FOR AGENDA

SM/83/129

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June 15, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Nepal - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Nepal. A draft decision appears on page 17. It is proposed to bring this subject to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Saito, ext. 57335.

Att: (1)

Other Distribution:
Department Heads

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INTERNATIONAL MONETARY FUND

NEPAL

Staff Report for the 1983 Article IV Consultation

Prepared by the Asian and Exchange and Trade Relations Departments

(In consultation with the Fiscal Affairs, Legal, Research, and Treasurer's Departments)

Approved by P.R. Narvekar and Donald K. Palmer

June 14, 1983

Contents

Contents

I. Introduction

The 1983 Article IV consultation discussions with Nepal were held in Kathmandu during April 10-22, 1983. Discussions were held with the Minister of Finance, the Governor of the Nepal Rastra Bank (the Central Bank), and officials of the Ministries of Finance, Agriculture, Industry, and Commerce and Supplies, the Planning Commission, and the Nepal Rastra Bank. The staff team consisted of Messrs. Saito (Head), Otani, Baban (all ASD), Ms. Milne (RES), and Miss Singh (secretary, ASD). Mrs. Mitchell, Fund Resident Advisor, participated in the work of the mission. Mr. Panday, Advisor to the Executive Director for Nepal, attended the 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 or any multiple currency practices that require approval by the Fund.

II. Background

1. Selected features of the economy

Nepal is a landlocked country with the Himalayas in the north and the Terai plain in the south. It is faced with severe transportation and communication difficulties and is poorly endowed with natural resources, with the exception of hydroelectric power potential. Nepal's economy is predominantly agricultural, with its output fluctuating widely depending on weather. About 60 per cent of its total international trade is with India and is virtually free of restrictions. Imports from countries other than India are subject to controls.

Nepal's growth performance over the last two decades has been disappointing, with the annual growth of real GDP averaging 2 to 3 per cent, approximately the same as the population growth, and with per capita GDP remaining among the world's lowest at about SDR 150. This sluggish growth is attributable partly to low levels of investment resulting from resource constraints and partly to the need to allocate a large part of available resources to the construction of infrastructure rather than more directly productive facilities. Other factors responsible for the slow growth have included the lack of trained manpower and severe transportation and communication constraints. However, considerable efforts made over the years have alleviated these difficulties in more recent years. A large number of education and public health facilities have been built;1/ basic road and telephone networks linking major economic centers have been established; and hydroelectric

1/ Between 1960 and 1980, improvements in education and public health facilities resulted in: (1) an increase in life expectancy at birth from 37 to 44 years; and (2) an increase in the number of children enrolled in primary schools from 10 per cent of the relevant age group to 90 per cent; and (3) an increase in the adult literacy rate from 9 per cent to 24 per cent (IBRD, World Development Report, various issues).

power facilities have been expanded significantly, especially in the last few years (Table 1).

Table 1. Nepal: Indicators of Long-term Economic Development, 1960/61-1982/83 1/

	1960/61	1970/71	1980/81	1982/83
Highways (1,000 km)	1	3	5	...
Electric generating capacity (1,000 kwh)	6	...	89	164
Irrigated area (1,000 hectares)	100	125	200	220

	1960/61-1968-69	1970/71-1978/79	1980/81-1982/83
	(Average annual growth in per cent)		
Population	2	2-3	2-3
Real GDP	2	2-3	3
(Investment as per cent of GDP)	(4)	(7)	(16)
(Incremental capital output ratio)	(2)	(4)	(5)
Real exports	...	4	-13
Real imports	...	6	8

Sources: IBRD, World Development Report, various issues; and Fund staff estimates.

1/ Fiscal year ending mid-July.

Nepal's balance of payments has been characterized by large trade deficits and, usually, even larger net receipts from service, transfer, and capital transactions. On the one hand, secular export growth has been slow, largely reflecting the above-mentioned low output growth and weak investment in productive sectors, especially rice and jute (Nepal's two major traditional exports). A steady increase in domestic demand has also reduced exportable surpluses in the case of rice and other food exports; deforestation and related erosion problems stemming from heavy use of wood as fuel have resulted in lower log exports.

Furthermore, exports have fluctuated widely reflecting the vulnerability of output to weather. In contrast, import growth has been relatively rapid and steady, reflecting increasingly larger capital goods imports. Consequently, the export/import ratio has declined from about 60 per cent in the early 1970s to about 20 per cent in the early 1980s. On the other hand, net receipts from services (largely tourism) and private transfers (mainly salaries and pensions of Ghurka soldiers), as well as net inflows of official grants and concessional loans, have risen strongly. As a result, the current account deficit (excluding official transfers) has remained substantially below the trade deficit, and the overall balance of payments has been in surplus in most years.

Nepal's prices (measured by consumer price indices) have traditionally been strongly influenced by India's through the extensive trading between the two countries. Such influences have been felt with a short time lag in the Terai plain along the Indian border, and with longer time lags in other parts of the country, including the Kathmandu valley. However, Nepal's prices have recently been deviating substantially from India's; with the expansion of the Government sector, prices now appear to be affected more by the authorities' financial policies, especially development expenditures (Chart 1).

Since 1980/81, the authorities have been implementing the Sixth Plan (1980/81-1984/85), which calls for sharply increased investment, with an emphasis on the expansion of more directly productive facilities. Accordingly, the Government's development expenditures have been stepped up, contributing to a somewhat faster growth of real GDP in 1980/81 and 1981/82. However, domestic resource mobilization and foreign aid utilization have lagged, raising the Government's borrowing from the domestic banking system. The resultant faster increase in total credit and liquidity have generated considerable pressures on prices and the balance of payments.

2. Developments in 1982/83

The fiscal year 1982/83 has been characterized by an economic deterioration resulting mainly from a severe drought at the beginning of the year. According to preliminary estimates, output has stagnated, inflation has worsened, and the external position has weakened.

Real GDP is estimated to remain broadly unchanged in 1982/83, as a sharp decline in agricultural output has been broadly offset by growth in the rest of the economy. Rice and other summer crops declined substantially because of the drought, and this decline has been only partly compensated for by relatively favorable wheat and other winter crops. Nonagricultural output has continued to rise at about 4 per cent per annum, as the supply of electricity increased significantly with the completion of a major power project at Kulekhani and the supply of construction materials continued to be satisfactory. On the expenditure side, consumption has continued to rise faster than GDP, since the adverse income effects of the drought have apparently been outweighed by the effects of wage and salary increases. Investment has also risen faster than GDP, despite cutbacks in the Government's development program during the course of the year. As a result, total domestic demand has continued to rise faster than output, and the external current account deficit has increased further (Table 2).

Table 2. Nepal: Indicators of Output and Prices, 1980/81-1983/84

	1980/81	1981/82	1982/83 Estimates	1983/84 Projections
		(Percentage change)		
Real GDP	6	4	--	6
Of which: Agriculture	(10)	(4)	(-3)	(7)
		(Per cent of GDP)		
Total domestic demand	106	108	110	108
Consumption	(92)	(93)	(94)	(92)
Investment	(14)	(16)	(16)	(16)
		(Percentage change)		
Inflation (consumer prices)				
Nepal	13	10	13	10
Trading partners	11	9	6	5
(India)	(12)	(11)	(8)	(7)

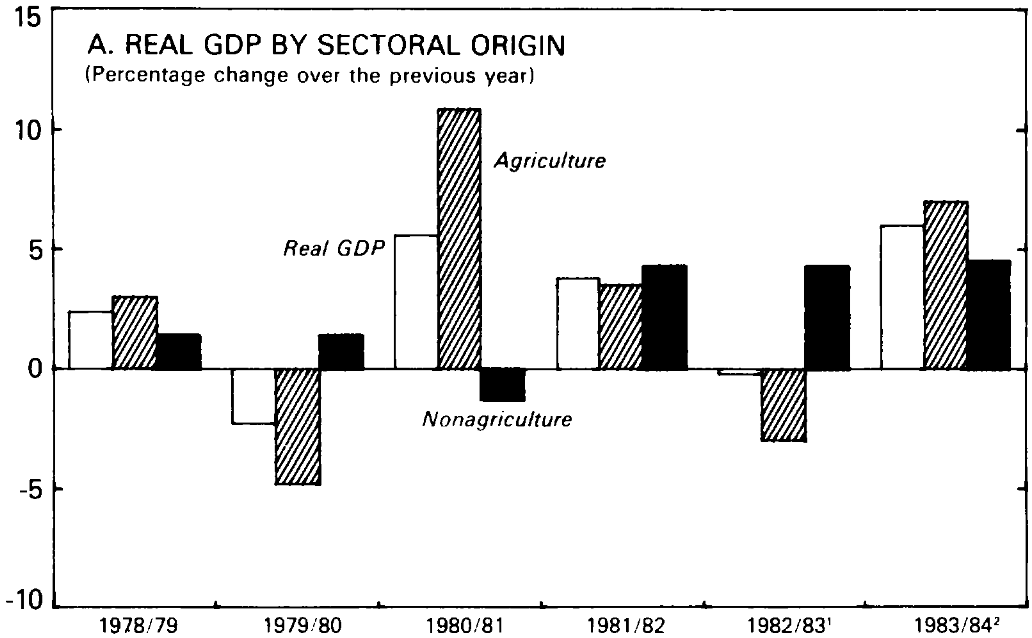
Source: Appendix Table I.

