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May 23, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Nepal - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Nepal, which has been tentatively scheduled for discussion on Monday, June 25, 1984. A draft decision appears on page 26.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. R. C. Williams, ext. (5)7610.

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NEPAL

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Article IV Consultations with Nepal

(In consultation with the Exchange and Trade Relations, Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by Tun Thin and Manuel Guitian

May 22, 1984

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I. Introduction

The 1984 Article IV consultation discussions with Nepal were held in Kathmandu during March 26-April 6, 1984. The Nepalese representatives included officials of the Nepal Rastra Bank, the Ministries of Finance, Agriculture, Commerce, Industry, and Supplies, and the National Planning Commission. The mission also met with the Minister of Finance and the Governor of the Nepal Rastra Bank. The staff team, all from ASD, consisted of Messrs. Richard C. Williams (head), Hyong C. Kim, Daniel Citrin, David Nellor, and Ms. Prabhavathi Job. Mr. John Rose, Fund Resident Advisor, assisted the work of the mission. Mr. Panday, Advisor to the Executive Director for Nepal, attended some meetings as an observer.

Nepal continues to avail itself of the transitional arrangements of Article XIV. It does not maintain any restrictions on payments and transfers for current international transactions subject to approval under Article VIII. In November 1983, the authorities introduced a cash incentive scheme for promotion of exports, which gave rise to a discriminatory multiple currency practice. The measure was to be in effect through July 15, 1984.

II. Background and Recent Economic Developments

1. Background

Nepal is among the least developed countries and faces formidable and, in some respects, unique problems. It is a land-locked mountainous country sharing a long common border with India. Almost all of Nepal's merchandise trade moves over land to or through India. Direct transit costs of exports to third countries (i.e., countries other than India) are estimated to range from 6-7 percent (for high value goods) to over 60 percent (for cement) of c.i.f. prices in Calcutta. 1/ Partly because of high transit costs, about 60 percent of Nepal's total international trade is with India. With rugged hills and high mountains of the Himalayan range covering two thirds of its land, Nepal has severe transportation and communication problems. The major focus of public investment in the last five development plans (1950/51-1979/80) 2/ was the build-up of basic economic infrastructure, such as the construction of road and telephone networks linking major economic centers. Physical infrastructure of a more directly productive nature is still underdeveloped and will require mobilization of substantial additional resources. Finally, Nepal's economy is predominantly agricultural, and that sector, centered in the Terai plain, contributes about 60 percent of GDP. Irrigation facilities cover only 15 percent of the total

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1/ Nepal: Recent Economic Developments and Selected Issues in Trade Promotion (World Bank Report No. 4663-NEP, p.66).

2/ Nepal's fiscal year is the 12-month period ending July 15.

cultivable land and, consequently, agricultural output fluctuates considerably with weather conditions.

Reflecting low productivity in agriculture and high population growth, Nepal's balance of payments has been structurally weak. During 1976/77-1980/81, merchandise exports were relatively stagnant, as growth in nonagricultural exports was largely offset by declining agricultural surpluses. In contrast, import growth was relatively rapid, reflecting growth in all import categories. As a result, the current account deficit in relation to GDP had increased from an annual average of 3 percent in the second half of the 1970s to about 5 percent in the early 1980s. However, sizable inflows of foreign grants and concessionary loans covered all or most of the current account deficit, and the overall balance of payments was in surplus in most years.

A severe drought in early 1982/83 caused a drastic decline in output of rice and other summer crops in that year. Although winter wheat production rose substantially as a result of the Government's successful winter wheat program, total foodgrain production declined by 13 percent, and real GDP declined by 1.4 percent. Partly in response to the drought, the Government stepped up its expenditure, which, combined with a weak revenue performance, contributed to a sharp increase in the overall budget deficit to almost 8 percent of GDP from about 3 percent in earlier years. The increased deficit was largely financed through the banking system; bank credit to the Government rose by 94 percent, compared with an annual average increase of about 23 percent during 1976/77-1980/81. The resultant increase in total liquidity, in conjunction with the supply shortages, contributed to an acceleration in inflation from 10 percent in 1981/82 to 14 percent in 1982/83.

On the external side, the value of exports, consisting largely of agricultural and agro-based products, fell by 25 percent, while imports, partly reflecting food imports, rose by 24 percent. As a result, the current account deficit increased to 9 percent of GDP from an annual average of 3-4 percent in earlier years, and the overall balance of payments position swung from its traditional surplus to a large deficit. Gross official international reserves declined by SDR 56 million to SDR 147 million, equivalent to four months of imports.

At the time of the 1983 Article IV consultation, Executive Directors expressed concern about the Government's heavy borrowing from the domestic banking system and, while welcoming the adoption of various measures by the Government to reduce such borrowing, they felt that even further measures were needed to reduce the budget deficit. Given the early stage of economic development in Nepal, Executive Directors thought that a comprehensive medium-term economic and development strategy was called for. They stressed that development efforts should be supported by appropriate incentives for production, particularly in export- and import-substituting sectors, and that domestic financing should be accomplished through savings mobilization by, inter alia, maintaining positive real interest rates. Executive Directors also considered that the use of a more active exchange rate policy would be an important way of strengthening export and import competitiveness and thus correcting the deterioration of Nepal's balance of payments and reserve position.

2. Developments in 1983/84

In 1983/84, the economy has rebounded strongly from the drought-induced decline in the previous year. Favorable weather has led to good winter and summer crops and output of foodgrains is expected to increase by 22 percent; rice production alone is estimated to have risen by nearly 50 percent. Buoyed by the increased agricultural production, nonagricultural activity is also expected to expand by about 5 percent in real terms. Reflecting these developments, real GDP should increase by close to 9 percent (Table 1 and Appendix Table I). With improved food supplies and a strengthening of financial management, inflation has moderated considerably in 1983/84. Preliminary data indicate that the increase in the urban consumer price index should be limited to 7 percent, or about one half the rate of increase recorded in 1982/83.

Table 1. Nepal: Indicators of Output and Prices, 1976/77-1984/85 1/

	1976/77-1980/81 (Annual Average)	1981/82	1982/83	1983/84 (Staff Est.)	1984/85 (Staff (Proj.)
			(Percentage Change)		
Real GDP	3.1	3.8	-1.4	9.1	3.5
Of which: Agriculture	(0.8)	(3.5)	(-2.5)	(11.8)	(3.0)
Inflation (consumer price)					
Nepal	8.0	10.4	14.2	7.3	5.0
Trading partners	6.9	9.1	7.7	10.0	...
India	(6.5)	(10.4)	(9.5)	(12.0)	(...)
			(As percent of GDP)		
Total domestic demand	105.0	107.4	111.0	107.9	108.7
Consumption	(90.5)	(91.6)	(94.6)	(91.9)	(...)
Investment	(14.5)	(15.8)	(16.3)	(16.0)	(...)

Sources: Data provided by the Nepalese authorities; and staff projections.
1/ Fiscal year ending mid-July.

The revised budget for 1983/84 was framed to restore financial stability primarily through expenditure control, and the actual outcome of budgetary operations is expected to be broadly in line with this objective. The overall budget deficit is estimated to decline from the level of the previous year both in absolute terms and in relation to GDP, to 6.5 percent, from 7.9 percent in 1982/83. Domestic bank financing of the estimated budget deficit is expected to decline sharply from 6 percent of GDP in 1982/83 to 2.5 percent in 1983/84 (Table 2 and Appendix Table II). Domestic revenue is expected to increase by close to 18 percent, somewhat greater than the rate of increase in nominal GDP. Total expenditure, on the other hand, is expected to increase by only 6 percent, representing a small decline in real terms. The growth of development expenditure has slowed from 28 percent in 1982/83 to an estimated 2 percent, considerably below the long-term trend of recent years. Regular expenditure is expected to rise by close to 16 percent, which is still somewhat less than the trend of the past several years.

Table 2. Nepal: Selected Budgetary Indicators, 1976/77-1984/85

	1976/77-1980/81 Annual Average	1981/82	1982/83	1983/84 (Staff Est.)	1984/85 (Staff Proj.)
			(Percentage change)		
Nominal GDP	9.6	10.8	11.1	16.1	8.7
Revenue	17.3	11.0	4.9	17.7	13.5
Foreign grants	19.7	14.3	20.9	4.2	21.8
Expenditure	16.3	31.5	26.8	6.2	13.0
Regular	14.3	20.5	24.7	15.9	24.3
Development	17.5	36.6	27.6	2.3	7.9
			(As percent of GDP)		
Overall deficit	2.9	5.2	7.9	6.5	6.4
Foreign financing	1.7	2.3	2.6	2.7	3.2
Domestic financing	1.1	2.9	5.3	3.8	3.2
Of which: Bank financing	0.8	2.6	6.0	2.5	2.0

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

Apart from the reduction in the magnitude of the overall fiscal deficit, the pattern of its financing has been altered significantly in 1983/84. For the fiscal year as a whole, the proportion of government borrowing from the domestic banking system is estimated at 38 percent of the deficit, down from 76 percent in 1982/83, while that of nonbank domestic financing is expected to rise to about 20 percent from 3 percent in the previous year. The growth in nonbank domestic financing is being achieved by the sale, at an attractive and tax-free yield, of a national savings certificate, which was introduced this year. Net foreign borrowing, both in absolute terms and in relation to the deficit, is expected to increase in 1983/84. In the first half of 1983/84, government borrowing from the banking system was running at a rate well ahead of the estimate for the year as a whole. However, government revenues are seasonally higher in the second half of the year and, in addition, reimbursements from foreign donors are expected to accelerate in that period.

Both monetary and credit expansion have slowed significantly in 1983/84. Broad money is expected to increase by 15 percent, as compared with a rise of 24 percent in 1982/83 (Table 3 and Appendix Table III). This deceleration is associated mainly with a sharp reduction in the rate of increase in net credit to the Government to 23 percent, from 94 percent in 1982/83. Also, bank credit to public enterprises has expanded only modestly. Reflecting the economic recovery, bank credit to the private sector has expanded more rapidly in 1983/84. The external sector has exerted a modest contractionary impact on total liquidity. Commercial banks were highly liquid in 1983/84, particularly in the first half of the year, reflecting the slowdown in credit expansion. Despite the sharp decline in the rate of inflation in 1983/84, the authorities have maintained the same nominal interest rates on bank deposits, which now offer significant positive yields.

