DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR
AGENDA

EBD/87/234

September 14, 1987

To: Members of the Executive Board

From: The Acting Secretary

Subject: Nepal - Policy Framework Paper, 1987/88-1989/90

Attached for consideration by the Executive Directors is the policy framework paper under the structural adjustment facility for Nepal which, together with a request by Nepal for arrangements under the structural adjustment facility (EBS/87/196, 9/15/87), is proposed to be brought to the agenda for discussion on Wednesday, October 14, 1987.

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)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

NEPAL

Structural Adjustment Facility

Policy Framework Paper, 1987/88-1989/90 1/

Prepared by the Nepalese authorities in collaboration with the staffs of the Fund and the World Bank

September 14, 1987

I. Economic Background and Adjustment Issues

Nepal is a landlocked country with poor natural resource endowment. Despite three decades of efforts to modernize the economy, progress has been slow. During the past decade, real GDP grew by only 3 percent per year on average and real per capita income increased only slightly. As a result, Nepal is still one of the poorest countries in the world with a per capita income of about SDR 135. Agriculture is the mainstay of the economy, providing the bulk of exports; the industrial sector is essentially agro-based and remains small. Despite considerable and rapidly rising investment in the agricultural sector, agricultural production has not kept pace with population growth, leading, among other adverse repercussions, to a reduction of exportable surpluses. Agricultural production remains highly vulnerable to vagaries of weather as only a small fraction of arable land is irrigated. Consequently, adverse weather has an immediate effect on growth and balance of payments performance. Moreover, population pressures on natural resources, reflecting the growing requirements for fuel and food, have led to major problems of deforestation, soil erosion, and destruction of water courses. The country's landlocked position, difficult terrain, and limited natural resource base have certainly all contributed to the poor economic performance. However, weaknesses in development administration and economic management have also been an important contributing factor. Until recently, budgetary policy was not conducive to financial discipline. With inadequate revenue mobilization in the face of rapidly growing spending, His Majesty's Government of Nepal became increasingly dependent on bank credit to finance expenditure. At the same time, the provision of subsidies to public institutions and to private producers and consumers became a considerable drain on the budget. Financially weak public enterprises, often outside the direct purview of the budget, exerted considerable pressure on domestic credit management. Although a large portion of development projects has been financed by steadily growing foreign assistance, the scarcity of domestic resources has constrained the level of public investment, as

---

1/ Nepal's fiscal year starts July 16.

well as the operations and maintenance of the existing capital stock. In addition, delays in project implementation have led to significant shortfalls from planned levels of public investment and, consequently, to the buildup of a sizable pipeline of unutilized foreign aid.

Agricultural development has been adversely affected by organizational and institutional weaknesses in supporting agencies, the absence of a consistent policy framework, and ineffective implementation of policy decisions. Deforestation, caused by growing demand for fuelwood, a major source of energy in Nepal, has resulted in soil erosion and flooding, damaging agricultural production. Industrial development has been constrained by periodic shortages of imported inputs and an inadequate tariff structure. The latter has led to re-exports to neighboring countries at the expense of investment in productive industry. Quantitative restrictions on imports have added to the difficulties of domestic producers.

These structural, institutional and economic management problems undermined the external position and led to the emergence of large balance of payments deficits. Until the early 1980s, even with slow export growth, Nepal enjoyed a relatively comfortable reserve position, as the widening current account deficit was mostly financed by growing concessional aid inflows. Commencing in 1982/83, however, declining exportable surpluses and rising imports sustained by large government expenditures financed through domestic bank credit have brought the balance of payments under considerable pressure. During 1982/83-1984/85, the current account deficit (excluding grants) averaged about 8 percent of GDP per year, almost twice the average ratio of the preceding two years. As a result, the overall balance shifted from traditional surpluses to large deficits, recording a cumulative deficit of SDR 113 million during the three-year period ending 1984/85. The bulk of the deficits was financed by a drawdown of reserves, which fell to the equivalent of about three months of imports in 1984/85. In December 1985, the Government embarked on an economic adjustment program supported by a stand-by arrangement from the International Monetary Fund. The program was designed to alleviate the immediate balance of payments pressures, contain inflation and strengthen growth performance. Principal elements of the program were a devaluation of the Nepalese rupee by 14.7 percent and the adoption of a flexible exchange arrangement; tightened fiscal policy mainly through expenditure restraint, followed by new revenue measures; tight wage policy; a marked reduction in the expansion of domestic bank credit; an interest rate reform; adjustment of administered prices; and some rationalization of the exchange and trade system. These measures were supported by a number of other policy initiatives--as proposed by the World Bank and the Asian Development Bank--to stimulate production, particularly in agriculture, and to increase aid absorption capacity (see below).

As a result of these measures, Nepal achieved substantial stabilization gains. The overall budget deficit and its net domestic financing declined in relation to GDP, and the growth of domestic bank credit decelerated significantly. Notwithstanding a deterioration in the terms of trade, the overall balance of payments deficit narrowed from SDR 53 million in 1984/85 to SDR 1 million in 1985/86, and a surplus of SDR 8 million is estimated for 1986/87. Owing to favorable weather and the improved availability of imported raw materials, aggregate output growth increased to 4.0 percent in 1985/86, but growth suffered a serious setback due to drought in 1986/87, with real GDP estimated to have risen by only slightly over 2 percent. After a temporary acceleration following the November 1985 devaluation, inflation declined to an annual rate of about 9 percent during the twelve-month period ended in July 1987.

