

Nepal: First Review of Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria—Staff Report; Staff Statement; and Press Release on the Executive Board Discussion

In the context of the first review of Three-Year Arrangement under the Poverty Reduction and Growth Facility and request for waiver of performance criteria with Nepal, the following documents have been released and are included in this package:

- the staff report for the first review of Three-Year Arrangement under the Poverty Reduction and Growth Facility and request for waiver of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **August 6, 2004**, 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 7, 2004.** 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 **October 20, 2004** updating information on recent developments.
- a Press Release summarizing the **views of the Executive Board as expressed during its October 20, 2004 discussion** of the staff report that completed the review.

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

Letter of Intent sent to the IMF by the authorities of Nepal*
Memorandum of Economic and Financial Policies by the authorities of Nepal*
Technical Memorandum of Understanding by the authorities of Nepal*
*May also be included in Staff Report

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

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NEPAL

**First Review of Three-Year Arrangement Under the
Poverty Reduction and Growth Facility and Request for
Waiver of Performance Criteria**

Prepared by Asia and Pacific Department

(In consultation with other departments)

Approved by Wanda Tseng and Anthony R. Boote

October 7, 2004

- The Executive Board approved a three-year PRGF arrangement (SDR 49.9 million, 70 percent of quota) for Nepal on November 19, 2003.
- In approving the PRGF arrangement, Executive Directors considered that the program's basic elements—sound macroeconomic management, better expenditure prioritization, structural reform in major economic sectors, and improved governance—were geared to delivering conditions for sustained growth and poverty reduction. Directors also recognized that the program was subject to significant risks related to an unsettled security and political situation. However, they observed that these risks were mitigated by the authorities' demonstrated commitment to reform, their established track record of policy implementation under difficult circumstances, and support for the PRSP strategy across the political spectrum.
- Discussions took place in Kathmandu on the first review of the arrangement during March 2–15 (with the Thapa government) and during July 27–August 6 (with the Deuba government). The staff teams comprised Messrs. Shishido (Head) and Kalra (both APD), Mss. Yelten and Jain-Chandra (EPs, APD), Mr. Hallaert (PDR), and Mss. Lee and Danklou (Administrative Assistants, APD). Mr. Singh, Resident Representative, assisted the missions. Mrs. Indrawati (ED) and Mr. Karki (Advisor, OED) participated in key meetings in March; Mr. Karki joined the mission in July/August. The mission coordinated with World Bank and AsDB resident offices.
- The principal authors of this staff report are Sanjay Kalra and Hisanobu Shishido.

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EXECUTIVE SUMMARY

The security situation remains difficult but political tensions have started to ease. The insurgency continues to take a heavy toll on life and to disrupt economic activity, including in the form of supply blockades in various locations including Kathmandu. The government has made restoration of peace its priority and initiated informal contacts with the insurgents, although the path to a ceasefire and peace talks appears difficult. Meanwhile, establishment of the coalition government of Prime Minister Deuba in July, with the participation of the influential left wing Communist Party of Nepal (CPN-UML), has contributed to fewer street protests and reduced tensions among political parties. The government is mandated to start general elections by April 2005.

The difficult political and security situation notwithstanding, the PRGF-supported program is broadly on track. All quantitative targets for the first review were met, and all structural reform measures are expected to be implemented by the Board date although some actions were completed after the target dates. For 2003/04, real GDP growth is estimated at 3½ percent, in line with the program, with strong agricultural growth and a rebound in tourist arrivals; inflation remains low; and international reserves are adequate. Reflecting robust revenue growth, large aid inflows and lower-than-programmed development spending, the domestically financed deficit was smaller than programmed. Monetary policy remains consistent with the peg to the Indian rupee.

Looking forward, the key elements of the program remain in line with the PRSP.

- The fiscal strategy is to improve revenue mobilization, prioritize spending, and contain domestic borrowing over the medium term to maintain fiscal sustainability. To raise revenues, revenue administration would be strengthened and tax rates raised. Spending would be directed toward priority social and infrastructure sectors to help reduce poverty.
- 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-Fiber Arrangement quotas by end-2004) while competitiveness is to be enhanced by reforms to reduce labor and nonlabor input costs.
- Financial sector reforms involve implementing a strengthened framework for loan recovery, central bank strengthening, and restructuring of ailing commercial and development banks.
- Public sector reforms include privatization/liquidation of unviable enterprises and divestment from profitable ones to enhance their efficiency. The large financial losses of Nepal Oil Corporation will be addressed, including through an automatic price adjustment mechanism.
- Governance reforms involve steps to combat corruption, reform the civil service, and improve service delivery through greater local decision-making and accountability.

Risks to the program stem from an unsettled security situation but the continued track record of implementation in a difficult situation mitigates these risks. While a resolution of the security situation would undoubtedly provide for a firmer basis for achieving program objectives, the authorities have cemented their track record of policy implementation under difficult circumstances. Moreover, the PRSP reform agenda has broad political support, limiting the risk of policy reversal. The World Bank, AsDB, and donor community are supporting the authorities' reform efforts.

I. INTRODUCTION

1. **His Majesty's Government of Nepal adopted a PRGF-supported program in November 2003 to help break a vicious cycle of low growth, poverty, and insurgency.**

The government's Poverty Reduction Strategy Paper (PRSP) provides a blueprint for achieving Nepal's development objectives, including Millennium Development Goals. The PRSP strategy has broad support across the political spectrum as it was prepared by a series of governments over 2000–02

and was finalized after extensive consultations with civil society and stakeholders.¹ Consistent with the priorities set out in the PRSP, the PRGF-supported program focuses on: (i) achieving 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

Nepal—Poverty and Development Indicators

Nepal is among the poorest and most vulnerable countries in the world. The 1995/96 Nepal Living Standards Survey (NLSS)—the last available nationwide household survey—estimated that around 40 percent of the population lived below the poverty line. The extent and intensity of poverty are greater in the rural areas, in the mid- and far-western regions, and among female-headed households. Human development indicators also remain low compared to other South Asian countries—almost half of the adult population is illiterate, less than one-half of the population has access to safe drinking water, and about half the children under five are malnourished.

resource allocation, including eliminating financial losses of Nepal Oil Corporation; and (iv) improving governance to reduce corruption, increase accountability, and enhance implementation capacity. A key component of poverty reduction efforts is increased development activities, including in the conflict affected regions, through higher budget allocations and targeted programs. The authorities' reform program is being supported by international financial institutions and bilateral donors are providing technical assistance and cofinancing multilateral program aid.²

¹ The first year progress report on PRSP implementation is expected by November 2004.

² The World Bank (Financial Sector Technical Assistance (FSTA) and Restructuring Credit (FSRC) and Poverty Reduction Support Credit (PRSC)) and the AsDB (Governance Reform Program (GRP, 2002–2005) and Public Sector Management Program (PSMP, July 2002–June 2005) are supporting the reforms. The objectives of the GRP include improvements in civil service efficiency and governance and reduction in government corruption. PSMP objectives include government disengagement from SOE management and ownership and strengthening public and corporate sector governance. The AsDB PSMP Loan was approved in July 2003 and the World Bank's PRSC in November 2003.

2. **The security situation has remained difficult since approval of the program in November 2003.** The insurgency continues to take a heavy toll on human life. Economic activity continues to be disrupted by frequent work stoppages (“bandhs”), temporary closure of businesses, extortion and threats to businesses by the insurgents (Box 1). In addition, supplies have been impeded by periodic “blockades” of key access roads from border areas to hinterland locations. The most recent, and visible, of these blockades in early August was aimed at disrupting supplies into the Kathmandu valley mainly from the southern India-Nepal border. The imposition of the blockade was unexpected; its removal a week later, citing requests from the public, civil society and human rights groups, was equally unexpected. The government has made achievement of peace its priority and initiated informal contacts with the insurgents, although the path to a ceasefire and peace talks appears difficult. Donors have urged resumption of peace talks, and expressed concerns over alleged human rights violations by both the insurgents and the security forces and strongly urged that the government implement its plans to combat human rights violations. The government has so far declined offers of external mediation, including from the United Nations, to help resolve the conflict.

3. **However, political uncertainties have diminished somewhat since the formation of a coalition government in July under Prime Minister Deuba.** As a result of the establishment of the coalition government—which includes the influential left-wing Communist Party of Nepal (CPN-UML) but not the large Nepali Congress—street protests of early 2004 have petered out and tensions among political parties have moderated. The government is mandated to start general elections by April 2005.

4. **The difficult security and political situation notwithstanding, the PRGF-supported program is broadly on track.** All quantitative performance criteria and indicative targets for the mid-January 2004 test date for the first review were observed, aided by high remittance inflows and underspending of the development budget (Table 1). In addition, all structural reform measures envisaged for the first review have been taken (except delayed implementation, awaiting World Bank financing, of a voluntary retirement scheme at a commercial bank; this is now a prior action for the first review), although implementation of two performance criteria and two benchmarks was delayed beyond the target dates (Table 2).³ In the attached Letter of Intent, the authorities request waivers for the delayed observance of these performance criteria, completion of the first review under the arrangement, and a rephrasing of the third disbursement. As regards more recent

³ IAS-compliant audits of NBL and RBB 2002/03 financial accounts were a structural benchmark for mid-January 2004. These accounts were prepared as per statutory requirements and were judged to be in line with NRB directives. However, NRB directives deviate, as permitted, from IAS standards and are tailored to local needs. As a result, the banks’ accounts are not IAS-compliant but the benchmark is assessed to have raised the quality and transparency of the banks’ financial accounts.

Box 1. Nepal: The Effects of Insurgency and Armed Conflict, 1996–2004

A. Antecedents

The insurgency—which began in early 1996—has its roots in Nepal’s pervasive poverty and a perception that economic policies and institutional structures have not delivered adequate growth and equity. A recent study, using district wise data, finds low human development indicators and landlessness as key explanatory variables accounting for the intensity of the conflict.¹ It notes the spatial, ethnic, and caste dimensions of the conflict. In particular, the conflict is most intense in the rural areas and mid- and far-western regions of the country which are also the most disadvantaged. The study also points to institutional failures—bonded labor which was abolished in 2000 and poor governance (rent-seeking politicians and corruption)—as contributory factors. In this context, many observers have noted the rise of popular expectations of improved living standards since the onset of multi-party democracy in the early 1990s and their fall due to the inter- and intra-fractional nature of the political parties.

B. Effects

Death toll and human rights. The most visible sign of the armed conflict is the fatalities on both sides—insurgents and security forces—and civilians caught in the cross fire. While estimates of the death toll necessarily lie within a broad range, the Informal Sector Service Center (INSEC)—a human rights group—places the death toll since the onset of the insurgency at over 10,000, with low fatalities during the January-August 2003 ceasefire. International and Nepalese human rights groups have also drawn attention to numerous counts of human rights violations by both security forces and insurgents.

Macroeconomic performance. The conflict has contributed to lower-than-potential growth across almost all sectors. For example, agriculture has suffered from nondelivery of extension services; the rate of return in manufacturing and transportation has been lowered by destruction of production capacity and extortion by the insurgents; progress in implementing large infrastructure and hydroelectric projects has been impeded by security concerns; and tourist arrivals remain below peak levels of the late 1990s. However, despite the setbacks, macroeconomic performance in Nepal has held up reasonably well during 1996/97–2003/04. Real GDP growth and inflation averaged 3¾ percent and 5¼ percent, respectively, during the period of armed conflict. In contrast, other conflict-stricken countries have fared markedly worse. A recent study finds that in a comparable sample of 10 countries that faced conflicts of varying degree of intensity during the 1990s, real GDP contracted by an average of about 4 percent per year over the conflict cycle.²

Program Implementation. Implementation of social sector projects in conflict-stricken areas has been hindered by active disruption by the insurgents. In these areas, under threats from the insurgents, a number of village and district level development committee officials had been unable to function, numerous school teachers and health officials have been forced to abandon their posts, and some donor service delivery projects have been forced to close down or move to alternative sites. Cessation of hostilities and a reduction in security spending could free up a significant amount of resources for development spending (Box 2).

Effects on the poor. The conflict has limited growth potential and disrupted targeted poverty alleviation programs in the affected areas. By disrupting economic activity, the conflict has increased uncertainties about incomes and livelihoods, including by the outflow of human capital and investible resources from the affected rural areas—where the bulk of the poor reside—to urban areas. Some of this influx into urban areas has translated into external labor migration and remittance inflows.

¹ S. M. Murshed, and S. Gates, 2003, “Spatial-Horizontal Inequality and the Maoist Insurgency in Nepal,” paper prepared for the Department for International Development (United Kingdom).

² Staines, N., 2004, “Economic Performance Over the Conflict Cycle,” IMF Working Paper 04/95. The conflict cycle varied from one year to 8 years, with conflict lasting 3 years, on average, in these 10 countries.

developments, all quantitative indicative targets for mid-April 2004 were observed, except the ceiling on reserve money. Developments since then have been consistent with the program and, based on provisional data, the mid-July quantitative floors and ceilings appear to have been met. However, some structural measures envisaged for mid-July were delayed in part because of political uncertainties leading up to the resignation of the previous government in early May and the formation of the current coalition in July. Looking forward, the authorities provide an update of the macroeconomic framework for the arrangement period and structural reform actions (including those delayed from mid-July) to be taken until mid-January 2005 (test date for the third review) in the attached Memorandum on Economic and Financial Policies (MEFP).

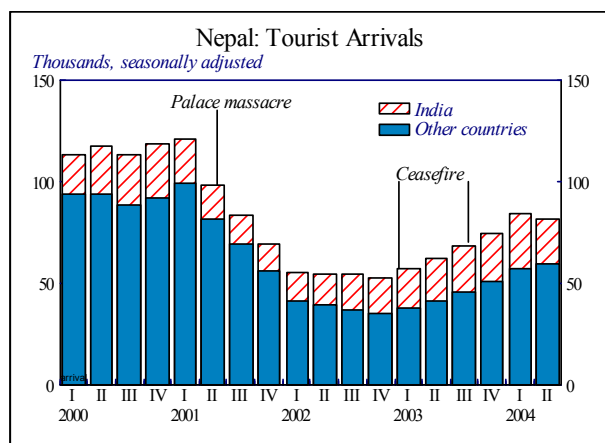
II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM IN 2003/04⁴

5. Macroeconomic developments in 2003/04 unfolded broadly as expected under the program (Table 2).

Real GDP growth in 2003/04 is estimated at 3½ percent, as envisaged under the program. Agricultural growth was higher-than-projected, in part due to a favorable monsoon during the first half of the year. Manufacturing sector activity showed resilience and held up reasonably well despite the insurgency, supported in part by demand generated by remittances, although performance across various industries was mixed. At the same time, strong remittances offset weak export performance, and tourist arrivals revived due to lower industry pricing, marketing efforts by the private sector and Nepal Tourism Board. CPI inflation (12-month basis) was 2 percent, reflecting the base effect of administered price adjustments in 2002/03 (Figure 1). International reserves, buoyed by remittances and aid inflows (while development spending was suppressed), increased rapidly and stood at around US\$1½ billion (around 7 months of imports of goods and services) at end-2003/04.

| | 2001/02 | 2002/03 | 2003/04 | |
|-----------------|---------|---------|---------|------|
| | | | Prog. | Est. |
| Real GDP Growth | -0.6 | 3.1 | 3.5 | 3.5 |
| Agriculture | 2.2 | 2.5 | 2.8 | 3.7 |
| Non-agriculture | -1.9 | 2.9 | 3.9 | 3.3 |
| Manufacturing | -10.0 | 2.0 | 2.3 | 2.0 |
| Services | -0.4 | 3.0 | 4.2 | 3.5 |

Sources: CBS; and Fund staff estimates.



⁴ The fiscal year begins mid-July.

6. **Fiscal developments in 2003/04 remained within the budget framework.** Revenue collection was higher than the budget target, with robust growth in income tax collections (as the income tax reforms of 2002 began to yield results) and excises (Table 4).⁵ VAT revenue growth (inland and customs) was also significant on a gross basis, although on a net basis growth was limited due to accelerated refunds of customs collection. On the spending side, expenditure (current and capital) was lower than programmed as the security situation constrained development spending on large donor-financed infrastructure projects and grants to district and village-level development committees fell short of targets.⁶ Notwithstanding the shortfall relative to the budget, development spending in 2003/04 is estimated to have been 13 percent higher than in 2002/03.⁷ Regular spending was in line with the budget framework, and health and education expenditures remained steady at 3¾ percent of GDP with increased devolution to local communities. Security spending was contained at 3 percent of GDP, a level similar to 2002/03, and spending pressures from security forces were accommodated with an additional allocation within the agreed budget framework by using the contingency allocation (Box 2). Large foreign aid inflows, robust revenue growth, and low spending resulted in negative net domestic financing of the budget (-0.2 percent of GDP) compared to the revised budget target of 1½ percent of GDP.

7. **Monetary developments were broadly consistent with the exchange rate peg to the Indian rupee.** For 2003/04 as whole, reserve money growth of 14¾ percent was somewhat larger-than-projected as the NFA of the Nepal Rastra Bank (NRB) rose significantly (Table 5). The NFA accumulation was made possible by a large inflow of

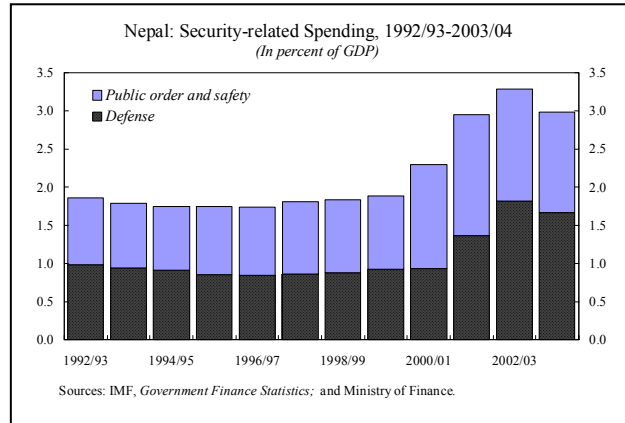
⁵ The income tax reforms led to significant base broadening, including through elimination of exemptions and closure of loopholes. For VAT collections, the lottery system, which requires invoices for participation, made a noticeable impact on compliance.

⁶ Until 2003/04, budget spending was classified into “regular” and “development.” While the bulk of regular expenditure (9–10 percent of GDP) was current spending, the development budget (6–8 percent of GDP) included both current (roughly ⅓) and capital spending.

⁷ While the insurgency aggravates the poverty situation in affected areas, the immediate impact of the level of development spending on poverty is hard to judge, given the multi-faceted nature of poverty. Besides the level of spending, improvements in the quality of spending and better targeting contribute to the achievement of poverty reduction goals. Other factors, including growth, in particular agricultural growth, and remittances also play an important role.

Box 2. Nepal: Security-Related Spending—A Cross-Country Comparison

For Nepal, security-related spending (defined as spending for defense and public order and safety (GFS basis), excluding off-budget donor assistance), includes current and capital spending for Royal Nepal Army, Armed Police Force and Nepal police. Although the insurgency began in early 1996, security-related spending stayed below 2 percent of GDP until 1999/00. Since then, there has been a step up. Average security-related spending rose from 1¾ percent during 1995/96–1999/00 to 3 percent during 2000/02–2003/04. For the period as a whole, security-related spending averaged 2¼ percent, roughly equally divided between defense and public order and safety.



Recent increases notwithstanding, security-related spending in Nepal is lower as a share of GDP by regional standards and to conflict situations for which comparable data is available.

| | | Defense | Public Order and Safety | Total |
|----------------|-----------------|---------------------|-------------------------|-------|
| | | (In percent of GDP) | | |
| Nepal 1/ | 1995/96-2003/04 | 1.1 | 1.2 | 2.3 |
| India | 1998/99-2002/03 | 2.4 | ... | ... |
| Pakistan 1/ 2/ | 2000/01-2003/04 | 3.7 | ... | ... |
| Sri Lanka 1/ | 1992-2001 | 4.0 | 1.0 | 5.0 |

Sources: GFS; IMF Staff Reports; Nepal MOF.
 1/ PRGF countries.
 2/ Includes current budget expenditure only.

