

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

**FOR
AGENDA**

MASTER FILES
ROOM C-525

0450

SM/92/54

CONTAINS CONFIDENTIAL
INFORMATION

March 11, 1992

To: Members of the Executive Board

From: The Secretary

Subject: Nepal - Staff Report for the 1991 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1991 Article IV consultation with Nepal, which is tentatively scheduled for discussion on Friday, April 3, 1992.

Mr. O. Evans (ext. 7183) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

NEPAL

Staff Report for the 1991 Article IV Consultation

Prepared by the Staff Representatives for the
1991 Consultation with Nepal

Approved by Bijan B. Aghevli and S. Kanesa-Thasan

March 10, 1992

<u>Contents</u>	<u>Page</u>
I. Introduction	1
II. Economic Background	2
1. Recent developments	2
2. Regional trade relations	5
III. Policy Discussions	6
1. Short-term policy issues	6
a. Fiscal issues	6
b. Monetary policy	8
c. External policies	9
2. Medium-term macro-economic framework	11
3. Structural policies	12
4. Poverty and the environment	15
IV. Staff Appraisal	16
 <u>Annexes</u>	
I. Economic Relations Between Nepal and India	19
II. Fund Relations	24
III. Relations with the World Bank	28
IV. Relations with the Asian Development Bank	30

I. Introduction

The 1991 Article IV consultation and preliminary ESAF discussions with Nepal were held in Kathmandu during December 2-15, 1991. The staff representatives 1/ met with the Prime Minister, the Minister of Finance, the Governor of Nepal Rastra Bank (the central bank), and other senior officials. Nepal continues to avail itself of the transitional arrangements under Article XIV, Section 2, and has been placed on the 12-month consultation cycle.

The last Article IV consultation was concluded on January 16, 1991 (EBM/91/6). 2/ Executive Directors commended the authorities for persevering with the medium-term structural adjustment program despite the disruptions caused by the trade and transit impasse with India. They called for appropriately tight financial policies to maintain economic and financial stability during the political transition and urged that the momentum of structural reforms be maintained. Key areas identified for further reform included trade and industrial liberalization, public enterprises, tax policy and financial reform.

The new Government, which took office after elections in mid-1991, has begun to take important structural initiatives and is eager for international support. In addition to the usual review of macro-economic performance, the consultation discussions focussed on the authorities' agenda for medium-term structural reform in preparation for discussions related to a possible ESAF arrangement which are expected to take place in a couple of months. 3/

When this report was being finalized in early March, the authorities took steps amounting to the adoption of a dual exchange rate regime, in response to a similar move in India. The measures are described in Section III.1.c., dealing with external policies. After more information has become available, the staff will issue a supplement to this report evaluating these measures, at a time closer to the Board meeting. The supplement will also contain a proposed decision.

1/ The staff representatives were: Messrs. Wong (Head) and Schulz (both CTA), Mulder (FAD), and Nielsen (ETR), and Mrs. Froliia (Administrative Assistant, CTA). Mr. Neiss (CTA) joined the mission during the second week. Mr. Di Mauro, an AsDB staff member, also participated in the mission.

2/ Nepal's relations with the Fund are summarized in Annex II. The World Bank and Asian Development Bank lending operations in Nepal are summarized in Annexes III and IV, respectively.

3/ Nepal completed a program supported by a three-year SAF arrangement in late 1990. Performance under the SAF was reviewed in the staff report for the 1990 Article IV consultation (SM/90/232, 12/18/1990) and the accompanying report on Recent Structural Reforms (SM/91/3; 1/2/1991).

Nepal has consented to its quota increase under the Ninth General Review but has not yet accepted the proposed Third Amendment to the Fund's Articles of Agreement.

II. Economic Background

1. Recent developments

Macroeconomic performance was mixed in 1990/91, with growth rebounding but inflation rising (Table 1 and Charts 1 and 2). ^{1/} The overall balance of payments position remained in substantial surplus--despite an external current account deficit of 12 percent of GDP--because of large unidentified inflows. ^{2/} This inflow is believed to have reflected unrecorded exports of foodgrains, inflows of short-term private capital and direct investment, and delays in the recording of aid inflows (Table 2). A substantial increase in short-term private capital inflows in 1990/91 is believed to have been associated with special economic and political events in both India and Nepal in that year, despite some narrowing of interest differentials between the two countries. The large overall payments surplus boosted gross external reserves to the equivalent of six months' imports of goods and services by July 1991. The Nepal rupee was devalued by 17 percent vis-a-vis the U.S. dollar in July 1991 after a 19 percent adjustment in India (Chart 3). The ratio of external debt to GDP has risen substantially in recent years on account of the effect of depreciation of the exchange rate relative to currencies other than the Indian rupee; the debt service ratio has remained low, reflecting the concessional terms on which most debt is contracted.

The rise in inflation during 1990/91 reflected both faster inflation in India and also the effect of expansionary domestic policies. The Central Government deficit remained high at 9 percent of GDP (excluding bank recapitalization operations) and the growth of broad money accelerated, fuelled by rapid expansion in reserve money. The financial performance of nonfinancial public enterprises also worsened because of increases in their wage bills and rigid pricing policies.

The new Government inherited a deteriorating fiscal situation and had little time to make major changes in direction before its first budget. In the period of political transition, heightened expectations had led to a significant increase in recurrent expenditure (especially wages), which, in

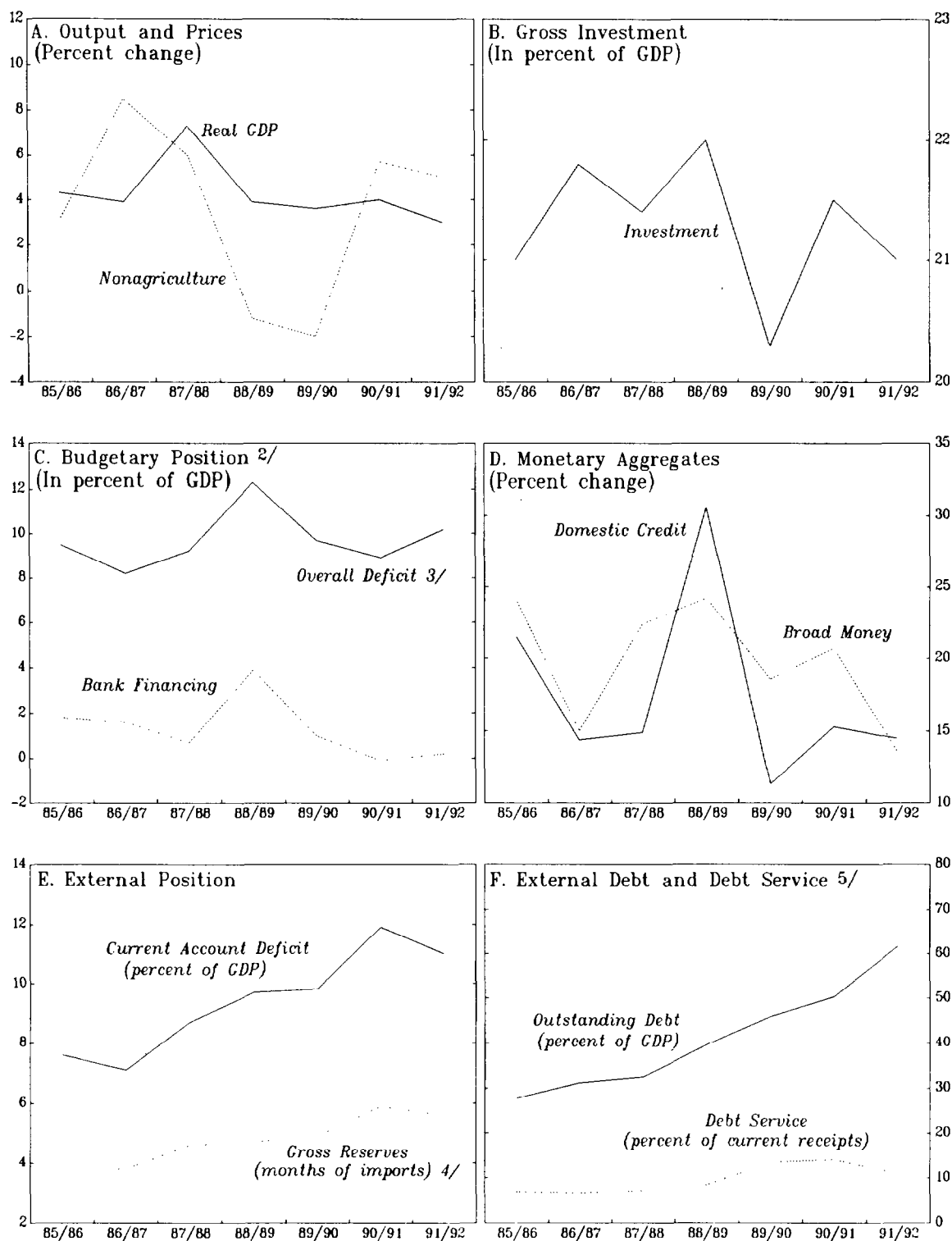
^{1/} The fiscal year begins in mid-July.