II. Medium-Term Policy Framework, 1987/88-1989/90

1. Macroeconomic objectives

The Government's macroeconomic objectives over the medium term are to sustain a GDP growth rate in the range of 4-5 percent per annum, while curbing inflation and strengthening the balance of payments (Attachment I). This rate of growth, which is to be broadly based, is considered the minimum required to absorb new entrants into the labor force and to reduce unemployment. The agricultural sector is projected to grow by about 3 percent per annum, and the nonagricultural sector by about 6 percent. This projected growth is expected to come from industry, tourism, and exports.

Inflation is projected to decline to an annual rate of 5 percent not later than by 1989/90. To maintain gross international reserves at about the equivalent of 3.5 months of imports of goods and services throughout the period ending 1989/90, the overall balance of payments is targeted to be in surplus, averaging approximately SDR 10 million per year. Reflecting increased aid utilization, as well as the acquisition of two aircraft for the Royal Nepal Airlines Corporation (RNAC) for which financing is being arranged through the U.S. Export-Import Bank, the external current account deficit (excluding grants) is projected to average about 8 percent of GDP per year during 1987/88-1989/90. 1/

To achieve these medium-term objectives, demand management policies will be complemented by growth-oriented structural measures, also supported by a World Bank structural adjustment loan. The priorities of

1/ The projections in this paper are based on the latest estimates of the outcomes for 1986/87. These projections therefore differ in some respects from those contained in the document of the World Bank's structural adjustment loan which were based on 1986/87 projections prepared in early 1987.

the structural adjustment program are to increase domestic resource mobilization to support a sizable increase in investment; improve the implementation of development projects; strengthen the financial position of public enterprises; continue the financial reforms aimed at improving monetary control and resource allocation; promote agricultural production and preserve forests; develop the industrial sector and liberalize the trade and payments system; expand tourism; and promote energy production and conservation. A key element underlying these structural reforms is the strengthening of the role of the price mechanism in resource allocation. Specific policy measures are described below and the timing of their implementation is provided in Attachment II.

2. Policy measures

a. Public sector policies

Fiscal policy will be aimed at providing room for a sizable increase in development outlays and expenditure for maintenance and operation of completed projects whilst at the same time allowing a reduction in the net domestic financing of the budget deficit. This will require a significant increase in domestic resource mobilization which, largely as a result of the inelasticity of the tax system, has been weak.

During the program period, a key objective of the Government will be to increase the revenue/GDP ratio by about 0.7 percentage point per year through a combination of new revenue measures and improved tax administration. Priority will be given to measures that will improve the elasticity of the tax system. Among the measures to be introduced will be reductions in exemptions in direct and indirect taxes. Service charges on a number of services provided by the public sector will be adjusted as needed to improve cost recovery. Consideration will be given to methods of increasing the taxes raised from the agricultural sector, which although accounting for some 60 percent of GDP, is largely tax exempt. Selective increases in import tariffs to accompany a reduction in quantitative import restrictions and the auction of import licenses (described below) are expected to generate additional revenue. Tax administration will be improved through better identification and registration of taxpayers; better assessment and collection procedures; and application of penalties and other means of enforcement. This would be supported by creating a Unified Revenue Service that would regroup the four revenue departments (tax, customs, excise, and land revenue) and, in addition, include divisions for revenue planning, administration, staff monitoring and management, and a special audit branch.

To cover the proposed increases in development and maintenance expenditure, restraint on other expenditures is required. Growth in the wage bill will be contained through restraint on wage increases and recruitment. In addition, future salary adjustments will take into account the recommendations of the administrative reform study to be undertaken soon. The growth of interest payments, which has been substantial in recent years, will be contained through slowing the growth of domestic borrowing and limiting nonconcessional foreign borrowing. Growth in other regular expenditure will be contained through, inter alia, savings in the costs of government procurement by an open tender system and through improvements in the control and monitoring systems of budgetary operations. Total expenditure is projected to increase from about 19 percent of GDP in 1985/86 to about 21 percent in 1989/90, but the increase will be concentrated in the area of development outlays (including operations and maintenance expenditure). Although the reliance on external assistance to finance development expenditure is projected to remain large during the program period, the continued domestic resource mobilization effort is expected to reduce that reliance over the longer term. However, if revenue mobilization falls short of targets, additional measures to limit less essential expenditures will be required to cover the projected growth in priority development and operation and maintenance outlays and ensure a reduction in the net domestic financing of the budget deficit.

With higher domestic resource mobilization and enhanced capacity to utilize foreign assistance, the net domestic financing of the budget deficit is projected to be reduced from about 2.5 percent of GDP in 1985/86 to approximately 1.5 percent by 1989/90, so that there would be a gradual reduction in total interest payments as a ratio of revenue. Reflecting increased utilization of foreign aid, the overall budget deficit is projected to average under 7 percent of GDP (excluding grants, about 9 percent) during the program period. Should there be a shortfall in domestic revenue mobilization, however, the net domestic financing of the budget deficit will need to be reduced below the above target so as to ensure a decline in interest payments as a proportion of revenue.

