

**FOR
AGENDA**

SM/01/260
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

August 28, 2001

To: Members of the Executive Board
From: The Secretary
Subject: **Nepal—Staff Report for the 2001 Article IV Consultation**

The attached corrections to SM/01/260 (8/16/01) have been provided by the staff:

Page 2, Table of Contents, Tables: for “3. Monetary Accounts, 1998–2002”
read “3. Monetary Accounts, 1998–2001 and Targets
for 2001/02”

for “5. Vulnerability Indicators, 1995/96–2000/2001”
read “5. Vulnerability Indicators, 1996/97–2000/01”

Table of Contents, Figures: for “1. Selected Financial Indicators, 1995–2001”
read “1. Selected External Indicators, 1995–2001”

for “2. Selected External Indicators, 1995–2001”
read “2. Selected Financial Indicators, 1995–2001”

Page 11, Figure 3: Chart updated

Page 12, bullet 1, line 1: for “Current.....by 29 percent, ”
read “Current.....by 36 percent,”

Page 28, Table 1, row 22, columns 1–3: for “-137” “27” “25” read “-135” “24” “28”
row 30, columns 1–3: for “6.8” “5.9” “4.8” read “6.7” “5.9” “4.7”
row 31, column 4: for “...” read “74.8”

Page 33, Table 6, row 26, columns 4 and 5: for “1,028” “1,148” read “1,014” “1,134”
row 31, columns 1–3: for “6.8” “5.9” “4.8” read “6.7” “5.9” “4.7”
row 44, columns 4 and 5: for “1,028” “1,028” read “1,014” “1,014”

Questions may be referred to Mr. J. Carter (ext. 38792) and Ms. Abdelati (ext. 37246).

Att: (5)

Other Distribution:
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INTERNATIONAL MONETARY FUND

NEPAL

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with Nepal

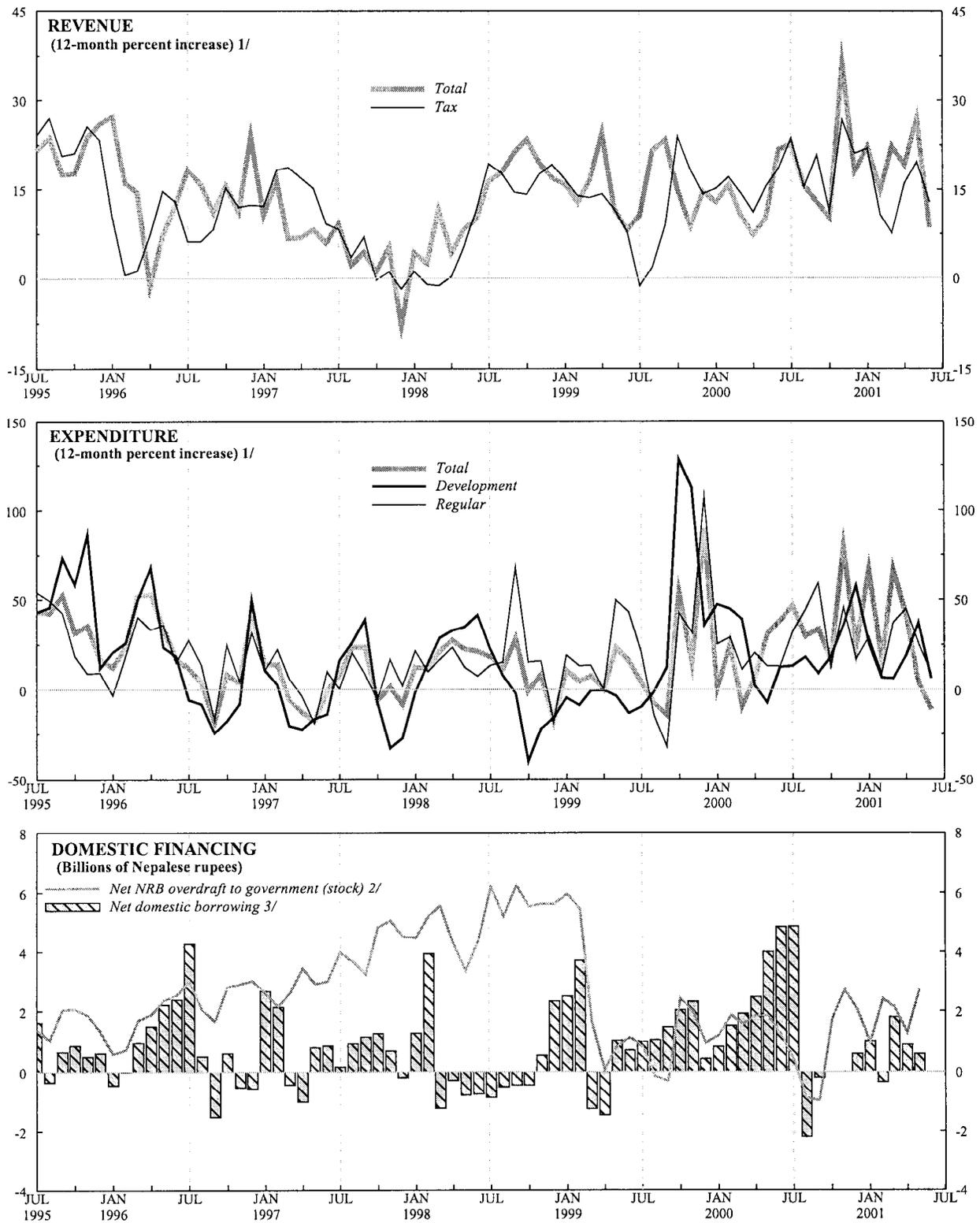
Approved by R. Anthony Elson and Mark Allen