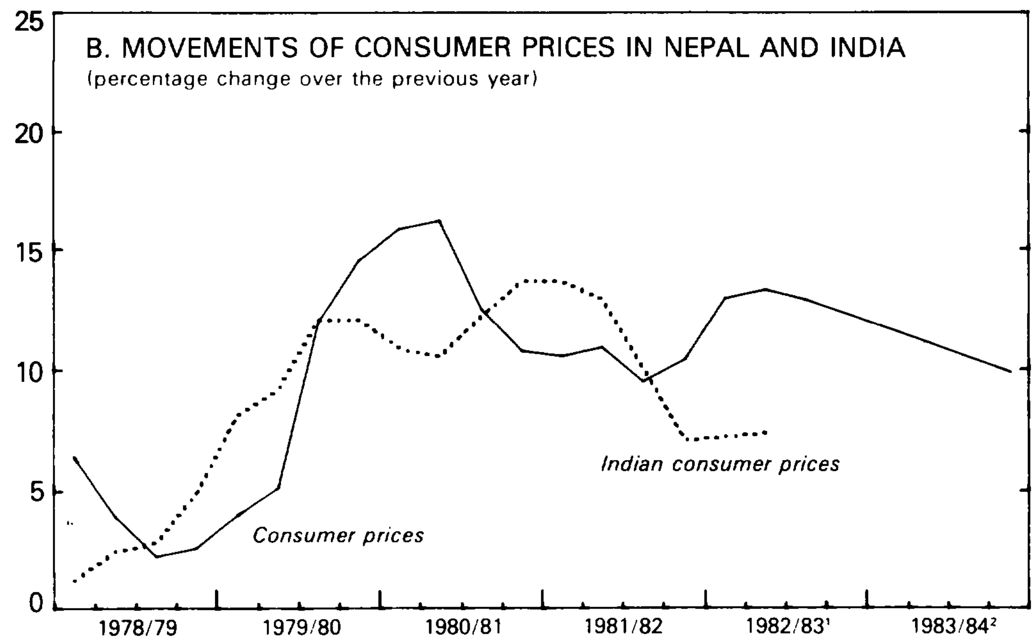
Inflation accelerated from an annual rate of about 10 per cent to 15 per cent in the first half of 1982/83, partly as a result of the drought-induced decline in food supply. The acceleration also reflected increased demand resulting from a sharp rise in government expenditures accompanied by a continued rapid credit and liquidity expansion. Large increases in wages and salaries implemented in both the public and private sectors in October 1982 also exerted considerable pressure on prices. In the second half of 1982/83, inflation has declined only slightly to about 13 per cent, despite a substantial slowing of inflation in India and other trading partner countries. The food situation has improved with the arrival of relatively favorable winter crops and

CHART 1

NEPAL

OUTPUT AND PRICES





Source: Data provided by the Nepalese authorities

[1]Preliminary estimates

[2]Projections.

food imports, but strong demand pressures remain. Also, a number of important administered prices (e.g., electricity rates and the Government's sales prices of rice) have been raised.

The deterioration in the balance of payments during 1982/83 has occurred largely on account of trade transactions. Exports have declined by 39 per cent, mainly reflecting a drought-induced drop in rice and other agricultural exports. In contrast, import growth has accelerated to 18 per cent, mainly because food imports have risen to alleviate the domestic shortage and large imports of capital goods have continued in connection with the development program. As a result, the trade deficit has risen to about 14 per cent of GDP from 11 per cent in the previous year. Although the traditionally large surplus on services and private transfers has continued to rise, the current account deficit (excluding official transfers) has risen to 9 per cent of GDP from 5 per cent in the previous year. Despite a continued large increase in receipts from official transfers and aid loans, the overall balance has swung to a deficit of SDR 33 million from its usual surplus position (Table 3 and Chart 2).

Table 3. Nepal: Balance of Payments Indicators
1980/81-1983/84

	1980/81	1981/82	1982/83 Estimate	1983/84 Projection
		(Percentage change)		
Exports 1/	47	-7	-39	34
Imports 1/	31	12	18	-5
		(Per cent of GDP)		
Merchandise trade deficit	10	11	14	11
Current account deficit (excluding official transfers)	4	5	9	6
		(Months of imports at end of period)		
International reserves	7	8	5	5
(Of which convertible currency)	5	5	3	3

Sources: Appendix Table II.

1/ Based on SDR values.

Between mid-July 1982 and mid-April 1983, official international reserves declined by about SDR 44 million to SDR 167 million. At mid-April, reserves were equivalent to about five months of imports (compared with about eight months at mid-July 1982); convertible currency reserves (i.e., excluding Indian rupees) were equivalent to three months of imports.

III. Prospects for 1983/84 and Beyond

Prospects for 1983/84 are guardedly hopeful. Real GDP is expected to increase by 6 per cent, largely on the strength of a projected recovery in agricultural output. Nonagricultural output is likely to increase at a rate of about 4 per cent, the same as in the previous two years. Inflation is expected to decline to 10 per cent in 1983/84, owing mainly to improvements in food supply in the second half of the year.

The external position is also likely to improve. The projected recovery in rice and other agricultural output is expected to raise exportable supplies and to ease the need for foodgrain imports. The latter factor, combined with the projected slower increase in import prices and the demand restraint measures described in the following section, should reduce import payments below this year's level. The resultant reduction in the trade deficit is expected to be partly offset by lower net receipts from services and transfers. Nevertheless, the current account deficit is expected to decline to 6 per cent of GDP from 9 per cent in the current year. With the continued large net inflows of grants and concessionary loans, the overall deficit is projected to be more than halved to SDR 12 million in 1983/84.

