2.8	-3.1	-2.9	-2.7
11 Contribution from exchange rate depreciation 5/	3.1	2.4	-2.1	0.1	3.4	-0.6	2.8	-0.5
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	-3.6	0.9	2.1	-0.1	-3.5	0.6	-2.8	0.5
Public sector debt-to-revenue ratio 1/	488.1	540.0	469.1	418.9	392.9	362.2	337.1	311.8
Gross financing need 6/	5.6	5.5	3.1	4.4	4.0	3.4	3.1	2.5
In billions of U.S. dollars	0.3	0.3	0.2	0.3	0.3	0.2	0.2	0.2
Key macroeconomic and fiscal assumptions								
Real GDP growth (in percent)	4.8	-0.5	2.3	3.5	4.6	5.4	5.5	5.5
Average nominal interest rate on public debt (in percent) 6/	1.9	2.2	2.2	2.6	2.7	2.9	3.4	3.5
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.2	-1.0	-1.3	-2.3	-1.9	-1.7	-1.2	-1.0
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-5.7	-4.3	4.0	-0.2	-6.4	1.2	-5.7	1.1
Inflation rate (GDP deflator, in percent)	3.1	3.2	3.5	4.9	4.6	4.6	4.6	4.5
Growth of real primary spending (deflated by GDP deflator, in percent)	18.9	-3.9	-4.4	19.4	3.1	3.6	3.2	3.0
				II. Stress Tests for Public Debt Ratio				
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2004-2008			67.7	65.6	63.5	61.7	60.0	58.4
2. Real interest rate is at historical average plus two standard deviations in 2004 and 2005			67.7	67.2	65.6	61.6	57.8	53.7
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005			67.7	68.2	68.8	64.6	60.7	56.4
4. Primary balance is at historical average minus two standard deviations in 2004 and 2005			67.7	68.8	69.6	65.3	61.4	57.1
5. Combination of 2-4 using one standard deviation shocks			67.7	69.4	71.3	66.1	61.5	56.4
6. One time 30 percent real depreciation in 2004 8/			67.7	93.9	90.6	84.7	80.5	74.9
7. 10 percent of GDP increase in other debt-creating flows in 2004			67.7	75.5	72.3	67.8	63.9	59.4
8. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2004-05			67.7	70.3	72.3	67.7	63.8	59.3

Historical statistics for key variables (past 10 years)	Historical Average	Standard Deviation	Average 2004-08
Primary deficit	2.6	1.1	0.4
Real GDP growth (in percent)	4.3	2.5	4.9
Nominal interest rate (in percent) 6/	2.4	0.3	3.0
Real interest rate (in percent)	-3.2	1.8	-1.6
Inflation rate (GDP deflator, in percent)	5.6	2.1	4.6
Revenue to GDP ratio	12.7	0.9	16.1

Source: Fund staff estimates and projections.

1/ Central government gross debt as reported in IFS. Differences between this external debt data series and staff estimates are attributable to differences in coverage and valuation.
2/ Includes privatization receipts.
3/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
4/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.
5/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 7. Nepal: Proposed Schedule of Disbursements Under the PRGF Arrangement

Amount	Available Date	Conditions for Disbursement
SDR 7.13 million (10 percent of quota)	November 14, 2003	To be disbursed upon board approval.
SDR 7.13 million (10 percent of quota)	April 30, 2004	Observance of the mid-January 2004 performance criteria and completion of the first review.
SDR 7.13 million (10 percent of quota)	October 31, 2004	Observance of the mid-July 2004 performance criteria and completion of the second review.
SDR 7.13 million (10 percent of quota)	April 30, 2005	Observance of the mid-January 2005 performance criteria and completion of the third review.
SDR 7.13 million (10 percent of quota)	October 31, 2005	Observance of the mid-July 2005 performance criteria and completion of the fourth review.
SDR 7.13 million (10 percent of quota)	April 30, 2006	Observance of the mid-January 2006 performance criteria and completion of the fifth review.
SDR 7.13 million (10 percent of quota)	October 31, 2006	Observance of the mid-July 2006 performance criteria and completion of the sixth review.

Source: Fund staff projections.

Table 8. Nepal: Fund Position and Indicators of Fund Credit, 2003/04-2007/08 1/

(In millions of SDRs)

	2003/04	2004/05	2005/06	2006/07	2007/08
Total use of fund resources (UFR) outstanding	14.3	28.5	42.8	49.9	49.9
PRGF 1992-95	0.0	0.0	0.0	0.0	0.0
Proposed PRGF	14.3	28.5	42.8	49.9	49.9
Proposed PRGF					
Disbursements	14.3	14.3	14.3	7.1	0.0
Debt service	0.0	0.1	0.1	0.2	0.2
Repayments	0.0	0.0	0.0	0.0	0.0
Charges	0.0	0.1	0.1	0.2	0.2
Total debt service to the Fund	1.8	0.2	0.2	0.3	0.3
PRGF 1992-95	1.7	0.0	0.0	0.0	0.0
Principle	1.7	0.0	0.0	0.0	0.0
Interest	0.0	0.0	0.0	0.0	0.0
Proposed PRGF	0.0	0.1	0.1	0.2	0.2
Principle	0.0	0.0	0.0	0.0	0.0
Interest	0.0	0.1	0.1	0.2	0.2
Other SDR charges	0.1	0.1	0.1	0.1	0.1
Memorandum items:					
Total UFR as a percentage of quota	20.0	40.0	60.0	70.0	70.0
Total UFR as a percentage of GDP	0.3	0.6	0.8	0.9	0.8
Debt service to the Fund as a percentage of exports of goods and services 2/	0.2	0.0	0.0	0.0	0.0

Source: Fund staff estimates and projections.

1/ Fiscal year begins mid-July.

2/ Excluding re-exports of oil.

Table 9. Nepal: External Financing Needs and Sources, 2002/03–2007/08

(In millions of U.S. dollars)

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
	Est.			Proj.		
Gross financing needs	249	287	307	364	415	458
External current account deficit (excl. official transfers)	59	109	123	178	224	274
Debt amortization	73	81	94	100	106	111
Repayments of arrears	0	0	0	0	0	0
Reserves accumulation	114	95	90	85	85	73
IMF repurchases and repayments	4	2	0	0	0	0
Financing sources	249	197	217	274	334	393
Foreign direct investment (net)	-2	5	10	15	17	19
Official creditors 1/	351	455	484	494	472	452
Other flows 2/	-100	-263	-277	-236	-155	-78
Accumulation of arrears (exceptional)	0	0	0	0	0	0
Financing gap 3/	0	90	90	90	80	65

Source: Fund staff estimates and projections.

1/ Includes both loans and grants.

2/ Includes all other net financial flows, and errors and omissions.

3/ Includes prospective IMF disbursements.

Table 10. Nepal: Vulnerability Indicators, 2000/01–2003/04

(In percent of GDP, unless otherwise indicated)

	2000/01	2001/02	2002/03 Est.	2003/04 Proj.
Official risk indicators				
Share of nonperforming loans (as percent of total loans)				
Rastriya Banjiya Bank	...	55.0 1/	...	...
Nepal Bank Ltd.	...	56.0 1/	...	...
Financial sector risk indicators				
Public and public guaranteed debt 2/	63.8	69.7	67.7	65.5
Broad money (percent change, 12-month basis)	15.2	4.4	8.1	11.1
Private sector credit (percent change, 12-month basis) 3/	15.7	3.9	13.7	14.0
Share of deposits in broad money (percent)	84.5	82.0	82.6	...
Share of foreign currency deposits in total deposits (percent)	9.5	9.6	9.5	...
Market assessment indicators				
91-day Treasury bill yield (end of period)	5.0	3.6	4.0	...
Stock market index (NEPSE Index, Feb. 12, 1994=100)	348.4	227.5	204.9	...
External indicators				
Exports (percent change, 12-month basis in U.S. dollars) 4/	4.6	-18.1	2.4	7.4
Imports (percent change, 12-month basis in U.S. dollars)	3.5	-15.6	9.0	9.0
Current account balance (excluding grants)	1.2	2.6	-1.0	-1.7
Gross foreign assets of the central bank (in millions of U.S. dollars)	1,020	1,048	1,173	1,233
In months of imports of goods and services	7.0	6.7	6.8	6.4
As percent of broad money	35.5	36.5	36.3	34.5
Gross foreign liabilities of the central bank (in millions of U.S. dollars)	15.8	9.0	5.0	22.5
Gross foreign assets of commercial banks (in millions of U.S. dollars)	403	323	312	347
Gross foreign liabilities of commercial banks (in millions of U.S. dollars)	231	229	254	275
Short-term debt 5/	2.8	2.3	2.3	2.3
Short-term debt to gross foreign assets of the central bank	15.3	11.9	11.5	10.9
Total external debt	49.9	52.9	52.2	47.2
As percent of exports of goods and services	196.3	262.8	297.8	279.8
Interest payments (as percent of exports of goods and services)	1.5	2.1	2.5	2.8
Amortization payments (as percent of exports of goods and services)	4.4	5.8	7.0	7.8
Exchange rate (Nrs per U.S. dollars, end of period)	74.7	78.0	75.1	75.2

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

1/ External managers of RBB and NBL.

