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EBS/86/182

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August 11, 1986

To: Members of the Executive Board

From: The Acting Secretary

Subject: Nepal - Review Under the Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the review under the stand-by arrangement for Nepal. A draft decision appears on pages 32 and 33.

It is understood that the Executive Director for Nepal will be requesting the Board for a waiver of the circulation period, to enable this subject to be brought to the agenda for discussion on Thursday, August 28, 1986.

Mr. R. C. Williams (ext. 7610) or Mr. Ishii (ext. 7330) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

NEPAL

Staff Report for the Review Under the Stand-By Arrangement

Prepared by the Asian Department
(In consultation with the Exchange and Trade Relations,
Legal, and Treasurer's Departments)

Approved by P. R. Narvekar and Eduard Brau

August 11, 1986

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I. Introduction

Discussions for the mid-term review of the stand-by arrangement were held in Kathmandu during March 26-April 12, 1986 with the Minister of Finance, the Governor of the Nepal Rastra Bank (NRB, the central bank), the Finance Secretary, and officials of various ministries and agencies, including the Ministries of Finance and Agriculture, the Planning Commission, the NRB, and the Nepal Oil Corporation (NOC). 1/ The staff team coordinated its activities closely with the World Bank mission in Nepal for preliminary discussions on a structural adjustment loan (SAL). The two missions agreed on the basic, medium-term policy and other parameters which underlie the projections given in Section IV of this report. Preliminary discussions of the major parameters were held with the authorities by each of the missions. A Fund staff member visited Kathmandu briefly again in mid-June 1986 to discuss implementation of domestic credit policy and the financial program for 1986/87.

The Fund approved the stand-by arrangement for Nepal on December 23, 1985 (EBS/85/264, 12/3/85) for the period through January 22, 1987. The amount of the arrangement is SDR 18.65 million or 50 percent of quota (equivalent to an annual access of 46.2 percent of quota). It was contemplated that purchases would be made as follows: SDR 10.25 million upon Executive Board approval of the arrangement and thereafter four equal installments of SDR 2.1 million each. The first purchase, in the amount of SDR 10.25 million, was made on December 27, 1985. However, ceilings on net domestic assets of the banking system (NDA) and net credit to Government were exceeded in both January and April 1986 (Table 1). Consequently, the purchases contingent upon the observance of these ceilings could not be made as scheduled, and the mid-term review was delayed.

The Government has now requested that the stand-by arrangement be extended through April 22, 1987 in order to allow sufficient time to fully achieve the adjustments envisaged in the program and that Nepal be permitted to proceed to make a purchase under the arrangement, in an amount of SDR 2.1 million, upon the completion of the review, notwithstanding that all the data for the period ending July 15, 1986 will not be available by that time (Table 2). As discussed below, it is estimated that the mid-July 1986 ceilings on both NDA and net credit to Government were breached but only by a modest amount. The staff expects to be able to provide preliminary data on credit developments for

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1/ The staff team comprised Messrs. R. C. Williams (Head), D. Villanueva, S. Ishii, and L. Mendras, with Ms. Rosario as secretary (all ASD). Mr. R. van Til, the Fund's Resident Representative in Nepal, assisted the mission. Mr. Williams held further discussions with the authorities in Kathmandu during June 14-18, 1986.

Table 1. Nepal: Quantitative Performance Criteria for the Period through July 15, 1986 1/

	1984/85		1985/86				
	July 15		Jan. 15		April 15		July 15
	Preliminary	Revised	Ceiling	Actual	Ceiling	Actual	Ceiling
			(In millions of Nepalese rupees)				
Net domestic assets 2/	10,431	10,537	11,485 (11,591)	11,725	12,045 (12,151)	12,735	12,720 (12,826)
Net credit to Government	6,433	6,470	6,833 (6,870)	7,006	6,977 (7,014)	7,095	7,233 (7,270)
			(In millions of SDRs)				
New external nonconcessional loans of 1-12 years' maturity contracted or guaranteed by the Government, cumulative through end of period 3/	...	...	10.0	--	10.0	--	10.0
			(In millions of Nepalese rupees)				
Memorandum item: Indicative ceiling on credit to non-financial public enterprises 4/	1,151	1,163	1,277 (1,289)	1,331	1,317 (1,329)	1,462	1,289 (1,301)

Sources: Data provided by the Nepalese authorities; and EBS/85/264.

1/ Figures in parentheses indicate ceilings as would be revised to reflect the technical correction of the base period data (July 15, 1985). The actual figures for net domestic assets and net credit to Government on July 15, 1985 were higher by NRs 106 million and, NRs 37 million, respectively, than the preliminary data, on which quarterly credit ceilings were based.

2/ Defined as M2 minus net foreign assets valued at exchange rates prevailing as of July 15, 1985.

3/ Refers to loans contracted after September 30, 1985 and excludes a loan related to the prospective purchase of an aircraft.

4/ Not performance criterion.

Table 2. Nepal: Fund Position During the Period of Arrangement with Rephasing of Purchases, July 1986-April 1987

	Outstanding as of Mid-July 1986	1986/87 Mid-Aug. - Mid-Dec.	1986/87 Mid.-Dec.- Mid.-March	1986/87 Mid.-March Mid.-April
		(In millions of SDRs)		
Transactions under tranche policies (net)	10.25	2.10	3.15	3.15
Purchases	10.25	2.10	3.15	3.15
Ordinary resources	10.25	2.10	3.15	3.15
Repurchases	--	--	--	--
Ordinary resources	--	--	--	--
Total Fund credit outstanding (end of period)	10.25	12.35	15.50	18.65
Under tranche policies	10.25	12.35	15.50	18.65
		(As percent of quota)		
Total Fund credit outstanding (end of period)	27.5	33.1	41.6	50.0
Under tranche policies	27.5	33.1	41.6	50.0

Source: International Monetary Fund.

July 15, 1986 by the time of Executive Board consideration of this report. The balance of SDR 6.3 million under the arrangement would be rephased as two purchases of SDR 3.15 million each, subject to the observance of the performance criteria for mid-October 1986 and mid-January 1987. The latter purchase would also be contingent upon the completion of a second review, to be concluded no later than March 15, 1987.

II. Performance Under the Stand-By Arrangement

1. The economic program for 1985/86

The economic adjustment program for 1985/86 supported by the stand-by arrangement was designed to sharply reduce the immediate balance of payments pressures, while achieving a higher rate of growth and containing demand-generated inflation. Accordingly, a major objective of the program was to reduce the overall balance of payments deficit from SDR 53 million in 1984/85 to SDR 4 million in 1985/86 (Table 3). 1/ However, the current account deficit was expected to rise in relation to GDP by 1 percentage point, to 8.9 percent, largely because of an anticipated increase in imports associated with better aid utilization, but also in reflection of a decline in GDP measured in SDR terms as a result of the devaluation of the Nepalese rupee. The program anticipated that real GDP growth would accelerate from 3 percent in 1984/85 to 4.5 percent in 1985/86 and that the rate of inflation (measured by changes in consumer prices) would be contained at 12 percent on an annual average basis; some 4-5 percentage points of the measured rise in prices would reflect the pass-through effect of the devaluation.

The major elements of the adjustment program for 1985/86 were: a discrete (14.6 percent) devaluation of the Nepalese rupee, to be followed by flexible exchange rate management; tightened budgetary management, focusing on expenditure restraint, while new revenue measures were being formulated for the following fiscal year; a marked reduction in the expansion of domestic bank credit, particularly to the Government and to nonfinancial public enterprises; progress in interest rate liberalization; measures to strengthen the financial position of public enterprises, including adjustments in administered prices; restraint on external borrowing on commercial terms; and some easing of approval policy for nonaid import licenses. These measures were to be accompanied by actions--as proposed by the World Bank and the Asian Development Bank--to stimulate domestic production, particularly in agriculture, and to increase Nepal's aid absorption capacity.

1/ Measured by changes in net foreign assets of the domestic banking system.

Table 3. Nepal: Selected Economic and Financial Indicators, 1982/83-1986/87 1/

	1982/83	1983/84	1984/85 Provisional	1985/86 Original 2/ program	1985/86 Revised estimate	1986/87 Program
	(Annual percentage changes; unless otherwise specified)					
National income and prices						
GDP at constant market prices	-1.4	7.4	3.0	4.5	4.2	4.0
GDP deflator	12.6	5.7	4.0	12.0	14.5	9.5
Consumer prices (annual average)	14.2	6.2	4.1	12.0	15.5	9.5
(July to July)	14.4	1.6	6.9	...	16.5	8.0
External sector (in SDRs)						
Exports, f.o.b.	-24.8	40.3	47.1	3.5	-8.1 3/	6.9
Imports, c.i.f.	26.8	-3.8	13.3	9.3	-2.3	8.6
Export volume	-29.0	27.5	33.3	3.7	7.3	4.8
Import volume	26.1	-4.3	7.4	5.1	8.5	11.6
Terms of trade	5.5	9.5	4.7	-3.8	-4.7	4.8
Real effective exchange rate 4/	5.5	-8.7	0.1	-10.7	-10.7 5/	--
Government budget						
Revenue and grants	6.5	7.9	13.5	43.6	22.9	24.2
Of which: Revenue	(5.2)	(18.5)	(15.7)	(27.4)	(16.5)	(23.2)
Total expenditure	30.6	5.2	13.2	25.5	12.2	23.2
Domestically financed expenditure	36.3	-1.7	17.1	12.8	2.5	16.8
Regular expenditure	24.8	10.9	29.1	33.3	20.6	12.8
Development expenditure	45.0	-10.0	7.5	-6.9	-15.1	22.4
Foreign-financed development expenditure	20.5	22.7	5.1	62.0	34.7	35.6
Money and credit						
Net domestic assets 6/	36.7	18.3	27.2	18.6	20.7	13.7
Credit to Government (net)	27.2	10.2	13.8	6.5	7.7	5.3
Credit to nonfinancial public enterprises	4.0	-2.0	2.0	1.0	3.6	1.2
Credit to private sector	1.6	6.3	9.6	7.8	12.1	8.8
Broad money	23.7	13.4	17.6	18.0	23.0	15.6
Income velocity (GDP/M2)	3.65	3.65	3.33	3.39	3.22	3.18
Interest rate on one-year bank deposits (end of period)	12.5	12.5	12.5	12.5-14.5	12.5	...
	(In percent of GDP; unless otherwise specified)					
External sector						
Current account balance	-8.9	-7.2	-7.9	-8.9	-7.9	-9.1
(Including grants)	-5.5	-4.1	-4.2	-4.7	-4.1	-4.4
(Excluding aid imports)	-5.0	-3.3	-3.9	-3.9	-3.3	-3.1
External debt (end of period)	12.3	16.5	17.4	22.2	21.7	26.9
Debt service (percent of exports of goods and services and private transfers)	3.8	4.0	4.1	4.6	4.6	5.2
Government budget						
Revenue and grants	11.6	11.0	11.7	14.0	12.0	13.1
Of which: Revenue	(8.4)	(8.7)	(9.4)	(10.0)	(9.2)	(9.9)
Revenue surplus 7/	2.7	3.2	2.8	2.6	2.5	3.3
Expenditure	20.4	18.9	19.9	21.0	18.8	20.3
Domestically financed expenditure	14.3	12.4	13.5	12.8	11.6	11.9
Foreign-financed development expenditure	6.2	6.7	6.5	8.9	7.4	8.8
Overall balance	-8.8	-7.9	-8.3	-6.9	-6.7	-7.2
(excluding grants)	-12.0	-10.2	-10.5	-10.9	-9.6	-10.3
Domestic financing (net)	6.0	3.7	4.1	2.3	2.5	2.0
Of which: Banking system	(6.0)	(2.5)	(3.5)	(1.6)	(1.9)	(1.4)
External sector						
Overall balance (in millions of SDRs)	-44	-18	-53	-4	4	12
Gross reserves (end of period, in millions of SDRs)	210	190	144	151	155	173
In months of imports	5.9	5.6	3.7	3.6	4.1	4.2
In months of nonaid imports	7.5	7.2	4.7	4.7	5.4	5.9

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

1/ Fiscal year ending July 15.