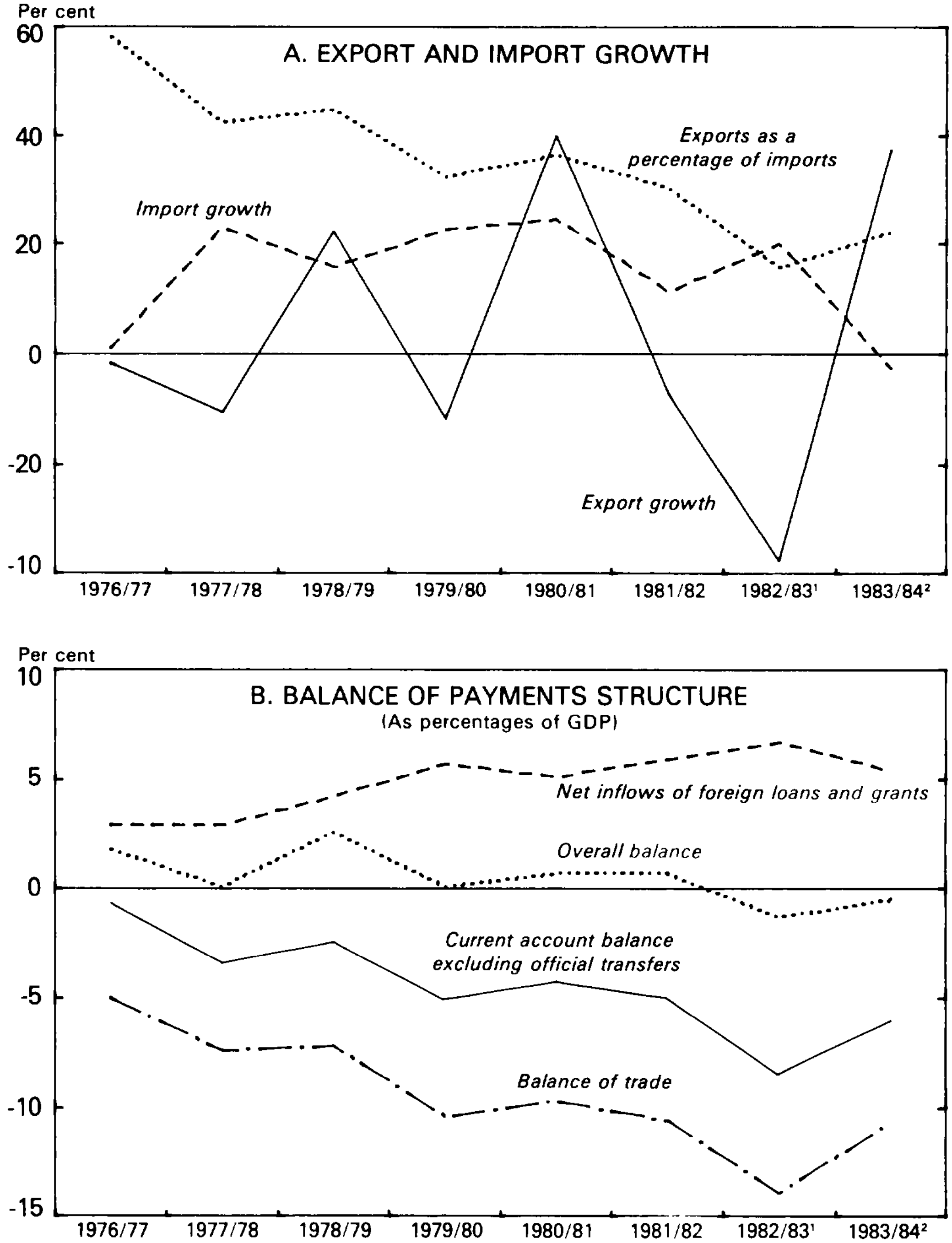
Prospects for the medium term are mixed. On the one hand, the rate of growth of real GDP is estimated to rise slightly to about 3 per cent per annum. Although agriculture will remain highly vulnerable to weather, the growth of its output is projected to accelerate slightly, assuming a further expansion of double cropping that has recently been introduced in many irrigated areas with greater fertilizer application. Nonagricultural growth is projected to continue at the recently accelerated rate of about 4 per cent on the basis of ongoing and prospective investments in productive facilities.

On the other hand, the external current account deficit is projected to rise further but moderately. Export growth is likely to remain below GDP growth, and to be outstripped by import growth, which is expected to remain high to meet the requirements of economic development. Tourist and other net service and transfer receipts will rise, but not sufficiently to cover the increased trade deficit. However, the increased current account deficit is expected to be more than offset by the inflows of official grants and aid-loans, which are estimated to rise by 14 per cent a year, slightly faster than the average annual increase in the last few years. Outstanding undisbursed aid funds are

CHART 2

NEPAL

BALANCE OF PAYMENTS



Source: Nepal Rastra Bank.
[1]Preliminary estimates
[2]Projections.

presently about five times the amount utilized during 1982/83. Recourse to commercial borrowing is likely to be kept to small amounts as in the past.1/

Largely reflecting the authorities' cautious policies on external borrowing, Nepal's outstanding external indebtedness (including Fund credit) has been kept at about 12 per cent of GDP, and its debt service payments, at about 7 per cent of exports of goods and services. Over the medium term, the former ratio is projected to rise moderately while the latter is expected to decline slightly, on the basis of the growth and balance of payments scenarios presented above (Appendix Table V).

IV. Policy Adjustments

The present economic situation and the immediate and medium-term prospects described above call for policies aimed at economic stabilization in the short term and strengthening of the economy and the balance of payments in the medium term. The authorities have been adjusting policies toward these goals.

1. Supply policies

The most urgent policy task for the authorities during 1982/83 has been to avert a serious food shortage problem. Thus, soon after it became clear that rice and other summer crops would decline sharply because of the drought, the authorities introduced measures designed to increase wheat and other winter crops. These measures, which included the distribution of more fertilizer, were implemented successfully and helped raise wheat output by 17 per cent. The authorities were also successful in arranging for timely foodgrain imports--some 100,000 tons (about 4 per cent of the estimated foodgrain requirement) with foreign assistance, and about 10,000 tons on commercial terms.

The developments in 1982/83 once again underlined the importance of intensifying efforts to raise foodgrain and other agricultural output so as to meet the demand of the growing population and to raise exports. These efforts have focused on the expansion of the irrigation system, the provision of more agricultural inputs, and the expansion of various extension services, especially to encourage double cropping. The authorities have also begun expanding storage facilities in order to facilitate food distribution and planning for the establishment of an official foodgrain buffer stock.

The authorities announced a new industrial policy in 1981, which was followed by the promulgation of the Industrial Enterprises Act and

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1/ Such borrowing has been limited almost exclusively to revolving credits obtained to finance part of oil imports, which amounted to SDR 39 million, or 10 per cent of total imports in 1982/83.

the Foreign Investment and Technology Act in 1982. This policy aims at encouraging the development of export-oriented cottage industries as well as import-substituting industries, mainly by providing incentives through exemptions from income taxes, sales taxes, and import duties. The formulation of the rules and regulations needed to implement these measures has been delayed but is expected to be completed in 1983/84. Import-substituting enterprises which are expected to benefit from the new policy will include textile mills, spinning mills, a cement factory, sugar mills, other food processing plants, and a dry-cell battery plant; export-oriented cottage industries which could benefit include carpet, handicrafts, and leather manufactures.

2. Fiscal policy

a. Fiscal policy in 1982/83

Over the period in 1980/81 and 1981/82, the first two years of the Sixth Plan, development expenditures nearly doubled, and regular expenditures rose considerably. Notwithstanding revenue increases in excess of GDP growth and further increases in foreign grants, the overall deficit rose two and a half times and its ratio to GDP doubled to 6 per cent. Although a large part of this deficit was financed by external concessional loans, the Government, for the first time in many years, had to resort to borrowing from the banking system equivalent to 2 per cent of GDP (Table 4 and Chart 3).

Table 4. Nepal: Selected Budgetary Indicators, 1980/81-1983/84

	1980/81	1981/82 Prel.	1982/83 Est.	1983/84 Staff Proj.
		(Percentage change)		
Nominal GDP	25	12	11	17
Revenue	30	19	16	21
Expenditure	19	41	26	24
(Of which: Development)	(19)	(48)	(26)	(28)
		(In per cent of GDP)		
Overall deficit	3	6	7	7
External concessional loans	2	3	4	5
Domestic financing	1	3	3	2
(Of which: bank borrowing)	(--)	(2)	(3)	(2)

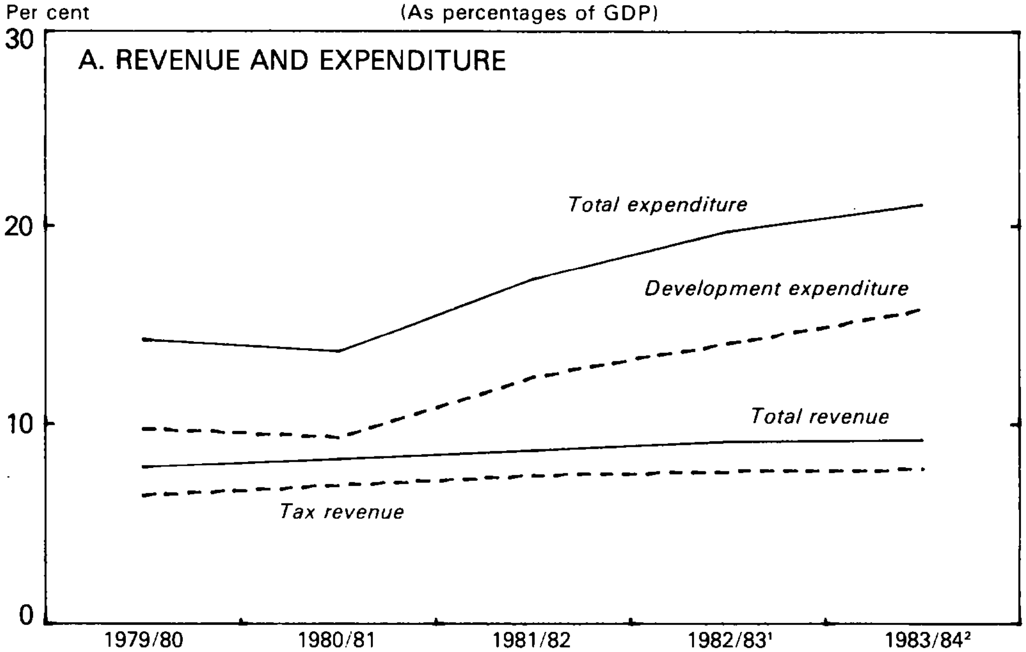
Source: Appendix Table III.

