FOR
AGENDA

EBS/87/196

CONFIDENTIAL

September 15, 1987

To: Members of the Executive Board

From: The Acting Secretary

Subject: Nepal - Request for Arrangements Under the Structural Adjustment Facility

Attached for consideration by the Executive Directors is the staff report on a request from Nepal for arrangements under the structural adjustment facility which, together with the policy framework paper (EBD/87/234, 9/14/87), is proposed to be brought to the agenda for discussion on Wednesday, October 14, 1987. A draft decision appears on page 21.

Mr. Szapary (ext. 7365) or Mr. Ishii (ext. 7330) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

NEPAL

Request for Arrangements Under the Structural Adjustment Facility

Prepared by the Asian and the Exchange and Trade Relations Departments

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

Approved by P. R. Narvekar and H. B. Junz

September 14, 1987

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I. Introduction

In the attached letter to the Managing Director, dated September 3, 1987, His Majesty's Government of Nepal requests a three-year structural adjustment arrangement in support of an economic program covering the period 1987/88-1989/90 and the first annual arrangement thereunder. 1/ The amount that will be available to Nepal under the Structural Adjustment Facility (SAF) is estimated at SDR 23.6855 million or 63.5 percent of quota, of which SDR 7.46 million (20 percent of quota) will be available in a single disbursement upon Executive Board's approval of the first annual arrangement. 2/ Of the remaining amount (SDR 16.2255 million), SDR 11.19 million will be available upon approval of the second annual arrangement. The three-year Policy Framework Paper (PFP) has been issued separately (EBD/87/234, 9/14/87), while the Memorandum on Economic and Financial Policies, describing the first year of the program, is attached to this document (Attachment II). The program is also supported by a structural adjustment loan (SAL) approved by the World Bank in March 1987. 3/

On December 23, 1985 the Fund approved a 13-month stand-by arrangement for Nepal in an amount equivalent to SDR 18.65 million (50 percent of quota). The arrangement was subsequently extended through April 22, 1987, and the full amount of the arrangement was drawn. The final review under the stand-by arrangement and the 1986 Article IV consultation with Nepal were concluded on March 25, 1987. Overall, Nepal has achieved notable stabilization gains under the arrangement, with the fiscal deficit and its net domestic financing declining as a ratio of GDP, monetary expansion slowing, and the balance of payments reverting to a surplus in 1986/87. The staff report for the stand-by review and the 1986 Article IV consultation (EBS/87/37, 2/23/87), and the report on recent economic developments (SM/87/65, 3/10/87) provide a detailed description of policies and performance under the stand-by arrangement. The following section provides an updated description of developments in 1986/87.

1/ Nepal's fiscal year starts on July 16.

2/ The negotiations that formed the basis of this request took place in Kathmandu during May 11-26 and August 3-13, 1987. The staff teams consisted of G. Szapary (head), E. Gurgen, S. Ishii, R. Corker, (all ASD), D. Robinson (FAD), and A. Santos (ETR), and F. O. Yeong (ADM) and C. Francis (ASD) as secretaries. Mr. Thornton, the Fund's Resident Representative in Nepal, assisted the missions. World Bank staff participated in the discussions.

3/ The amount of the SAL is SDR 40.9 million to be disbursed over 18 months. As of end-July 1987, the equivalent of SDR 15 million was disbursed.

II. Developments During 1986/87

Aggregate output growth is estimated to have fallen to about 2 1/2 percent in 1986/87 (from 4 percent in the previous year), as agricultural growth suffered a severe setback owing to drought (Tables 1 and 2). In contrast, nonagricultural growth was above the trend rate of recent years, as a result of improved electricity supply and increased industrial capacity, partly in import substituting activities. Real domestic demand growth went down by about 1 1/2 percentage points. Consumption growth slowed only slightly, with the impact of lower rural incomes largely offset by wage increases in the nonagricultural and public sectors. On the other hand, real gross domestic investment fell sharply as private investment dropped owing to tighter credit conditions, as well as the postponement of investment plans on the expectation of lower agricultural incomes. Reflecting a fall in exports, the external sector's net contribution to growth was negative. Import demand also declined slightly, owing mainly to weak investment activity, import substitution, and the price effects of higher import taxes and the 14.7 percent devaluation of the Nepalese rupee in November 1985. The rate of consumer price inflation remained high in the first half of the fiscal year as the price level continued to adjust to the devaluation. However, inflation moderated as the year progressed and the 12-month rate of increase in consumer prices was down to 9 percent by July 1987.

Budgetary performance in 1986/87 built on the progress made in 1985/86 and preliminary estimates suggest that it was broadly in line with program targets (Table 3 and Chart 1). Revenue performance exceeded the target, an outcome that owed much to the introduction of an auction system in July 1986 for import licenses for a wide range of products. 1/ Regular expenditure overshot the program objective by about 14 percent, of which three fifths was due to the payment of interest arrears on government-guaranteed commercial bank loans, mostly to the Nepal Food Corporation (NFC). While this action was not anticipated in the original program, it was in line with staff recommendations. Other reasons for the higher regular expenditure were the mid-fiscal year wage increase granted to civil servants and a payment for

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1/ Proceeds from the auction system, which was introduced after the adoption of the 1986/87 budget, were not envisaged in the original program target. For a discussion of the auction system, see SM/87/65, pp. 41-42.

Table 1. Nepal: Selected Economic and Financial Indicators, 1984/85-1986/87

	1984/85	1985/86	1986/87 Stand-By Program	1986/87 Prelim. Actual
	(Annual percentage changes; unless otherwise specified)			
National income and prices				
GDP at constant market prices	3.0	4.0	4.0	2.3
GDP deflator	6.2	15.4	9.5	13.0
Consumer prices (annual average)	4.1	15.7	9.5	13.0
(July to July)	6.9	21.7	9.0	9.1
External sector (in terms of SDRs)				
Exports, f.o.b.	46.4	-8.9	9.1	-19.7
Imports, c.i.f.	8.3	-1.4	13.1	-6.6
Export volume	31.5	9.7	9.0	-12.7
Import volume	2.6	9.5	16.2	-0.5
Terms of trade	5.5	-7.7	2.9	-2.1
Real effective exchange rate 1/	0.3	-9.9	—	-5.0
Government budget				
Revenue and grants	13.5	19.0	28.2	27.3
Of which: Revenue	(15.7)	(17.1)	(22.6)	(29.1)
Total expenditure, including net lending	13.2	14.3	20.9	20.8 2/
Domestically-financed expenditure	17.1	4.3	14.7	24.7 2/
Regular expenditure	29.1	18.8	14.5	30.0 2/
Development expenditure	7.5	-9.7	15.0	18.0
Foreign-financed development expenditure	5.1	37.2	33.1	14.3
Money and credit				
Net domestic assets 3/	36.6	25.2	16.9	15.8
Credit to Government (net)	26.9	16.4	10.8	11.9 2/
Credit to nonfinancial public enterprises	22.0	48.4	10.1	3.5 4/
Credit to private sector	27.4	24.7	20.2	14.9
Broad money	17.6	23.3	14.7	15.6
Interest rate on one-year bank deposits (end of period)	12.5	12.5	...	12.5
	(In percent of GDP; unless otherwise specified)			
External sector				
Current account balance (excluding grants)	-7.6	-8.1	-9.0	-7.8
External debt (end of period)	22.0	26.5	31.5	33.0
Debt service (percent of exports of goods and services and private transfers)	4.7	5.4	5.6	5.6
Overall balance (in millions of SDRs)	-53	-1	12	8
Gross reserves (end of period, in SDR mns.)	143	149	167	161
(In months of imports of goods and services)	3.2	3.4	3.5	3.9
Government budget				
Revenue and grants	11.4	11.3	12.9	12.5
Of which: Revenue	(9.2)	(9.0)	(9.8)	(10.0)
Total expenditure, including net lending	19.5	18.6	19.9	19.4 2/
Domestically financed expenditure	13.3	11.5	11.7	12.4 2/
Regular expenditure	6.5	6.4	6.5	7.3 2/
Development expenditure	6.7	5.1	5.2	5.2
Foreign-financed development expenditure	6.4	7.3	8.7	7.3
Overall balance	-8.1	-7.3	-7.0	-6.9 2/
(Excluding grants)	-10.3	-9.6	-10.2	-9.4 2/
Domestic financing (net)	4.0	2.6	1.9	2.6 2/
Of which: Banking system	(3.5)	(2.1)	(1.4)	(1.5) 2/
Investment and savings				
Gross fixed investment	19.5	19.0	...	18.1
Public	9.4	8.1	...	8.0
Private	10.2	10.9	...	10.1
Domestic savings	11.2	10.3	...	8.5
National savings	13.1	11.9	...	10.7

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

1/ Minus sign indicates real effective depreciation of the exchange rate.

2/ Including repayment of public enterprise arrears (0.5 percent of GDP).

3/ Based on exchange rates prevailing as of July 15, 1985 for 1985/86; and those prevailing as of January 31, 1986 for 1986/87.

4/ Excluding the repayment of public enterprise arrears by the Government, the rate of growth would have been 20.6 percent.

Table 2. Nepal: Developments in Output, Expenditure, and Prices, 1983/84-1987/88 1/

	1983/84	1984/85	1985/86	1986/87 Prelim.	1987/88 Proj.
	(In millions of Nepalese rupees; at current prices)				
Nominal GDP	38,184	41,738	50,124	57,921	67,554
Agriculture	22,317	24,641	29,895	34,477	40,022
Nonagriculture	15,867	17,097	20,229	23,445	27,531
GDP deflator	174.6	185.3	213.9	241.7	263.5
Agriculture	163.3	176.1	204.6	233.8	254.7
Nonagriculture	193.4	200.4	229.2	254.4	277.3
	(Annual percentage change)				
Real GDP 2/	7.8	3.0	4.0	2.3	7.0
Agriculture	9.5	2.4	4.4	1.0	6.5
Nonagriculture	4.9	4.0	3.4	4.4	7.8
GDP deflator	4.9	6.2	15.4	13.0	9.0
Agriculture	5.7	7.9	16.2	14.2	9.0
Nonagriculture	4.4	3.6	14.4	11.0	9.0
Domestic demand 2/	4.9	5.5	4.2	2.6	8.8
Consumption	5.0	3.9	4.8	4.3	6.5
Investment	4.3	12.6	1.3	-5.3	18.9 3/
Net foreign demand 2/	25.1	-31.8	-5.3	-5.6	-27.7 4/
	(In percent of nominal GDP)				
Memorandum items:					
Consumption	89.7	88.8	89.7	91.5	90.2
Investment	19.4	20.7	20.0	18.5	20.5 5/
National savings	12.2	13.1	11.9	10.7	11.7
Net factor income from abroad	1.9	1.9	1.6	2.2	1.9
Domestic savings	10.3	11.2	10.3	8.5	9.8
Foreign savings	7.1	7.6	8.1	7.8	8.8

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

1/ Components may not add to totals due to rounding.
2/ Measured at 1974/75 prices.
3/ 8.6 percent, excluding aircraft purchase.
4/ Minus 8.3 percent, excluding aircraft purchase.
5/ 18.7 percent, excluding aircraft purchase.

Table 3. Nepal: Fiscal Developments, 1984/85-1987/88

	1984/85	1985/86	1986/87 Original Program	1986/87 Prelim. Outturn	1987/88 Budget Est.	1987/88 Program
	(In millions of Nepalese rupees)					
Revenue	3,849	4,508	5,525	5,820	7,186	7,079
Tax	3,151	3,660	4,665	4,300	4,916	4,904
Nontax	698	848	860	1,520	1,766	1,760
New measures	...	...	...	...	505	415
Expenditure	8,153	9,318	11,265	11,255 1/	14,560	13,158
Regular	2,720	3,232	3,700	4,200 1/	4,492	4,492
Development	5,489	6,213	7,811	7,196	10,226	8,825
Foreign-financed	2,678	3,674	4,890	4,200	6,602	5,308
Domestically-financed	2,811	2,539	2,921	2,996	3,624	3,517
Net lending	-56	-128	-246	-141	-159	-159
Overall balance 2/	-4,304	-4,810	-5,740	-5,435 1/	-7,374	-6,080
Net foreign financing 3/	2,622	3,515	4,640	3,935	6,244	4,950
Net domestic financing	1,682	1,295	1,100	1,500 1/	1,130	1,130
Banking system	1,467	1,043	800	881 1/	750	750
Nonbank	215	252	300	619	380	380
	(As percent of GDP)					
Revenue	9.2	9.0	9.8	10.0	10.6	10.5
Expenditure	19.5	18.6	19.9	19.4 1/	21.6	19.5
Regular	6.5	6.4	6.5	7.3 1/	6.7	6.7
Development	13.2	12.4	13.8	12.4	15.1	13.1
Net lending	-0.1	-0.3	-0.4	-0.2	-0.2	-0.2
Overall balance 2/	-10.3	-9.6	-10.2	-9.4 1/	-10.9	-9.0
Net foreign financing 3/	6.3	7.0	8.2	6.8	9.2	7.3
Net domestic financing	4.0	2.6	1.9	2.6 1/	1.7	1.7
Banking system	3.5	2.1	1.4	1.5 1/	1.1	1.1
Nonbank	0.5	0.5	0.5	1.1	0.6	0.6

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

1/ Excluding the repayment of public enterprise arrears, the figures would have been lower by NRs 295 million or 0.5 percent of GDP.
2/ Excluding grants.
3/ Including grants.

accumulated leave. 1/ As a result, the net domestic financing of the budget deficit, and net credit to Government, were higher than programmed. On the other hand, the overall deficit (excluding grants) was lower than targeted, but this reflected continued weakness in project implementation and a consequent shortfall in development expenditure and associated aid disbursements.