The Government intends to implement measures designed to improve both the quantity and the quality of development expenditure. In the past, poor project implementation has not only thwarted growth but has also raised the unutilized pipeline of aid commitments to over US$1 billion. The main problems related to development expenditure are: (i) too many activities undertaken in relation to institutional, manpower, and budgetary capacity; (ii) weak project management and weak monitoring and control functions; (iii) inadequate accounting and auditing functions which in turn delay funding releases; (iv) inefficiencies associated with the local construction industry; (v) delays in procurement decisions; and (vi) insufficient financial resources allocated to operations and maintenance. The Government has committed itself to an approach which stresses the implementation of well-designed projects rather than maximization of new aid commitments. This approach has received a favorable response from donors. The emphasis will be placed on improving project selection, project implementation/monitoring, and financial accountability, as well as on strengthening the local construction industry. With respect to project selection, the Government has already initiated, with assistance from the IBRD, the UNDP and an outside consulting firm, a comprehensive review of existing development projects. The review, which was completed in May 1987, identified those projects in the areas of agriculture, irrigation and forestry, power, and tourism which have high costs and/or low short-term net benefits and those expected to yield significantly positive net benefits over the coming years. The result of the review, which was partially reflected in the 1986/87 budget, is fully reflected in a core investment program, which was introduced starting with the 1987/88 budget. The program contains projects of high priority, selected on the basis of foreign aid content, nearness to completion, economic efficiency, and strategic importance in the country's overall development program. It also contains higher allocations for operations and maintenance expenditure and reflects a more effective link between the programming of project implementation and the timely release of budgetary funds.

In order to improve project implementation/monitoring, a network of monitoring units and a system of reporting and referral to decision makers has been introduced. With technical assistance from the UNDP, prototype monitoring systems have been introduced for key projects, and a more comprehensive system will be installed later. The Government is also undertaking, with the support of the UNDP, measures to improve financial accountability through improved accounting frameworks, streamlined auditing procedures, and better training of accountants. With a view to strengthening the construction industry, the Government has drawn up an action plan to address manpower training, contractor registration and procedures, material and equipment supply, and improved access to bank credit and foreign exchange.

On the basis of the nature of their operations and objectives, public enterprises in Nepal may be classified into three categories: (i) enterprises engaged in commercial ventures (e.g., cement, cigarettes, sugar, and the national airline); (ii) public utilities providing services such as power and drinking water; and (iii) those serving not only economic, but also social objectives and operating with the aid of budgetary transfers and subsidies such as the Agricultural Inputs Corporation (AIC) and the Nepal Food Corporation (NFC). Public enterprises have generally performed poorly. Many of them have accumulated substantial indebtedness to the banking system and are in arrears. In order to put these enterprises on a sound financial footing, realistic pricing policies will be adopted, and managerial capacity will be strengthened. The Government has recently adjusted a number of administered prices and initiated the sale of government-held shares in certain public enterprises to the private sector with a view to increasing the responsiveness of the management of these enterprises to market and profit considerations. In addition, the Government intends to implement policies to reduce the size of the public sector through divestiture--recently the Government has identified 46 public enterprises that it may wish to divest in whole or in part. Donors have indicated their support of such policies. The Government will draw up an action plan to carry out the reform program in 1987/88. It is intended that each public enterprise will be reviewed to identify measures either to improve the marketability of its shares, if it is to be sold, or its operational performance, if it is to be retained in the public sector. Technical assistance to facilitate the review is being arranged. With regard to the AIC and the NFC, specific measures to improve their financial performance and operational efficiency are described below.

b. Monetary and credit policy

The aim of monetary and credit policy will be to support the macroeconomic objectives of the program. Domestic credit expansion will be contained primarily through limiting bank financing of the budget deficit and the operating losses of publicly owned enterprises, while providing adequate resources for the private sector. To improve the effectiveness of monetary policy, several reform measures are being implemented. In May 1986, the Government introduced an interest rate reform. Banks were allowed to freely set key deposit rates above certain minimum rates and the former complex structure of concessional refinancing rates applied to certain sectors was replaced by a higher, uniform maximum rate; all other lending rates were freed. The minimum deposit and maximum lending rates will be kept under review and adjusted as needed to reflect price developments and ensure positive real interest rates. The interest rates on treasury bills and overdrafts of the Nepal Rastra Bank (NRB, the central bank) will be raised to market levels. In addition, the maturity structure of government securities will be improved so as to make them more attractive to potential buyers. At the same time, the provision of automatic loans by the NRB to commercial banks against government bonds will be phased out. Furthermore, the development of short-term government securities will be explored, including measures to promote a more active secondary market in government securities, with a view to placing greater reliance on open market operations in the management of bank liquidity. Finally, access to concessional refinancing facilities will be contained within limits consistent with the overall credit program.

c. External policies

Given the high degree of openness of the Nepalese economy vis-a-vis India, restrained financial and wage policies and the maintenance of appropriate interest rate levels are essential policy instruments for achieving shorter-term balance of payments objectives. These policies will be supported by flexible exchange rate management to be pursued through the new exchange rate system introduced in May 1986, under which the Nepalese rupee is pegged, within margins, to a basket of currencies, including the Indian rupee. During the program period, exchange rate policy will be kept under close review in light of progress toward the overall balance of payments objectives and the liberalization of the trade and payments system, and developments in trade, capital flows, and external competitiveness. As discussed under industrial and trade policies, several measures, including a liberalization and rationalization of the import regime, will be undertaken to encourage the development of export-oriented and efficient import-substituting industries.