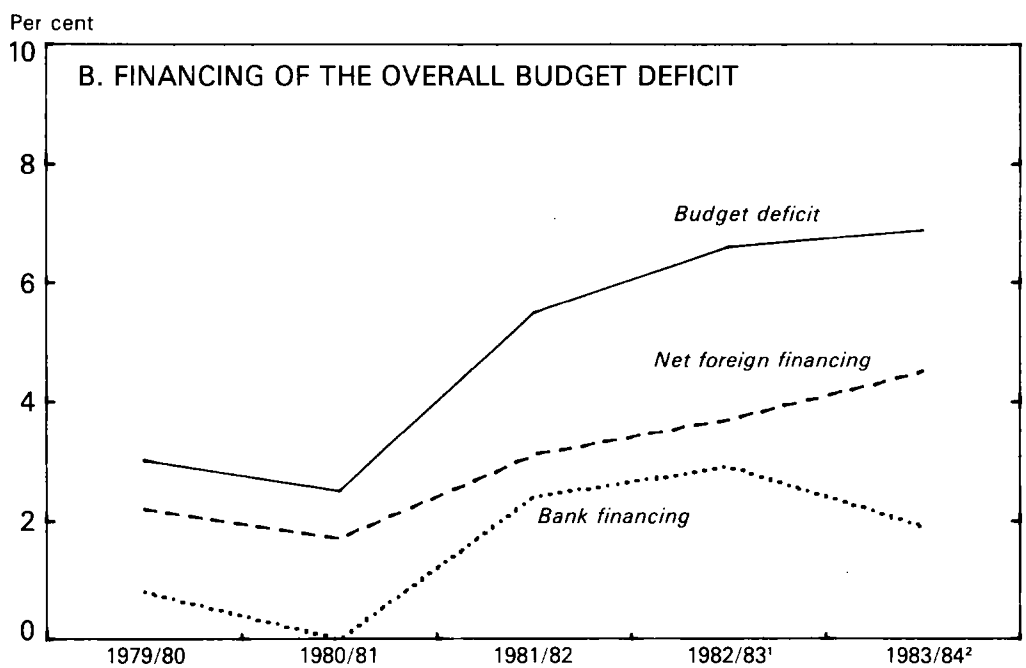
CHART 3

NEPAL

GOVERNMENT BUDGET

(As percentages of GDP)





Source: Data provided by the Nepalese authorities.
[1]Preliminary estimates.
[2]Projection.

In 1982/83, the overall deficit and government borrowing from the banking system have risen further to about 7 per cent and 3 per cent of GDP, respectively. The stagnant real activity has weakened revenue collection, particularly income taxes and export duties, and exemptions from land taxes were granted to alleviate the economic difficulties of districts hardest hit by drought. As a result, the growth of Government revenue has slowed to 16 per cent, despite discretionary measures implemented during the year, including wider coverage for sales taxes and increases in excise taxes and land registration fees. In contrast, the growth of regular expenditures has remained at 26 per cent, reflecting partly a 20 per cent wage and salary increase for civil servants 1/ and partly the need to provide food and other relief to drought-affected areas. Development expenditures have also risen by 26 per cent, despite cutbacks during the course of the year; as in the recent past, foreign aid has covered only about half of these expenditures.

b. Budget for 1983/84

At the time of the staff mission, the authorities were in the process of preparing the budget for 1983/84. While precise details were not available, the authorities were able to indicate their budgetary targets, as well as the measures to support them.

The authorities stated that in 1983/84, budgetary efforts toward economic stabilization will be intensified; development objectives will be pursued mainly through the implementation of aid-financed projects. The overall budget deficit will be kept at about 7 per cent of GDP, while borrowing from the banking system will be reduced to 2 per cent of GDP. The staff believes that these budgetary targets are appropriate and can be achieved through the forceful implementation of the authorities' revenue, expenditure, and financing measures outlined below.

In respect of revenue, a number of measures announced in the 1982/83 budget are to take effect in 1983/84. These measures include increases in income tax rates on higher income brackets and increases in various registration and user fees (e.g., use of roads, bridges and airports, and registration of private vehicles). The authorities indicated that they would introduce a number of additional measures in the 1983/84 budget, particularly in respect of import duties and sales taxes on finished goods. Furthermore, the authorities will intensify their ongoing efforts to strengthen tax administration, including: (1) a more vigorous effort to collect tax arrears; (2) increased door-to-door canvassing, particularly of small businesses; (3) greater efficiency in customs collections; and (4) more selectivity in the extension of tax incentives to promote industrial development. With regard to public enterprises, norms of after-tax profits in relation to paid-up capital were introduced in August 1982, and they have been given greater autonomy in setting prices; in April 1983, the Nepal

1/ This increase was announced in July 1982, but to minimize its budgetary impact, it was not put into effect until October.

Electricity Corporation raised electricity rates by an average of 58 per cent.

The authorities intend to contain the growth of regular expenditures at about the estimated inflation rate, mainly by (1) a deferment of additional increases in the wages and salaries of civil servants; and (2) by the reduction of subsidy payments relating to official rice and fertilizer transactions. Accordingly, no provision will be made for new wage and salary increases in the 1983/84 budget. The Government sales prices of rice and fertilizer were raised by about 22 to 36 per cent and 13 to 17 per cent, respectively, in April 1983.1/ As for development expenditures, the authorities' restraint efforts will focus on nonaid-financed projects. They have already begun suspending many such projects in 1982/83, and intend to intensify this effort in 1983/84. As a result, the share of nonaid-financed expenditures in the total is estimated to decline to about 40 per cent from about half in 1982/83.

Despite the revenue and expenditure measures described above and the authorities' related efforts to accelerate aid utilization, fiscal year 1983/84 will become the third successive year in which the Government will have resorted to substantial domestic borrowing. To reduce the monetary impact of this borrowing by expediting sales of development bonds to nonbank sectors, it has recently been decided to raise the interest rate on these bonds by 1 to 2 percentage points from 10.5 per cent per annum effective from early 1984/85. The authorities believe that the new rate will be sufficiently attractive to the Provident Fund, which has in the past invested most of its resources in time deposits. They plan to place some NRs 200 million worth (about 20 per cent of the envisaged domestic borrowing requirement) in the portfolios of the Provident Fund.

The authorities provided the staff mission with a set of preliminary figures for the 1983/84 budget. The staff projects that both revenue and development expenditure (and related foreign aid utilization) may turn out somewhat lower than the authorities' estimates. However, the staff's adjustments to these items broadly offset each other, and its estimate of the Government's domestic borrowing is about the same as that of the authorities (Appendix Table III).

1/ In the medium term, the authorities plan to limit rice subsidies to the amount required for transportation costs to the six regions delineated for this purpose. The authorities stressed the importance of continuing the rice subsidy program on this basis since transportation costs generally rise inversely with regional incomes.

3. Monetary policy

a. Monetary policy in 1982/83

The growth of overall credit has nearly doubled to 29 per cent during 1982/83, largely on account of sharp increases in credit to the public sector. Credit to the Government has increased by 49 per cent as a result of the budgetary developments described above. Credit to public enterprises has increased by 59 per cent, reflecting the local financing needs of the newly-constructed Hetauda Cement Factory, as well as the increased credit requirements in respect of rice and fertilizer distribution. In contrast, the growth of credit to the private sector has remained below the rate of inflation. This slow growth is largely attributable to sluggish economic activity, but also reflects the Rastra Bank's instruction to commercial banks in August 1982 not to renew existing loans or extend new ones with foodgrain stocks as collateral so as to prevent hoarding (Table 5 and Chart 4).