The balance of payments situation has improved considerably in 1983/84. Exports of agricultural products, particularly to India, have risen sharply. Total exports are estimated to expand by 25 percent in value and 19 percent in volume, after successive declines in the last two years. Imports, on the other hand, are expected to decline by 8 percent in value and 7 percent in volume, following a large expansion in the previous two years. The marked increase in foodgrain production in 1983/84 obviated the need for foodgrain imports, which amounted to SDR 22 million in 1982/83. There has also been a tightening of import licensing policy with respect to imports of nonessential consumer goods. Reflecting these developments, the trade deficit is expected to have narrowed considerably in 1983/84. With estimated net earnings from services and private transfers remaining broadly unchanged over the level of 1982/83, the current account balance has thus improved correspondingly; as a percent of GDP, the current account deficit is estimated to have declined from 9 percent in 1982/83 to 6 percent this year. The current account, excluding aid-financed imports, was approximately in balance. As inflows of official transfers and capital are expected to have been somewhat less than in 1982/83, a small overall balance of payments deficit is likely to have resulted in 1983/84 (Table 4).

Table 3. Nepal: Selected Monetary Indicators, 1976/77-1984/85

	1976/77-1980/81 Annual Average	1981/82	1982/83	1983/84 (Staff Est.)	1984/85 (Staff Proj.)
			(Percentage change)		
Domestic credit	23.9	16.2	39.6	17.5	12.8
Public sector	21.2	38.4	81.9	19.6	14.4
Government	22.2	57.0	93.9	23.4	16.6
Public enterprises	21.4	1.0	44.0	3.7	3.2
Private sector	26.4	2.4	3.7	14.4	10.4
Broad money	20.2	18.2	23.6	15.4	11.8
			(Absolute number)		
Income velocity of money	5.30	4.40	4.06	3.93	3.77

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

In the first half of 1983/84, the authorities took a number of measures designed to improve the trade balance, in particular, vis-a-vis third countries. In September 1983, import policy was tightened to restrain the growth of third country imports. In November, the authorities introduced a 9-point export promotion program designed to provide incentives to exports to third countries through, inter alia, the provision of cash grants equivalent to 10 percent of the value (f.o.b.) of exports, rebates of export/import duties and sales taxes, and other measures.

Table 4. Nepal: Balance of Payments Indicators, 1976/77-1984/85

	1976/77-1980/81 Annual Average	1981/82	1982/83	1983/84 (Staff Est.)	1984/85 (Staff Proj.)
			(Percentage change)		
Exports					
Value 1/	5	-7	-25	25	8
Volume	3	-15	-32	19	3
Imports					
Value 1/	16	12	24	-8	12
Volume	9	3	15	-7	8
			(As percent of GDP)		
Trade balance	-8	-11	-15	-12	-13
Current account balance	-3	-5	-9	-6	-7
Current account balance excluding aid imports 2/	2	1	-1	--	--
			(Months of imports at end of period)		
Gross international reserves	8	7	4	4	4

Sources: Data provided by the Nepalese authorities; and staff projections.
1/ In SDRs.
2/ Excluding aid-financed imports of goods and services.

Largely reflecting the authorities' cautious policies on external borrowing, virtually all of Nepal's external public debt is on highly concessional terms, with an average maturity of about 30 years and an average interest rate of 1-2 percent. By the end of 1983/84, Nepal's outstanding external public debt (including Fund credit) is estimated to reach SDR 337 million, equivalent to 13.8 percent of GDP, with debt service payments of 5.7 percent of receipts from exports of goods, services, and private transfers.

In close consultation with the Fund, the authorities have progressively rationalized the exchange system in recent years. The process, begun in 1978, involved the elimination of a complicated multiple rate system and culminated in the adoption in June 1983 of a basket peg arrangement. The new arrangement eliminated the broken cross rates which had emerged as a result of maintaining a fixed rate for the Nepalese rupee against both the Indian rupee and the U.S. dollar. Since the basket peg arrangement was introduced, the Nepalese rupee has depreciated vis-a-vis the U.S. dollar by about 12.6 percent through mid-May 1984, and in real effective terms, by about 6.5 percent through February 1984. The exchange rate vis-a-vis the Indian rupee has remained unchanged. Over a longer perspective, various indicators show a modest deterioration in Nepal's international competitiveness since the late 1970s. Between July 1979 and February 1984, an index of the trade-weighted real effective exchange rate rose by 9 percent, and the competitor-weighted index rose by 5 percent. In addition, the ratio of nontradable goods prices to tradable goods prices in Nepal's CPI rose by 4 percent during the same period, suggesting a modest deterioration in the relative competitiveness of the tradable goods sector.

III. Medium-term Prospects

1. Growth and inflation prospects

Prospects for 1984/85, the final year of the current (Sixth) Five-Year Plan period, will depend importantly on weather conditions. Assuming adequate rainfall, real GDP growth is projected to be in the 3-4 percent range, with increases in agricultural and non-agricultural output of 3 percent and 4.5 percent, respectively. In the context of adequate food supplies, and assuming an increase in import prices (in SDR terms) of no more than 4 percent and implementation of appropriately restrained demand management and public sector wage policies, the underlying inflation rate should moderate further to about 5 percent. The measured increase in domestic prices could be somewhat higher than 5 percent if the authorities implement vigorously their general policy to rationalize the price structure for public entities. If the projected growth is attained, the compound growth rate of GDP during the four-year period through 1984/85 would be 3.7 percent.

While the Seventh Plan is still in preparation, the overall strategy calls for an annual increase of about 4.5 percent in real GDP, 3.5 percent in the agricultural sector, and 5 percent in the non-agricultural sector. The level of public development expenditure envisaged in the Seventh Plan is less ambitious than targeted in the Sixth Plan, and on absorptive capacity grounds might be attainable (Table 5); the World Bank staff will be evaluating the Plan in coming months. With respect to the structure of expenditure, a greater proportion of resources is to be devoted to directly productive uses, particularly in agriculture, and to water resource development. In light of the planned level and structure of development expenditure, and taking

Table 5. Nepal: Public Development Expenditure and Financing under Sixth and Seventh Development Plans, 1980/81-1989/90

(In NRs billions, at constant 1984/85 prices)

	Sixth Plan (1980/81-1984/85)		Seventh Plan (1985/86-1989/90)	
	Plan Targets	Staff Projection	Plan Targets	Staff Projection
Development Expenditure and Financing	35.0	24.4	32.1	32.1 3/
Government revenue surplus after current expenditure	10.5	6.3	5.1	4.6
Foreign aid	21.0	11.8	22.5	18.0
Domestic borrowing	3.5	6.3	3.0	3.0 3/
Banking system	(...)	(5.2)	(2.0)	(2.0)
Nonbank	(...)	(1.1)	(1.0)	(1.0)
Additional financing requirement	--	--	1.5	6.5
Memorandum items				
Domestic borrowing as percent of GDP	1.8 1/	3.2 2/	1.3	1.3
Additional financing requirement as percent of GDP	...	...	0.6	2.7

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

1/ Based on plan GDP targets.
2/ Based on actual and projected GDP.
3/ The staff projections take as given (policy targets) the plan assumptions for development expenditure and for domestic financing.

into account the past relationship between output and investment, the Plan growth target would, a priori, appear to be broadly attainable.

One major question that arises is whether, and under what assumptions about financial policies, such a level of public development expenditure can be effected without straining domestic resources and putting pressure on the price level and/or the balance of payments. Medium-term fiscal prospects suggest that it will either be necessary to restrict the rate of growth of expenditure, relative to the past few years, or to accelerate significantly the rate of growth of domestic resource mobilization. In the absence of such measures, domestic financing of the fiscal deficit would increase at a rate inconsistent with domestic price stability objectives and would undermine further the structurally weak balance of payments. As shown in the staff projections for the Seventh Plan period, even assuming considerable revenue buoyancy and a significant increase in foreign aid utilization, attainment of development expenditure objectives without additional resource mobilization would imply a domestic financing requirement over three times as great as assumed in the Plan. The increase in annual revenue in real terms which seems to be required is equivalent to about 35 percent of government revenue projected for 1984/85. Since a significantly more rapid expansion of revenue is unlikely to be feasible in the early years of the Plan period, additional expenditure restraint probably will be needed in those years. Development expenditure comprises about 70 percent of total government expenditure, and the growth of domestically financed development expenditure probably will have to be restricted below the amounts envisaged in the early years of the Plan period if domestic financing of the deficit is to be held to manageable proportions.

The major difference between the staff projection and the Plan targets is the assumption about the pace of aid utilization--there seems to be little question about the availability of aid. The staff considers that, even if the rigorous efforts underway to improve the implementation of project commitments continue, net disbursements from foreign grants and loans would not be likely to increase by more than 8 percent per year in real terms, after returning to trend in 1984/85. The Plan appears unduly optimistic in assuming that, in addition to completion of the Marsyangdi hydro project (NRs 3.9 billion) and timely disbursements on new aid commitments, there will be a full drawdown of the current aid pipeline of about US$650 million during 1984/85 and the Plan period.

2. Balance of payments prospects

On the basis of relatively cautious assumptions for the world economy, and assuming normal rainfall in 1984, continuation of the domestic adjustment policies pursued this year appear to be broadly sufficient to attain approximate balance in the external accounts in 1984/85. The current account deficit would rise by about SDR 25 million, or from 6 percent to 6.6 percent of GDP, but this would be more than covered by a projected increase in aid from 5.8 percent of GDP in 1983/84 to 6.5 percent. Gross official reserves at the end of 1984/85 are projected to reach SDR 125 million, equivalent to 3.5 months of total 1984/85 imports of goods. External public debt (including Fund credit) at the end of 1984/85 would be SDR 407 million, equivalent to 15.7 percent of GDP. The debt service ratio 1/ in 1984/85 would be 5.6 percent, down marginally from 5.7 percent in the current fiscal year.

Balance of payments projections for even a year ahead are problematic because of uncertainty about weather conditions; forecasts beyond 1984/85 are fraught with uncertainties. Aside from their concerns about the durability of the current recovery in the industrial countries, at the time of the consultation discussions the authorities had not yet formulated all policy parameters, particularly with respect to resource mobilization measures. Therefore, to judge the adequacy of policies reflected in the authorities' early indications about 1984/85, and the broad policy parameters of the Seventh Plan, the staff developed a scenario incorporating certain assumptions about likely external conditions facing Nepal, as well as the broad policy stance.

The scenario assumes that the Plan's growth targets are achieved, and that domestic financing of the budget deficit is limited to an amount no more than 3 percent of GDP, which would require a combination of new revenue measures and cuts in domestically-financed expenditure. It is further assumed for the Plan period that the index of the real effective exchange rate is at approximately the same level as in the first quarter of 1984, and that import licensing policy is sufficiently liberal to permit non-aid imports to grow in line with the GDP growth assumption. 2/ Annual growth in export volume (4.4 percent) is above the 3 percent trend of recent years, reflecting the sustained increase in agricultural production. Tourism receipts and private transfers, continuing past trends, are projected to grow in SDR terms by 10 percent per year. The assumption on aid disbursements was discussed above; the policy of abstaining from medium-term borrowing on commercial terms is assumed to be maintained throughout the period.