2/ Percentage changes are based on the revised 1984/85 data.

3/ An increase of 2.1 percent in U.S. dollar terms.

4/ Negative sign indicates real effective depreciation of the exchange rate.

5/ A 14.6 percent depreciation from November 1985.

6/ In relation to the broad money stock at the end of the previous period and based on exchange rates prevailing as of July 15, 1985 for 1985/86 and those prevailing as of end-January 1986 for 1986/87.

7/ Defined as revenue less regular expenditure.

The overall budget deficit in relation to GDP was projected to decline from 8.3 percent in 1984/85 to 6.9 percent in 1985/86. 1/ As a policy target, the net domestic financing of the budget deficit in relation to GDP was to be reduced to 2.3 percent, from 4.1 percent in 1984/85. As performance criteria, the growth rate of NDA (measured at constant exchange rates) was to decelerate from 27.2 percent in 1984/85 to 18.6 percent in 1985/86, while that of net credit to Government, from almost 14 percent to 6.5 percent. 2/ As an indicative target, the increase in bank credit to nonfinancial public enterprises was to be limited to 1 percent of broad money stock at the end of the previous period. The program for 1985/86 also included, as a performance criterion, a limit of SDR 10 million on the contracting or guaranteeing by the Government of new nonconcessional external loans with maturities of 1-12 years in the period from October 1, 1985 through July 15, 1986.

In addition, the program incorporated understandings with respect to administered prices, interest rate policy, and exchange rate management in the program period through the end of fiscal year 1985/86 (July 15, 1986). Most administered prices were increased prior to or at the time of the devaluation, and a timetable was established for price adjustments for some specific items. Interest rate policy was to accommodate the maintenance of positive real interest rates for key bank loans and deposits. 3/ The general thrust of exchange rate policy was to complement restrained financial policies through flexible management in order to achieve the immediate balance of payments objective and to support the strengthening of the external accounts over the medium term.

2. Recent economic developments

Economic activity, which was adversely affected by a drought in 1984/85, improved in 1985/86: an estimated 5 percent increase in the output of foodgrains and cash crops boosted the growth of the agricultural sector to 3 percent (2 percent in 1984/85), while the liberalization of industrial licensing policy and the increase in electric power

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1/ The overall deficit excluding grants under the original program was projected to be the equivalent of 10.9 percent of GDP (10.5 percent in 1984/85). Reflecting both the impact of the devaluation on the local currency value of grants and the expectation of more rapid absorption of foreign aid in general, the utilization of foreign grants was projected to rise from the equivalent of 2.3 percent of GDP in 1984/85 to 4 percent in 1985/86. Accordingly, the overall budget deficit excluding grants was projected to remain at 10.9 percent of GDP as originally estimated for 1984/85.

2/ The percentage changes are measured in relation to the stock of broad money at the end of the previous period.

3/ This was to be facilitated by a specified widening of the band within which banks are free to set deposit rates. This undertaking was to be monitored monthly according to an agreed formula.

supply contributed to an acceleration in the growth of the nonagricultural sector to an estimated 5.5 percent in 1985/86 (4.5 percent in 1984/85). On the negative side, the external terms of trade deteriorated somewhat more than foreseen in the program. On this basis, real GDP growth rate accelerated to an estimated 4.2 percent (3 percent in 1984/85), only slightly lower than the program target (Chart 1).

The impact of the November 1985 devaluation on consumer prices was immediate and strong because of the close substitutability between many Nepalese goods and similar goods produced in India and because of the open trade between the two countries. Inflation (measured by quarterly changes in the seasonally adjusted consumer price index on the annualized basis) accelerated from 17 percent in November 1985 to a fiscal year peak of 34 percent in February 1986, mainly on account of increases in the prices of traded goods (Chart 2). However, with tightened financial and wage policies and improved food supply following good winter harvests, inflation began to decelerate in March 1986 and moderated to 15.5 percent in June 1986. It is estimated that the annual average rate of inflation was about 15.5 percent in 1985/86. There were no general wage increases in the government sector in 1985/86, and wage adjustments in the private sector appeared on average to have been significantly lower than the rate of inflation. In Kathmandu, the wage rates of skilled and unskilled workers in the construction sector are estimated to have increased by 11.1 percent and 12.5 percent, respectively, whereas those of industrial workers, which were substantially adjusted in 1984/85, are estimated to have remained virtually unchanged.

The overall balance of payments outcome for 1985/86 was somewhat better than projected in the program, with an estimated overall surplus of SDR 4 million, compared with a deficit of SDR 4 million envisaged in the program and a deficit of SDR 53 million in 1984/85 (Appendix Table 5). The estimated current account deficit was SDR 29 million lower than originally forecast, and at about the same level as the previous two years, in spite of the notable intervening deterioration in the terms of trade. Export volume is estimated to have increased by about 7 percent (4 percent projected in the program), but because of a decline in export unit prices, particularly of raw jute and jute goods, the value of exports declined by about 8 percent in SDR terms, 1/ to a level SDR 18 million below the original program projection (Chart 3). Reflecting a sharp increase in the volume of aid-financed imports, total import volume grew by an estimated 8.5 percent in 1985/86. However, owing to the decline in import unit prices, the value of imports fell by about 2 percent, compared with the originally projected increase of about 9 percent (both in SDR terms). Foreign loan disbursements were somewhat below the program projection, but much of the shortfall is estimated to have been offset by a reflow of short-term private capital

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1/ In U.S. dollar terms, the value of exports increased by about 2 percent.

that followed the devaluation and the announcement, in December 1985, of a new economic adjustment program.

3. Policy implementation

The policies on the exchange rate, interest rates, administered prices, and commercial external borrowing pursued by the authorities in 1985/86 generally conformed to the guidelines of the stand-by program. However, there were some slippages in implementation of the credit program, resulting in deviations from performance criteria on NDA and net credit to Government in January and April 1986. However, the higher-than-planned NDA level, which was already present in the quarter ending October 15, 1985 before the stand-by arrangement was approved, was more than absorbed by domestic money flows that were persistently and substantially above the projected time path. 1/ Accordingly, the level of net foreign assets also was above the projected trend throughout the period after the adjustment program was announced. The instruments of credit control and monitoring techniques were greatly strengthened during May 1986, and by June (when NDA declined by about 2 percent in absolute terms) the NDA level came down to the program path. It is estimated that in mid-July, ceilings on both the NDA and net credit to Government were breached but only by a modest amount (i.e., 2 percent or less). 2/

a. Fiscal policy and management

In line with the immediate policy priority of reducing quickly and sharply balance of payments pressures, the authorities began to tighten the fiscal stance in the weeks prior to the devaluation in late November 1985. In reflection of the subsequent fiscal adjustment, it is estimated that both the overall budget deficit and its domestic financing declined in relation to GDP by 1.6 percentage points, compared with the 1984/85 levels (Appendix Table 6 and Chart 4). Moreover, the estimated overall deficit for 1985/86 was lower than that envisaged in the program

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1/ The initial underestimation of the demand for money related to the unexpectedly strong shift from currency holdings in Indian rupees to monetary assets of the domestic banking system following the devaluation in late November 1985.

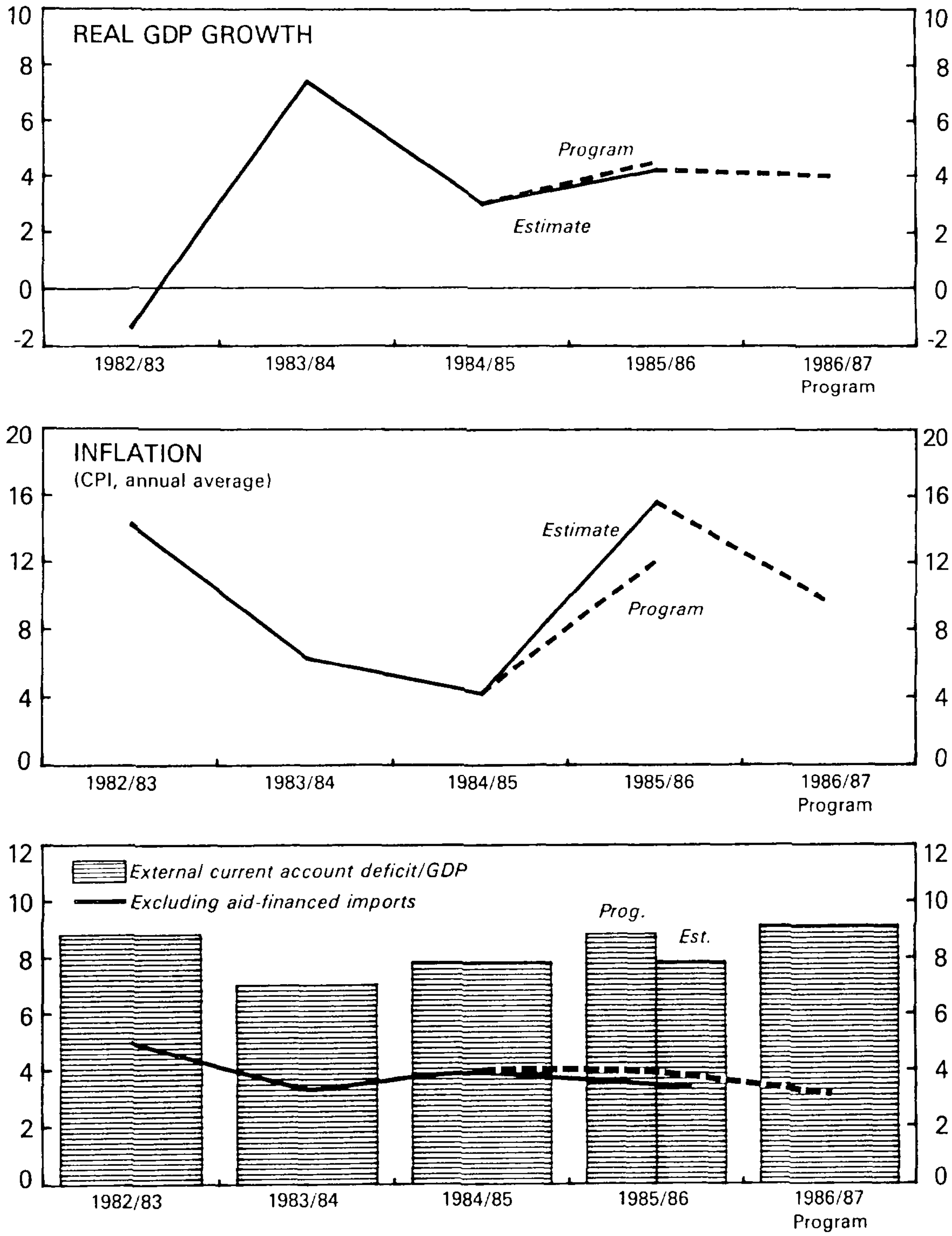
2/ Adjusted for the amount reflecting the correction of the base data (July 15, 1985). The actual figures for NDA and net credit to Government on July 15, 1985 were higher by NRs 106 million and NRs 37 million, respectively, than the preliminary data, on which the quarterly credit ceilings were based. Discussions on quantitative performance throughout this paper take into account the technical correction of the base data.