Table 5. Nepal: Selected Monetary Indicators, 1980/81-1983/84

	1980/81	1981/82	1982/83 Estimate	1983/84 Projection
		(Percentage change)		
Domestic credit	19	16	29	18
Public sector	9	36	52	17
Private sector	27	4	11	20
Broad money	19	18	18	16
		(Absolute number)		
Income velocity of money	5.05	4.77	4.44	4.45

Source: Appendix Table IV.

As the accelerated credit expansion was accompanied by a sharp decline in net foreign assets, the growth of broad money remained roughly the same at 18 per cent, implying a further decline in the velocity of money. This decline reflected the continued monetization of the economy, as well as an increase in deposit rates by 0.5 percentage point (to a range of 4.5 per cent to 13.5 per cent per annum) in June 1982. At that time, the loan rates of commercial banks were also raised by 1 to 2 percentage points (to a range of 10 per cent to 17 per cent)1/ in order to maintain their profit margins against the background of higher deposit rates, an increase in the share of time deposits in broad money, and the reimposition of liquidity reserve requirements.2/ With the increase in inflation in 1982/83, interest rates in real terms became negative or close to nil for deposits, while most loan rates have remained positive.

b. Monetary policies for 1983/84

The authorities' monetary program for 1983/84 calls for a slowing in total credit growth to 18 per cent. The growth of credit to the public sector would decelerate sharply, reflecting smaller borrowing requirements of the Government and public enterprises; the rate of growth of private sector credit would double because of the anticipated recovery in economic activity. Taking into account the projected decline in net foreign assets, liquidity growth is projected to decline slightly, implying virtually no change in income velocity of money. The staff shares the authorities' view that this projected liquidity growth would be consistent with the recovery in real growth and the slowdown in inflation presently forecast for 1983/84.

The authorities plan to implement a number of measures with the monetary program. First, they plan not to lower nominal interest rates unless inflation falls substantially below the rate presently anticipated. This will help bolster the mobilization of domestic financial savings, and at the same time absorb liquidity into the banking system. Second, within the framework of the monetary program, the authorities intend to encourage commercial banks to channel an increasing amount of credit to priority sectors;3/ the objective is 10 per cent of deposits by 1984/85, compared with 7 per cent at present. Third, to increase the degree of monetization of the economy and introduce more efficient forms of financial intermediation in rural areas, the establishment of more commercial bank branches will remain a high priority. With a view to achieving a branch per 30,000 persons by

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1/ On a weighted basis, deposit rates average about 12 per cent and loan rates about 15 per cent.

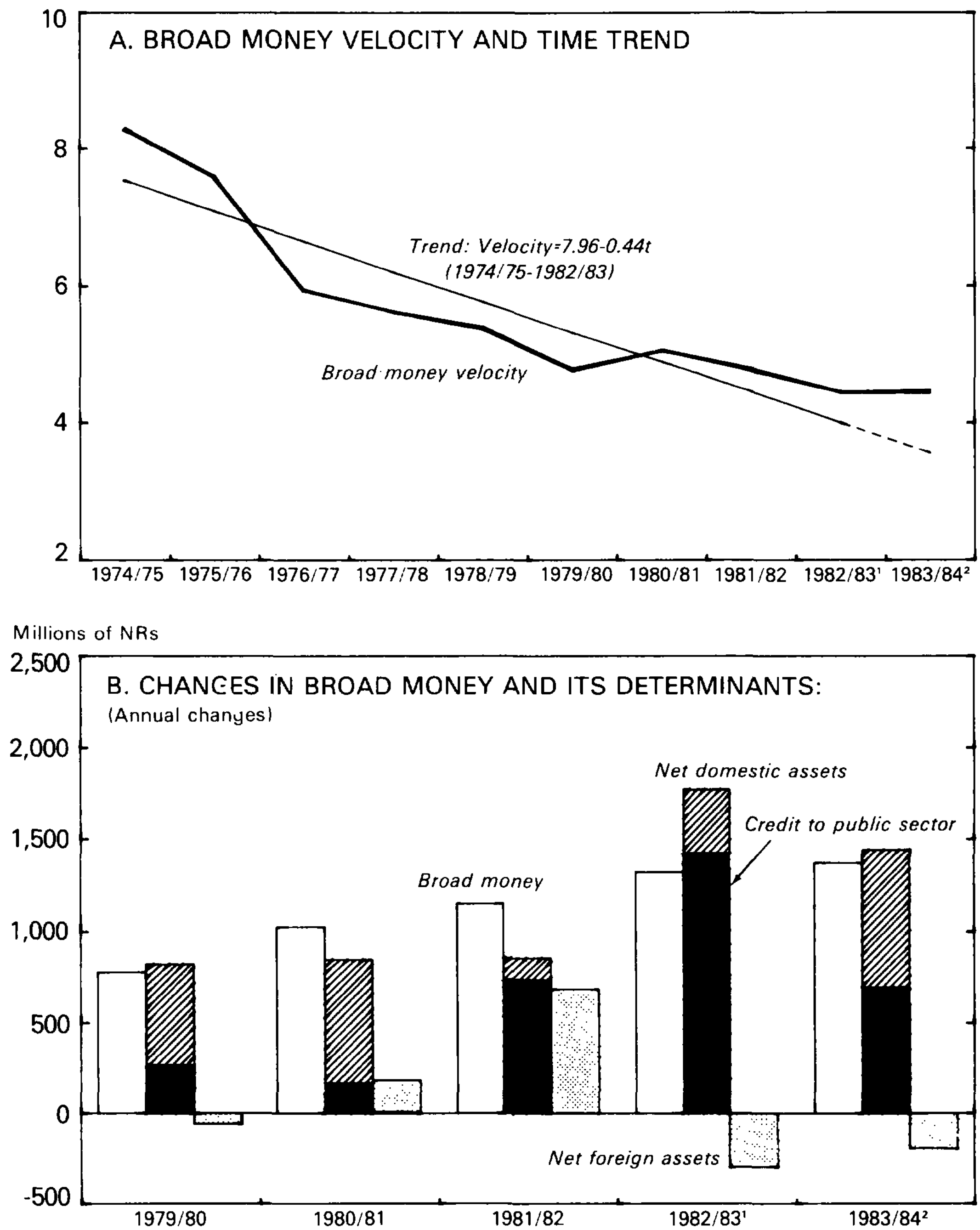
2/ In March 1981, the Rastra Bank reintroduced a minimum liquidity reserve requirement at 25 per cent of banks' deposit liabilities, part of this would be met by the 9 per cent minimum cash reserve requirement that had already been in place.

3/ Priority sectors consist of agriculture, cottage industries with fixed capital of less than NRs 200,000, and certain services.

CHART 4

NEPAL

MONETARY DEVELOPMENTS



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

[1]Estimate.

[2]Projection.

1984/85 (compared with a branch per 50,000 persons, at present), the Nepal Rastra Bank will continue to partially compensate the commercial banks for losses incurred in the initial operation of new branches. Fourth, to enable the Nepal Rastra Bank to execute its monetary program more effectively, commercial banks will be required, beginning in 1983/84, to prepare annual deposit projections and credit plans at the beginning of each fiscal year, and to revise them periodically during the course of the year.

4. Exchange rate system and policy

Over the last few years, Nepal has made considerable progress in rationalizing its exchange rate arrangement. In March 1978, it simplified a multiple exchange rate arrangement to a dual arrangement; in February 1980, the gap between the two exchange rates vis-a-vis the U.S. dollar was narrowed; in September 1981, the exchange rates were unified; and in early June 1983, the practice of simultaneously maintaining fixed exchange rates vis-a-vis the U.S. dollar and the Indian rupee--a practice that had given rise to broken cross rates in the past--was terminated, and an arrangement of pegging the Nepalese rupee to a basket of currencies of major trading partner countries was adopted (EBD/83/162, 6/6/83). With this last action, the authorities' rationalization program has been completed. Nepal no longer maintains exchange practices that require approval by the Fund.