2/ Consists of public and public guaranteed external debt, domestic claims on government by banking sector, and domestic credits to the central government by nonbanking sector.

3/ Including private sector credit by NRB.

4/ Excluding re-exports.

5/ Provisional; short-term debt in the form of outstanding trade credits and amortizations due in the following year.

Nepal—Fund Relations

(As of August 31, 2003)

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

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	71.30	100.00
Fund holdings of currency	65.54	91.92
Reserve position in Fund	5.77	8.10

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	8.10	100.0
Holdings	0.01	0.15

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

V. **Financial Arrangements**:

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

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

	Overdue	**Forthcoming**				
	04/30/03	2003	2004	2005	2006	2007
Principal	--	1.12	0.56			
Charges/Interest	--	0.03	0.13	0.12	0.12	0.12
Total	--	1.15	0.69	0.12	0.12	0.12

VII. **Exchange Rate Arrangement**

In February 1993, Nepal unified its exchange rate and eliminated the multiple currency practice associated with the previous dual exchange rate arrangement. In October 1997, the exchange arrangement of Nepal was reclassified as that pegged to a single currency unit from pegged to a currency composite. Currently, all merchandise imports (except for a few goods restricted for security or related reasons) are freely available through an open general license system, with foreign exchange provided through the banking system at the market exchange rate. Nepal's exchange system is free of restrictions on the making of payments and transfers for current international transactions. As of August 31, 2003, the exchange rate was US$1=Nrs 74.54.

VIII. Safeguards Assessments

Under the Fund's safeguards assessment policy, Nepal Rastra Bank (NRB) is subject to an assessment with respect to the prospective new arrangement. A safeguards assessment of the NRB was completed on September 3, 2002. The assessment concluded that substantial risks may exist in the area of external and internal audits, and the internal control system of the NRB. Staff findings and recommendations were reported in SM/02/270. Implementation of the measures by the NRB needs to be monitored by staff.

IX. 2003 Article IV Consultation

Staff discussions were held in Kathmandu in April–May 2003. Subsequently, discussions were continued during June 28–July 3. The Executive Board discussed the staff report (SM/03/275) on August 22, 2003. Nepal is on the standard 12-month consultation cycle.

X. Technical Assistance Since 2000

Department		Purpose	Date
MFD	-	Central bank and banking reform	12/01–3/02
	-	Monetary Policy	6/03
MFD/ LEG	-	Reform of Central Bank and Depository Institutions Legislation.	7/00
FAD	-	Review of Tax policy and VAT administration.	5/03
		- Tax and customs administration reform.	10/03
LEG	-	Redrafting of income tax laws.	3/00, 7/01
STA	-	Improving the compilation and reporting of the monetary statistics.	3/00
	-	Multisector statistics mission	1/01
	-	Balance of payments statistics advisor	4/02, 12/02
	-	Producer price statistics	1/02, 1/03
	-	Monetary Statistics	7/03

XI. Resident Representative/Advisor

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

Nepal—Relations with the World Bank Group

(As of October 1, 2003)

A. Partnership in Nepal's Development Strategy

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

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

The Poverty Reduction Strategy Paper (PRSP) was formally sent to the World Bank and the IMF in July 2003 and is expected to be discussed by the Boards in November 2003. The two institutions are currently carrying out a joint staff assessment. Meanwhile, the Government has requested assistance from the Bank and the IMF in implementing the IAP/PRS. The IMF is in the lead in assisting Nepal maintain macroeconomic stability. In April–May 2003, an IMF mission conducted Article IV consultations and worked together with the Government towards developing a medium-term macroeconomic framework. Subsequently, further discussions were held during a visit in June 28–July 3. An agreed medium-term macroeconomic framework will form the basis for a proposed three-year Poverty Reduction and Growth Facility (PRGF), which the IMF is preparing in support of the reform program. The PRGF—envisaged for IMF Board presentation in November 2003—would focus on medium-term fiscal consolidation as well as structural reforms related to the financial system, public sector management, and government revenue mobilization.

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

B. IMF-World Bank Collaboration in Specific Areas

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

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

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

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

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

To help generate broad-based growth, the Bank supports investments in key ***infrastructure*** sectors by financing projects in ***Rural Water Supply and Sanitation, Road Maintenance and Development, Irrigation Sector Development, Power Sector Development, Telecommunications Sector Reform and Multimodal Trade and Transit.*** At the same time, project finance is supporting decentralization to improve service delivery in most of these sectors by promoting grassroots-driven, bottom-up planning and community-based management. The Rural Water Supply and Sanitation project relies on a semi-independent management Board to ensure that rural water and sanitation services are provided in a sustainable, reliable, cost-effective and demand-led manner with an emphasis on community-based methods.

The Road Maintenance and Development project supports key sectoral policy reforms by establishing a Roads Board and Road Fund to assure a stable source of funding for maintenance expenditures, while also promoting motorable access to isolated regions. The Irrigation Sector Development project is helping to increase productivity and sustainability of irrigation systems in the western and eastern regions. The Power Sector Development project will help with the development of the country's hydropower potential to meet electricity demand, improve access of rural areas to electricity services and promote private sector participation. The Telecommunications Sector Reform Project supports sectoral policy reforms in addition to the provision of greater rural access to telecommunications services through the introduction of a private operator. The Multimodal Trade and Transit project is helping to reduce international trade-related transport costs, streamline trade and transit procedures and improve the efficiency of transit trade documentation.

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

Understanding Child Labor Project towards a comprehensive framework for addressing child labor issues.

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

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

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

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

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

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

Areas of shared responsibility

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

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

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

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

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

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

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

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

C. World Bank Group Strategy and Lending Operations

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

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

Bank Assistance Program in Nepal. As of September 30, 2003, IDA's lending portfolio consisted of nine projects with a total commitment of US$298 million and a total undisbursed balance of US$166 million (Table 1). As previously mentioned, three projects have been approved in FY03 and two operations are at an advanced stage of preparation—Poverty Alleviation Fund project and PRSC I.

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

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

	IDA Amount	Undisbursed 1/	Board Date
Multimodal Transit	23.5	3.9	1998
Rural Water Supply and Sanitation	16.7	0.5	1997
Irrigation Sector Development	71.8	6.0	1998
Basic & Primary Education II	12.5	2.9	1999
Road Maintenance and Development	54.5	33.2	2000
Telecommunications Sector Reform	22.6	23.2	2002
Financial Sector Technical Assistance	16.0	14.9	2003
Power Development 2/	75.6	76.5	2003
Community School Support Learning and Innovation Loan 2/	5.0	5.0	2003
Total	298.2	166.1	

1/ Credit accounting is in SDRs. As these figures are in US$, exchange rate fluctuations may result in undisbursed balances greater than the principal amounts.
2/ Not yet effective.

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

IFC's Activities in Nepal. As of August 31, 2003, IFC-held portfolio in Nepal was US$79 million (US$52 million from IFC's own account and US$27 million in B-loans) in two power generation projects, one tourism project and one leasing company.

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

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

Nepal—Relations with the Asian Development Bank

Lending Program

As of December 31, 2002, total commitments by the Asian Development Bank (AsDB) consisted of 99 loans amounting to $1.96 billion covering projects in agriculture (including forestry), energy, transport, industry, social infrastructure, finance, and tourism. Undisbursed funds of $442.5 million represent about 59 percent of the total net loan amount as of December 31, 2002. For the period 2003–05, 15 projects amounting to $315 million are tentatively programmed.

Loans by the Asian Development Bank, 1969–2002

(As of December 31, 2002)

	1969–1999 Approved	2000 Approved	2001 Approved	2002 Approved
		(In millions of U.S. dollars)		
Agriculture and natural resources	777.5	11.0	-	-
Energy	395.9	-	-	-
Finance and Industry	70.1	7.3	-	-
Social Infrastructure	137.1	155.0	19.6	60.0
Transport and communications	224.7	-	46.0	-
Others	27.6	-	30.0	-
Total commitments	1,632.9	173.3	95.6	60.0
Gross Disbursements	1,120.9	99.7	57.3	28.2
Technical Assistance Projects				
Total commitments	89.3	7.3	4.0	3.9
Gross Disbursements	50.6	3.5	5.0	3.9

Source: Data provided by the Asian Development Bank.

Technical Assistance

Since 1968, the AsDB has provided Nepal with technical assistance in most sectors. Recent assistance includes Support for Financial Sector Reforms, Community-based Water Supply and Sanitation, Teacher Education, Empowerment of Women, Privatization/Liquidation of Public Enterprises, Commercial Agriculture Development, Skills for Employment, Public Debt Management, and Community Livestock Development. As of December 31, 2002, total technical assistance commitments consisted of 230 projects—89 of which were in preparation for loans—for a total of $104.5 million.

Private Sector Operations

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

Nepal—Statistical Issues

While Nepal's economic and financial database is adequate for program monitoring purposes, the lack of consistent and timely data hampers analysis and policy formulation and implementation. A multisector statistics mission (January 2001) prepared recommendations and an action plan to upgrade Nepal's statistics to international standards. Nepal provides core data to the Fund and releases data in government and central bank publications. Nepal has participated in the GDDS since May 2001 and its metadata are posted on the Dissemination Standards Bulletin Board.