Nevertheless, durable peace would improve implementation capacity and could free up significant resources for development spending over the medium term.

remittances, including through commercial banks.⁸ A reduction in NRB holdings of T-Bills—motivated by the aim to meet the statutory limits on NRB holding of government securities under the 2002 NRB Act—helped sterilize these inflows. Commercial banks absorbed the bulk of these T-Bills, given low rates of return on dollar-denominated assets and restrictions on their investment in the Indian T-Bill market. Development spending and financing needs of the budget remained muted. During the latter half of the year, while the flow of remittances and NFA accumulation remained sustained, the pickup in development spending contributed to acceleration in reserve money growth. Meanwhile, broad money growth is estimated at 13½ percent (12-month basis), with limited budget financing by the banking system. Private sector credit growth (9–10 percent in real terms) was satisfactory as banks sought to expand their portfolios into consumer lending given limited opportunities for financing manufacturing and service sector activities. Reflecting ample market liquidity, the T-Bill interest rates fell significantly (Figure 2). The Nepalese rupee appreciated mildly by about 1 percent vis-à-vis the U.S. dollar, reflecting appreciation of the Indian rupee. The real effective exchange rate remained relatively stable.

8. Structural reforms progressed under the program.

- A large taxpayer office (LTO) was established. The Customs Department prepared and started implementing a three-year customs modernization action plan, consistent with IMF technical assistance recommendations.
- The NRB eliminated all restrictions on commercial bank lending rates and foreign exchange buy/sell rate spreads.⁹
- For financial sector reform, the authorities took steps on three fronts—improvements in loan recovery and the banking environment, strengthening of the NRB, and restructuring of commercial and development banks (Box 3).

⁸ During the year, commercial banks were flush with liquidity as remittances shifted increasingly through formal channels. A number of commercial banks are actively tapping remittances by setting up agency arrangements with banks and money transfer agencies in the labor emigration destinations.

⁹ Market participants indicated that elimination of lending rate restrictions had led to greater transparency in rate setting and the elimination of foreign exchange buy/sell spreads had allowed banks to reflect better market conditions and improved their profit opportunities.

Box 3. Nepal: Financial Sector Reforms—An Update

The objective of financial sector reforms in Nepal is to address weaknesses in the sector and improve financial intermediation to create conditions for higher growth. Three main areas for Fund involvement under the PRGF arrangement with macroeconomic and systemic implications were identified—the overall framework for financial sector activity; shortcomings at the NRB; and restructuring of commercial and development banks with large nonperforming portfolios. Reforms in the sector are also being supported by the World Bank, AsDB and Dfid.

A. Status at the Onset of Reforms

Weaknesses were identified in the three areas of Fund involvement.

- **Financial Sector Framework.** The legal framework for NRB and financial sector activity was outdated and fragmented. Prudential norms were also outdated. Existing provisions made enforcement of debt recovery difficult and protracted.
- **NRB.** Despite being overstaffed, the NRB was unable to devote adequate resources to its key tasks, including financial sector supervision.
- **Commercial and development banks.** Government ownership and interference in the banking sector activity was excessive. Together with poor supervision and limited competition despite a number of banks, the quality of lending and reporting was poor. Willful default was rampant. As a result, the two largest commercial banks in the country—RBB and NBL—which accounted for over 50 percent of banking system assets made losses and were insolvent. The two largest development banks—Agricultural Development Bank of Nepal (ADB) and Nepal Industrial Development Corporation (NIDC)—suffered from similar problems. As a result of these problems, the buildup of financial sector contingent liabilities is estimated at 7–8 percent of GDP, the bulk of it related to the need to recapitalize insolvent banks.

B. Reform Measures to Date

- **Financial sector framework.** The new NRB Act was enacted in 2002 to enhance central bank autonomy and provide it with stronger supervisory authority. Revised prudential regulations of internationally accepted standards were issued in 2001. The Banking and Financial Institutions Ordinance which unified existing overlapping financial institutions laws was promulgated in February 2004. A process for time-bound loan recovery was instituted with the establishment of the Debt Recovery Tribunal in September 2003 and the Appellate Tribunal in March 2004. NRB's directives for blacklisting loan defaulters were significantly strengthened in 2003.
- **NRB.** The NRB shifted to a streamlined organizational structure in December 2003 and implemented VRSs in March 2004 and May 2004 to reduce overstaffing. An audit of NRB's 2002/03 accounts by an international accounting firm was completed in August 2004.
- **Commercial and development banks.** External managers were installed at NBL (July 2002) and RBB (January 2003). These managers have significantly improved lending practices at the banks, undertaken vigorous debt recovery, cut operating costs, and downsized the banks significantly through VRSs. Cabinet approved restructuring plans for ADB and NIDC in January and February 2004, respectively.

| | NBL | | RBB | |
|--|--------|----------------|----------|----------------|
| | Jul-03 | Jul-04 Est. | Jul-03 | Jul-04 Est. |
| NPLs (percent of gross loans, end-period) | 61 | 52 | 60 | 56 |
| Nonperforming loan recovery (principal and interest, in billions of Nrs) | 2.4 | 1.8 | 1.2 | 2.9 2/ |
| Cost to income ratio (in percent) | 104 | 81 | 1,455 1/ | 78 |
| Staffing level | 5,269 | 3,808 | 5,402 | 3,996 |
| Net worth (in percent of GDP) | -2.2 | -1.8 | -4.9 | -4.3 |

Sources: World Bank; NBL; RBB; and Fund staff estimates.

1/ This includes a one time provision for pension/gratuity and endowment life insurance fund liability aggregating to Nrs 2.55 billion.

2/ Cash recoveries only.

9. Some actions were, however, delayed beyond target dates, and problem areas remain.

- A key safeguard measure—international audit of 2002/03 NRB accounts—was delayed beyond mid-February by initial reluctance and subsequent delays in appointing a non-Nepalese audit firm; the audit report was finalized in mid-August (Box 4).
- In the financial sector, implementation delays led to the NRB VRS slipping beyond mid-March; the RBB (Phase II) VRS was delayed to enable financing under the World Bank's FSRC. External audits and restructuring plans for two development banks were delayed beyond mid-January to garner consensus within the government around the proposed actions plans.
- In the area of public sector reforms, Bhaktapur Brick Factory was privatized (a sale and purchase agreement signed in January 2004), but settlement of liabilities at Nepal Coal Limited was delayed until end-2003/04 in part by legal challenges.
- Finally, progress in debt recovery from well-connected, large defaulters—who continue to resist using political influence and a judicial system that is not seen as fully transparent—remained slow.

III. REPORT ON THE DISCUSSIONS

A. Macroeconomic Outlook and Risks

10. Growth is projected to rise in 2004/05 and over the medium term provided there is some improvement in the security situation and structural reforms are implemented. Real GDP growth is projected to rise to 4 percent in 2004/05 and to 5½ percent over the medium term.¹⁰ Achieving these growth rates would require sustained growth in agriculture and a higher contribution from the nonagricultural sector, including a rebound in manufacturing and tourism. Inflation (12-month) is expected to be around 5½ percent (taking into account the impact of oil price adjustments in 2004/05), broadly in line with price

¹⁰ The projected growth rates are in line with experience (real GDP growth averaged 5¼ percent during the first half and 4¾ percent during the latter half of the 1990s). The projected growth rate of 4 percent in 2004/05 assumes agricultural and nonagricultural growth rates of 3¾ percent and 4¾ percent, respectively. For a further discussion of Nepal's sources of growth see IMF Country Report No. 03/283, pp. 13.

Box 4. Nepal: Safeguards, NRB Audit and Data Issues in Program Monitoring

A. Safeguards Assessment and NRB Audit

Under the Safeguards Assessment, an international audit of 2002/03 NRB financial statements was recommended in 2002. This recommendation was incorporated as structural conditionality for the second disbursement under the PRGF arrangement in November 2003. The international audit of the accounts was completed by an international firm in August 2004. The audit report identified a number of reporting and control deficiencies in the accounts. Given these deficiencies, the auditor issued an adverse opinion on the financial statements.

Based on the final audit report, Fund staff has proposed corrective actions. The recommendations include: (i) conduct an international audit of the 2003/04 NRB statements; (ii) prepare and implement an action plan to strengthen the Financial Management and Internal Audit Departments; (iii) prepare accounting manuals that fully incorporate International Financial Reporting Standards in the accounting system; and (iv) rectify control weaknesses identified by the international auditor. Looking forward, key recommendations are being proposed as program conditionality. Implementation of these recommendations and a full reconciliation of NRB balance sheet data with all accounting records are currently ongoing and reconciliation for all test dates will take some time.

B. Data Issues in Program Monitoring

For purposes of program monitoring and assessing observance of performance criteria under the PRGF arrangement accurate data is required from the NRB accounts and balance sheet on net foreign assets (NFA), net domestic assets (NDA) and reserve money (RM), as defined in the Technical Memorandum of Understanding (TMU). The TMU defines NDA as the difference between RM and NFA. Therefore, monitoring of performance criteria focused on NFA and RM to assess observance of NFA floors and NDA ceilings.

Given the identified data deficiencies in the NRB balance sheet, NRB efforts to ensure that program data for the first test date under the arrangement (January 14, 2004) are accurate included third party confirmation of the bulk of foreign assets. Most of these assets are held as foreign currency deposits at commercial banks abroad. A large portion of the NRB's foreign assets is also invested in United States and Indian T-Bills. Confirmations for NRB's foreign currency deposits were obtained from the corresponding foreign commercial banks and of T-Bill holdings from the US Federal Reserve and Reserve Bank of India. However, the data on reserve money on January 14, 2004 included a carry-over of an upward adjustment of Nrs. 1 billion (made in the accounts at end-July 2003 to correct for an earlier erroneous entry). The international auditors were not able to identify the source of the earlier error, and thus were unable to ascertain the accuracy of the upward adjustment. Nevertheless, the upward adjustment, on RM, if incorrectly made, had the effect of overstating both RM and NDA, for a given amount of NFA.

As the NFA and NDA performance criteria for January 14, 2004 were met by a large margin, even based on possibly overstated NDA, the staff's conclusion is that the quantitative performance criteria for January 14, 2004 have been met.

developments in India. International reserves are projected to remain around 6¾ months of imports of goods and services. Higher growth, especially in agriculture, together with better targeting of the poor, is expected to help achieve poverty reduction goals.¹¹

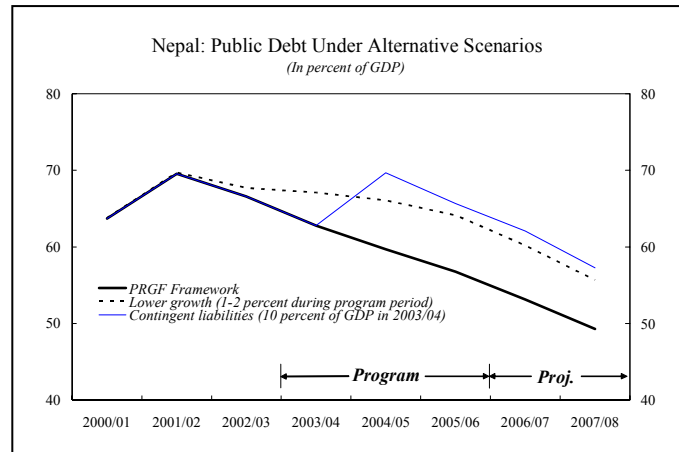
11. **The program remains subject to implementation risks.** In particular, a deterioration in the security situation could undermine growth and revenue targets, restrict development spending, and impede poverty alleviation efforts. Political unrest, if revived, would also impact economic activity adversely. While the overall direction of reforms is expected to remain unchanged, the pace of implementation and agreement on specific policy actions would be subject to consensus within the coalition government. In particular, the CPM-UML has raised issues about goals of the privatization program, citing concerns about the effects on employment and post-privatization efficiency gains. The coalition partners can also be expected to be mindful of their electoral prospects in judging the impact of policy actions taken under their stewardship. Weak implementation capacity, especially until local level government bodies can be fully activated, and governance problems continue to pose obstacles to achievement of PRSP goals.

B. Fiscal Policy and Reforms

12. **The authorities agreed that fiscal policy objectives over the medium term should remain raising the revenue-to-GDP ratio, improving the efficiency of public spending, and reducing domestic borrowing.** The 2004/05 budget adopted on July 15 is consistent with these medium-term fiscal policy objectives. The budget targets an increase in the revenue-to-GDP ratio of around ½ percentage point to 12¾ percent, based on strong revenue administration efforts to check excise leakages and collection of income tax arrears and the receding of VAT refunds to more normal levels compared to accelerated refunds in 2003/04. Total expenditure is set to rise with a substantial increase in the capital spending allocation. Social sector spending is also set to rise, with higher health, education and poverty-related spending. Although pressure for an increase in civil service wages is mounting after a three-year freeze, the authorities are committed to keeping the current salary scale unless the pay hike can be financed by an increase in the VAT rate and a wage decompression can be achieved (with progress in the ongoing civil service reform program (see ¶20)). Security-related spending in 2004/05 is budgeted to remain broadly unchanged as a share of GDP

¹¹ World Bank analysis of the 1995/96 Nepal Living Standard Survey (NLSS) suggested that sustained 4-5 percent real GDP growth and better targeting could potentially reduce poverty noticeably (by about 5–7 percentage points) over a 5–10 year horizon. Preliminary analysis of data from the 2000/01 Rural Household Consumption Surveys and the 2003/04 NLSS suggests a decline in poverty during the latter half of the 1990s attributable to acceleration in agricultural growth and higher remittances—as the World Bank’s Development Policy Review (June 2004) reports. A recovery in manufacturing and tourism is also essential to address urban poverty and absorb rural-urban migration.

compared to 2003/04 (3 percent of GDP). The overall deficit (after grants) would be contained to around 2½ percent of GDP and domestic financing to ¾ percent of GDP. With a further reduction in budget deficits beyond 2004/05, including through a further increase in the revenue-to-GDP ratio (by increases in the VAT rate and elimination of exemptions to broaden the tax base), this framework would help reduce the public debt-to-GDP ratio over the medium term and create room for meeting contingent liabilities from financial and public sector reforms (see figure, Table 8).^{12 13}



13. Further steps are envisaged to reform both revenue administration and expenditure management to achieve fiscal policy objectives.

First, the LTO is scheduled to be fully operational in the coming months, with technical assistance from FAD, Denmark, and Germany. However, making the LTO an effective agency would require a shift in operational practices, including through the proposed performance-based incentive system and indicators of staff performance. Second, the Customs Department would continue implementing its time bound reform action plan, with IMF and donor technical assistance (Box 5). A key element of customs reform would also be a provision for performance based incentives for staff. The tax structure is to be further streamlined, including a reduction in the number of commodities subject to export taxes. On expenditure management, the 2004/05 budget allocations have been reclassified into current and capital spending and prioritized for inclusion in the Medium Term Expenditure Framework (MTEF).

¹² These liabilities are estimated to be around 10 percent of GDP, with the bulk of them (7-8 percent of GDP) for recapitalizing insolvent banks (see Box 3). The carrying cost of the reforms is estimated at ¼–1 percent of GDP (see IMF Country Report 03/360, Box 3).

¹³ As regards external vulnerability, at end-2002/03 external debt stood at 52 percent of GDP and the ratio of net present value of debt to exports was 136 percent. These ratios are also projected to decline slightly over the medium term. Stress tests suggest that the debt profile is vulnerable to low export growth and large shifts in the exchange rate.

Box 5. Nepal: Tax Reforms—Achievements and Next Steps

Nepal has made significant progress in tax reforms in recent years, but much remains to be accomplished. A recent review of revenue policy (King, et. al., 2003) concluded that "... following the introduction of the VAT in 1997 and implementation of the new Income Tax Act in 2002, Nepal already has a good tax structure."^{1/} The review, however, recommended "tidying up" of the tax structure, including elimination of exemptions and curtailing of export taxes. Preliminary estimates of revenue yield from eliminating VAT and customs exemptions were placed around ½ percent of GDP; the revenue loss from rationalization of the taxes was also placed around ½ percent of GDP. On the other hand, revenue administration by the system was characterized as "extremely weak" and the review recommended steps to modernize and strengthen both the inland revenue and customs departments.

Progress is being made on strengthening revenue administration. Tax reforms form an important component of structural conditionality under the PRGF-supported program and implementation is underway. Structural performance criteria for the first review of the arrangement included establishment of a Large Taxpayer Office (LTO) and initiation of a time-bound customs modernization plan. These reform actions were completed by the target date of mid-January 2004. For high quality operations of the LTO, appointment and service requirements have been approved to recruit and retain qualified staff. The customs department has prepared a three-year customs modernization plan, customs procedures manuals, guides for the business community and customs officials, and a code of conduct. In particular, ASYCUDA has been extended to three additional customs offices.

Further steps to improve revenue administration are envisaged.

- **Large Taxpayer Office.** The LTO will be fully operational in the coming months and will cover audit, taxpayer service and collection functions and the MOF intends to clarify job descriptions of officials, develop performance indicators for staff, provide for performance-based incentives to recruit and retain highly qualified staff, and publish a code of conduct for LTO officials. With the LTO fully operational, the focus will shift to strengthening operations, including establishing a database to improve audit capabilities, preparing an audit manual and a strategy for audit, collection, and taxpayer compliance.
- **Customs administration.** The Customs Act is to be amended for consistency with WTO valuation provisions and a valuation database is to be prepared. Clearance facilities at customs offices are to be improved and a model customs is to be set up by early 2005. As in the case of the LTO, a provision is to be made for performance-based incentives.

Tax policy changes can also be considered although increases in rates would depend on political feasibility, effectiveness of revenue administration reforms, and broader economic policy goals. In this context, King, et. al. noted that the VAT now constitutes the single most important revenue source, "... even though its single rate of 10 percent is relatively low by international standards." A 1 percent increase in the VAT rate is estimated to generate an increase in revenue of about ⅓ percentage point of GDP. The government's Fiscal Reform Task Force report also recommended a phased increase in the VAT rate to generate revenue efficiently.

| | Nepal 2002/03 | Bangladesh 2002/03 | Pakistan 2002/03 | Sri Lanka 2003 |
|-----------------------|------------------|-----------------------|---------------------|-------------------|
| Tax Revenue | 9.7 | 7.9 | 13.8 | 12.9 |
| <i>Of which:</i> | | | | |
| VAT | 4.1 | 4.1 | 4.9 | 5.4 |
| Memorandum item: | | | | |
| VAT rate (in percent) | 10 | 15 | 15 | 12.5 |

Sources: IMF staff reports.

^{1/} J. King, G. Holland, A. Goorman, and D. Hansen, 2003, "Nepal: Next Steps in Tax Reform," IMF Fiscal Affairs Department.

C. Monetary, Exchange Rate, and External Policies

14. **The NRB agreed that monetary policy should remain geared to supporting the exchange rate peg to the Indian rupee.** With this objective in mind, the financial program for 2004/05, which projects broad money growth of 13¼ percent, assuming a continued small decline in velocity and projected real GDP growth of 4 percent, remains appropriate. This growth would accommodate domestic financing needs of the budget while allowing real private credit growth of about 8–9 percent. Consistent with monetary and exchange rate policy goals, reserve money is projected to grow by around 9 percent, with limited budget financing and NFA accumulation by the NRB of US\$95 million.

15. **The NRB maintained, and staff agreed, that the current level of the peg remains largely appropriate.** For now, market participants appear to be comfortable with the level of the peg to the Indian rupee and the real effective exchange rate has been relatively stable. Looking forward, the imminent loss of protected access to overseas markets due to the phasing out of the Multi-Fiber Arrangement (MFA) quotas by end-2004 pose challenges for export growth. More generally, there was agreement that the balance of payments outlook remained subject to external shocks, including the pace of recovery in export markets and oil prices, and to potential volatility in remittance inflows. The authorities agreed that medium-term challenges to exports are best addressed through steps to make Nepal's exports more competitive, including reduced labor and nonlabor inputs costs and by infrastructure investment to ease supply and transport bottlenecks, as suggested by recent studies.¹⁴ In this regard, the authorities indicated their willingness to modify legislation to make labor recruitment and retrenchment more flexible, although the pace of reforms in this area may be governed by the political environment. Finally, Nepal's integration in the global economy received a significant boost in April when it became the 147th member of WTO, the first low-income country to join the institution through accession. As part of the accession commitments, Nepal would open a number of service sub-sectors, including in the financial sector and telecommunication, to foreign investment.¹⁵

16. **The NRB intends to take steps to improve monetary, public debt and foreign exchange reserves management.** To improve liquidity and public debt management, the NRB has already shifted to a new framework for its monetary operations, with IMF technical

¹⁴ Global Development Solutions (2004), Identifying Nepal's Emerging Comparative Advantage, Study commissioned by the Asian Development Bank; and World Bank (2003), Nepal's Trade and Competitiveness Study.