Nepal's debt service burden is at a manageable level, as most of the external debt outstanding is on concessional terms. The public sector will limit its guaranteeing or contracting of new foreign loans on nonconcessional terms with a view to avoiding an undue increase in debt service obligations.

d. Sectoral policies

(i) Agriculture

The principal objective of agricultural policy is to move the economy to a higher growth path and secure an adequate supply of foodgrains and cash crops. The primary focus will be on increasing the effectiveness of public sector institutions in supplying inputs and supporting services, providing adequate price incentives, increasing the role of the private sector in the distribution of inputs, expanding irrigation, and strengthening agricultural research.

An important first step will be the strengthening of the financial positions and management of the NFC and the AIC. The Government has prepared and is implementing a plan to restore the financial viability of both institutions. Technical assistance programs have already been initiated to help improve their accounting systems. Steps have also been taken to ensure full and prompt payment to the institutions by cooperatives and other public entities for goods and services provided. In addition, while the Government intends to provide adequate funds to support their noncommercial operations, the objective is to gradually reduce overall subsidies and transfers to these enterprises.

The effectiveness of the NFC as an instrument to help promote food security has been hampered by unclear objectives and operational inadequacies. Domestic grain procurement has relied heavily on levies imposed on millers and exporters, while direct purchasing from producers to help support post-harvest producer prices has been very limited. Foodgrain sales by the NFC have been at prices below cost, and predominantly in the major urban markets or to target groups who do not represent the most needy.

UNDP-funded technical assistance has already been obtained to help improve the NFC's financial management and devise effective farmgate price support and consumer price stabilization operations. Beginning in

1986/87, foodgrain procurement through levies was abolished, and procurement from domestic production is to take place exclusively through purchases at prices set in close proximity to those in effect in neighboring Indian states. Sufficient operating funds have been provided to ensure effective procurement operations, and rural cooperatives are being increasingly utilized as intermediaries in foodgrain procurement. Instead of subsidized year-round sales, a market-oriented system of consumer price stabilization through grain sales during high-price periods has been introduced in the Kathmandu Valley as a pilot project for future application in other major consumer centers. In addition, a plan will be prepared for identifying consumer groups vulnerable to chronic and/or severe seasonal food shortages and for distributing foodgrains to such target groups.

While subsidization of foodgrain prices in remote areas of the country is needed for some time to come, in order to make the cost of subsidies more transparent, such subsidization will be financed through explicit provision in the government budget for that purpose rather than through the domestic banking system. At the same time, the Government is gradually clearing the government-guaranteed arrears of the NFC, as well as of the rice exporting companies under liquidation.

The use of chemical fertilizers is low by international standards, owing partly to inappropriate pricing and inefficient distribution. Fertilizer prices are fixed by the Government and, until recently, involved significant subsidies. Price differences between Nepal and India resulting from delays in price adjustments led to fertilizer re-exports to India, causing shortages in Nepal. In mid-1986, the Government raised domestic sales prices of chemical fertilizers by 15-24 percent to bring them in line with those in India. During the period ahead, the Government intends to maintain the domestic sales prices of fertilizers at levels that will prevent their re-export. The Government has introduced a more flexible fertilizer pricing policy by granting the AIC authority to adjust prices whenever incentives to re-export emerge or costs increase. With a view to improving the distribution of fertilizers, private sector participation at the retail and local wholesale levels has been freed. To make the use of fertilizers more effective, imports will be shifted toward those fertilizers that have a higher nutrient content and are more agronomically suitable for Nepal.

Fertilizer consumption has also been constrained by limited irrigation facilities. Public sector irrigation development has been severely circumscribed by the very high costs of medium- and large-scale gravity schemes. In recent years, there has been some development of private shallow tubewells, but the high cost of diesel fuel for pumping limits the scope for using this technique to meet the country's broader irrigation requirements. The Government will design a comprehensive strategy for the development of irrigation that, inter alia, addresses the issue of regional areas to be assigned priority for irrigation development, the extension of the scope for year-round irrigation, and the identification of appropriate agricultural technologies based on more intensive water use. In addition, the relative roles to be played by both the private and public sectors in the country's irrigation development will be carefully examined.

Inadequate supply and the low rate of use of quality seeds are also an important factor constraining crop production in Nepal. The Government intends to undertake measures to improve the supply and timely availability of quality seeds and to expand the capability of the seed processing and marketing system. The measures include providing more operational autonomy to the seed division of the AIC, enacting a National Seed Act, establishing a National Seed Board which would regulate activities in this subsector, and increasing private sector involvement in the production and distribution of superior quality seeds.