CHART 1

NEPAL

SELECTED ECONOMIC INDICATORS, 1982/83-1986/87

(In percent)

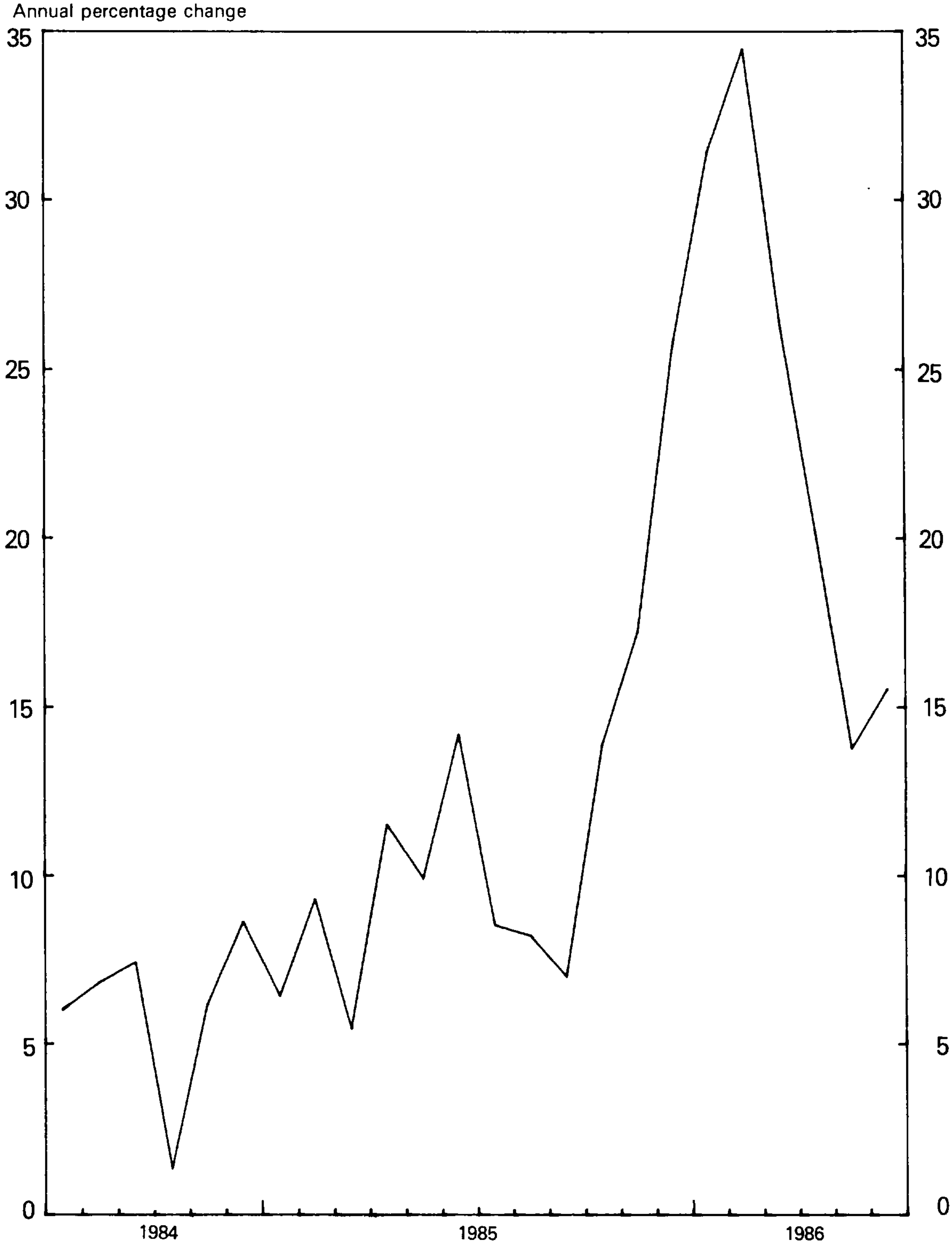


Sources: Data provided by the Nepalese authorities; and staff estimates.

CHART 2

NEPAL

CHANGES IN CONSUMER PRICES, JULY 1984-JUNE 1986



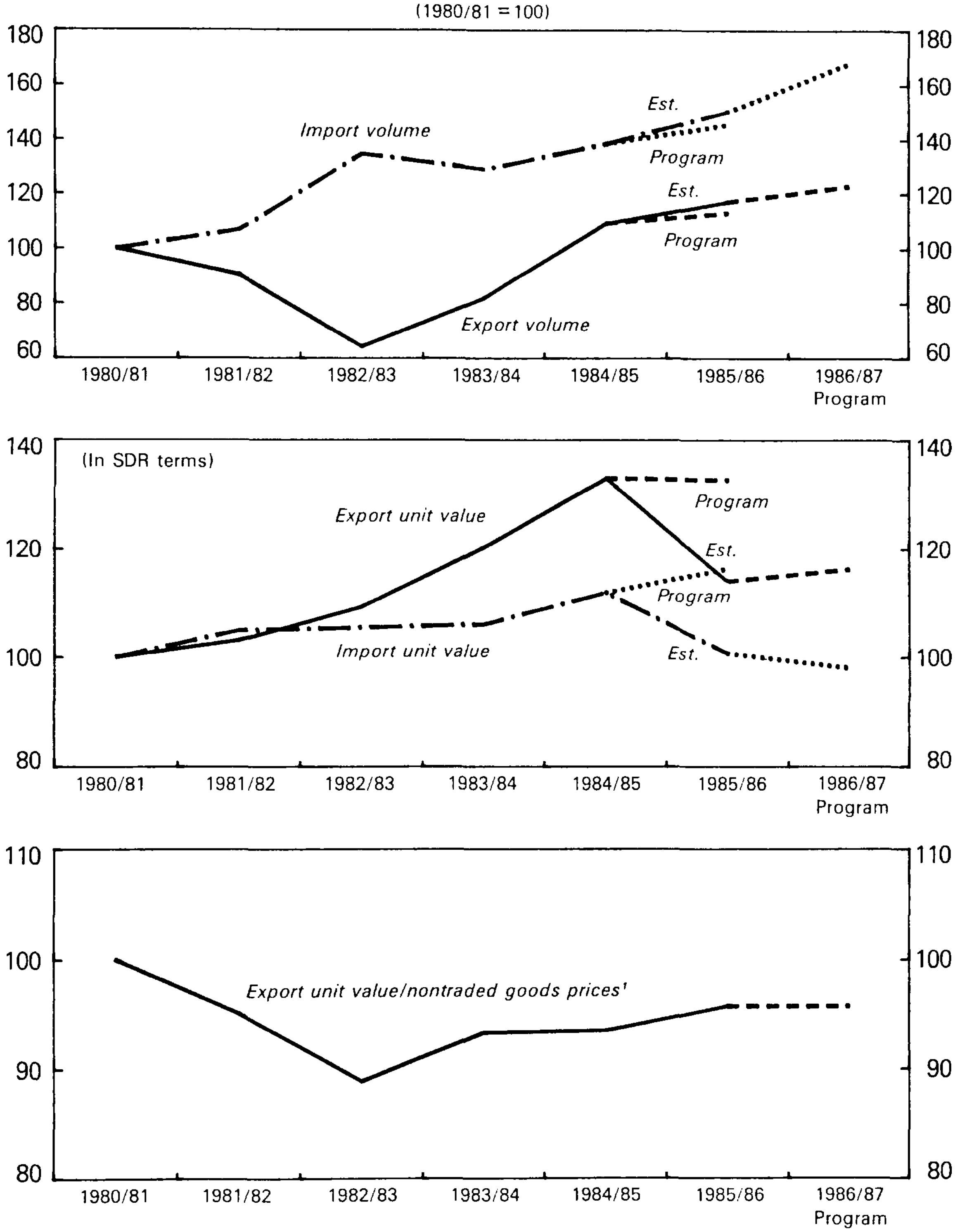
Source: Data provided by the Nepalese authorities.
[1] Measured by quarterly changes in the seasonally adjusted consumer price index on the annualized basis.