¹⁵ To make the trade regime compatible with WTO provisions, a number of acts and regulations would be enacted or amended.

assistance.¹⁶ The NRB is also considering implementation of IMF technical assistance recommendations to beef up foreign exchange reserves management, including in the areas of credit, currency, and interest rate risk management.

D. Structural Reforms

17. **Structural reforms would remain focused on financial sector, public sector and governance reforms.** These reforms would create conditions for higher growth by improving intermediation and resource allocation, reducing corruption, and increasing accountability. The authorities expressed their strong commitment to the reform agenda, although it was recognized that, in some areas such as labor market reforms, implementation would have to be managed carefully to be in tune with political circumstances.

18. **The authorities' plans for further financial sector reforms are well advanced.**

- To create a sound banking environment, the government and the NRB expressed support for external managers in their efforts to improve loan recovery at the commercial banks, especially from well-connected large defaulters. The NRB is also committed to enforcing blacklisting provisions strictly to tackle the culture of nonrepayment while avoiding unintended restriction of credit to good borrowers. A draft Asset Management Company legislation has been prepared to expand the portfolio of instruments available to banks to resolve nonperforming loans. The authorities are also considering amendments to the Banking and Financial Institutions (BFI) Ordinance with IMF and World Bank technical assistance. These amendments are intended to align provisions of the BFI Ordinance with a revised Company Ordinance and to strengthen regulation over all deposit taking institutions.
- At the NRB, the focus would be on improving performance incentives for staff through a revision of human resources policies, including introduction of merit-based recruitment and promotions; introduction of provisions for compulsory retirement to further reduce overstaffing; and strengthening bank supervision (including through streamlined NRB procedures for timely delivery of supervision reports to commercial banks) and accounting practices.
- For commercial banks, the authorities have decided that, after further restructuring, the NBL and RBB are to be privatized.¹⁷ Efforts are to be made to place ADBN on a

¹⁶ The framework involves market determination of the repo rate through auctions (compared to the current administrative setting of the repo rate above the short-term T-Bill rate), complemented with a standing credit facility for commercial banks at the NRB. NRB secondary market operations are also to be simplified. A liquidity monitoring and forecasting framework would underpin these arrangements.

sound commercial footing through improvements in loan recovery and reductions in staffing. As regards the NIDC, the bank would be restructured with a view to privatization; if privatization efforts do not succeed, liquidation proceedings would be initiated.

19. Significant progress is envisaged on public enterprise reforms to lower government ownership, create further room for private sector activity, increase the SOEs' net budgetary contribution, and address contingent liabilities.¹⁸

- Under the program, privatization/liquidation procedures are envisaged for a number of enterprises. Severance payments and unfunded liabilities to staff retrenched during privatization/liquidation/restructuring are to be met with external financial assistance. The authorities are committed to not incurring any new direct or contingent liabilities or providing any off-budget support.
- To eliminate the financial losses of the Nepal Oil Corporation (NOC), oil product prices will continue to be adjusted towards international prices.¹⁹ By end-2004, an automatic pricing mechanism with a built-in element for loss recovery, developed by the Petroleum Price Fixing and Monitoring Committee, is expected to be in place. The authorities also intend to adopt the Petroleum Products Sale and Distribution Ordinance to allow private sector participation in oil imports and distribution by

¹⁷ The cabinet approved recently amendments to the NRB Act to facilitate restructuring of ailing commercial banks.

¹⁸ Thirty nonfinancial public enterprises were under full government ownership at end-2002/03 with total employment of around 35,000 (½ percent of the labor force). The majority of these are loss makers. Contingent liabilities for the budget from public enterprises reform are estimated at around ¾ percent of GDP.

¹⁹ The NOC has made substantial losses—of the order of Nrs. 400–600 million per month (0.1 percent of GDP) recently—as international oil prices have risen. Domestic administered prices have not been adjusted since early 2003. Distortions and differentials in petroleum products' prices have led to adulteration, cross-border smuggling and poor targeting of fuel subsidies. The government initiated the process of petroleum price adjustments in August. During August and September, aviation fuel prices were raised to international levels, and prices for LPG, kerosene, diesel and petrol were raised. While the reduction in NOC losses from these measures is estimated around Nrs. 330 million, NOC estimates that its losses are still around Nrs. 400 million per month, as international oil prices have risen in the meantime. Further adjustments are to be undertaken on the way to automatic pricing.

February 2005. Furthermore, to assess NOC's financial position, an international firm is to finalize its 2003/04 accounts by mid-January 2005.²⁰

- The authorities are implementing plans for share sales in the profitable Nepal Telecommunications Corporation (NTC) and National Life Insurance Corporation and an internal unbundling of power generation and distribution operations of Nepal Electricity Authority. To this end, NTC was converted into a company in April 2004.

20. **Progress is being made on governance reforms, although much remains to be accomplished.** The anti-corruption strategy approved by cabinet in early 2003 has been developed into an action plan. The Commission for Investigation of Abuse of Authority (CIAA) continues its strong anti-corruption efforts, with capacity building support from DfID/DANIDA. A National Vigilance Center in the Prime Minister's office is now in operation. The government has prepared a draft Fiscal Transparency Ordinance, which is to be finalized, with IMF assistance, in the context of the forthcoming fiscal ROSC mission. Moreover, a draft procurement law is under preparation that will address the issues raised in the Bank's Country Procurement Assessment Report. A commission on fiscal decentralization has produced its report on tackling challenges associated with improving service delivery through devolution, and the clarifying and enhancing of the responsibilities of local governments. However, the authorities need to remain mindful that effective decentralization would require a significant strengthening of local level accountability and implementation capacity. All these steps notwithstanding, changing public perceptions about corruption and poor governance in Nepal remains a daunting task.

21. **Civil service reforms are aimed at reducing the size of the government while improving its efficiency, although progress to date remains slow.** The government eliminated over 7,600 vacant nongazetted civil service posts. It intends to continue eliminating remaining vacant positions. The government has also drafted amendments to the Civil Service Act, including provisions for VRS, annual performance assessment, and merit-based/gender sensitive recruitment and promotion, and cabinet intends to approve the ordinance by mid-November 2004.

22. **Several laws are being amended to foster private sector development.** A Build-Own-Operate-Transfer (BOOT) Ordinance was issued in September and several projects have been opened for private sector participation. Furthermore, cabinet has approved Secured Transactions, Insolvency and Securities Ordinances. The cabinet has discussed the Company Ordinance that is at final stages of approval. A new Competition Ordinance to eliminate monopolistic practices is also close to finalization.

²⁰ Given delays in initiating international audit of 2002/03 NOC accounts, structural conditionality is changed to audit of 2003/04 accounts.

IV. OTHER ISSUES

23. **The program will be monitored through semi-annual reviews.** Quantitative performance criteria and benchmarks have been proposed through mid-July 2005 and structural performance criteria have been proposed through mid-January 2005. The second program review by the Board is tentatively scheduled for early 2005.

24. **The authorities have committed to improving data quality and reporting.** IMF technical assistance is being provided to achieve these goals. The authorities are also committed to upgrading significantly monetary data based on recommendations made in the NRB's external audit report prepared in the context of the safeguards assessment.

V. STAFF APPRAISAL

25. **Nepal's growth and poverty reduction prospects are closely linked to a resolution of the insurgency and achieving a political consensus on development policies.** Specific events related to the insurgency—including the recent unexpected imposition of the blockade on Kathmandu and its withdrawal within a week—remain unpredictable. A resolution of the insurgency and the armed conflict would create a more favorable climate for growth, allow reduction of security-related spending and speedier implementation of development and social sector projects, and accelerate delivery of targeted poverty alleviation programs to the poor. Likewise, a resolution of the remaining political uncertainties would help reduce disruption of economic activity, cement the consensus on policies around development objectives contained in the PRSP, and focus national energies on the achievement of these objectives. The authorities would be well advised to use all available avenues to secure a lasting peace and to ensure that the political process is better geared to meet development needs and goals.

26. **Against the background of disruptions caused by the insurgency and the unsettled political situation, favorable macroeconomic outcomes were the result of sound economic management and good fortune.** While the insurgency has dampened growth potential, in some cases by outright closure and damage to productive facilities, the economy appears to have weathered the disruptions reasonably well. Real GDP growth in 2003/04 was in line with expectations (in agriculture due to good weather conditions) and relatively broad-based (due to resilience of manufacturing and the rebound in tourist arrivals). Revenue growth was robust and regular spending was in line with budget plans with prudent use of budget savings, when available, to reduce public debt. While development spending appears to have been a casualty of the conflict, in retrospect, the shortfall reflects in part the ambitious initial targets. In the face of robust remittance inflows, monetary and exchange rate management was appropriate, and quantitative program targets were met. The 2004/05 budget, the measures taken to adjust oil product prices, and recent cabinet approval of a number of key ordinances all point to the new government's commitment to program implementation.

27. **Prospects for fiscal policy implementation remain good but structural reforms are required to achieve program objectives over the medium-term.** The growth momentum should help achieve revenue targets in 2004/05 and continued prudent management is expected to keep spending on track. Low development spending—which would reduce growth, compromise poverty alleviation goals and limit delivery of social services—may remain a weak spot. Over the medium term, revenue efforts would receive a boost from administration reforms, but policy changes—adjustments in tax rates and base broadening, including through reduction in exemptions—are also required. On expenditure, extension of the MTEF to all spending will help raise allocations for priority sectors and increase poverty-related spending. It is crucial for poverty reduction that the authorities sustain efforts to increase social sector spending as a share of GDP seeking, as needed, donors’ support. The planned low levels of domestic borrowing will contribute to fiscal sustainability.

28. **Monetary and exchange rate policies are to be appropriately 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, recent steps to improve the NRB’s monetary operations, foreign exchange reserves and public debt management need to be implemented in full. The focus on structural reforms—higher investment in physical and human capital and labor market reforms to reduce unit labor costs—to boost competitiveness and address challenges from prospective external developments is well placed and implementation is required urgently.

29. **Financial sector reforms have advanced but much remains to be done.** While the legislative framework for banking sector activity—the Banking and Financial Institutions Ordinance, the blacklisting directives, Debt Recovery and Appellate Tribunals, the proposed legislation on Asset Management Companies—has improved considerably, determined implementation of this framework is still in the works. In this context, a key test of the authorities’ commitment to improving the climate for banking sector activity will be the support provided to commercial banks to recover loans from large defaulters. As regards the NRB itself, the focus needs to be on accelerating its transformation into a modern and efficient central bank, with a stronger capacity to supervise the financial sector and actively manage monetary policy operations. While restructuring of troubled commercial banks is already well under way, steps towards privatization need to be taken on a timely basis. Concurrently, plans for restructuring development banks need to be implemented.

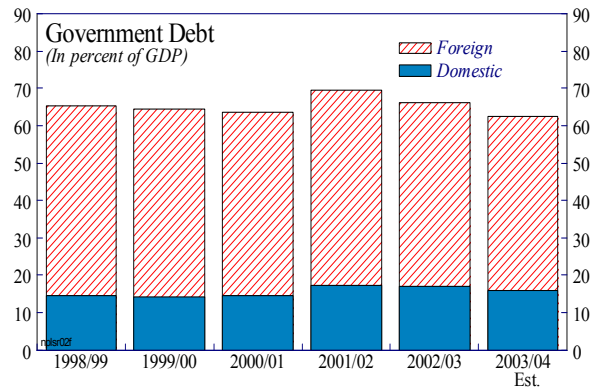
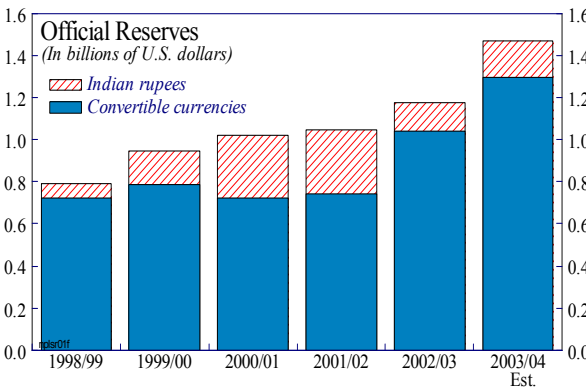
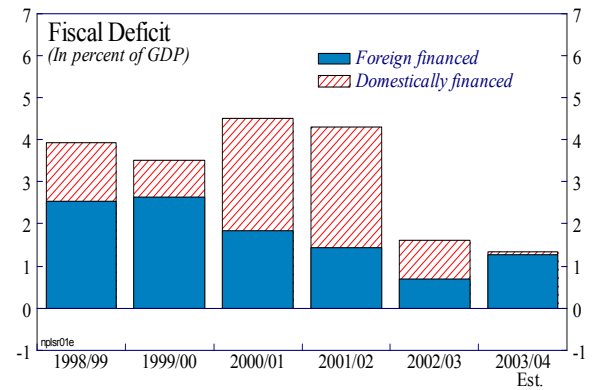
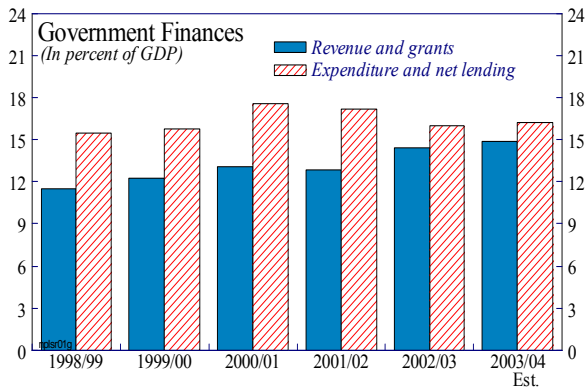
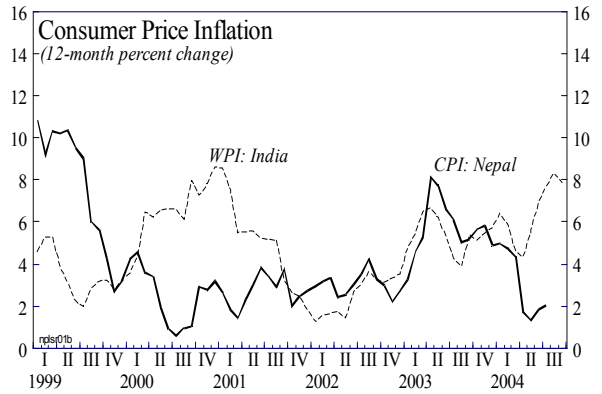
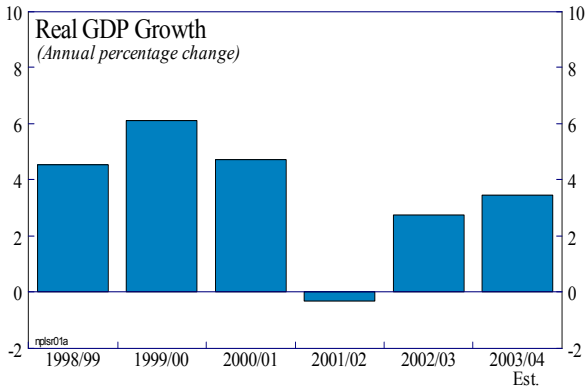
30. **Implementation of public enterprise and governance reforms is essential to create conditions for higher growth over the medium term.** The privatization/liquidation of public enterprises needs to continue to reduce the drain on the economy and to further enhance efficiency. Among the important steps in this area are finalization of NOC’s international audit, further adjustment in petroleum products’ prices, and introduction of the automatic pricing mechanism. Other reform measures, including the preparation of updated audited accounts of SOEs, would improve management accountability, including through a

better assessment of their financial condition. Civil service reforms and decentralization are required to improve service delivery, and forceful steps need to be taken to curb corruption.

31. **Trade policy and legal reforms can improve the climate for private sector development.** As a WTO member, Nepal needs to implement its accession commitments, including opening a number of service sub-sectors to foreign investment on a timely basis.

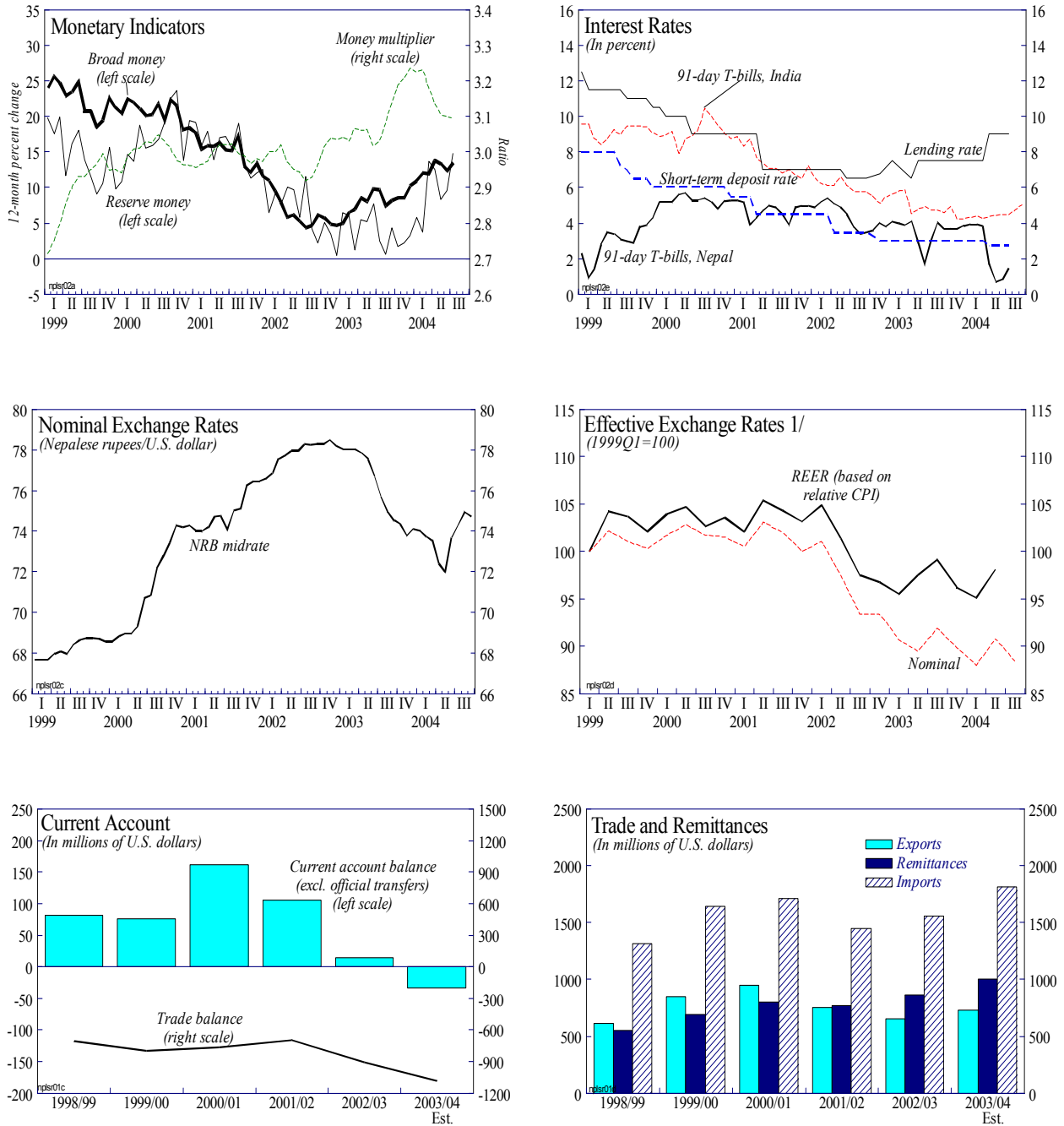
32. **The authorities efforts and achievements—macroeconomic stability and progress in structural reforms—against the background of a difficult security and political environment merit continued international support.** The staff considers risks to the program, primarily from the security situation, acceptable in view of the authorities' demonstrated commitment to reforms, the broad support for the PRSP strategy that underpins the program, continued efforts to seek peace negotiations with insurgents, and the call for general elections to help resolve the political impasse. The staff recognizes the authorities' record of policy implementation, including the recent, difficult hikes in petroleum products' prices implemented by the new government, and continued commitment to reforms and encourages them to persevere with their efforts. Together with the temporary nature of the nonobservance of structural performance criteria and proposed corrective action taken by the authorities, the staff recommends approval of the authorities' request for waivers for nonobservance of performance criteria and completion of the first review under the arrangement.

