EBS/85/264
Correction 1

CONFIDENTIAL

December 13, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Nepal - Staff Report for the 1985 Article IV Consultation and Request for Stand-By Arrangement

The following correction has been made in EBS/85/264 (12/3/85):

Page 10, line 2: for "12 million" read "27 million"

A corrected page is attached.

Att: (1)

banking system, and the growth of broad money accelerated only moderately, to 17 percent.

The overall deficit in the balance of payments rose from SDR 8 million in 1983/84 to SDR 47 million in 1984/85. This marked the third year in a row that an overall balance of payments deficit was recorded in lieu of the traditional surplus. The current account deficit remained at about SDR 170 million, equivalent to about 7 percent of GDP in both years (Chart 3). With the level of foreign grants and loans remaining virtually the same, most of the deterioration in the overall balance was traceable to a net outflow of SDR 40 million recorded under miscellaneous capital and errors and omissions. The NRB has estimated that about half of this outflow was attributable to leads and lags associated with the export-import operations of ready-made garment firms, which proliferated in 1984/85. These firms tended to obtain loans from the banking system to prepay for imported inputs, while repatriating export receipts with some lag, in conformity with Nepalese regulations that permit delays in the surrender of export receipts of up to six months from the date of exportation. Although there is no hard information on the remaining half of the outflow, it is believed to reflect a combination of unrecorded border trade, misvaluation of exports and imports, and capital flight.

The rapid expansion of the ready-made garment industry in 1984/85 raised the scale of both exports and imports substantially. In terms of SDRs, total merchandise exports rose by 47 percent, of which half was attributable to an increase in export volume, which, in turn, mainly reflected the rapid rise in recorded ready-made garment exports. Similarly, imports rose by 10 percent, about a third of which was attributable to inputs destined for the ready-made garment industry. Relative to GDP, exports and imports both rose by 2 percentage points, to about 7 percent and 19 percent, respectively.

Measures taken in 1983/84 to divert some import demand to India, in light of the perceived imbalance in official reserves in favor of Indian rupees, continued to have an impact in 1984/85. These measures, which were directed at imports from third countries, included more stringent import licensing, selective quotas, and the widening of the range of import licensing fees from 5-15 percent to 1-25 percent. The strength of these measures was such that official Indian rupee reserves, which amounted to SDR 41 million at the end of 1983/84, were virtually depleted by the close of 1984/85. At that stage, the NRB began selling convertible currency reserves in order to maintain adequate working balances in Indian rupees.

The diversion of import demand to India was complemented by measures aimed at stimulating exports to third countries. In November 1983, the authorities announced a reduction of export duties, the establishment of a scheme whereby exporters may retain 15 percent of convertible currency receipts for own imports, and the introduction of a

cash subsidy of 10 percent of f.o.b. value, payable upon surrender of export receipts to the banking system. Under this scheme, NRs 27 million was paid out in 1983/84. The application of this scheme gave rise to a discriminatory multiple currency practice and was not approved by the Fund at the conclusion of the Article IV consultation in June 1984. The authorities suspended the application of this measure in July 1984.

The bulk of Nepal's external debt has been contracted on highly concessional terms. 1/ The ratio of total debt service payments to exports of goods and nonfactor services, which remains low (estimated at about 5 percent in 1984/85), has progressively increased as service payments on more loans have come on stream.

A fixed exchange rate of NRs 1.451 per Indian rupee was maintained from 1978 to November 29, 1985, despite the adoption in June 1983 of an exchange rate arrangement based on a trade-weighted basket. Since that month, frequent changes in the exchange rate of the Nepalese rupee vis-a-vis the U.S. dollar, the intervention currency, have prevented broken cross rates from re-emerging.

While the real effective exchange rate (REER) index indicates virtually no change in the external competitiveness of the tradable sector over the position of five years ago, other indices indicate a substantial deterioration in export competitiveness over the same period. The trade-weighted REER index has depreciated significantly in the last two years, reflecting the abatement of domestic inflation and nominal depreciations vis-a-vis convertible currencies (Chart 4). 2/ However, this movement has served only to compensate for the appreciation observed from mid-1980 to mid-1983. In contrast, movements in an index of the ratio of average export unit values to nontradable prices indicate a deterioration of export competitiveness of about 20 percent during 1980/81-1983/84. If the period is extended to include 1984/85, this figure declines to 8 percent because of the apparently transitory boom in jute goods prices. Analogous indices for important exports show a wide range of losses in competitiveness over the last five years: rice (21 percent); ghee (5 percent); jute goods (35 percent during four years ending 1983/84 and 11 percent during five years ending 1984/85); hides and skins (46 percent); and carpets (8 percent). These developments appear to have been important contributing factors to the slow secular growth of overall export volume.

1/ Equipment purchases under some development projects are financed in part through suppliers' credits extended by certain donors in conjunction with concessional aid.

2/ The use of Nepal's consumer price index in the calculation of the REER index makes the latter highly sensitive to movements in foodgrain prices and, thus, to weather conditions. For this and other reasons, the REER index should be treated as only one of several indicators of external competitiveness.