^{2/} Nepal's balance of payments statistics do not record private capital and direct investment flows and consequently movements in these items contribute to large swings in errors and omissions. A Statistics Department team visited Kathmandu in late February 1992 to provide technical assistance on improving balance of payments statistics.

CHART 1

NEPAL

SELECTED ECONOMIC AND FINANCIAL INDICATORS, 1985/86-1991/92 ^{1/}



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

^{1/} Data for 1991/92 are projections.

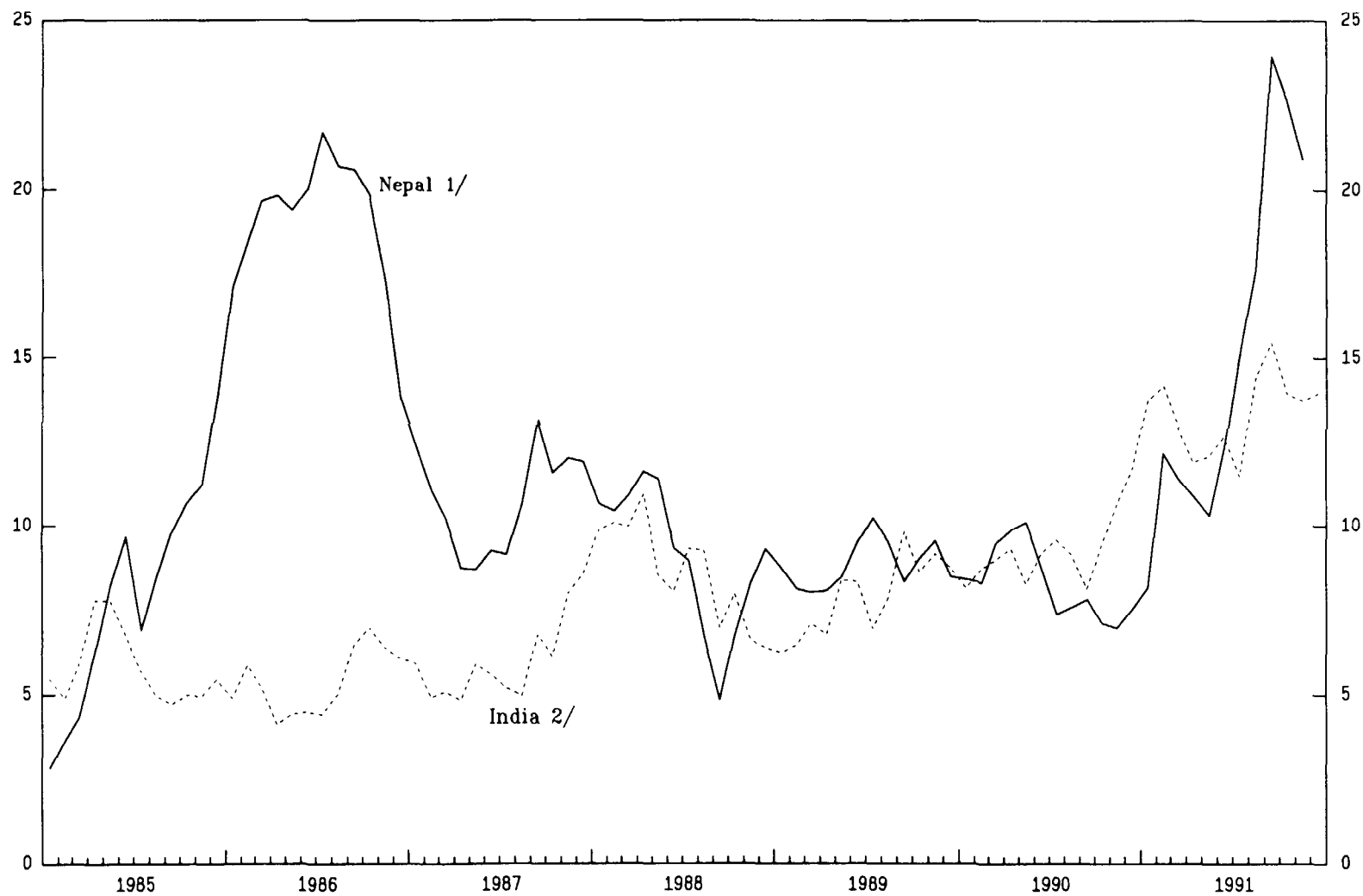
^{2/} In 1990/91 excluding bank rescue operation.

^{3/} Original estimate in 1991/92.

^{4/} Imports of the following year's goods and services.

^{5/} Including the fund.

CHART 2
NEPAL
INFLATION, 1985-91
(Annual percentage change)



Source: IFS, International Financial Statistics.
1/ Consumer prices for Nepal.
2/ Wholesale prices for India.

Table 1. Nepal: Economic Trends, 1987/88-1991/92

(In percent)

	1987/88	1988/89	1989/90	1990/91	1991/92 Est.
Real GDP (growth rate)	7.3	3.9	3.6	4.0	3.0
Agriculture	8.1	7.5	7.3	3.0	1.7
Nonagriculture	6.0	-1.2	-2.0	5.7	5.0
Rate of inflation <u>1/</u>	11.0	8.1	11.5	9.8	18.0
Budget deficit/GDP	-9.2	-12.3 <u>2/</u>	-9.7 <u>2/</u>	-8.9 <u>2/</u>	-10.2
Of which: Bank-financed/GDP	0.7	3.9 <u>2/</u>	1.0 <u>2/</u>	-0.1 <u>2/</u>	0.2
Broad money (growth rate)	22.4	24.2	18.6	20.7	13.6
Domestic credit (growth rate)	14.9	30.6	11.3	15.3	14.5
Reserve money (growth rate)	18.4	26.0	22.8	20.5	...
Exports (growth rate) <u>3/</u>	34.4	-11.5	11.3	31.5	36.7
Imports (growth rate) <u>3/</u>	24.3	2.2	0.1	19.5	1.3
Current account deficit/GDP	-8.7	-9.7	-9.8	-11.9	-11.0
Real effective exchange rate <u>4/</u>	-4.9	-3.9	-4.3	-4.8	-8.3 <u>5/</u>
Nominal exchange rate <u>4/</u>	-7.4	-7.3	-4.1	-10.7	-12.6 <u>5/</u>
External debt/GDP	32.4	39.6	45.9	50.4	61.7
Debt service ratio <u>6/</u>	7.1	8.4	13.5	14.1	11.0

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

1/ Based on the national consumer price index (period average).

2/ Excluding bank rescue operations.

3/ In U.S. dollar terms.

4/ End-of-period change.

5/ December

6/ Based on current receipts; excluding Indian excise refund.

Table 2. Nepal: Summary of Balance of Payments, 1987/88-1991/92

	1987/88	1988/89	1989/90	1990/91	1991/92 Est.
(In millions of U.S. dollars)					
Exports, f.o.b.	186	165	183	241	329
Imports, c.i.f.	-627	-640	-641	-766	-776
Trade balance	<u>-441</u>	<u>-476</u>	<u>-458</u>	<u>-526</u>	<u>-447</u>
Services and transfers (net) <u>1/</u>	172	177	153	148	131
Services	93	120	91	85	76
Transfers <u>1/</u>	78	58	61	62	56
Current account balance	<u>-269</u>	<u>-298</u>	<u>-305</u>	<u>-378</u>	<u>-315</u>
Grants and nonmonetary capital (net)	372	301	398	529	354
Official	262	281	244	253	255
Grants	63	49	38	54	83
Capital	199	232	206	200	172
Commercial loan (net) <u>2/</u>	44	52	-6	-7	-7
Errors and omissions	66	-32	160	283	106
Overall balance	<u>103</u>	<u>3</u>	<u>93</u>	<u>151</u>	<u>38</u>
(In units indicated)					
Memorandum items:					
Current account balance (in percent of GDP)	-8.7	-9.7	-9.8	-11.9	-11.0
Gross international reserves					
In millions of U.S. dollars	313	316	412	454	488
In months of next year's imports of goods and services	(4.6)	(4.7)	(4.9)	(5.9)	(5.6)