Real Sector

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

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

Fiscal Sector

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

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

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

The Nepal Rastra Bank reports data regularly for publication in the *Government Finance Statistics Yearbook.*

Monetary Sector

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

The July 2003 monetary and financial statistics mission noted that the NRB has implemented some important guidelines of the IMF's *Monetary and Financial Statistics Manual,* notably on the sectorization of the economy and categorization of financial assets and liabilities. The mission identified a number of still outstanding deficiencies in monetary statistics and provided high priority recommendations to overcome the following important shortcomings: (1) inadequate staff and computer resources; (2) interdepartmental data discrepancies on foreign reserve data; (3) late reporting of commercial banks and other banking institutions; (4) inaccurate estimation for late reporting commercial bank branches; (5) large interbank discrepancies; and (6) incorrect recording of repurchase agreements. The mission also recommended that the authorities should consider the establishment of a Statistics Department in the context of NRB's ongoing reorganization.

Balance of Payments

Despite improvements, **balance of payments accounts** continue to exhibit large and volatile net errors and omissions. An advisor was stationed in Kathmandu for a six-month period in 1997–98 to provide technical assistance and help implement previous recommendations. As a result, methodologies were developed to improve recording of grants, workers' remittances, and re-exports. These revised estimates were presented in the 1998 staff report and substantially amended the current account balance and reduced net errors and omissions. However, further work is needed to improve recording of oil transactions, remittances, grants, foreign direct investment, short-term inflows, and other private capital flows. A peripatetic Statistical Adviser conducted the second of a series of four missions during November/December 2002. In September 2003, the authorities began publishing the balance of payments in the format recommended by Fund technical assistance, but some other recommendations have not yet been fully implemented.

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

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

Nepal—Core Statistical Indicators

(As of September 30, 2003)

	Exchange Rates	International Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 2/	GDP	External Debt	Debt Service 3/
Date of latest observation	9/29/03	9/5/03	07/03	07/03	07/03	9/15/03	7/03	6/03	6/03	9/12/03	2002/03	2001/02	2002/03
Date received	9/29/03	9/25/03	8/18/03	8/18/03	8/18/03	9/25/03	8/14/03	7/22/03	9/15/03	9/29/03	7/03	08/02	6/03
Frequency of data 4/	D	W	M	M	M	W	M	M	Q/A	Q	A	A	A
Frequency of reporting 5/	W	W	M	M	M	W	M	M	Q/A	Q	A	A	A
Source of data 6/	A	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting 7/	E/C	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 8/	C	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	A

1/ Refers to net international reserves.
2/ Overall balance refers to central government balance.
3/ Refers to public debt service.
4/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, or O-other.
5/ D-daily, W-weekly, M-monthly, Q-quarterly, A-annually, V-irregularly in conjunction with staff visits, or O-other irregular basis.
6/ A-direct reporting by central bank, Ministry of Finance, or other official agency, N-official publication or press release, P-commercial publication, C-commercial electronic data provider, E-IMF's Economic Information System (EIS), O-other.
7/ E-electronic data transfer, C-cable or facsimile, T-telephone, M-mail, V-staff visits, O-other.
8/ A-for use by the staff only, B-use by the staff and the Executive Board, C-unrestricted use, D-embargoed for a specified period and thereafter for unrestricted use, E-subject to other use restrictions.

Kathmandu, Nepal
October 31, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Köhler:

His Majesty's Government of Nepal has adopted an economic program for 2003/04-2005/06 which aims to reduce poverty through private-sector led growth and social inclusion. Our economic program is detailed in the Poverty Reduction Strategy Paper (PRSP) and summarized in the attached Memorandum on Economic and Financial Policies (MEFP). The PRSP strategy focuses on creating the conditions for higher growth through a vibrant private sector and sound macroeconomic management. We believe that policy actions under this strategy will provide a basis for lasting peace. In support of this strategy and program of policy actions, we are requesting a three-year PRGF arrangement in the amount of SDR49.9 million (70 percent of quota). The first annual program under the PRGF will support policies to be implemented over the period July 16, 2003–July 15, 2004.

The Government believes that the policies set forth in the MEFP are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. Nepal will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

The Government will provide the Fund with all the information in a timely manner as might be requested to monitor progress in implementing policies and achieving the objectives of the PRGF-supported program.

We assure you that His Majesty's Government of Nepal is determined to fully implement the program and we hope we can count on Fund support for our endeavors.

Sincerely yours,

/s/

Dr. Prakash C. Lohani
Minister of Finance

/s/

Dr. Tilak Rawal
Governor, Nepal Rastra Bank

Attachments:
Memorandum on Economic and Financial Policies
Technical Memorandum of Understanding

NEPAL—MEMORANDUM ON ECONOMIC AND FINANCIAL POLICIES FOR 2003/04 UNDER THE THREE-YEAR PRGF ARRANGEMENT

I. INTRODUCTION AND BACKGROUND

1. **Nepal needs to accelerate implementation of economic reforms to achieve and sustain high growth and reduce poverty**. Our country remains among the poorest in the world—the high poverty incidence is attributed to insufficient growth and limited targeting of past poverty alleviation efforts. To address these issues, the government prepared its 10^{th} Five Year Plan—also its Poverty Reduction Strategy Paper (PRSP)—in July 2003, which aims to lower the poverty rate from 38 percent to 30 percent by the end of the plan period. Our strategy sets out a far-reaching agenda to deliver broad-based growth, improve social service delivery, promote social inclusion, and strengthen governance so as to improve economic performance and ensure that the poor benefit from growth. The donor community has indicated strong support for the PRSP, including a willingness to provide financial resources to assist with its implementation.

2. **PRSP reforms would also help address the root cause of the seven-year old civil strife and break the vicious cycle of insurgency, low growth, and high poverty incidence**. Pervasive poverty and perception of unfair distribution of economic opportunities breed support for the insurgency, while the conflict prevents Nepal from realizing its growth potential—low growth, in turn, impedes poverty reduction. The PRSP reforms are expected to end this vicious cycle by providing increased income opportunities and better social services to the poor. In January 2003, the government reached a ceasefire agreement with the insurgents and has since conducted three rounds of peace talks. However, the ceasefire came to an abrupt end in August 2003 when the insurgents temporarily withdrew from peace negotiations. We continue to make a determined effort to resume the negotiations and contain the fallout from the insurgency. Despite these developments, strong reform efforts are continuing. This reflects government's commitment and the fact that the PRSP was developed through an extensive consultative process, and these reforms have broad-based support across the political spectrum and civil society.

3. **Macroeconomic stability has been maintained and substantial progress has been made in reforms over the past two years to prepare the ground for the PRGF**. Major efforts are being made in addressing structural constraints to growth, improving social service delivery and in governance—along the lines of the PRSP. Key reforms that have been implemented in recent years are summarized in Section III.

4. This memorandum outlines the medium-term objectives and policy framework through 2003/04–2005/06, provides a brief summary of the current economic setting and progress in reform, and sets out the economic and financial policies of the program for 2003/04 for which we are seeking support under a PRGF arrangement from the IMF. Policies described in the memorandum are consistent with the objectives and strategy in the PRSP, the Medium-Term Expenditure Framework (MTEF), and the 2003/04 budget which was passed in July 2003.

II. Medium-Term Framework and Policies

5. **The PRSP rests on four pillars that are critical for addressing poverty in Nepal.** These are: (i) promoting higher broad-based and pro-poor growth; (ii) improving service delivery; (iii) promoting social inclusion and targeted programs; and (iv) improving governance.

- Higher and broad-based growth is essential to achieving the government's poverty reduction goals. Macroeconomic stability and peace are pre-requisites for such growth. The PRSP focuses on: (i) private sector led growth combined with a reduction of government ownership in the public sector and improvement in the efficiency of state-owned enterprises (SOEs); and (ii) agricultural productivity growth through implementation of the Agriculture Perspective Plan. We are also working to raise external competitiveness and promote export growth by addressing financial sector weaknesses, lowering transport costs, improving access to and reliability of power, and easing labor market regulations.

- Service delivery will be improved through decentralization, with increased involvement of local communities in primary school and basic health management. Measures to further improve access to drinking water services are also envisaged.

- Social inclusion will be fostered by policy and institutional changes that actively promote the access of marginalized groups, and women, to basic services and employment opportunities. In this regard, our strategy includes targeted programs in education, as well as affirmative action programs. The recently approved Poverty Alleviation Fund, supported by the World Bank and other donors, will help fund these programs.

- Improvements in governance are essential if the PRSP reforms are to be effective. The main policy actions include measures to increase the effectiveness of the civil service, strengthen anti-corruption institutions and take action against corrupt officials, and to improve financial management and procurement through greater transparency and accountability.

6. **In line with PRSP objectives, our medium-term macroeconomic framework envisages**:

- Real GDP growth reaching 5–6 percent by 2005/06. Under more favorable conditions such as a rapid improvement in security and recovery in the domestic economy, GDP growth rates could reach 6–7 percent.

- Reducing inflation from 6 percent at end-2002/03 to 4 percent by end-2005/06 through prudent monetary policy and the exchange rate peg to the Indian rupee.