August 15, 2001

- At the conclusion of the 1999 Article IV consultation in February 2000, Executive Directors stressed the critical importance of accelerating key structural reforms to lay the foundation for high and sustainable growth as a basis for poverty alleviation.
- Discussions for the 2001 Article IV consultation were held in Kathmandu during November 16–30, 2000 and April 16–May 2, 2001. The staff team comprising Mr. Carter (head), Ms. Abdelati, Messrs. Lee and Baig (all APD), Mr. Kitabire (PDR), Mr. Ahsan (IBRD), and Ms. Godo (staff assistant, APD), was assisted by the Resident Representative, Mr. DeMilner. Local IBRD and AsDB staff also participated in the discussions. Mr. Low, Alternate Executive Director, attended the November mission, while Mr. Bhatta, Advisor to the Executive Director, attended the April mission. The team met Prime Minister Koirala, Finance Ministers Acharya and Mahat, National Planning Commission Vice-Chairman Ligal, Nepal Rastra Bank (NRB) Governors Dhakal and Rawal, other senior government officials and representatives of private business, donors, and opposition parties.
- Macroeconomic performance has been satisfactory in the past two years, but poverty remains a critical problem. The government has formulated a medium-term structural reform program based on the priorities and objectives identified in their draft Interim-PRSP. The government's program focuses on maintaining macroeconomic stability and stimulating growth by increasing agricultural productivity, removing the constraints posed by a weak and segmented financial sector, inefficient public sector operations, an inadequate legal framework, and poor governance.
- Following the death of nine members of the royal family on June 1, a new king was crowned and Parliament reconvened on June 29. However, civil strife escalated and conflicts within the ruling National Congress Party continued, culminating in the resignation of Prime Minister Koirala on July 19.
- Nepal accepted the obligations of Article VIII, Sections 2, 3, and 4 in May 1994, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.
- Major statistical weaknesses continue to limit economic analysis. A comprehensive program of technical assistance to address these weaknesses is under way by donors, including the Fund.
- The principal authors of the staff report are Jeremy Carter and Wafa Abdelati.

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Figure 3. Nepal: Selected Fiscal Indicators, 1995-2001



Source: Data provided by the Nepalese authorities.