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

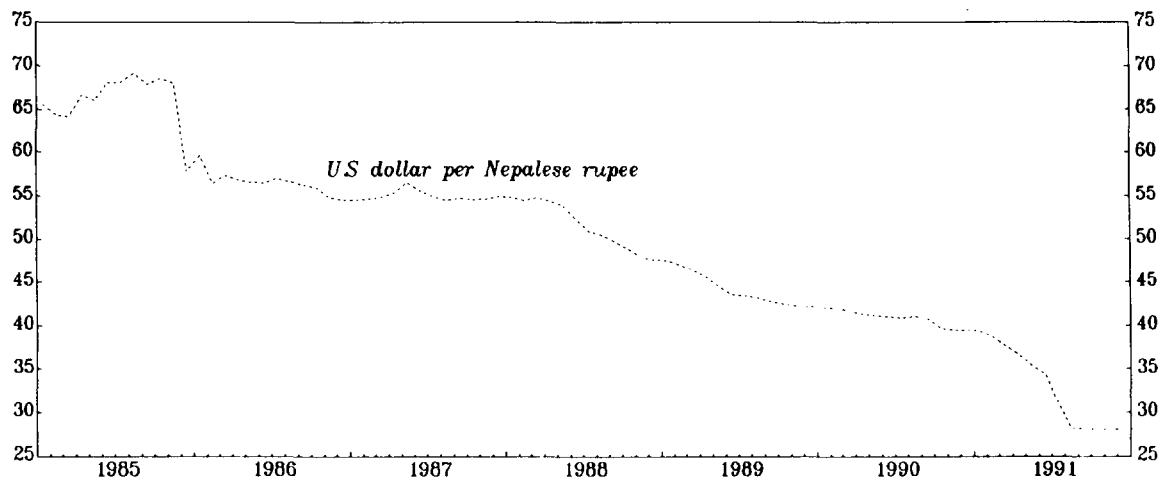
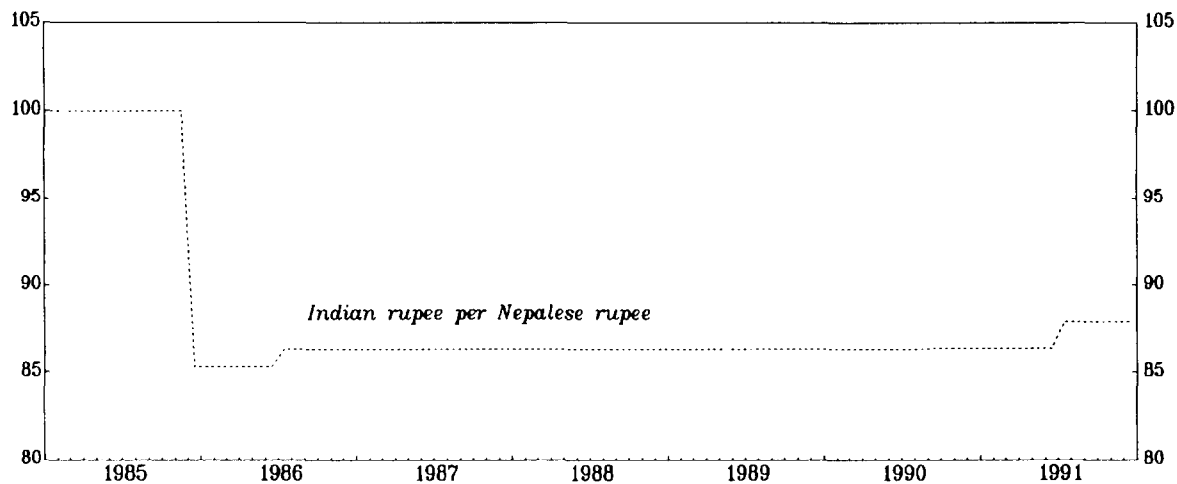
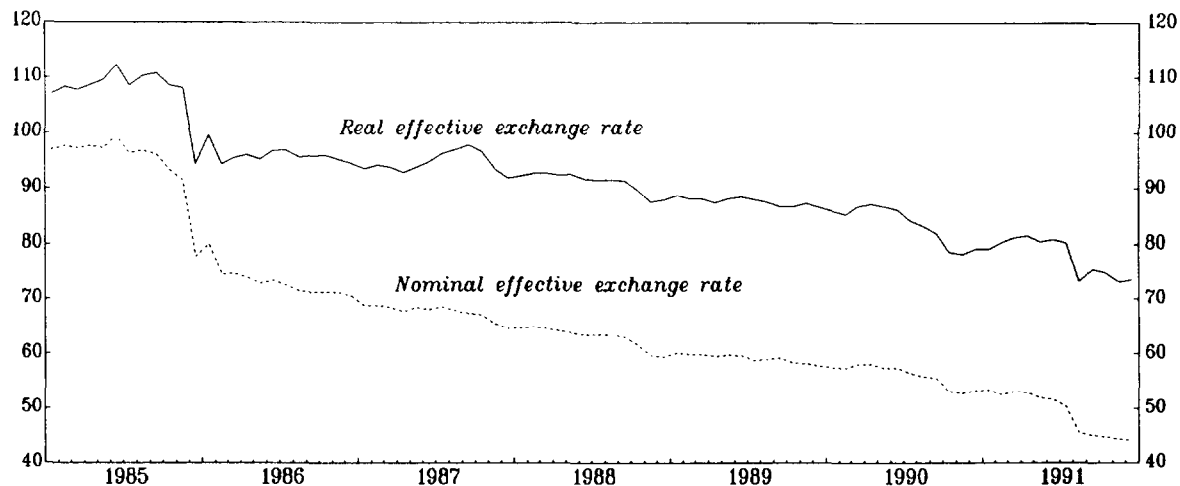
1/ Excluding official grants and including private remittances.

2/ For the purchase of aircraft in 1987/88 and 1988/89.

CHART 3

NEPAL

EXCHANGE RATE DEVELOPMENTS, 1985-91
(1980=100)



Sources: IMF, Information Notice System; data provided by the Nepalese authorities.

turn, contributed to the emergence of shortages of counterpart funds for development projects. As discussed later, the underlying fiscal situation has worsened in 1991/92, but the Government appears to be limiting the extent of the deterioration. Moreover, politically sensitive adjustments to public enterprise prices have been implemented.

For 1991/92, output growth is estimated to decline to 3 percent, as a weather-related drop in rice production has curtailed agricultural output, while industrial sector performance is expected to remain buoyant. Consumer price inflation accelerated to 22 percent by January 1992 on account of the impact of the devaluation in July, substantial upward adjustments in utility rates and domestic demand pressures. The price surge was, however, confined to the period July-September 1991 and subsequently, the consumer price index has essentially been flat, in line with the normal seasonal pattern. The staff projects that the 12-month inflation rate will abate to about 11-12 percent by the end of the fiscal year as tighter domestic financial policies take effect and imported inflation (from India) falls.

The external current account deficit is projected to decline from 12 percent of GDP in 1990/91 to 11 percent in 1991/92, owing to rapidly growing exports and a slowing of imports after the July devaluation. Available part-year data indicate a sharp increase in export earnings, especially carpets, resulting from the improved competitive position after the devaluation in July 1991. The overall balance of payments is expected to shift to a smaller surplus in 1991/92 in part because a smaller unrecorded inflow is expected, as indicated both by part-year data and the absence of special factors which contributed to a spike in this inflow in 1990/91. Gross official reserves would amount to the equivalent of five and a half months of import cover by the end of the fiscal year. ^{1/}

2. Regional trade relations

The economy of Nepal is closely linked to that of India because both goods and capital move relatively freely across the long and open border and because of the full convertibility between the two currencies. Consequently, in formulating economic policies, Nepal has to take close account of developments in India. Recent efforts by India to shift to a more outward-oriented development strategy, dismantling trade barriers in the process, afford Nepal the opportunity to press ahead with its own policy changes.

Nepal and India have recently concluded new trade and transit treaties and renewed the agreement of cooperation to control unauthorized trade. The arrangements (see Annex I) include a relaxation of domestic value-added content requirements for Nepal's exports to India and a simplification of

^{1/} Gross official reserves (Indian rupees and convertible currency reserves) of the banking system relative to projected imports for the subsequent year.

procedures. While the re-establishment of these arrangements is welcome, the treaties fall short of a more desirable liberal and transparent system, inter alia, because most provisions are still complex and subject to considerable bureaucratic discretion.

III. Policy Discussions

The policy discussions focussed on the fiscal and monetary policies needed to achieve a reduction in inflation in the near-term and the structural reforms required to raise medium-term growth potential while maintaining low inflation and external balance. ^{1/} These objectives are to be promoted by a mix of demand management measures and structural reforms.

1. Short-term policy issues

The short-term challenge facing the authorities is to check the rapid rise in inflation in order to maintain competitiveness and lay the foundation for sustained medium-term growth. A continuation of inflation in excess of that in major trading partners, especially India, would erode competitiveness over time and eventually prove incompatible with maintaining a fixed exchange rate. Consequently, the staff called for measures to reduce inflation in Nepal to 10 percent by mid-1992, in line with the inflation rate projected for India at that time. Such a target implied the need for additional efforts to reduce the budget deficit and slow monetary growth.

The authorities agreed that inflation needed to be brought down rapidly but saw the measures needed to achieve the proposed inflation target as too demanding, given the devaluation and administered price adjustments earlier in the year and that half of the fiscal year had passed. Since the consultation discussions, the fiscal outlook has improved somewhat and the authorities have implemented decisive measures of monetary restraint.

a. Fiscal issues

The original budget for 1991/92 projected an overall deficit of 11 1/4 percent of GDP (domestic financing of 1 3/4 percent of GDP) compared with 9 percent of GDP for 1990/91, net of spending related to special measures of bank recapitalization (Table 3). Staff analysis indicated that the impact of the July devaluation--not built into the budget--would be to raise the deficit by more than 1 percent of GDP, in the absence of offsetting measures. The budget projections entailed a 1 3/4 percent of GDP rise in

^{1/} The authorities' medium-term strategy is aimed at these macro-economic objectives, and also poverty alleviation, redressing environmental degradation, improving the status of women in development, and slowing population growth.