Agricultural research needs to be strengthened to achieve sustained agricultural growth. Agricultural research in Nepal has been poorly funded, has lacked clear objectives and priorities, and has been constrained by inappropriate administrative regulations and procedures and inadequate personnel policies. The Government intends to implement effective operational and management reforms in this area by creating an autonomous research planning, funding, and coordinating agency at the national level. The agency will set national research priorities, control funding for research, administer the national agricultural research system, monitor progress, establish meaningful career paths for researchers, and ensure effective linkages with other institutions. As a first step, the Government has established a National Agricultural Research Coordination Committee (NARCC). At the same time, the various research units operating under the administrative control of the Department of Agriculture have been reorganized into a single National Agricultural Research Services Center (NARSC) headed by the Deputy Director of Agriculture.

(ii) <u>Forestry</u>

Deforestation is a major cause of Nepal's environmental problems. Since the nationalization of forests in 1956, Nepal has experienced severe deforestation, as the nationalization reduced the incentive for the private sector to protect forests and to undertake reforestation. Recently, the Government embarked on an intensive campaign to heighten public awareness of the need to reverse the trend of deforestation. Communities have been assigned a key role in managing panchayat (village) forests, but they lack commensurate financial resources and incentives. The Government has introduced the necessary legislation to permit the communities to retain the revenue obtained from the sale of forest products. The revenue is expected to be used to finance the operations of the community-level forest management committees, which have already been established in many cases, but will be entitled in 1987/88 to handle funds, employ staff, and manage forests and resources. With respect to promoting reforestation, the Government has already begun shifting much of the responsibility for this activity and other forest management activities to the district and community levels in line with its policy of decentralization, and it will clarify legislation on ownership of trees on private land. These efforts are being supported by several Bank community forestry projects which provide financing for local communities to purchase more seedlings and for strengthening training programs and forestry management.

(iii) Industrial and trade policies

Industrial and trade policies will be focused on the development of efficient export-oriented and import-substituting industries. The Government is presently reviewing its industrial policy with a view to formulating a comprehensive industrial development program. Meanwhile, it is liberalizing the industrial licensing system. Licenses will be required only for industries whose import needs exceed 40 percent of total input requirements. This will free a large number of industries from time-consuming and cumbersome licensing procedures. In addition, with a view to easing the shortages of imported inputs, imports of industrial inputs have been significantly liberalized by the recent introduction of a passbook system, which has simplified administrative procedures and reduced the uncertainties about the timely availability of inputs. At the same time, the amount of foreign exchange allocated for this program was significantly increased.

With a view to further improving industrial development and the efficient allocation of resources, the import of raw materials, intermediate inputs and capital goods will be gradually liberalized by placing them on Open General License (OGL). The removal of quantitative restrictions will be accompanied by the imposition of appropriate tariffs to discourage re-exports. At the same time, a duty drawback/exemption system will be introduced for exporters. As a first step, imports of raw wool, gypsum and iron billets were placed on OGL in February 1987. Subsequently, in May 1987, more than 20 additional items were placed on OGL, bringing the amount of goods currently imported under OGL to about 20 percent of non-aid imports from countries other than India. This amount will be increased as much as possible during the program period, but at least to 50 percent by 1989/90. Furthermore, the previous complex structure of import taxation has been simplified by introducing a system of 10 tariff slabs. To help implement this tariff reform, a Fund-Bank technical assistance mission visited Nepal in early 1987 and further technical assistance in this area was provided in June. Finally, as an intermediate step toward a greater liberalization of imports, the Government has recently introduced an auction system of import licenses for so-called "commercial" imports. This system is aimed at a more efficient allocation of import licenses, while generating considerable revenue for the Government.

The Government has also streamlined the export licensing system by converting a positive list of items not subject to licenses to a negative list of items subject to licenses. With technical assistance from the World Bank, the Government intends to further improve export policies and licensing procedures. In particular, efforts will be aimed at reducing the onerous and highly redundant paper work required to make an export shipment, streamlining customs operations, and negotiating special commodity rates on air freight with foreign carriers. Exports will be encouraged also through expanded warehouse facilities and the establishment of an export promotion zone. To encourage exports, the Government has recently introduced bonded warehouse facilities for imports of inputs from third countries and will shortly extend them to cover also imports from India.

(iv) Tourism

Tourism has been an important source of foreign exchange earnings, accounting for about 20 percent of total export receipts from goods and services. The Government will vigorously promote the growth of tourism. As a part of this effort, charter flights to Nepal have been recently liberalized and the Government also intends to upgrade the RNAC's services through the acquisition of two new aircraft during 1987/88-1988/89. At the same time, high priority will be given to promotion and marketing. Efforts will be intensified to develop new areas for mountaineering and trekking and to restore historic sites.

(v) Energy

Per capita energy consumption in Nepal is low by international standards. Energy requirements are primarily met by traditional fuels, such as fuelwood from rapidly disappearing forests. The development of the country's abundant hydroelectric resources will be stimulated by additional agreements with neighboring countries on the sale of surplus electric power.

The Government will select and conduct studies from among the following issues: (i) how to mitigate the severe environmental degradation in the rural areas, while protecting the livelihood of the populace in those areas; (ii) how to increase per capita energy consumption and to shift this consumption toward more use of commercial fuels; (iii) how to exploit the full potential of the vast hydroelectric resources with due regard for the macroeconomic impact of alternative development sequences; and (iv) how to improve the information base for future energy development planning. In addition, the Government will develop a rational energy pricing policy that aims at improving cost recovery, encouraging energy substitution, and promoting energy conservation. In this regard, the Government initiated an energy pricing study in 1986/87.