Balance of payments projections based on this scenario were made for the period through 1986/87 (Table 6 and Chart 1) and projections for the major accounts were extended through 1989/90. The projections indicate continuous and increasing balance of payments strains during the 5-year Plan period. The current account deficit would rise steadily from 6 percent of GDP in 1983/84 to 8 percent by 1989/90. Aid

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1/ The ratio of debt service to receipts from exports of goods and services and private transfers.

2/ The income elasticity of these imports is assumed to be 1.7 similar to the relationship between changes in real GDP and non-aid import volume for the whole period 1978/79-1983/84, but significantly below the longer-term trend of about 2.0.

Table 6. Nepal: External Public Debt and Balance of Payments
1981/82-1986/87

	1981/82	1982/83	1983/84 Est.	1984/85 Projections 1/	1985/86	1986/87
			(In millions of SDRs)			
Amortization	4.8	9.6	10.2	11.5	9.1	9.5
Of which: to IMF	(2.6)	(4.8)	(5.1)	(5.2)	(1.3)	(--)
Interest	3.2	5.1	5.1	6.7	7.9	9.3
Of which: to IMF	(1.2)	(1.0)	(0.7)	(0.4)	(0.2)	(--)
Total debt service	8.0	14.7	17.1	18.2	17.0	18.8
Of which: to IMF	(3.8)	(5.8)	(5.8)	(5.6)	(1.5)	(--)
Debt outstanding 2/	238.8	280.8	336 6	407.1	488.0	580.5
Of which: to IMF	(30.1)	(25.1)	(20.0)	(14.8)	(13.5)	(13.5)
			(In percent)			
Debt service/exports of goods and services and private transfers	2.7	5.2	5.7	5.6	4.7	4.7
Of which: to IMF	(1.3)	(2.0)	(1.9)	(1.7)	(0.4)	(--)
Outstanding debt/GDP	11.7	12.5	13.8	15.7	17.2	18.7
Of which: to IMF 2/	(1.5)	(1.1)	(0.8)	(0.6)	(0.5)	(0.4)
Memorandum items:			(In millions of SDRs)			
Exports of goods and services	256.0	237.7	252.8	277.0	305.0	336.0
Imports of goods and services	-396.1	-473.9	-443.9	-497.0	-554.0	-616.0
Private transfers, net	35.4	43.1	44.2	49.0	54.0	59.0
Current account	-104.7	-193.0	-146.9	-171.0	-195.0	-221.0
Official grants and net loans, including errors and omissions	138.6	147.9	142.0	169.0	187.0	210.0
Overall balance	33.9	-45.2	-4.9	-2.0	-8.0	-11.0
Current account/ GDP (in percent)	-5.1	-8.6	-6.0	-6.6	-6.9	-7.1
Gross official international reserves (in months of imports) 2/ 3/	7.3	4.3	4.0	3.5	2.9	2.4

Sources: Nepal Rastra Bank; Fund Treasurer's Department; and staff estimates.

1/ Projections of debt service and outstanding debt are based on the assumption that loan disbursements will return to trend in 1984/85 and rise by 12 percent per annum thereafter, with no further purchases from the Fund. Nominal GDP is assumed to increase by 9 percent per annum in 1984/85-1986/87; exports of goods and services are projected to rise by about 10 percent per annum and non-aid imports of goods and services by 12 percent per annum during 1984/85-1986/87; aid-financed imports are assumed to grow in line with foreign aid disbursements.

2/ End-of-period.

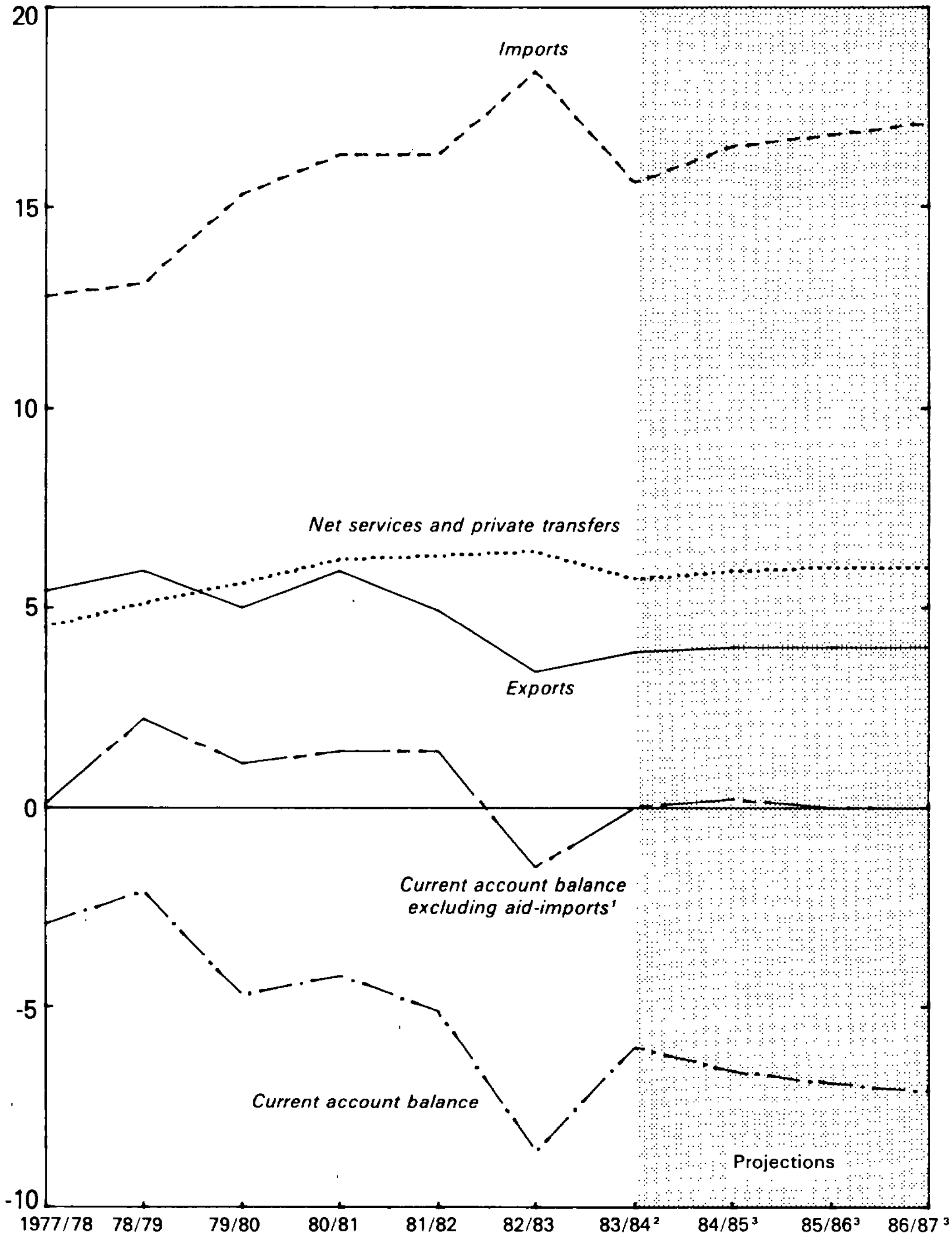
3/ Excluding gold. The change in gross official reserves is assumed to be equivalent to the overall balance of payments outcome for 1984/85 and thereafter.

CHART 1

NEPAL

BALANCE OF PAYMENTS STRUCTURE, 1977/78-1986/87

(As a percentage of GDP)



Sources: Nepal Rastra Bank; and staff estimates.

[1] Excluding aid-financed imports of goods and services.

[2] Staff estimates.

[3] Staff projections.

disbursements (net) also would rise considerably, from 5.8 percent of GDP in 1983/84 to 7.3 percent in 1989/90, but the proportion of the current account deficit thus financed would decline to about 91 percent, from 97 percent in the current year. The cumulative overall deficit in the Plan period would approximate SDR 80 million; end-of-period reserves would be equivalent to less than one month's imports at the 1989/90 level.

Balance of payments management in Nepal needs to focus on the balance between current exchange earnings on the one hand, and the level of non-aid imports on the other--the difference between them approximates the changes in reserves (Chart 1). While both service earnings and private remittances have been and are projected to be fairly buoyant, exports of goods have been relatively stagnant, as growth in non-agricultural exports has been largely offset by declining agricultural surpluses. This trend is projected to be partially reversed, with the volume of agricultural exports being projected to increase annually by 3.5 percent on average, and total export volume projected to rise by 4.4 percent per year. Non-aid imports, on the other hand, are projected to increase in volume terms by 7 percent per year, even assuming greater progress in import substitution. Therefore, unless either more progress is made in production of tradable goods and export promotion, or aid donors are willing to provide assistance in the form of untied balance of payments support, balance of payments adjustment considerations will require a significant tightening of domestic demand management, with a probable reduction of the GDP target by about 1 percent per year. For Nepal, such a decline in growth represents the difference between modest growth in per capita GDP for the period, and almost no growth at all. 1/

The projections indicate that outstanding public external debt would rise from SDR 337 million in 1983/84 to SDR 930 million at the end of 1989/90, the ratio of debt to GDP rising 9 percentage points to 23 percent. The debt service ratio would decline from 5.7 percent at present to 4.7 percent in the first two years of the Plan period, reflecting declining repayments to the Fund, and then rise slowly to 5.9 percent in 1989/90. The external debt management perspective would change considerably were Nepal to consider medium-term borrowing on commercial terms to fill the emerging gap discussed above. Net commercial borrowing of SDR 25 million per year throughout the period, for example, would yield a steadily growing gross commercial borrowing requirement which would double by 1989/90 and the debt service ratio would be 2 1/4 times as large as projected without such borrowing. In short, recourse to commercial borrowing would not present a viable option in Nepal's balance of payments management. The challenge is to strengthen the tradable goods sector and medium-term export prospects more rapidly. It was in this context that the staff discussed with the

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1/ United Nations data indicate average annual population growth at 3.2 percent during the 5-year period 1976/77-1980/81.

authorities a more active exchange rate policy, in conjunction with the Government's efforts to ease supply constraints, particularly in agriculture.

IV. Current Policies

The current economic situation and the medium-term prospects described above require continuity in demand management policies, together with sustained efforts to strengthen the economy and the balance of payments over the medium term. The authorities have been adjusting their policies toward these goals, although additional efforts may be required, particularly in resource mobilization and export promotion.

1. Supply policies

The Agricultural Inputs Corporation (AIC) provides fertilizers at subsidized, uniform prices throughout the country and bears the transportation costs. Actual distribution in relation to program targets has risen considerably in recent years, from 48 percent during 1975/76-1979/80, to over 70 percent during 1980/81-1981/82 and almost 80 percent in 1982/83. In the first half of 1983/84, about 41,000 tons were distributed, equivalent to 74 percent of the target for the whole year. Nevertheless, distribution of chemical fertilizer still has reached only about 10 kg/ha., one of the lowest levels of usage in Asia.