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 estimates.

1/ An increase indicates an appreciation.

Table 1. Nepal: Quantitative Performance Criteria and Indicative Targets, July 2003–July 2004
(In billions of Nepalese rupees, unless otherwise stated)

| | July 16, 2003 | Oct 17, 2003 | Jan 14, 2004 PC | Apr 12, 2004 IT | July 15, 2004 Prov. |
|---|---------------|--------------|--------------------|--------------------|------------------------|
| Performance criteria (PC) and indicative targets (IT) 1/ | | | | | |
| I. Floor on net foreign assets of the NRB (in millions of U.S. dollars) | | | | | |
| 1. SM/03/360 2/ | ... | ... | 1,208.1 | 1,218.1 | 1,228.1 |
| 2. Adjusted 3/ | ... | ... | 1,261.6 | 1,271.6 | 1,276.6 |
| 3. Actual 4/ | 1,217.6 | 1,268.2 | 1,383.3 | 1,415.2 | 1,449.6 |
| II. Ceiling on net domestic assets of the NRB | | | | | |
| 1. SM/03/360 5/ | ... | ... | -4.0 | -4.8 | -2.6 |
| 2. Adjusted 6/ | ... | ... | -8.4 | -9.2 | -6.2 |
| 3. Actual 7/ | ... | -17.1 | -25.3 | -18.0 | -15.7 |
| III. Ceiling on change in net domestic financing of central government budget. Cumulative from July 16, 2003 | | | | | |
| 1. SM/03/360 8/ | ... | ... | 6.4 | 7.4 | 8.4 |
| 2. Adjusted 9/ | ... | ... | 6.1 | 7.1 | ... |
| 3. Actual | ... | 0.9 | -6.5 | -6.5 | -0.8 |
| IV. Ceiling on short-term external debt contracted or guaranteed by the central government and NRB (in millions of U.S. dollars) | | | | | |
| 1. SM/03/360 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 2. Adjusted | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 3. Actual | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| V. Accumulation of external payments arrears Continuous performance criterion during the program period (in millions of U.S. dollars) | | | | | |
| 1. SM/03/360 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 2. Adjusted | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 3. Actual | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Indicative targets (IT) | | | | | |
| VI. Ceiling on reserve money | | | | | |
| 1. SM/03/360 | 81.0 | 83.0 | 86.6 | 86.5 | 89.5 |
| 2. Actual | 81.0 | 78.0 | 78.4 | 88.1 | 93.0 |
| VII Floor on central government revenue Cumulative from July 16, 2003 | | | | | |
| 1. SM/03/360 10/ | ... | 9.5 | 22.0 | 38.0 | 60.2 |
| 2. Adjusted 11/ | ... | 9.6 | 22.0 | 37.9 | ... |
| 3. Actual | ... | 10.8 | 26.1 | 40.0 | ... |

Notes:

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

2/ Net Foreign Assets (NFA) as defined in the Technical Memorandum of Understanding. Valued at program exchange rates; monetary gold (estimated at 0.15 million oz.) valued at historical price (US\$42.4 per oz.). To be adjusted upward/downward by excess/shortfall of foreign program financing. Details specified in the Technical Memorandum of Understanding.

3/ Valued at program exchange rates; monetary gold (estimated at 0.15 million oz.) valued at program price (US\$360 per oz.). Adjusted upward/downward by excess/shortfall of foreign program financing.

4/ Valued at program exchange rates; monetary gold (estimated at 0.15 million oz.) valued at program price (US\$360 per oz.).

5/ Net Domestic Assets (NDA) as defined in the Technical Memorandum of Understanding. Calculated as the difference between reserve money (VI.1) and NFA (I.1). To be adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign financing. Details specified in the Technical Memorandum of Understanding.

6/ Calculated as the difference between reserve money (VI.1) and NFA (I.2). Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing.

7/ Calculated as the difference between reserve money (VI.2) and NFA (I.3).

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

9/ Adjusted upward/downward by excess/shortfall of privatization receipts. Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing.

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

11/ Adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the Technical Memorandum of Understanding.

Table 2. Nepal: Structural Performance Criteria and Benchmarks for First Review Under the PRGF Arrangement

| Measures | Target Date | Status |
|--|-------------------|---|
| 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 | Completed; January 15, 2004 |
| 2. Eliminate restrictions on commercial banks' lending rates and foreign exchange buy/sell spreads | January 15, 2004 | Completed; December 15, 2003 |
| B. Financial Sector Reforms | | |
| 1. Finalize audit of NRB 2002/03 accounts by international auditor | February 15, 2004 | Completed; August 6, 2004 |
| 2. Implement voluntary retirement schemes at NBL and RBB (Phase I) | January 15, 2004 | Completed; January 15, 2004 |
| 3. Implement voluntary retirement scheme at NRB and RBB (Phase II) | March 15, 2004 | NRB completed July 16, 2004; RBB ¹ |
| Structural Benchmarks | | |
| 1. Strengthen the Nepal Rastra Bank (reorganize NRB) | January 15, 2004 | Completed; December 15, 2003 |
| 2. NRB to approve amended off-site supervision manual | January 15, 2004 | Completed; January 15, 2004 |
| 3. Prepare IAS-compliant 2002/03 audited accounts for RBB and NBL ² | January 15, 2004 | Completed |
| 4. Approve external audits and restructuring plans for ADBN and NIDC | January 15, 2004 | Completed; January 15/February 15, 2004 |
| 5. Complete liquidation/privatization of two SOEs | January 15, 2004 | Completed; July 15, 2004 |
| Prior Action for First Review | | |
| Implement VRS at the RBB (Phase II) | | |

1/ RBB VRS commenced on September 8, 2004; expect to be completed in early Oct.

2/ The statutory audit of RBB was completed on November 24, 2003 and NBL's on January 9, 2004. RBB's were approved by the Office of Auditor General on February 12, 2004. The accounts were prepared as per statutory requirements and were judged to be in line with NRB directives. However, NRB directives deviate, as permitted, from IAS standards and are tailored to local needs. As a result, the banks' accounts are not IAS-compliant.

Table 3. Nepal: Selected Economic Indicators, 2000/01–2005/06 1/

Nominal GDP (2002/03): US\$5,581 million

Population (2002/03): 24.6 million

| | 2000/01 | 2001/02 | 2002/03 | 2003/04 | | 2004/05 | 2005/06 |
|---|---------------------------------|---------|---------|---------|--------|---------|---------|
| | | | | Prog. | Est. | Proj. | |
| | (Percent change) | | | | | | |
| Real GDP at market prices | 5.5 | -0.6 | 3.1 | 3.5 | 3.5 | 4.0 | 5.0 |
| CPI (12-month change) 2/ | 3.4 | 3.5 | 6.1 | 4.5 | 2.0 | 5.5 | 4.5 |
| CPI (period average) | 2.4 | 2.9 | 4.7 | 5.3 | 4.0 | 4.4 | 4.0 |
| GDP deflator | 2.6 | 3.4 | 4.5 | 4.9 | 4.5 | 5.5 | 4.6 |
| Fiscal indicators | (In percent of GDP) | | | | | | |
| Total revenue | 11.4 | 11.5 | 12.3 | 12.4 | 12.3 | 12.7 | 13.0 |
| Total expenditure | 17.5 | 17.2 | 16.0 | 18.7 | 16.2 | 18.0 | 17.8 |
| Current expenditure | 11.2 | 11.5 | 11.5 | 13.1 | 11.6 | 12.5 | 12.1 |
| Capital expenditure and net lending | 6.4 | 5.6 | 4.6 | 5.6 | 4.7 | 5.5 | 5.7 |
| Overall deficit before grants | 6.1 | 5.7 | 3.7 | 6.3 | 3.9 | 5.3 | 4.9 |
| Overall deficit after grants | 4.5 | 4.3 | 1.6 | 3.1 | 1.3 | 2.5 | 2.4 |
| Domestic financing (net) | 2.7 | 2.9 | 0.9 | 1.7 | -0.2 | 0.7 | 0.5 |
| Public debt | 63.8 | 69.7 | 66.5 | 65.5 | 62.8 | 59.7 | 56.8 |
| Money and credit | (Percent change, end-of-period) | | | | | | |
| Broad money | 15.2 | 4.4 | 9.8 | 11.1 | 13.5 | 13.3 | ... |
| Domestic credit | 18.8 | 9.2 | 12.0 | 13.7 | 8.7 | 11.5 | ... |
| Velocity | 1.9 | 1.8 | 1.8 | 1.8 | 1.8 | 1.7 | ... |
| Interest rates | (In percent) | | | | | | |
| 91-day treasury bill (end-of-period) | 5.0 | 3.6 | 4.0 | ... | 1.5 | ... | ... |
| Central bank refinancing | 6½–7½ | 2–5½ | 2–5½ | ... | 2–5½ | ... | ... |
| Loans to industry | 9½–15 | 7–14½ | 7–14½ | ... | 8½–13½ | ... | ... |
| Balance of payments 3/ | (In millions of U.S. dollars) | | | | | | |
| Current account balance (excluding grants) | 162 | 106 | 15 | -109 | 8 | -163 | -178 |
| (In percent of GDP) | 2.9 | 1.9 | 0.3 | -1.7 | 0.1 | -2.2 | -2.2 |
| Trade balance | -765 | -694 | -903 | -1,098 | -1,059 | -1,287 | -1,362 |
| (In percent of GDP) | -13.7 | -12.5 | -15.5 | -17.1 | -16.1 | -18.4 | -18.1 |
| Gross official reserves (end-of-period) | 1,020 | 1,048 | 1,178 | 1,233 | 1,471 | 1,568 | 1,623 |
| (In months of imports of goods and services) | 7.2 | 7.0 | 6.7 | 6.4 | 7.3 | 6.8 | 6.6 |
| Export value growth 4/ | 5.5 | -18.4 | 5.6 | 7.4 | 12.9 | 6.9 | 6.0 |
| Import value growth | 4.1 | -15.3 | 7.4 | 9.0 | 15.4 | 15.5 | 14.9 |
| External debt/GDP (in percent) 5/ | 49.8 | 53.2 | 51.5 | 47.2 | 46.5 | 43.7 | 42.0 |
| Debt service 6/ | 4.2 | 4.9 | 4.9 | 6.0 | 4.5 | 5.0 | 4.7 |
| Exchange rate (Nrs per U.S. dollar, end-of-period) | 74.7 | 78.0 | 75.1 | ... | 74.1 | ... | ... |
| REER (end-of-period; percent change; -=depreciation) | 3.8 | -9.2 | -7.2 | ... | -3.0 | ... | ... |
| NEER (end-of-period; percent change) | 2.9 | -11.2 | -2.0 | ... | -2.0 | ... | ... |
| Fund operations (outstanding loans at end-of-period; SDR million) | | | | | | | |
| SAF/ESAF | 7.8 | 4.5 | 1.7 | ... | 7.1 | ... | ... |
| Nominal GDP at market prices (Nrs billion) | 410.8 | 422.3 | 454.9 | 484.3 | 491.9 | 539.9 | 593.3 |

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

1/ Fiscal year begins mid-July.

2/ The low increase in the 12-month CPI for 2003/04 reflects the base effect of an increase in administered prices in April 2003.

3/ The program and projections for 2003/04 are not fully comparable due to a change in the format of the balance of payments.

4/ Excluding re-exports.

5/ Includes estimated short-term trade credits.

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

Table 4. Nepal: Summary of Government Operations, 2002/03–2006/07 1/

| | 2002/03 | | | 2003/04 | | | 2004/05 | 2005/06 | 2006/07 |
|-----------------------------------|---------|----------------|---------|---------|----------------|-------|--------------------|-------------|---------|
| | Budget | Budget revised | Outcome | Budget | Budget revised | Prov. | Budget/ Program | Projections | |
| (In billions of Nepalese rupees) | | | | | | | | | |
| Total revenue and grants | 70.2 | 62.2 | 65.7 | 75.7 | 73.2 | 73.2 | 83.7 | 91.4 | 100.5 |
| Total revenue | 55.6 | 53.0 | 56.1 | 60.2 | 60.2 | 60.7 | 68.3 | 76.9 | 86.2 |
| Tax revenue | 45.9 | 42.3 | 43.9 | 48.2 | 48.2 | 47.8 | 53.8 | 62.4 | 70.8 |
| Nontax revenue 2/ | 9.7 | 10.7 | 12.1 | 12.0 | 12.0 | 12.8 | 14.6 | 14.5 | 15.4 |
| Grants | 14.6 | 9.2 | 9.6 | 15.5 | 13.0 | 12.5 | 15.4 | 14.5 | 14.3 |
| Total expenditure | 86.3 | 76.7 | 72.9 | 90.7 | 85.6 | 79.8 | 97.2 | 105.8 | 110.6 |
| Current | 61.1 | 56.1 | 52.1 | 63.5 | 59.8 | 56.8 | 67.6 | 71.9 | 73.0 |
| <i>Of which:</i> Interest payment | 8.0 | 7.2 | 6.6 | 7.9 | 7.2 | 6.5 | 7.6 | 7.6 | 7.9 |
| Capital and net lending | 25.1 | 20.6 | 20.8 | 27.2 | 25.9 | 22.9 | 29.6 | 33.9 | 37.6 |
| Overall balance before grants | -30.7 | -23.7 | -16.9 | -30.5 | -25.5 | -19.1 | -28.9 | -28.9 | -24.4 |
| Overall balance after grants | -16.1 | -14.5 | -7.3 | -15.0 | -12.5 | -6.6 | -13.5 | -14.4 | -10.1 |
| Financing | 16.1 | 14.5 | 7.3 | 15.0 | 12.5 | 6.6 | 13.5 | 14.4 | 10.1 |
| Net foreign loans | 6.4 | 5.6 | 3.1 | 6.7 | 5.5 | 7.4 | 10.0 | 11.3 | 10.1 |
| Gross disbursements | 12.4 | 11.3 | 8.6 | 12.8 | 11.1 | 13.2 | 17.0 | 18.4 | 17.5 |
| Amortization | 6.0 | 5.6 | 5.5 | 6.1 | 5.5 | 5.8 | 7.0 | 7.1 | 7.4 |
| Net domestic financing | 9.7 | 8.8 | 4.2 | 8.4 | 6.9 | -0.8 | 3.5 | 3.1 | 0.0 |
| Net NRB financing | ... | ... | -7.1 | 1.0 | ... | -6.8 | 0.5 | ... | ... |
| Net commercial bank | ... | ... | 10.2 | 7.0 | ... | 4.3 | 2.5 | ... | ... |
| Net nonbank | ... | ... | 1.1 | 0.4 | ... | 1.7 | 0.5 | ... | ... |
| (In percent of GDP) | | | | | | | | | |
| Total revenue | 11.9 | 12.0 | 12.3 | 12.4 | 12.2 | 12.3 | 12.7 | 13.0 | 13.2 |
| Tax revenue | 9.8 | 9.5 | 9.7 | 9.9 | 9.8 | 9.7 | 10.0 | 10.5 | 10.8 |
| Nontax revenue 2/ | 2.1 | 2.4 | 2.7 | 2.5 | 2.4 | 2.6 | 2.7 | 2.5 | 2.4 |
| Grants | 3.1 | 2.1 | 2.1 | 3.2 | 2.6 | 2.5 | 2.8 | 2.4 | 2.2 |
| Total expenditure | 18.4 | 17.3 | 16.0 | 18.7 | 17.4 | 16.2 | 18.0 | 17.8 | 16.9 |
| Current | 13.0 | 12.7 | 11.5 | 13.1 | 12.2 | 11.6 | 12.5 | 12.1 | 11.2 |
| <i>Of which:</i> Interest payment | 1.7 | 1.6 | 1.5 | 1.6 | 1.5 | 1.3 | 1.4 | 1.3 | 1.2 |
| Capital and net lending | 5.4 | 4.6 | 4.6 | 5.6 | 5.3 | 4.7 | 5.5 | 5.7 | 5.8 |
| Overall balance before grants | -6.5 | -5.3 | -3.7 | -6.3 | -5.2 | -3.9 | -5.3 | -4.9 | -3.7 |
| Overall balance after grants | -3.4 | -3.3 | -1.6 | -3.1 | -2.5 | -1.3 | -2.5 | -2.4 | -1.5 |
| Financing | 3.4 | 3.3 | 1.6 | 3.1 | 2.5 | 1.3 | 2.5 | 2.4 | 1.5 |
| Net foreign loans | 1.4 | 1.3 | 0.7 | 1.4 | 1.1 | 1.5 | 1.8 | 1.9 | 1.5 |
| Gross disbursements | 2.6 | 2.5 | 1.9 | 2.6 | 2.2 | 2.7 | 3.1 | 3.1 | 2.7 |
| Amortization | 1.3 | 1.3 | 1.2 | 1.3 | 1.1 | 1.2 | 1.3 | 1.2 | 1.1 |
| Net domestic financing | 2.1 | 2.0 | 0.9 | 1.7 | 1.4 | -0.2 | 0.7 | 0.5 | 0.0 |
| Central bank financing | ... | ... | -1.6 | 0.2 | ... | -1.4 | 0.1 | ... | ... |
| Commercial bank financing | ... | ... | 2.2 | 1.4 | ... | 0.9 | 0.5 | ... | ... |
| Nonbank financing | ... | ... | 0.2 | 0.1 | ... | 0.3 | 0.1 | ... | ... |
| Memorandum items: | | | | | | | | | |
| Public savings | -1.2 | -0.7 | 0.9 | -0.7 | 0.1 | 0.8 | 0.1 | 0.8 | 2.0 |
| Primary balance | -1.7 | -1.6 | -0.1 | -1.5 | -1.1 | 0.0 | -1.1 | -1.2 | -0.3 |
| Debt service | 3.5 | 3.7 | 3.6 | 3.6 | 3.6 | 3.5 | 3.7 | 3.9 | 3.7 |
| Domestic | 1.6 | 1.9 | 1.9 | 1.8 | 2.0 | 2.0 | 1.9 | 2.2 | 2.2 |
| Foreign | 1.8 | 1.8 | 1.7 | 1.8 | 1.6 | 1.5 | 1.8 | 1.6 | 1.6 |
| Public debt | 66.1 | 69.5 | 66.5 | 65.5 | 64.0 | 62.8 | 59.7 | 56.8 | 53.1 |
| Domestic | 17.8 | 18.6 | 17.4 | 18.1 | 17.5 | 15.9 | 15.1 | 14.3 | 13.0 |
| External | 48.3 | 50.9 | 49.1 | 47.5 | 46.5 | 46.9 | 44.6 | 42.5 | 40.1 |
| Education expenditure | 3.0 | 3.1 | 3.0 | 3.0 | 3.0 | 2.9 | 3.3 | 3.4 | 3.2 |
| Health expenditure | 1.0 | 0.9 | 0.8 | 1.0 | 1.0 | 0.9 | 1.2 | 1.1 | 1.0 |
| Nominal GDP (in billions of Nrs) | 468.8 | 443.4 | 454.9 | 484.3 | 491.9 | 491.9 | 539.9 | 593.3 | 652.9 |

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

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

2/ Includes privatization receipts.