III. The Social Impact of Adjustment

The impact of Nepal's structural adjustment program on income distribution is expected to be positive. The macroeconomic, industrial and trade measures being introduced under the program are aimed at capturing excessive economic rents and transferring them from the current middle- and high-income beneficiaries to the budget, where they will be available to finance more investment and employment. Areas where high rents are prevalent are generally characterized by low value added and hence low employment. With augmented financial resources and a more efficient development expenditure program, both employment and economic growth should benefit. The most obvious benefits for the poor are the consequences of improved agricultural policies and programs which will increase the income of farmers who form the bulk of the poorest groups. Better targeted food programs for the poor will also be introduced and accounted for explicitly in the budget. On the other hand, the necessary financial adjustment measures involved under the program will not have significant adverse effects on the poor, since their economic activities are primarily in subsistence agriculture and hence, are not closely linked with developments in the monetized sector. The urban poor should benefit from policies to stimulate industrial output. Under the assumptions of the program, it is expected that there will be no decline in real wages during the program period.

In addition to the redistributional implications of the structural adjustment program, His Majesty's Government has recently announced a major Basic Needs program. The purpose of this program is to raise basic social indicators over the next 13 years to levels similar to those found today in neighboring South Asian countries. While the medium-term budgetary implications of this program will require further analysis, it is expected to serve as a powerful rallying point for development programs which by their very nature are poverty-oriented; it will also give added impetus to initiatives in the social sectors such as the current reform of the health delivery system, and to ensure that human resource development achieves a higher priority than in the past in terms of the allocations of the nation's resources. Population issues are given high prominence in the Basic Needs program; the Government is well aware of the implications of uncontrolled population growth. Donors have in the past provided strong support for the Government's social sector programs, with the UN system, USAID, and a number of NGOs supplying major funding for population and health, and the Bank assisting in the expansion of primary education and with vocational and technical training.

IV. External Financing Requirement

Even with the implementation of the structural adjustment program, Nepal will continue to have to rely on foreign assistance for financing its economic development in the years to come. Successful promotion and diversification of exports will still leave the economy heavily dependent on export earnings from agro-based products, which are highly sensitive to exogenous shocks. Taking into account an expected recovery of exports in 1987/88, total exports are projected to grow by about 16 percent per annum in SDR terms during the program period. With an expected increase in aid utilization and some progress in import substitution, imports are projected to rise by about 10 percent per annum. Despite a projected 10 percent growth of net services receipts and private transfers, the current account deficit is projected to widen. While this would require a significant increase in foreign aid disbursements, increased domestic resource mobilization is expected to reduce Nepal's reliance on foreign assistance to finance development projects over the longer term.

Given the existing large pipeline of unutilized aid and an expected improvement in aid absorption, and in view of an expected slight increase in aid commitments in real terms in line with donors' support expressed during the Aid Group meeting held in early 1987, aid disbursements per year are likely to increase from SDR 153 million in 1985/86 to about SDR 220 million in 1989/90. In addition, financing of SDR 88 million for the above-mentioned aircraft acquisitions is being arranged with the guarantee of the U.S. Export-Import Bank. On this basis, and assuming that gross international reserves are maintained at the equivalent of about 3.5 months of imports of goods and services, a financing gap of about SDR 90 million is projected during 1987/88-1989/90. It is expected that this gap should be covered by the World Bank's recent structural adjustment loan (SAL), a follow-up SAL, and Fund resources. In 1987/88, an estimated financing gap of about SDR 32 million is expected to be covered by disbursements under the SAF (SDR 7.5 million), and the SAL (SDR 24.8 million). As most external debt has been and will be contracted on concessional terms, debt service payments are expected to remain at manageable levels; largely as a result of the above-mentioned aircraft acquisition, the ratio of debt service payments to current receipts is projected to be about 10.5 percent in 1989/90, compared with about 5.5 percent in 1986/87.