Table 3. Nepal: Summary of Central Government Budgetary Operations,
1987/87-1991/92

	1987/88	1988/89	1989/90	1990/91	1991/92 Budget	1991/92 Est.
(In millions of Nepalese rupees)						
Revenue	7,200	7,598	9,036	10,564	12,207	13,067
Tax	5,753	6,287	7,283	8,176	9,554	10,414
Nontax	1,447	1,311	1,753	2,388	2,653	2,653
Total expenditure <u>1/</u>	13,558	17,292	18,054	22,751	25,084	25,499
Regular	4,280	5,142	5,883	6,944	8,539	8,809
Development <u>1/</u>	9,278	12,070	11,770	12,535	16,545	16,690
CBPASS <u>2/</u>	--	80	400	3,272	--	--
Overall balance before grants	-6,358	-9,694	-9,018	-12,187	-12,877	-12,432
Foreign grants	2,077	1,681	1,715	2,700	3,511	3,511
Net foreign loans	3,508	5,282	5,271	5,537	7,460	7,740
Net domestic financing	773	2,731	2,032	3,950	1,906	1,181
Banking system	471	3,110	1,330	3,197	1,007	281
Other domestic	291	-379	700	751	898	898
(In percent of GDP)						
Revenue	10.5	9.7	10.2	10.5	10.6	10.7
Total expenditure <u>1/</u>	19.7	22.1	20.4	22.6	21.9	20.9
Regular	6.2	6.6	6.6	6.9	7.4	7.2
Development & net lending <u>1/</u>	13.5	15.4	13.3	12.5	14.4	13.7
CBPASS <u>2/</u>	--	0.1	0.5	3.3	--	--
Overall balance before grants	-9.2	-12.4	-10.2	-12.1	-11.2	-10.2
Foreign grants	3.0	2.1	1.9	2.7	3.1	2.9
Net foreign loans	5.1	6.7	5.9	5.5	6.5	6.3
Net domestic financing	1.1	3.5	2.3	3.9	1.7	1.0
Banking system	0.7	4.0	1.5	3.2	0.9	0.2
Other domestic	0.4	-0.5	0.8	0.7	0.8	0.7
Memorandum items:						
Overall balance excluding CBPASS	-9.2	-12.3	-9.7	-8.9	-11.2	-10.2
Domestic financing excluding CBPASS	1.1	3.4	1.8	0.7	1.7	1.0

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

1/ Including net lending.

2/ Including repayment of public enterprises' arrears to the banking system by the Government and bank rescue operations (Nrs. 3,030 million in 1990/91).

development spending; new revenue measures, notably a rise in alcohol and tobacco taxes and a new urban property rental tax, slated to yield about 1/2 percent of GDP; and limits on wage adjustments to 2 percent to contain non-interest current spending. The budget also redirected spending priorities in favor of key social programs, such as primary education, health, rural water supply and roads in rural areas. An important unresolved issue concerns the recent recommendations of the Pay Commission, which if implemented, would impose a severe strain on the budget. The staff judged that pay adjustments for civil servants should be delayed until the streamlining of the Government's administrative apparatus has begun and should be framed in light of fiscal realities.

In view of the projected widening in the underlying deficit, the staff called for a mid-year fiscal correction to bring the deficit for 1991/92 down to 10 percent of GDP, which would almost eliminate bank financing for the year as a whole. The authorities were skeptical about achieving such a target because of the impact of the devaluation and the fact that only half of the fiscal year remained. However, they intended to maintain adequate restraint over spending and pointed to initiatives to freeze hiring of government personnel (including defense and security staff).

On the basis of current policies and incorporating more recent data--which indicate more buoyant-than-expected revenue growth, and some under-implementation of development spending--the staff's revised estimates indicate an overall deficit for 1991/92 of 10 1/4 percent of GDP, still well above the 1990/91 figure (net of special spending related to bank recapitalization). The improved revenue picture may reflect in part the authorities' efforts to improve tax administration. It will be crucial for the authorities to use the next budget to begin a process of medium-term fiscal consolidation and also to initiate improvements in public sector resource management, including heightened scrutiny of development projects in light of shortages of counterpart funds and emerging evidence of limitations to absorptive capacity. ^{1/}

The Government has made politically sensitive adjustments in public enterprise prices. Prices of petroleum products and chemical fertilizer were raised by an average 25 and 40 percent respectively after the July devaluation and corresponding adjustments in India; the electricity tariff was increased by 61 percent in November 1991 and telephone charges by 50 percent.

b. Monetary policy

In order to rein in inflation by the end of the financial year, the staff estimated that monetary growth needed to be reduced to 12 percent. Nepal representatives concurred and, beginning in late December 1991, the

^{1/} A focus of current World Bank operations in Nepal is to enhance the effectiveness of public sector resource management.

authorities took decisive measures which are estimated to have absorbed liquidity equivalent to nearly 6 percent of broad money. The Government sold NRs 600 million of national saving certificates while the Rastra Bank auctioned three-month central bank bills (NRs 500 million), and moved to a weekly schedule of treasury bill auctions (formerly twice monthly) at average pre-tax yields of 13.5 percent with no cap placed on yields. In addition, the Rastra Bank announced introduction of a temporary 24 percent statutory liquidity requirement against rupee deposits, with eligible securities comprising treasury bills, central bank bills and government development bonds. ^{1/} While the shift to monetary restraint is laudable, the reliance on a new liquidity ratio is not fully consistent with the drive for a more market-oriented approach to monetary policy. Nevertheless, these measures represent the first decisive effort in the recent past to address excessive monetary expansion.

Assessment of the level of real interest rates is complicated because underlying inflation at present appears to be well below the measured inflation rate. Although both commercial bank deposit and lending rates are below the measured 12-month inflation rate, lending rates (in the range of 15 to 21 percent) appear to exceed the underlying rate of inflation. As the current temporary surge in inflation subsides, the structure of interest rates will need to be monitored closely to ensure that positive real interest rates are restored and that interest rates on Government paper are maintained at levels consistent with the intended overall tightness of monetary policy.

The large and unexpected unrecorded external inflows, along with a rigid foreign exchange budgeting procedure, have complicated the task of monetary management by boosting reserve money growth. Indeed, recent larger-than-expected external inflows have boosted the staff projection of the growth of broad money during 1991/92 to 13 1/2 percent (Table 4). In addition to longer-term advantages, a more liberal and flexible import regime could have the short-term benefit of limiting money creation associated with unexpected foreign currency inflows.

c. External policies

Nepal's exchange rate regime comprises a de facto peg of the Nepalese rupee to the Indian currency. During the discussions, the staff underscored the benefits of this approach in terms of providing an anchor for financial policies and enhancing access to the larger Indian market. The devaluation in July 1991--concurrent with a similar adjustment in India--has acted to safeguard the competitiveness of Nepal's exports for the near-term, contributing to a rapid export growth and a further rise in reserves.

^{1/} Excluding those issued previously for the bank recapitalization operation.

Table 4. Nepal: Monetary Survey, 1987/88-1991/92

	1987/88	1988/89	1989/90	1990/91	1991/92 Proj.
<u>(In millions of Nepalese rupees; outstanding at end of period)</u>					
Net foreign assets	5,574	6,204	9,339	16,489	18,114
Assets	7,395	8,691	12,014	19,371	20,846
Liabilities	-1,821	-2,487	-2,675	-2,882	-2731
Net domestic assets	15,849	20,401	22,213	21,596	25,138
Domestic credit	20,026	26,164	29,127	33,585	39,164
Public sector	10,782	14,093	15,434	17,991	18,351
Government (net)	8,815	11,925	13,406	16,283	16,940
Nonfinancial public enterprises	1,966	2,168	2,028	1,708	1,411
Private sector	9,244	12,071	13,693	16,817	20,096
Other items (net)	-4,176	-5,763	-6,914	-11,989	-13,309
Broad money	21,423	26,605	31,552	38,085	43,253
Narrow money	9,597	11,775	14,223	16,489	18,649
Time deposits	11,826	14,830	17,329	21,596	24,604
<u>(Annual percentage change)</u>					
Net domestic assets	9.8	28.7	8.9	-2.8	16.4
Domestic credit	14.9	30.7	11.3	15.3	14.5
Public sector	5.7	30.7	9.5	16.6	2.0
Government (net)	5.6	35.3	12.4	21.5	4.0
Nonfinancial public enterprises	5.9	10.3	-6.5	-15.8	-17.4
Private sector	27.8	30.6	13.4	13.9	28.9
Broad money	22.4	24.2	18.6	20.7	13.6
(Reserve money)	(18.4)	(26.0)	(22.8)	(20.5)	...
<u>(Change as a percent of broad money at beginning of the year)</u>					
Net foreign assets <u>1/</u>	13.0	0.4	10.0	15.2	4.3
Net domestic assets <u>1/</u>	9.4	23.8	8.6	5.6	9.3
Domestic credit	14.8	28.7	11.1	14.1	12.8
Public sector	3.3	15.5	5.0	8.1	0.9
Government (net)	2.7	14.5	5.6	9.1	1.7
Nonfinancial public enterprises	0.6	0.9	-0.5	-1.0	-0.8
Private sector	11.5	13.2	6.1	6.0	11.8
Other items (net) <u>1/</u>	-5.4	-4.8	-2.5	-8.6	-3.5
Memorandum items:					
Velocity (GDP/M2)	3.54	3.26	3.05	2.89	3.00
Money multiplier	2.38	2.35	2.27	2.27	...