The growth of net domestic assets of the banking system slowed down substantially as a result of a sharp decline in the rate of growth of both private and public sector credit (Table 4 and Chart 2). The indicative credit ceilings for April and July (preliminary data) 1987 were observed, with the exception of the July ceiling on net credit to Government. 2/ However, adjusting for the above-mentioned repayment of arrears by the Government, net credit to Government was well below the ceilings; on the other hand, the growth of credit to public enterprises was higher than presumed because of a further accrual of interest arrears, mostly by rice export companies under liquidation and the Jute Development and Trading Corporation. Despite an increase in net foreign assets, the growth of broad money declined by 8 percentage points to 15 percent during the year ended in July 1987.

Nepal's external position continued to improve during 1986/87 (Table 5 and Chart 3). Despite a sharp fall in exports and a deterioration in the terms of trade, the current account deficit declined to the equivalent of about 8 percent of GDP--below the target envisaged under the program--reflecting mainly a fall in imports and an increase in private remittances. The main reasons for the weak export performance were declines in exports of rice and pulses owing to the drought, of hides and skins resulting from a loss of competitiveness associated with the removal of an export subsidy, and of readymade garments following delays in the allocation of the newly established U.S. quota among local producers. Aid inflows increased only marginally but there was a continued large amount of "other capital" inflows, which is believed to reflect mostly unrecorded exports to India. As a result,

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1/ In a move to tighten leave and pension policies, in May 1987 the authorities discontinued the practice under which civil servants could accumulate annual and sick leave without limit and receive a lump sum payment in lieu of leave upon retirement. At the same time, the practice of allowing employees with 20 years of service to take early retirement and receive in cash the equivalent of 7 years of pension was abolished. As a compensation for the termination of these benefits, it was decided to pay off, over several years, the accumulated leave of all civil servants, and an initial payment of about NRs 100 million was made in May 1987.

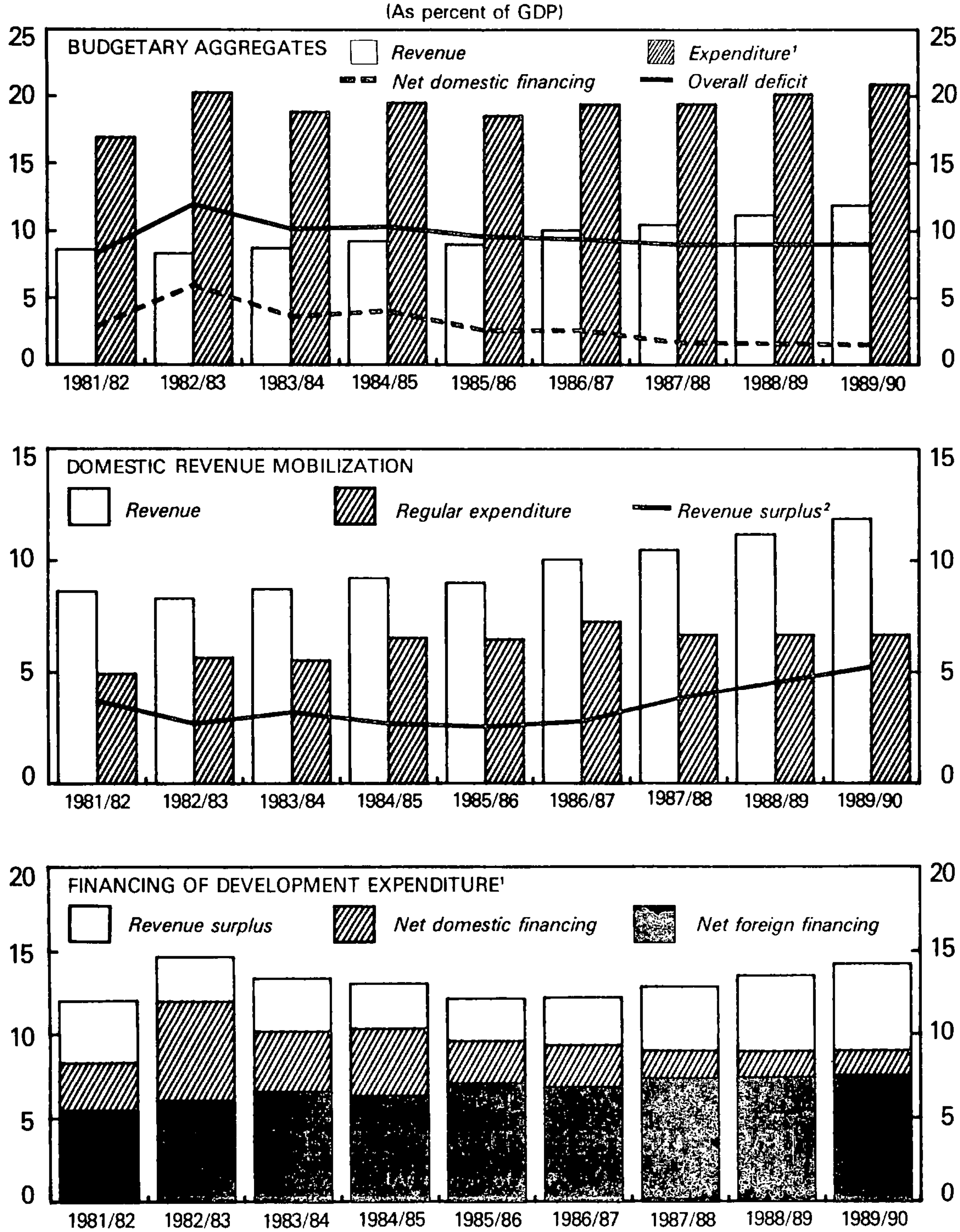
2/ To maintain the discipline of monitoring, the authorities established indicative credit ceilings for April and July 1987 to bridge the gap between the expiration of the stand-by arrangement and the coming into effect of the SAF arrangement.

CHART 1

NEPAL

FISCAL DEVELOPMENTS, 1981/82-1989/90

(As percent of GDP)



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

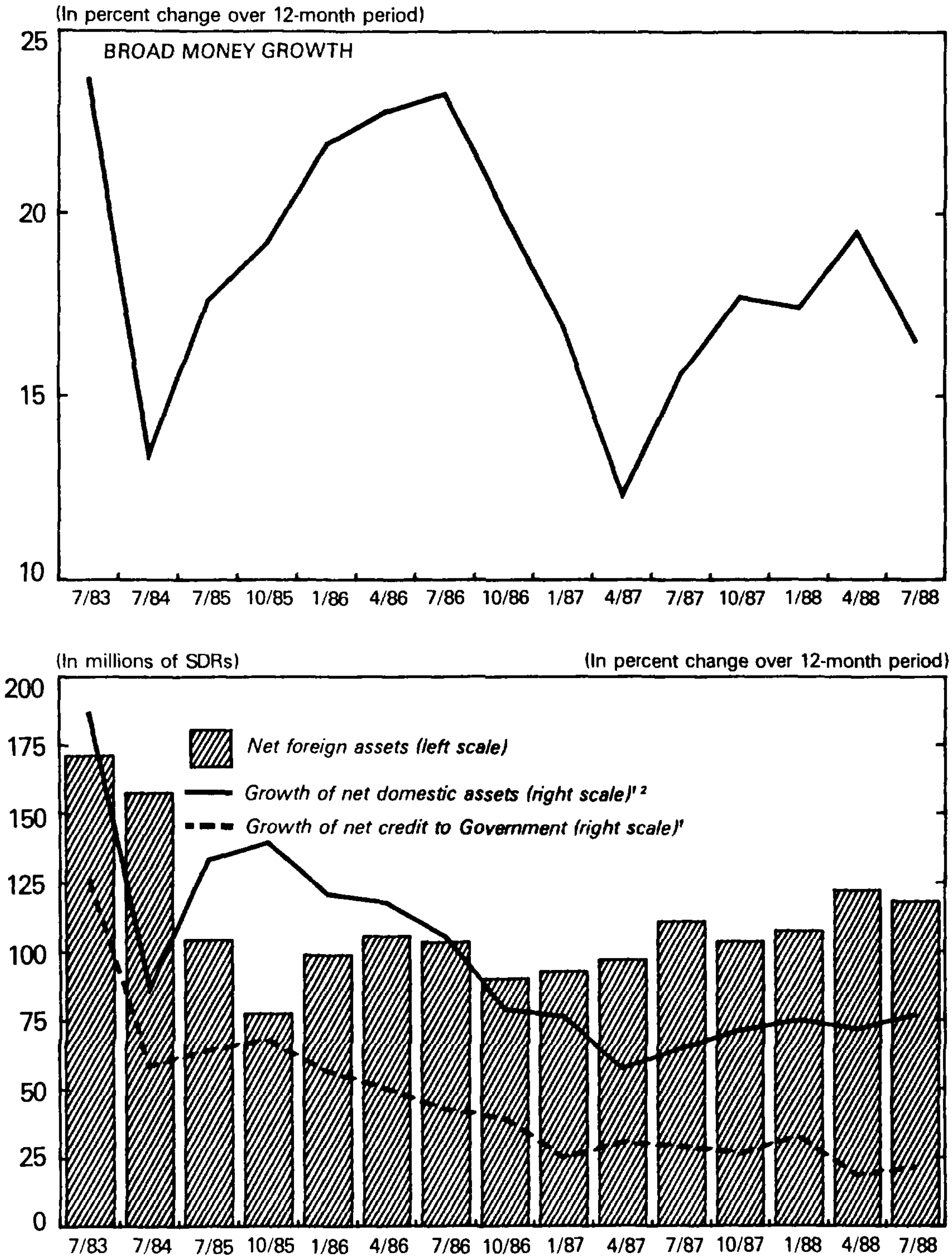
[1] Including net lending.

[2] Defined as the difference between revenue and regular expenditure.

CHART 2

NEPAL

MONETARY INDICATORS, 1983-88



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

[1] In relation to the stock of broad money.

[2] Measured at constant exchange rate.

Table 4. Nepal: Monetary Survey, 1985-88 1/

	1985	1986	1986/87								1987/88			
	July	July	Oct.		Jan.		April		July		Oct.	Jan.	April	July
			Program	Actual	Program	Actual	Program	Actual	Program	Prelim.	Benchmarks			
							(In millions of Nepalese rupees)							
Net foreign assets 2/	1,898	2,588	2,347	2,264	2,574	2,489	2,640	2,637	2,695	3,073 3/	2,865	2,975	3,405	3,265
Net domestic assets 4/	10,399	12,572	13,098	12,883	13,523	13,394	14,480	14,022	14,695	14,451 3/	14,960	15,675	16,495	17,145
Domestic credit	12,433	15,245	15,639	15,674	16,346	16,349	17,300	16,913	17,450	17,095	17,515	18,320	19,045	19,639
Public sector	7,538	9,143	9,269	9,479	9,750	9,367	10,050	9,498	10,118	10,085	10,390	10,530	10,620	11,049
Government (net)	6,375	7,418	7,600	7,734	7,900	7,599	8,100	8,019	8,218	8,299	8,540	8,630	8,670	9,049
Nonfinancial public enterprises	1,163	1,725	1,669	1,745	1,850	1,768	1,950	1,479	1,900	1,786	1,850	1,900	1,950	2,000
Private sector	4,895	6,102	6,370	6,195	6,596	6,982	7,250	7,414	7,332	7,010	7,125	7,790	8,425	8,590
Other items (net)	-2,034	-2,673	-2,541	-2,791	-2,823	-2,955	-2,820	-3,149	-2,755	-2,644	-2,555	-2,645	-2,550	-2,494
Broad money	12,297	15,160	15,445	15,147	16,097	15,883	17,120	16,659	17,390	17,524	17,825	18,650	19,900	20,410
						(Percentage change over the 12-month period)								
Memorandum items:														
Net domestic assets	36.6	25.2 5/	20.3	18.3	19.5	18.4	17.6 6/	13.9	16.9	15.9 7/	16.9 7/	17.9 7/	18.5 7/	18.6 7/
Domestic credit	26.6	22.6	18.5	18.8	17.0	17.1	15.3 6/	12.9	14.5	12.1	11.7	12.1	12.6	14.9
Public sector	26.1	21.3	15.4	18.0	17.9	13.3	17.3 6/	10.8	10.7	10.3	9.6	12.4	11.8	9.6
Government (net)	26.9	16.4	12.7	14.7	14.2	9.8	13.9 6/	12.8	10.8	11.9	10.4	13.6	8.1	9.0
Nonfinancial public enterprises	22.0	48.4	29.5	35.3	36.7	30.7	33.9	1.6	10.1	3.5	6.0	7.5	31.8	12.0
Private sector	27.4	24.7	23.5	20.1	15.8	22.6	13.2	15.8	20.2	14.9	15.0	11.6	13.6	22.5
Broad money	17.6	23.3	22.4	20.0	18.5	16.9	15.4	12.3	14.7	15.6	17.7	17.4	19.5	16.5

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

1/ Components may not add to totals due to rounding.
2/ Based on exchange rates prevailing on January 31, 1986 for 1986/87; and those prevailing on July 15, 1987 for 1987/88.
3/ Based on January 31, 1986 exchange rates, net foreign assets were NRs 2,960 million and net domestic assets were NRs 14,564 million.
4/ Defined as broad money less net foreign assets.
5/ On the basis of July 15, 1986 exchange rates; changes in domestic credit items and in broad money are not affected by the exchange rate assumptions.
6/ These figures differ from those in EBS/87/37 due to subsequent revisions in the April 1986 base.
7/ On the basis of July 15, 1987 exchange rates; changes in domestic credit items and in broad money are not affected by the exchange rate assumptions.