Table 1. Nepal: Key Economic Indicators and Projections, 1983/84-1989/90 1/

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90
		Actual		Prelim. Actual		Projections	
GDP growth 2/	7.8	3.0	4.0	2.3	7.0	4.5	4.5
GDP per capita growth 2/	5.1	0.3	1.5	-0.1	4.6	2.1	2.1
Per capita consumption growth	2.3	1.2	2.3	1.9	2.3	2.4	2.6
Debt service (In US$ million)	13.6	16.5	20.4	22.7	32.6	49.1	62.0
Debt service ratio 3/	4.2	4.7	5.4	5.6	6.7	9.1	10.5
Debt service/GDP	0.5	0.7	0.8	0.8	1.1	1.4	1.7
Gross domestic investment/GDP	19.4	20.7	20.0	18.5	20.5 4/	21.1 4/	20.2
Domestic savings/GDP	10.3	11.2	10.3	8.5	9.8	10.9	12.1
National savings/GDP	12.2	13.1	11.9	10.7	11.7	12.6	13.4
Marginal national savings rate	19.5	22.1	5.9	3.0	18.0	20.0	21.8
Public investment/GDP	8.7	9.4	8.1	8.0	10.1 4/	10.4 4/	9.2
Public savings/GDP	3.2	2.7	2.5	2.8	3.8	4.5	5.2
Private investment/GDP	9.5	10.2	10.9	10.1	10.4	10.7	11.0
Private savings/GDP	9.0	10.3	9.3	7.9	7.9	8.1	8.2
Ratio of public/private investment	0.92	0.92	0.74	0.79	0.98 4/	0.97 4/	0.84
Government revenues/GDP	8.7	9.2	9.0	10.0	10.5	11.2	11.9
Government expenditures/GDP 5/	18.9	19.5	18.6	19.4	19.5	20.2	20.9
Government budget balance/GDP 6/	-10.2	-10.3	-9.6	-9.4	-9.0	-9.0	-9.0
Export value growth	39.7	46.4	-8.9	-19.7	22.9	12.3	12.2
Exports/GDP	4.4	6.6	6.2	5.3	5.7	5.8	6.0
Import value growth	-3.9	8.3	-1.4	-6.6	23.0 4/	7.8 4/	0.1
Imports/GDP	17.0	18.6	18.4	18.8	20.4 4/	20.0 4/	18.3
Current account (In US$ million)	-178.6	-178.9	-205.5	-210.3	-272.0 4/	-287.0 4/	-252.0
Current account/GDP 6/	-7.1	-7.6	-8.1	-7.8	-8.8 4/	-8.5 4/	-6.8

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

1/ Data are for fiscal years ending July 15.

2/ At constant prices.

3/ As a percent of exports of goods and services and private transfers.

4/ Including, in each year, the purchase of an aircraft (about 1.8 percent of GDP) by the Royal Nepal Airlines Corporation.

5/ Including net lendings.

6/ Excluding grants.

Table 2. Nepal: External Financing Requirements, 1986/87-1989/90

(In millions of SDRs)

	1986/87	1987/88	1988/89	1989/90
Current account deficit excluding official transfers	168	216	227	200
Amortization	8	11	17	20
Change in arrears	--	--	--	--
Change in net reserves 1/	8	4	16	14
IMF repurchases	3	3	5	8
Total financing requirement	187	234	265	242
Disbursements: existing commitments				
Grants and loans	187	227	196	152
Of which: World Bank adjustment lending	(15)	(25)	(--)	(--)
Private creditors 2/	(30)	(42) 3/	(42) 3/	(--)
IMF purchases	(--)	(--)	(--)	(--)
Disbursements: expected new commitments				
Grants and loans	--	7	69	90
Of which: World Bank adjustment lending	(--)	(--)	(20)	(20)
Private creditors	(--)	(--)	(--)	(--)
IMF purchases	(--)	(--)	(--)	(--)
SAF	(--)	(7)	(11)	(5)
Total identified financing	187	234	265	242
Financing gap	--	--	--	--
Debt rescheduling	--	--	--	--

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

1/ Excluding IMF purchases and repurchases and the repayment of Trust Fund loans.

2/ Including errors and omissions.

3/ Reflecting loans related to the purchase of two aircraft.

Nepal: Summary of Macroeconomic and Structural
Adjustment Policies, 1987/88-1989/90

Issues	Objectives and Targets	Strategies and Measures	Timing of Measures
1. Public sector policies			
a. Fiscal Policy			
Net domestic financing of the budget deficit	Reduce it in relation to GDP from 2.5 percent in 1985/86 to about 1.5 percent in 1989/90.	Increased resource mobilization and restraint on regular expenditure.*	Each year
Revenue mobilization	Increase government revenue in relation to GDP by 0.7 percentage point, per annum.	Broaden the tax base by reducing tax exemptions. Improve tax administration through better identification and registration of taxpayers, better assessment and collection procedures, and application of penalties and other means of enforcement. Adjust service charges. Selective increase in import taxation.	Each year
		Obtain formal approval of Public Services Commission and any other necessary bodies for setting up a closed and Unified Revenue Service covering all essential personnel.	1987/88
		As a first step, set up closed and unified revenue service for all gazetted officers, including tax assessors.	1987/88
		Establish closed and Unified Revenue Service covering all essential personnel.	1988/89
Regular expenditure	Limit growth to allow increases in development and maintenance expenditure.	Wage restraint and restrictive recruitment policy. Contain interest payments by slowing growth of domestic and noncessional borrowing. Savings in the cost of central government procurement. Improvements in the control and monitoring systems.*	Each year
Development expenditure	Increase development expenditure/GDP ratio from about 12 percent in 1985/86 to about 14 percent in 1989/90. At the same time, improve implementation and quality of development outlays.	Introduce a core investment program that will contain improved provision of resources for operation and maintenance.*	1987/88

* Incorporated in the recent World Bank structural adjustment loan.