Sources: Data provided by the Nepal Rastra Bank; and staff estimates and projections.

1/ Excludes foreign exchange valuation adjustment.

However, if the competitive position is to be maintained, then--as discussed above--inflation in Nepal needs to be brought in line with that in India.

In early March 1992, the authorities announced the adoption of what amounts to a dual exchange rate regime together with what could be a major shift toward a genuine open general license system, in line with a similar move in India. Exporters (of both goods and services) will be allowed to sell 65 percent of receipts of convertible currencies to commercial banks at a market determined exchange rate. The remaining 35 percent would be surrendered to the central bank at the official exchange rate and used to finance imports of petroleum products, Government imports, industrial machinery, chemical fertilizers and pharmaceuticals. Imports of virtually all other commodities would be placed under open general license with foreign exchange to be obtained from the export retention market at the free market exchange rate. However a short list of sensitive items would be retained, for which import licenses (and thus in effect foreign exchange) would be rationed through the existing import license auction system. As noted earlier, the staff will obtain more information on these policy changes and present an assessment, in a supplement to the staff report to be issued closer to the Board meeting.

Exchange restrictions maintained by Nepal on transactions with countries other than India comprise a foreign exchange budget linked to the issue of import licenses; limits on certain invisibles payments; and margins on letters of credit for some imports. ^{1/} The bilateral payments agreements with Poland, Czechoslovakia, and Bulgaria, previously identified as giving rise to restrictions requiring Board approval, have been terminated.

2. Medium-term macroeconomic framework

Assuming policy adjustments as recommended by the staff and in line with the authorities' intentions, the staff's medium-term projections point to a substantial improvement in macroeconomic performance in the coming years. ^{2/} Several factors should contribute to the improved outlook, including the increasing importance of trade in GDP; the effects of domestic deregulation and liberalized foreign investment; the benefits of firmer financial policies; and the more efficient and streamlined public sector. Real GDP growth is projected to pick up from 3 percent in 1991/92 to 4-5 percent annually over the medium-term (Table 5), while inflation should decline to around the average expected in trading partners.

^{1/} A complete description of the exchange and trade system may be found in Annual Report on Exchange Arrangements and Exchange Restrictions, 1991.

^{2/} The projections are only illustrative and potentially subject to a wide margin of error, inter alia since many of the details of the authorities' policies remain to be spelled out. The projections would need to be revisited at the time of discussions related to a possible ESAF arrangement, to incorporate additional information and a more up-to-date assessment of policies.

A key assumption is a sustained reduction in the Central Government deficit permitting an eventual cessation of domestic financing of the budget. The fiscal consolidation together with improvement in private savings would permit a reduction in the current account deficit together with an increase in domestic investment.

The external current account deficit is projected to decrease from 11 to 8 percent of GDP over this period reflecting proximately the expected stronger real growth in merchandise exports than of merchandise imports and more fundamentally the improvement in domestic saving (including public saving) relative to investment. The export sector would benefit from Nepal's improved competitive position vis-a-vis overseas countries and from reform of the trade system more generally. As the external current account deficit is expected to be broadly financed by normal capital inflows, including substantial external assistance, the overall balance would remain on average close to zero. With the projected rise in imports, reserves are thus expected to decline from six months of imports in 1991/92 to some four months by the mid-1990s.

Nepal needs a relatively high level of foreign reserves, in view of its landlocked status and special vulnerability to changes in trade arrangements with India. The need for a large reserve cushion is reinforced by the Government's desire to introduce significant trade reforms and the inevitable uncertainty in projecting errors and omissions. In the staff projection, while these flows remain positive, reserves nevertheless decline over time in terms of months of imports. Should this inflow be less than assumed here, the reduction in reserves would be more pronounced.

The medium-term projections abstract from possible investments in a large hydro-electric project (Arun III) which may be made over the next several years. While initial outlays could commence soon if the project goes forward, the peak period of investment would be in the second half of the decade, by which time the investment could amount to several percentage points of GDP. The magnitude, timing and financing of these investments remain under discussion among the authorities, the World Bank and other donors and so any estimates are highly uncertain.

3. Structural policies

The authorities are considering an ambitious program of structural reforms, in which the key areas would be trade liberalization, a freer foreign investment policy, more efficient management of public sector resources, financial reform and deregulation of private sector activities. Trade policy reform would aim at a more transparent trade system and a transition to current account convertibility over the next several years, in line with similar plans in India. Regulations concerning foreign investment flows are to be streamlined and inflows facilitated. Public sector reform will aim at pruning the development budget, a streamlined civil service, and

Table 5. Nepal: Macroeconomic Projections, 1990/91-1996/97 ^{1/}

	1990/91	1991/92 Est.	1992/93	1993/94	1994/95	1995/96	1996/97
			Projections				
			(Annual percentage change)				
Real GDP	4.0	3.0	4-5	4-5	4-5	4-5	4-5
Consumer prices (period average)	9.8	18.0	7.5	6.0	5.0	5.0	5.0
(end of period)	15.1	11.5	6.5	5.5	5.0	5.0	5.0
			(In millions of U.S. dollars)				
Trade balance	-526	-447	-483	-521	-556	-593	-631
Net invisibles	148	131	147	166	185	208	235
Current account balance	-378	-315	-336	-355	-371	-385	-396
Overall balance	151	38	-13	-4	13	47	62
			(In units indicated)				
Gross external reserves ^{2/}	5.9	5.6	4.9	4.4	4.0	3.9	3.9
Debt service ratio (percent) ^{3/}	14.1	11.0	9.7	9.7	9.9	9.0	9.3
Gross external debt ^{4/}	50.4	61.7	60.4	59.2	58.2	57.4	56.3
Current account deficit ^{4/}	11.9	11.0	10.5	9.9	9.4	8.8	8.2

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

^{1/} Excludes operations related to a proposed large hydro project (Arun III).

^{2/} In months of imports of goods and services.

^{3/} In percent of current receipts; excluding Indian excise refund.

^{4/} In percent of GDP.

enhancing the elasticity of the tax system. Financial sector reforms are aimed at improving the efficiency of financial intermediation, with beneficial effects expected on both the level and allocation of financial saving. Domestic deregulation would focus on the abolition of investment licensing except in a limited number of cases for non-economic reasons (such as environmental and strategic concerns). In addition, tax reforms will be undertaken with a view to remove obstacles to private investment and enhance revenue mobilization and public sector saving. The staff sees a program of tax reform as important to the success of the overall package. Initiatives along these lines would form the basis for negotiation of a program which could be supported by an ESAF arrangement.

Nepalese officials view the unfolding trade reform in India as providing an important opportunity and they plan a phased move toward current account convertibility in step with the Indian process. The policy changes announced in early March (Section II.1.c) appear to be a first step in this process. The authorities are also considering an overhaul of the currently inoperative duty drawback system and steps to reduce the level and dispersion of import tariffs. On foreign direct investment, the authorities are considering reforms to provide automatic approval for foreign investment in all industries, except for a small negative list.

An Administrative Reform Commission (ARC) has been formed to stream-line public administration and improve human resource management. The objective is to enhance implementation capacity and service delivery of the government. As a first step, a census of public sector employment and a hiring freeze of civil servants are being implemented, while the number of positions in defense and security areas is maintained at current levels. Recommendations for broader policy reform are due in April. The staff noted the importance of a social safety net for employees who might be retrenched and rigorous implementation of other reforms in order to increase the private sector's capacity to absorb retrenched employees.

Regarding public enterprises, the authorities are formulating, with the assistance of the World Bank and UNDP, an action plan for privatization. So far, six enterprises have been selected, of which three are being prepared for privatization; others will follow. Following the repayment by the Government of non-performing loans to enterprises under the bank rehabilitation (CBPASS) operation, the Government has discontinued guaranteeing public enterprise borrowing from commercial banks. The staff commended the privatization agenda and observed that efforts to improve efficiency should be strengthened for the enterprises that will not be privatized.

In the area of financial reform, the authorities intend to implement most of the recommendations of the recent CBD advisory mission to strengthen market-based monetary management and to open a secondary window at the central bank. In this respect, it is important to allow treasury bill rates to fully reach market levels and to establish a full-fledged monetary programming division at the central bank to monitor monetary developments closely. To enhance the liquidity of the treasury bills, steps are being

taken towards the opening of a secondary window, while the elimination of the 45 day limit on rediscounting is under active consideration.

The first phase of the bank rehabilitation (CBPASS) project, which focussed on capital restructuring and provisioning for bad debt for two Government-owned commercial banks, has nearly been completed and the second phase, concentrating on institutional strengthening, is expected to be completed in late 1992. Subsequently, privatization of at least one of these two banks would be feasible.

The medium-term agenda for tax reform consists of efforts to broaden the tax base, simplify the tax system and enhance its elasticity. Such efforts will be crucial if the desired fiscal consolidation is to be achieved while also reducing reliance on import tariffs. In 1991/92, the focus has been improved tax administration. Efforts are being undertaken to bring more individuals in the income tax net and to identify property holders for the urban house and land tax. A new valuation system for customs and excise duties is being implemented with a view to increasing revenue and permitting a reduction in duty rates.