Table 5. Nepal: Balance of Payments, 1983/84-1987/88 1/

	1983/84	1984/85	1985/86	1986/87 Program	1986/87 Prelim. Actual	1987/88 Program
	(In millions of SDRs)					
Exports, f.o.b.	107	156	141	154	113	139
Imports, c.i.f.	-408	-440	-433	-490	-405	-498 2/
Aid imports	-91	-84	-88	-138	-89	-108
Nonaid imports	-316	-356	-346	-352	-316	-390 2/
Trade balance	-301	-285	-292	-336	-291	-358
Services (net)	87	61	68	83	74	90
Receipts	161	154	159	169	160	191
Payments	-74	-93	-91	-86	-86	-101
Private transfers (net)	43	43	38	46	49	53
Receipts	46	45	44	51	52	56
Of which: Private remittances	(38)	(39)	(36)	(40)	(44)	(46)
Payments	-3	-2	-6	-5	-3	-3
Current account balance	-171	-181	-186	-207	-168	-216 2/
Nonmonetary capital movements	157	130	185	219	179	223
Official grants	86	76	61	107	52	61
Official capital (net)	75	72	83	113	98	120
Foreign loans	80	77	92	121	106	131
Of which: Structural Adjustment Loan (IBRD)	(--)	(--)	(--)	(23)	(15)	(25)
Amortization	-4	-5	-9	-9	-8	-11
Aircraft loan (net)	--	--	--	--	--	42
Other capital (net) 3/	-5	-17	40	--	26	--
Overall balance	-14	-50	-1	12	8	7
Monetary movements	14	50	1	-12	-8	-7
Assets (increase -)	20	47	-6	-18	-12	-12
Liabilities	-6	4	7	6	4	5
Of which: Fund credit (net)	-4	-5	9	8	8	7
Trust Fund (net)	-1	-1	-2	-3	-3	-3
Memorandum items:				(In percent)		
Gross reserves						
In millions of SDRs	190	143	149	167	161	173
In months of imports of goods and services	4.8	3.2	3.4	3.5	3.9	3.5
Current account/GDP 4/	-7.1	-7.6	-8.1	-9.0	-7.8	-8.8 2/
Debt service ratio 5/	4.2	4.7	5.4	5.6	5.6	6.7
External debt/GDP	16.7	22.0	26.5	31.5	33.0	36.0
Terms of trade change	9.5	5.5	-7.7	2.9	-2.1	5.1
Foreign aid	6.9	6.5	6.7	9.9	7.3	7.9

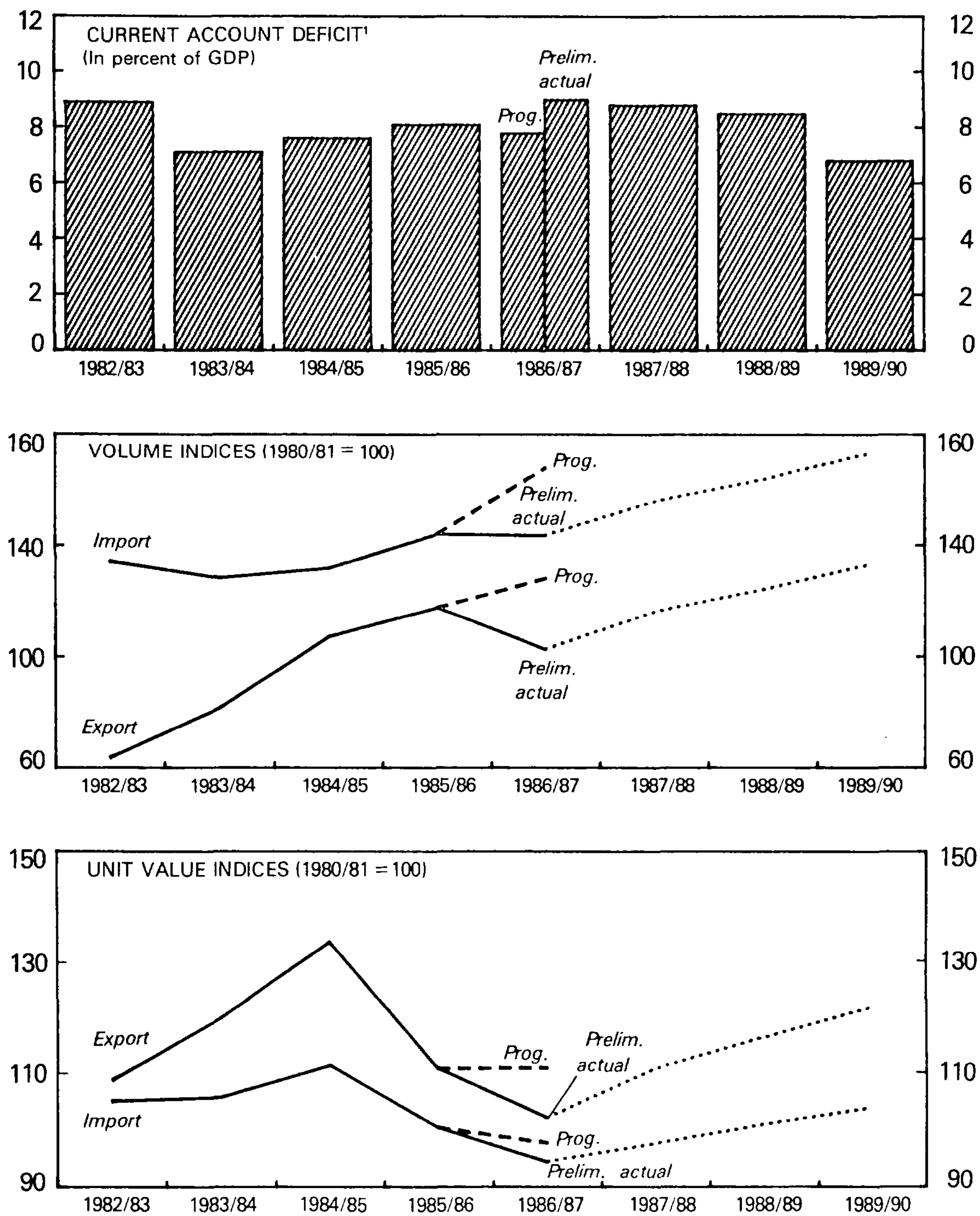
Sources: Data provided by the Nepalese authorities; and staff estimates.

1/ Components may not add to totals due to rounding.
2/ Including the prospective purchase of an aircraft (SDR 44 million or about 1.8 percent of GDP).
3/ Including errors and omissions and valuation adjustments.
4/ Excluding grants.
5/ In percent of exports of goods and services and private transfers.

CHART 3

NEPAL

EXTERNAL INDICATORS, 1982/83-1989/90



Sources: Data provided by the Nepalese authorities; and staff estimates.
[1]Excluding grants.

the overall balance of payments registered a surplus of SDR 8 million, close to the program target of SDR 12 million.

III. The Three-Year SAF Program

With a per capita income of only about SDR 135, Nepal is one of the world's poorest countries. Agriculture accounts for about 60 percent of GDP, with subsistence farming constituting the most important single activity. Agricultural productivity is low because of the hilly terrain, low use of fertilizers, and inadequate irrigation and flood control facilities which make agricultural production highly vulnerable to the vagaries of weather. Another serious constraint is the inadequacy of the road network which considerably increases transportation costs and fragments local markets. The industrial base is small and many basic manufactured and virtually all capital goods are imported. The export base supporting such imports is weak, 1/ and Nepal has had to rely heavily on foreign aid to finance the ensuing external current account deficits. Nepal possesses abundant hydroelectric power resources, which, however, remain largely unexploited.

Over the past two decades, economic growth has barely kept pace with the rate of increase in population (2.7 percent per year), although with the rate of investment rising, there has been some improvement in the growth performance in the 1980s (Chart 4). The principal challenge facing Nepal is to place the economy on a higher sustainable growth path which, in view of the weak infrastructure, the narrow export base, and the unexploited natural resource potential, will require an increase in the rate of investment but also, more important, a considerable improvement in economic efficiency. Therefore, key elements of the medium-term program are: increased domestic resource mobilization; improved public enterprise management; greater reliance on the price mechanism in resource allocation; and better project implementation cum higher aid utilization. Domestic resource mobilization will be increased through improved tax administration, new revenue measures, including a greater taxation of agriculture, strict control over regular expenditure, and financial reforms. Greater efficiency will be sought in public enterprise activities through managerial strengthening, sounder financial practices, and divestiture. Industrial and trade policies will be liberalized to stimulate private sector initiative and help diversify exports. The program also incorporates a series of measures to improve project implementation and monitoring; inadequate project implementation has seriously limited economic progress and has led to the accumulation of an unutilized aid pipeline of over $1 billion (almost 40 percent of GDP). Finally, as outlined in the PFP, a wide range of structural

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1/ The main traditional exports are jute, jute goods, hides and skins, and rice. In recent years, garments, carpets, and handicrafts have emerged as important export items. Tourism has also become an important and growing source of foreign exchange.

policies will be implemented in the areas of agriculture, forestry, industry, tourism, and energy to better tap the unexploited potential in these sectors.

The main macroeconomic objectives under the proposed SAF arrangement are to sustain an annual rate of real GDP growth in excess of 4 percent over the period 1987/88-1989/90 and to contain the external current account deficit to about 8 percent of GDP per year on average (Annex I). To increase budgetary resources, revenue measures will be taken with the objective of raising the revenue/GDP ratio by about 0.7 percentage point per year. Together with restraint on regular expenditure, this would allow development outlays, including outlays for operation and maintenance, to rise in relation to GDP by about 2 percentage points by 1989/90. The net domestic financing of the deficit is projected to be reduced from 2.5 percent of GDP in 1986/87 to 1.5 percent in 1989/90, thereby freeing resources to the private sector and allowing a reduction in interest payments as a proportion of government revenue. 1/ Export volume is expected to grow by about 7 percent per year--compared with an average annual rate of growth of less than 4 percent over the last five years--reflecting increased output of agricultural goods and manufactured items such as carpets and garments which will benefit from the liberalization of industry and trade. The overall balance of payments is projected to be in surplus in each year of the program, averaging about SDR 10 million per year; this will allow gross reserves to be maintained at a level equivalent to about 3.5 months of imports.

One anticipated result of the program is that aid utilization will increase, which will be reflected in higher imports and government expenditure. As a consequence, despite an increase in domestic resource mobilization, no significant decline is expected in the external current account and the overall budget deficit is projected to remain about 9 percent of GDP during the SAF period. While the accelerated utilization of aid will initially increase the relative dependence on foreign saving, self-reliance will increase over time as the economic base strengthens and domestic saving rises.

Nepal's external debt service burden is low as most of the debt outstanding is on concessional terms. Largely owing to the expected acquisition of two aircraft to promote tourism and air freight, the debt service ratio is projected to increase from 5.5 percent of current receipts to about 11 percent by 1989/90 (7 percent excluding the aircraft acquisitions), and to decline thereafter. Assuming SAF disbursement totaling SDR 23.7 million through 1989/90, obligations to the Fund would peak in 1990/91 at 2 percent of current external receipts. Nepal should therefore be able to meet its obligations to the Fund on the basis of current and prospective commitments.

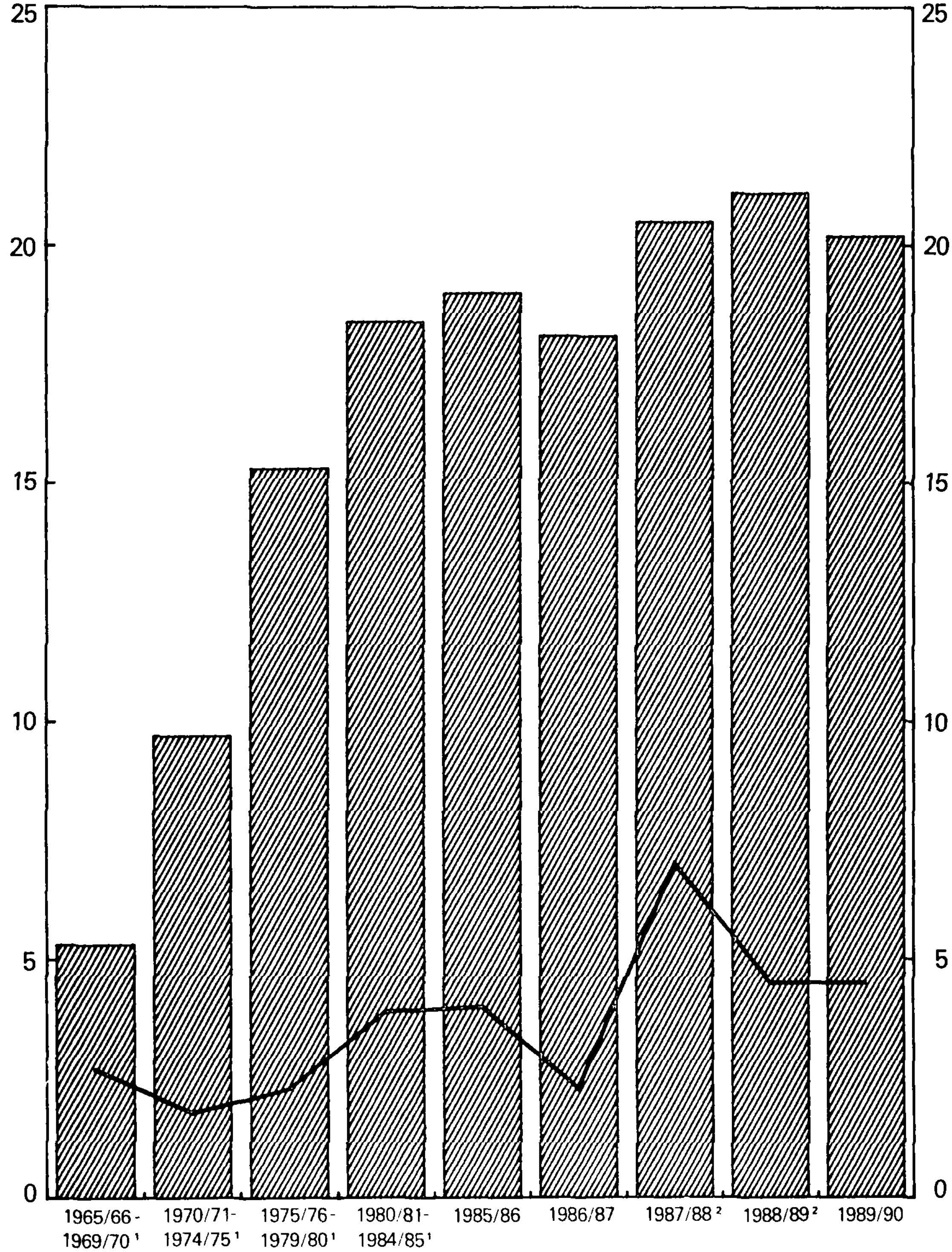
1/ Interest payments have risen at a rapid rate in recent years to reach almost 17 percent of government revenue in 1986/87.