In December 1982, the Nepalese rupee was depreciated by about 8 per cent against the U.S. dollar; the exchange rate vis-a-vis the Indian rupee was kept unchanged. This depreciation partly offset the effective appreciation of the Nepalese rupee that arose in the preceding several months because of the strengthening of the U.S. dollar vis-a-vis other major currencies and Nepal's maintenance of a fixed rate vis-a-vis the U.S. dollar. Nevertheless, the Nepalese rupee appreciated by 8 per cent in nominal effective terms and by 18 per cent in real terms between 1980/81 (annual average) and February 1983 (Chart 5).1/

The growth of output in export and import-substituting sectors has been slow, partly reflecting weak profitability and limited incentives in these sectors. The authorities' efforts to promote these sectors have been mainly through tax relief measures (e.g., selective exemptions from income taxes for exporters and suspension of export taxes) and preferential credit arrangements. However, in the staff's view, the authorities' ability to provide such support without jeopardizing stabilization objectives has diminished, while the need for providing

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1/ Measured by an effective exchange rate index based on fixed weights derived from trade data for 1980/81. The effective appreciation is estimated to be about 20 per cent in nominal terms and 28 per cent in real terms, if it is measured from 1978/79 (average). However, such estimates are subject to a wide margin of error because of the frequent changes in the exchange rate arrangement and the associated substantial changes in the volume of transactions applying to different rates.

greater incentives, especially through the exchange rate, has increased. The authorities agreed with some of these observations but questioned whether it would be wise to adjust the exchange rate at a time when the economy was facing significant inflation pressures resulting from a supply shortfall. Moreover, the authorities considered that the shift to a basket arrangement would constitute a major change to which the public would need time to adjust. In these circumstances, they believed that they would need to re-evaluate the price outlook and gauge the public's reaction to the new exchange rate arrangement before deciding on the exchange rate adjustment issue.

V. Staff Appraisal

Under a series of development plans implemented since the mid-1950s, Nepal has made considerable progress in building social infrastructure so as to meet the basic needs of its population. Progress has also been made in building economic infrastructure, especially transportation and communication systems. However, the expansion of output has been disappointing, partly because of the need to allocate large resources to the building of infrastructure, rather than to more directly productive facilities. Against this background, since 1980/81, the authorities have been implementing the Sixth Plan, sharply raising development expenditures with added emphasis on the expansion of directly productive facilities. However, domestic resource mobilization and foreign aid utilization have lagged, necessitating large government borrowing from the domestic banking system and causing pressures on prices and the balance of payments.

In 1982/83, a severe drought has aggravated the economic situation. Agricultural and overall output has declined, reducing supplies for both domestic consumption and exports. The Government's revenue and current expenditure have also been adversely affected, and its bank borrowing has risen further, despite cutbacks in development expenditure during the year. The resultant continued rapid increase in total credit and liquidity has led to a further rise in demand in the face of a supply shortfall. As a result, inflation has worsened and the overall balance of payment position has turned into a large deficit from its traditional surplus.

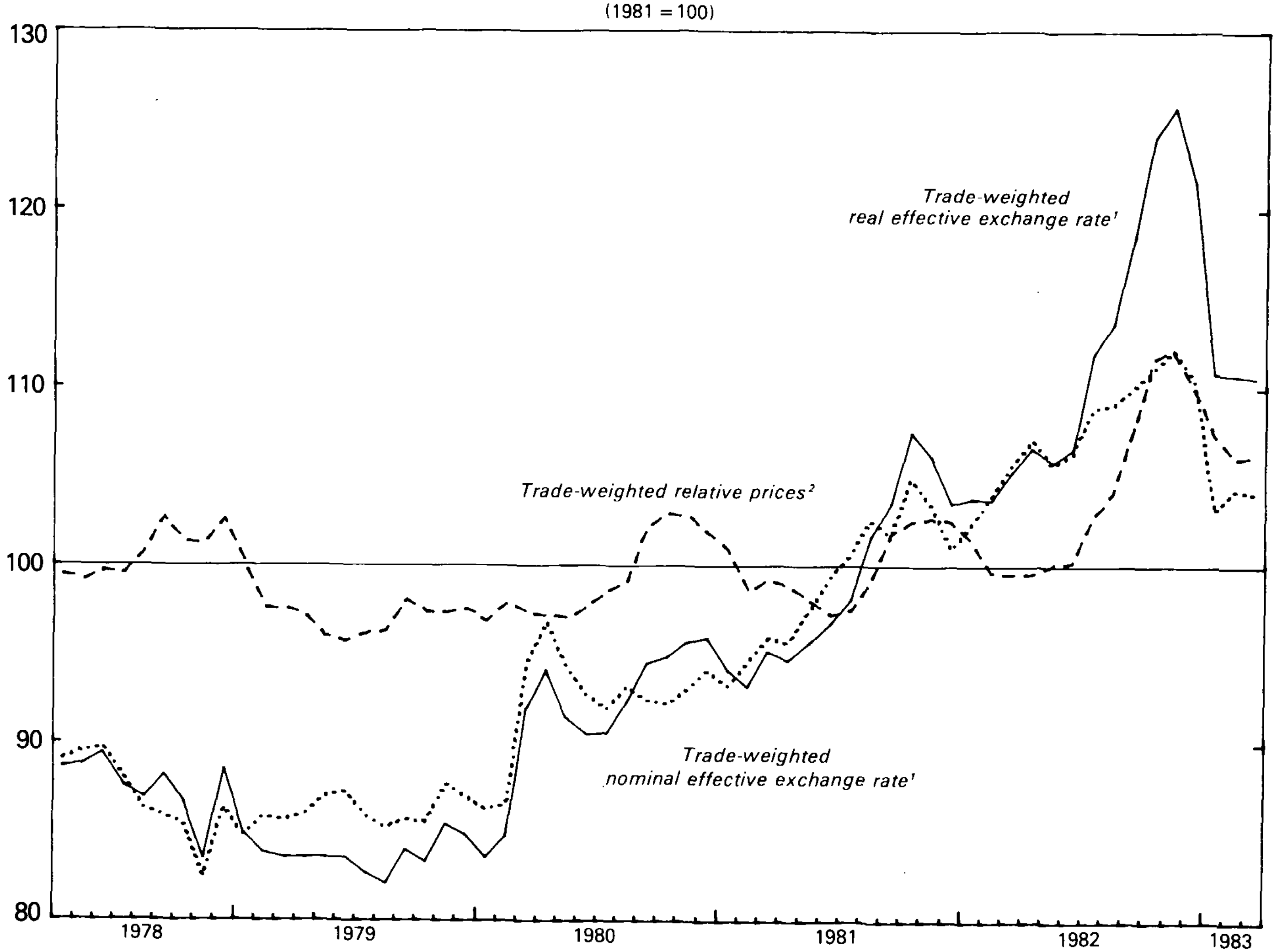
A significant part of Nepal's present economic difficulties is a result of the temporary effects of last year's drought and will be alleviated with a return of normal weather. However, the difficulties are also associated with the rapid expansion in demand over the last few years and the slow output and export growth over the last two decades. The authorities share these views and have begun adjusting policies toward economic stabilization in the short term and strengthening of the economy and the balance of payments in the medium term.

CHART 5

NEPAL

TRADE-WEIGHTED EFFECTIVE EXCHANGE RATE INDICES

(1981 = 100)



Source: Staff estimates based on data in IMF, *IFS*.
[1] An increase indicates appreciation of the Nepalese rupee.
[2] Nepal's consumer price index relative to trade weighted consumer price indices of trading partners.

In the present situation, reducing government borrowing from the banking system is the most important prerequisite for successful economic stabilization. Given the urgency of this task, it has to be achieved mainly through slowing expenditure growth and appropriately adjusting financing arrangements. Accordingly, the authorities have recently raised the administered prices of key commodities, so as to reduce major subsidy payments. They have also decided in the context of the 1983/84 budget to defer additional wage and salary increases for civil servants and to suspend many nonaid-financed projects. Furthermore, the authorities have recently decided to raise the interest rate on development bonds in order to increase their sale to nonbank sectors. These actions, together with a faster revenue increase resulting from the envisaged economic recovery, ongoing efforts to rationalize tax administration, and the intended adjustments of the tax system, should help reduce the Government's bank borrowing. However, it is also the staff's view that revenue mobilization efforts will have to be intensified substantially if the authorities' development program is to be pursued successfully.

Given the expected gradual slowdown in inflation, the authorities' policy of not lowering interest rates will raise them in real terms. This will help bolster the mobilization of savings through the banking system. In the staff's view, this interest rate policy and the budgetary policies described above will bring the credit and liquidity situation into line with the envisaged macroeconomic developments in 1983/84--a recovery in output, a slowdown in inflation, and a reduction in the external deficit.