CHART 3

NEPAL

EXTERNAL INDICATORS, 1980/81-1986/87

(1980/81 = 100)



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

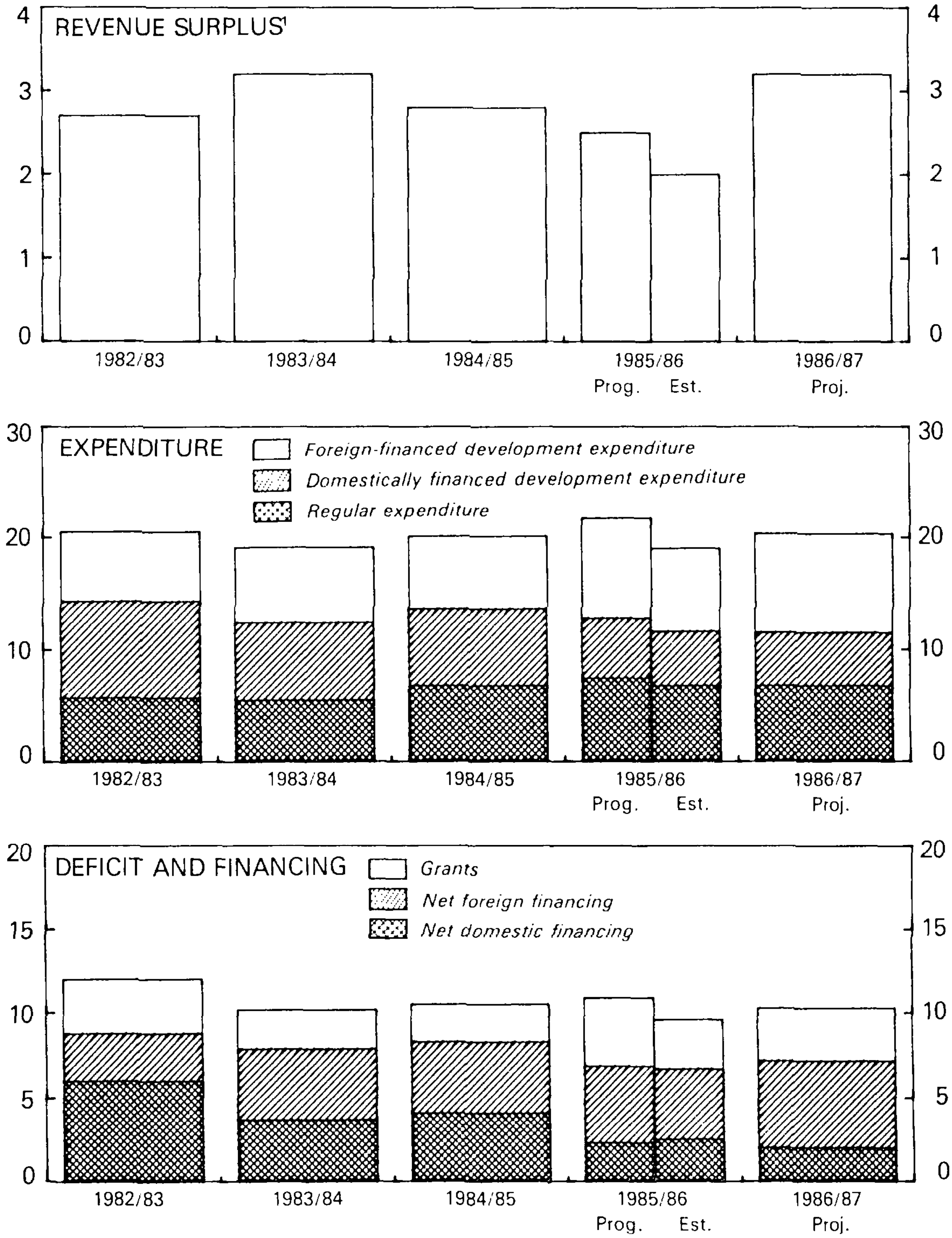
[1] Excluding export prices of raw jute and jute goods.

CHART 4

NEPAL

BUDGETARY DEVELOPMENTS, 1982/83-1986/87

(In percent of GDP)



Sources: Data provided by the Nepalese authorities; and staff estimates.
[1] Defined as revenue less regular expenditure.

by an amount equivalent to 0.2 percentage point of GDP. 1/ However, owing to significantly lower-than-expected disbursements of concessional foreign loans, the net domestic financing of the budget deficit exceeded the program target.

The additional fiscal adjustment was concentrated on expenditure reductions, as revenue and foreign aid disbursements both fell well short of the program targets. 2/ It is estimated that revenue and expenditure increased by about 17 percent and 12 percent, respectively, in 1985/86 compared with an increase of 27 percent and 26 percent, respectively, envisaged in the program. Tax revenue is estimated to have increased by 19 percent in 1985/86, compared with a program target of 33 percent. A marked increase in receipts from taxes on international trade following the November 1985 devaluation was largely offset by an unexpectedly poor tax collection in May and in the first half of June. During the six-week period, the involvement of tax collection agents in the election process resulted in a substantial tax revenue loss, which could not be recouped during the remainder of 1985/86. Faced with the shortfalls in revenue, the authorities were compelled to retrench considerably more than planned on domestically financed expenditure, which is estimated to have increased in 1985/86 by only 2.5 percent in relation to the 1984/85 level. A 13 percent increase was projected in the program and the estimated actual was below the program target by an amount equivalent to 1.2 percent of GDP. Similarly, regular expenditure was contained, primarily by a freeze on wages, salaries, and the number of civil servants, to a level well (9 percent) below that programmed, and is estimated to have increased by 21 percent. 3/ Given the magnitude of the revenue shortfall, however, domestically financed development expenditure bore the brunt of the adjustment, and is estimated to have declined by 15 percent (a reduction equivalent to 0.5 percentage point of GDP from the level projected in the program). With lower-than-anticipated disbursements of foreign aid, foreign-financed development expenditure was also well below (17 percent) the program target. Nevertheless, such expenditure is estimated to have increased by 35 percent, as compared with the 5 percent growth

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1/ The extent of the additional fiscal adjustment is even more apparent in the estimated outcome for the overall balance excluding grants, which was below the amount projected in the program by an amount equivalent to 1.3 percent of GDP.

2/ In Nepal, government expenditure is divided into two major categories: regular and development expenditure. The former comprises mainly wages and salaries, purchases of other goods and services, interest payments, and subsidies and transfers, while the latter includes mainly capital expenditure, expenditures on operations and maintenance, subsidies and transfers, and wages and salaries mainly related to primary, post-middle, and technical education. Expenditure in middle school level education is classified as regular expenditure.

3/ Wages and salaries in regular expenditure increased by an estimated 6 percent in 1985/86 owing to wage drift.

achieved in 1984/85, reflecting considerable progress in aid absorption. Total development expenditure increased by 9 percent in relation to 1984/85, but declined substantially in real terms.

The planned sale to the public of government-held equity in a number of enterprises failed to materialize during 1985/86, but the impact on the deficit was far more than offset by the substantial reductions in other expenditure categories. In some cases, the weak financial position of the enterprise made its shares relatively unattractive to potential investors and, in others, legal complications arose because the private shareholders could not agree on the Government's proposed action. The authorities consider that in the latter cases, the legal problems will be resolved in the present fiscal year, while in the former cases, fundamental internal reforms may be necessary to improve the financial performance of the enterprises. The authorities believe that, apart from being a source of revenue, the sale of government-held equity, by permitting expanded private ownership in a number of enterprises, will increase their sensitivity to profit and market considerations.

To reduce the need for budgetary transfers/subsidies and domestic bank credit, administered prices charged by public enterprises are adjusted periodically to reflect changes in import and/or domestic production costs. During calendar year 1985, the authorities made a number of upward adjustments in administered prices in anticipation of the November 30, 1985 devaluation. 1/ Subsequently, the prices of sugar and cement were raised by 19 percent and 6 percent, respectively. The prices of iron rods and corrugated sheets are mainly market determined, but to some extent also administered when they are supplied by public corporations. Since the devaluation, the price of iron rods charged by the public corporation remained higher than the market price; and corrugated sheets have been supplied entirely by private enterprises. In the case of chemical fertilizers, which are wholly imported and solely distributed by public enterprises, their domestic prices were increased by 20-29 percent on May 21, 1986. The increases in these prices brought them into close conformity with those in India. The upward adjustments in fertilizer prices, together with the sharp decline in their international prices, reduced the average subsidy per unit by over 80 percent in 1985/86. In the case of petroleum products, the Government is reviewing the structure and adequacy of their domestic prices in light of the recent upward price adjustments in India, the sharp decline in international prices, and the terms of import contracts of the NOC, which have been recently renegotiated on more favorable terms.

The net flow of funds to public enterprises provides a comprehensive indicator of the burden that the operations of these enterprises place on the budget. The amount by which flows from the budget to public enterprises exceed those from the enterprises to the budget

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1/ These measures were described in EBS/85/264.

amounted to 6.1 percent of expenditure in 1983/84. 1/ Available data for 1984/85 indicate a turnaround, with the net flows from public enterprises to the budget amounting to 1.4 percent of expenditure. The authorities indicated that this ratio probably would not increase in 1985/86, even with the upward adjustments of various administered prices, particularly in view of the lag before the NOC--for reasons explained in the next section--would fully benefit from declining international oil prices.

b. Monetary policy

In the first quarter of 1985/86 (July 16-October 15, 1985), domestic bank credit grew rapidly (by 31 percent during the year ending mid-October 1985), reflecting a higher-than-expected budgetary domestic financing requirement and a strong expansion in credit to both nonfinancial public enterprises and the private sector (Appendix Table 7). The unexpectedly large expansion in bank credit to the Government in that period reflected mainly the failure to sell government securities to the nonbank sector, clearance of checks and payments orders carried over from the previous fiscal year, and revenue shortfall associated with a delay of several weeks in the devaluation. Reflecting these developments, on October 15, 1985, the stock of net credit to Government exceeded the staff projection by NRs 87 million (1.3 percent). The strong expansion in credit to nonfinancial public enterprises mainly reflected the cash flow problems experienced by three major enterprises: the Jute Development and Trading Corporation, which was unable to sell the stocks purchased (through bank credit) at minimum support prices that were higher than rapidly declining market prices; the Nepal Food Corporation, which needed the funds to purchase and distribute rice; and the recently established Hetauda Cement Corporation, which required working capital. The increase in credit to the private sector was associated partly with the establishment of small-scale production units (textiles, plastics, and processed foods) for the domestic market. With the surge in credit to nonfinancial public enterprises and to the private sector and the unplanned financing of the budget deficit, NDA expanded by NRs 322 million more than projected in the first quarter of fiscal year 1985/86 and exceeded the mid-October projected level by 2.9 percent.

The authorities had tightened credit policy, without recourse to direct credit guidelines, by the time of devaluation and hoped to be in conformity with the program by mid-January 1986. The NRB in early January 1986 issued credit guidelines to commercial banks which were designed to limit the various categories of domestic assets in conformity with the credit ceilings, but the mechanism for close monitoring of

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1/ Flows from the budget to public enterprises consist of share capital, loans, and operating and transport subsidies, and those from the enterprises to the budget comprise indirect and income tax, dividends, and debt service payments.

credit developments was not yet in place. Net credit to Government exceeded the January ceiling by NRs 136 million (2.0 percent), and the indicative limit on credit to nonfinancial public enterprises was exceeded by NRs 37 million. Consequently, even though private credit and other assets moved along the planned path, the ceiling on NDA was exceeded by NRs 149 million (1.3 percent). Nevertheless, the gap between planned and actual NDA had narrowed considerably compared with the position in mid-October 1985 (Chart 5).