A sales tax reform based on FAD technical assistance is under consideration for 1992/93. The sales tax would first be widened to the wholesale sector and subsequently the retail sector. The number of products for which excise taxes are levied would be reduced (and tax rates increasingly shifted to an ad valorem basis), while the sales tax would be enhanced.

The Government is considering initiatives to increase the taxation of the agricultural sector, traditionally undertaxed compared to other sectors of the economy; the staff concurs that such taxation should be strengthened. For this purpose, the land revenue rates--unchanged for 24 years--could be increased and special incentives for smallholders withdrawn; the latter would generate some NRs 100 million (0.1 percent of GDP) in revenue. The valuation of rural land and urban land and houses and other wealth could be upgraded, which could be coupled with a lowering of the tax rates.

Regarding agriculture, the authorities intend to increase private sector participation in fertilizer procurement and distribution in order to improve the availability of agricultural inputs, and at the same time permit a reduction in subsidies to the Agricultural Inputs Corporation. To promote free market determination of output prices, food subsidies will be reduced and transportation subsidies for food grains eventually phased out.

4. Poverty and the environment

Nepal's poverty and environmental degradation problems are closely connected because rapid growth of population in rural areas has both undermined efforts to alleviate poverty and also increased exploitation of marginal agricultural land, contributing to a severe deforestation. The staff views an outward-oriented development strategy as crucial to increasing economic growth and alleviating poverty but also sees an important

role for micro-economic policies. Greater success in the Government's efforts to encourage a lower rate of population growth would help both in poverty alleviation and also reduce pressure on environmental resources. The shift in expenditure priorities by the new Government in favor of education, health and rural water, and road programs should also contribute to poverty alleviation over time.

IV. Staff Appraisal

The Government--elected in mid-1991--inherited a difficult macro-economic environment, with the fiscal situation worsening and inflationary pressure rising. It had little time for major changes in direction before the 1991/92 budget, but subsequently has sought to check the fiscal deterioration, has tightened monetary policy considerably, and has implemented politically sensitive price adjustments. Moreover, a bold agenda of structural reforms has been articulated and awaits implementation.

The immediate challenge is to ensure that a high rate of inflation is checked in order to safeguard the gains in competitiveness and lay the foundation for a strong structural adjustment program. The staff supports the thrust of the monetary measures taken at the turn of 1991 to reduce the rate of liquidity growth, which should go much of the way to reducing the inflation rate to about 12 percent--in line with current inflation in India.

Nevertheless, a further tightening of monetary policy will be needed over the next year, in order to reduce inflation further. The staff is also concerned that the re-introduction of a statutory liquidity ratio, as one of the recent measures, goes against the general movement towards a more market-oriented approach to monetary policy.

In the budget for 1992/93, to be presented in June, it will be crucial to establish a process of medium-term fiscal consolidation, aimed at achieving both a clear downward movement in the Central Government deficit over time and better management of public sector resources. Tax reform will be needed to broaden the tax base, simplify the tax structure, and increase tax elasticity. On the expenditure side, the implementation of the proposed administrative reform should help to contain the increase in current spending (especially the wage bill). Heightened scrutiny of development projects will also be crucial in light of shortages of counterpart funds for development projects and signs of limited absorptive capacity. Plans to privatize public enterprises should be expedited. For those enterprises not identified for privatization, efforts should be strengthened to improve efficiency and remove barriers to closure.

The authorities have placed industrial and trade reforms at the top of their structural agenda for the medium term. Bold reforms in these areas would mark a break with the past and reinforce the credibility of the overall program. Against the background of the healthy foreign reserve position, efforts to liberalize the trade system can afford to be far-

reaching and would complement the increase in investment expected to result from industrial delicensing. The steps just announced will be assessed in a supplement to this report, to be issued closer to the Board meeting. Beyond trade and industrial reform, other key areas would be liberalization of the environment for foreign investment and reforms of the financial system, as well as the public sector reforms outlined earlier.

The authorities are committed to an outward-oriented growth strategy and are eager to obtain the support of the international community for their reform program, which they wish to carry out in the context of an ESAF arrangement. They see the Fund's policy input as helpful and, despite the current healthy level of foreign reserves, view financial support from the Fund under a possible ESAF arrangement as important to underpin medium-term external viability. These considerations are reinforced by the crucial role of trade liberalization in their strategy and the uncertainties in the external environment. The staff's medium-term projections--based on tight macro-economic policies and vigorous structural reforms--suggest that over the next several years additional external support is likely to be needed to maintain an adequate reserve cushion, indicating a possible role for support from the Fund.

As a near program country, Nepal has been placed on the 12-month consultation cycle and the staff recommends that this practice continue.

Nepal: Selected Economic and Financial Indicators
1987/88-1991/92 1/

	1987/88	1988/89	1989/90	1990/91	1991/92 Est.
<u>Output, demand, and prices</u> (percent change)					
Real GDP	7.3	3.9	3.6	4.0	3.0
GDP deflator	8.2	9.6	9.4	9.1	18.0
CPI (annual average)	11.0	8.1	11.5	9.8	18.0
Terms of trade (percent change)	10.8	4.4	-4.6	-5.7	-4.0
<u>Exchange rates</u>					
Nominal effective (percent change) 2/	-7.4	-7.3	-4.1	-10.7	-12.6 3/
Real effective (percent change) 2/	-4.9	-3.9	-4.3	-4.8	-8.3 3/
NRs per U.S. dollar (period average)	22.1	25.5	28.6	31.6	42.7 3/
<u>Central government budget</u>					
Revenue (growth in percent)	23.7	5.6	18.9	16.9	23.7
Expenditure (growth in percent)	27.3	27.5	4.4	26.0 (7.8) 4/	12.1
Overall balance (percent of GDP) 5/	-9.2	-12.4	-10.2	-12.1 (-9.1) 4/	-10.2
Net borrowing from the banking system (percent of GDP)	0.7	4.0	1.5	3.2 (0.2) 4/	0.2
Net foreign aid (percent of GDP)	8.1	8.8	7.8	8.2	9.2
<u>Money and credit</u> (end of year, percent change)					
Total domestic credit	14.9	30.7	11.3	15.3	14.5
Broad money	22.4	24.2	18.6	20.7	13.6
Interest rate 6/	12.5	12.5	12.0	12.0	...
<u>Balance of payments</u> (\$ mn.)					
Exports, f.o.b.	186	165	183	241	329
Imports, c.i.f.	-627	-640	-641	-766	-776
Current account balance	-269	-298	-305	-378	-315
(percent of GDP)	(-8.7)	(-9.7)	(-9.8)	(-11.9)	(-11.0)
Net aid	262	281	244	253	255
Net commercial borrowing	44	52	-6	-7	-7
Errors and omissions	66	-32	160	283	106
Overall balance	103	3	93	151	38
<u>Reserves</u> (\$ mn.)					
Gross official reserves 7/	313	316	412	454	488
(In months of next year's imports of goods and services)	(4.6)	(4.7)	(4.9)	(5.9)	(5.6)
<u>External debt</u>					
Medium- and long-term debt					
(end-of-year stock, \$ mn.)	1,009	1,214	1,424	1,607	1,770
Of which: Use of Fund resources	34	45	47	38	35
Total (percent of GDP)	(32.4)	(39.6)	(45.9)	(50.4)	(61.7)
Debt service (\$ mn.) 8/	34.8	39.5	64.0	77.6	67.8
(percent of current earnings)	(7.1)	(8.4)	(13.5)	(14.1)	(11.0)

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

1/ All data are for fiscal years beginning in mid-July, unless otherwise stated.

2/ End of period. Minus sign indicates depreciation of the Nepalese rupee.

3/ December.

4/ Excluding bank rescue operations (NRs 3,030 million).

5/ Excluding foreign grants.

6/ Percent per annum on one-year fixed deposits.

7/ Held by the banking system.

8/ Including the Fund.

Economic Relations between Nepal and India

1. Introduction

Because of geographical proximity and historical connections, economic developments in Nepal have long been heavily influenced by those in India. Migration flows have occurred since ancient times; the business communities in the two countries have long had close connections and the Indian currency circulates freely in the border areas of Nepal. India is Nepal's major trading partner, providing the chief market for Nepalese agricultural exports (rice, jute products, and vegetable oils) and supplying essential imports such as medicine, cotton, petroleum products, construction materials, machinery and transport equipment. India is also the important counterpart market for development of Nepal's huge water resources. Several rivers run along the border where waters are shared for irrigation and flood control purposes. For the development of hydropower projects and the distribution of electricity power, cooperation between the two countries would be essential.

2. The balance of payments vis-a-vis India

A major feature of Nepal's balance of payments vis-a-vis India is the great difficulty of controlling unauthorized trade in the face of the relatively flat terrain in much of the 800 kilometer (500 mile) long open border. The flow of such transactions occurs in both directions, depending on price differentials and transportation costs. Agricultural goods move relatively freely across the border despite the official prohibition on export of certain agricultural goods in order to secure availability for the domestic market. Given the highly protected import regime in India--involving both quantitative restrictions and high tariffs--a notable feature has been the diversion of overseas goods from Nepal to India. The magnitude of such transactions is believed to be substantial and is reflected in the large positive entry of errors and omissions in the balance of payments statistics. Nepal's recorded trade balance vis-a-vis India has been in large deficit, partly offset by net receipts from tourism and transfers.