In the medium term, expansion of output, especially of the export and import substituting sectors, is of utmost importance. Toward this end, the authorities will have to forcefully implement the existing and planned agricultural and industrial policies in conjunction with the Development Plan. In addition, the staff believes that exchange rate policy should be used more actively to provide appropriate incentives for export and import-substituting sectors and strengthen the balance of payments over the medium term. The authorities have recently adopted a basket peg arrangement that should facilitate a more flexible use of the exchange rate. The staff notes the authorities' view that it would be unwise to adjust the exchange rate when pressures on prices remain strong because of a drought-induced supply shortfall. The staff suggests that the implementation of the new exchange rate arrangement should not preclude appropriate policy action, at an early date, to offset the cumulative loss in competitiveness observed in recent years, which has not been fully reversed by recent exchange rate actions.

The authorities have maintained a cautious external borrowing policy by relying on grants and concessionary loans for development financing and limiting short-term commercial financing of imports to small amounts. Because of this policy, both outstanding external debt and debt service payments have been relatively low. It is hoped that this policy will continue to be followed.

At the last Article IV consultation in December 1982, the staff expressed concern about the deteriorating economic situation and underlined the need for the authorities to take prompt correcting action. The authorities have since adopted a number of important measures, especially those relating to fiscal restraint and more flexible exchange rate management, and intend to implement additional measures in the context of the 1983/84 budget. The staff believes that these efforts will help alleviate the present economic difficulties and strengthen the economy and the balance of payments in the medium term.

It is proposed that Article IV consultation with Nepal be held generally on the standard 12-month cycle. Taking into account the fact that the present consultation was advanced, it is proposed that the next consultation with Nepal be concluded by October 1984.

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 1983 Article XIV 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).

2. 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.

Table I. Nepal: Output and Prices, 1980/81-1983/84

	1980/81	1981/82	1982/83 Estimate	1983/84 Projection
	(In percentage change over the previous year)			
Real GDP	5.6	3.8	-0.2	6.0
Agriculture	10.4	3.5	-3.0	7.0
Of which:				
Foodgrains 1/	19.1	4.1	-6.9	11.8
(Rice) 2/	19.6	4.0	-27.7	38.8
Nonagriculture	-1.3	4.3	4.3	4.5
Consumption	6.2	4.6	1.7	2.8
Investment	-6.4	14.9	3.3	4.7
Total domestic demand	4.3	6.0	1.9	3.1
Consumer prices				
Nepal 3/	13.4	10.4	13.0	10.0
Trading partners	11.0	8.9	5.5	5.0
Of which: India	11.9	10.8	8.3	7.0
	(As per cent of nominal GDP)			
Investment and savings				
Investment	14.0	15.5	16.0	15.8
Domestic savings	8.0	7.3	5.6	8.4
Foreign savings	6.3	6.9	10.4	7.4

Sources: Central Bureau of Statistics; Ministry of Agriculture; 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/ In the past few years, the average share of the rice sector in real GDP was about 18 per cent (according to Nepal's national account statistics).
3/ Based on the national urban consumer price index.

Table II. Nepal: Balance of Payments, 1980/81-1983/84

	1980/81	1981/82	1982/83 Estimates	1983/84 Projection
	(In millions of SDRs)			
Exports, f.o.b.	108.2	101.1	61.9	83.1
Imports, c.i.f.	-298.2	-334.3	-394.4	-375.6
Trade Balance	-190.0	-233.2	-332.5	-292.5
Services net	75.0	93.1	91.8	96.5
(Of which: travel receipts)	(51.9)	(56.8)	(56.6)	(63.1)
Private transfers, net	31.3	30.6	36.8	31.0
Current account balance 1/	-83.7	-109.5	-203.9	-165.0
Official transfers	63.8	83.0	99.3	91.5
(Of which: Grants)	(57.8)	(78.2)	(94.3)	(85.7)
Official capital, net	42.5	52.3	66.5	61.4
Miscellaneous capital 2/	-9.6	8.3	4.8	--
Overall balance	13.0	34.1	-33.3	-12.1
Ratio to GDP	(In per cent)			
Exports	5.5	4.6	2.6	3.0
Imports	15.3	15.2	16.5	13.8
Current account deficit 1/	4.3	5.0	8.5	6.1
External public debt	9.0	10.6	12.0	12.4

Sources: Nepal Rastra Bank; and staff estimates

1/ Excluding official transfers.
2/ Including errors and omissions.

Table III. Nepal: Government Budget, 1980/81-1983/84

	1980/81	1981/82	1982/83		1983/84	
		Prelim. actuals	Budget est.	Revised est.	Official proj.	Staff proj.
			(In millions of Nepalese rupees)			
Revenue	2,403	2,866	3,933	3,310	4,236	3,990
Expenditure	3,990	5,623	8,975	7,100	9,187	8,775
Regular	1,264	1,589	2,112	2,000	2,228	2,228
Development	2,726	4,034	6,863	5,100	6,959	6,547
Foreign grants	869	955	1,608	1,400	2,030	1,864
Overall deficit (-)	-718	-1,802	-3,434	-2,390	-2,921	-2,921
Foreign financing (net)	505	998	1,918	1,320	1,914	1,914
Domestic financing (net)	213	804	1,516	1,070	1,007	1,007
Banking system 1/	(-5)	(775)	(1,000)	(1,050)	(790)	(790)
Nonbank sector	(21)	(9)	(516) 2/	(20)	(217)	(217)
Discrepancy	(197)	(20)	(--)	(--)	(--)	[illegible]
			(Percentage change from previous year)			
Revenue	30.2	19.3	37.2	15.5	28.0	20.5
Expenditure	19.2	40.9	59.6	26.3	29.4	23.6
Regular	19.8	25.7	32.9	25.9	11.4	11.4
Development	18.9	48.0	70.1	26.4	36.5	28.4
			(In per cent of GDP) 3/			
Revenue	8.3	8.8	10.9	9.2	10.1	9.5
Expenditure	13.7	17.3	24.9	19.7	21.8	20.9
Regular	4.3	4.9	5.9	5.5	5.3	5.3
Development	9.4	12.4	19.0	14.1	16.5	15.6
Overall deficit	2.5	5.5	9.5	6.6	6.9	6.9
Foreign financing	1.7	3.1	5.3	3.7	4.5	4.5
Domestic financing	0.7	2.5	4.2	3.0	2.4	2.4
Banking system	(--)	(2.4)	(2.8)	(2.9)	(1.9)	(1.9)

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

1/ Derived from monetary survey.
2/ Includes expected receipts of NRs 465 million from foreign donors as reimbursements for government expenditures undertaken in 1981/82.
3/ Totals may not add exactly due to rounding. In 1982/83 ratios, actual estimated GDP is used as a denominator for both budget and revised estimates.

Table IV. Nepal: Monetary Survey, 1980/81-1983/84

	1980/81	1981/82	1982/83 Est.	1983/84 Proj.
	(Mid-July levels in millions of NRs)			
Net foreign assets	2,415	3,101	2,810	2,616
Domestic assets	5,256	6,113	7,883	9,324
Public sector	2,025	2,750	4,166	4,860
Government 1/	(1,357)	(2,132)	(3,185)	(3,975)
Public enterprises 2/	(668)	(618)	(981)	(885)
Private sector 3/	3,231	3,363	3,717	4,464
Other items, net	-1,363	-1,755	-1,913	-1,790
Broad money (M2)	6,308	7,459	8,780	10,150
Money (Ml)	3,208	3,612	4,003	4,413
Quasi-money	3,100	3,847	4,777	5,737
	(Percentage change from previous year)			
Domestic credit	19.2	16.3	29.0	18.3
Public sector	8.7	35.8	51.5	16.7
Private sector	26.9	4.1	10.5	20.1
Broad money (M2)	19.4	18.2	17.7	15.6
Money (Ml)	13.4	12.6	10.8	10.2
Quasi-money	26.3	24.1	24.2	20.1
Memorandum items:				
Average broad money (NRs millions) 4/	5,756	6,829	8,120	9,465
Income velocity of money	5.05	4.77	4.44	4.45

Sources: Data provided by the Nepalese authorities; and official 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 1981/82; average of end-of-fiscal-year estimates thereafter.