CHART 4

NEPAL

INVESTMENT AND OUTPUT GROWTH, 1965/66-1989/90

(In percent)



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

[1] Five-year average

[2] Including purchase of an aircraft (about 1.8 percent of GDP) in each year.

IV. The First-Year Program, 1987/88

Important initiatives have already been taken or are to be taken soon in all the policy areas outlined above. The most important actions taken so far are: a major import tariff reform accompanied by a liberalization of trade and industry; steps to strengthen tax administration; new revenue measures; a sharp reduction in food subsidies; major improvements in the process of project selection and monitoring; and a series of initiatives in the areas of agriculture, forestry, industry, and divestiture. The authorities also will soon undertake a reform of the government securities market. A summary of the main targets and policy content of the 1987/88 program is provided in Annex I.

1. Macroeconomic targets

Economic growth is projected to rebound to 7 percent in 1987/88, largely on the strength of an anticipated recovery in agriculture. 1/ Nonagricultural sectors, which can be expected to benefit from buoyant agricultural income, are projected to grow by almost 8 percent. Investment is expected to recover strongly as private investment benefits from import liberalization, while public investment will receive a boost from the acquisition of an aircraft by the Royal Nepal Airlines Corporation (RNAC), as well as from an improvement in project implementation. The contribution of net exports to overall economic growth is expected to be negative, as the recovery in exports will not match the growth in import demand. Thus, notwithstanding an anticipated increase in the domestic savings ratio, the improvement in the investment/GDP ratio will be accompanied mostly by increased use of foreign savings.

The average rate of consumer price inflation is projected to decline to about 8 percent in 1987/88, from 13 percent in the previous year. Given the long and open border with India, the price level in Nepal cannot substantially differ from that in India. Historically, in the absence of bilateral exchange rate changes, inflation differentials between Nepal and India have been small (Chart 5). Since the devaluation of the Nepalese rupee in November 1985, higher Nepalese inflation has almost restored historical relative price levels. 2/ The higher projected inflation rate in Nepal than in India during 1987/88 3/ would complete the convergence of Indian and Nepalese prices.

1/ Some parts of the country experienced heavy flooding in August 1987; however, it is too early yet to judge how this will affect agricultural output.

2/ About 50 percent of the price gap (corrected for the exchange rate change) between India and Nepal that developed following the devaluation of the Nepalese rupee was closed in the six months after the devaluation and by July 1987, the price gap was estimated at only 3 percent.

3/ The rate of consumer price inflation in India is projected at about 6 percent.

The overall balance of payments is projected to remain in surplus (SDR 7 million) in 1987/88. Despite an expected improvement in the terms of trade and export growth of over 20 percent resulting largely from a recovery of rice, pulses, and readymade garment exports, a rebound in import demand is projected to raise the current account deficit in relation to GDP by 1 percentage point to about 9 percent. The rapid increase in imports is largely a consequence of the aircraft purchase 1/ and the anticipated improvement in project implementation, which is expected to lead to a commensurate increase in aid disbursements.

2. Policies

a. Public sector policies

(i) Fiscal policy

The 1987/88 government budget is designed to further strengthen the revenue effort and to increase development expenditure, including outlays on operation and maintenance, while reducing the net domestic financing of the budget deficit. To this end, the authorities introduced revenue measures that include increases in import taxes implemented within the framework of the tariff reform, and increases in excise and sales taxes, the land registration fee, the flight departure tax, and the vehicle tax (for details see Table 6). Altogether, these measures are expected to yield about NRs 500 million (0.8 percent of GDP) in additional revenue. At the same time, the authorities have embarked on a major effort to improve tax administration. In the past, the staffing of various revenue departments by civil servants on temporary posting has prevented the formation of an experienced and trained body of personnel essential for effective tax administration. To redress this shortcoming, the authorities intend to set up a closed and unified revenue service, staffed by permanent civil servants and encompassing all revenue departments. In 1987/88, this service will be set up, as a first step, for the more senior civil servants, with extension to all essential officers involved in revenue collection in the subsequent two years. In addition, tax administration will be further strengthened by the establishment of specialized units in the tax departments to concentrate on important revenue sources.

Notwithstanding a further rapid rise in interest payments, regular expenditure is expected to remain broadly unchanged as a percentage of GDP, as a consequence of no general salary increase for employees and a freeze on the number of civil servants and on outlays for material and supplies. On the other hand, development outlays, including operation and maintenance expenditure, are projected to increase substantially as the authorities try to improve project implementation. To this end, the Government is implementing a variety of measures under the World Bank's

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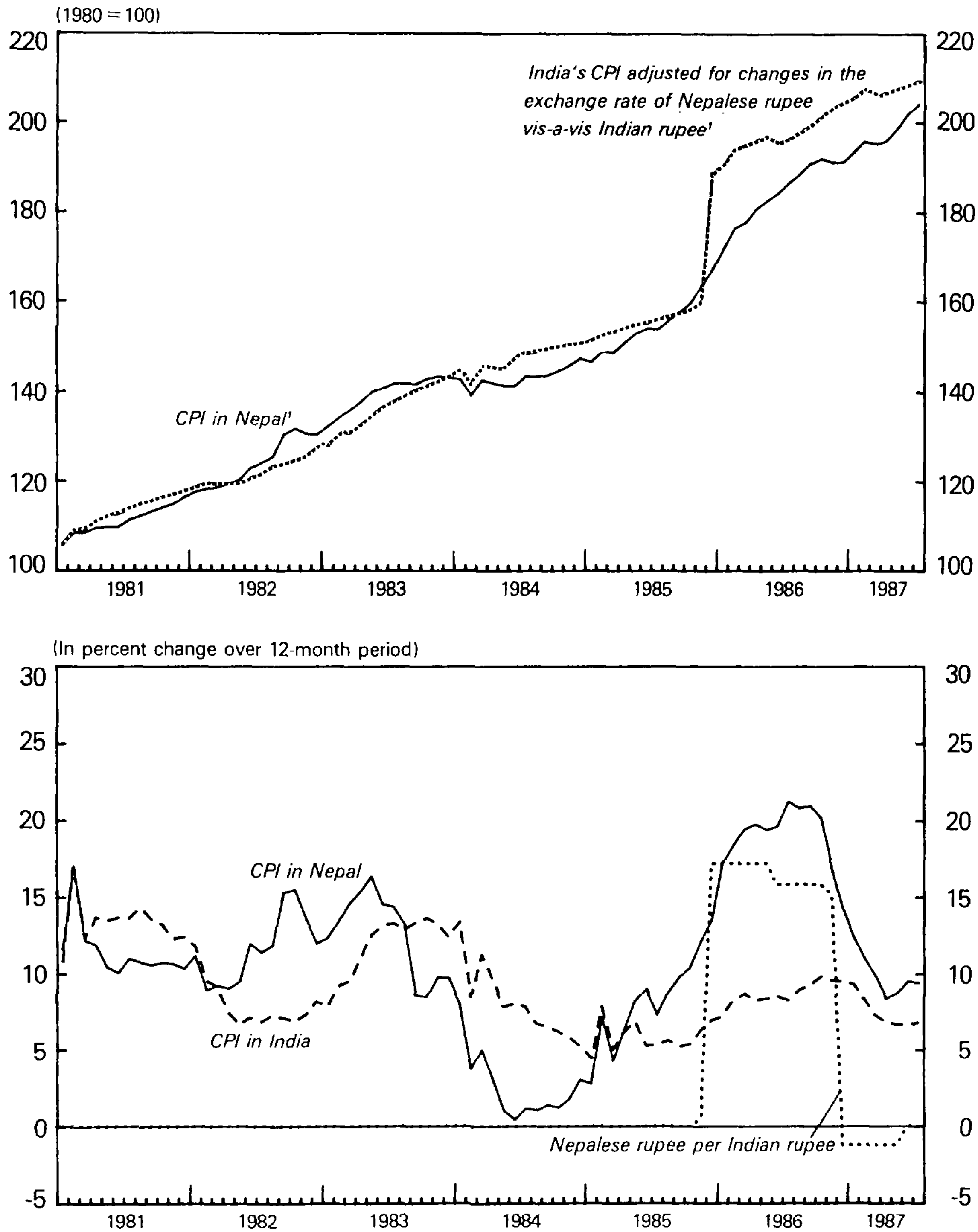
1/ The aircraft purchase adds about 9 percent to imports.

CHART 5

NEPAL

CONSUMER PRICE INFLATION, 1981-87



Sources: Data provided by the Nepalese authorities; and International Monetary Fund, *International Financial Statistics* (IFS).
[1]Seasonally adjusted.

Table 6. Nepal: Revenue Measures Introduced in the 1987/88 Budget

Measure	Revenue Impact (NRs millions)
Reform of tariff system	310.0
Increase in excise duty on various products, including cigarettes	65.5
Increase in sales tax on cement, iron rods, and iron wire	45.0
Increase in land registration fees for land transferred under endowment deed	50.0
Increase in gasoline prices of 10 paisa per liter	10.0
Increase in the flight departure tax from NRs 150 to NRs 200	15.0
Increase in valuation of urban land and property for tax purposes	5.0
Increase in vehicle license fees	2.5
Introduction of annual television license fees	1.5
Total	504.5

Source: Data provided by the Nepalese authorities.

SAL. These include the adoption of a core program of projects (representing about 70 percent of development expenditure) selected on the basis of foreign aid content, nearness to completion, economic efficiency, and strategic importance in the overall development program. Improved financial accountability, streamlined auditing procedures, and better training of accountants are also part of this effort. Despite these efforts, however, it is expected that project implementation and thus aid disbursements and development expenditures will fall short of the budget target. Correspondingly, the overall deficit (excluding grants) is expected to be about 9 percent of GDP, 2 percentage points lower than in the budget. 1/ Recognizing this, the authorities have stated that any shortfall in aid utilization relative to budget estimates will be fully reflected in a corresponding reduction in development expenditure. The authorities are also aware that in the 1987/88 budget the revenue projections contain a larger degree of uncertainty than usual because of the implementation of the tariff reform. Consequently, in designing their program, they have committed themselves to slow down the implementation of noncore development projects until it becomes clear that sufficient resources will be available. Thus, the target of reducing the net domestic financing of the budget deficit to 1.7 percent of GDP will not be jeopardized.

(ii) Public enterprises

The Government plans to continue its efforts to strengthen the financial position of public enterprises, which have run large operating losses in recent years, financed either through government subsidies, bank credit, or a buildup of arrears.

The most important loss-making enterprise is the NFC, which buys and distributes foodgrains. On account of its obligation to undertake subsidized sales, the NFC has sustained substantial losses in recent years which have been financed by both direct subsidies and the accumulation of arrears to commercial banks. To reduce such losses, the NFC has eliminated recently the subsidized sale of foodgrains in the Kathmandu Valley where it is limiting its operations to price stabilization at prices that cover costs. As a result, in the future the NFC should break even on its commercial activities. Subsidized sales will be limited mostly to the hilly areas where transportation costs are very high, and will be financed by explicit budgetary provisions.

Measures have also been taken to improve the financial position of the Agricultural Inputs Corporation (AIC), which imports and sells fertilizers at subsidized prices. The AIC does not borrow from commercial banks, but has financed its losses by falling behind in

1/ The benchmark for the overall budget deficit has been set at about 9 percent of GDP. To the extent that aid inflows exceed current staff estimates, the overall deficit can be increased up to a maximum of the budget estimate of 11 percent of GDP.

transferring to the Government the proceeds from the sale of aid-financed fertilizer. To reduce the subsidy element and discourage smuggling, fertilizer prices have been raised, beginning in 1986, to levels prevailing in India. In addition, the Government has agreed to allow the AIC to retain 20 percent of the proceeds from fertilizer sales to cover its distribution costs.

The Government has decided, in principle, to float shares in 15 public enterprises to the general public and will put into effect, beginning in 1987/88, an action plan for the sale of public enterprises to the private sector. So far, shares in three enterprises 1/ have been offered for sale; however, the results have been somewhat disappointing, with only 30 percent of the shares being taken up on average. Further progress in this area is likely to be difficult, owing to the weak financial position of many public enterprises or, in some cases, to legal difficulties. 2/ However, the authorities plan to float shares in up to four additional profitable public enterprises in 1987/88, and have requested technical assistance from the IFC on privatization of the remaining enterprises.

b. Monetary and credit policies

Consistent with the macroeconomic targets, the credit program for 1987/88 limits the growth of net domestic assets of the banking system to about 19 percent. The growth of credit to the public sector remains virtually unchanged, while the growth of credit to the private sector is expected to accelerate substantially to accommodate the anticipated buoyant credit demand of the industrial and agricultural sectors. In line with the expected strong economic recovery and the consequent increase in demand for money, broad money growth is projected to accelerate slightly.