1/ Three-month moving average.

2/ The government's central bank overdraft balance was converted to treasury bonds in March 1999.

3/ Cumulative from start of fiscal year.

- **Current expenditures increased by 36 percent, higher than budgeted**, principally because of the impact of a large pay increase.⁶ Interest costs increased only modestly because of the large share of concessional financing and low nominal interest rates on government securities.
- **Continued slow project implementation and associated slower-than-anticipated disbursement of foreign grants resulted in a shortfall of 1¾ percent of GDP in development spending.** Capital spending is estimated to have reached 6½ percent of GDP, but there remain significant concerns regarding the quality of these outlays and little progress was made in streamlining projects.

12. **Although the government has set out a comprehensive structural reform agenda—which it hopes will be supported by donors, including the Fund—implementation has been uneven, partly reflecting political difficulties.**⁷

- **The legislative agenda was placed on hold because of the opposition’s blocking of the February-April parliamentary session:** the new central bank law, income tax law, and bankruptcy laws had been stalled, but these have now been tabled for the current parliamentary discussion.
- **Financial sector reforms have advanced, albeit at a slow pace.** The government published a broad-ranged and ambitious Financial Sector Strategy Statement in December 2000. New prudential regulations, based on international practice, came into force in July 2001 raising capital adequacy requirements and imposing tighter loan classification guidelines. Progress, however, on the World Bank-assisted program to address the problems of RBB and NBL was slow—they still operate with large levels of nonperforming loans, and no proper accounting or loan management.⁸

⁶ Although the final budget outcome is not available, there are reports that development spending allocations were used to cover the increased cost of teacher salaries.

⁷ The World Bank and AsDB have prepared financial sector projects focusing on banking supervision, regulatory framework, and restructuring (World Bank), nonbank financial institutions and corporate governance (AsDB). The IMF has assisted with central and commercial banking legislation and central bank operations, as well as with amending the income tax law. The AsDB is leading the work on civil service reform and agricultural sector reform. Of other note, DfID is supporting the work of the Public Expenditure Review Commission (PERC) and is financing a long-term privatization consultant and a financial management project at the Ministry of Finance. The Danish and German aid agencies (Danida and GTZ) are assisting the Inland Revenue Department.

⁸ Following an assessment by KPMG that the two largest banks (RBB state-owned, NBL minority state-owned) had negative net worth in the range of \$250–420 million (5–9 percent of GDP) in July 1998.

57. **The government should continue to ensure its open trade and investment regime and encourage access to world markets.** The authorities are urged to reverse the recent imposition of exceptional tariffs on vehicles and rationalize the tariff structure by reducing the number of bands. Efforts to enhance the performance of the financial sector and strengthen supervision should be pursued before opening up the capital account. Further simplifying the existing legal framework and improving governance will also be important.

58. **Although extensive data are compiled in a timely manner, there remain serious deficiencies in official statistics that impair effective monitoring and policy formulation.** The authorities are encouraged to implement the recommendations of the STA multi-sector mission and strengthen statistical legislation, survey methodologies, and data gathering. Considerable donor assistance will be needed to strengthen the limited capacities of the national statistical office over the long term.

59. **The staff recommends that the next Article IV consultation remain on the 12-month cycle.** The authorities have consented to the publication of the staff report.