Table V. Nepal: External Public Debt and Balance of Payments 1980/81-1985/86

	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86
			Estimates		Projections 1/	
			(In millions of SDRs)			
Amortization	2.4	4.7	8.2	9.8	10.7	9.9
(Of which: to IMF)	(0.5)	(2.6)	(5.0)	(4.6)	(8.3)	(5.2)
Interest	2.6	3.2	5.2	5.1	5.7	5.7
(Of which: to IMF)	(0.7)	(1.2)	(1.1)	(0.7)	(0.4)	(0.1)
Total debt service	5.0	7.9	13.4	14.9	16.4	15.6
(Of which: to IMF)	(1.2)	(3.8)	(6.1)	(5.4)	(8.7)	(5.3)
Outstanding debts	194.1	238.8	280.8	337.1	407.7	492.6
(Of which: to IMF)	(32.7)	(30.1)	(25.1)	(19.8)	(11.2)	(8.2)
			(In per cent)			
Debt service/exports of goods and services	2.0	3.3	6.5	6.4	6.4	5.4
(Of which: to IMF)	(0.6)	(1.6)	(3.0)	(2.3)	(3.4)	(1.8)
Outstanding debt/GDP	9.0	10.6	12.0	12.4	13.4	14.4
(Of which: to IMF)	(1.6)	(1.4)	(1.1)	(0.7)	(0.4)	(0.2)
			(In millions of SDRs)			
Memorandum items:						
Exports of goods and services	236.4	242.7	203.5	233.5	258.0	288.0
Imports of goods and services	-359.5	-393.7	-453.4	-435.4	-483.0	-537.0
Net investment income and private transfers	39.4	41.5	46.0	36.9	50.0	55.0
Current account	-83.7	-109.5	-203.9	-165.0	-175.0	-194.0
Official transfers	63.8	83.0	99.3	91.5	107.0	118.0
Net capital inflows including errors and omissions	32.8	60.5	71.3	61.4	76.0	86.0
Overall balance	13.0	34.1	-33.3	-12.1	8.0	10.0

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

1/ Projections of debt services and outstanding debts are based on the assumption that from 1984/85, disbursements of aid loans will rise by 13 per cent a year, the same as the assumed average annual increase in aid-financed imports. From 1984-85, nominal GDP is assumed to increase by 12 per cent per annum, while exports of goods and services are assumed to rise by about 11 per cent annually.

Fund Relations with Nepal 1/

Date of membership:	September 6, 1961
Status:	Article XIV
Quota:	SDR 28.5 million (proposed new quota under the Eighth General Review: SDR 37.3 million)
Fund holdings of Nepalese rupees:	SDR 34.48 million or 120.99 per cent of quota. Of which: CFF, SDR 11.67 million or 40.97 per cent of quota
SDR position:	Holdings are SDR 665,417 million or 8.2 per cent of net cumulative allocation of SDR 8.1 million
Trust Fund:	SDR 5.8 million was disbursed in the first period, and SDR 7.8 million has been disbursed in the second period
Direct distribution of profits from gold sales (July 1, 1976-March 31, 1981):	US$1.9 million.
Gold distribution:	10,611.998 fine ounces
Exchange rate system:	On September 19, 1981, Nepal unified the dual exchange rate system, establishing a new rate of NRs 13.2 per U.S. dollar; the rate for the Indian rupee was kept unchanged at NRs 145.1 = Rs 100. On December 17, 1982, the Nepalese rupee was devalued by 8 per cent to NRs 14.3 = US$1; the rate for the Indian rupee was kept unchanged. On June 1, 1983, Nepal introduced an arrangement under which its currency is pegged to a basket of currencies of major trading partners; this new arrangement replaced the practice of maintaining fixed rates vis-a-vis both the U.S. dollar and the Indian rupee.
Technical assistance:	Since 1967 the Fund has provided technical assistance in various fields, including staff members as Resident Advisors during July 1977-July 1980 and September 1981 April 1983, and technical assistance missions on tax administration during 1979.
Last Article IV consultation:	December 21, 1982; Decision No. 7269-(82/159). Staff discussions were held during August 6-13, 1982 (SM/82/210 and SM/82/215).

1/ As of May 31, 1983.

Nepal: Relations with IDA and IFC

(In millions of U.S. dollars)

Total lending 1/	IDA	IFC	Total	Of which: Undisbursed
Agriculture	76.6	--	76.6	58.9
Irrigation	94.5	--	94.5	60.9
Education	20.0	--	20.0	17.7
Water supply	46.8	--	46.7	23.7
Industry	13.7	9	22.7	13.3
Transportation	19.2	--	19.2	3.5
Telecommunication	21.8	--	21.8	11.3
Power and energy	50.0	--	50.0	8.8
Other	3.0	--	3.0	0.2
Total	345.6	9	354.6	198.3
Adjusted total 2/				191.7

Source: Data provided by the World Bank.

1/ As of March 31, 1983. No IBRD loans have been made to Nepal.
2/ Adjusted for changes in U.S. dollar/SDR exchange rate as of approval and disbursement dates of IDA credits.

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 Banks' new program of nonreimbursable technical assistance, one staff member is expected to join the Ministry of Finance in June 1983 to assist in establishing a Development Project Monitoring and Evaluation System.

Recent economic and sector missions: The most recent economic mission visited Kathmandu during April-May 1983. In addition, the World Bank has sent a number of sector missions in recent years, including a mission on domestic resource mobilization in December 1980, and one on development administration in April 1983.

Basic Data 1/

	1980/81	1981/82 Provisional	1982/83 Estimate	1983/84 Projection
	(Changes in per cent)			
GDP and Prices				
Real GDP	5.6	3.8	-0.2	6.0
Of which: agriculture	10.4	3.5	-3.0	7.0
Nominal GDP	24.5	12.0	10.8	16.6
Implicit GDP deflator	17.9	7.9	11.0	10.0
Consumer prices (annual average)	13.4	10.4	13.0	10.0
Central Government Budget				
Revenue	30.2	19.3	15.5	20.5
Expenditure	19.2	40.9	26.3	23.6
Current	(19.8)	(25.7)	(25.9)	(11.4)
Development	(18.9)	(48.0)	(26.4)	(28.4)
Money and Credit 2/				
Domestic credit	19.2	16.3	29.0	18.3
Public sector	(8.7)	(35.8)	(51.5)	(16.7)
Government	[-0.4]	[57.1]	[49.4]	[24.8]
Other	[33.3]	[-7.5]	[58.7]	[-9.8]
Private sector	(26.9)	(4.1)	(10.5)	(20.1)
Broad money	19.4	18.2	17.7	15.6
Income velocity of money (absolute number)	5.05	4.77	4.44	4.45
International Trade 3/				
Exports, f.o.b.	46.8	-6.6	-38.8	34.2
Imports, c.i.f.	30.7	12.1	18.0	-4.9
	(In millions of SDRs)			
Balance of Payments				
Exports	108.2	101.1	61.9	83.1
Imports	-298.2	-334.3	-394.4	-375.6
Services and private transfers, net	106.3	123.7	128.6	127.5
Current account	-83.7	-109.5	-203.9	-165.0
Official transfers, net	63.8	83.0	99.3	91.5
Official capital, net	42.5	52.3	66.5	61.4
Miscellaneous capital, net	-9.6	8.3	4.8	--
Overall balance	13.0	34.1	-33.3	-12.1
External Public Debt				
Total outstanding (including Fund credit) 2/	194.1	238.8	280.8	337.1
Debt service (as per cent of exports of goods and services)	(2.0)	(3.3)	(6.5)	(6.4)
Gross International Reserves 2/	169.0	210.2	178.2	165.6
(in months of imports)	(6.8)	(7.5)	(5.4)	(5.3)
	(In per cent)			
Ratios to GDP				
Investment	14.0	15.5	16.0	15.8
Domestic saving	8.0	7.3	5.6	8.4
Government revenue	8.3	8.8	9.2	9.5
Government expenditure	13.7	17.3	19.7	20.9
Government overall deficit	2.5	5.5	6.6	6.9
Domestic bank financing of government deficit	--	2.4	2.9	1.9
Broad money 2/	21.7	22.9	24.3	24.1
Exports	5.5	4.6	2.6	3.0
Imports	15.3	15.2	16.5	13.8
Current account deficit (Excluding official transfers)	4.3	5.0	8.5	6.1
External public debt 2/4/	9.0	10.6	12.0	12.4

Sources: Data provided by the Nepalese authorities; and staff projections based on present and prospective budgetary and monetary policies.

1/ Data relate to fiscal years ending mid-July.
2/ End of period.
3/ Percentage changes in values expressed in SDRs.
4/ Including payments to the Fund.