- Reducing domestic budget financing to ½ percent of GDP in 2005/06.

- Maintaining international reserve cover at around six months of imports of goods and services.

III. The Current Economic Setting and Progress in Reform

7. **The economy is beginning to recover following the contraction in 2001/02 and inflation is under control, but balance of payments vulnerabilities remain.** The economy contracted by ½ percent of GDP in 2001/02 as the conflict intensified, the global economy slowed down and agriculture was affected by poor weather conditions. The ceasefire agreed in January 2003 helped restore some normality in agriculture, transport, and service sectors. GDP growth is estimated at 2⅓ percent in 2002/03. Inflation was 6 percent at end-2002/03 and is expected to moderate as the pass-through effect of administrative price adjustments and supply shortfalls of agricultural commodities fades. On the external front, weak export growth is expected to have contributed to a current account deficit (excluding official transfers). Although gross international reserves have remained adequate at over six months of imports of goods and services, this has been sustained by large remittance, aid, and other inflows, all of which are volatile.

8. **Budgetary pressures have been increasing in recent years**. The escalation of security related spending, declines in external financing, and shortfalls in revenue collection have increased the domestically financed deficit to over 2½ percent of GDP during 2000/01–2001/02. The fiscal situation has been contained by expenditure cuts, particularly in capital spending, and various tax policy and administration reforms during the latter half of the 1990s. Nevertheless, the public debt ratio has been increasing and there remain potentially large contingent liabilities from financial sector and SOE reforms.

9. **Significant progress has been made in reforms in recent years**:

- *Fiscal reforms.* A modern VAT was introduced in 1997 and tax administration has been strengthened by merger of the Inland Revenue and VAT Departments. A new Income Tax Act has been introduced and ASYCUDA has been implemented at some customs points. A public expenditure review was undertaken and expenditure management has improved with the introduction in 2002/03 of the MTEF which prioritizes projects and programs.

- *Financial sector reforms.* The new NRB Act, which increases the central bank's autonomy and strengthens its supervisory and regulatory functions, was enacted in early 2002. To further strengthen NRB oversight over the financial system, a new Banking and Financial Institutions (BFI) Ordinance has been introduced. This legislation replaces a number of separate laws and will cover all deposit-taking financial institutions. The debt recovery framework has been strengthened with the establishment of a Debt Recovery Tribunal (DRT). The tribunal provides for a time bound decision for debt recovery and is now considering a number of cases. In this regard, regulations clarifying action required prior to petition at the DRT have been issued. In addition, a new strengthened blacklisting directive was issued by the NRB in September 2003. To "reengineer" the NRB, a voluntary retirement scheme (VRS) has been implemented, all non-officer level vacancies eliminated, and salaries decompressed. To further strengthen monetary operations, the NRB has announced an issuance calendar for government securities and introduced one month and six months treasury bills. External management teams are working at the two largest, financially troubled commercial banks—Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL)—and their financial performance is improving. To address overstaffing at these banks, VRSs have been announced.

- *Public enterprise reforms*. The government has divested its shareholding in a major power company. Privatization/liquidation of five public enterprises is well underway, with a further four enterprises identified for divestment. The government has been gradually increasing the state-owned enterprises being audited. Petroleum product prices have been adjusted to avoid losses at the Nepal Oil Corporation (NOC).

- *Governance reforms*. Several anti-corruption bills have been passed, a Special Court to tackle corruption cases was established, and the Commission for the Investigation of Abuse of Authority (CIAA) has initiated investigations against politicians and revenue officials. An anti-corruption strategy has been approved by the cabinet. Considerable work has also been done to improve public financial management and procurement, with World Bank support. Civil service reform is proceeding with the elimination of over 6,000 vacant posts, the introduction of a Personnel Information System (PIS), partial decompression of salaries, and implementation of the first phase of a VRS. On decentralization, the transfer of basic health and education services to local communities is underway.

- Nepal concluded negotiations for WTO accession on September 12, 2003. Nepal has made history by being the one of two less-developed countries to join the WTO by accession.

IV. Macroeconomic Objectives and Policies for 2003/04

A. Macroeconomic Objectives

10. **The recovery is expected to gain strength in 2003/04.** Real GDP growth is projected to rise to 3½ percent, with downside risks if a resumption of the ceasefire takes time. The recovery could be broad-based, with a rise in agricultural productivity and a rebound in manufacturing, although the prospects for tourism have worsened. Inflation is expected to stay around 5 percent as the exchange peg would help keep prices in line with developments in India. The current account deficit (excluding official transfers) is projected to widen to 1¾ percent of GDP, as imports rise to fuel the recovery. However, higher foreign aid, remittances and other inflows, should help the NRB meet the targeted increase in its net foreign assets of US$60 million to over US$1¼ billion by end–2003/04.

B. Fiscal Policy

11. **The government's principal fiscal policy objectives are to raise the revenue-to-GDP ratio, improve the efficiency of public spending and reduce domestic borrowing.** In line with understandings reached with the IMF, the medium-term fiscal framework aims to raise the revenue-to-GDP ratio to 13½ percent of GDP by 2005/06. Over this period, expenditure is projected to rise to 18¼ percent of GDP. The bulk of the increase will be in capital expenditure, in line with the prioritization set out in the MTEF. Current expenditure is set to rise in 2003/04 but then fall as the special factors which raise spending in 2003/04 abate (see next paragraph). With higher aid inflows, net domestic financing of the budget would be reduced to ½ percent of GDP in 2005/06. This path of budget financing will help to stabilize, and then reduce, the public debt ratio and create room to meet contingent liabilities which will need to be borne under the ongoing banking sector and public enterprise reforms.

12. **The 2003/04 budget takes the first step in achieving these objectives**. The budget targets a stable revenue-to-GDP ratio of around 12½ percent of GDP, with a major revision of a wide range of charges, fees and excises. The increase in current spending reflects larger allocations for clearance of domestic arrears and to meet contingent liabilities of SOEs undergoing liquidation, integration of off-budget funds into the budget, a contingency allocation for elections, and wage allocation for additional security personnel. Capital spending is expected to increase from the depressed level of 2002/03 as implementation constraints at the local level are overcome. Social sector spending will rise, with higher health and education spending. With higher aid flows, the net domestic financing target of 1¾ percent of GDP is achievable, but the government will stand ready to take additional revenue measures or expenditure cuts to limit domestic budget financing. In this context, the government intends to conduct and publish a mid-year review of the budget.

13. **The government is also determined to achieve the fiscal targets beyond 2003/04.** In particular, the VAT rate would be raised and tax exemptions eliminated to mobilize additional tax revenues and the government will keep a tight control over current spending. However, after a three year freeze, pressures for a civil service wage increase are mounting. To address these pressures within the agreed fiscal framework, savings in other areas would be required, including through downsizing of the civil service in the context of the Public Sector Management Program and reduction in security outlays. These elements will be incorporated in the 2004/05 budget.

14. **The 2003/04 budget incorporates several important tax policy and administration reforms**. These reforms, based on the government's Fiscal Reform Task Force and IMF recommendations, include: (i) elimination of one half of the special duty on imports and integration of this into customs duties and excises; (ii) reduction in some import duties offset by increases in excises; (iii) removal of the export service fee and a reduction in export taxes; (iv) elimination of the VAT exemption for edible oils; and (v) an increase in the income tax threshold.

15. **Further fiscal reforms are envisaged to improve tax administration, prioritize spending and enhance fiscal transparency**. The government's Task Force has made recommendations, consistent with IMF technical assistance, to expand the audit operations of the current office in the Inland Revenue Department into a full-fledged Large Taxpayer Unit (LTU) which covers collection and service functions as well. The government intends to make this LTU operational by mid-January 2004, and has secured further technical assistance from the IMF and donors to help make it into an efficient unit. The government is also looking forward to IMF technical assistance to help implement its three-year customs administration reform program, especially to improve customs valuation. Understandings on specific actions in this area can be reached during the first review of the program and will be incorporated in the 2004/05 budget which will be prepared in consultation with the IMF. On the expenditure side, steps are being taken to weed out low-priority projects in the MTEF, improve costing and budget classification, and extend prioritization to regular expenditure. The government will also limit the operation of special funds outside the budget and will not create any additional funds to enhance fiscal transparency and flexibility.

C. Monetary and Exchange Rate Policies

16. **A key monetary policy objective of the NRB is to support the exchange rate peg to the Indian rupee**. To achieve this objective, reserve money growth will be limited to 10½ percent, given the projected GDP growth and a broadly unchanged multiplier. The corresponding increase in broad money growth would be sufficient to allow real private sector credit growth of 9–10 percent and to meet budget financing needs from the banking system. However, the NRB intends to keep the peg under review, in view of the potential impact on external competitiveness of WTO accession and phasing out of the Multi-Fiber Arrangement by 2005. The NRB is committed to not taking exchange rate actions which generate unacceptable cross rate differentials under the IMF's Articles of Agreement.

17. **The NRB is taking steps to improve monetary management and foster market development**. Reserve requirements for commercial bank deposits were unified and the separate vault cash requirement has been eliminated. The NRB is strengthening its liquidity forecasting capability to help support implementation of reserve money programming. A separate high-level monetary policy committee will be established at the NRB. To make its open market operations more transparent, longer-term government bonds will be auctioned from the second half of 2003/04.