The returns on government securities in Nepal have, in general, not been sufficiently attractive relative to the yields on commercial bank deposits of comparable maturities. 3/ The relatively low yields, coupled with a limited choice of maturities concentrated mostly in the longer-term categories, have adversely affected domestic resource mobilization and allocation. They have also interfered with effective monetary management, since the absence of short-term paper with attractive yields has entailed automatic lending to commercial banks by the

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1/ The National Insurance Company, Himal Cement, and the Nepal Industrial Development Corporation.

2/ For example, an amendment to the legislation establishing the RNAC will be required before shares can be sold to the public.

3/ Since May 1986, banks have been allowed to set interest rates freely, with the exception that deposit rates remain subject to certain minimum levels and a uniform maximum lending rate has been set for most loans to priority sectors (for details of the interest rate reform of May 1986, see EBS/86/182, 8/11/86).

Nepal Rastra Bank (NRB, the central bank) against long-term government bonds, detracting from an important discretionary element of monetary policy. To address these weaknesses, the authorities plan to introduce a wider spectrum of maturities in government securities carrying market-related interest rates; at the same time, the automatic loan provision against government bonds will be phased out. Furthermore, the interest rates on government overdrafts with the NRB will be raised in line with those on treasury bills and the maximum amount of government overdraft outstanding will be limited to about 15 percent of government revenue. Also, to further diversify holders, encourage domestic savings, and strengthen monetary management, the Government intends to introduce central bank securities and develop a secondary market for government securities. To help implement these reforms, the authorities have requested technical assistance from the Fund.

c. External policies

Exchange rate policy will be managed through the new exchange arrangement introduced in 1986, under which the Nepalese rupee is pegged, within margins, to a basket of currencies in which the Indian rupee has a large weight. The role of exchange rate policy is limited in Nepal by the close integration of the Nepalese and Indian economies which dictates that frequent changes in the Nepalese rupee/Indian rupee exchange rate should be avoided. In this setting, restrained financial and wage policies and the maintenance of appropriate interest rate levels are essential policy tools for achieving short-term balance of payments objectives. In the longer term, competitiveness of the traded goods sector will be enhanced through improved productivity and efficiency. As discussed below, the export sector will be strengthened mainly through increased agricultural output and import liberalization, which is designed to improve manufacturers' access to imported inputs and capital goods. During 1986/87, the nominal effective exchange rate of the Nepalese rupee continued to depreciate in line with the depreciation of the Indian rupee and the real effective exchange rate depreciated by an estimated 5 percent (Chart 6).

To avoid an undue increase in debt service obligations, the authorities will limit nonconcessional public and publicly guaranteed borrowing with maturities of 1-12 years contracted during 1987/88 to SDR 10 million. In addition, short-term borrowing will be limited to revolving loans required in the normal operations of the Nepal Oil Corporation and drawings under the traditionally provided stand-by arrangement by the Reserve Bank of India (Rs 250 million). 1/

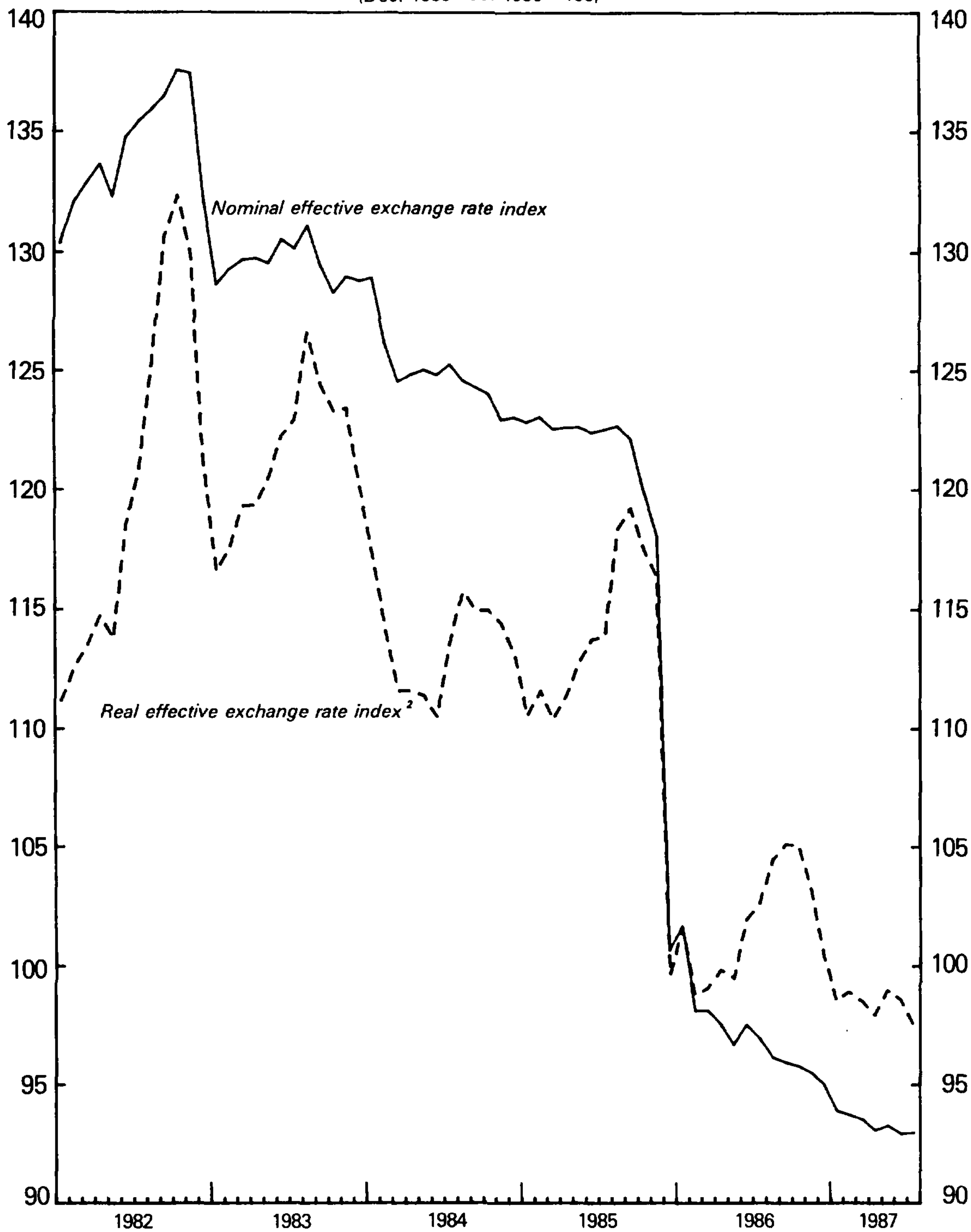
1/ Outstanding liabilities under this stand-by arrangement are included as a reserve liability in the definition of international reserves used as a quarterly benchmark.

CHART 6

NEPAL

EFFECTIVE EXCHANGE RATE INDICES, 1982-87[1]

(Dec. 1985-Feb. 1986 = 100)



Sources: International Monetary Fund, *IFS*; and staff estimates.

[1]Indices are weighted by trade shares of Nepal's major trading partners.

[2]The figures for June and July 1987 are staff estimates.

d. Industry and tourism

Industrial policy will focus on developing efficient export-oriented and import-substituting industries. To this end, the Government is formulating a new industry act, to be introduced in the latter part of 1987, which will outline a number of tax incentives to encourage production by local enterprises. In addition, industrial licenses will be automatically granted to firms importing 40 percent or less (compared to the present limit of 20 percent) of their inputs. At the same time, imports of raw materials, intermediate inputs, and capital goods are being gradually liberalized by placing them under Open General License (OGL).

Import liberalization is seriously complicated in Nepal by the long open border with India and the fact that India's own trade regime is highly protective. Given Nepal's small domestic market, its comparative advantage lies mainly in an export-oriented, outward-looking strategy, which implies that manufacturers should have easy access to inputs and capital goods at world prices. However, these items are liable to be smuggled to India, which is naturally a concern to the Nepalese authorities, both because it is against the Nepal-India trade treaty and because it entails the loss of convertible currency for inconvertible Indian rupees. Under these circumstances, the removal of quantitative restrictions has to be accompanied by the imposition of tariffs that will discourage smuggling. 1/ These tariffs then need to be exempted for or rebated to exporters. A Fund technical assistance mission with IBRD participation visited Nepal in early 1987 to advise in this area, and further Fund technical assistance was provided in May-June. Following the recommendations of these missions, the authorities introduced a rationalization and simplification of the tariff system in July 1987 2/ and are introducing a system of duty drawbacks and exemptions for exports. In addition, imports of 23 items, mainly raw materials and intermediate goods, were placed under OGL in the first half of 1987. The number of goods presently under OGL account for approximately 20 percent of total nonaid imports from countries other than India, which has been the target set for the first year of the SAF. The list of items under OGL will be expanded during the SAF program so as to raise the above proportion of OGL imports to at least 50 percent by 1989/90.

In the area of tourism, increased resources are being directed to promotion and marketing, as well as to the development of areas for

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1/ To discourage smuggling, Nepalese tariffs on third country imports must be equal to the implicit tariff (the actual tariff plus the price effect of any quantitative restrictions) on the same goods in India, less smuggling and transportation costs.

2/ The measures included a simplification of the tariffs into ten slabs and the absorption into the tariff of such tariff-like charges as license fees and sales tax markups.

mountaineering and trekking and the restoration of historic sights. In addition, air access to Nepal will be improved through the acquisition of two new aircraft (one purchased and another leased), with delivery of the first scheduled for 1987/88. These aircraft acquisitions are expected to generate sufficient foreign exchange earnings to cover the additional debt service payments. By leasing one aircraft, the RNAC retains flexibility if air traffic does not meet expectations.

e. Agriculture and forestry

Agricultural productivity is to be enhanced through improved availability of agricultural inputs and the development of irrigation facilities. The use of fertilizers in Nepal is very low 1/ owing both to inadequate distribution and the lack of irrigation facilities. To improve distribution, private sector involvement in fertilizer distribution is being promoted. Since July 1987, fertilizer distribution has been opened to the private sector and the dealer margin on fertilizer prices has been raised.

Since the nationalization of forests in 1956, villagers have had little incentive to exploit prudently Nepal's fuelwood resources. This has led to severe deforestation which now poses an important environmental problem. To promote reforestation, the Government has recently decentralized forest management responsibilities to the district and community levels, and will soon enact legislation that will allow local panchayats to retain revenues obtained from forestry product sales. This will encourage villagers to pursue more commercially responsible forest management policies.

3. Benchmarks for the first-year program

Progress under the program and the appropriateness of policies will be monitored through quantitative and structural benchmarks specified in Tables 1 and 2 of the Memorandum on Economic and Financial Policies. Quantitative benchmarks include: (i) an annual benchmark for the overall government budget deficit excluding grants; (ii) quarterly benchmarks for the net domestic financing of the budget deficit, net domestic assets of the banking system, net bank credit to the Government, and bank credit to nonfinancial public enterprises; (iii) quarterly benchmarks on international reserves net of outstanding liabilities under stand-by arrangements with other central banks and (iv) quarterly benchmarks on the contracting and guaranteeing of new nonconcessional loans by the public sector in the 1-12-year maturity range. These benchmarks will also serve as signals for additional measures, should these become necessary for achieving the program's objectives.

1/ In Nepal, average fertilizer consumption is 14 kg./ha., compared with about 40 kg./ha. in India and 60 kg./ha. in Bangladesh.

V. Staff Appraisal

Nepal's external and domestic financial position has significantly improved since 1984/85 under an economic adjustment program supported by a stand-by arrangement from the Fund. The challenge facing Nepal now is to achieve the sustainable economic growth necessary to raise the standard of living of its people by tackling some major structural problems, including low domestic savings, a narrow export base, and a weak infrastructure. The structural adjustment program undertaken by the Government in close collaboration with the staffs of the Fund and the Bank represents a start at meeting this challenge. With the successful implementation of this program, Nepal should, at the end of the SAF period, find itself in a better position to ensure a more broadly based and stable growth: revenue mobilization and domestic savings would be higher; the management of public resources more efficient; the reliance on market forces and private initiative strengthened; and the export base somewhat stronger and more diversified.

Fiscal policies are directed at increasing domestic resource mobilization to allow an expansion of outlays on development and operations and maintenance while limiting the budget deficit and its net domestic financing. To this end, the authorities have introduced significant new revenue measures in 1987/88. Since a large portion of the additional revenue is to come from changes in import taxes implemented within the framework of a major tariff reform, a somewhat more-than-usual degree of uncertainty exists about the revenue outcome. The staff would, therefore, underscore the importance of the authorities' commitment to slow down noncore development expenditures until it becomes clear that sufficient resources will be available to finance them. The importance of maintaining strict control over regular expenditures should also be emphasized.

An underlying weakness of Nepal's tax system is its inelasticity, and the Government is in the unenviable position of having continuously to introduce new tax measures just to maintain the revenue/GDP ratio. In effect, Nepal must run fast even to stand still. A major cause of this inelasticity has been weak tax administration, and the speedy introduction of a closed and unified revenue service is, in the staff's view, of great importance in remedying this problem. Other causes include extensive tax exemptions and a narrow tax base, with taxes on agriculture, which constitutes 60 percent of GDP, having fallen to negligible levels. While some measures to improve tax elasticity--including the replacement of specific by ad valorem taxes--were taken in the 1987/88 budget, further measures will be necessary in the next two years of the SAF arrangement.