Table 5. Nepal: Monetary Accounts, 2001/02–2004/05

| | 2001/02 | 2002/03 | 2003/04 | | | | 2004/05 | | | |
|--|---------|---------|---------|-------|-------|------------|------------|------------|------------|------------|
| | Jul. | Jul. | Oct. | Jan. | Apr. | Jul. Prel. | Oct. Proj. | Jan. Proj. | Apr. Proj. | Jul. Proj. |
| Monetary authorities (In billions of Nepalese rupees) | | | | | | | | | | |
| Reserve money | 79.0 | 81.0 | 78.0 | 78.4 | 88.1 | 93.0 | 89.4 | 89.1 | 97.5 | 101.6 |
| Net foreign assets | 81.1 | 87.7 | 86.8 | 101.1 | 101.9 | 108.2 | 109.7 | 112.8 | 115.5 | 118.6 |
| Net domestic assets | -2.1 | -6.7 | -8.8 | -22.7 | -13.7 | -15.2 | -20.4 | -23.7 | -18.0 | -17.0 |
| (Annual percentage change) | | | | | | | | | | |
| Reserve money | 11.9 | 2.5 | 1.7 | 5.7 | 12.6 | 14.8 | 14.6 | 13.6 | 10.6 | 9.3 |
| (12-month change in percent of reserve money at start of period) | | | | | | | | | | |
| Reserve money | 11.9 | 2.5 | -3.7 | -3.2 | 8.8 | 14.8 | -3.9 | -4.2 | 4.9 | 9.3 |
| Net foreign assets | 8.7 | 8.3 | -1.1 | 16.6 | 17.5 | 25.4 | 1.7 | 4.9 | 7.9 | 11.2 |
| Net domestic assets | 3.2 | -5.8 | -2.6 | -19.7 | -8.7 | -10.5 | -5.5 | -9.1 | -3.0 | -1.9 |
| Monetary survey (In billions of Nepalese rupees) | | | | | | | | | | |
| Broad money | 224.0 | 245.9 | 247.3 | 257.0 | 269.1 | 279.1 | 279.8 | 290.4 | 298.8 | 316.1 |
| Narrow money | 77.2 | 83.8 | 80.6 | 83.0 | 88.6 | 94.3 | 92.3 | 95.8 | 98.5 | 104.3 |
| Quasi money 1/ | 146.8 | 162.2 | 166.7 | 174.0 | 180.4 | 184.8 | 187.5 | 194.6 | 200.3 | 211.9 |
| Net foreign assets 2/ | 88.4 | 91.4 | 89.2 | 101.5 | 103.6 | 109.3 | 111.1 | 114.3 | 117.2 | 120.6 |
| Net domestic assets | 135.6 | 154.5 | 158.1 | 155.5 | 165.5 | 169.8 | 168.7 | 176.1 | 181.6 | 195.5 |
| Domestic credit 1/ | 200.3 | 224.3 | 228.9 | 225.5 | 228.9 | 243.8 | 239.9 | 248.0 | 254.3 | 271.9 |
| Public sector | 58.6 | 61.5 | 61.0 | 52.5 | 54.2 | 58.4 | 58.6 | 59.4 | 60.3 | 61.0 |
| Government | 55.5 | 58.7 | 58.5 | 49.8 | 51.2 | 56.2 | 56.7 | 57.3 | 58.2 | 59.4 |
| Public enterprises | 3.1 | 2.8 | 2.4 | 2.7 | 3.0 | 2.2 | 1.9 | 2.1 | 2.2 | 1.6 |
| Private sector | 141.7 | 162.8 | 167.9 | 173.0 | 174.7 | 185.4 | 181.4 | 188.5 | 193.9 | 210.9 |
| Other items, net | -64.7 | -69.8 | -70.8 | -70.0 | -63.5 | -74.0 | -71.2 | -71.9 | -72.7 | -76.4 |
| (Annual percentage change) | | | | | | | | | | |
| Broad money | 4.4 | 9.8 | 8.6 | 10.9 | 13.7 | 13.5 | 13.2 | 13.0 | 11.1 | 13.3 |
| Narrow money | 9.3 | 8.6 | 4.6 | 7.4 | 10.3 | 12.6 | 14.5 | 15.4 | 11.2 | 10.6 |
| Quasi money | 2.1 | 10.4 | 10.7 | 12.7 | 15.5 | 14.0 | 12.5 | 11.9 | 11.0 | 14.6 |
| Domestic credit | 9.2 | 12.0 | 8.3 | 5.0 | 6.4 | 8.7 | 4.8 | 10.0 | 11.1 | 11.5 |
| Public sector | 24.7 | 4.9 | -1.7 | -15.8 | -9.3 | -5.0 | -3.9 | 13.2 | 11.2 | 4.5 |
| Government | 24.0 | 5.6 | 0.0 | -15.1 | -9.1 | -4.3 | -3.2 | 15.1 | 13.6 | 5.8 |
| Private sector credit | 3.9 | 14.9 | 12.4 | 13.6 | 12.4 | 13.9 | 8.0 | 9.0 | 11.0 | 13.8 |
| (12-month change in percent of broad money at start of period) | | | | | | | | | | |
| Broad money | 4.4 | 9.8 | 0.6 | 4.5 | 9.4 | 13.5 | 0.2 | 4.0 | 7.0 | 13.3 |
| Net foreign assets | 0.3 | 1.3 | -0.9 | 4.1 | 5.0 | 7.3 | 0.6 | 1.8 | 2.8 | 4.0 |
| Net domestic assets | 4.2 | 8.5 | 1.5 | 0.4 | 4.5 | 6.2 | -0.4 | 2.3 | 4.2 | 9.2 |
| Domestic credit | 7.9 | 10.7 | 1.9 | 0.5 | 1.9 | 7.9 | -1.4 | 1.5 | 3.8 | 10.1 |
| Private sector | 2.5 | 9.4 | 2.1 | 4.1 | 4.8 | 9.2 | -1.4 | 1.1 | 3.1 | 9.1 |

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

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

2/ Jan-04 commercial bank foreign liability is adjusted downward for the letter of credit issued by a commercial bank.

Table 6. Nepal: Balance of Payments, 2000/01–2008/09

| | 2000/01 | 2001/02 | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 |
|--|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| | | | | Est. | Proj. | | | | |
| (In millions of U.S. dollars, unless otherwise stated) | | | | | | | | | |
| Current account | 270 | 249 | 150 | 223 | 91 | 64 | 39 | 15 | -4 |
| Current account (excl. official transfers) | 162 | 106 | 15 | 8 | -163 | -178 | -200 | -226 | -248 |
| Trade balance | -765 | -694 | -903 | -1059 | -1287 | -1362 | -1428 | -1491 | -1560 |
| Exports, f.o.b. | 945 | 754 | 653 | 737 | 788 | 1,023 | 1,118 | 1,223 | 1,322 |
| Merchandise exports | 758 | 618 | 653 | 737 | 788 | 835 | 912 | 996 | 1,085 |
| Re-exports of oil 1/ | 187 | 136 | 0 | 0 | 0 | 188 | 207 | 228 | 238 |
| Imports, f.o.b. | 1,710 | 1,448 | 1,556 | 1,796 | 2,075 | 2,384 | 2,547 | 2,714 | 2,882 |
| Oil products | 338 | 288 | 242 | 266 | 344 | 521 | 543 | 573 | 591 |
| Other imports | 1,372 | 1,160 | 1,314 | 1,530 | 1,730 | 1,863 | 2,003 | 2,141 | 2,292 |
| Services (net) | 123 | 64 | 91 | 109 | 115 | 116 | 128 | 144 | 163 |
| Receipts | 404 | 319 | 341 | 436 | 471 | 503 | 540 | 581 | 623 |
| <i>Of which</i> : Tourism | 159 | 113 | 151 | 230 | 262 | 290 | 322 | 358 | 394 |
| Payments | 281 | 255 | 250 | 327 | 356 | 387 | 413 | 437 | 460 |
| Income | 23 | -8 | -9 | -30 | -33 | -32 | -29 | -29 | -28 |
| Credit | 74 | 56 | 58 | 44 | 45 | 46 | 47 | 48 | 49 |
| Debit | 51 | 64 | 66 | 74 | 78 | 78 | 76 | 77 | 77 |
| Current transfers | 889 | 887 | 971 | 1,203 | 1,296 | 1,341 | 1,369 | 1,391 | 1,421 |
| Credit | 908 | 913 | 1,000 | 1,254 | 1,352 | 1,403 | 1,436 | 1,465 | 1,503 |
| General government 2/ | 108 | 143 | 135 | 215 | 254 | 242 | 239 | 241 | 244 |
| Workers remittances | 640 | 618 | 697 | 818 | 893 | 957 | 986 | 1,017 | 1,052 |
| Recorded | 130 | 165 | 234 | 340 | 408 | 469 | 500 | 533 | 568 |
| Estimated | 510 | 453 | 463 | 478 | 486 | 488 | 486 | 485 | 483 |
| Debit | 19 | 26 | 29 | 51 | 56 | 61 | 68 | 74 | 82 |
| Capital account | 84 | 74 | 69 | 102 | 127 | 117 | 102 | 84 | 69 |
| Capital Transfers | 84 | 74 | 69 | 102 | 127 | 117 | 102 | 84 | 69 |
| <i>Of which</i> : Official grants | 58 | 48 | 42 | 92 | 117 | 107 | 92 | 74 | 59 |
| Financial account | -416 | -426 | -180 | -83 | -213 | -196 | -146 | -102 | -66 |
| Direct investment | 0 | -4 | 12 | 7 | 26 | 15 | 17 | 19 | 20 |
| Portfolio investment | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other investment 3/ | -415 | -422 | -193 | -90 | -239 | -211 | -163 | -121 | -86 |
| <i>Of which</i> : Loans to the Government | 103 | 39 | 40 | 85 | 67 | 83 | 136 | 149 | 158 |
| Disbursements | 164 | 105 | 111 | 164 | 163 | 179 | 230 | 241 | 247 |
| Amortization | 61 | 66 | 71 | 79 | 96 | 95 | 94 | 92 | 89 |
| Errors and omissions 3/ | 100 | 64 | 54 | 0 | 0 | 0 | 0 | 0 | 0 |
| Overall balance | 38 | -38 | 93 | 243 | 4 | -15 | -5 | -2 | 0 |
| Financing | -38 | 38 | -93 | -243 | -4 | 15 | 5 | 2 | 0 |
| Change in reserve assets (=-increase) | -75 | 51 | -90 | -304 | -117 | -85 | -85 | -73 | -70 |
| IMF purchases (net) | -5 | -4 | -4 | 8 | 0 | 0 | 0 | 0 | 0 |
| Other liabilities | 42 | -8 | 1 | 53 | 12 | 10 | 10 | 10 | 10 |
| Financing gap 4/ | 0 | 0 | 0 | 0 | 101 | 90 | 80 | 65 | 60 |
| <i>Of which</i> : | | | | | | | | | |
| IMF | ... | ... | ... | ... | 31 | 21 | 10 | 0 | 0 |
| (In percent of GDP, unless otherwise stated) | | | | | | | | | |
| Memorandum items: | | | | | | | | | |
| Current account (excl. official transfers) | 2.9 | 1.9 | 0.3 | 0.1 | -2.2 | -2.2 | -2.3 | -2.4 | -2.5 |
| Current account (incl. official transfers) | 4.8 | 4.5 | 2.6 | 3.3 | 1.2 | 0.8 | 0.5 | 0.2 | 0.0 |
| Total external debt 5/ | 49.8 | 53.2 | 51.5 | 46.5 | 43.7 | 42.0 | 41.0 | 39.9 | 38.6 |
| Debt service 6/ | 4.2 | 4.9 | 4.9 | 4.5 | 5.0 | 4.7 | 4.4 | 4.2 | 3.9 |
| Gross foreign assets (end of period) | 1,423 | 1,371 | 1,462 | 1,767 | 1,884 | 1,969 | 2,054 | 2,127 | 2,197 |
| <i>Of which</i> : Central bank | 1,020 | 1,048 | 1,178 | 1,471 | 1,568 | 1,623 | 1,678 | 1,738 | 1,798 |
| (In months of imports of goods and services) | 7.2 | 7.0 | 6.7 | 7.3 | 6.8 | 6.6 | 6.4 | 6.2 | 6.0 |
| Nominal GDP (in millions of U.S. dollars) | 5,589 | 5,562 | 5,851 | 6,707 | 7,400 | 7,974 | 8,572 | 9,223 | 9,987 |

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

1/ Nepal buys oil in the international market and re-exports it to India for refinery. This activity is not currently in operation and is expected to resume in 2005/06.

2/ Includes estimated international NGO transfers.

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

4/ Provisional. The remaining financing gap will be filled by the World Bank (\$50-60 million) and the AsDB (\$10-20 mn) in 2004/05 and 2005/06.

5/ Includes estimated private sector debt and short-term trade credits.

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

Table 7. Nepal: Medium-Term Macroeconomic Framework, 2001/02–2007/08
(In percent of GDP, unless otherwise indicated)

| | 2001/02 | 2002/03 | 2003/04 Est. | 2004/05 | 2005/06 | 2006/07 | 2007/08 |
|--|---------|---------|-----------------|---------|---------|---------|---------|
| | | | | Proj. | | | |
| Real sector | | | | | | | |
| Real GDP growth (percent change) | -0.6 | 3.1 | 3.5 | 4.0 | 5.0 | 5.4 | 5.4 |
| Agriculture | 2.2 | 2.5 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 |
| Nonagriculture | -1.9 | 2.9 | 3.3 | 4.2 | 5.9 | 6.4 | 6.5 |
| GDP deflator (percent change) | 3.4 | 4.5 | 4.5 | 5.5 | 4.6 | 4.4 | 4.4 |
| Saving-investment balance | | | | | | | |
| Gross domestic savings | 26.0 | 26.1 | 23.5 | 22.2 | 23.2 | 24.1 | 25.0 |
| Public 1/ | 0.2 | 0.8 | 0.9 | 1.2 | 0.9 | 2.1 | 2.2 |
| Private | 25.8 | 25.3 | 22.6 | 21.1 | 22.2 | 21.9 | 22.7 |
| Gross fixed investment | 19.3 | 19.1 | 18.5 | 19.5 | 20.5 | 21.5 | 22.5 |
| Public 1/ | 7.6 | 6.9 | 6.6 | 7.4 | 7.7 | 7.8 | 8.5 |
| Private | 11.7 | 12.2 | 11.9 | 12.1 | 12.8 | 13.7 | 14.0 |
| Fiscal sector | | | | | | | |
| Total revenue | 11.5 | 12.3 | 12.3 | 12.7 | 13.0 | 13.2 | 13.4 |
| Grants | 1.4 | 2.1 | 2.5 | 2.8 | 2.4 | 2.2 | 2.2 |
| Current expenditure | 11.6 | 11.5 | 11.6 | 12.5 | 12.1 | 11.2 | 11.1 |
| Capital expenditure & net lending | 5.7 | 4.6 | 4.7 | 5.5 | 5.7 | 5.8 | 5.7 |
| Overall balance before grants | -5.8 | -3.7 | -3.9 | -5.3 | -4.9 | -3.7 | -3.3 |
| Overall balance after grants | -4.4 | -1.6 | -1.3 | -2.5 | -2.4 | -1.5 | -1.1 |
| Net foreign financing | 1.4 | 0.7 | 1.5 | 1.8 | 1.9 | 1.5 | 1.1 |
| Net domestic debt financing | 2.9 | 0.9 | -0.2 | 0.7 | 0.5 | 0.0 | 0.0 |
| External sector | | | | | | | |
| Export value (percent change) 2/ | -18.4 | 5.6 | 12.9 | 6.9 | 6.0 | 9.2 | 9.2 |
| Import value (percent change) | -15.3 | 7.4 | 15.4 | 15.5 | 14.9 | 6.8 | 6.6 |
| Current account balance (excluding official transfers)/GDP | 1.9 | 0.3 | 0.1 | -2.2 | -2.2 | -2.3 | -2.4 |
| Overall balance/GDP | -0.7 | 1.6 | 3.6 | 0.1 | -0.2 | -0.1 | 0.0 |
| Financing gap (million U.S. dollars) | 0 | 0 | 0 | 101 | 90 | 80 | 65 |
| Change in reserves (million U.S. dollars) | 51 | -90 | -304 | -117 | -85 | -85 | -73 |
| External debt/GDP (in percent) | 53.2 | 51.5 | 46.5 | 43.7 | 42.0 | 41.0 | 39.9 |
| Debt service ratio | 4.9 | 4.9 | 4.5 | 5.0 | 4.7 | 4.4 | 4.2 |
| Monetary sector | | | | | | | |
| Broad money (percent change) | 4.4 | 9.8 | 13.5 | 13.3 | ... | ... | ... |
| Private sector credit (percent change) | 3.9 | 14.9 | 13.9 | 13.8 | ... | ... | ... |

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

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

2/ Excluding re-exports.

Table 8. Nepal: Public Sector Debt Sustainability Framework, 2002–2009
(In percent of GDP, unless otherwise indicated)

| | Actual | | Estimate | | Projections | | | |
|--|--------------------|--------------------|-----------------|-------|-------------|-------|-------|-------|
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| 1 Public sector debt 1/ <i>Of which:</i> Foreign-currency denominated 1/ | 69.6 | 66.6 | 62.8 | 59.7 | 56.8 | 53.1 | 49.3 | 45.5 |
| 2 Change in public sector debt | 53.6 | 49.9 | 46.4 | 44.4 | 42.2 | 39.6 | 37.1 | 35.1 |
| 3 Identified debt-creating flows (4+7+12) | 5.9 | -3.0 | -3.8 | -3.1 | -2.9 | -3.6 | -3.8 | -3.8 |
| 4 Primary deficit | 5.0 | -5.7 | -4.1 | -1.6 | -5.2 | 0.7 | -5.8 | -0.5 |
| 5 Revenue and grants 2/ | 2.9 | 0.1 | 0.0 | 1.1 | 1.1 | 0.3 | -0.1 | -0.4 |
| 6 Primary (noninterest) expenditure | 12.9 | 14.5 | 14.9 | 15.5 | 15.4 | 15.4 | 15.2 | 15.1 |
| 7 Automatic debt dynamics 3/ | 15.8 | 14.6 | 14.9 | 16.6 | 16.6 | 15.7 | 15.1 | 14.7 |
| 8 Contribution from interest rate/growth differential 4/ | 2.1 | -5.8 | -4.1 | -2.7 | -6.3 | 0.4 | -5.7 | -3.4 |
| 9 <i>Of which:</i> Contribution from real interest rate | -0.4 | -3.5 | -3.7 | -4.2 | -4.1 | -4.0 | -3.7 | -3.4 |
| 10 <i>Of which:</i> contribution from real GDP growth | -0.7 | -1.5 | -1.5 | -1.9 | -1.3 | -1.2 | -1.1 | -1.0 |
| 11 Contribution from exchange rate depreciation 5/ | 0.4 | -2.0 | -2.2 | -2.3 | -2.7 | -2.8 | -2.6 | -2.5 |
| 12 Other identified debt-creating flows | 2.4 | -2.3 | -0.4 | 1.4 | -2.2 | 4.4 | -2.0 | 3.2 |
| 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) | 0.9 | 2.7 | 0.3 | -1.5 | 2.2 | -4.4 | 2.0 | -3.3 |
| Public sector debt-to-revenue ratio 1/ | 540 | 459.8 | 421.9 | 385.1 | 368.4 | 345.1 | 323.5 | 301.6 |
| Gross financing need 6/ | 5.4 | 2.8 | 2.5 | 3.8 | 3.6 | 2.7 | 2.1 | 1.7 |
| In billions of U.S. dollars | 0.3 | 0.2 | 0.2 | 0.3 | 0.3 | 0.2 | 0.2 | 0.2 |
| Key macroeconomic and fiscal assumptions | | | | | | | | |
| Real GDP growth (in percent) | -0.6 | 3.1 | 3.5 | 4.0 | 5.0 | 5.4 | 5.4 | 5.5 |
| Average nominal interest rate on public debt (in percent) 6/ | 2.2 | 2.2 | 2.2 | 2.5 | 2.4 | 2.3 | 2.4 | 2.4 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) 7/ | -1.2 | -2.3 | -2.3 | -3.0 | -2.2 | -2.1 | -2.0 | -1.9 |
| Nominal appreciation (increase in U.S. dollar value of local currency, in percent) | -4.3 | 4.4 | 0.8 | -2.9 | 5.1 | -9.0 | 5.1 | -7.6 |
| Inflation rate (GDP deflator, in percent) | 3.4 | 4.5 | 4.5 | 5.5 | 4.6 | 4.4 | 4.4 | 4.3 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | -4.1 | -5.1 | 5.8 | 15.9 | 4.8 | 0.2 | 1.5 | 2.7 |
| II. Stress Tests for Public Debt Ratio | | | | | | | | |
| 1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2005-2009 | | | 62.8 | 61.0 | 59.3 | 58.0 | 56.4 | 55.5 |
| 2. Real interest rate is at historical average plus two standard deviations in 2005 and 2006 | | | 62.8 | 61.7 | 58.6 | 55.0 | 50.9 | 47.1 |
| 3. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006 | | | 62.8 | 62.1 | 61.8 | 58.2 | 53.9 | 50.0 |
| 4. Primary balance is at historical average minus two standard deviations in 2005 and 2006 | | | 62.7 | 63.7 | 64.6 | 60.8 | 56.2 | 52.3 |
| 5. Combination of 2-4 using one standard deviation shocks | | | 62.7 | 64.6 | 66.6 | 62.1 | 56.5 | 51.9 |
| 6. One time 30 percent real depreciation in 2005 8/ | | | 62.8 | 85.3 | 79.7 | 76.2 | 69.9 | 66.0 |
| 7. 10 percent of GDP increase in other debt-creating flows in 2005 | | | 62.8 | 69.7 | 65.7 | 62.1 | 57.3 | 53.5 |
| 8. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2005-06 | | | 62.8 | 64.7 | 66.2 | 62.6 | 57.8 | 54.0 |
| Historical statistics for key variables (past 10 years) | | | | | | | | |
| | Historical Average | Standard Deviation | Average 2005-09 | | | | | |
| Primary deficit | 2.3 | 1.4 | 0.4 | | | | | |
| Real GDP growth (in percent) | 3.8 | 1.9 | 5.1 | | | | | |
| Nominal interest rate (in percent) 6/ | 2.4 | 0.3 | 2.4 | | | | | |
| Real interest rate (in percent) | -3.0 | 1.7 | -2.3 | | | | | |
| Inflation rate (GDP deflator, in percent) | 5.4 | 2.0 | 4.6 | | | | | |
| Revenue-to-GDP ratio | 12.8 | 1.1 | 15.3 | | | | | |

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 $[(r - \pi(1+g) - g + \alpha(1+r))/(1+g+\pi+g\pi)]$ 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 $\alpha \epsilon(1+r)$.