The AIC also distributes improved seeds at subsidized prices. In 1982/83, for the first time, the target for seed distribution (6,000 tons) was fully met as the Government lowered prices in some areas. The prices were raised in 1983/84 and distribution declined somewhat (to one third of the annual target in the first half year), but nevertheless distribution still was running at an annual rate close to that of 1982/83. Currently, improved seeds are used in an estimated 50 percent of wheat cultivation but are used much less extensively in paddy. In 1983/84 the authorities have expanded an intensive program to increase wheat and other agricultural production, based in part on more extensive distribution of fertilizer and seeds. The success of this program in 1982/83, which was reflected in a 25 percent increase in the wheat crop, was recognized by Executive Directors in last year's Article IV consultation.

The AIC has incurred substantial deficits in its operations and given the strain on resources, there is a policy question of whether the subsidy should be available to all farmers without regard to their financial circumstances. In some cases, as the authorities recognize, the subsidy program may simply raise the profit margin of farmers for whom it is clearly profitable to use fertilizer even at international prices. However, the authorities believe that it is too difficult at present to categorize farmers into groups on the basis of need. They also note that, under the land reform, the maximum size of land holdings per household is 16.6 hectares and, hence, the subsidy to any one family is unlikely to be excessive. Nevertheless, the Government is currently considering whether or not to allow the private sector to import and distribute fertilizer at market prices. The authorities define the major policy issue as the likely impact on fertilizer and food prices. In examining the trade-offs, it is important that the authorities also consider the overall resource strains and the inflationary pressures that can emerge as subsidies compete with development projects for scarce resources.

Credit is provided to small farmers by the Agricultural Development Bank (ADBN) through its Small Farmers Development Program, and by commercial banks under the Intensive Banking Program. Consideration is being given to allowing the ADBN to compete for deposits with commercial banks in urban areas for commitment to this program. The experience with this credit allocation scheme up to now suggests that a more active role in deposit taking and credit allocation by the ADBN may serve over time to improve the credit flow to the rural sector. The banks, whose major operations consist of commercial lending to a relatively few large firms, are to commit the equivalent of 10 percent of their deposits to loans for agriculture, cottage industry, and priority service sectors at subsidized interest rates. As of November 1983, priority sector credit from commercial banks was equivalent to only 3.5 percent of deposits; about one half (NRs 113 million) of such credit had gone to agriculture.

A major effort has been made to raise agricultural productivity by increasing irrigation facilities. Land area under irrigation has risen by about 25 percent over the past four years, but nevertheless only 15 percent of the cultivable land is currently under irrigation. Moreover, the current utilization rate is estimated at less than 50 percent. In 1983/84, the Government launched an extensive program to provide 3,000 shallow tube wells to growers during the year, with the Government absorbing about one third of the cost.

An important element in improving agricultural productivity is the adequacy of pricing policy and buffer stock facilities. Frequently, support prices are announced only after planting and then set at levels below market prices, without providing adequate financial incentives to increase production. The authorities indicated that they would like to announce minimum support prices earlier so as to encourage production, but there are serious constraints, such as the lack of storage facilities and the difficulty in predicting Indian support prices. The support price for paddy was raised by 27 percent in July 1983, and that for raw jute, by 86 percent in February 1984. To facilitate implementation of the support price scheme, the Government intends to expand the storage capacity of the National Food Corporation (NFC) from the present 54,000 tons to 100,000 tons by end 1984/85. The targeted volume of foodgrain procurement for 1983/84 is 38,000 tons and, in addition, 10,000 tons is to be procured under the food security (buffer stock) program under which stocks are to be increased to 20,000 tons by the end of 1984/85. Rice from NFC stocks is sold at uniform, subsidized prices throughout the country. Since this rice is of low quality, the authorities did not believe that the subsidized rice sales were discouraging foodgrain production by depressing producer prices for standard quality rice.

The main thrust of the Government's industrial policy is set forth in the Industrial Enterprises Act and Foreign Investment and Technology Act. The Acts aim at encouraging the development of export-oriented cottage industries, as well as import-substituting industries, mainly through provision of tax incentives and credit facilities. The basic objective has been to develop 30 industries, mainly in the private sector, including textile mills and spinning mills, a cement factory, sugar mills, a dry cell battery plant, dairy products, metal works, carpet making, handicrafts and leather manufactures. To implement these Acts effectively, the authorities intend to strengthen their administrative capacity in general. In particular, adequate coordination between the Ministry of Industry, which is responsible for implementation of industrial policies, and the Ministry of Commerce, which issues import licenses, will be required to ensure adequate supplies of raw materials and intermediate goods. Shortages of inputs are reported to have constrained production in some of the industries concerned.

2. Demand management policies

a. Fiscal policy

Following the deterioration in demand management policies in the previous two years, which was particularly serious in 1982/83, the Government's revised budget for 1983/84 reflected a strong commitment to the pursuit of economic stabilization as the foundation for sustainable growth. With respect to revenue, the strong increase in 1983/84 (Table 2 and Chart 2) reflects buoyant economic activity, but also the impact of new revenue measures and improvements in revenue administration. Revenue measures announced in 1982/83 which came into effect in 1983/84 include increases in income taxes in the higher brackets and increases in automobile registration and user fees. The 1983/84 budget introduced further revenue measures, such as an import license fee ranging from 5 to 25 percent on imports from countries other than India and increases in sales taxes on unfinished goods. The increase in nontax revenue of about 50 percent reflects not only the additional fees and charges, but also a notable increase in operating surpluses of some public enterprises.

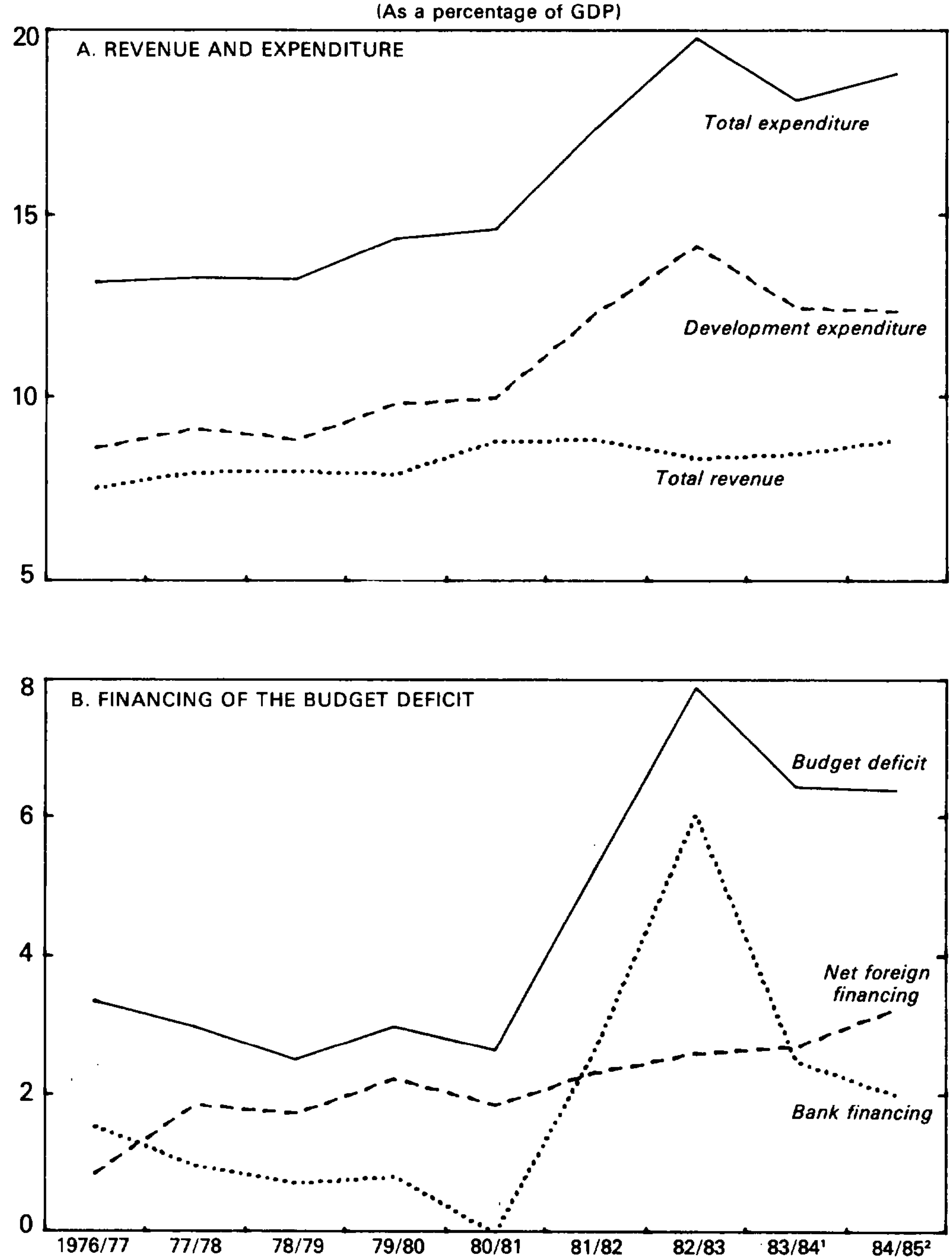
The growth rate of expenditure has been cut sharply this year, with a particularly steep decline in the growth of development expenditure. In part this is due to special one-time, drought-related expenditures in 1982/83 but, in addition reflects the Government's concern about its overall budget deficit. The slower growth of current expenditure in 1983/84 also reflects, inter alia, the Government's decision not to grant a wage increase to civil servants this year. Budgeted development expenditure was reduced by almost 20 percent in the revised budget, many

CHART 2

NEPAL

GOVERMENT BUDGET, 1976/77-1984/85

(As a percentage of GDP)



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

[1]Staff estimates.

[2]Staff projections.

nonaid financed projects being eliminated, or cut back sharply. Another important factor in the reduction, however, is the continuing problem with the implementation of large, multi-donor projects, which have been particularly difficult to coordinate and monitor. Currently, there is no project monitoring system to enable the authorities to revise projected development expenditure effectively. The authorities are intensifying efforts to improve the implementation of project commitments, including early preparation of implementation schedules (program budgeting) to cover the whole life of projects. In addition, a lack of domestic counterpart funds has delayed project implementation to some extent. While an increased effort is being made to ensure a sufficient flow of these funds, the situation tends to reflect the constraints on domestic budget resources.