In addition to increased domestic resource mobilization, improved project implementation is also needed if Nepal is to make full use of the foreign aid available to it. The measures that have been initiated under the aegis of the World Bank's SAL, including the adoption of a core program of projects, are important. Despite these measures, however, the staff believes that the authorities' expectations of improvement in the implementation of projects and hence the level of aid disbursements in the budget are optimistic; therefore, it welcomes their commitment that any shortfall in aid inflows associated with slower-than-expected implementation of aided projects will be fully offset by reductions in development expenditures so as not to jeopardize the targeted reduction in the net domestic financing of the budget deficit.

The Government is also implementing a series of measures to improve the performance of public enterprises which, despite substantial government support, have built up large arrears to the banking system. A number of important measures have already been taken to improve the financial position of two major public enterprises--the Nepal Food Corporation and the Agricultural Inputs Corporation. It is now time to address the problems of the other main loss-making enterprises so as to avoid a continued buildup of arrears. Where further repayments of public enterprise arrears to commercial banks by the Government are necessary, the improvement in the enterprises' credit standing should not be allowed to lead to bank borrowing to finance operating losses. Privatization remains an important objective of the Government; while the staff recognizes the difficulties involved, the authorities are encouraged to push ahead with their divestiture plans.

The Government intends to introduce a variety of measures to improve domestic financial markets, including the provision of more attractive yields and maturities for government securities, the development of a secondary market for such securities, and the introduction of central bank bonds. These reforms, which would enhance domestic saving and allow more effective monetary management, should be implemented at an early date.

A major hindrance to the growth of Nepalese industry has been the existence of import and industrial licensing systems that have discouraged investment and new entrants by restricting manufacturers' and exporters' access to essential imported inputs. The liberalization of industrial licensing and the measures to reduce import restrictions are therefore to be welcomed. The introduction of the tariff reform, which considerably simplifies and rationalizes what had been a very complex system, is also an important improvement in Nepal's trade system. The staff urges the authorities to continue to place new items, particularly raw materials and intermediate inputs, under Open General License with appropriate tariffs to prevent re-exports. To support this measure, a duty drawback/exemption system for exporters should be implemented soon so as to allow them to be competitive in world markets.

In summary, the staff considers that the structural adjustment program launched by the authorities is a truly ambitious one and that the program for 1987/88 represents a substantial first step, with most of the measures already in place. The authorities must be commended for their boldness in tackling some of the main structural problems. As the Government continues to implement its program of reforms, however, weaknesses in administrative capacity may become an increasing bottleneck. The process of administrative strengthening needed to rectify this will take time and perseverance will be necessary to see the reform program through to fruition.

VI. Proposed Decision

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

1. The Government of Nepal has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the Structural Adjustment Facility.

2. The Fund approves the arrangements set forth in EBS/87/196.

Nepal: Social and Demographic Indicators 1/

Area	Population (1986)	Density	
140.8 thousand sq. km.	16.9 million Annual rate of growth: 2.5 percent	120.0 per sq. km. 411.1 per sq. km. of arable land	
Population characteristics		Health	
Life expectancy at birth - male	46.7	Population by physician (1980)	33,100
- female	46.7	Population per hospital bed	6,300
Infant mortality rate			
(Age under 1, in percent)	13.5		
(Age 1-4, in percent)	2.0		
Income distribution		Distribution of land	
Percent of national income		Percent area exploited by largest	
Highest quintile	...	11 percent of farmers	...
Lowest quintile	...	Percent area exploited by smallest	
		12 percent of farmers	...
Access to safe water		Access to electricity	
Percent of population - urban	83.0	Percent of dwellings - urban	...
- rural	7.0	- rural	...
Nutrition		Education	
Calorie intake (percent of		Adult literacy rate (percent)	19.0
requirements)	93.0	Primary school enrollment rate	73.0
Per capita protein intake		Secondary school enrollment rate	22.0
(grams per day)	50.0		

Sources: Data provided by the Nepalese authorities; and the World Bank.
1/ Data refer to the most recent estimates between 1982 and 1985 unless otherwise specified.

Nepal--Fund Relations
(As of July 31, 1987)

I. Membership Status

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

(A) Financial Relations

II. General Department

(a) Quota:	SDR 37.3 million
(b) Total Fund holdings of Nepalese rupees:	SDR 50.24 million (134.7 percent of quota)
(c) Fund credit:	SDR 18.65 million (50.0 percent of quota)
Of which: Credit tranche purchases (ordinary resources)	SDR 18.65 million (50.0 percent of quota)
(d) Reserve tranche position:	SDR 5.71 million (15.3 percent of quota)
(e) Current operational budget:	Not applicable.
(f) Lending to the Fund:	Not applicable.

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

(a) Current arrangement:	None
(b) Previous stand-by and extended arrangements during the last 10 years:	
(i) Type of arrangement	Stand-by
(ii) Duration:	From 12/23/85 to 4/22/87
(iii) Amount:	SDR 18.65 million
(iv) Utilization:	SDR 18.65 million
(v) Undrawn balance	--
(c) Special facilities during the past two years:	None

IV. SDR Department

(a) Net cumulative allocation:	SDR 8.1 million
(b) Holdings:	SDR 0.39 million or 4.86 per cent of net cumulative allocation
(c) Current Designation Plan:	Not applicable.

Nepal--Fund Relations (continued)
(As of July 31, 1987)

V. Administered Accounts

(a) Trust Fund loans:
(i) Disbursed: SDR 13.7 million
(ii) Outstanding: SDR 4.54 million
(b) SFF Subsidy Account: Not applicable.

VI. Overdue Obligations to the Fund

Not applicable

Schedule of Principal and Interest Due to the Fund
(In millions of SDRs)

	1987 Apr.-Dec.	1988	1989	1990
1. Principal	1.6	2.3	6.8	8.5
Repurchases	--	--	5.4	8.1
Trust Fund repayments	1.6	2.3	1.4	0.4
2. Charges and interest (including SDR and Trust Fund)	2.8	4.0	8.4	10.2
Total due (1 + 2)	4.4	6.3	15.2	18.7

(B) Nonfinancial Relations

VII. 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.

Nepal--Fund Relations (continued)
(As of July 31, 1987)

VIII. Last Article IV Consultation	March 25, 1987; staff discussions were held during December 4-20, 1986 (EBS/87/37, 2/23/87 and Supplement 1, 3/24/87; SM/87/65, 3/10/87). The Executive Board adopted the following decision: "1. The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Section 2(a) and in concluding the 1986 Article XIV consultation with Nepal, in the light of the 1986 Article IV consultation with Nepal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies). 2. Nepal's exchange restrictions as described in EBS/87/37, are maintained in accordance with Article XIV, Section 2, except that the restriction on payments and transfers for current international transactions arising from the bilateral arrangements with a Fund member is subject to approval under Article VIII, Section 2(a). The Fund urges Nepal to eliminate the restrictive features of this bilateral payments arrangement as soon as possible."

Nepal--Fund Relations (continued)
(As of July 31, 1987)

IX. Technical Assistance:

(a) CBD:

For four months in 1983, the Fund provided an advisor for compiling cost of living indices. The same advisor took up another assignment for five months starting in May 1986. A mission reviewed the financial system and proposed measures for increasing savings and investments in December 1984.

(b) Fiscal:

A mission in August 1984 reviewed budget projections embodied in the Seventh Plan (1985/86-1989/90) and recommended tax reform and expenditure measures. A mission in February-March 1986 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.

(c) 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.

Nepal--Fund Relations (concluded)
(As of July 31, 1987)

IX. Technical Assistance: (contd.)

(d) Exchange rate: A mission on the exchange system in October-November 1985 and a follow-up mission in May 1986 assisted with the introduction of a more flexible exchange rate management.

(e) Other: A mission from STA in November 1986 reviewed the treatment and valuation of Fund accounts and recommended improvements in the currentness and coverage of monetary data.

X. Resident Representative/Advisor: The Fund has provided staff members as Resident Advisors/Representatives since 1977. The current Resident Representative is Mr. Thornton, who took up his assignment in February 1987.

Nepal - Relations with the World Bank

Bank operations in Nepal began in 1969 with an IDA credit of $1.8 million for a telecommunications project. Since then, 47 additional credits have been approved, bringing total IDA assistance to $741 million. No IBRD loans have been made to Nepal but IFC has made three loan/equity investments totaling $9 million. To address the underdevelopment of the country's economic infrastructure, the Bank Group has allocated some 38 percent of its resources for Nepal to the transportation, telecommunications, and power and energy sectors. Agriculture, forestry, and irrigation sectors that contribute about 60 percent of GDP account for about 40 percent of Bank Group operations.

The main constraint on the utilization of increased aid has been Nepal's limited absorptive capacity, affecting the pace of project preparation and implementation. Over the next several years, the Bank will seek to strike a proper balance between the necessary emphasis on quick- and high-yielding investments (such as agricultural extension service, irrigation rehabilitation, and cottage industries), which is dictated by Nepal's precarious budgetary and balance of payments position, and an equally important commitment to longer-term developmental and institutional issues (such as public administration inefficiencies, poor project planning and implementation, rapid population growth, and export-oriented hydropower development). This assistance will be delivered through a combination of program and project lending, technical assistance, and economic and sector work.

Technical assistance

The World Bank currently provides two staff members in its Resident Mission. It also has been providing technical assistance in industrial finance and policy, and in cottage industry development. The Bank is currently discussing with the authorities the possibility of providing a staff member under its program of nonreimbursable technical assistance to assist the National Planning Commission and several of the key line ministries in strengthening the function of project formulation and evaluation.

Recent economic and sector missions

The most recent economic mission visited Kathmandu during May-June 1985. In addition, the World Bank has sent a number of sector missions in recent years, including a mission to review the Seventh Plan in November 1984, to assess public administration training needs in January 1985, to assist the Government to define a strategy for power development in January 1987, and to review Bank agricultural strategy in March 1987.

Nepal - Relations with the World Bank (Concluded)

Structural Adjustment Loan

A SAL was approved by the Bank's Executive Directors on March 24, 1987. The amount of the loan is SDR 40.9 million (US$50 million equivalent) to be disbursed in two tranches over a period of 18 months. The structural adjustment program focuses on improved domestic financial and external policies, reduced government intervention in the agricultural sector, restructuring of public enterprises, and more efficient administration of development expenditures.

Nepal: Lending by the World Bank Group 1/

(In millions of U.S. dollars)

Sectoral lending	IDA	IFC	Total	Of which: Undisbursed
Agriculture	132.4	--	132.4	84.0
Irrigation	159.0	--	159.0	84.2
Education	32.8	--	32.8	20.6
Water supply	46.8	--	46.8	2.9
Industry	28.0	9.0	37.0	19.2
Transportation	67.0	--	67.0	51.8
Telecommunications	43.8	--	43.8	26.2
Power and energy	168.0	--	168.0	126.9
SAL	50.0	--	50.0	33.5
Other	13.2	--	13.2	4.9
Total	741.0	9.0	750.0	454.2

Source: Data provided by the World Bank.

1/ As of June 30, 1987. No IBRD loans have been made to Nepal.

NEPAL

Three-Year and First Annual Arrangements
Under the Structural Adjustment Facility

Attached hereto is a letter dated September 3, 1987 with a Policy Framework Paper (EBD/87/234, 9/14/87) and an annexed Memorandum on Economic and Financial Policies from His Majesty's Government of Nepal, requesting from the Fund a three-year structural adjustment arrangement and the first annual arrangement thereunder, and setting forth:

(i) the objectives and policies of the program to be supported by the three-year arrangement, and

(ii) the objectives and policies of the program to be supported by the first annual arrangement.

To support these objectives and policies, the International Monetary Fund grants the requested arrangements in accordance with the following provisions and subject to the Regulations for the administration of the Structural Adjustment Facility:

1. For a period of three years from October .., 1987, Nepal will have the right to obtain three successive loans from the Fund under the Structural Adjustment Facility in a total amount equivalent to SDR 23.6855 million.

2. The first loan, in an amount equivalent to SDR 7.46 million, is available for disbursement at the request of Nepal.

3. The second and third loans will be available upon approval by the Fund of the corresponding annual arrangements and will be disbursed at the request of Nepal. The amount of the second loan will be equivalent to SDR 11.19 million, and the amount of the third loan will be equivalent to SDR 5.0355 million.

4. Before approving the second annual arrangement, the Fund will appraise the progress of Nepal in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, taking into account primarily:

a. the benchmarks specified in the Tables 1 and 2 attached to the Memorandum on Economic and Financial Policies;

b. imposition or intensification of restriction on payments and transfers for current international transactions;

c. introduction or modification of multiple currency practices;

d. conclusion of bilateral payments agreements which are inconsistent with Article VIII;

e. imposition or intensification of import restrictions for balance of payments reasons.

5. In accordance with paragraph 4 of the attached letter, Nepal will provide the Fund with such information as the Fund requests in connection with the progress of Nepal in implementing the policies and reaching the objectives supported by the first annual arrangement.

6. In accordance with paragraph 5 of the attached letter, Nepal will consult with the Managing Director on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because he considers that consultation on the program is desirable. These consultations may include correspondence and visits of officials of the Fund to Nepal or of representatives of Nepal to the Fund.

Kathmandu, Nepal

September 3, 1987

Dear Mr. Camdessus:

1. On behalf of His Majesty's Government of Nepal, I am pleased to transmit herewith a Policy Framework Paper prepared in collaboration with the staffs of the International Monetary Fund and the World Bank. The paper describes the major economic problems and challenges facing Nepal: the objectives of a three-year medium-term program; the priorities and broad thrust of macroeconomic and structural adjustment policies; and the likely external financing requirements, together with the available sources of such financing.

2. The annexed Memorandum on Economic and Financial Policies pursuant to the policy framework described in paragraph 1 above sets out the objectives and policies that His Majesty's Government of Nepal intends to pursue during the period July 16, 1987 to July 15, 1990, and the objectives and policies for the first year of this period, for which balance of payments assistance is needed. In support of these objectives and policies, Nepal hereby requests from the Fund a three-year structural adjustment arrangement in the amount that will be available to Nepal under the Fund's Structural Adjustment Facility, and the first annual arrangement thereunder.