18. **The NRB will issue directives to ease limits on commercial banks' interest rate and foreign exchange rate spreads and phase out lending requirements**. By mid-January 2004, the permissible spread limits on published lending rates and foreign exchange buy/sell will be eliminated. The priority sector lending requirement will be eliminated by end 2005/06.

D. Structural Reforms

19. **The structural reform agenda for the 2003/04 program under the PRGF Arrangement will focus on**:

Financial Sector Reform

- With the BFI Ordinance in place, the NRB will focus on ensuring adherence with the strengthened provisions, including capital adequacy, licensing, corporate governance, insolvency and compliance with International Accounting Standards (IAS). The BFI Ordinance will be revised, if needed, by mid-April 2004 to make it consistent with registration and incorporation provisions in the new Company Ordinance.

- The government and NRB are fully committed to addressing the problems of the non-performing assets of banks and of willful default by borrowers. We will continue to support DRT operations and implement the strengthened blacklisting mechanism. The government is also committed to removing impediments to the transfer of cases from district courts to the DRT. These debt recovery efforts will also be supported by the establishment of a Credit Information Bureau as a public limited company to disseminate blacklisting and repayment record information.

- Reengineering of the NRB will be taken forward. The NRB's supervision and regulation capacity is being strengthened, with World Bank support. To strengthen supervision capacity, the NRB will aim to recruit skilled personnel for the Supervision Department, limit the transfer of qualified supervisors, and adopt a strengthened off-site supervision manual. The NRB will inspect each commercial bank at least once every two years. A new organizational structure of the bank will in place by mid-January 2004. Further to the remuneration decompression, performance incentives will be improved by new policies on merit-based promotion, transfers, and training to be introduced by mid-July 2004. A number of support services will be outsourced and a targeted VRS will be implemented to reduce staffing. A hiring freeze at the non-officer level will be continued. Privatization of the payments system is also under consideration. During 2003/04, the NRB will introduce IAS-compliant accounting manuals and chart of accounts, and upgrade the auditing manual to strengthen internal controls.

- Reforms at RBB and NBL will continue under the external management teams. These teams have made considerable progress in loan recovery and these efforts will have the full support of the government and NRB. The government recognizes that given the reform agenda facing the teams, an extension to their tenure will be necessary. To reduce staffing, VRSs will be implemented at RBB and NBL. If the schemes are unable to generate the expected separations, consideration will be given to extending the schemes or other means sought to achieve appropriate staffing levels at the banks. The government is seeking external financing to help defray the costs of the schemes. At the same time, in consultation with the World Bank and the IMF, the government is actively considering key strategic decisions—such as privatization as separate or merged entities—on the future of these banks, with the eventual goal of privatization during the arrangement period. The banks will also prepare IAS-compliant audited accounts for 2002/03 by mid-January 2004.

- The government will approve external audit reports and restructuring plans for Agriculture Development Bank of Nepal (ADBN) and the Nepal Industrial Development Corporation (NIDC) by mid-January 2004. Restructuring options would include liquidation, if needed, and introduction of professional management, financial restructuring, a phased reduction in overstaffing, and eventual privatization/commercialization.

Public Sector Reform

- The privatization/liquidation of five SOEs is expected to be completed by mid-July 2004, of which two enterprises would be privatized/liquidated by mid-January 2004. Preparation for privatization/liquidation of four other SOEs will be continued. The 2003/04 budget also announced divestment plans for Nepal Telecommunications Corporation, Royal Nepal Airline Corporation, and the National Life Insurance Corporation. An internal unbundling of Nepal Electricity Authority is also planned during 2003/04.

- Petroleum product imports will be opened up to the private sector to generate competition and improve the efficiency of NOC. To ensure that NOC does not incur losses, petroleum product prices will be adjusted on at least a quarterly basis to reflect cost conditions. The government will introduce an automatic petroleum pricing formula during 2003/04 , which will be published. An IAS-compliant audit of NOC's 2002/03 accounts by an international auditor will be completed by mid-July 2004.

- SOE reform efforts would aim to improve corporate governance, reduce the fiscal drain and manage contingent liabilities. In this regard, the boards of SOEs are being strengthened with the introduction of professional management. The cap on the aggregate employment in SOEs will be continued and lowered to reflect divestment that has been completed. Moreover, performance indicators and contracts will be established with the management of SOEs. A strong effort is also underway to update audits of all SOEs to international accounting standards.

- Civil service reform will continue to make the service more accountable and efficient. A further 4,000 vacant positions will be eliminated by mid-July 2004, and the freeze on recruitment for nongazetted positions will be maintained. The government is extending the PIS to teachers, connecting the PIS with the payroll, reducing transfers, outsourcing selected support activities to downsize lower level positions, and further decompressing salaries. Merit based wages will be introduced at selected government agencies during 2003/04. The civil service act will be amended in 2003/04 to strengthen provisions for merit based recruitment and promotion, performance appraisal, and VRS.

Governance Reforms

- Actions to improve accountability, financial management and transparency, and to tackle corruption feature strongly in the PRSP. During 2003/04, the anti-corruption strategy approved by cabinet in early 2003 will be developed further into a strategic action plan that includes priority actions, a timeframe for implementation, and indicators for monitoring progress. Resources for the CIAA will be increased and the government will also seek to enhance the capacity of the Special Court to ensure a more accelerated processing of cases.

- In the area of financial management and transparency, the government will implement the recommendations of the Country Financial Accountability Assessment and Country Procurement Assessment Reports prepared with World Bank support. A new procurement law based on international standards and procedures will be approved. The Fiscal Transparency Ordinance will be issued by mid-July 2004 which, among other things, would help make government procurement more transparent. New Financial Administration Regulations have also been prepared.

Private Sector Development

- Future trade reforms will focus on legal amendments to make the trade regime consistent with WTO accession. To increase transparency, the remaining security levy will be integrated into customs duties and excises. In addition, all import levies will be consolidated into a single customs duty with the highest rate of 35 percent. Export taxation will be phased out within two years by the 2004/05 budget.

- Corporate and financial governance reforms will be advanced by issuance of Secured Transactions Ordinance, Insolvency Ordinance and a new Company Ordinance in 2003/04.

- Draft amendments to relevant legislation to make labor employment more flexible will be finalized by mid July 2004.

E. Poverty and Social Impact Analysis and Monitoring

20. **Further work on poverty and social impact analysis (PSIA) is envisaged**. We expect the key reforms supported by the PRGF to have PSIA conducted with the support of the World Bank. The government is also committed to taking countervailing measures to protect the poor, such as through VRS schemes and provisions for retraining.

21. **A monitoring framework for the PRSP is in place**. A new poverty monitoring unit has been established in the National Planning Commission. The Nepal Living Standards

Survey will be completed in 2003/04 and will provide the basis for monitoring MDG indicators. Strengthening the monitoring of public expenditures is a priority, and information on expenditures (and revenues) as well as physical performance of all high priority projects will be published each trimester. The first annual PRSP progress report will be produced by October 2004.

F. External Financing

22. We expect that the policy commitments elaborated in the PRSP and in this MEFP will help secure donor financing for the program. The financing gap for 2003/04 is estimated at US$90 million, of which US$70 million is expected from the World Bank's Poverty Reduction Support Credit. The remainder of the financing gap is to be filled by the PRGF arrangement.

G. Safeguards and Statistical Issues

23. **The government is fully committed to the financial soundness of the NRB and to implementing the 2002 safeguards assessment report's recommendations.** An external auditor with experience in auditing central banks is to finalize IAS-compliant 2002/03 NRB accounts by mid-February 2004.

24. **The government recognizes the critical importance of producing timely and accurate statistics**. During 2003/04, we will continue to implement IMF technical assistance recommendations.

H. Risks and Contingencies

25. **There are risks to the program but we believe that these are manageable and that the reforms supported by the IMF and donors will help mitigate these risks**:

- Progress in the peace talks is critical if growth and poverty reduction targets are to be met. Despite the recent setback in the peace process, we are making efforts to resume the negotiations. Furthermore, implementation of reforms that promote pro-poor spending and broad-based growth are expected to erode support for the insurgency.

- There are political uncertainties due to the impasse with the political parties. We are working to resolve this impasse. In the meantime, the risks of policy reversal from the impasse are limited as these parties have been consulted during the PRSP preparation process and the reform strategy has broad support among them.

- Adverse external developments could curb the effectiveness of reforms and require revisions to the macroeconomic framework. The main risks include a slower global recovery that would affect both demand for a narrow export base and tourism receipts, the impact of unpredictable weather patterns on agriculture, higher oil prices, and volatility in remittances. The PRSP is partly insulated against these risks through the inclusion of alternative macroeconomic scenarios. Moreover, the impact of the phasing out of the MFA and our accession to the WTO presents a number of urgent challenges for improving competitiveness, diversifying exports, and improving the investment climate.