3. Implications for commercial policy

The potential for extensive diversion of overseas imports through Nepal to India has important implications for formulation of Nepalese commercial policy and exchange rate policy, particularly against the background of the full convertibility between the Nepalese and Indian rupees. Diversion of overseas imports entails the use of Nepal's convertible currency reserves in exchange for inflows of Indian rupees (the counterpart of unrecorded exports to India) and consequently could result in a depletion of convertible currency reserves and accumulation of non-convertible Indian rupees. For Nepal, this would complicate reserve management while for India, the

effectiveness of its own commercial policy could potentially be affected. 1/

To prevent such developments, Nepal's tariff rates on overseas imports need to be calibrated to deter trade diversion from Nepal to India; this criterion implies a need for similar (or higher) tariffs in Nepal to those in India for products in heavy demand in India and with relatively low transportation costs while a greater degree of divergence can be allowed for products where weak Indian demand, higher transportation costs or other factors make incentives for trade diversion less compelling. However, Nepalese tariff policy also needs to reflect purely domestic objectives and as a result, the present tariff structure is a compromise, with tariff rates higher than desirable for Nepal's own economic developments, but lower than those in India.

4. The framework of bilateral relations

The foundation of the present structure of bilateral relations is the 1950 Treaty of Peace and Friendship. The treaty lays out the principles of bilateral cooperation in foreign security and economic areas, including preferential tariff arrangements, special arrangements for the procurement of certain commodities, the full convertibility between the two currencies, and the freedom of portfolio investment, commercial activities, and residence across the border.

The political tension which emerged in early 1989 led to a temporary suspension of preferential trade and other arrangements, with India closing the border, except for two trade and transit points. However, with a changed political situation, bilateral relations were normalized in July 1990 and new trade and transit treaties were signed in December 1991.

a. Trade relations

Trade between the two countries is promoted through provisions of preferential trade arrangements. As mentioned above, the arrangements provide specific provisions to prevent trade deflection and are governed by three treaties; (1) the Treaty of Trade; (2) the Treaty of Transit; and (3) the Agreement of Cooperation to Control Unauthorized Trade.

1/ However, with India's GDP 80 times larger than that of Nepal--and Nepal's entire stock of convertible currency reserves equivalent to less than 3 percent of India's annual import bill--the magnitude of such diversion is unlikely to be of major economic significance for India.

(i) The preferential trade arrangement

The trade between the two countries is free from quantitative restriction except in respect of certain goods. ^{1/} Trading of primary commodities is exempt from all the import duties. Nepalese manufactured exports to India are provided with tariff concessions subject to a rules-of-origin condition to ensure the intended protection for Indian domestic industries; no such condition is required for Indian exports to Nepal.

Manufactured exports from Nepal to India are exempt from the Indian basic duty, provided that they meet the condition that the content of raw materials and labor which originate in either Nepal or India, or both, accounts for 55 percent or more of the value of the good. If the value of such content is at least 40 percent on an ex-factory basis, Nepalese manufactured exports to India receive at least 50 percent concession on India's Most-Favored-Nations (MFN) rates. However, the granting by the Indian authorities of this tariff concession is made on a case by case basis, not on a generic basis, which tends to make the concessions less effective and the procedures cumbersome.

Manufactured imports from India to Nepal are exempt from the Nepalese additional duty. Prior to the July 1990 agreement, the exemption was limited to those goods on which the basic duty rates were less than 50 percent. Thus, goods such as consumer goods including TVs, video decks, automobiles, refrigerators for which the basic duty rates were more than 50 percent, did not receive the tariff concession.

(ii) Refund of Indian excise duty

For goods imported directly from manufacturers in India, the Government of India reimburses Nepal for the Indian central excise tax under the Duty Refund Procedure. The arrangement is intended to promote Indian exports to Nepal. However, to prevent the unauthorized re-flow of these Indian exports back to India, such refund is permitted only for those cases where Nepalese tariff on the Indian exports exceed the Indian excise tax.

(iii) The transit arrangement

Because Nepal is a land-locked country, most of its trade with overseas countries is moved through India. The treaty allows Nepalese imports entering Calcutta by sea to pass through to Nepal at any one of 15 points along the Nepal-India border free from Indian taxes and import

^{1/} Exports from one country to the other are prohibited for: (1) goods which are prohibited for export to overseas countries and to each other's territories to prevent deflection to third countries (e.g., certain staple foods, exports of which are banned to avoid shortages in the domestic market), and (2) goods which are subject to price control within the domestic market (e.g., fertilizers).

duties. It also specifies provisions for storage, use of harbor facilities, and transshipment.

(iv) Agreement to control unauthorized trade

As discussed above, tariff protection and quantitative restrictions in Nepal are less severe than in India, which encourages diversion of overseas imports from Nepal to India. Under the Agreement to Control Unauthorized Trade, both Governments are obliged to take necessary measures to control such trading activities, including border patrol. In Nepal, the import license auction system is intended partly to meet this objective.

(v) The special commodity arrangement

To ensure steady supplies of certain essential goods, Nepalese state trading companies have special commodity arrangements with India to purchase petroleum products, coal, and coke. Trade is undertaken on the basis of agreed formulae on prices and quantity. The arrangement also provides Nepalese state trading companies with preferential access to subsidized sugar and cement in India.

In the case of petroleum products (POL), the Nepal Oil Corporation purchases POL or crude oil in the international markets and delivers them to the Indian ports where they become a property of the India Oil Corporation (IOC). ^{1/} In exchange, the IOC releases quarterly Nepal's required mix of petroleum products from Indian refineries close to the border with Nepal. The price is determined on a basis of refining and transportation costs. Through this mechanism, Nepal saves the cost of maintaining large reserves of petroleum products.

b. Financial relations

(i) The exchange arrangement

Residents of both countries may freely purchase the currency of the other country and securities issued in either country. They may hold any amount of notes and coins and open bank accounts in the other country. Payments of current transactions between the two countries are free from foreign exchange control and are made in Indian rupees. Both central banks guarantee free and unlimited convertibility between Nepalese rupees and Indian rupees. However, Indian rupees are not legal tender in Nepal and similarly, Nepalese rupees are not legal tender in India.

Cross-border direct investments are free from exchange control but subject to domestic regulations. However, purchases of property by Indians

^{1/} The exchange legally takes place at high sea, with the result that landing costs are borne by India.

are restricted in Nepal whereas purchases of property by Nepalese in India are freely permitted.

The absence of capital controls and the full convertibility between the two currencies facilitate integration of the financial markets in both countries. Such financial integration is further aided by the close ties maintained between the business community in both countries. As a result, too large an interest differential cannot be maintained without contributing to large capital movements. Financial integration is more direct for the unofficial or parallel markets where official regulation is absent.

(ii) The stand-by credit facility

To facilitate settlement of payments, the Reserve Bank of India provides a stand-by credit facility to the Nepal Rastra Bank in the amount of Indian Rs 350 million, with an interest rate of 7 percent. The present facility is effective for six months through end-1991, and can be extended for another six months subsequently. Because of Nepal's favorable reserve position, there has been only a limited use of the facility recently.

Nepal--Fund Relations
(As of February 29, 1992)

I. Membership status

- | | | |
|----|---------------------|-------------------|
| 1. | Date of membership: | September 6, 1961 |
| 2. | Status: | Article XIV |

(A) Financial Relations

II. General Department

- | | | |
|----|--|---|
| 1. | Quota: | SDR 37.3 million |
| 2. | Total Fund holdings
of Nepalese rupees: | SDR 32.4 million
(86.8 percent of quota) |
| 3. | Fund credit outstanding: | SDR 26.9 million
(72.1 percent of quota) |
| | Of which: Credit
tranche purchases
(ordinary resources): | SDR 0.8 million
(2.1 percent of quota) |
| | Loans: | SDR 26.1 million
(70 percent of quota) |
| 4. | Reserve tranche position: | SDR 5.7 million
(15.3 percent of quota) |
| 5. | Current operational budget: | Not applicable |
| 6. | Lending to the Fund: | Not applicable |

III. Previous SAF, stand-by or extended arrangement
and special facilities

- | | | |
|----|---|--------------------------|
| 1. | Previous SAF arrangement: | |
| | a. Duration | From 10/4/87 to 10/13/90 |
| | b. Amount: | SDR 26.11 million |
| | c. Utilization: | SDR 26.11 million |
| 2. | Previous stand-by arrangement
during the last ten years: | |
| | a. Duration: | From 12/23/85 to 4/22/87 |
| | c. Amount: | SDR 18.65 million |
| | d. Utilization: | SDR 18.65 million |
| 3. | Special facilities during the
past two years: | None |

IV. SDR Department

- | | |
|-------------------------------|---|
| 1. Net cumulative allocation: | SDR 8.1 million |
| 2. Holdings: | SDR 0.13 million or
1.60 percent of net
cumulative allocation |
| 3. Current Designation Plan: | Not applicable. |

V. Administered accounts

- | | |
|-------------------------|------------------|
| 1. Trust Fund loans: | |
| a. Disbursed: | SDR 13.7 million |
| b. Outstanding: | -- |
| 2. SFF Subsidy Account: | Not applicable. |

VI. Overdue obligations to the Fund

Nepal is current in its obligations to the Fund.