3. The Government of Nepal will remain in close contact with the staffs of the Fund and the World Bank on developments and progress in implementing these policies, and the Policy Framework Paper will be updated annually as the program is implemented.

4. Nepal will provide the Fund with such information as the Fund requests in connection with the progress of Nepal in implementing the policies and achieving the objectives of the program.

5. The Government believes that the policies set forth in the attached Memorandum on Economic and Financial Policies are adequate to achieve the objectives of its program but will take any further measures

that may become appropriate for this purpose. Nepal will consult with the Managing Director of the Fund on the adoption of any measures that may be appropriate at the initiative of the Government of Nepal or whenever the Managing Director requests such consultation.

Sincerely yours,

/s/

B. B. Pradhan
Minister of State for
Finance and Industry

Encl: Annexes: (I) Policy Framework Paper
(II) Memorandum on Economic and Financial Policies

Mr. Michel Camdessus
Managing Director
International Monetary Fund
700 19th Street, N. W.
Washington, D. C. 20431

Nepal: Memorandum on Economic and Financial Policies

1. Nepal has made substantial stabilization gains during the past two years under an economic adjustment program supported by a stand-by arrangement from the Fund. The Government's financial position has improved, monetary expansion has been curtailed, and the balance of payments has moved into a surplus, allowing for the strengthening of international reserves. In order to carry forward the process of adjustment, and to correct longstanding structural impediments to sustainable economic growth, His Majesty's Government of Nepal will implement a comprehensive program of economic and financial policies during the three-year period beginning July 16, 1987. The Policy Framework Paper accompanying this memorandum describes the major problems and challenges facing Nepal, the objectives and priorities of the Government's program for the period 1987/88-1989/90, and the broad thrust of macroeconomic and structural policies to be implemented.

2. The key objectives of the three-year program are: to realize an economic growth of 4-5 percent per year; to achieve, not later than by 1989/90, an annual rate of inflation of 5 percent--that is, the expected rate of inflation in India, since the level of prices in Nepal cannot substantially differ from those in India given the open border between the two countries; to contain the external current account deficit (excluding grants) at an average level of about 8 percent of GDP per year; and to maintain gross international reserves at the equivalent of about 3.5 months of imports of goods and services by realizing a moderate balance of payments surplus in each year. To achieve these objectives, the following structural policies will constitute an integral part of the Government's three-year program: (i) measures to increase domestic resource mobilization, to reduce the net domestic financing of the fiscal deficit, and to improve implementation of development projects; (ii) financial sector reforms designed to promote private savings and investment, and to strengthen monetary control; (iii) industrial and trade policies to improve the efficiency of export-oriented and import-substituting industries; and (iv) sectoral policies to promote agricultural production, reforestation, energy production and conservation, and tourism. An important strategy underlying the program will be to promote private sector initiative through divestiture and appropriate pricing and incentive policies, and to achieve greater efficiency in public resource management through improved project selection and implementation, reform of the public enterprise sector, and strengthening of government finances as outlined below.

3. Consistent with the medium-term policy framework, the basic objectives of the first annual program covering 1987/88 are to: (i) realize a real GDP growth of about 7 percent following the drought-induced setback in 1986/87; (ii) achieve an average rate of consumer price inflation of about 8 percent; and (iii) contain the external

current account deficit (excluding grants) to about 9 percent of GDP, and achieve an overall balance of payments surplus of approximately SDR 7 million. Toward these ends, the Government will pursue appropriate financial policies and make significant progress in the implementation of structural reforms.

4. Beginning in mid-1985/86, the Government embarked on a program of fiscal adjustment which resulted in a significant reduction in the Government's overall deficit (excluding grants) and its net domestic financing in relation to GDP in both 1985/86 and 1986/87. The fiscal program for 1987/88 and beyond envisages a consolidation of these gains. Accordingly, the Government intends to limit the net domestic financing of the budget deficit to NRs 1,130 million (excluding any possible repayment of arrears to banks of the National Food Corporation) in 1987/88 and to reduce it gradually as a percentage of GDP thereafter. Net credit to Government from the banking system will be limited to NRs 750 million. In line with our efforts to improve project implementation and aid utilization, development expenditures are budgeted at NRs 10.2 billion and the overall deficit (excluding grants from revenue) is budgeted to increase to about NRs 7.4 billion, reflecting increased aid disbursements. Despite our efforts, however, it is possible that project implementation and hence foreign aid disbursements may fall short of budget targets. In order to ensure that the targeted reduction in the net domestic financing of the budget deficit is achieved, any shortfall in aid utilization will be fully reflected in corresponding reductions in development expenditure and the overall budget deficit. On present expectations of aid disbursements, the overall budget deficit is projected to be equivalent to about 9 percent of GDP. Quarterly benchmarks for the net domestic financing of the budget deficit, and an annual benchmark for the overall budget deficit are set out in the attached Table 1.

5. To attain these targets, the Government has implemented measures to increase revenue whilst allowing for an increase in development expenditure, including operations and maintenance spending. The revenue measures include adjustment in import tariffs (expected to raise NRs 310 million); increases in excise duty on various products, including cigarettes (NRs 65.5 million); increases in sales tax on cement, iron rods, and iron wire (NRs 45 million); an increase in land registration fees for land transferred under endowment deed (NRs 50 million); an increase in the flight departure tax from NRs 150 to NRs 200 (NRs 15 million); an increase in gasoline prices of 10 paisa per liter (NRs 10 million); an increase in the valuation of urban land and property for tax purposes (NRs 5 million); an increase in vehicle tax (NRs 2.5 million); and the introduction of annual television license fees (NRs 1.5 million). Altogether, these measures are expected to raise about NRs 500 million additional revenue, and total revenue is budgeted at NRs 7.2 billion in 1987/88. The Government has also taken a number of measures to improve tax administration, including the setting up of specialized units to concentrate on the Kathmandu area, major

companies, and small taxpayers. During 1987/88, the Government intends to set up a closed and unified revenue service covering all gazetted officers in the four tax departments, as a first step toward the introduction of a unified revenue service for all tax officers by the end of 1989/90. While the Government believes that the revenue targets set out in the budget can be achieved, revenue projections for 1987/88 are particularly uncertain as a result of the implementation of a major tariff reform. The Government therefore intends to slow down the implementation of noncore development projects until it becomes clear that sufficient resources will be available for them to be implemented without jeopardizing the net domestic financing target.

6. Regular expenditure, excluding amortization and loans and investment, will be contained at NRs 4.5 billion, excluding any possible further repayment of arrears on behalf of the NFC. Following the wage increase granted in December 1986, the Government will not grant any further general salary increase to civil servants in 1987/88. Payments on account of accrued leave in compensation for the tightening of leave and pension policies will be limited to NRs 50 million. Strict control of other regular expenditures will be maintained. In the past, development expenditure has been hampered not only by a lack of domestic resources, but also by poor project implementation which has resulted in a sizable buildup of unutilized aid commitments. The Government, with the assistance of the World Bank and the UNDP, has implemented a variety of measures to improve project implementation, as well as the quality of development expenditure. A core program of projects covering about 70 percent of development expenditure has been identified, based on the criteria of foreign aid content, nearness to completion, economic efficiency, and strategic importance. In addition, measures have been taken: to expand the authority and accountability of project managers; to introduce a network of monitoring units and a system of reporting and referral to decision makers; to improve financial accountability through strengthened accounting frameworks; to streamline audit procedures; and to improve the training of accountants.

7. Public enterprises in Nepal have generally performed poorly and, despite large subsidies from the Government, have accumulated substantial indebtedness to the banking system. Since 1986/87, we have taken several steps to improve the financial position of these enterprises. The Government has recently adjusted a number of administered prices and initiated the sale of government-held shares in three public enterprises to the private sector. Policies in 1987/88 will build on the progress already made and will include selective price increases in certain enterprises, general efforts to strengthen managerial capacity, and a program of further divestiture. Shares in up to four public enterprises will be floated, and technical assistance from the IFC is to be provided to advise on privatization of other enterprises. Moreover, beginning in May 1987, the Government has initiated a phased reduction of public enterprise arrears to commercial banks on government

guaranteed loans. While this measure has added to government expenditure and hence borrowing from the banking system, this borrowing was offset by an equivalent reduction in bank financing of public enterprises; at the same time, financial control over the affected enterprises is being tightened.

8. Monetary and credit policy will be conducted in a manner consistent with the macroeconomic objectives of the program outlined in paragraph 3 above. Accordingly, the growth in net domestic assets of the banking system will be limited to about 19 percent during 1987/88, which is consistent with the expected increase in the demand for broad money and the projected developments in net foreign assets of the banking system. Within the global net domestic asset ceiling, the envisaged expansion of domestic credit is designed to: limit the increase in outstanding net bank credit to Government to NRs 750 million (excluding any possible further repayment of public enterprises' arrears); contain the growth of nonfinancial public enterprises' recourse to the banking system; and extend sufficient credit to the private sector to promote private investment activity. Developments in net domestic assets of the banking system, net credit to Government, and credit to nonfinancial public enterprises through July 15, 1988 will be monitored through quarterly benchmarks set out in the attached Table 1.

9. With a view to improving the efficiency of resource allocation and mobilization of domestic resources, the Government will implement in 1987/88 a reform of the government securities market. The reform will include a raising of the interest rate paid on Treasury bills to levels that would attract investors, the introduction of securities with a wider range of maturities than the current 10- and 15-year bonds, and the phasing out of the automatic loan provision of the Nepal Rastra Bank (NRB) to commercial banks against government bonds. The interest rate on government overdrafts with the NRB will also be raised in line with the interest rates on Treasury bills and the maximum amount of overdrafts outstanding will be limited to about 15 percent of government revenue. Finally, to further diversify holders and tap domestic savings and to improve the management of bank liquidity, the Government is examining the possibility of issuing Central Bank securities and ways of developing a secondary market in government securities and an interbank money market. We have requested technical assistance from the Fund to help implement these reforms.

10. In order to improve the efficiency of export-oriented and import-substituting industries, the Government initiated a major reform of its tariff policies and import regime, guided by the findings of two recent IMF technical assistance missions. The main objectives of this reform are a general rationalization and simplification of the tariff system and the gradual replacement of quantitative restrictions on imports by tariffs, accompanied by duty drawbacks/exemptions for exporters. As a first step in this effort, the Government has simplified the tariff structure into ten slabs and absorbed into the tariffs

the various sales tax markups and license fees. Furthermore, the number of goods imported under Open General License (OGL) was significantly increased. The number of goods currently available under OGL represents approximately 20 percent of non-aid imports from countries other than India and the Government intends to raise this proportion to at least 50 percent by 1989/90. In addition, with the help of technical assistance from the Fund, work has begun on the necessary administrative changes required to simplify customs procedures and to set up an effective system of duty drawbacks and exemptions for exporters.

11. The adjustment measures described above, together with improved prospects for exports in 1987/88, are expected to sustain the recent gains in the external situation. Reflecting improved aid utilization and the acquisition of an aircraft, the external current account deficit (excluding grants) is projected to rise to about 9 percent of GDP (about SDR 215 million) in 1987/88, but to decline gradually thereafter to about 7 percent of GDP by 1989/90. The overall balance of payments is projected to register a surplus of about SDR 7 million in 1987/88, allowing the import coverage of gross international reserves to be maintained at the equivalent of about 3.5 months. Quarterly benchmarks for 1987/88, as set out in the attached Table 1, will be observed for monitoring developments in international reserves.

12. To achieve the balance of payments objectives, the Government will pursue a flexible exchange rate policy under the exchange rate arrangement adopted in mid-1986 of pegging the Nepalese rupee, within margins, to a basket of currencies in which the Indian rupee has a large weight. Given the high degree of openness of the Nepalese economy, restrained financial and wage policies and the maintenance of an appropriate level of interest rates will be a crucial complement to flexible exchange rate management.

13. Most of Nepal's public and publicly guaranteed external debt has been contracted on highly concessional terms so that Nepal has a relatively low debt service burden of about 5.5 percent of exports of goods and services. Although this ratio is projected to rise to about 6.5 percent in 1987/88 and to 10.5 percent by 1989/90, largely as a result of the acquisition of two aircraft to remove a serious bottleneck in air freight and the tourist industry, the debt service burden will remain manageable. Nevertheless, to avoid an undue increase in debt service obligations, the public sector will limit the contracting or guaranteeing of additional nonconcessional loans in 1-12 year maturity range. Quarterly benchmarks for monitoring of this undertaking in 1987/88 are set out in Table 1. Short-term external borrowing will be contained to revolving loans required in the normal operations of the Nepal Oil Corporation and to drawings under the traditionally provided stand-by arrangement from the Reserve Bank of India to the NRB.

14. Given the predominant role of agriculture in Nepal's economy, the Government will continue to emphasize promotion of agricultural output and efficiency. Measures will be implemented to improve the effectiveness of public sector institutions engaged in agriculture; establish appropriate prices for agricultural inputs to prevent re-export; increase the role of the private sector in the distribution of inputs; expand irrigation; and strengthen agricultural research. An important first step will be to increase the effectiveness of the Nepal Food Corporation (NFC) and the Agricultural Inputs Corporation (AIC) by improving their accounting systems and increasing the transparency of their operations. The subsidized sales of the NFC have been sharply reduced, with the remaining subsidies being directed to the most needy in the hilly areas. To increase the supply of quality seeds, the Government will soon enact a National Seed Act, establish a National Seed Board, and increase private sector involvement in the production and distribution of superior quality seeds. To promote the use of fertilizers, a flexible pricing policy is being pursued with the aim of discouraging re-exports to India and importing those fertilizers more agronomically suitable for Nepal. Private sector participation in fertilizer distribution at both the wholesale and retail levels has been freed and is being promoted by making distributor licenses more readily available and establishing adequate levels of sales commission. The Government will design a comprehensive strategy to develop irrigation facilities and provide adequate funds for operation and maintenance of existing facilities. Agricultural research has been poorly funded in the past and has lacked clear objectives and priorities. The Government will therefore create an autonomous research planning agency which will establish national research priorities, control funding, and administer the national agricultural research system.