- Implementation capacity may be a concern. The extensive reform agenda being supported by the international community will stretch capacity, and it will be a challenge to implement the development budget and the envisaged reforms. Significant technical assistance will continue to be required from donors. But we believe the PRSP sets ambitious yet realistic implementation targets and the existence of a dedicated core of senior officials in key ministries combined with the gradual decentralization of service provision will mitigate this risk.

26. There are also risks to the budget. The revenue targets will require a sustained effort to improve administration. On the expenditure side, the pressure for the civil service wage increase would have to be managed within the broad parameters of the fiscal framework. Shortfalls or delays in external funding would also complicate fiscal management. At the time of the mid-term budget review, the government will also decide whether additional revenue and expenditure measures are needed to meet the domestic borrowing ceiling. The government stands ready to take compensatory fiscal measures to keep the deficit within the budget target, including raising the VAT rate or reducing lower priority spending in line with the MTEF.

V. Program Monitoring and Review

27. **Understandings have been reached with the Fund staff on the conditions for monitoring policy implementation under the program.** The program period supported by the PRGF arrangement will begin in July 2003. Prior actions, a set of quantitative performance criteria for mid-January 2004 and mid-July 2004 and structural performance criteria and benchmarks are detailed in Tables 1 and 2.

28. **The government is aware that the first review under the PRGF arrangement is scheduled to be completed by end-April 2004, and will be conditional on the observance of mid-January 2004 performance criteria.** This review will focus on progress in reforms in areas discussed in this memorandum, as well as progress in developing the next phase of policy measures in these areas. Performance criteria, indicative targets, and precise definitions of quantitative variables monitored under the program are set out in the attached Technical Memorandum of Understanding (TMU). The government will make available to IMF staff all core data, appropriately reconciled and on a timely basis, as specified in the TMU. The nonaccumulation of external payment arrears will constitute a continuous performance criterion, as will the standard injunctions against overdue financial obligations to the IMF, imposition or intensification of restrictions on current payments, multiple currency practices, conclusion of bilateral payments agreements inconsistent with Article VIII, and imposition or intensification of import restrictions for balance of payments purposes.

Table 1. Quantitative Performance Criteria and Indicative Targets

(In billions of Nepalese rupees unless otherwise stated)

	July 16, 2003 Actual	Oct 17, 2003 Proj.	Jan 14, 2004 (PC)	Apr 12, 2004 (IT)	July 15, 2004 (PC)
Performance criteria (PC) and indicative targets (IT) 1/					
I. Floor on net foreign assets of the NRB (in millions of US dollars) 2/ 3/	1,168.1	1,178.1	1,208.1	1,218.1	1,228.1
II. Ceiling on net domestic assets of the NRB 2/ 4/	-6.6	-5.3	-4.0	-4.8	-2.6
III. Ceiling on change in net domestic financing of central government budget 4/ 5/ Cumulative from July 16, 2003	...	3.1	6.4	7.4	8.4
IV. Ceiling on contracting or guaranteeing of new nonconcessional medium- and long-term external debt by the central government and NRB Cumulative from July 16, 2003 (in millions of US dollars) 6/	...	...	0.0	0.0	0.0
V. Ceiling on short-term external debt contracted or guaranteed by the central government and NRB (in millions of US dollars) 6/	...	...	0.0	0.0	0.0
VI. Accumulation of external payments arrears Continuous performance criterion during the program period (in millions of US dollars)	...	...	0.0	0.0	0.0
Indicative targets (IT)					
I. Ceiling on reserve money	81.0	83.0	86.6	86.5	89.5
II. Floor on central government revenue 5/ Cumulative from July 16, 2003	...	9.5	22.0	38.0	60.2

Notes:

1/ Mid-January 2004 and mid-July 2004 are performance criteria test dates. Figures for mid-April 2004 are indicative targets.

2/ Valued at the program exchange rates.

3/ To be adjusted upward/downward by excess/shortfall of rupee equivalent of foreign financing. Details specified in the Technical Memorandum of Understanding.

4/ To be adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing. Details specified in the Technical Memorandum of Understanding.

5/ To be adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the Technical Memorandum of Understanding.

6/ External debt as defined in the Technical Memorandum of Understanding.

Table 2. Prior Actions, Structural Performance Criteria and Benchmarks Under the First Year of the PRGF Arrangement

Measures	Status/Timing
Prior Actions	
1. Establish Debt Recovery Tribunal	Completed
2. Cabinet approval of Bank and Financial Institutions Ordinance	Completed
3. Issue NRB directive to implement strengthened blacklisting mechanism	Completed
4. NRB Executive Board to approve remuneration decompression scheme	Completed
Structural Performance Criteria	
A. Fiscal and Monetary Sector Reforms	
1. Establish a full-service large tax payer unit in the Inland Revenue Department	January 15, 2004
2. Eliminate restrictions on commercial banks' lending rates and foreign exchange buy/sell spreads	January 15, 2004
3. Formulate and implement time-bound action plan to improve customs administration[1]	July 15, 2004
B. Financial Sector Reforms	
1. Finalize audit of NRB 2002/03 accounts by international auditor	February 15, 2004
2. Implement voluntary retirement schemes at NBL and RBB (Phase I)	January 15, 2004
3. Implement voluntary retirement scheme at NRB and RBB (Phase II)	March 15, 2004
C. Public Enterprise Reform	
1. Finalize IAS-compliant NOC 2002/03 accounts by international auditor	July 15, 2004
Structural Benchmarks	
1. Strengthen the Nepal Rastra Bank (reorganize NRB; revise human resource policies)	January/July 15, 2004
2. NRB to approve amended off-site supervision manual	January 15, 2004
3. Prepare IAS-compliant 2002/03 audited accounts for RBB and NBL	January 15, 2004
4. Approve external audits and restructuring plans for ADBN and NIDC	January 15, 2004
5. Complete liquidation/privatization of five SOEs and prepare four additional SOEs	January/July 15, 2004
6. Prioritize regular expenditure and include in Medium-Term Expenditure Framework	July 15, 2004
7. Implement plans to eliminate vacant civil service positions	July 15, 2004
8. Issue Fiscal Transparency Ordinance	July 15, 2004

[1] The plan, actions to be implemented, and the timeframe for implementation will be specified at the time of the first review of the first-year arrangement.

NEPAL
TECHNICAL MEMORANDUM OF UNDERSTANDING FOR PRGF ARRANGEMENT
October 31, 2003

1. This memorandum sets out the framework for monitoring the PRGF-supported program for 2003/04. It specifies quantitative performance criteria and indicative targets and the content and frequency of the data to be provided for monitoring the financial program. All foreign currency nondollar denominated quantities under the program will be converted into U.S. dollars at program exchange rates specified in Table 1. A description of selected structural performance criteria and benchmarks is also provided.

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Net Foreign Assets of Nepal Rastra Bank

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

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

B. Net Domestic Assets of NRB

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

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

C. Reserve Money of the NRB

6. **Reserve Money (RM) of the NRB** consists of currency in circulation outside the NRB, deposits of commercial banks at the NRB, and other deposits at NRB. As of mid-July 2003, RM defined in this manner stood at Nrs 81.0 billion.

D. Net Domestic Financing of the Central Government Budget

7. **Net domestic financing (NDF) of the budget is defined as net credit to the government (NCG) by the banking system (NRB and deposit money banks (DMBs)) and net change in holdings of treasury bills and other government securities by the non-bank sector**. The flow NDF of the budget would be the cumulative change in book value from mid-July 2003 in the sum of the following government debt instruments: (i) treasury bills; (ii) development bonds; (iii) national and citizen savings certificates; (iv) special bonds (including duty drawback bonds); and (iv) loans and advances from the NRB and deposit money banks (DMBs) *minus* government deposits with NRB and DMBs. This stock stood at Nrs 84.2 billion at mid-July 2003. Central government is defined here to include line ministries, departments and public institutions.

8. **The ceiling on net domestic financing** will be adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign program financing as set out in Table 2. External program financing received for financial and public sector reforms over the amounts identified in Table 2 would not lead to a downward adjustment of the NDF ceiling. The upward adjustment in the ceiling due to a shortfall in external program financing compared to Table 2 would be capped at Nrs 5 billion (around 1 percent of GDP). The ceiling on net domestic financing will be adjusted upward/downwards by 50 percent of the amount of any shortfall/excess in privatization receipts beyond the programmed amounts (Table 3).

E. Central Government Revenue

9. **Central government revenue** is defined as reported in the treasury accounts (economic classification), excluding principal repayments to the budget by corporations and including privatization receipts. The floor on central government revenue is cumulative from the start of the fiscal year. The central government revenue benchmark will be adjusted upwards/downwards by 50 percent of the excess/shortfall in privatization receipts.

F. Contracting or Guaranteeing of New Nonconcessional External Debt

10. **Contracting or guaranteeing of new medium- and long-term nonconcessional external debt** is defined as contracting or guaranteeing new nonconcessional external debt by the central government and the NRB with an original maturity of more than one year (valued at program cross exchange rates as defined in Table 1). Nonconcessional debt is defined as borrowing containing a grant element of less than 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates. For maturities of less than 15 years, the grant element would be calculated based on six-month CIRR averages, while for maturities longer than this, the grant element would be based on

ten-year CIRR averages. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274–(00/85), August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are credits extended by the IMF and financing from the World Bank and Asian Development Bank (AsDB), and government counter guarantees on project loans from both the World Bank and AsDB, as well as changes in indebtedness resulting from rescheduling operations or rollovers. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee issued.