Table I. Nepal: Selected Economic Indicators, 1997/98–2001/02 1/

Nominal GDP (2000/01): US\$5,568 million

Population (2000/01): 23.2 million

	1997/98	1998/99	1999/00	2000/01 Estimate	2001/02 Projection
Growth (percent change)					
Real GDP at market prices	3.0	4.4	6.5	5.3	6.0
Savings and investment (percent of GDP)					
Gross investment	24.8	20.5	24.3	25.7	26.8
National savings	22.0	21.0	24.8	26.0	25.4
<i>Of which:</i> Public savings	1.3	0.9	1.4	-0.3	1.1
Prices (percent change)					
Consumer prices (end-of-period/12-month)	12.0	9.0	0.6	3.9	5.0
CPI (average)	8.3	11.4	3.4	2.2	5.0
GDP deflator	4.1	8.9	4.3	2.4	5.0
Government budget (percent of GDP)					
Total revenue	10.5	10.2	10.7	11.5	12.8
Total expenditure	16.8	15.4	15.5	18.2	18.7
Current expenditure	9.2	9.3	9.4	11.8	11.6
Capital expenditure and net lending	7.6	6.1	6.1	6.4	7.1
Overall deficit after grants	4.5	3.9	3.3	4.8	3.4
Overall deficit before grants	6.3	5.2	4.8	6.7	6.0
Domestic financing (net)	0.6	1.4	0.6	2.1	0.2
Money and credit (percent change; end-of-period)					
Broad money	21.9	20.8	21.8	15.0	15.0
Domestic credit	14.8	16.1	17.8	20.4	16.4
Interest rates					
91-day treasury bill (end-of-period)	2.4	3.1	5.4	5.0	...
Central bank refinancing	9.0	9.0	6½–7½	6½–7½	...
Loans to industry	13½–17	11½–17	10½–15½	7.0–15.0	...
External trade (percent change)					
Export value 2/	11.8	18.0	37.4	8.0	11.0
Import value 3/	7.1	-2.0	27.7	9.8	13.5
Balance of payments (U.S. dollars million)					
Current account balance (excluding grants)	-135	24	28	18	-87
(in percent of GDP)	-2.8	0.5	0.5	0.3	-1.4
Official grants and loans (net)	479	353	349	299	375
Overall balance	177	145	209	121	94
Other external indicators					
Gross official reserves (U.S. dollars million; end-of-period)	716	795	946	1,014	1,134
In months of imports of goods and services 4/	5.3	4.9	5.5	5.3	5.3
<i>Of which:</i> In convertible currencies	4.1	4.4	4.5	3.7	4.3
Public and public guaranteed debt/GDP (in percent)	49.7	50.3	56.6	58.8	56.3
Debt service 5/	6.7	5.9	4.7	5.2	5.0
National currency per U.S. dollar (end-of-period)	67.9	68.5	70.8	74.8	...
REER (end-of-period; percent change; - = depreciation)	-1.0	7.3	-2.2	...	...
NEER (end-of-period; percent change)	-7.8	-1.5	-0.7	...	...
Fund operations (outstanding loans at end-of-period; SDR million)					
SAF/ESAF	19.6	14.7	10.6	6.6	3.2
Nominal GDP at market prices (Nrs billion)	301	342	380	409	456

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

1/ Fiscal year ends July 15. Data reflect GDP deflator revisions made by the authorities for the period between 1997/98 and 1999/2000.

2/ Cumulative, excluding re-exports.

3/ Cumulative, excluding gold.

4/ Ratio is in terms of projected imports of goods and services.

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

Table 6. Nepal: Medium-Term Scenarios, 1997/98–2004/05

(In percent of GDP, except where indicated)