With respect to domestic financing of the budget deficit in 1983/84, the revised budget estimate is NRs 1.14 billion, of which NRs 640 million represents borrowing from the banking system and NRs 500 million, sales of national savings certificates to the public. Following their initial issue in December 1983, sales of this instrument amounted to NRs 220 million through March 1984, and it is expected that the annual target will be met. Data on the financing from the banking system for the first half of the fiscal year (i.e., through January 15, 1984) showed that such borrowing was already in excess of NRs 500 million (80 percent of the revised budget estimate for the whole year). The staff team expressed concern about the rate of expansion of such credit and the implications for domestic prices and the balance of payments, were it to continue. The authorities indicated that the level of banking system financing largely reflected the seasonality of domestic revenue and the fact that the Government had provided resources to some aid-financed projects for which it would be reimbursed later in the year. The authorities said they would monitor developments closely in the remainder of the fiscal year and were prepared to implement further expenditure cuts should the trend in bank financing continue. Data for an additional two months indicate that the rate of increase in Government recourse to the banking system slowed somewhat, but bank financing may exceed the revised budget estimate by some NRs 300 million. Given the more rapid increase in money income and the greater demand for liquidity than assumed when the revised budget was formulated, such a level of banking system credit to the Government still would appear to allow sufficient credit to the private sector while attaining macroeconomic objectives.

With respect to 1984/85, the budgetary process was not sufficiently advanced at the time of the consultation discussions to permit a detailed examination of a prospective budget, particularly on the expenditure side. Nevertheless, the discussion with the authorities of their broad policy parameters for fiscal management enabled the staff team to prepare projections of the major fiscal accounts for 1984/85 (Appendix Table II).

The authorities recognize the need to implement a budget in 1984/85 consistent with stabilization objectives. They intend to restrain expenditure to a level which, given the likely availability of foreign assistance and a realistic appraisal of domestic revenue buoyancy, would limit the budget deficit to a level modestly above the 1983/84 estimate. A significant increase in concessionary foreign loan disbursements would limit recourse to domestic financing of the deficit, both in absolute terms and in relation to GDP, to a level below that which the staff team estimates for the current year. Within this total, borrowing from the banking system would decline further to 2 percent of GDP. Such an outcome would be compatible with the broad policy objectives for 1984/85 of a further decline in inflation, approximate balance in the external accounts, and a modest increase in real GDP per capita.

Measures are being implemented or are under consideration which will increase revenue buoyancy in 1984/85. The Government has increased its efforts to collect income tax arrears, a substantial portion of which is owed by public enterprise, which in mid-year amounted to about NRs 250 million. A plan to eliminate income tax arrears by the end of 1984/85 is now largely in place, including assignment of an identification number to all taxpayers. Several new revenue schemes are currently under study. One of these, which may be incorporated in the 1984/85 budget, would induce local governments to raise revenue for commitment for projects (e.g., roads, bridges) in their communities by limiting the Government's contribution (currently 100 percent) to a matching grant basis. Ways in which the agricultural sector can be taxed effectively and various alternative sales and excise tax schemes are also under study. To assist in these efforts, the Government has recently requested technical assistance from the Fund in the tax policy area.

The Government is pressing ahead to finalize, late this year or in early 1984/85, a plan to rationalize the financial planning and pricing policies of public enterprises, under which many of them would be given much greater autonomy in pricing policy. Where the new financial plans of public enterprises indicate losses, these are to be included and clearly identified in the budget. Some public entities, such as the electricity authority and the Nepal Oil Corporation, will not be given such autonomy in pricing. The 56 percent increase in electricity rates last year has improved the financial position of the authority, but a further increase to maintain an adequate rate of return on some major World Bank-financed projects must be effected by November 1984. The Oil Corporation has suffered increasing financial losses, as domestic sales prices of petroleum products have been fixed for four years whereas the local currency cost of petroleum imports has risen significantly. Compensation for the Corporation's past losses is expected to be provided in the 1984/85 budget, and a decision to raise domestic sales prices, which the staff team believes is long overdue, was under active consideration by the Government at the time of the consultation discussions. An estimated increase in prices of about 25 percent would be required for the Corporation to break even. Another part of the strategy to rationalize the operations of public enterprises is to attract private participation in them. For example, 20 percent of the shares of the National Insurance Company were offered for public sale, and a decision is pending on sales of shares in a major cement factory.

b. Monetary policy and conditions

In 1984/85, an expansion of broad money of about 12 percent would appear consistent with the Government's macroeconomic objectives. The velocity of broad money is expected to continue its downward trend in 1984/85 (Chart 3), even after adjusting for the high degree of substitutability between the Government-issued savings certificates and quasi-money deposits of the banking system. The outcome for net domestic assets will again reflect the extent of the accommodation of the public sector, whose domestic credit demands should decline somewhat further in relation to other economic aggregates. The broad budget parameters discussed above imply an increase in credit to the Government of about 17 percent. Reflecting the efforts to rationalize the financial planning and pricing policies of public enterprises, bank credit to the rest of the public sector would be expected to expand modestly again in 1984/85. Within this framework, there would be scope for expanding bank credit to the private sector by about 10 percent, an increase in real terms broadly consistent with expected private economic activity.

At the time of the consultation discussions, data on commercial bank accounts through the mid-point in the fiscal year (January 1984) indicated a high degree of liquidity in the system. The decline in import margin deposits and sales of savings certificates outside the banking system would be expected to absorb some of the excess liquidity and, in any case, a sharp increase in private credit demand was not expected. The Nepalese authorities noted that monetary instruments available to the Nepal Rastra Bank--e.g., reserve requirements, interest rates and possible credit ceilings--were sufficient and would be used without hesitation if the pace of credit expansion were to expand at a rate significantly above their program targets.

Interest rates were being kept unchanged in 1983/84, which, given the decline in the rate of inflation, now offer significantly positive yields in real terms. The interest rates on shorter-term bank deposits (up to 90 days) and on Treasury bills (4.5 percent), however, are low in relation to longer-term rates, and are negative in real terms. An increase in the yield on Treasury bills could make them attractive to nonbank investors and would permit an increase in rates on short-term bank deposits as well. Given the large gap between short-term deposit rates and commercial lending rates (15-17 percent), such action need not raise lending rates. Progress toward developing a securities market would be enhanced if, in addition to the longer-term development bonds and savings certificates, shorter-term Treasury instruments with adequate yields were also available. Moreover, development of a nonbank market for Treasury bills would add flexibility to treasury cash management and to monetary policy.

With respect to credit allocation, the authorities indicated that the Intensive Banking Program is to be expanded further in the bank branch network, but this will require further upgrading of commercial bank administration and extensive training of their staff. The program has been successful in terms of the loan recovery rate, but credit extension to priority sectors has, as noted above, considerably lagged behind target levels. The authorities are hopeful that the decision to allow the ADBN to compete over time with the commercial banks in capturing deposits in urban areas will facilitate a greater flow of credit to the rural sectors. They also believe that the efficiency of the banking system will improve from exposure to foreign bank competition. In this regard, a license for one joint venture bank has already been granted--operations are expected to commence shortly--and another application is under review. The authorities recently have requested technical assistance from the Fund in the area of resource mobilization through financial institutions.

3. External policies

a. Trade policy

During the course of 1983/84, the authorities undertook a number of measures, with a view to limiting imports and promoting exports, particularly to third countries. On the import side, the fee on licenses for imports from third countries, which was partially a revenue measure, has already been mentioned. Margin deposits on import letters of credit were raised from 30 percent to 100 percent for a range of commercial imports considered nonessential, including consumer durables and luxury goods. For most industrial imports, i.e., raw materials and production-related intermediate or capital goods, margin deposits were unchanged at 30 percent. Further, there was a significant tightening in import licensing policy, particularly in respect of imports from third countries. In addition, import licenses were also required for the importation of industrial development and construction materials and consumer essentials, and the period for which import licenses are valid was reduced from 6 months to 3 months. While NRs 4 billion of licenses (for aid and non-aid imports) were issued in 1982/83, it was estimated that this would be reduced to about NRs 3 billion in 1983/84.

In the absence of more detailed information on the application of the import policy, it is not certain that a continuation of the policy as applied in the second half of 1983/84 would be consistent with the growth and inflation objectives for 1984/85. The authorities indicated that they were monitoring the situation carefully and that an adequate level of essential imports would be approved. The staff team thus projected non-aid imports for 1984/85 on estimated relationships between imports and domestic demand, assuming that the authorities would administer import policy in a manner consistent with growth objectives.

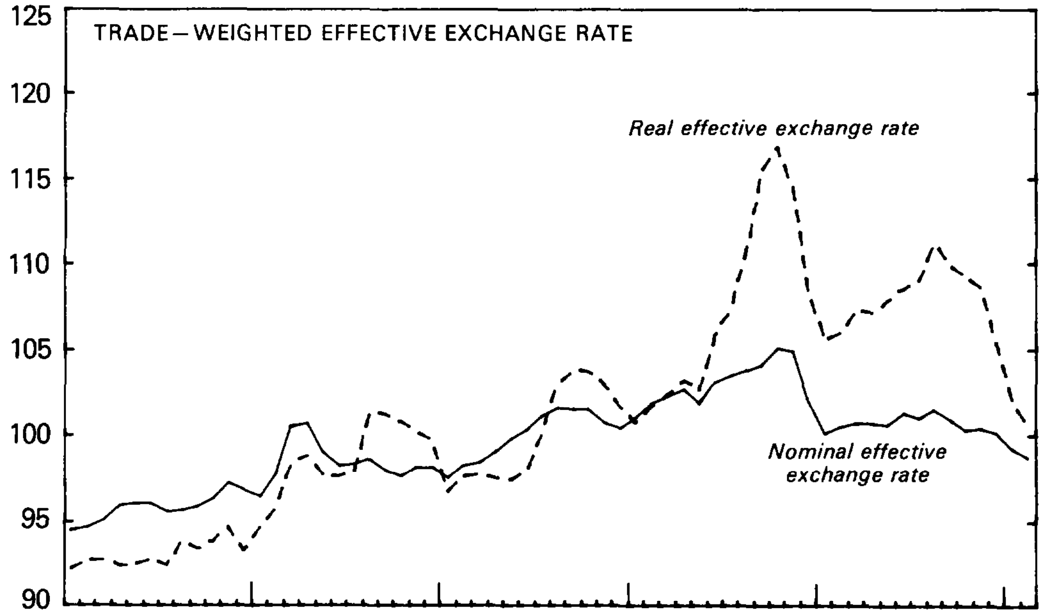
A package of export promotion measures was introduced in November 1983 which, inter alia, included a cash payment for exports to third