G. Contracting or Guaranteeing of Short-Term External Debt

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

H. Accumulation of External Payment Arrears

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

II. Data Reporting Requirements

13. For the purpose of monitoring the performance under the program, data will be provided in the format shown in Tables 4-9. Nepal shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Nepal in achieving the objectives and policies set forth in the letter. All the program monitoring data would be provided by the Ministry of Finance and the NRB. Data on gross foreign assets and gross foreign liabilities would be provided at market prices. All the data relating to the above programmed targets will be furnished within 8 weeks after the end of each test date.

Table 4. Net Foreign Assets of Nepal Rastra Bank
Table 5. Balance Sheet of Nepal Rastra Bank
Table 6. Net Domestic Financing of Central Government Budget
Table 7. Central Government Revenue

Table 8. Contracting or guaranteeing of new medium and long-term nonconcessional external debt by the central government and NRB
Table 9. Contracting or guaranteeing of short-term external debt by the central government and NRB

III. Structural Performance Criteria and Benchmarks

1. Take actions towards establishment of a large taxpayer unit (LTU) in the Inland Revenue Department (IRD)

The following actions would constitute observance of the performance criterion.

i. Cabinet approval of the organizational structure and staffing of the LTU;
ii. MOF approval of financial allocation for the LTU to fund its development, implementation and operation in 2003/04 and 2004/05;
iii. IRD selection of taxpayer files to be managed by the LTU and transfer of relevant accounts, records and files to the new unit;
iv. IRD identification, appointment and transfer to the LTU at least 50 percent of the total staff approved for full operation of the unit; and
v. IRD identification, acquisition and possession of accommodation for the LTU.

2. Implement voluntary retirement schemes (VRS) at Nepal Rastra Bank, Nepal Bank Limited and Rastriya Banijya Bank

Definition of actions

Implementation of the VRS comprises all of the following:
i. announcement of the scheme, including benefits, eligible staff, and an application deadline;
ii. receipt of applications from employees; and
iii. notification to accepted applicants, including terms of severance.

If, in any entity implementing the VRS, the number of applications received is less than the expected reductions in staff, the entity's scheme would be revisited at the time of the first review. A decision would be made to extend the scheme, change its coverage, or other means of staff reduction will be identified. In this context, the performance criteria for the second review will be set.

Schedule of actions

Nepal Rastra Bank

By March 15, 2004. Implement a VRS targeted at non-officer levels. The expected reduction in non-officer staff is 400.

Nepal Bank Limited

The NBL announced a VRS on September 17, 2003. The application deadline is November 7, 2003. Employees with longer than 20 years of service are eligible. The expected staff reduction under the scheme is 1,000.

By January 15, 2004. Implement the VRS scheme.

Rastriya Banijya Bank

The RBB announced a VRS on September 15, 2003. The application deadline is November 16, 2003. RBB intends to implement the scheme in two phases. Phase I is targeted at employees with service above 20 years; Phase II would be applicable to service periods of 15–19 years and to specific functions that are overstaffed. The expected reduction under Phase I is 800; the expected reduction under Phase II is 1,000.

By January 15, 2004. Implement Phase I of the VRS scheme.
By March 15, 2004. Implement Phase II of the VRS scheme.

2. Liquidation/privatization of state-owned enterprises (SOEs)

SOEs under consideration

Bhaktpur Brick Factory; Cottage and Handicrafts Emporium; Nepal Coal Limited; Nepal Transport Corporation; Hetauda Textile Factory; Birgunj Sugar Factory; Agriculture Tools Factory; Nepal Rosin and Turpentine Limited; and Himal Cement Company

Definition of actions

Liquidation. Settlement of all liabilities. **Commencement** of liquidation means appointment of a liquidator and initiation of settlement of liabilities.

Cabinet approval of privatization. Cabinet approval of sale and purchase agreement (SPA). The SPA must include the chosen buyer, final price and other financial and technical understandings between the government authority and the private buyer. The SPA would have been previously endorsed by the Privatization Committee. **Commencement** of privatization means endorsement of the SPA by the Privatization Committee.

Schedule of actions

By January 15, 2004. Cabinet approval of privatization or liquidation of two SOEs.
By July 15, 2004. Cabinet approval of privatization or liquidation of five SOEs. Commence privatization or liquidation of remaining four SOEs

3. **Strengthening Nepal Rastra Bank**

Re-organization of the NRB

The NRB's corporate reorganization will be completed by January 15, 2004. This reorganization will be based on a proposal of the NRB's internal Reengineering Committee, issued on March 1, 2002. The new corporate structure will maintain the Committee's recommendation to classify the NRB's functional activities into four groups (monetary policy, banking operations, supervision, and administration) in addition to offices/departments directly supervised by NRB Governor including in the areas of internal audit and corporate planning.

Human Resource Policies

The NRB Board will approve new polices on human resource management. These policies will be issued by July 15, 2004. The following points will be included:

Performance appraisal, recruitment and promotion. Performance appraisal, especially of department heads and other senior officers, will be conducted at least once a year. The NRB will move towards ensuring that all new openings at higher levels are announced both internally and externally to attract qualified people. Provisions will be made for merit-based recruitment and promotion. It is expected that less preference will be given to seniority in internal promotion decisions. A new code of staff conduct, including provisions on staff rules on taking external assignments, will be developed.

Transfers. Specialist positions and career paths in the NRB will be clearly identified to maintain functional continuity and build expertise. Tenure requirements in these positions will also be clearly identified. Assurances will be provided that satisfaction of the tenure requirements, subject to satisfactory performance, will not adversely affect the staff member's promotions and compensation prospects.

Training. Candidates for internal and external training would be selected based on relevance of training for the candidates' current or announced future assignments. Following training, the candidates would remain in the originating department for at least two years to utilize and disseminate acquired expertise.

Table 1. Program Exchange Rates and Gold Prices 1/

Foreign currency	Nepalese rupees/Foreign currency
Indian rupee	1.6
SDR	104.0
U.S. dollar	75.0
Japanese yen	0.64
Euro	83.0
Pound sterling	120.0
Gold prices (U.S. dollars per ounce)	360.0

1/ Currencies not shown here will be converted first into U.S. dollars using official exchange rates used by the IMF's Finance Department on July 16, 2003.

Table 2. Program Foreign Financing, 2003/04
(In millions of U.S. dollars)

	Oct 17, 2003	Jan 14, 2004	Apr 12, 2004	July 15, 2004
Foreign financing (cumulative)	20.0	90.0	90.0	95.0

Table 3. Program Privatization Receipts, 2003/04
(In millions of Nepalese rupees)

	Oct 17, 2003	Jan 14, 2004	Apr 12, 2004	July 15, 2004
Privatization receipts (cumulative)	0	76	196	500

Table 4. Net Foreign Assets of the NRB, 2003/04
(In millions of U.S. dollars)

	Oct 17, 2003	Jan 14, 2004	Apr 12, 2004	July 15, 2004
Net foreign assets 1/				
Assets				
Foreign Exchange				
Monetary Gold				
Reserve Position in the Fund				
SDR holding				
Liabilities				
Deposits				
CSI Credit Accounts				
ESAF/PRGF				

1/ At program exchange rates and prices.

Table 5. Balance Sheet of the Nepal Rastra Bank, 2003/04 1/
(In billions of Nepalese rupees)

	Oct 17, 2003	Jan 14, 2004	Apr 12, 2004	July 15, 2004
Net foreign assets				
Assets				
Liabilities				
Net domestic assets				
Claims on public sector				
Net credit to government				
Claims on government 2/				
Less: Deposits				
Claims on public enterprises				
Claims on private sector				
Claims on commercial banks				
Other items (net)				
Reserve money				
Currency outside banks				
Currency held by banks				
Bankers' deposits				
Private sector deposits				

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

Table 6. Net Domestic Financing of the Budget, 2003/04
(In millions of Nepalese rupees)

	Oct 17, 2003	Jan 14, 2004	Apr 12, 2004	July 15, 2004
Net claims on government (stock)				
Banks				
NRB (net)				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				
Loans and advance				
Less: Deposits				
DMBs				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				
Nonbanks				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				

Table 7. Central Government Revenue, 2003/04
(In millions of Nepalese rupees)

	Oct 17, 2003	Jan 14, 2004	Apr 12, 2004	July 15, 2004
Total revenue (HMG)				
Less: Principal repayment by corporations				
Total revenue 1/				
Tax revenue				
Taxes on goods and services				
VAT/Sales tax				
Excise taxes				
Other				
Taxes on international trade				
Import taxes				
Indian excise refund				
Export taxes				
Agriculture reform fee and other				
Taxes on income and profits				
Taxes on property				
Nontax revenue 1/				
Charges, fees and fines				
Sales of goods and services				
Dividends				
Royalty and fixed asset sales				
Interest receipts				
Other				

1/ Excluding principal repayments by corporations.