The new credit guidelines on commercial banks turned out to be ineffective in keeping the credit developments moving toward the program path during the quarter ending mid-April 1986. Branches of the two dominant (government-owned) banks 1/ continued to accelerate their loan expansion, as no limits were established at the branch level. The NRB was unable to closely monitor these developments. On an annual rate basis, the growth of private sector credit accelerated from 34 percent in January 1986 to over 37 percent in April 1986. In contrast, the expansion of credit to the nonfinancial public enterprises decelerated sharply, from 34 percent to 22 percent, during the same period, although this was still significantly higher than the growth envisaged in the program. The Government's position vis-a-vis the banking system improved considerably during this period, but not to the full extent of its unexpectedly high borrowing from the banking system during the quarter ending mid-January 1986. Consequently, although the excess of net credit to Government was reduced to NRs 81 million (1.2 percent), in mid-April 1986, the NDA ceiling breach widened to NRs 584 million (4.8 percent). Nevertheless, the annual growth rate of NDA, which had decelerated from 36 percent to 30 percent between October 1985 and January 1986, decelerated further to 28 percent in April 1986. At the same time, the unplanned expansion of NDA was, as noted, more than absorbed by higher-than-projected money demand, resulting in a more rapid improvement in the overall balance of payments than targeted in the program.

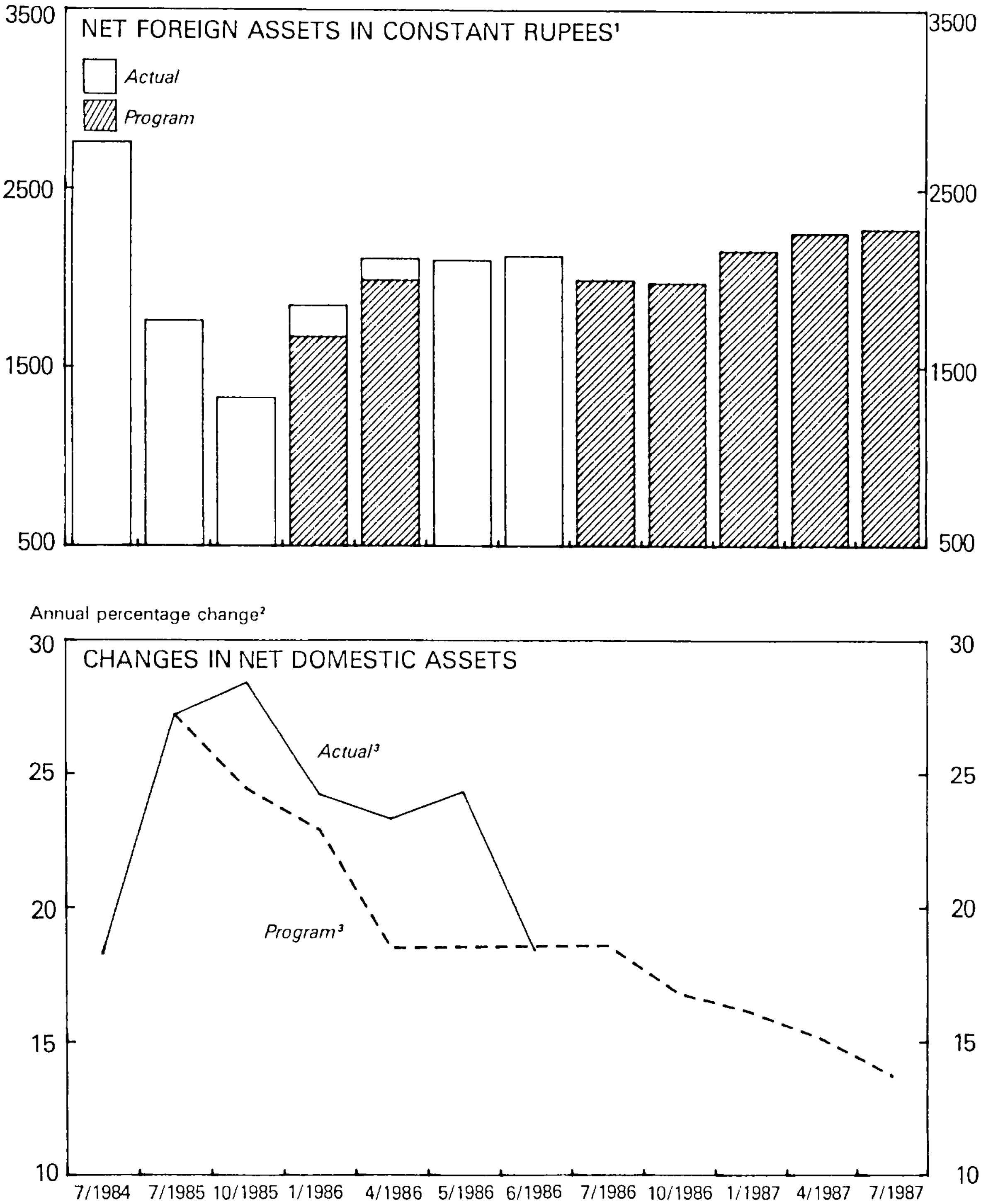
Following the April outcome, the NRB reformulated and tightened its direct credit guidelines for commercial banks and greatly strengthened its monitoring capability. The banks were instructed to institute the necessary guidance and control over their branch networks to ensure the effectiveness of the new directives. Consequently, the banks set credit limits on each branch and curtailed the credit approval authority of branch managers. The monitoring of credit development by the NRB was significantly improved through provision for weekly reports from banks on major account totals, and a reporting lag for provisional estimates of domestic credit was halved to four weeks. Preliminary estimates indicate that outstanding credit to the private sector declined by almost 3 percent in May 1986, largely offsetting the modest increase in credit to Government and the continued expansion of credit to non-financial public enterprises.

1/ At present, there are five commercial banks in Nepal.

CHART 5

NEPAL

NET DOMESTIC ASSETS AND NET FOREIGN ASSETS, JULY 1984-JULY 1987



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

1 At the rate of NRs 17.7 per U.S. dollar.

2 In relation to broad money stock.

3 Adjusted, using the rate of NRs 17.7 per U.S. dollar for the period through July 1986, and NRs 21.0 per U.S. dollar thereafter.

With a view to further slowing the expansion of domestic credit, the authorities decided to essentially freeze private sector credit at the average April-May level during the remainder of 1985/86 and to reduce modestly the outstanding credit to nonfinancial public enterprises. Provisional data for June 1986 indicate that domestic credit expansion decelerated significantly further, as a decline in outstanding credit to nonfinancial public enterprises partly offset normal, seasonal recourse to bank borrowing by the Government, with outstanding credit to the private sector still 2.5 percent below the April level. In order to contain the Government's bank borrowing, sales of savings certificates to the nonbank private sector were accelerated, and expenditures other than wages and salaries were essentially frozen during the last month of the fiscal year. On this basis, the annual expansion of net credit to Government 1/ is estimated to have declined to 7.7 percent by July 1986, from almost 14 percent in the previous year, although the outstanding level would still exceed the mid-July ceiling by about NRs 150 million (2 percent). With the preliminary June results and the aforementioned policies in place, the authorities consider that the July 1986 NDA ceiling may have been observed. There is still some uncertainty on that score, in part due to fluctuations in capital and surplus accounts. Clearly that outcome appears to have been feasible, but the staff has estimated a possible breach of the NDA ceiling for July of about NRs 250 million (2 percent). Even on that basis, the annual expansion of NDA in relation to the broad money stock would have decelerated to less than 21 percent, from a fiscal year peak of over 28 percent in October 1985.

During the April discussions, the authorities expressed concern about one aspect of monetary/credit management that bears on the efficacy of quantitative credit controls. Starting from a point where domestic credit was well above the desired trend path, the specific quantitative guidelines for each commercial bank were introduced at a time when banks appeared to be increasingly liquid. Thus, a marked slowdown in banks' domestic asset expansion would be required at a time when their deposit base, under the influence of a faster-than-anticipated balance of payments turnaround, was reaching levels considerably higher than foreseen. Banks were reporting that their profitability was being seriously squeezed, and the authorities were concerned that they might bid down deposit rates or in the extreme--if administered minimum rates were rigidly enforced--begin to reject additional deposits. Such actions, with inflation exceeding the target, would run counter to the policy objective of stimulating the flow of financial savings through the banking system.

The staff noted that the data on bank reserves and on the credit/deposit ratio did not support the contention that bank earnings in the aggregate had been squeezed when account was taken also of developments before the credit guidelines came into effect. Moreover, this should be

1/ In relation to the broad money stock at the end of 1984/85.

viewed as essentially a short-term circumstance, because banks' credit and deposit growth would be expected to be much better balanced in the period ahead. Nevertheless, the staff recognized the importance of appropriate balance between developments in market liquidity and in credit policy even where the major control instrument would be administrative guidelines for the time being, and suggested various alternatives for attaining this balance. One of these would be for the Government to sell bills or shorter-term bonds with market-related interest rates to the commercial banks and, with the proceeds, retire an equivalent amount of its outstanding overdraft obligations to the NRB (these obligations carry interest rates well below market levels). This would effectively transfer part of the NRB's loan portfolio to the commercial banks, giving them a larger portfolio of interest earning assets. Nevertheless, the authorities felt constrained by the already heavy burden of interest payments in government expenditure, although they agreed in principle that this would help create a framework for development of instruments for the indirect control of credit through liquidity management and help rationalize the structure of interest rates. The staff also emphasized that the system of quasi-automatic refinancing facilities from the NRB, at highly subsidized rates, for a wide variety of "priority" sector credits severely impaired the ability of the monetary authorities to effectively regulate banking system liquidity and credit demand. This view was shared by the authorities, who were formulating an interest rate reform package at the time of the April discussions.

On May 29, 1986, the authorities introduced a major reform of interest rates, under which banks became free to set deposit rates at any level above the minimum savings deposit rate of 8.5 percent and the minimum one-year fixed deposit rate of 12.5 percent (Appendix Table 8). 1/ For fixed deposits with a maturity of less than one year, interest rates should be set equal to or higher than 8.5 percent, and for those with a maturity of more than one year, equal to or higher than 12.5 percent. The three-month fixed deposit rate, previously tied to the treasury bill rate, was freed, subject to the requirement that it has to be equal to or higher than 8.5 percent. This requirement removed the previous anomaly in the term structure of deposit rates, whereby the interest rate on liquid savings deposits was roughly double the rate on three-month term deposits. The former complex structure of seven lower concessional lending rates which applied to loans for a wide range of activities in "productive" and "priority" sectors was replaced by a higher, uniform ceiling rate of 15 percent; all other lending rates were freed. With this upward adjustment in the concessional lending rate, the NRB raised its refinancing rate to a uniform 11 percent.