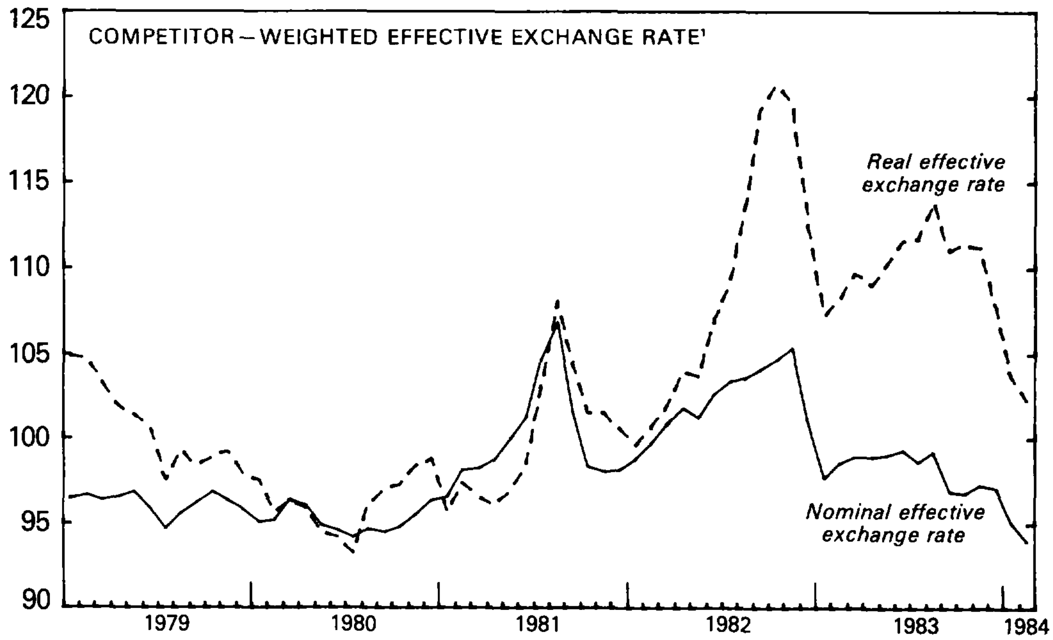
CHART 4

NEPAL

EFFECTIVE EXCHANGE RATE INDICES, 1979-84

(1981=100)





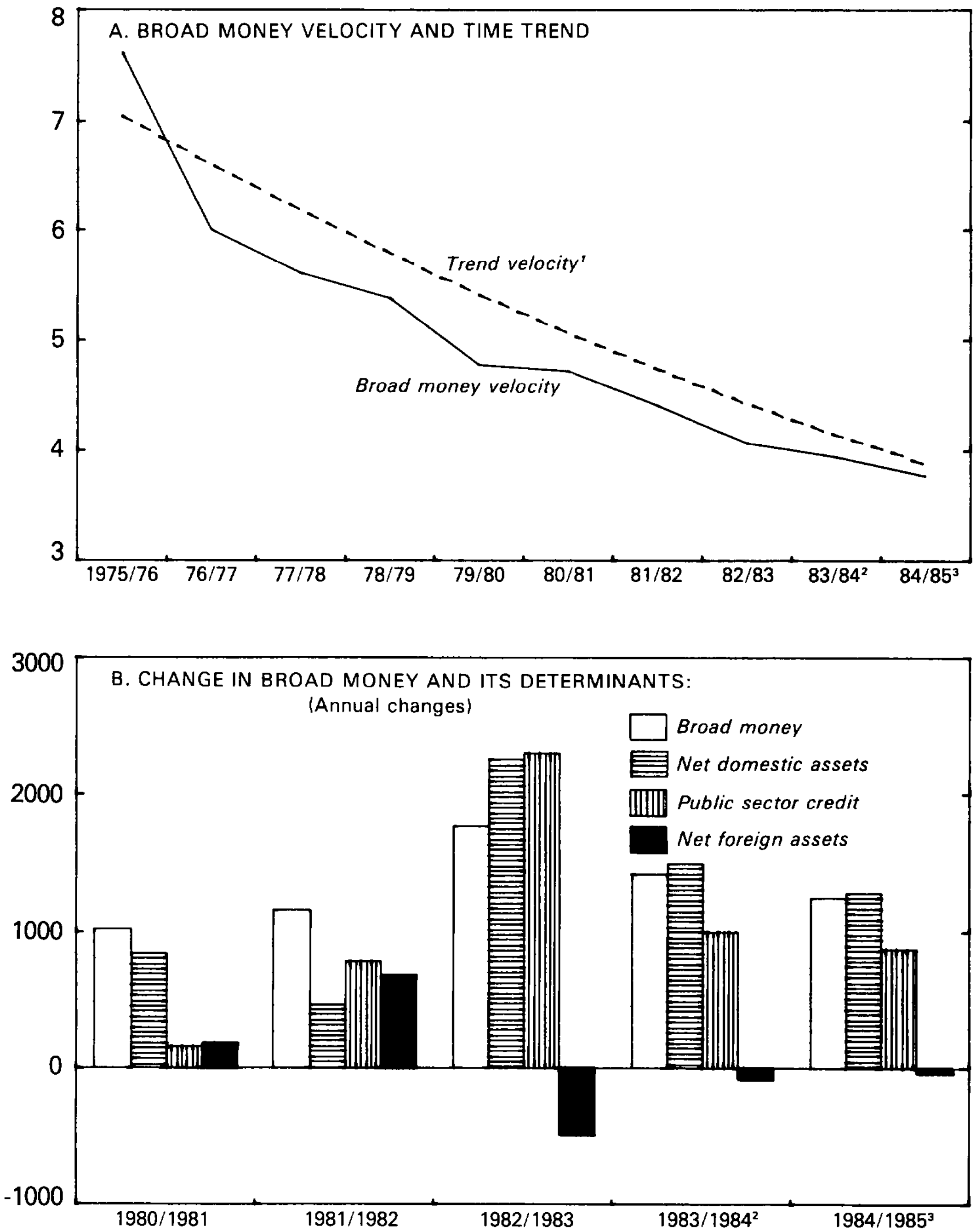
Source: Data provided by the Nepalese authorities; and staff estimates.

[1]Competitor-weights are based on total exports of Nepal's major competitor countries.

CHART 3

NEPAL

MONETARY DEVELOPMENTS, 1975/76-1984/85



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

[1] Velocity = $12.6513 - 0.671423T + 0.011028T^2$; sample period: 1966/67 - 1982/83.

[2] Staff estimates.

[3] Staff projections.

countries equivalent to 10 percent of f.o.b. value. The 10 percent cash incentive for third country exports, which was designed to cover transport costs to Calcutta, was to be in effect through the end of fiscal year 1983/84 (i.e., through July 15, 1984). The measure as introduced gave rise to a multiple currency practice because of a direct link between the subsidy payment and foreign exchange surrender.

The cash incentive for third country exports was in part an attempt, within an otherwise unitary exchange rate framework, to offset the comparative disadvantage to Nepalese exports to third countries arising from high transportation costs to a port of exit. Moreover, an asymmetry in reserves management arises from the fact that deficits with third countries are settled in convertible currencies, whereas surpluses with India are settled in nonconvertible Indian rupees. Thus, despite a competitive advantage in trade with India vis-a-vis that with third countries, the Nepalese authorities do not want to create an imbalance in the structure of their foreign reserve holdings. While these considerations are understandable, it is important that sufficient policy attention be paid to global balance of payments management and, in particular, to the need for the overall financial incentive to export to be consistent with the objective of strengthening the balance of payments over the medium term.

b. Exchange rate policy

Although the various indicators of competitiveness show only a modest deterioration in recent years (Chart 4), there are other factors bearing on exchange rate policy. Exports have been relatively stagnant for some years, while non-aid imports have grown steadily, and by well above the economy's growth rate. In reflection of these trends, none of the reserve loss sustained last year was being recouped in 1983/84, in spite of favorable supply conditions and a tightening of import procedures. Unless there is sustained improvement in export performance, the balance of payments would weaken further over the medium term, with a potentially significant strain on international reserves. In these circumstances, the staff team suggested that a more active exchange rate policy would be appropriate in conjunction with rigorous implementation of supply policies and greater progress in resource mobilization.

The Nepalese authorities did not concur with the staff team's view on exchange rate policy for several reasons: (a) Due to the openness of the economy, prices in Nepal would rapidly move up in line with the depreciation of the exchange rate. Moreover, since wage rates and costs of nontradable inputs would also rise rapidly and broadly in line with tradable goods prices, financial incentives to producers would increase for only a brief period following any exchange rate action; (b) On the export side, producers are already producing all they can and exporting any available exportable surplus; and (c) With respect to imports, due to the high proportion in imports of price-inelastic raw materials and essential inputs, a depreciation would not have a significant impact on the volume of total imports--only a few luxury imports would be curtailed. In short, depreciation of the rate would lead to an increase in domestic prices without benefitting the external accounts. The appropriate policy stance, in the authorities' view, was continued improvements in agricultural infrastructure and input availabilities, with fiscal actions as necessary to provide additional export incentives.

As against the foregoing, there is evidence of differential domestic price developments between Nepal and India for various periods and, in fact, only agricultural labor in the border areas appears to be highly mobile. With containment of public sector wages, which set the trend, and appropriately restrained demand management policies, a wedge could be driven between the price of tradable and nontradable goods, so that a depreciation of the rate would improve the profitability of exports. Although there are serious supply constraints, particularly in agriculture, there would appear to be scope for a supply response, although initially it would be very small. The fact that a significant portion of existing irrigation facilities are not fully utilized, for example, suggests that even at present agricultural production methods could be more intensive. The balance of payments is not currently under strain nor, assuming implementation of the financial policies described above, would it be expected to come under pressure in 1984/85. The argument for implementing a more active exchange rate management policy now, rather than waiting until international reserves come under pressure, is based on Nepal's medium-term prospects and the likely pace of the supply response. It is, therefore, predicated on developmental rather than on short-term liquidity grounds.

V. Staff Appraisal

Efforts to meet basic social needs in Nepal are circumscribed by rapid population growth and low income. Nevertheless, significant achievements have been made in building social infastructure under a series of development plans implemented since the 1950s. Progress also has been made in building economic infastructure, particularly in transportation and communications. In part because of the structure of past public investment, the expansion of output has been slow, and has barely kept pace with population growth. In particular, gains in agricultural productivity have been limited and production of foodgrains has lagged behind population growth. The declining exportable surplus in agriculture, in the face of steadily increasing import requirements for consumption and intermediate use, has structurally weakened the balance of payments.

Under the current (1980/81-1984/85) development plan, which has received strong and widespread support from the international community, development expenditure has been increased sharply and a much greater proportion devoted to more directly productive facilities in agriculture and small industry, and to hydroelectric power. Nevertheless, foreign aid utilization has tended to lag behind expenditure increases and--with slow progress in domestic resource mobilization--budgetary recourse to the banking system has been magnified, at times creating pressure on the balance of payments and on domestic prices. Economic and financial management has been seriously complicated also by the economy's critical dependence on favorable monsoons. In years of drought, most recently in 1982/83, the balance of payments has deteriorated significantly and inflation has accelerated as a result of supply deficiencies exacerbated by a weakening of budgetary management.