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 9. Nepal: Proposed Schedule of Disbursements Under the PRGF Arrangement

| Amount | Available Date | Conditions for Disbursement |
|---|-------------------|---|
| SDR 7.13 million (10 percent of quota) | November 19, 2003 | Disbursed. |
| SDR 7.13 million (10 percent of quota) | October 20, 2004 | Observance of the mid-January 2004 performance criteria and completion of the first review. |
| SDR 7.13 million (10 percent of quota) | January 15, 2005 | Observance of the mid-October 2004 and mid-November 2004 performance criteria and completion of the second review. |
| SDR 7.13 million (10 percent of quota) | April 30, 2005 | Observance of the December 31, 2004, mid-January 2005, and mid-February 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. |

Table 10. Nepal: Projected Fund Transactions Under the PRGF, 2003/04–2007/08

(In millions of SDRs)

| | 2003/04 Actual | 2004/05 | 2005/06 | 2006/07 | 2007/08 |
|--|-------------------|-------------|---------|---------|---------|
| | | Projections | | | |
| Total use of fund resources (UFR) outstanding | 7.1 | 28.5 | 42.8 | 49.9 | 49.9 |
| ESAF 1992–95 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| PRGF | 7.1 | 28.5 | 42.8 | 49.9 | 49.9 |
| PRGF | | | | | |
| Disbursements | 7.1 | 21.4 | 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 |
| ESAF 1992–95 | 1.7 | 0.0 | 0.0 | 0.0 | 0.0 |
| Principal | 1.7 | 0.0 | 0.0 | 0.0 | 0.0 |
| Interest | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| PRGF | 0.0 | 0.1 | 0.1 | 0.2 | 0.2 |
| Principal | 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 | 10.0 | 40.0 | 60.0 | 70.0 | 70.0 |
| Total UFR as a percentage of GDP | 0.2 | 0.6 | 0.8 | 0.9 | 0.8 |
| Debt service to the Fund as a percentage of exports of goods and services 1/ | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 |

Sources: Fund staff estimates.

1/ Excluding re-exports of oil.

Table 11. Nepal: External Financing Needs and Sources, 2002/03–2008/09

(In millions of U.S. dollars)

| | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 |
|---|---------|---------|---------|---------|---------|---------|---------|
| | | Est. | | | Proj. | | |
| Gross financing needs | 150 | 367 | 376 | 358 | 379 | 391 | 407 |
| External current account deficit (excl. official transfers) | -15 | -8 | 163 | 178 | 200 | 226 | 248 |
| Debt amortization | 71 | 79 | 96 | 95 | 94 | 92 | 89 |
| Repayments of arrears | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Reserves accumulation | 90 | 304 | 117 | 85 | 85 | 73 | 70 |
| IMF repurchases and repayments (net) | 4 | -8 | 0 | 0 | 0 | 0 | 0 |
| Financing sources | 150 | 367 | 274 | 268 | 299 | 325 | 347 |
| Foreign direct investment (net) | 12 | 7 | 26 | 15 | 17 | 19 | 20 |
| Official creditors 1/ | 287 | 471 | 533 | 528 | 561 | 556 | 550 |
| Other flows 2/ | -149 | -111 | -285 | -274 | -278 | -250 | -224 |
| Accumulation of arrears (exceptional) | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Financing gap 3/ | 0 | 0 | 101 | 90 | 80 | 65 | 60 |

1/ Includes both loans and grants.

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

3/ Includes prospective IMF disbursements.

Table 12. Nepal: Vulnerability Indicators, 2000/01–2004/05
(In percent of GDP, unless otherwise indicated)

| | 2000/01 | 2001/02 | 2002/03 | 2003/04 Est. | 2004/05 Proj. |
|---|---------|---------|---------|-----------------|------------------|
| Financial sector risk indicators | | | | | |
| Public and public guaranteed debt 1/ | 63.8 | 69.7 | 66.5 | 62.8 | 59.7 |
| Broad money (percent change, 12-month basis) | 15.2 | 4.4 | 9.8 | 13.5 | 13.3 |
| Private sector credit (percent change, 12-month basis) 2/ | 15.7 | 3.9 | 14.9 | 13.9 | 13.8 |
| Share of deposits in broad money (percent) | 84.5 | 82.0 | 82.4 | 83.7 | ... |
| Share of foreign currency deposits in total deposits (percent) | 9.5 | 9.6 | 8.6 | 8.7 | ... |
| Market assessment indicators | | | | | |
| 91-day Treasury bill yield (end of period) | 5.0 | 3.6 | 4.0 | 1.5 | ... |
| Stock market index (NEPSE Index, Feb. 12, 1994=100) | 348.4 | 227.5 | 204.9 | 222.0 | ... |
| External indicators | | | | | |
| Exports (percent change, 12-month basis in U.S. dollars) 3/ | 5.5 | -18.4 | 5.6 | 12.9 | 6.9 |
| Imports (percent change, 12-month basis in U.S. dollars) | 4.1 | -15.3 | 7.4 | 15.4 | 15.5 |
| Current account balance as percent of GDP (excluding grants) | 2.9 | 1.9 | 0.3 | 0.1 | -2.2 |
| Gross foreign assets of the central bank (in millions of U.S. dollars) | 1,020.0 | 1,048.4 | 1,177.8 | 1,471.2 | 1,567.9 4/ |
| In months of imports of goods and services | 7.2 | 7.0 | 6.7 | 7.3 | 6.8 |
| As percent of broad money | 35.5 | 36.5 | 35.8 | 39.1 | 38.6 |
| Gross foreign liabilities of the central bank (in millions of U.S. dollars) | 15.8 | 9.0 | 5.0 | 11.7 | 44.7 |
| Gross foreign assets of commercial banks (in millions of U.S. dollars) 4 | 403 | 323 | 284 | 296 | 316 |
| Gross foreign liabilities of commercial banks (in millions of U.S. dollar | 231 | 229 | 234 | 281 | 291 |
| Short-term debt 5/ | 2.8 | 2.2 | 2.4 | 2.4 | 2.4 |
| Short-term debt to gross foreign assets of the central bank | 15.3 | 11.9 | 11.8 | 10.8 | 11.2 |
| Total external debt | 49.8 | 53.2 | 51.5 | 46.5 | 43.7 |
| As percent of exports of goods and services | 206.5 | 275.7 | 303.2 | 265.7 | 256.8 |
| Interest payments (as percent of exports of goods and services) | 1.6 | 2.1 | 2.5 | 2.6 | 2.5 |
| Amortization payments (as percent of exports of goods and services) | 4.7 | 6.1 | 7.1 | 7.2 | 7.1 |
| Exchange rate (Nrs per U.S. dollars, end of period) | 74.7 | 78.0 | 74.8 | 74.1 | ... |
| Official risk indicators | | | | | |
| Share of nonperforming loans (as percent of total loans) | | | | | |
| Rastriya Banjiya Bank 6/ | ... | ... | 60.0 | 56.0 | ... |
| Nepal Bank Ltd. 6/ | ... | ... | 61.0 | 52.0 | ... |

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

1/ 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.

2/ Including private sector credit by NRB.

3/ Excluding re-exports.

4/ Excludes expected IMF disbursement.

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

6/ External managers of RBB and NBL.

Table 13. Nepal: Millennium Development Goals, 1990–2015

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

Source: *World Development Indicators* database.

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

2/ Develop further an open, rule-based, predictable, nondiscriminatory trading and financial system. Address the special needs of the least developed countries. Address the special needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

Nepal—Fund Relations

(As of August 31, 2004)

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 | 0.48 | 5.88 |

| IV. Outstanding Purchases and Loans: | SDR Million | % Quota |
|---|--------------------|----------------|
| PRGF arrangements | 7.13 | 10.00 |

V. Financial Arrangements:

| Type | Approval Date | Expiration Date | Amount Approved (SDR Million) | Amount Drawn (SDR Million) |
|-------------|--------------------------|----------------------------|--|---|
| PRGF | 11/19/03 | 11/18/06 | 49.91 | 7.13 |
| 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):

| | Forthcoming | | | | |
|------------------|--------------------|-------------|-------------|-------------|-------------|
| | 2004 | 2005 | 2006 | 2007 | 2008 |
| Principal | | | | | |
| Charges/Interest | <u>0.05</u> | <u>0.19</u> | <u>0.19</u> | <u>0.19</u> | <u>0.19</u> |
| Total | 0.05 | 0.19 | 0.19 | 0.19 | 0.19 |

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, Nepal's exchange arrangement 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, 2004, the exchange rate was US\$1=Nrs. 74.64.

VIII. Safeguards Assessments

Under the Fund's safeguards assessment policy, Nepal Rastra Bank (NRB) is subject to an assessment with respect to the PRGF 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 IMF Country Report No. 02/205. A safeguards monitoring mission visited the NRB during July 2004. Based on the international audit of 2002/03 NRB financial statements, the key recommendations of this mission were to conduct an international audit of the 2003/04 NRB statements and to prepare and implement an action plan to strengthen the Financial Management and Internal Audit Departments so that identified deficiencies are rectified. These recommendations have been integrated into program conditionality.

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 (IMF Country Report No. 03/283) on August 22, 2003. Nepal is on a 24-month consultation cycle, subject to the provision of the July 15, 2002 decision on consultation cycles (Decision No. 12794 (02/76), as amended).

X. Technical Assistance Since 2001

| Department | Purpose | Date |
|-------------------|--|--------------|
| MFD | Central bank and banking reform | 12/01–3/02 |
| | - Monetary Policy | 6/03 |
| | - Monetary Operations | Continuous |
| | - Foreign Exchange Reserves Management | 8/04 |
| FAD | Implementation of a large tax payer unit | 10/03 |
| | - Review of Tax policy and VAT administration | 5/03 |
| | - Tax and customs administration reform | 10/03 |
| | - Follow up on the LTO and customs administration reform | 8/04 |
| LEG | Redrafting of income tax laws | 7/01 |
| STA | Multisector statistics mission | 1/01 |
| | - Balance of payments statistics advisor | 12/02, 10/03 |
| | - 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. Singh began his term in October 2002.

Nepal—Relations with the World Bank Group

(As of August 31, 2004)

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 group of committed, reform-minded Government officials and technocrats began implementing reforms in earnest in late 2001. These initiatives formed the basis for the first Immediate Action Plan (IAP) adopted by the Government in June 2002. 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 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)—formally sent to the World Bank and the IMF in July 2003—was discussed by the Boards in November 2003. The two institutions carried out a joint staff assessment. Moreover, the Government 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. An agreed medium-term macroeconomic framework forms the basis for the three-year Poverty Reduction and Growth Facility (PRGF) approved by the IMF Board in November 2003 in support of the reform program. The PRGF focuses 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 2003 Country Assistance Strategy (CAS) considered by the Board at the same time as the PRSP, i.e., in November 2003, the Bank is in the lead with the policy dialogue in the structural and institutional areas. The Bank conducted 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, the Bank's Board approved the first Poverty Reduction Support Credit I (PRSC I) also in November 2003. The Bank's future engagement is complemented by a program of financial assistance articulated in the CAS.

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-up to the 1999 study, *Poverty at the Turn of the Twenty-First Century*. The Bank is 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 15 other donors are actively supporting the Government's well-formulated ten-year primary education reform program. IDA along with Denmark, Finland, Norway and the UK have established a joint financing arrangement with the Government whereby donor funds are pooled with government budgetary resources to support the program. IDA support is in the form of financing for the *Education for All* project under a Sector Wide Approach (SWAp) approved in August 2004.

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 *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*—envisaged for Board discussion in September 2004—will 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 ***Road Maintenance and Development, Power Development, and Telecommunications Sector Reform***. At the same time, project finance is supporting decentralization to improve service delivery in most of these sectors by promoting grassroots-driven, bottom-up planning and community-based management. The Road Maintenance and Development project 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 Power 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.

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. 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. Bank financing for the PAF project approved in FY04 is supporting the fund's implementation. 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, the Bank is carrying out a Social and Gender Analysis. 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. Accordingly, a Country Environmental Analysis is planned for FY05.

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 for FY04 priority projects, and efforts are underway to apply it to all

expenditures in the future. As the Government implements 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 a proposed PER comprising 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 subsequent PRSCs—to follow PRSC I—in line with the programmatic approach articulated in the 2003 CAS. PRSC I supports the implementation of the PRS by expanding the fiscal space to increase priority spending. It also assists 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. In addition to the Development Policy Review which will be formally discussed with the Government shortly, key studies on rural factor markets and labor remittances are envisioned to help prioritize future policy reforms.

With respect to *governance*, in implementing the 1998 CAS and the new strategy, the Bank has consistently and firmly assisted Nepal in addressing its 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 are providing 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, provided assistance in the preparation of the PRS discussed at the Bank and IMF Boards last

November 2003. The two institutions completed 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 the work with the recently completed Trade and Competitiveness Study which helped 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. The *Financial Sector Restructuring* project—for which Bank financing was approved in FY04—supports further strengthening of the Central Bank and deepening the reform process within the two large ailing commercial banks.

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

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

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

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.

World Bank Group Strategy and Lending Operations

The Country Assistance Strategy (CAS). In November 2003, the Board considered a new Country Assistance Strategy (CAS), which discussed the rationale for implementing the Base Case lending program. Indeed, given the nature of the country's ongoing reforms, the 2002 CAS Progress Report (CAS PR) had already presented the justification 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 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 FY04, credit approvals included the Poverty Reduction Support Credit I, Financial Sector Restructuring Project, Second Rural Water Supply and Sanitation and Poverty Alleviation Fund projects. In early FY05, IDA financing of the Education for All project was approved.

Bank Assistance Program in Nepal. As of August 31, 2004, IDA's lending portfolio consisted of ten projects with a total commitment of US\$410 million and a total undisbursed balance of US\$317 million (Table 1).

Table 1: World Bank Operations
(As of August 31, 2004)

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

| | IDA Amount | Undisbursed 1/ | Board Date |
|---|------------|----------------|------------|
| Road Maintenance and Development | 54.5 | 29.2 | 2000 |
| Telecommunications Sector Reform | 22.6 | 21.8 | 2002 |
| Financial Sector Technical Assistance | 16.0 | 12.7 | 2003 |
| Power Development | 75.6 | 81.2 | 2003 |
| Community School Support (LIL) | 5.0 | 4.3 | 2003 |
| Poverty Reduction Support Credit I 2/ | 70.0 | 0.0 | 2004 |
| Financial Sector Restructuring (Phase II) | 75.5 | 77.0 | 2004 |
| Poverty Alleviation Fund | 15.0 | 14.8 | 2004 |
| Rural Water Supply & Sanitation II | 25.3 | 25.0 | 2004 |
| Education for All | 50.0 | 50.7 | 2005 |
| Total | 409.5 | 316.7 | |

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/ While this credit is fully disbursed, its closing date is November 1, 2004.

Economic and Sector Work. The *2003 Country Assistance Strategy* (Report No. 26509-NEP, 11/24/2003) was discussed by the Bank's Board in November 2003. 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), *Financial Accountability in Nepal: A Country Assessment* (Report No. 25833-NEP, 3/31/2003) and *Nepal: Trade and Competitiveness Study* (published by the Government in March 2004).

IFC's Activities in Nepal. As of end-July 2004, IFC-held portfolio in Nepal is US\$73 million in two power generation projects, one tourism project and one leasing company. Of this portfolio, US\$49 million is from IFC's own account and US\$24 million is in B loans.

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 South Asia 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.

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

Nepal—Relations with the Asian Development Bank

(As of June 30, 2004)

Lending Program

As of June 30, 2004, total commitments by the Asian Development Bank (AsDB) consisted of 104 loans amounting to \$2.05 billion covering projects in agriculture energy, transport, industry, social infrastructure, finance, governance, and tourism. Undisbursed funds of \$524.9 million represent about 85 percent of the total net loan amount as of June 30, 2004. For the period 2004–07, 16 projects amounting to \$460 million are tentatively programmed.

Loans by the Asian Development Bank, 1969–2004

(As of June 30, 2004)

| | 1969–2000 | 2001 | 2002 | 2003 | 2004 |
|-----------------------------------|-----------|----------|----------|----------|----------|
| | Approved | Approved | Approved | Approved | Approved |
| (In millions of U.S. dollars) | | | | | |
| Agriculture and natural resources | 788.5 | -- | -- | 20.0 | -- |
| Energy | 395.9 | -- | -- | -- | -- |
| Finance and industry | 77.4 | -- | -- | -- | -- |
| Social Infrastructure | 292.1 | 19.6 | 60.0 | 39.0 | -- |
| Transport and communications | 224.7 | 46.0 | -- | -- | -- |
| Others | 27.6 | 30.0 | -- | 35.0 | -- |
| Total commitments | 1,806.2 | 95.6 | 60.0 | 94.0 | -- |
| Gross Disbursements | 1,220.6 | 57.3 | 28.2 | 33.5 | 7.09 |
| Technical assistance projects | | | | | |
| Total commitments | 96.6 | 4.0 | 3.9 | 4.06 | 0.75 |
| Gross disbursements | 54.1 | 5.0 | 3.9 | 4.17 | 2.03 |

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 Education Sector Development Strategy and Road Connectivity Sector projects. As of June 30, 2004, total technical assistance commitments consisted of 238 projects for a total of about 109.5 million (net amount)—93 of which were in preparation for loans.

Private Sector Operations

As of June 30, 2004, 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 (current and constant prices) and by expenditure categories (current prices), and gross national income and savings. 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 year 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. The third STA mission to provide technical assistance to the CBS as part of the ongoing project on price statistics aiming at the development of the PPI took place in April-May 2004.

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 August 2004 edition of *IFS* shows data for the monetary authorities, deposit money banks, and interest rates through June 2004. 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 fourth of a series of four missions during April 2004. 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 United Kingdom'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 August 27, 2004)

| | 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 | 8/26/04 | 8/13/04 | 7/04 | 7/04 | 7/04 | 8/26/04 | 07/04 | 06/04 | 6/04 | 5/20/04 | 2003/04 | 2003/04 | 2003/04 |
| Date received | 8/27/04 | 8/27/04 | 8/27/04 | 8/27/04 | 8/27/04 | 8/27/04 | 8/20/04 | 8/20/04 | 8/25/04 | 8/27/04 | 7/04 | 08/04 | 8/04 |
| 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 | V | V |
| 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.

October 4, 2004

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

Dear Mr. de Rato:

His Majesty's Government of Nepal is committed to implementing the program supported by the three year Poverty Reduction and Growth Facility (PRGF) Arrangement approved by the Executive Board in November 2003. The attached Memorandum on Economic and Financial Policies (MEFP) reviews progress in implementation during 2003/04 and sets out the objectives and policies for 2004/05. More broadly, the government is fully committed to its reform agenda detailed in the 10th Plan/PRSP, which aims to reduce poverty through private-sector led growth and social inclusion.