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
				Projections				
("High Growth" Scenario)								
Real sector								
Real GDP growth (percent change)	3.0	4.4	6.5	5.3	6.0	6.3	6.5	6.5
Agriculture	1.0	2.7	5.0	4.0	4.1	4.0	4.0	4.0
Nonagriculture	5.1	5.6	7.4	6.0	7.2	7.7	8.0	7.9
GDP deflator (percent change)	4.1	8.9	4.3	2.4	5.0	5.0	5.0	5.5
Real per capita GDP (percent change)	0.6	2.0	3.8	-1.5	3.3	3.7	3.9	4.0
National savings	22.0	21.0	24.8	26.0	25.4	25.0	24.6	25.4
Public 1/	1.3	0.9	1.4	-0.3	1.1	1.7	2.1	2.5
Private	20.7	20.1	23.4	26.3	24.2	23.3	22.5	23.0
Gross investment 2/	24.8	20.5	24.3	25.7	26.8	27.4	27.9	28.6
Public 1/	7.6	6.1	6.1	6.4	7.1	7.3	7.5	7.4
Private 2/	17.2	14.4	18.2	19.2	19.7	20.1	20.4	21.2
Fiscal Sector								
Total revenue	10.5	10.2	10.7	11.5	12.8	13.2	13.6	14.0
Grants	1.8	1.3	1.5	2.0	2.5	2.7	2.5	2.1
Current expenditure 4/	9.2	9.3	9.4	11.8	11.6	11.5	11.5	11.6
Capital expenditure & net lending 3/ 4/	7.6	6.1	6.1	6.4	7.1	7.3	7.5	7.4
Overall balance before grants	-6.3	-5.2	-4.8	-6.7	-6.0	-5.6	-5.4	-4.9
Overall balance after grants	-4.5	-3.9	-3.3	-4.8	-3.4	-2.9	-2.9	-2.9
Net foreign financing (including grants)	5.6	3.8	4.1	4.6	5.5	6.3	6.2	5.8
Net domestic debt financing	0.6	1.4	0.6	2.1	0.2	-1.0	-1.1	-1.2
Privatization proceeds	...	...	...	...	0.3	0.4	0.4	0.3
External sector								
Export value (percent change) 5/	11.8	18.0	37.4	8.0	11.0	12.0	12.0	12.0
Import value (percent change) 6/	7.1	-2.0	27.7	9.8	13.5	10.6	12.9	12.7
External current account balance	-2.8	0.5	0.5	0.3	-1.4	-2.4	-3.3	-3.2
Overall balance	3.6	2.9	3.8	2.2	1.6	1.9	2.0	2.0
Financing gap (million US\$)	...	...	...	0	40	30	35	20
Gross official reserves (millions US\$)	716	795	946	1,014	1,134	1,284	1,459	1,615
(in months of imports of goods and services)	5.3	4.9	5.5	5.3	5.3	5.4	5.5	5.3
(Of which: in convertible currencies)	4.1	4.4	4.5	3.7	4.3	4.6	4.7	4.7
Total external debt (millions US\$)	2,612	2,730	3,381	3,624	3,817	4,057	4,298	4,565
Total external debt	53.8	54.2	61.5	65.1	63.6	62.8	61.8	60.9
Debt service ratio	6.7	5.9	4.7	5.2	5.0	5.1	5.2	5.3
Monetary sector 7/								
Broad money (percent change)	21.9	20.8	21.8	15.0	15.0	16.3	16.5	17.0
Private sector credit (percent change)	18.4	18.5	19.9	18.7	19.5	23.1	19.9	20.1
("Low Growth" Scenario)								
Real sector								
Real GDP growth (percent change)	3.0	4.4	6.5	5.3	3.5	3.5	3.5	3.5
Agriculture	1.0	2.7	5.0	4.0	3.0	3.0	3.0	3.0
Nonagriculture	5.1	5.6	7.4	6.0	3.8	3.8	3.8	3.8
Real per capita GDP (percent change)	0.6	2.0	3.8	-1.5	1.2	1.2	1.2	1.2
Gross investment 2/	24.8	20.5	24.3	25.7	24.0	24.0	24.0	24.0
Fiscal Sector								
Public savings 1/	1.3	0.9	1.4	-0.3	0.3	0.5	0.5	0.5
Overall fiscal balance before grants	-6.3	-5.2	-4.8	-6.7	-6.7	-7.0	-7.0	-7.0
Net domestic financing	0.7	1.4	0.6	2.1	2.4	2.8	2.9	3.0
Net foreign financing (including grants)	5.6	3.8	4.1	4.6	4.3	4.2	4.1	4.0
External sector								
External current account balance	-2.8	0.5	0.5	0.3	-2.3	-3.2	-3.9	-3.6
Gross official reserves (millions US\$)	716	795	946	1,014	1,014	998	1,003	979
(in months of imports of goods and services)	5.3	4.9	5.5	5.5	5.3	4.8	4.6	4.0
(Of which: in convertible currencies)	4.1	4.4	4.5	3.9	4.1	3.9	3.7	3.2
Total external debt	53.8	54.2	61.5	65.1	61.9	61.4	61.0	60.6
Debt service ratio	6.7	5.9	4.7	5.2	5.7	6.0	6.4	6.8

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

1/ Public savings and investment estimate derived from fiscal accounts. Gross investment derived from national income accounts (adjusted).