In 1983/84, the economy has rebounded strongly from the sharp, drought-induced decline last year. The improved supply situation, particularly in agriculture, accompanied by a significant strengthening of demand management and public wage policies, has led to a notable moderation of inflation and easing of balance of payments pressures. The reduction in government borrowing from the banking system in 1983/84 reflects in part the revenue effects of the economic recovery, but also is indicative of ongoing efforts to rationalize tax administration and of special measures taken during the course of the year: increases in administered prices to reduce subsidies; deferment of salary increases for government workers; suspension of many lower priority, non-aid financed projects; introduction of government savings certificates with attractive yields for sale outside the banking system. In the staff's view, this package of measures was a timely and appropriate response to the serious deterioration in financial conditions which had emerged in the preceding year.

If these short-term gains are to be consolidated and sustained progress is to be made toward strengthening the economy and the balance of payments over the medium-term, it is important that fiscal and monetary developments be monitored closely in the remainder of this fiscal year and that financial policies for next year be appropriately restrained. The authorities share this view and intend to pursue a policy of expenditure restraint in the 1984/85 budget and to implement further measures to enhance resource mobilization. The scale of the domestic financing of the budget deficit, in particular financing from the banking system, is a key policy variable. If domestic financing is limited to no more than 3 percent of GDP, public sector wage increases are limited, and pricing policies of public corporations are rationalized as presently contemplated, prospects are favorable for reducing inflation further and achieving approximate balance in the external accounts in 1984/85, with a growth rate of 3-4 percent.

The authorities and the staff agree that, if the development program is to be pursued successfully, revenue mobilization efforts will have to be intensified. In this regard, several policy initiatives are under way or under consideration and the staff encourages their timely implementation; these include: efforts to reduce tax arrears and to collect government loans to public corporations on a current basis; plans to rationalize the financial planning of public corporations and to give many of them greater autonomy in pricing policies; increases in administered prices of public utilities to maintain an adequate return and of petroleum products to eliminate losses on domestic sales; requiring local governments to raise revenue directly for commitment to development projects in the locality in order to receive government grants on a matching basis. However, there is a general and pressing need to expand the revenue base in Nepal, and the staff would urge the authorities to vigorously pursue efforts to this end.

With respect to private resource mobilization, the authorities appropriately have maintained interest rates while inflation has been declining. Rates on longer-term government obligations are now adequate to attract private financial savings. In the short run, sales of such instruments to partially finance the budget deficit substitute to a large extent for time deposits with the banking system, and the authorities should take this factor into account in formulating their financial plan. The interest rates on Treasury bills is low in relation to longer-term rates, and insufficient for this instrument to be attractive to non-bank private investors. Progress toward the goal of widening and deepening the securities market would be enhanced were the range of maturities available with adequate yields to be broadened. Moreover, treasury cash management would be eased and monetary policy made more flexible if a genuine market for Treasury bills were developed.

The commercial banking system has been very liquid, although the monetary authorities have adequate policy instruments and are prepared to use them should private sector credit demand pick up rapidly. In the staff's view, the interest rate and budgetary policies described above should keep the credit and liquidity situation broadly in line with the macroeconomic policy objectives for 1984/85--a modest increase in per capita output, a further slowing of inflation, and maintenance of international reserves. The efficiency of the banking system should benefit from the new competition from foreign banks, as well as from the decision to permit the Agricultural Development Bank to compete for deposits. The latter initiative could improve the allocation of credit to priority uses in the agricultural sector, while avoiding many of the pitfalls inherent in administrative credit allocation schemes.

In the medium-term, attainment of development goals and greater balance of payments sustainability requires further progress in raising productivity in the traded goods sector, notably in agriculture from which most exports derive. Export earnings, together with net receipts from services and private remittances, have to grow in line with non-aid imports if reserves are to be maintained. External borrowing on commercial terms to fill a gap would not be a viable option, given Nepal's limited debt servicing capacity. While in most of the past several years there has been a surplus of exchange receipts, none of the significant reserve loss of 1982/83 is being recouped this year, in spite of favorable supply conditions, and at best only approximate balance in the external accounts is expected next year. Moreover, continuation of the past trend of sluggish exports and sustained increases in nonaid imports seems likely to create growing imbalance and reserve pressure after 1984/85.

The staff therefore believes that, in conjunction with continued rigorous implementation of policies to reduce supply constraints, exchange rate policy should be used more actively to provide appropriate financial incentives to the traded goods sector. The authorities are not persuaded that this would be the correct policy course because they believe that devaluation would simply yield a proportional increase in domestic prices and costs due to the openness of the economy and to existing supply constraints in agriculture. The staff believes that an active exchange rate management, accompanied by appropriate demand management policies, would improve export incentives, but agrees that the supply response would be slow. These considerations suggest the appropriateness of adopting a more flexible policy now, complementary to supply oriented policies, rather than waiting until the balance of payments comes under strain.

Over the last few years, Nepal's exchange system has been considerably rationalized. Presently, Nepal does not maintain any restrictions on payments and transfers for current international transactions that require approval by the Fund under Article VIII. The cash incentive scheme for export promotion, which has been in effect since November 1983, gives rise to a multiple currency practice subject to approval under Article VIII, Section 3. The scheme contains a discriminatory feature in that it discriminates among Fund members. In accordance with the policy set forth in Decision No. 6790-(81/43) of March 20, 1981, the Fund does not grant approval to such practices. Nepal maintains restrictions on payments and transfers under Article XIV (as described in Nepal: Recent Economic Developments, to be issued shortly), mainly in the form of administrative allocations of foreign exchange for most invisible payments. Nepal's trade system has some restrictive features; during 1983/84 import licensing procedures with respect to goods from third countries and to specific commodities were tightened considerably.

In 1983, the Article IV consultation was advanced by four months. At this stage, it is proposed that the next Article IV consultation with Nepal be concluded by November 1985, to put Nepal back on the standard 12-month cycle.

VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with Nepal, in the light of the 1984 Article IV consultation with Nepal conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Nepal maintains a multiple currency practice as described in SM/84/117 and SM/84/ . The Fund encourages Nepal to eliminate the multiple currency practice as soon as possible.

Table I. Nepal: Output and Prices, 1976/77-1984/85

	1976/77-1980/81 Annual Average	1981/82	1982/83	1983/84	1984/85
	(In percentage change over the previous year)				
Real GDP	3.1	3.8	-1.4	9.1	3.5
Agriculture	0.8	3.5	-2.5	11.8	3.0
Of which:					
Foodgrains 1/	-0.4	4.0	-12.9	22.1	...
(Rice) 2/	(-1.1)	(3.9)	(-28.4)	(49.7)	(...)
Nonagriculture	7.3	4.2	0.4	5.2	4.5
Consumption	2.8	3.8	1.7	5.9	...
Investment	11.1	8.4	14.6	6.8	...
Total domestic demand	3.8	4.5	1.9	6.0	...
Consumer prices					
Nepal 3/	8.0	10.4	14.2	7.3	5.0
Trading partners	6.9	9.1	7.7	7.0	...
Of which: India	6.5	10.4	9.5	12.0	...
	(As percent of nominal GDP)				
Investment and savings					
Investment	14.5	15.8	16.3	16.0	...
Domestic savings	9.5	8.4	5.4	8.1	...
Foreign savings	5.0	7.4	10.9	7.9	8.7

Sources: Central Bureau of Statistics, Nepal Rastra Bank and staff estimates.

1/ Based on the index of foodgrain production consisting of five major items, including rice, wheat, and maize.

2/ The average share of the rice sector in real GDP has been about 18 percent in the past few years.

3/ Based on the national urban consumer price index.

Table II. Nepal: Government Budget, 1981/82-1984/85

	1981/82	1982/83	1983/84 Staff 1/ Est.	1984/85 Staff Proj.
	(In millions of Nepalese rupees)			
Revenue	2,668	2,798	3,294	3,738
Expenditure	5,246	6,651	7,060 2/	7,976
Regular	1,523	1,899	2,200	2,734
Development	3,723	4,752	4,860	5,242
Foreign grants	993	1,200	1,250	1,523
Overall deficit (-)	-1,585	-2,653	-2,516	-2,715
Foreign financing (net)	700	870	1,050	1,370
Domestic financing (net)	885	1,783	1,466	1,345
Banking system 3/	(799)	(2,028)	(966)	(845)
Nonbank sector	(26)	(74)	(500)	(500)
Discrepancy	(60)	(-319)	(--)	(--)
	(Percentage change from previous year)			
Revenue	11.0	4.9	17.7	13.5
Expenditure	31.5	26.8	6.2	13.0
Regular	20.5	24.7	15.9	24.3
Development	36.6	27.6	2.3	7.9
	(As percent of GDP) 4/			
Revenue	8.8	8.3	8.4	8.8
Expenditure	17.3	19.8	18.1	18.8
Regular	5.0	5.6	5.6	6.5
Development	12.3	14.2	12.4	12.4
Overall deficit	5.2	7.9	6.5	6.4
Foreign financing	2.3	2.6	2.7	3.2
Domestic financing	2.9	5.3	3.8	3.2
Banking system	2.6	6.0	2.5	2.0

Sources: Ministry of Finance, *Budget Speech* (various issues); and official and staff projections.

1/ The staff estimates of revenue, expenditure and the overall deficit are in broad agreement with those of the official revised estimates prepared in the first half of the fiscal year. The staff estimates anticipate less foreign financing and additional domestic financing than the official estimates. In particular, the official estimates restrict bank financing to NRs 640 million.

2/ This figure reflects reductions in domestically financed expenditures proposed by the authorities.

3/ Derived from monetary survey.

4/ Totals may not add exactly due to rounding. In 1983/84 and 1984/85 ratios, estimated GDP is used as a denominator.

Table III. Nepal: Monetary Survey, 1981/82-1984/85

	1981/82	1982/83	1983/84 Staff Est.	1984/85 Staff Proj.
	(Mid-July levels in millions of NRs)			
Net foreign assets	3,097	2,611	2,533	2,500
Domestic credit	6,113	8,532	10,028	11,312
Public sector	2,806	5,103	6,105	6,982
Government 1/	(2,131)	(4,131)	(5,097)	(5,942)
Public enterprises 2/	(675)	(972)	(1,008)	(1,040)
Private sector 3/	3,307	3,429	3,923	4,330
Other items, net	-1,751	-1,921	-1,921	-1,921
Broad money (M2)	7,459	9,222	10,640	11,891
Money (M1)	3,612	4,349	...	...
Quasi-money	3,847	4,873	...	...
	(Percentage change from previous year)			
Domestic credit	16.2	39.6	17.5	12.8
Public sector	38.4	81.9	19.6	14.4
Government	57.0	93.9	23.4	16.6
Public enterprises	1.0	44.0	3.7	3.2
Private sector	2.4	3.7	14.4	10.4
Broad money (M2)	18.2	23.6	15.4	11.8
Money (M1)	12.6	20.4	...	...
Quasi-money	24.1	26.7	...	...
Memorandum items:				
Average broad money (NRs millions) 4/	6,875	8,278	9,931	11,266
Income velocity of money	4.40	4.06	3.93	3.77

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

1/ Includes exchange profit/loss arising from dual exchange rate system which was unified in September 1981 and excludes Treasury IMF account.