15. Since the nationalization of forests in 1956, Nepal has experienced severe deforestation which is threatening the country with grave ecological consequences. To promote reforestation, the Government has initiated the decentralization of forest management responsibilities to the district and community levels, and has introduced legislation that will allow panchayats to retain the revenues obtained from forest product sales. Since fuelwood is the major source of energy in Nepal, forestry conservation and energy policies are closely linked. The Government, with the assistance of donors, is working on ways in which the country's abundant hydroelectric power sources might be exploited.

16. The objective of industrial policy will be to develop efficient export-oriented and import-substituting industries. This will require the formulation and implementation of a comprehensive industrial development program, including the automatic granting of industrial licenses to firms that import less than 40 percent of their production requirements. Already, the Government has begun to liberalize the industrial licensing system; this process will continue in the first and subsequent years of the program. In general, measures to encourage growth in industry will be closely linked to the policy of import

liberalization (paragraph 10 above), as well as to measures to promote exports.

17. Tourism has been an important source of foreign exchange earnings and the Government intends to vigorously promote this sector in the future. High priority will be given to promotion and marketing, and development of new areas for mountaineering and trekking, and the restoration of historic sights. Air access to Nepal will be improved through the acquisition of two new commercial aircraft.

18. The close monitoring of several key indicators, as well as the quantitative benchmarks for 1987/88 set out in the attached Table 1, will enable the Government of Nepal to assess performance under the first annual program of the SAF and take timely remedial action when necessary. Benchmarks for policy implementation in the structural areas in 1987/88 are presented in the attached Table 2.

Table 1. Nepal: Quantitative Benchmarks Under the Structural Adjustment Facility Arrangement, 1987/88

	1986/87	1987/88			
	July 15 Prelim.	Oct. 15	Jan. 15	Apr. 15	July 15
		(In millions of Nepalese rupees)			
Net domestic assets of the banking system 1/	14,451	14,960	15,675	16,495	17,145
Net bank credit to the Government 2/	8,299	8,540	8,630	8,670	9,049
Credit to nonfinancial public enterprises 2/	1,786	1,850	1,900	1,950	2,000
		(In millions of SDRs)			
New external nonconcessional loans outstanding of 1-12 years' maturity contracted or guaranteed by the public sector	--	10	10	10	10
International reserves (end of period) 3/	161	153	157	175	173
	1986/87 Prel. Actual				
		(In millions of Nepalese rupees)			
Net domestic financing of the budget deficit 2/	1,500	425	635	730	1,130
Overall budget deficit (excluding grants)	5,435	...	...	...	6,080 2/ 4/

1/ Defined as broad money minus net foreign assets valued at constant July 15, 1987 exchange rates.
2/ Excluding the impact of any possible further repayments of public enterprises' arrears to commercial banks.
3/ Gross international reserves minus outstanding liabilities under stand-by arrangements with other central banks.
4/ To be increased by any additional foreign aid disbursements from the presently expected level of NRs 5.3 billion, up to a maximum deficit of NRs 7,374 million.

Table 2. Nepal: Structural Benchmarks of Policy Implementation Under the Structural Adjustment Facility Arrangement, 1987/88

	1987/88 Program
	(In millions of Nepalese rupees)
1. Revenue raising measures	
Adjustments in import tariffs	310
Increase in excise taxes	65.5
Increase in sales taxes	40
Increases in land registration fees	50
Other	39
2. Improvement in tax administration and revenue elasticity	
Introduction of a closed and unified Revenue Service for gazetted officers	
Setting up of specialized groups to deal with the Kathmandu area, major businesses, and individual taxpayers	
Replacement of specific by ad valorem taxes	
3. Financial sector reform	
Raise the interest rate on treasury bills and NRB overdrafts	
Improve maturity structure of government securities	
Phase out automatic loans by NRB to commercial banks against government bonds	
4. Trade liberalization	
Simplification and rationalization of import tariff system	
Placing on OGL of imports of raw materials, intermediate inputs, and capital goods	
Establish duty drawback/exemption system for exporters	

Nepal: Summary of the Program

1. Policies and targets for 1987/88-1989/90

The principal elements of the three-year SAF program are: (i) increased domestic resource mobilization; (ii) improved public enterprise management; (iii) liberalization of industrial and trade policies; (iv) financial sector reforms; and (v) improved project implementation cum higher aid utilization (the unutilized aid pipeline is equivalent to about 40 percent of GDP). The main macroeconomic objective of the three-year program is to sustain an annual rate of growth of 4-5 percent, while containing the external current account deficit to about 8 percent of GDP per year on average (Annex II). The increased aid utilization is expected to result in higher imports and government expenditure so that despite an increase in domestic resource mobilization, no significant decline is expected during the SAF period in the external current account or overall budget deficits in relation to GDP. The net domestic financing of the budget deficit is, however, projected to be reduced, thereby freeing resources for the private sector. The overall balance of payments is to record a surplus each year to allow reserves to be maintained at about 3.5 months of imports. Nepal's external debt service ratio is low (about 5.5 percent) and while it is expected to rise temporarily mainly as a result of the acquisition of two aircraft to relieve a serious bottleneck in tourism and air freight, it will remain manageable.

2. The first annual program, 1987/88

a. Targets

The main macroeconomic targets for 1987/88 are set out in Annex III. Real GDP growth is forecast at 7 percent on the strength of an expected recovery in agriculture and the average rate of inflation is projected at 8 percent. The external current account deficit is expected to widen due to the import of the first of the two aircraft, but the overall balance is forecast to record a surplus of SDR 7 million.

b. Main policies

(i) Fiscal policy

Introduction of new revenue measures estimated to yield NRs 500 million (0.8 percent of GDP) in additional revenue.

Improvement of tax administration through the establishment of a closed and unified revenue service for senior revenue officials* and the establishment of specialized units to concentrate on important revenue sources.

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* Still to be done.

Restraint on regular expenditure through freeze on the number of civil servants and on expenditures for materials and supplies. No general salary increase granted to civil servants.

Improvement of project implementation through the adoption of a core investment program with IBRD assistance, improved financial accountability, streamlined auditing procedures.

(ii) Public enterprises

Elimination of subsidized sales of foodgrains in the Kathmandu Valley; food subsidization is henceforth limited to hilly areas where transportation cost is very high; subsidies to be financed through explicit budgetary provision rather than bank credit.

Reduction of fertilizer subsidies and promotion of fertilizer distribution by the private sector.

Sale of government-held shares of four public enterprises.*

(iii) Financial sector

An increase in the interest rate on treasury bills and government overdrafts with the central bank. Introduction of a wider range of maturities for government securities.*

Development of an interbank money market and introduction of central bank securities.*

Phasing out of the automatic loan provision to banks by the NRB against government bonds.*

Quarterly quantitative benchmarks on net domestic assets of the banking system, net credit to Government, and credit to nonfinancial public enterprises.

(iv) Industry and trade

Liberalization of industrial licensing.*

Import liberalization through placing 23 items, mostly raw materials, intermediate inputs, and capital goods on Open General License.

Major tariff reform including rationalization and simplification of the tariff system and adoption of a duty drawback/exemption system for exports.

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* Still to be done.

(v) External debt

Quarterly quantitative benchmarks on nonconcessional external borrowing by the public sector.

(vi) Agriculture and forestry

Improved availability of agricultural inputs through increased private sector participation in distribution and appropriate pricing policy.

Development of new irrigation facilities and provision of increased funds for operation and maintenance of the existing facilities.

Decentralization of forest management responsibilities at the district and community levels and the introduction of a system which allows local communities to retain revenues from forestry product sales.*

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* Still to be done.

Nepal: Selected Economic and Financial Indicators, 1986/87-1989/90

	1986/87	1987/88	1988/89	1989/90
	Prelim. Actual	SAF Program Projections		
	(Annual percentage changes; unless otherwise specified)			
National income and prices				
GDP at constant market prices	2.3	7.0	4.5	4.5
GDP deflator	13.0	9.0	5.0	5.0
Consumer prices (annual average)	13.0	8.0	5.0	5.0
(July to July)	9.1	6.5	5.0	5.0
External sector (in terms of SDRs)				
Exports, f.o.b.	-19.7	22.9	12.3	12.2
Imports, c.i.f.	-6.6	12.2 1/	8.7 1/	8.9
Export volume	-12.7	13.0	7.0	7.3
Import volume	-0.5	8.4	5.1	5.8
Terms of trade	-2.1	5.1	1.5	1.5
Real effective exchange rate 2/	-5.0	--	--	--
Government budget 3/				
Revenue and grants	27.3	21.2	16.6	15.9
Of which: Revenue	(29.1)	(21.6)	(17.1)	(16.6)
Total expenditure, including net lending	20.8 4/	16.9	13.5	13.7
Domestically financed expenditure	24.7 4/	11.3	15.4	14.7
Regular expenditure	30.0 4/	7.0	9.7	9.7
Development expenditure	18.0	17.4	22.5	20.3
Foreign-financed development expenditure	14.3	26.4	10.4	11.8
Money and credit				
Net domestic assets 5/	15.8	18.6	...	...
Credit to Government (net)	11.9 4/	9.0	...	...
Credit to nonfinancial public enterprises	3.5 6/	12.0	...	...
Credit to private sector	16.5	22.5	...	...
Broad money	15.2	16.5	...	...
Interest rate on one-year bank deposits (end of period)	12.5	...	...	...
	(In percent of GDP; unless otherwise specified)			
External sector				
Current account balance (excluding grants)	-7.8	-8.8	-8.5	-6.8
(Excluding grants and aircraft)	-7.8	-7.0	-6.9	-6.8
External debt (end of period)	33.0	36.0	39.3	40.3
Debt service (percent of exports of goods and services and private transfers)	5.6	6.7	9.1	10.5
Overall balance (in millions of SDRs)	8	7	10	15
Gross reserves (end of period, in SDR mns.)	161	178	194	206
In months of imports of goods and services	3.9	3.5	3.5	3.6
Government budget 3/				
Revenue and grants	12.5	13.0	13.8	14.6
Of which: Revenue	(10.0)	(10.5)	(11.2)	(11.9)
Total expenditure, including net lending	19.4 4/	19.5	20.2	20.9
Domestically-financed expenditure	12.4 4/	11.9	12.5	13.0
Regular expenditure	7.3 4/	6.7	6.7	6.7
Development expenditure	5.2	5.2	5.8	6.4
Foreign-financed development expenditure	7.3	7.9	7.9	8.1
Overall balance	-6.9 4/	-6.5	-6.4	-6.3
(Excluding grants)	-9.4 4/	-9.0	-9.0	-9.0
Domestic financing (net)	2.6 4/	1.7	1.6	1.5
Of which: Banking system	(1.5) 4/	(1.1)	(...)	(...)
Investment and savings				
Gross fixed investment	18.1	20.5 7/	21.1 7/	20.2
Public	8.0	10.1 7/	10.4 7/	9.2
Private	10.1	10.4	10.7	11.0
Domestic savings	8.5	9.8	10.9	12.1
National savings	10.7	11.7	12.6	13.4

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

1/ Excluding the acquisition of two aircraft by the Royal Nepal Airlines Corporation.

2/ Minus sign indicates real effective depreciation of the exchange rate.

3/ Figures for 1987/88 are Fund staff estimates.

4/ Including repayment of public enterprise arrears in 1986/87 (0.5 percent of GDP).

5/ Based on exchange rates prevailing as of January 31, 1986 for 1986/87; and those prevailing as of July 15, 1987 for 1987/88.

6/ Excluding the repayment of public enterprise arrears by the Government, the rate of growth would have been 20.6 percent.

7/ Including the acquisition of an aircraft (about 1.8 percent of GDP) in each year.

Nepal: Assumptions and Targets of the 1987/88 Program

	1985/86	1986/87 Prelim.	1987/88 Proj.
	(Percentage change)		
Assumptions and targets			
Real GDP	4.0	2.3	7.0
GDP deflator	15.4	13.0	9.0
CPI (annual average)	15.7	13.0	8.0
(July to July)	21.7	9.1	6.5
Net domestic assets 1/	25.2	15.8	18.7
Public sector credit	21.3	10.3	9.6
Net credit to Government	16.4	11.9	9.0 2/
Credit to nonfinancial public enterprises	48.4	3.5 3/	12.0 2/
Private sector credit	24.7	--	22.5
Broad money	23.3	--	16.5
	(Percent of GDP; unless otherwise specified)		
Overall budget deficit			
Excluding grants	9.6	9.4	9.0 2/
Including grants	7.3	6.9	6.5 2/
Net domestic financing of budget deficit	2.6	2.6	1.7 2/
Of which: banking system	2.1	1.5	1.1 2/
External current account deficit			
Excluding grants	8.1	7.8	8.8
Excluding grants and aircraft imports	8.1	7.8	7.0
Overall balance of payments (In millions of SDRs)	-1.0	8.0	7.0
Gross international reserves (In months of imports of goods and services)	3.4	3.9	3.5

1/ Based on exchange rates prevailing as of January 31, 1986 for 1986/87; and those prevailing as of July 15, 1987 for 1987/88.

2/ Excluding any possible further repayment of public enterprise arrears by the Government.

3/ Including the repayment of public enterprise arrears by the Government. Excluding this repayment, the rate of growth would have been 20.6 percent.