Table 8. Contracting or Guaranteeing of New Nonconcessional
Medium- and Long-term External Debt by the Central Government and the NRB
(In millions of U.S. dollars)

Date	Creditor	Project	Date of agreement	Currency	Maturity period	Grace period	Interest rate	Amount	Disbursement

Table 9. Contracting or Guaranteeing of New Short-term
External Debt by the Central Government and the NRB
(In millions of U.S. dollars)

Date	Creditor	Project	Date of agreement	Currency	Maturity period	Grace period	Interest rate	Amount	Disbursement

Statement by the IMF Staff Representative
November 14, 2003

1. This statement contains the information that has become available since the staff report was circulated to the Board on November 3, 2003. It does not change the thrust of the staff appraisal.

2. There have been no major changes in the security and political situations. Armed clashes between the insurgents and security forces have continued. Army sources place the death toll since the August breakdown of the ceasefire at around 900, with significant losses for the insurgents. The scope of the conflict appears to be shifting from remote districts to more densely populated border areas. There also appear to be no immediate prospects for a resumption of negotiations. At the same time, the political standoff continues between the opposition parties and the Thapa government. Nevertheless, the government has recently indicated that it would hold local elections in the latter half of 2003/04.

3. Macroeconomic developments appear to be unfolding broadly as envisaged in the staff report. Information as of mid-October suggests that favorable monsoon rains benefited the first harvest of the year and preliminary arrivals data indicate that tourism may be edging up. The inflation rate in mid-September was around 5 percent (year-on-year), in line with expectations. The budget appears to be on track so far, with revenue growth of about 13 percent in the first three months of the current fiscal year compared to the same period last year and domestic financing estimated at ½ percent of GDP. International reserves cover at mid-October was stable at around 6 months of imports of goods and services.

Press Release No. 03/194
FOR IMMEDIATE RELEASE
November 14, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves In-Principle Three-Year US$72 Million Poverty Reduction and Growth Facility Arrangement for Nepal

The Executive Board of the International Monetary Fund (IMF) today approved in-principle a three-year SDR 49.9 million (about US$72 million) Poverty Reduction and Growth Facility Arrangement for Nepal to support the country's economic reform program through July 2006. The IMF Board's decision will become effective upon a further decision following the World Bank's Executive Board review of Nepal's Poverty Reduction Strategy Paper, scheduled for November 18, 2003. At that time Nepal will be able to draw an amount equivalent to SDR 7.13 million (about US$10 million) under the PRGF arrangement.

Following the Executive Board discussion, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, said:

"Nepal's Poverty Reduction Strategy Paper (PRSP) is a comprehensive and participatory effort to address the country's low growth, inadequate social sector investment, and limited income opportunities for the poor. The authorities' Fund-supported reform program aims at improving the conditions for sustained growth and poverty reduction, based on sound macroeconomic policies, better prioritization and enhanced efficiency in government expenditure, structural reforms in major sectors of the economy, and improved governance. The authorities are to be commended for their strong track record of policy implementation in support of their request for Fund assistance.

"To maintain macroeconomic stability, the authorities are firmly committed to putting fiscal policy on a sound and sustainable basis. Determined implementation of tax policy measures and strengthened tax and customs administration will help mobilize additional revenue. At the same time, careful prioritization of all spending will help raise allocations for key sectors and poverty-related spending. This will need to be supported by improved capacity building efforts to enhance the efficiency and effectiveness of development spending.

"Continued implementation of financial sector reforms is critical for achieving the PRSP's objectives. The Nepal Rastra Bank will be transformed into a modern and efficient central bank, and the authorities are strengthening the commercial banking sector through enhanced debt recovery, including tightened criteria for blacklisting loan defaulters and the establishment of a Debt Recovery Tribunal. It will be important to ensure the effective and timely application of these measures to all defaulters. Progress is also being made in improving the performance of the two largest and financially troubled commercial banks through installation of external managers.

"Implementation of the authorities' structural reform agenda will be key to creating conditions for higher, private sector-led growth. This includes the privatization or liquidation of selected public enterprises, civil service reforms and decentralization measures aimed at improving service delivery. Ongoing efforts to curb corruption, including strengthening of the Commission for Investigation of Abuse of Authority and the Special Corruption Court, are welcome and will need to be sustained over time.

"The authorities are to be commended for reaching an agreement on WTO accession. To fully realize the benefits from accession, it will be important to enhance external competitiveness, including through measures that will make the labor market more flexible.

"The authorities have demonstrated their commitment to reforms through strong policy implementation under difficult circumstances, and the broad support for the PRSP strategy represents an encouraging basis for breaking the cycle of low growth, poverty, and insurgency which Nepal has faced. Nevertheless, peace and political stability will be essential to ensure that the strategy's objectives of high economic growth and broad-based poverty reduction are fully achieved, and the authorities are encouraged to make strong efforts to work toward a peaceful resolution of the conflict," Mr. Sugisaki stated.

ANNEX

Recent Economic Developments

Despite decades of development efforts supported by foreign aid, Nepal remains among the poorest countries in the world with almost 40 percent of the population living in poverty. While macroeconomic conditions remained broadly stable in the 1990s, growth was constrained by financial sector weaknesses, weak public sector management, poor governance, and low agricultural productivity. More recently, economic management has been complicated by security problems related to the Maoist insurgency and an uncertain political environment, with real GDP growth amounting to negative 0.5 percent in 2001/02.

However, there have been some modest improvements in 2002/03 made possible by the ceasefire, and GDP growth rose to more than 2 percent. The January 2003 ceasefire, however, broke down in August 2003 and peace talks stalled. If peace can be restored and structural reforms are implemented, growth is projected to rise further to 5-6 percent over the medium term. Similarly, the economy has witnessed price stability, with inflation expected to remain below 5 percent. While manufacturing and tourism are expected to be the main sources of growth, a significant contribution from agriculture is also envisaged. The current account deficit is projected to increase, but higher aid, remittances, and other inflows should allow international reserves to be maintained at six months of imports of goods and services.

Program Summary

The Nepalese authorities are seeking to break a vicious cycle of low growth, pervasive poverty, and insurgency. To this end, they intend to implement a comprehensive reform agenda outlined in their Poverty Reduction Strategy Paper (PRSP). The PRSP strategy is focused on broad based sustainable economic growth, social sector development, and targeted programs for the poor and disadvantaged people, and good governance.

The key elements of the Nepal's PRGF-supported program are in line with the PRSP:

On **fiscal policy,** the program aims at boosting revenue and reducing domestic financing, while redirecting spending to social and key infrastructure sectors. By 2005/06, revenue would be targeted to increase by 1 ¼ percentage points to 13 ½ percent of GDP, based on revenue administration reforms, increases in VAT rate, and rationalization of VAT and custom's exemptions. Reductions in domestic borrowing would help maintain fiscal sustainability.

The program's **monetary** and **exchange rate policies**, would remain geared to supporting the peg to the Indian rupee, which has served Nepal well given close ties with India. However, the level of the peg would be kept under review in light of prospective external developments, such as the phasing out of the Multi-Fibre Arrangement by 2005, which could pose challenges for export growth. Over the medium-term, competitiveness is to be enhanced by reforms to reduce labor and nonlabor input costs.

The strategy for the **structural reform agenda** focuses on financial and public sector reforms, and improving governance. Reforms in this area would create conditions for higher growth by improving intermediation and resource allocation, reducing corruption, and increasing accountability.

- **Financial sector reforms** involve central bank strengthening, improved legislation and loan recovery, and restructuring of commercial and development banks

- **Public sector reforms** include reforming the civil service to make it more efficient; privatization/liquidation of unviable enterprises and divestment from profitable ones to enhance their efficiency.

- **Governance reforms** involve steps to combat corruption and efforts to decentralize delivery of social services.

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

	1998/99	1999/00	2000/01	2001/02	2002/03 Est.
			(Percent change)		
Output and prices					
Change in real GDP	4.5	6.1	4.8	-0.5	2.3
Change in CPI (end–period)	9.0	0.6	3.4	3.5	6.1
			(Percent of GDP)		
Budgetary operations					
Total revenue	10.2	10.7	11.4	11.5	12.3
Total expenditure	15.4	15.7	17.6	17.2	16.3
Current expenditure	9.3	9.6	11.2	11.6	11.6
Capital expenditure and net lending	6.1	6.1	6.4	5.7	4.7
Overall deficit 2/	3.9	3.5	4.5	4.3	1.9
			(Percent change)		
Money and credit					
Domestic credit	16.1	17.8	18.8	9.2	11.2
Broad money	20.8	21.8	15.2	4.4	8.1
			(In millions of U.S. dollars, unless otherwise indicated)		
External sector					
Exports , f.o.b. 3/	763	971	942	754	633
Imports, c.i.f.	1,390	1,713	1,773	1,496	1,630
Current account 4/	24	28	64	143	-59
(In percent of GDP) 4 /	0.5	0.5	1.2	2.6	-1.0
Overall balance	136	192	38	-25	83
Gross foreign assets	795	946	1,020	1,048	1,173
Rupees per U.S. dollar (end–period)	68.5	70.8	74.7	78.0	75.1

Sources: Nepalese authorities; and IMF staff estimates.

1/ Fiscal year ending July 15.
2/ After grants.
3/ Includes re–exports.
4/ Before grants.