2/ Excludes public financial institutions.

3/ Includes public financial institutions and rice export companies.

4/ Average of actual monthly figures until 1982/83; average of end of fiscal year estimates thereafter.

Table IV. Nepal: Summary Balance of Payments, 1981/82-1984/85 1/

	1981/82	1982/83	1983/84 Staff Est.	1984/85 Staff Proj.
		(In millions of SDRs)		
Exports, f.o.b.	101.1	76.0	95.0	103.0
Imports, c.i.f.	-334.3	-414.3	-380.8	-427.0
Trade balance	-233.2	-338.3	-285.8	-324.0
Services, net	93.1	102.2	94.7	104.0
Of which: Tourism receipts	(56.8)	(56.4)	(51.9)	(57.0)
Private transfers, net 2/	35.4	43.1	44.2	49.0
Current account balance	-104.7	-193.0	-146.9	-171.0
Current account excluding aid-financed imports 3/	(28.0)	(-33.5)	(0.2)	(4.0)
Official transfers	78.2	95.0 4/	81.1 5/	93.0
Official capital, net	52.3	59.7	60.9	76.0
Foreign loans	(54.5)	(64.5) 6/	(66.0)	(82.0)
Amortization	(-2.2)	(-4.8)	(-5.1)	(-6.0)
Miscellaneous capital	8.1	-6.8	--	--
Overall balance	33.9	-45.2	-4.9	-2.0
		(As percent of GDP)		
Exports	4.9	3.4	3.9	4.0
Imports	16.3	18.4	15.6	16.5
Current account balance	-5.1	-8.6	-6.0	-6.6
Current account balance excluding aid-financed imports	1.4	-1.5	--	0.2

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

1/ Based on the following conversion rates: NRs 14.8031 per SDR in 1981/82, NRs 14.945 per SDR in 1982/83, NRs 15.992 per SDR in 1983/84, and NRs 16.382 per SDR in 1984/85.

2/ Includes Indian Excise Fund receipts.

3/ Excluding aid-financed imports of goods and services.

4/ Includes food aid grants of SDR 13.8 million.

5/ Includes food aid grants of SDR 2.9 million.

6/ Includes food aid loan from India of SDR 7.3 million.

Nepal - Fund Relations
(As of April 30, 1984)

I. Membership Status

(a) Date of membership:	September 6, 1961
(b) Status:	Article XIV

(A) Financial Relations

II. General Department

(a) Quota:	SDR 37.3 million.
(b) Total Fund holdings of Nepalese rupees:	SDR 39.5 million (105.8 percent of quota).
(c) Fund credit:	SDR 7.9 million (21.1 percent of quota), all under CFF.
(d) Reserve tranche position:	SDR: 5.7 million.
(e) Current operational budget:	Not applicable.
(f) Lending to the Fund:	Not applicable.

III. Current Stand-by or Extended Arrangement and Special Facilities

Not applicable

IV. SDR Department

(a) Net cumulative allocations:	SDR 8.1 million.
(b) Holdings:	SDR 0.5 million or 6.2 percent of net cumulative allocations.
(c) Current Designation Plan:	Not applicable.

V. Administered Accounts

(a) Trust Fund loans:	
(i) Disbursed:	SDR 13.6 million.
(ii) Outstanding:	SDR 12.7 million.
(b) SFF Subsidy Account:	Not applicable.

VI. Overdue obligations to the Fund

Not applicable.

Nepal - Fund Relations (Concluded)

VII. Country has not used Fund resources to date

Not relevant.

(B) Nonfinancial Relations

VIII. Exchange rate management: On June 1, 1983, Nepal introduced an arrangement under which its currency is pegged to a basket of currencies of major trading partners.

IX. Last Article IV consultation: July 11, 1983; Decision No. 7415-(83/101). Staff discussions were held during April 10-22, 1983 (SM/83/129, 6/15/83; and SM/83/145, 6/29/83). The Executive Board adopted the following decision:

"The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1983 Article IV consultation with Nepal, in the light of the 1983 Article IV consultation with Nepal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

The Fund welcomes the termination of the practice of simultaneously maintaining fixed rates vis-a-vis the currencies of two Fund members, a practice that has given rise to broken cross rates in the past."

X. Technical Assistance:

(a) CBD: For four months in 1983, the Fund provided an advisor for cost of living indices.

(b) Fiscal: None.

(c) Other The Bureau of Statistics provided technical assistance on money and banking statistics in March 1982.

XI. Resident Representative/Advisor: The Fund provided staff members as Resident Advisors during 1977-July 1980 and since September 1981.

Nepal: Relations with IDA and IFC

In millions of U.S. dollars

Total lending 1/	IDA	IFC	Total	Of which: Undisbursed
Agriculture	94.6	--	94.6	57.6
Irrigation	94.5	--	94.5	53.8
Education	20.0	--	20.0	14.9
Water supply	46.8	--	46.8	20.7
Industry	13.7	8.7	22.4	14.3
Transportation	19.2	--	19.2	2.5
Telecommunication	21.8	--	21.8	5.3
Power and energy	61.0	--	61.0	17.4
Other	9.0	--	9.0	6.0
Total	380.6	8.7	389.3	192.5

Source: Data provided by the World Bank.

1/ As of March 31, 1984. No IBRD loans have been made to Nepal.

Technical assistance: The World Bank currently provides a staff member as resident representative. It also has been providing technical assistance in industrial finance and policy, rural, and cottage industry development. Under the Bank's new program of nonreimbursable technical assistance, one staff member joined the Ministry of Finance in June 1983 to assist in establishing a Development Project Monitoring and Evaluation System.

Recent economic and sector missions: The last economic mission visited Kathmandu during April-May 1983. In addition, the World Bank sent a mission on development administration in April 1983.

Nepal: Basic Data 1/

Area:	140.797 square
Population (mid-1982/83):	15.8 million
Population growth rate (1978-82):	3.4 percent per annum
GDP per capita (1982/83):	SDR 145

	1980/81	1981/82	1982/83	1983/84	1984/85 Proj.
			(Changes in percent)		
GDP and prices					
Real GDP	8.1	3.8	-1.4	9.1	3.5
Of which: agriculture	10.4	3.5	-2.5	11.8	3.0
Nominal GDP	16.1	10.8	11.1	16.1	8.7
Implicit GDP deflator	7.9	6.8	12.6	6.4	5.0
Consumer prices (annual average)	13.4	10.4	14.2	7.3	5.0
Central government					
Revenue and grants	30.2	11.9	9.2	13.7	15.8
Expenditure	19.2	31.5	26.8	6.2	13.0
Current	(19.8)	(20.5)	(24.7)	(15.9)	(24.3)
Development	(18.9)	(36.6)	(27.6)	(2.3)	(7.9)
Money and credit 2/					
Domestic credit	19.3	16.2	39.6	17.5	12.8
Public sector	8.9	38.4	81.9	19.6	14.4
Government	(-0.1)	(57.0)	(93.9)	(23.4)	(16.6)
Other	(33.3)	(1.0)	(44.0)	(3.7)	(3.2)
Private sector	26.9	2.4	3.7	14.4	10.4
Broad money	19.4	18.2	23.6	15.4	11.8
Income velocity of money (absolute number)	4.71	4.40	4.06	3.93	3.77
External sector (in SDRs)					
Exports, f.o.b.	46.8	-6.6	-24.8	25.0	8.4
Imports, c.i.f.	30.7	12.1	23.8	-8.1	12.1
			(In millions of SDRs)		
Balance of payments					
Exports	108.2	101.1	76.0	95.0	103.0
Imports	-298.2	-334.3	-414.3	-380.8	-427.0
Services and transfers, net	106.3	125.8	145.3	138.9	153.0
Current account	-83.7	-107.4	-193.0	-146.9	-171.0
Overall balance	13.0	33.9	-45.2	-4.9	-2.0
External public debt					
Total outstanding (including Fund credit) 2/	194.1	238.8	280.8	338.8	409.3
Debt service (as percent of exports of goods and services and private transfers)	1.8	2.7	5.2	5.7	5.6
Gross international reserves 2/	158.2	202.3	148.4	126.1	124.1
In months of imports	(6.4)	(7.3)	(4.3)	(4.0)	(3.5)
			(In percent)		
Ratios to GDP					
Investment	15.2	15.8	16.3	16.0	...
Domestic saving	8.4	8.4	5.4	8.1	...
Government revenue	8.8	8.8	8.3	8.4	8.8
Government expenditure	14.6	17.3	19.8	18.1	18.8
Government overall deficit	2.6	5.2	7.9	6.5	6.4
Domestic bank financing of government deficit	--	2.6	6.0	2.5	2.0
Broad money 2/	23.1	24.6	27.4	27.3	28.0
Exports	5.9	4.9	3.4	3.9	4.0
Imports	16.3	16.3	18.4	15.6	16.5
Current account deficit	4.2	5.1	8.6	6.0	6.6
External public debt 2/	10.6	11.7	12.5	13.9	15.8

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

1/ Data relate to fiscal years ending mid-July.

2/ End of period.

Nepal - Statistical Issues

1. Coverage, Currentness, and Reporting of Data in IFS

		Latest Date in May 1984 IFS
Real Sector	- National Accounts	F.Y. ended 07-15-82
	- Prices	November 1983
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1982
	- Financing	1982
	- Debt	n.a.
Monetary Accounts	- Central Bank	October 1983
	- Deposit Money Banks	August 1983
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	November 1983
	- Merchandise Trade: Prices	n.a.
	- Balance of Payments	Q1 - 1983
	- International Reserves	n.a.
	- Exchange Rates	n.a.

During the past year, the reporting record of the IFS correspondent has been somewhat irregular as far as submission of report forms, but cabled data have been sent regularly.

2. Outstanding Statistical Issues

Real Sector: There is a need to improve the reporting of the expenditure components of Nepal's national accounts. At present, only data for the total gross domestic product are published in IFS.

Government Finance: Only annual data are published in IFS at present. The presentation would be improved by the publication of monthly or quarterly data.

Monetary Accounts: Data on other financial institutions are in the process of compilation and it is expected that a new section will shortly be included in IFS.