1/ Savings accounts were initially subject to the following restrictions: savings accounts can only be opened by individuals and nonprofit institutions; the maximum withdrawal at one time is NRs 1,000 and no more than NRs 2,000 per week; and the maximum size of deposits is NRs 100,000. Those restrictions were abolished in June 1986.

Across the range of deposit and lending rates, and taking into account both past and prospective inflation, the authorities thus are in broad conformity with the understanding that interest rates policy should be consistent with market rates that are positive in real terms. Moreover, deposit rates appear to be sufficiently high in relation to comparable rates in India. The staff fully agreed that these measures should enhance the flow of financial savings into the system and improve their economic allocation over time. Moreover, in the shorter run, they should improve the profitability of bank lending and perhaps ease some of the pressures felt by the NRB to ease up on the quantitative credit restrictions. The staff also noted, however, that the treasury bill rate and the NRB overdraft rate for the Government also ought to be raised to market-related levels. This would help provide a basis on which the NRB could begin to move away from quantitative credit controls toward the use of interest rates and liquidity management as primary tools of monetary/credit policy. It would also help eliminate the built-in incentive for the Government to finance its deficit through the domestic banking system. This process would be further facilitated if the Government were to develop a wider range of marketable obligations and/or if the NRB were to develop an instrument of its own for placing with the commercial banks. The authorities indicated that they would consider these proposals, although early action was not necessarily being contemplated.

c. External policies

The improvement in external competitiveness achieved by the November 30, 1985 devaluation has so far been largely maintained, owing partly to intervening changes in the relationships of international currencies (Chart 6). 1/ With a view to increasing flexibility of exchange rate management, the authorities announced on May 31, 1986 that the Nepalese rupee would be pegged to a basket of currencies, including the Indian rupee. At the same time, the NRB was given the authority to implement exchange rate policy within the framework of the new regime. On June 1, 1986, the Nepalese rupee was appreciated by about 1 percent.

Reflecting partly the impact on import demand of the devaluation and of tightened domestic credit policy, and partly the limitation on import license approvals related to the scarcity of foreign exchange, the total value of import licenses issued for nonaid-financed imports from countries other than India declined by about 13 percent in SDR terms (by about 6 percent in U.S. dollar terms) in the first eight months of 1985/86, compared with the same period of the previous year.

1/ Preliminary data indicate that the latest available three-month geometric average REER index (February-April 1986) was virtually unchanged from the base period index (December 1985-February 1986). Other indicators of competitiveness, e.g., internal terms of trade, also show the same pattern.

The program envisaged a 13 percent increase in the SDR value of such licenses in 1985/86.

The service requirement on the public and publicly guaranteed debt, which consists largely of concessional loans, remained at an easily manageable level in 1985/86. While outstanding external debt in relation to GDP is estimated to have increased by about 4 percentage points, estimated debt service payments remained below 5 percent of exports of goods and services and private transfers. In the applicable period since September 1985, the Government refrained from contracting or guaranteeing any additional nonconcessional loans in the 1-12 year maturity range and contained public sector short-term borrowing to revolving loans traditionally required in the normal operations of the NOC.

III. The Economic Program for 1986/87

1. Objectives

During 1986/87, the authorities intend to continue to assign the highest priority to strengthening the balance of payments and growth prospects, while reducing inflation markedly. In support of these objectives, the 1986/87 adjustment program focuses on policies to stimulate production, increase development expenditure through greater mobilization of domestic resources and better aid utilization, restrain domestic demand and wage increases, provide flexible management of the exchange rate, liberalize imports, and implement pricing and management policies by public enterprises that are more market oriented. With the pursuit of these policies, the authorities and the staff consider that the growth rate of about 4 percent can be sustained in 1986/87, the inflation rate reduced to about 8 percent (from an estimated 16.5 percent), and the overall balance of payments surplus increased to SDR 12 million (from an estimated SDR 4 million).

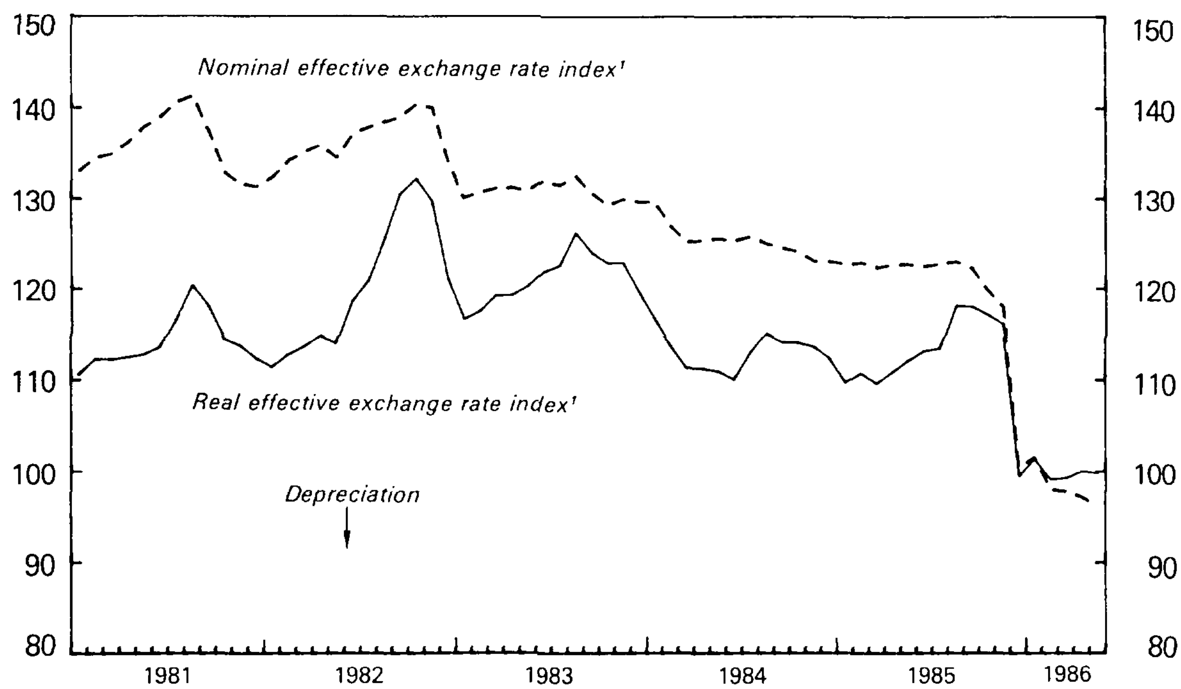
With respect to the external accounts, export volume is projected to increase by about 5 percent, about 2 percentage points lower than the estimated outturn in 1985/86, largely in reflection of a projected slowdown in the growth of ready-made garment exports as a result of the recently concluded U.S. textile quota agreement. That agreement limits the volume growth of those exports to about 6 percent per annum, compared with a growth rate approaching 20 percent in 1985/86. However, export prices are foreseen to recover; thus, the value of exports should increase by about 7 percent in SDR terms. Increased external aid utilization together with the planned progress in import liberalization should boost import volume growth from 8.5 percent in 1985/86 to about 12 percent in 1986/87. However, with continued weakness in import prices, the value of imports would increase by about 9 percent. These prospective developments would increase the ratio of the current account deficit to GDP by 1.2 percentage points to 9.1 percent in 1986/87;

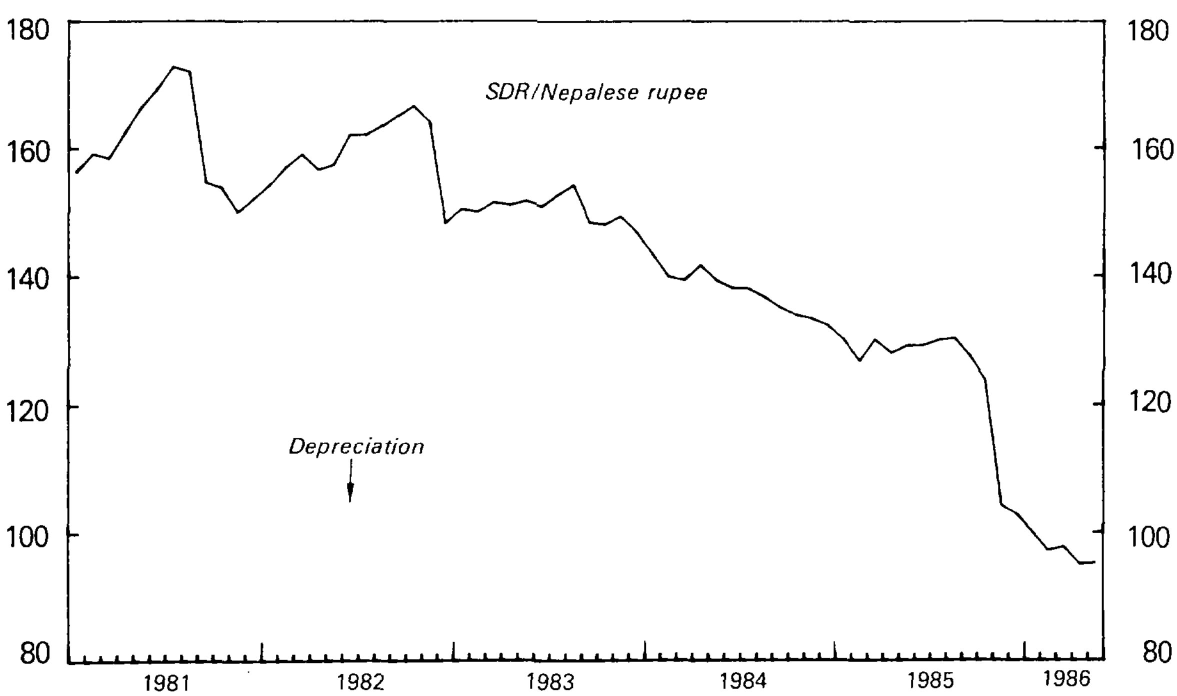
CHART 6

NEPAL

EXCHANGE RATES, 1981-86

(Dec. 1985-Feb. 1986 =100)





Source: International Monetary Fund.

[1] The index is weighted by trade shares of Nepal's major trading partners.

excluding aid-financed imports, the ratio would decline by 0.2 percentage point to 3.1 percent of GDP. Because of the anticipated acceleration in receipts from official grants and loans, including a prospective structural adjustment loan from the World Bank, the overall balance of payments surplus is projected to rise to SDR 12 million in 1986/87, thus permitting external reserves to increase slightly to the equivalent of 4.2 months of imports.