2/ Historical totals include changes in stocks.

3/ For 2000/01, capital and development includes partial cost of voluntary retirement scheme. Staff estimate for 2001/02, not the budget target.

4/ From 2002/03, current includes interest cost of restructuring bonds and capital includes remaining cost of voluntary retirement scheme.

5/ Excluding re-exports.

6/ Excluding gold.

7/ Excludes balance sheet impact of restructuring RBB and NBL.

Table 7. Nepal: Social Indicators

	Latest single year			Same Region/Income Group		
	1970-75	1980-85	1993-98	India	South Asia	Low Income
Total population, mid-year (millions)	12.8	16.5	22.9	979.7	1,304.6	3,536.4
Growth rate (percent annual average)	2.4	2.6	2.0	1.4	1.5	1.4
Urban population (percent of population)	5.0	7.8	11.3	27.8	27.7	30.5
Total fertility rate (births per woman)	6.3	6.1	4.4	3.2	3.4	3.1
Total labor force (millions)	...	7	11	439	585	1,085
Females in labor force (percent)	...	39	40	32	33	38
Labor force participation rate	...	48	48	43	43	50
Poverty						
National headcount index	...	...	42	35	...	...
Urban headcount index	...	...	23	31	...	...
Rural headcount index	...	...	44	37	...	...
Income						
GNP per capita (U.S. dollars)	120	170	210	440	430	520
Consumer price index (1995=100)	17	35	125	132	131	136
Food price index (1995=100)	...	33	113	132	...	...
Income/consumption distribution						
Gini index	...	...	36.7	37.8	...	...
Lowest quintile (percent of income or consumption)	...	...	7.6	8.1	...	...
Highest quintile (percent of income or consumption)	...	...	44.8	46.1	...	...
Public expenditure						
Health (percent of GDP)	...	...	1.3	0.6	0.8	1.3
Education (percent of GDP)	1.5	2.6	3.2	3.2	3.1	3.2
Social security and welfare (percent of GDP)	0.1	0.1	0.3	...	...	...
Net primary school enrollment rate (percent of age group)						
Total	...	60	78	77	77	86
Male	...	80	93	83	83	89
Female	...	37	63	71	70	82
Gross secondary school enrollment						
Total	12	27	32	49	...	...
Male	19	39	45	59	...	...
Female	4	14	18	39	...	...
Adult literacy (percent)	...	22	33	55	53	60
Female literacy	...	...	22	43	41	51
Access to safe water (percent of population)						
Total	8	24	59	81	77	69
Urban	85	78	61	85	83	80
Rural	5	20	59	79	70	66
Access to electricity (percent)	...	...	15	54	...	...
Population per physician	...	30,221	13,617	2,459	2,500	...
Population per hospital bed	...	5,719	4,308	1,503	1,429	1,152
Immunization rate (percent under 12 months)						
Measles	...	34	85	81	81	80
DPT	...	32	78	90	87	82
Child malnutrition (percent under 5 years)	69	...	57	53	53	...
Life expectancy at birth (in years)						
Total	43	49	58	63	62	63
Male	44	50	58	62	62	62
Female	43	48	58	64	63	64
Mortality						
Infant (per thousand live births)	160	125	77	70	75	68
Under 5 (per thousand live births)	234	180	107	83	89	92
Adult (15-59)						
Male (per 1,000 population)	482	376	273	215	220	235
Female (per 1,000 population)	476	395	309	204	213	208
Maternal (per 100,000 live births)	...	...	540	410	...	...

Sources: Staff reports, EDSS, World Bank 2000 World Development Indicators CD-ROM.