Nepal:: Summary of Macroeconomic and Structural
Adjustment Policies, 1987/88-1989/90 (Continued)

Issues	Objectives and Targets	Strategies and Measures	Timing of Measures
		Expand the authority of project managers.*	Each year
		Installation of prototype monitoring systems on key projects.*	1987/88
		Installation of a comprehensive monitoring system.*	1988/89
		Strengthen financial accountability through improved accounting framework, streamlined auditing procedures, and better training of accountants.*	1987/88-1989/90
		Formulation of an action plan to strengthen the construction industry.*	1987/88
b. Public enterprise policy	Improve the profitability of nonfinancial public enterprises.	Realistic pricing policies and strengthening managerial capacity.*	Each year
		Sale of government-held shares in certain public enterprises to the private sector.*	Each year
		Improve financing and operational efficiency of the AIC and the NFC (see below).*	Each year
		Formulate an action plan for closure, divestiture, and management reforms of public enterprises.*	1987/88
2. Monetary and credit policy			
Domestic bank credit	Credit expansion limited to amounts compatible with macroeconomic objectives of program.	Limit the growth of public sector credit while providing adequate resources for the private sector.*	Each year
Financial sector reforms	Improve the effectiveness of monetary/credit policy.	Raise the interest rates on treasury bills and NRB overdrafts.	1987/88
		Improve maturity structure of government securities.	1987/88
		Phase out automatic loans by NRB to commercial banks against government bonds.	1987/88-1989/90
		Reduce arrears on government-guaranteed commercial bank loans to public enterprises with a view to eliminating them by 1989/90.	Each year
3. External policies (see also industrial and trade policies)			
Exchange rate management	Strengthen external position over medium term.	Flexible exchange rate management.	Each year
External debt management	Contain increase in debt service obligations.	Limit borrowing on nonconcessional terms.	Each year

* Incorporated in the recent World Bank structural adjustment loan.

Nepal:: Summary of Macroeconomic and Structural
Adjustment Policies, 1987/88-1989/90 (Continued)

Issues	Objectives and Targets	Strategies and Measures	Timing of Measures
4. Sectoral policies			
a. Agriculture			
Public institutions	Increase the effectiveness of the AIC and the NFC.	Improve their accounting systems. Ensure full and prompt payments to the institutions by other public entities.*	Each year
		Reduce overall subsidies and transfers to them, while providing adequate funds to support their operations.	Each year
Foodgrains	Improve the efficiency of the NFC's foodgrain operations.	Procure foodgrains exclusively through purchases at or above guaranteed floor prices.*	Each year
		Continue to announce guaranteed floor prices in light of prices prevailing in India.*	Each year
		Use the cooperatives as intermediaries in the NFC's foodgrain procurement.*	Each year
		Sharply reduce foodgrain subsidies and target them to low-income groups.*	Each year
		Prepare a plan for identifying vulnerable consumer groups and for distributing foodgrains to such target groups.*	Each year
Chemical fertilizers	Improve supply and availability of fertilizers, improve the profitability of the AIC's fertilizer operations, and improve economic return on fertilizer usage.	Maintain domestic sales prices at levels that would prevent the re-export of chemical fertilizers.*	Each year
		More flexible pricing policy by granting the AIC authority to adjust prices whenever re-exports emerge and costs increase.*	Each year
		Introduce price differentials among regions.*	1987/88
		Increase permissible commission on trading in fertilizers.*	1987/88
		Increase private sector participation in fertilizer distribution at both wholesale and retail levels.*	1987/88-1989/90
		Shift fertilizer imports toward those fertilizers that have a higher nutrient content and are more agronomically suitable for Nepal.*	Each year
Irrigation	Expand irrigation	Development of a comprehensive strategy, including regional priority for irrigation development, the extension of the scope for year-round irrigation, and the identification of appropriate agricultural technologies based on more intensive water use.*	1987/88-1989/90

* Incorporated in the recent World Bank structural adjustment loan.

Nepal:: Summary of Macroeconomic and Structural
Adjustment Policies, 1987/88-1989/90 (Concluded)

Issues	Objectives and Targets	Strategies and Measures	Timing of Measures
Seeds	Imprcve supply and timely availability of quality seeds.	Revamp the Seed Division of the AIC.*	1987/88
		Establish a National Seed Board.*	1987/88
		Increase private sector involvement in the production and distribution of quality seeds.*	1987/88-1989/90
Agricultural research	Strengthen agricultural research.	Establish the NARSC.*	1987/88
		Establish an autonomous research planning, funding and coordinating entity.*	1987/88
b. Forestry	Protect forests and undertake reforestation.	Introduce legislative changes to permit panchayats to retain the revenues obtained from forest product sales.*	1987/88
		Establishment of community-level forest management committees.*	1987/88-1989/90
		Increase the role of the district and village panchayats.*	Each year
c. Industrial and trade policies	Develop efficient export-oriented and import-substituting industries.	Formulate a comprehensive industrial development program.*	1987/88
		Liberalize the industrial licensing system.*	Each year
		Simplify and rationalize the tariff system. Gradually place the import of raw materials, intermediate inputs, and capital goods on Open General License and impose appropriate tariffs to discourage re-export. Establish duty drawback/exemption system for exporters.*	Each year
		Strengthen customs administration and procedures.*	Each year
		Streamline the export licensing system, expand warehouse facilities, establish export promotion zone.*	1987/88-1989/90
d. Tourism	Accelerate growth of tourist arrivals.	Strengthen promotion and marketing.	Each year
		Develop new areas for mountaineering and trekking; restore historic sites.	Each year
		Improve air access to Nepal through the acquisition of two commercial aircraft.	1987/88-1988/89
e. Energy	Develop commercial energy resources.	Conduct a study with a view to developing rational energy pricing policy.	1987/88
		Select and conduct energy development studies.	1987/88-1989/90

* Incorporated in the recent World Bank structural adjustment loan.