2. Policies

a. Supply policies

In 1986/87, there will be a continuation and acceleration of the measures to stimulate production that was included in the economic program for 1985/86. In the agricultural sector, efforts are being directed toward increasing irrigation facilities, as well as rehabilitating existing facilities and improving their maintenance. In general, much greater attention will be given for provision of adequate funds in the budget for operations and maintenance expenditure. Technical services, agricultural inputs, and agricultural credits are being made available in the form of packaged programs in selected areas with irrigation facilities; the programs have already been launched on 35,000 hectares of land located in 26 districts. In programs worked out with the Asian Development Bank and other donors, availability of fertilizers will be increased substantially, while the per unit subsidy has been reduced significantly to help strengthen budgetary management. The rural sector's access to agricultural credit is being improved through the expansion of the resource base of the Agricultural Development Bank of Nepal (which has been authorized to raise deposits in urban areas and to issue agricultural savings certificates) and by the expansion in commercial bank branches in rural areas (17 new branches were opened in 1984/85, and 10 branches in the first 10 months of 1985/86).

The industrial sector will benefit from more liberal industrial and import licensing policies. Also, ready-made garment firms are being given facilities to import raw materials exclusive of import duty and sales tax. Programs, which are supported by a loan from the World Bank, are being formulated to increase production, reduce costs, and improve the quality of the products of cottage and small-scale industries. Finally, specific export-promotion measures discussed with the World Bank in the context of a flexible exchange rate policy is expected to lead to a further strengthening of the export sector, as well as to the enhanced efficiency of import substitution activities.

b. The budget and public enterprises

Fiscal policy in 1986/87 aims at increasing domestic and external resource mobilization, while restraining the wage bill and other regular outlays, thereby providing room for a significant increase in development expenditure. Domestic resource mobilization is being intensified with the implementation of new tax measures that are expected to yield additional revenue equivalent to at least 0.7 percent of projected GDP. 1/ With a projected 25 percent increase in revenue and a 72 percent increase in grants, total expenditure is budgeted to increase by about 36 percent in 1986/87 (12 percent in 1985/86). Most of the increase is concentrated in development expenditure, which is budgeted to rise by 46 percent or by 3.4 percentage points in relation to GDP, while the budgeted growth in regular expenditure would be limited to 19 percent (a 7.7 percent increase in relation to the 1985/86 program target). 2/ The ratio of the overall budget deficit to GDP is budgeted to increase by 1.2 percentage points to 7.9 percent of GDP. The program for 1986/87 envisages, however, significantly lower foreign aid disbursements than anticipated in the budget. On this basis, the overall deficit relative to GDP is projected to increase by 0.5 percentage point to 7.2 percent (or by 0.7 percentage point to 10.3 percent, excluding grants). Most of the deficit will be externally financed, with the domestically financed deficit and net bank financing limited to below 2 percent and 1.4 percent of GDP (NRs 800 million), respectively.

The 1986/87 budgetary emphasis on domestic revenue mobilization and on containment of regular expenditures is in line with the authorities' efforts to improve their ability to finance a sizable and sustained increase in development expenditure, emphasizing completion of ongoing projects and provision of adequate funds for operations and maintenance. The authorities believe that such a growth-oriented shift in budgetary management is necessary in order to achieve the growth objective of the Seventh Development Plan (1985/86-1989/90) in a framework of external account viability and reasonable price stability. Accordingly, in the 1986/87 budget, the authorities introduced a wide range of new tax measures including most of those recommended by a recent Fund fiscal technical assistance mission. These measures are expected to yield additional tax revenues of about NRs 415 million (over 0.7 percent of GDP) in 1986/87. Altogether, tax revenue is projected in the budget to increase by 27 percent in 1986/87, thereby raising the ratio of tax revenue to GDP by about 0.9 percentage point to 8.6 percent in 1986/87. The staff believes that tax revenue would increase by 24 percent and its ratio to GDP by 0.7 percentage point to 8.4 percent.

Major new tax measures introduced in the 1986/87 budget include: the simplification of the sales tax structure and broadening of the tax base; increases in import duties on petroleum products, sugar, and synthetic fibers and yarn, as well as an expansion of the list of

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1/ Taking into account the projected increase in net receipts from the sales of aid-financed fertilizers arising from the increase in domestic sales prices, equivalent to 0.2 percent of GDP, the positive impact of new measures is equivalent to 0.9 percent of projected GDP.

2/ In Nepal, expenditures and the availability of resources have been systematically overstated in the budget. The staff's view is that the actuals of expenditure and available resources would be significantly below the projections presented in the budget.

imports not eligible for the 1 percent duty rate; increases in excise duties on selected items; the introduction of a reduced flat allowance for purposes of personal income tax deduction and the generalization of withholding tax on interest, dividends, and rental income; the introduction of a flat corporate tax; an increase in airflight departure tax; and an increase in the minimum property values to more realistic levels (Appendix Table 9). The increase in the import duty on petroleum products is expected to generate an additional revenue of NRs 73.5 million in 1986/87, while lower international oil prices will allow the NOC to repay loans incurred to cover past losses. The general policy is that the windfall from the decline in crude oil prices will be wholly captured by the public. 1/

Together with significant revenue-generating effort, the authorities are assigning a high priority to restraining the growth in regular expenditure so that development expenditure can be stepped up considerably without jeopardizing balance of payments and inflation objectives. However, the room for maneuver in this policy area has narrowed considerably. Interest payments on domestic and external debt now take up one fifth of regular expenditures, 2/ and moreover, allowance has to be made in the growth of expenditure categories associated with completion of development projects. Under these circumstances, in the 1986/87 budget, the authorities have maintained the freeze on wages and salaries of civil servants and have provided for no increase in employment levels during 1986/87. This will permit the Government to contain the increase in the wage bill to about 4 percent, implying a substantial decline in real terms. 3/ As a result, regular expenditure in 1986/87 is projected by the staff to increase by about 13 percent in relation to the estimated outcome in 1985/86 (only 3.4 percent above the 1985/86 program target). With the adjustments in the administered prices of chemical fertilizers and the strengthening of the financial position of the NOC, the net flows from public enterprises to the budget will increase in 1986/87.

With a view to strengthening growth prospects for the medium term as well as sustaining economic growth during the program period, domestically financed development expenditure is budgeted to increase by 24 percent in 1986/87, after declining by 15 percent during 1985/86.

1/ Nepal's major exports are unprocessed or semiprocessed agricultural commodities with relatively little energy-intensity in their production. Therefore, in the staff's assessment, the revenue potential of this policy outweighs efficiency considerations to maintain export competitiveness through a reduction in domestic oil prices.

2/ The below-market interest rates paid by the Government on its treasury bills and overdrafts with the central bank understate the true level of interest payments on domestic borrowing.

3/ The 1986/87 budget provides for a 3.6 percent increase in the wage bill in regular expenditure, as compared with the estimated outcome for 1985/86.

Foreign-financed development expenditure is projected in the budget to rise by 61 percent (35 percent estimated in 1985/86), reflecting an acceleration in aid commitments, some success in joint efforts by the authorities and donor agencies to improve Nepal's ability to utilize external aid, and a shift in the margin toward quicker disbursing aid. As recommended by the World Bank staff, the 1986/87 budget emphasizes the introduction of a core program that mainly comprises projects already under way and those with short gestation periods; provision of adequate funds for operations and maintenance to prevent a deterioration in the existing capital stock; and improvements in project implementation and monitoring. Accordingly, the authorities intend to strictly limit the number of new projects undertaken with requirement of a minimum internal rate of return of 13 percent. To improve cost-effectiveness of development projects, the authorities have recently initiated, with the assistance from the United Nations Development Program and an outside consulting firm, a comprehensive review of development projects. The review has been completed for agricultural and irrigation projects, and has identified a number of projects with high costs and/or low internal rate of return, which will be canceled or at least scaled down. Upon the completion of the review during the first quarter of 1986/87, the authorities are considering the submission of a supplementary budget, incorporating the relevant expenditure cuts. Therefore, development expenditure will be substantially lower than the 1986/87 budget estimate. The staff's preliminary view is that, in light of expenditure cuts and overestimation of aid utilization, development expenditure would increase by 30 percent at most in 1986/87.

Net lending during 1986/87 is budgeted at negative NRs 246 million (negative NRs 127 million estimated for 1985/86), partly representing scheduled sales to the public of government-held equity. The figure is about half of the planned sales during 1985/86, none of which materialized at that time, for reasons explained earlier. The authorities indicated that these scaled-down amounts refer to those cases in which the legal problems surrounding government divestiture could be resolved in 1986/87 in time for those sales to proceed.

With the adjustments in the domestic sales prices of chemical fertilizers and the downward trend in international prices of petroleum and petroleum-based fertilizers, the financial position of the major public enterprises concerned is expected to improve substantially in 1986/87. The Agricultural Input Corporation (AIC), which distributes fertilizers, does not borrow from banks but receives government subsidies. However, fertilizer subsidies to the AIC shown in the budget reflect only a portion of actual subsidies. The Government receives chemical fertilizers in the form of grants from aid donors and turns the fertilizers over to the AIC, which sells them at prices that until recently had been about 40 percent below market value; their provision at subsidized prices is aimed at encouraging the use of fertilizers in Nepal through programs jointly agreed with the donors. The AIC spends a portion of the sales proceeds to pay for cash imports of fertilizers and to cover other operating expenses, but has been unable to transfer some of the proceeds to the Government, partly because of difficulties in collecting payments from the Agricultural Development Bank of Nepal (ADBN), which extends credit to farmers for fertilizer purchases and has had problems recovering a large amount of such loans. The authorities have instructed the ADBN to step up its loan recovery efforts so that the AIC is repaid and can increase its contribution to the counterpart fund in the budget.

In light of a strong intervening decline in international prices of chemical fertilizers, at the end of July, the Government reduced their domestic sales prices by 5 percent across the board. Even with the small price reduction, however, net receipts from sales of fertilizers are expected to increase by about NRs 100 million (equivalent to about 0.2 percent of projected GDP) in 1986/87, assuming the continuation of the present international fertilizer prices. Given transportation costs, the price reduction is unlikely to result in the re-export of fertilizers to India. It is the authorities' intention to maintain the domestic sales prices of fertilizers at levels that will prevent their re-export.