In support of its objectives and policies, the government requests completion of the first review, disbursement of the second loan under the PRGF of SDR 7.13 million (10 percent of quota) and a rephrasing of the third disbursement. All quantitative performance criteria and benchmarks for the first review were met. However, some structural reform actions were delayed beyond the target dates. In this regard, we request waivers for nonobservance of two structural performance criteria: (i) finalization of 2002/03 audited accounts of Nepal Rastra Bank (NRB) by an international firm; (ii) implementation of voluntary retirement schemes (VRS) at NRB and Rastriya Banijya Bank (RBB). These actions have now been completed.

The Government believes that 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 on the adoption of 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 required information in a timely manner to monitor progress of the PRGF-supported program. The Government also intends to make this letter, the MEFP, and the staff report on the first review of the PRGF, available to the public and authorize their posting on the IMF website subsequent to Board completion of the first review.

Sincerely yours,

/s/

Hon. Mr. Bharat Mohan Adhikari
Deputy Prime Minister and Minister of Finance

/s/

Dr. Tilak Rawal
Governor, Nepal Rastra Bank

Attachments
Memorandum on Economic and Financial Policies
Technical Memorandum of Understanding

NEPAL—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES UNDER THE PRGF ARRANGEMENT, 2003/04–2004/05

33. **The government is implementing its 10th Plan/PRSP and the policies agreed for the first-year program under the PRGF Arrangement.** The Poverty Reduction Strategy Paper (PRSP), finalized in July 2003, lays out the government's economic objectives and policy agenda for 2002/07. The strategy has broad-based support from domestic stakeholders and the international community. The first annual progress report on PRSP implementation will be finalized soon. This memorandum reviews progress of the first year program under the PRGF Arrangement. The memorandum also updates the macroeconomic framework and structural reform agenda for 2004/05. In particular, it details structural reform actions to be taken until January 15, 2005, which is the test date for the third review.
34. **The newly formed coalition government has made restoration of peace its priority.** Economic activity and social life in the country continues to be disrupted by the insurgency. To counter these disruptions, the government has strengthened security arrangements, especially in the worst affected districts. At the same time, we continue to seek a peaceful solution to the insurgency. Furthermore, general elections are expected to start by April 2005.
35. **On the economic front, the new government remains firmly committed to implementing PRSP/PRGF policies.** As a signal of this commitment, the government has already implemented some difficult and overdue policy measures in three key areas. First, administrative prices have been adjusted to stem operating losses of Nepal Oil Corporation (NOC) and to recoup accumulated losses. Further adjustments are in the pipeline to safeguard its financial position in the future. These price adjustments and efforts to improve governance at the NOC are described in ¶29. Second, the cabinet approved a number of long awaited ordinances at end-July (¶32). Third, the government has moved quickly to reinvigorate public sector reform, including privatization/liquidation of loss-making state owned enterprises (¶28).
36. **All structural performance criteria and benchmarks for the first review have been completed, albeit with delays in some cases.** The international audit of NRB's 2002/03 accounts was delayed in large part by the need to ensure consistency with local auditing laws; implementation of the second phase of the voluntary retirement scheme (VRS) at the RBB had to await availability of World Bank financing; and privatization of SOEs was often hampered by the difficult security situation and legal actions by employees.
37. **The NRB and the government wish to reiterate their commitment to accurate data reporting under the PRGF-supported program, especially in view of the recent international audit of NRB accounts.** In this context, the NRB intends to follow through fully with IMF recommendations made in the context of the Safeguards Assessment, based on the international audit of NRB's 2002/03 financial accounts (¶33). In particular, the NRB has already made a strong effort to ensure that quarterly data for the test dates reported for observance of quantitative performance criteria is accurate, fully reconciled, and consistent

with program definitions. Based on the reconciled data, all quantitative performance criteria for January 14, 2004 were met. Also, all indicative targets for April 15, 2004, except the ceiling on reserve money, were observed.

I. ACHIEVEMENTS OF THE 2003/04 PROGRAM

A. Macroeconomic Objectives and Policies

38. Macroeconomic performance in 2003/04 was broadly in line with program objectives, the domestically financed deficit was lower than budgeted, and monetary developments remained favorable.

- Real GDP is estimated to have grown by 3½ percent, with strong growth in agriculture, resilient manufacturing, and a rebound in tourist arrivals; CPI inflation was 4 percent (period average), reflecting price developments in India; robust remittances supported an international reserves buildup, even as the trade deficit widened, reflecting weak export performance to nonIndian markets and rising imports.
- On the fiscal front, while revenue collections exceeded the revised budget target, total expenditure was lower than programmed as the security situation constrained spending (current and capital) on development activities. Regular spending has been in line with the budget framework. Security spending has been contained at 3 percent of GDP, a similar level to 2002/03. Large foreign aid inflows, robust revenue growth, and low spending resulted in minimal (net) domestic financing of the budget (0.1 percent of GDP).
- Monetary and exchange rate policy remained geared to supporting the peg to the Indian rupee. Remittances contributed to robust growth in bank deposits while private sector credit grew as banks diversified their loan portfolios, including into financing consumer durables. The flow of remittances through the banking system created room for foreign exchange market intervention and helped generate a higher-than-projected growth in NRB's net foreign assets (NFA). At the same time, constrained government spending limited net domestic assets (NDA) growth. Broad money and reserve money grew broadly as programmed. The real effective exchange rate was stable.

39. Significant progress was made in improving tax administration, fostering money and foreign exchange market development, and improving public debt management.

- A Large Taxpayer Office (LTO) was established in the Inland Revenue Department. The LTO covers audit, taxpayer service, and collection functions. For high quality operations of the LTO, the appointment and service requirements have been approved to recruit and retain qualified staff and additional allocation for the office was made from the budget. There has also been significant progress in customs administration reform. A three-year customs time-bound modernization action plan was developed

based on IMF and World Bank recommendations, and a number of actions were implemented.

- The NRB eliminated restrictions on permissible spread limits on commercial bank lending rates and limits on foreign exchange buy/sell spreads in December 2003, as agreed. To promote interbank transactions, the NRB started quoting buy/sell rates around the mid-rate for foreign exchange market intervention. To expand the maturity spectrum of public debt, one-month and six-month treasury bills were introduced.

B. Structural Reforms

Financial Sector Reform

40. Steps were taken to improve the banking framework and loan recovery, further NRB reengineering, and restructure troubled commercial and development banks.

41. The Banking and Financial Institutions Ordinance was promulgated in February 2004 and key steps were taken to resolve nonperforming loans. This BFI ordinance unifies five separate banking laws under a single umbrella act and strengthens the NRB's supervisory powers over the financial sector. Blacklisting directives were strengthened in September 2003 to penalize willful defaulters. These directives were modified in June 2004, in consultation with the IMF and World Bank, to streamline information requirements for blacklisting and to make the provision of these directives consistent with limited liability provisions of the Company Law, without diminishing their effectiveness. The Debt Recovery Tribunal (DRT) was established in July 2003 to rule on cases of loan defaults on a time-bound basis. The appointment in February 2004 of an Appellate Judge rendered the DRT fully operational. The DRT has ruled on a number of cases and is now committed to moving expeditiously to execute the decisions and clear the backlog of cases. However, loan recovery from large, willful defaulters remained difficult.

42. Re-engineering of the central bank has continued with support from the IMF and the World Bank. An improved organizational structure of the NRB along functional lines was approved in December 2003. As agreed under the PRGF-supported program (albeit with some delay), the NRB implemented in May 2004 a VRS to reduce overstaffing. The scheme led to a staff reduction of about 100, mostly at the nonofficer levels. To set an example for other VRS schemes, the incentive component of the scheme remained unchanged.

43. Bank supervision and accounting were strengthened to improve NRB oversight over the financial sector. An amended off-site supervision manual was approved in January 2004. The amended manual includes a number of provisions, including the development of CAELS ratings. The new manual formed the basis for the preparation of the second quarter supervision reports in April 2004. As regards on site supervision, the NRB issued by-laws on July 14 which establish clear timeframes for finalization of on site supervision reports (three months from the on site inspection to the submission of the report

to bank management) and streamlined review and clearance procedures to achieve this timeframe.

44. **Commercial Banks.** The external management teams at NBL and RBB made progress in restructuring the banks and are estimated to have generated operating profits in 2003/04. The first phase of their VRSs were implemented in January 2004 to right size the banks. Both commercial banks prepared their financial accounts for 2002/03 on a timely basis. To facilitate its restructuring, shares of NBL were delisted from the stock exchange in March 2004.

45. **Development Banks.** The Cabinet approved external audits and restructuring plans for Agriculture Development Bank of Nepal (ADBN) and Nepal Industrial Development Corporation (NIDC) in January and February 2004, respectively, along the lines suggested by AsDB financed consultants. For the ADBN a VRS with a reduction in 340 staff was implemented in April; a VRS was initiated at the NIDC in mid-July.

Public Sector Reforms, Governance and Private Sector Development

46. **Progress was made in state owned enterprises (SOEs) and civil service reform.** Privatization/liquidation of two SOEs was envisaged under the program. A sales and purchase agreement for Bhaktapur Brick Factory was signed in January 2004 and the company has been handed over to the purchaser. Liquidation of another enterprise was completed in July 2004. Nepal Telecommunications Corporation (NTC) was converted into a public limited company in April 2004 and an international consultant is evaluating the assets and liabilities of Royal Nepal Airlines Corporation (RNAC). The government eliminated over 7,500 vacant civil service posts.

47. **The anti-corruption strategy approved by cabinet in early 2003 was developed into a strategic action plan.** The Commission for Investigation of Abuse of Authority (CIAA) continued its strong anti-corruption efforts with capacity building support from DfID/DANIDA. A National Vigilance Center in the Office of the Prime Minister and Council of Ministers was made operational. A commission on fiscal decentralization produced its report on ways to clarify and enhance the responsibilities of local governments while strengthening accountability.

48. **Several laws were amended to foster private sector development.** A Build-Own-Operate-Transfer (BOOT) Ordinance was issued in September 2003 and several projects were opened for private sector participation. Nepal became a member of the WTO in April, and a legislative action plan for compliance with accession commitments was developed.

II. MACROECONOMIC OBJECTIVES AND POLICIES, 2004/05

A. Macroeconomic Objectives

49. **The macroeconomic program for 2004/05 is in line with the PRGF medium-term framework.** Real GDP in 2004/05 is projected at around 4½ percent, driven by agriculture

and continued recovery in manufacturing and tourism; inflation is projected to be 4-5 percent; and the NRB will maintain international reserves around seven months of imports of goods and services.

B. Fiscal Policy

50. **The government's principal fiscal policy objectives over the medium term remain raising the revenue-to-GDP ratio, improving the efficiency of public spending, and reducing 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 (HMG format) by 2006/07. Over this period, expenditure (including principal repayments) is projected to rise to 20 percent of GDP. The bulk of the increase will be in capital expenditure and poverty reduction spending, in line with the prioritization set out in the Medium-Term Expenditure Framework. With higher aid inflows, net domestic financing of the budget will remain limited. This path of budget financing will help to stabilize and then reduce the public debt ratio and create room to meet contingent liabilities from the ongoing banking sector and public enterprise reforms.

51. **The 2004/05 budget adopted on July 15 is consistent with the medium-term fiscal policy objectives.** The budget targets an increase in the revenue-to-GDP ratio of around ½ percent to 13 percent (HMG format) based on strong revenue administration efforts to check excise leakages and collection of income tax arrears. Total expenditure is projected to rise with a substantial increase in the capital spending allocation. Social sector spending (health, education, drinking water and local development) is also set to rise (from about 4¾ percent in 2003/04 to about 6 percent). Security-related spending in 2004/05 is budgeted to remain broadly unchanged as a share of GDP compared to 2003/04 (3 percent of GDP). The overall deficit (after grants) would be contained to around 4¾ percent of GDP and (gross) domestic financing to 1¾ percent of GDP. Looking forward, any increase in government employees' wages would be linked to responsibility levels. Such an increase would need to be financed by an increase in tax rates, including the VAT rate, in consultation with the IMF. More generally, an increase in the VAT rate and elimination of tax exemptions is required to mobilize revenue over the medium term.

52. **Further steps in reforming both revenue administration and expenditure management are being taken to achieve fiscal policy objectives.** To help improve revenue administration, we have requested IMF and other donor assistance.

- The Large Taxpayer Office is to be fully operational by November 15, 2004. A key element of the effort to improve its operations is the provision for performance-based incentives to recruit and retain highly qualified staff. Further, actions are contemplated by January 15, 2005 to strengthen the LTO, as specified in the TMU. On customs administration, reform actions are to be taken by mid-November 2004 and January 15, 2005, as specified in the TMU. As in the case of the LTO, the government is committed to a provision for performance based pay incentives for staff at the Customs Department.

- To improve expenditure management, the 2004/05 budget adopted a reclassification of expenditure into current and capital, along GFS lines. Moreover, expenditures are fully prioritized, by ministry, and by objective (sustainable broad based growth, social sector and infrastructure development, targeted programs, governance, and general administration).

C. Monetary and Exchange Rate Policies

53. **Monetary policy will remain geared to supporting the exchange rate peg to the Indian rupee which has served Nepal well given its close ties with India.** Consistent with this objective and the 2004/05 monetary policy statement, 12-month broad money growth is projected to be around 12–13 percent by end-2004/05, assuming real GDP growth of 4-4½ percent and a small decline in velocity. This growth would accommodate domestic financing needs of the budget while allowing private sector credit growth of about 9 percent in real terms. Reserve money growth is projected at 9–10 percent, with a targeted increase in the NFA of the NRB by US\$95 million. The current level of the peg remains appropriate.

54. **The monetary policy statement also outlines steps to improve policy implementation, and foreign exchange reserves and public debt management.**

- The NRB has adopted a new framework for its monetary operations, in line with IMF recommendations, to facilitate market determination of short-term interest and repo rates through buy, sell, and repo (and reverse repo) auctions and provide greater control over market liquidity. These auctions are to be complemented by a standing credit facility for commercial banks at the NRB on a lender-of-last resort basis by November 15, 2004. Furthermore, to help determine quantities for open market and repo auctions, a liquidity monitoring and forecasting framework is being operationalized also by November 15, 2004. The high-frequency analysis from this framework will inform the discussions of the recently established high-level monetary management committee.
- To enhance its foreign exchange reserve management capabilities, the NRB has been provided technical assistance by the IMF.
- To further improve public debt management, auctions of long-term government bonds will be introduced. The government has committed itself to a domestic borrowing schedule and intends to stick to the announced auction calendar. Preparations for the introduction of a comprehensive book entry system of electronic records and accounting of ownership of government securities have been initiated.

D. Structural Reforms

Financial Sector Reforms

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

banks. The government and NRB are fully committed to further improving the banking framework, effective loan recovery from willful defaulters, and to resolution of nonperforming loans. The BFI Ordinance will be revised, taking into consideration the concerns of IMF and the World Bank, including for consistency with the new Company Ordinance by February 15, 2005. We will fully support the actions of NBL and RBB management teams, especially against large, willful defaulters. The government is committed to providing additional resources to ensure that the DRT functions effectively including for the expeditious execution of the DRT's decisions. The DRT decisions and their rationale will be available to the public. To widen the instruments available to commercial banks to resolve nonperforming loans, the cabinet intends to approve an Asset Management Company (AMC) ordinance by January 15, 2005.

56. **The NRB has an ambitious “re-engineering” agenda for 2004/05.** The NRB will achieve its long-term organizational structure by end 2004/05, with a reduction in the number of departments from 20 to 13/15. As regards human resource policies, NRB by-laws will be amended to improve recruitment, transfers, performance appraisal, and promotion procedures, in line with recommendations of the World Bank financed consultants. The NRB will amend the employee rules and regulations to make provision for a tenure-based Compulsory Retirement Scheme (CRS) by November 15, 2004 and further staffing reduction will be made with the CRS to right size the NRB. Improvements in the NRB's information technology (IT) platform and process automation, especially in the branch offices, with World Bank support, will also help achieve staff reductions. The hiring freeze at nonofficer levels will be maintained.

57. **Bank supervision, accounting, and auditing are to be further strengthened.** All commercial banks will be inspected at least once every two years and a system of monitoring follow up actions developed. An IFRS (formerly IAS)-compliant accounting manual and upgraded auditing manual will be prepared by July 2005. To further enhance NRB oversight over the financial system, a strong effort will be made to improve financial sector accounting. This will involve reducing substantially the amounts in the interbank reconciliation and interest suspense accounts, as recommended by the World Bank financed consultants. Furthermore, to facilitate interbank reconciliation on a high frequency basis, the banks will be instructed to shift their accounting practices from an account to bank basis.

58. **Commercial banks.** External managers will continue to prepare NBL and RBB for privatization. The government has extended external management at NBL, and expects to do the same for RBB. The cabinet has approved amendments to the NRB Act to provide the NRB sufficient powers to restructure ailing commercial banks. The external managers are expected to further improve the financial condition of the banks, as agreed, groom local counterparts, and increase staff productivity through training and full use of the new IT platforms. Operating costs would be further reduced by the Phase II VRSs at the two banks. As regards the overall strategy for these banks, we have discussed various options with the IMF and the World Bank including liquidation, merger, and privatization as separate entities. It is expected that the two banks can be sold as separate entities, but the government is open to other modalities should separate privatization prove to be difficult. The government will

move to privatize the banks as rapidly as possible and aims to accomplish this objective by the end of the PRGF arrangement in 2005/06. To this end, sales advisors will be recruited under Phase II of the financial sector reform program supported by the World Bank.

59. **Development banks.** The ADBN is to be restructured by January 15, 2005, including through introduction of professional management and staff reduction, and actions will be taken to place the bank on a sound commercial footing. Despite the poor financial condition of the NIDC, the government has, for the time being, decided to attempt a restructuring as specified in the TMU—vigorous loan recovery, no gross lending, closure of regional offices, and a VRS has been introduced mid-July to achieve a significant staff reduction—with the aim of privatization. However, should privatization not be possible by end 2004/05, liquidation proceedings will be initiated. In the meantime, no further capital injections will be made in NIDC.

Public Sector Reforms, Governance and Private Sector Development

60. **The government is committed to staying the course in SOE reform.** All known liabilities have been settled for Cottage and Handicrafts Emporium and Nepal Coal Limited. As decided earlier, privatization/liquidation of five additional SOEs is expected to be completed in the first half of the fiscal year. The government is committed to continuing with the settlement of liabilities/privatization of all SOEs identified in the TMU and is committed to not incurring any new direct or contingent liabilities or providing any off-budget support. The sale of NTC shares to the public is expected to be completed by January 15, 2005; private participation will be invited in RNAC; and the internal unbundling of Nepal Electricity Authority completed. More generally, the cap on the aggregate employment in SOEs will be continued and lowered to reflect divestment that has been completed; performance contracts will be introduced with all major SOEs and efforts to update audits of all SOEs to international accounting standards will continue to determine the full extent of their contingent liabilities.

61. **Efforts are under way to improve the financial condition of NOC.**

- Steps are to be taken to improve governance at the NOC, raise efficiency, and significantly reduce leakages following the recommendations of a high-level committee. The Board has been professionalized and an international audit of the NOC's 2003/04 accounts will be completed by February 15, 2005. The procurement arrangement with IOC will be revisited. Legal preparations are underway to issue the Petroleum Products Sale and Distribution Ordinance to open up the petroleum sector to private importers by mid-February 2005. The government will undertake an extensive program of public education of these reform measures and of the rationale for the proposed price adjustments.
- As noted above, to stem and eliminate NOC's financial losses, the government has already begun upward adjustments in prices of petroleum products. Recently, aviation fuel prices were fully adjusted to international levels; and prices of petrol, diesel, LPG

and kerosene were adjusted up. Should adulteration between petroleum products persist even after prices are raised towards international levels, the price differentials will be modified to address the problem; prices will be adjusted further, as needed. To ensure smoother adjustment in NOC pricing in the future, the automatic pricing formula recommended by the Petroleum Price Fixing and Monitoring Committee—which builds in an element of cost recovery for NOC’s accumulated losses—will be implemented by end-December 2004. The formula will be published and prices will be adjusted monthly by the NOC Board.

62. **Civil service reform will be reinvigorated.** One half of the nongazetted civil service vacancies will be eliminated by mid-January 2005, and the freeze on recruitment for nongazetted positions will be maintained. A personnel information system for teachers will be completed. Based on the experiences at the LTO and the Customs Department, performance based incentive systems will be introduced at other selected government ministries and agencies. The government has also drafted amendments to the Civil Service Act, including provisions for VRS, annual personnel assessment, and merit based/gender sensitive recruitment and promotion, and cabinet intends to approve the ordinance by November 15, 2004. The Governance Ordinance is to be approved by cabinet.