VII. Schedule of principal and interest due to Fund

	<u>1992</u>	<u>1993</u>	<u>1994</u>
	<u>(In millions of SDRs)</u>		
1. Principal	<u>0.8</u>	<u>1.5</u>	<u>3.7</u>
Repurchases	0.8	1.5	3.7
2. Charges and interest (including SDR and SAF)	<u>0.7</u>	<u>0.7</u>	<u>0.7</u>
Total due (1 + 2)	<u>1.5</u>	<u>2.2</u>	<u>4.4</u>

(B) Nonfinancial Relations

VIII. Exchange rate arrangement

On June 1, 1983, Nepal introduced an arrangement under which its currency was pegged to a basket of currencies of major trading partners. On November 30, 1985, the midpoint exchange rate was changed from NRs 1.4508 to NRs 1.7008 per Indian rupee. On May 31, 1986, the authorities introduced a new currency basket, to which the Nepalese rupee is pegged within margins. On June 1, 1986, the exchange rate was changed to NRs 1.6808 per Indian rupee, and on July 2, 1991 it was changed to NRs 1.6500 per Indian rupee.

IX. Last Article IV consultation

Staff discussions were held in Kathmandu during October 7-19, 1990; the Executive Board discussed the staff report (SM/90/232) on January 18, 1991 (EBM/91/6). The following decision was adopted:

1. The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Section 2(a) and in concluding the 1990 Article XIV consultation with Nepal, in the light of the 1990 Article IV consultation with Nepal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on making payments and transfers for current international transactions as described in SM/90/232, are maintained by Nepal under Article XIV, Section 2, with exception of the restrictive features of the bilateral arrangements with three Fund members, which are subject to approval under Article VIII, Section 2(a). The Fund urges Nepal to eliminate the restrictive features of these bilateral payments arrangements as soon as possible.

X. Consultation cycle

Nepal is on the standard 12-month consultation cycle.

XI. Technical assistance

1. CBD: In December 1987, a mission made proposals to strengthen monetary policy operations and to develop secondary markets in government securities. In February 1988, a short mission reviewed the NRB's management of foreign exchange reserves. In January 1989, a mission assisted the NRB in developing open market-type operations and an institutional framework for a secondary market in government securities. Subsequently, an expert was assigned to the NRB to oversee the auction of treasury bills and other government securities. In February 1989, a CBD staff member participated in the World Bank appraisal mission concerning bank supervision. In August 1991, a mission recommended measures to strengthen monetary control and improve operations of the primary money market.

2. FAD: A mission in August 1984 reviewed budget projections embodied in the Seventh Plan (1985/86-1989/90) and recommended tax reform and expenditure measures. In February-March 1986, a mission helped the authorities to design a package of tax and other revenue measures and examined the scope for tax reform in the medium term. A member of the fiscal panel, who participated in the mission, stayed in Kathmandu for an additional three months to advise on the implementation of recommendations in the area of tax administration. A mission in March 1989 visited Kathmandu to undertake a preliminary study of the possible introduction of a value-added tax. A mission in March 1990 provided technical assistance for structural reform of public enterprises.

3. STA: A mission in November 1986 reviewed the treatment and valuation of Fund accounts and recommended improvements in the currentness and coverage of monetary data. In February 1992, a mission reviewed the compilation of balance of payments statistics.

4. Other

Tariff reform: A mission, with World Bank participation, in February-March 1987 and a follow-up mission in June 1987 assisted the authorities in implementing a tariff reform. A member of the fiscal panel, who participated in the latter mission, stayed in Kathmandu for over two months to help set up a duty-relief system for industrial imports. In June 1988, a mission evaluated the impact on revenue of the tariff reform introduced in July 1987, and recommended further simplification and rationalization measures.

Trade policy reform: In January 1992, a mission assisted the authorities in preparing a trade policy reform.

XII. Resident representative/advisor

The Fund has provided staff members as Resident Advisors/ Representatives since 1977. The current Resident Representative, Mr. Ishihara, took up his assignment in July 1990.

Relations with the World Bank Group 1/

(As of December 31, 1991)

Since its first operation in Nepal in 1969, IDA has approved 59 credits for Nepal totaling over \$1.1 billion. No IBRD loans have been made to Nepal, but IFC has made two loan/equity investments totaling nearly \$8 million. The bulk of IDA's project assistance has supported investments in agriculture and irrigation, as well as in infrastructure including transport, energy, water supply, and telecommunications.

The Bank's strategy is to help Nepal attack its pervasive rural poverty through rapid and broad-based growth which will include productive investments in agriculture, small-scale enterprises, as well as physical and human infrastructure. Since poverty, population growth, and environmental degradation are integrally related in Nepal, poverty alleviation will depend on a strong population program and improved social services. Thus, the Bank's assistance will have increased emphasis on population and human resources, including health and education, in addition to agriculture and supporting infrastructure (water, transport, and irrigation). The Bank will continue to take a leading role in the energy sector, but support for industry will be confined to strengthening financial intermediaries and fostering increased competition in the financial sector. In several key sectors, including the social sectors, transport, irrigation, and energy, the Bank will seek an understanding with the Government and other donors on a sectoral policy framework and investment plan which all development projects will support. The Bank's dialogue with the new Government is currently focussing on public resource management issues. The Bank will complement the Fund's work on fiscal reforms by assisting the Government in carrying out a public expenditure review. To further improve the efficiency of public expenditures and improve service delivery, the Bank is also assisting the Government in its efforts to reform public administration.

Technical assistance

The World Bank has been providing technical assistance in energy planning, irrigation, industrial finance, cottage industry and municipal developments, planning and program budgeting, and remote area access, principally through projects financed by the UNDP and executed by the Bank-- as well as through two technical assistance projects directly funded by IDA.

Bank economic and sector missions visit Nepal regularly. A country memorandum is prepared every 18 months for distribution prior to the Paris Aid Group meeting chaired by the Bank. The last full report was distributed

1/ Prepared by the World Bank staff.

in March 1990, just before the change of Government. A short report updating economic developments and outlining a policy agenda for the new Government was distributed in October 1990. A major Bank report on Poverty Alleviation in Nepal was also distributed in October 1990. The next Aid Group Meeting is scheduled for April 1992. The next economic report, due in March 1992, will focus on public resource management issues.

Structural Adjustment Credit (SAC)

The Bank has approved two SACs--in FY87 and FY89. Closely coordinated with the IMF's SAF program, the SACs supported policy reforms in trade, finance, and agriculture. While performance under the SACs was generally satisfactory, the final tranche of SAC II has not yet been released because of questions over implementation of measures to improve irrigation management.

Nepal: Lending by the World Bank Group, 1986-91 1/

	1986	1987	1988	1989	1990	Est. 1991
IDA (net)	<u>54.0</u>	<u>78.4</u>	<u>82.6</u>	<u>107.4</u>	<u>65.0</u>	<u>51.5</u>
Disbursements	54.9	79.5	84.1	10.3	67.3	54.0
Amortization	-0.9	-1.1	-1.5	-1.9	-2.3	2.5
IFC (net)	<u>-0.3</u>	<u>-1.4</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>
Disbursements	--	--	--	--	--	--
Amortization	-0.3	-1.4	--	--	--	--
Total loans (net)	53.7	77.0	82.6	107.4	65.0	51.5
Interest and charges	3.3	4.3	4.5	3.6	4.5	4.0

Source: Data provided by the World Bank.

1/ As of end-December 1991 (partially estimated).

Relations with the Asian Development Bank

As of end-January 1992, cumulative lending by the Asian Development Bank consisted of 73 loans amounting to a little under \$1,080 million for 63 projects in agriculture (including forestry), energy, transport, industry, and social infrastructure (mainly water supply and education). Cumulative undisbursed funds are a little over half of the total committed amount. The lending program for 1991, with a total amount of \$84.4 million, comprised four projects for agriculture (including credit and irrigation) and primary education. The lending program for 1992 amounts to about \$80 million. For the period 1993-95 an amount of \$200 million has been tentatively programmed for about 9 projects. This excludes the amount for financing the proposed Arun III Hydropower Project. Moreover, as of end-January 1992, AsDB has provided technical assistance to Nepal for 144 projects totalling a little over \$54.4 million.

Table 1. Nepal: Loans by the Asian Development Bank
(1970-91) 1/

(In millions of U.S. dollars)

	1970-90 Approved	1991 Approved	1992 Projected
Agriculture and agro-industry	604.1	64.9	50.0
Energy	185.9	--	--
Industry and nonfuel minerals	54.6	--	50.0
Transport and communication	157.7	--	--
Social infrastructure	67.5	19.5	30.4
Total	<u>1,069.7</u>	<u>84.4</u>	<u>130.4</u> <u>2/</u>
Gross disbursements	(447.5)	(74.2)	--
Memorandum item:			
Outstanding (disbursed debt to AsDB (end-period))	414.1	61.6 <u>3/</u>	--

Source: Asian Development Bank.

1/ Fiscal year ending December 31.

2/ Includes an amount of overprogramming of about \$50 million.

3/ As of 30 September 1991.