63. **Governance can be improved by a series of measures envisaged in 2004/05.** The anti-corruption strategy will be translated into a prioritized, time bound, monitorable action plan with quarterly progress reports on implementation. The government will provide adequate resources to enhance the CIAA’s operations to complement DfID/DANIDA technical assistance. The government will also seek to enhance the capacity of the Special Court to ensure a more accelerated processing of cases. To enhance disclosure of fiscal operations, the cabinet will approve by January 15, 2005 the Fiscal Transparency Ordinance, which will provide the public with information on public contracts and privatization transactions. Further improvements in the ordinance will be undertaken following the IMF Fiscal ROSC mission in November 2004. A Procurement Ordinance will address the issues raised in the World Bank’s Country Procurement Assessment Report.

64. **Measures to foster private sector participation and labor market flexibility are envisaged.** Cabinet approved at end-July a Secured Transactions Ordinance and an Insolvency Ordinance. The Company Ordinance is at final stages of cabinet approval. A new Competition Ordinance to eliminate monopolistic practices is also close to finalization. Cabinet intends to approve an anti-money laundering ordinance by December 2004. The Ministry of Labor is working to build consensus on amendments to labor legislation. We believe understandings can be reached with stakeholders in key areas such as regulations against dismissal, on minimum wages, and other employment conditions by December 2004 and labor legislation finalized at that time. The government also intends to liberalize recruitment and retrenchment provisions of labor laws in special economic zones.

Safeguards and Statistical Issues

65. **The NRB intends to fully implement the recommendations of the IMF safeguards mission.** The recommendations from the international audit of the NRB's 2002/03 accounts and IMF recommendations will be implemented fully. In particular, early preparations will be made for a follow up audit of the 2003/04 accounts by an international audit firm, in consultation with the Auditor General to ensure that the benefits from the 2002/03 audit are internalized.

66. The government will continue to strengthen the quality, coverage, and timeliness of its macroeconomic statistics and implement IMF technical assistance recommendations. In particular, PRGF program data will be reconciled with NRB's accounts for all test dates.

III. PROGRAM MONITORING

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

68. **Performance criteria.** Table 1 shows quantitative performance criteria and benchmarks until mid-July 2005. In addition, the nonaccumulation of external payment arrears will constitute a continuous performance criterion, as will the standard injunctions against overdue financial obligations to the IMF, imposition or intensification of restrictions on current payments, introducing or modifying multiple currency practices, conclusion of bilateral payments agreements inconsistent with Article VIII, and imposition or intensification of import restrictions for balance of payments purposes. Structural performance criteria and benchmarks for second and third reviews are identified in Table 2.

69. **Program review.** The second review of the program under the PRGF arrangement will be completed by mid-January 2005. This review will focus on: (i) progress in financial sector reform, including the debt recovery framework; (ii) the implementation of administration reforms at the Inland Revenue Department and Customs; (iii) safeguards issues; and (iv) progress in SOE reform. The third review under the arrangement is expected to be completed by end-April 2005.

Table 1. Nepal: Quantitative Performance Criteria and Indicative Targets
(In billions of Nepalese rupees, unless otherwise stated)

| | July 15, 2004 Prel. | October 16, 2004 (PC) | Jan 13, 2005 (PC) | Apr 13, 2005 (IT) | July 15, 2005 (IT) |
|--|------------------------|--------------------------|----------------------|----------------------|-----------------------|
| Performance criteria (PC) and indicative targets (IT) 1/ | | | | | |
| I. Floor on net foreign assets of the NRB (in millions of U.S. dollars) 2/ 3/ | 1,449.6 | 1,459.6 | 1,489.6 | 1,514.6 | 1,544.6 |
| II. Ceiling on net domestic assets of the NRB 2/ 4/ | -15.7 | -20.1 | -22.6 | -16.1 | -14.2 |
| III. Ceiling on change in net domestic financing of central government budget 4/ 5/ Cumulative from July 15, 2004 | ... | 0.5 | 1.4 | 2.2 | 3.5 |
| IV. Ceiling on contracting or guaranteeing of new nonconcessional medium- and long-term external debt by the central government and NRB Cumulative from July 15, 2004 (in millions of U.S. dollars) 6/ | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| V. Ceiling on short-term external debt contracted or guaranteed by the central government and NRB (in millions of U.S. dollars) 6/ | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| VI. Accumulation of external payments arrears Continuous performance criterion during the program period (In millions of U.S. dollars) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Indicative targets (IT) | | | | | |
| I. Ceiling on reserve money | 93.0 | 89.4 | 89.1 | 97.5 | 101.6 |
| II. Floor on central government revenue 5/ Cumulative from July 15, 2004 | ... | 10.8 | 25.0 | 43.1 | 68.3 |

Notes:

1/ Mid-October 2004 and mid-January 2005 are performance criteria test dates. Figures for mid-April 2005 and mid-July 2005 are indicative targets.

2/ Valued at the program exchange rates. Monetary gold valued at program prices (US\$360 per oz.).

3/ To be adjusted upward/downward by excess/shortfall of foreign program 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. Nepal: Structural Performance Criteria and benchmarks under the PRGF Arrangement 1/ 2/

| Measures | Timing |
|--|---|
| Prior Action for First Review | |
| 1. Implement VRS at the RBB (Phase II) | November 15, 2004 and January 15, 2005 November 15, 2004 and January 15, 2005 November 15, 2004 |
| Structural Performance Criteria | |
| A. Fiscal and Monetary Reforms | |
| 1. Implement time-bound action plan to improve customs administration | November 15, 2004 and January 15, 2005 |
| 2. Fully operationalize the large tax payer office (LTO) in the Inland Revenue Department | November 15, 2004 and January 15, 2005 |
| 3. Implement new framework for monetary operations, including a liquidity monitoring framework | November 15, 2004 |
| B. Financial Sector Reforms | |
| 1. Finalize audit of NRB's 2003/04 accounts by an international auditor | January 15, 2005 |
| 2. Strengthen the Nepal Rastra Bank (Provide for compulsory retirement scheme in NRB employee rules and regulations) | November 15, 2004 |
| C. Public Sector Reform | |
| 1. Finalize audit of NOC 2003/04 accounts by international auditor | February 15, 2005 |
| 2. Implement automatic pricing mechanism for oil products | December 31, 2004 |
| Structural Benchmarks | |
| 1. Cabinet approval of Fiscal Transparency Ordinance | January 15, 2005 |
| 2. Amend BFI ordinance including for consistency with other legislation | February 15, 2005 |
| 3. Cabinet approval of Asset Management Companies Ordinance | January 15, 2005 |
| 4. Strengthen the Nepal Rastra Bank (Revise Human Resource Policies) | November 15, 2004 |
| 5. Prepare a time bound action plan to strengthen Financial Management and Internal Audit Depts. of NRB | November 15, 2004 |
| 6. Implement restructuring plans for ADBN and NIDC | November 15, 2004 and January 15, 2005 |
| 7. Adopt Petroleum Products Sale and Distribution Ordinance | February 15, 2005 |
| 8. Complete liquidation/privatization of five SOEs | November 15, 2004 and January 15, 2005 |
| 9. Cabinet approval of amended Civil Service Ordinance | November 15, 2004 |
| 10. NRB to reconcile accounting data with program monitoring data | Quarterly test dates (Table 1) |

1/ The actions are to be described in the Technical Memorandum of Understanding.

2/ November 15, 2004 actions relate to the second review. December 31, 2004, January 15, 2005, and February 15, 2005 actions relate to the third review.

NEPAL
TECHNICAL MEMORANDUM OF UNDERSTANDING FOR PRGF ARRANGEMENT
October 4, 2004

This memorandum sets out the framework for monitoring the PRGF-supported program for 2004/05. 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.

IV. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Net Foreign Assets of Nepal Rastra Bank

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

3. **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.
4. **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

5. **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 2004, RM defined in this manner stood at Nrs. 92.97 billion.

D. Net Domestic Financing of the Central Government Budget

6. **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 nonbank sector.** The flow NDF of the budget would be the cumulative change in book value from mid-July 2004 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. 83.9 billion at mid-July 2004. Central government is defined here to include line ministries, departments and public institutions.

7. **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

8. **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

9. **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

10. **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). 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

11. **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-July 2004, there were no reported external payment arrears.

V. DATA REPORTING REQUIREMENTS

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

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

- Table 8. Contracting or Guaranteeing of New Medium- and Long-Term Nonconcessional External Debt by the Central Government and NRB
- Table 9. Contracting or Guaranteeing of Short-Term External Debt by the Central Government and NRB

VI. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

A. Fiscal and Monetary Reforms

1. Operationalize Large Taxpayer Office (LTO) in Inland Revenue Department

The following actions would constitute observance of the performance criterion.

By November 15, 2004

- i. MOF to ensure full staffing;
- ii. LTO to clarify job descriptions of officials;
- iii. LTO to publish a code of conduct for its officials; and
- iv. LTO to prepare an audit manual.

By January 15, 2005

- i. LTO to develop performance indicators for staff;
- ii. MOF to provide for performance based incentives to recruit and retain highly qualified staff in the LTO;
- iii. LTO to establish a database to improve its audit capabilities; and
- iv. LTO to prepare a strategy for audit, collection, and taxpayer compliance.

2. Implement Time-Bound Action Plan to Improve Customs Administration

By November 15, 2004

- i. MOF to approve the model customs office plan proposal of Customs Department, including a provision for performance based incentives.

By January 15, 2005

- i. Customs Department to operationalize one model customs office; and
- ii. Customs Department to prepare valuation database.

3. Monetary Policy Operations and Public Debt Management

By November 15, 2004

- i. NRB to introduce repo (and reverse repo) operations on an auction basis;
- ii. NRB to introduce a standing credit facility for commercial banks at the NRB. The facility would be automatic, fully collateralized, with individual bank quotas, and carry a penalty rate over short-term interest rates; and
- iii. MOF, in consultation with NRB, to announce a domestic borrowing schedule for 2004/05.

B. Financial Sector

1. Strengthening Nepal Rastra Bank

a. Human Resource Policies

By November 15, 2004

The NRB Board will approve new policies on human resource management. 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.

b. Compulsory Retirement Scheme

By November 15, 2004

NRB to include a provision for compulsory retirement in its employee rules and regulations.

2. Banking Framework

By February 15, 2005

The Banking and Financial Institutions Ordinance will be revised in consultation with IMF and World Bank staffs.

3. Commercial and Development Banks

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 second review. A decision would be made to extend the scheme, change its coverage, or other means of staff reduction (including compulsory retirement) will be identified. In this context, the performance criteria for the third review will be set.

a. Rastriya Banijya Bank (RBB)

Prior Action

Implement a VRS scheme. The expected staff reduction is 100.

b. Agricultural Development Bank of Nepal (ADB)

By January 15, 2005

- i. Complete financial audit of 2003/04 accounts;
- ii. Prepare Memorandum and Articles of Association. Incorporate ADBN under the new Company Act. Transfer assets and liabilities to the new company;

- iii. File for banking license; and
- iv. Prepare business plan consistent with restructuring plan.

c. Nepal Industrial Development Corporation

By November 15, 2004

Implement a VRS scheme. The expected staff reduction is 50.

By January 15, 2005

- i. Close regional offices, dispose their fixed assets, and transfer debt related transactions to the Head Office; and
- ii. Settle employee liabilities, including under VRS.

Continuous until January 15, 2005

No capital injection by government.

C. Public Sector Reforms

a. Liquidation/Privatization of State-Owned Enterprises (SOEs)

SOEs Under Consideration

Nepal Transport Corporation; Hetauda Textile Factory; Birgunj Sugar Factory; Agriculture Tools Factory; Nepal Rosin and Turpentine Limited; Himal Cement Company; Lumbini Sugar; Janakpur Cigarettes; NCCN; and NEPECON.

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.

By November 15, 2004

Liquidation or Cabinet approval of privatization of two SOEs.

By January 15, 2005

Liquidation or Cabinet approval of privatization of a total of five SOEs.

b. Nepal Oil Corporation

By December 31, 2004

Implement automatic petroleum pricing formula recommended by the Petroleum Price Fixing and Monitoring Committee. The formula is expected to have the following key elements: (a) a provision for monthly adjustment of petroleum products' prices; and (b) reflect international prices of petroleum products, transactions costs, NOC overheads, VAT and other applicable taxes, and a margin for NOC profits that allows for recovery of past losses.

By January 15, 2005

Finalize audit of 2003/04 NOC accounts by an international firm.

By February 15, 2005

Cabinet approval of Petroleum Product and Sales and Distribution Ordinance.

| 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 15, 2004.

| Table 2. Program Foreign Financing, 2004/05 (In millions of U.S. dollars) | | | | |
|--|--------------|--------------|--------------|---------------|
| | Oct 16, 2004 | Jan 13, 2005 | Apr 13, 2005 | July 15, 2005 |
| Foreign financing (cumulative) | 0.0 | 0.0 | 0.0 | 70.0 |

| Table 3. Program Privatization Receipts, 2004/05 (In millions of Nepalese rupees) | | | | |
|--|--------------|--------------|--------------|---------------|
| | Oct 16, 2004 | Jan 13, 2005 | Apr 13, 2005 | July 15, 2005 |
| Privatization receipts (cumulative) | 0.0 | 50.0 | 260.0 | 620.0 |

| Table 4. Net Foreign Assets of the Nepal Rastra Bank, 2004/05 (In millions of U.S. dollars) | | | | |
|--|--------------|--------------|--------------|---------------|
| | Oct 16, 2004 | Jan 13, 2005 | Apr 13, 2005 | July 15, 2005 |
| 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, 2004/05 1/ (In billions of Nepalese rupees) | | | | |
|---|--------------|--------------|--------------|---------------|
| | Oct 16, 2004 | Jan 13, 2005 | Apr 13, 2005 | July 15, 2005 |
| Net foreign assets 1/ | | | | |
| Assets | | | | |
| Liabilities | | | | |
| Net domestic assets | | | | |
| Claims on public sector | | | | |
| Net credit to government | | | | |
| Claims on government 2/ | | | | |
| Less: Deposits | | | | |
| Claims on public enterprises | | | | |
| Claims on private sector | | | | |
| Claims on commercial banks | | | | |
| Other items (net) | | | | |
| Reserve money | | | | |
| Currency outside banks | | | | |
| Currency held by banks | | | | |
| Bankers' deposits | | | | |
| Private sector deposits | | | | |
| 1/ For program monitoring purposes. | | | | |
| 2/ Excluding IMF promissory notes. | | | | |

| Table 6. Net domestic financing of the Budget, 2004/05 (In millions of Nepalese rupees) | | | | |
|--|--------------|--------------|--------------|---------------|
| | Oct 16, 2004 | Jan 13, 2005 | Apr 13, 2005 | July 15, 2005 |
| 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, 2004/05 (In millions of Nepalese rupees) | | | | |
|--|--------------|--------------|--------------|---------------|
| | Oct 16, 2004 | Jan 13, 2005 | Apr 13, 2005 | July 15, 2005 |
| Total revenue (HMG) | | | | |
| Less: Principal repayment by corporations | | | | |
| Total revenue 1/ | | | | |
| Tax revenue | | | | |
| Taxes on goods and services | | | | |
| VAT/sales tax | | | | |
| Excise taxes | | | | |
| Others | | | | |
| Taxes on international trade | | | | |
| Import taxes | | | | |
| Indian excise refund | | | | |
| Export taxes | | | | |
| Agriculture reform fee and other | | | | |
| Taxes on income and profits | | | | |
| Taxes on property | | | | |
| Nontax revenue 1/ | | | | |
| Charges, fees, and fines | | | | |
| Sales of goods and services | | | | |
| Dividends | | | | |
| Royalty and fixed asset sales | | | | |
| Interest receipts | | | | |
| Other | | | | |
| 1/ Excluding principal repayments by corporations. | | | | |

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

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

**Statement by the IMF Staff Representative
October 20, 2004**

Prior Action

The prior action for the first review—implementation of Phase II of the voluntary retirement scheme (VRS) at the Rastriya Banijiya Bank—has been completed. The VRS was announced on September 8, 2004 and closed on October 8, 2004. On October 13, all eligible applicants (180 employees excluding those under departmental action) were notified that their applications had been accepted together with the agreed severance terms.

Recent Economic Developments

External and internal security developments have recently contributed to lower net foreign exchange inflows, significantly slowing the pace of reserve accumulation in 2004/05 compared to 2003/04. In September, riots erupted in protest over the government's inability to prevent the killing of 12 Nepalese hostages in Iraq. The protests were also aimed at employment agencies for having sent Nepalese workers to Iraq. As a result, these agencies suspended operations temporarily. The government imposed a curfew for five days to quell the riots, while trying to move other Nepalese workers out of Iraq. These disruptions appear to have contributed to a significant decline in remittance inflows. Recent demand for closure of select businesses by the insurgents may also have led to an outflow of capital by foreign-owned businesses operating in Nepal. These factors, along with rapidly rising oil import prices, slowed the pace of international reserve accumulation in recent months. The authorities are cautiously hopeful that some of these factors may reverse in the coming months facilitating their ability to meet the program's quantitative performance criteria going forward in the run-up to the second review under the arrangement, tentatively scheduled for early 2005.



Press Release No. 04/218
FOR IMMEDIATE RELEASE
October 20, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review Under Nepal's Three-Year PRGF Arrangement and Approves US\$10.6 million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the first review of Nepal's economic performance under the three-year Poverty Reduction and Growth Facility (PRGF) Arrangement. In doing so, the Board approved a request for a waiver for the non-observance of the February 15, 2004 structural performance criterion on finalizing the audit of the Nepal Rastra Bank 2002/03 accounts by an international auditor, and the March 15, 2004 structural performance criterion on implementing a voluntary retirement scheme at Nepal Rastra Bank and phase II of the voluntary retirement scheme at Rastriya Banijya Bank.

Today's decision enables Nepal to draw an amount equivalent to SDR 7.1 million (about US\$10.6 million) under the arrangement. The Executive Board approved the three-year arrangement on November 19, 2003 (see [Press Release No. 03/202](#)) for amount equivalent to SDR 49.9 million (about US\$73.9 million). Completion of the first review will bring total disbursements under the program to SDR 14.3 million (about US\$21.2 million).

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

“Nepal's Poverty Reduction Strategy Paper (PRSP) continues to provide a sound basis for achieving higher growth and poverty alleviation. The main elements of the PRGF-supported program—sound macroeconomic management, better expenditure prioritization and enhanced efficiency, structural reform in major economic sectors, and improved governance—are geared to delivering conditions for sustained growth and enhancing the pro-poor focus of budget spending.

“Peace remains critical for achieving sustained, high economic growth in the medium term. With a durable peace, the nation's energies can be fully focused on its developmental and poverty-reduction objectives, including Millennium Development Goals.

“To maintain macroeconomic stability, the authorities' medium-term fiscal objectives are to raise the revenue-to-GDP ratio, improve the efficiency of public spending, and reduce domestic borrowing in order to put the government's finances on a sustainable basis. Achieving these objectives would require strengthening of tax and customs administration and determined

implementation of tax policy changes to mobilize additional revenue. The prioritization of expenditures under the medium-term expenditure framework (MTEF) would help to raise allocations for priority sectors and increase poverty-related spending. At the same time, a strong effort is required to improve the government's implementation capacity to ensure that the budgeted development spending targets are achieved.

“Continued implementation of financial sector reforms is a key element for the success of the PRGF-supported program. These reforms include further restructuring of Nepal Rastra Bank to transform it into a modern and efficient central bank, with a stronger capacity for financial sector supervision. Determined implementation of reforms in the banking sector is also essential, including strong government support for the commercial banks' debt recovery, efforts, particularly from the largest defaulters, and additional efforts to restructure the two development banks.

“Further steps envisaged in public enterprise and governance reforms would also help create conditions for higher growth over the medium term. These steps should include further advances in the ongoing privatization or liquidation of selected public enterprises, and the preparation of audited accounts of enterprises, including the Nepal Oil Corporation (NOC) by an international audit firm. In addition, the shift to an automatic pricing mechanism for petroleum products would help address and contain NOC losses. Civil service reforms, including through amendments to the Civil Service Act, and decentralization are also needed to improve service delivery, and further steps need to be taken to curb corruption,” Mr. Kato said.

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