The NOC, which is the sole importer and distributor of petroleum products, does not receive a subsidy from the Government, but borrows from banks to cover any deficit. The year 1985/86 was profitable for the NOC, although it incurred a substantial foreign exchange valuation loss on the stock of its short-term foreign loans resulting mainly from the November 30, 1985 devaluation. The NOC did not benefit fully from the decline in international oil prices, because the renegotiation of the terms of import contracts with the Indian Oil Corporation (IOC), took place only recently. 1/ The financial position of the NOC is, however, expected to improve markedly in 1986/87, even with the increased duty rates on petroleum products incorporated in the 1986/87 budget. The NOC, therefore, will be in a position not only to repay its loans to the banking system, but also to increase its contribution to taxes and profit sharing.

c. Monetary policy

During 1986/87, monetary/credit policy is to be conducted in a manner consistent with the overall balance of payments objective, the targeted output growth, and a sharp deceleration in the rate of inflation. The interest rate measures already taken will further enhance the ability of the banking system to attract deposits, and the authorities will contain the expansion of bank credit to levels commensurate with

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1/ The arrangement with the IOC calls for contract prices to be fixed every six months (from April 1 and from October 1) on the basis of the average Calcutta c.i.f. price during the preceding six months plus a markup (NRe 0.4 per liter) to cover costs of transportation, handling, and storage.

those resource flows. The domestic credit program for 1986/87 is consistent with the target for net foreign assets of the banking system and the projected demand for money, taking into account the impact of the interest rate reform on income velocity. Measured in relation to the broad money stock at the end of 1985/86, the credit program calls for a reduction in the rate of growth of NDA to about 14 percent during 1986/87 (about 21 percent estimated in 1985/86). Measured similarly, the growth of credit to the public sector, including the Government and nonfinancial public enterprises, is limited to about 6 percent (11 percent estimated in 1985/86). The restraint on bank borrowing by the public sector will allow credit to the private sector to increase by about 16 percent (23 percent estimated for 1985/86). 1/ Within the framework of the annual program, quantitative limits on NDA and on net credit to Government (performance criteria) and an indicative ceiling on credit to nonfinancial public enterprises have been established for October 15, 1986 and January 15, 1987, 2/ taking into account seasonal factors.

In order to increase the monetary authorities' control over the liquidity position of commercial banks, and therefore facilitate the implementation of the credit ceilings in 1986/87, the staff suggested that access to concessional refinancing facilities be made less automatic, and that the interest rate on treasury bills be freed, while that on NRB overdraft facilities to the Government be increased to comparable levels as a matter of some priority. The authorities have indicated their intention to keep these issues under careful review and, as a first step, have made a commitment to phase out in 1986/87 the access to NRB refinancing by the ADBN and the Nepal Industrial Development Corporation. Progress in this area will be assessed at the time of the second review of the stand-by arrangement.

d. External policies

Given the high degree of openness of the Nepalese economy to India, the Nepalese authorities and the staff agree that restrained demand management and wage policies, together with maintenance of appropriate interest rates, are the essential policy tools for achieving shorter-term balance of payments objectives. As a complement to those policies in achieving the program's external objectives and with a view to strengthening the balance of payments over the medium term, the authorities intend to pursue a policy of flexible exchange rate management. Exchange rate flexibility is to be pursued through the new exchange rate system introduced on May 31, 1986, under which the Nepalese rupee is pegged to a basket of currencies, including the Indian rupee. Exchange

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1/ The percentage expansion of credit to the private sector is measured in relation to the stock of such credit outstanding at the end of 1985/86.

2/ This is the final testing date for these credit aggregates under the prolonged stand-by arrangement.

rate management policy will be kept under close review in light of actual developments in external competitiveness, the overall balance of payments, and trends and flows of trade and capital. In the staff's view, achievement of the program's balance of payments objectives and maintenance of adequate external competitiveness should not require marked changes in the exchange rate between the Nepalese rupee and that of its major trading partner, India, if the financial program described above is fully implemented.

With a view to improving industrial growth prospects, the Government has introduced significant liberalization of imports of all inputs by the industrial sector. Under this scheme, entrepreneurs, upon documentation of production capacity and need for imported inputs, will receive entitlements (in the form of a passbook) to obtain requisite import licenses automatically, as needed, for a period of one year. This measure represents a first step in a phased reduction of reliance on quantitative import restrictions and a shift toward the use of tariffs. In addition, the authorities introduced an auction system for registered trades to obtain licenses with a total value of NRs 250 million to import a range of consumer goods from countries other than India. This scheme is designed to regulate the demand for those licenses, and is expected to generate considerable revenue.

Most of Nepal's public and publicly guaranteed external debt, which amounted to about SDR 482 million at end-1985/86 (21 percent of GDP), 1/ has been contracted on highly concessional terms. The debt service during 1985/86 is estimated at about 5 percent of exports of goods and services and private transfers. It was stated in the previous staff report (EBS/85/264, 12/3/85) that the Royal Nepal Airlines Corporation (RNAC) planned to purchase a passenger jet aircraft in late 1985/86 or early 1986/87 with a second aircraft to be acquired a year later, perhaps under a leasing arrangement. In May 1986, an agreement for two commercial jet aircraft to be delivered in September 1987 and September 1988 was signed. 2/ While discussions with the exporter and the U.S. Export-Import Bank have not been concluded, it appears that both aircraft may be obtained through a long-term financial leasing arrangement. The quarterly leasing payments arising from the delivery of the first aircraft, the contract value of which is about SDR 50 million, will commence in 1987/88 and that from the second aircraft in 1988/89. Taking into account the positive impact on foreign exchange earnings, and treating leasing payments as debt service, the debt service ratio is projected to increase from 5.2 percent in 1986/87 to 6.7 percent in 1987/88, and to 9.7 percent in 1988/89, largely as a result of these aircraft transactions. The authorities have undertaken to ensure that

1/ Including Trust Fund but excluding Fund credit of SDR 10.25 million (0.5 percent of GDP).

2/ The authorities are currently discussing with the U.S. Export-Import Bank a possible financial leasing arrangement for a period of 12 years and an annual leasing rate of 10 percent of contract value.

the necessary amounts will be set aside regularly by the airline to service the contracts before any dividends are paid to shareholders. 1/ The World Bank staff has generally endorsed these aircraft transactions, as the RNAC is profitable, does not have enough quality equipment to accommodate existing traffic, and should contribute sufficiently to foreign exchange earnings to cover the additional services payments. 2/

To avoid exacerbating the debt service burden over the medium term, the Government will strictly refrain from external borrowing on nonconcessional terms. In this regard, the publicly contracting or guaranteeing of new nonconcessional loans with maturities of 1-12 years will be limited to SDR 10 million during the whole period of the stand-by arrangement. Moreover, short-term borrowing will be limited to revolving loans traditionally required in the normal operations of the NOC, which have been at the ceiling established by the creditor bank for some time; this debt is likely to be reduced somewhat after October 1986.

3. Performance Criteria

Performance criteria for the remaining period of the arrangement were established as indicated in Table 4. These performance criteria apply to ceilings on net domestic assets of the banking system; ceilings on net domestic credit of the banking system to the Government; and a ceiling on nonconcessional external borrowing contracted or guaranteed by the Government, excluding contracts related to the prospective acquisition of the two aircraft by the RNAC. The purchase related to the January 15, 1987 performance criteria will also require the completion of a second review with the Fund by March 15, 1987. In the course of the review, the staff will discuss the progress made in achieving the program objectives.

IV. Medium-Term Prospects

The Nepalese authorities had not, at the time of the review discussions, concluded a review of the Seventh Development Plan in the light of recent developments. Nonetheless, preliminary discussions on medium-term policy parameters were held with the authorities and these parameters are incorporated in the scenarios presented in this section. The scenarios underscore the need for continued structural and adjustment measures beyond 1986/87 if a sustainably higher growth path is to be reached over the medium term. The scenarios indicate that in the

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1/ The RNAC is now 100 percent government owned, but under the Government's privatization policy, shares will soon be offered to the public, up to 49 percent of the total.

2/ The cash flow projections developed by the Nepalese and the supplier and reviewed by the U.S. Export-Import Bank indicate that the aircraft will be self-financing in foreign exchange right at the outset.

Table 4. Nepal: Quantitative Performance Criteria, 1986-87

	1986		1987
	Mid-July 1/ Est.	Mid-Oct. Ceilings	Mid-Jan. Ceilings
	(In millions of Nepalese rupees)		
Net domestic assets	12,698	13,165	13,590
Net credit to Government	7,420	7,660	7,825
	(In millions of SDRs)		
Net external nonconcessional loans of 1-12 years' maturity contracted or guaranteed by the Government cumulative through end of period	...	10 2/	10 2/
Memorandum items:			
Indicative ceilings on credit to nonfinancial public enterprises 3/	1,600	1,650	1,670

1/ Base figures.
2/ Excluding contracts related to the prospective acquisition of the two aircraft.
3/ Not performance criterion.

absence of increased domestic resource mobilization in particular, as well as appropriate supply policies, including trade liberalization, the reliance on demand management policies alone would unduly constrain Nepal's future economic growth without achieving medium-term balance of payments viability.

Two scenarios are shown in Appendix Tables 10 and 11 and Chart 7. Scenario I, which was prepared in close collaboration with the World Bank staff, assumes that the authorities would continue to increase domestic resource mobilization and other adjustment/structural measures during 1987/88-1990/91 in line with the 1986/87 economic program. In this scenario, real GDP growth is targeted to accelerate from 4 percent to 4.5 percent, while the rate of inflation moderates to 5 percent and gross international reserves are maintained above the equivalent of 3.5 months of imports. To achieve the growth objective, development expenditure would be increased significantly through increased domestic resources mobilization, enhanced aid absorption capacity, and restraint on regular expenditure, while reducing the domestically financed budget deficit in relation to projected GDP. In Scenario II, the gross international reserve target is retained as is the same inflation target from Scenario I, but assuming no adjustment or structural measures other than restrained demand management. Targets, policy parameters, and assumptions of the two scenarios are summarized in Appendix Table 12.

Given the foregoing targets, policy parameters, and assumptions, Scenario I indicates that exports and imports (excluding aircraft) in SDR terms would increase by annual average rates of 11 percent and 10 percent, respectively. Export volume growth would gradually accelerate to over 6 percent by 1990/91, while import volume growth would decelerate to less than 5 percent, reflecting progress in import substitution. The ratio of the external current account deficit to GDP, which is projected to rise from 9.1 percent in 1986/87 to 9.8 percent in 1988/89, would decline to 9.5 percent by 1990/91. 1/ Foreign aid disbursements are projected to increase at an annual average rate of 13 percent, reflecting improved aid absorption capacity and a shift toward quick disbursing aid. On this basis the overall balance of payments would be in annual surplus of SDR 12-19 million, with gross reserves being maintained above the equivalent of 3.5 months of imports throughout the period. Debt service payments would increase from 5.2 percent of exports of goods and services and private transfers in 1986/87 to about 10 percent in 1990/91, largely owing to payments related to the forthcoming acquisition of commercial aircraft.

With respect to the government budget, the ratio of revenue to GDP would rise by 3.1 percentage points to 13 percent by 1990/91. This increase in revenue, together with contained regular expenditure, would raise the revenue surplus (defined as revenue less regular expenditure)

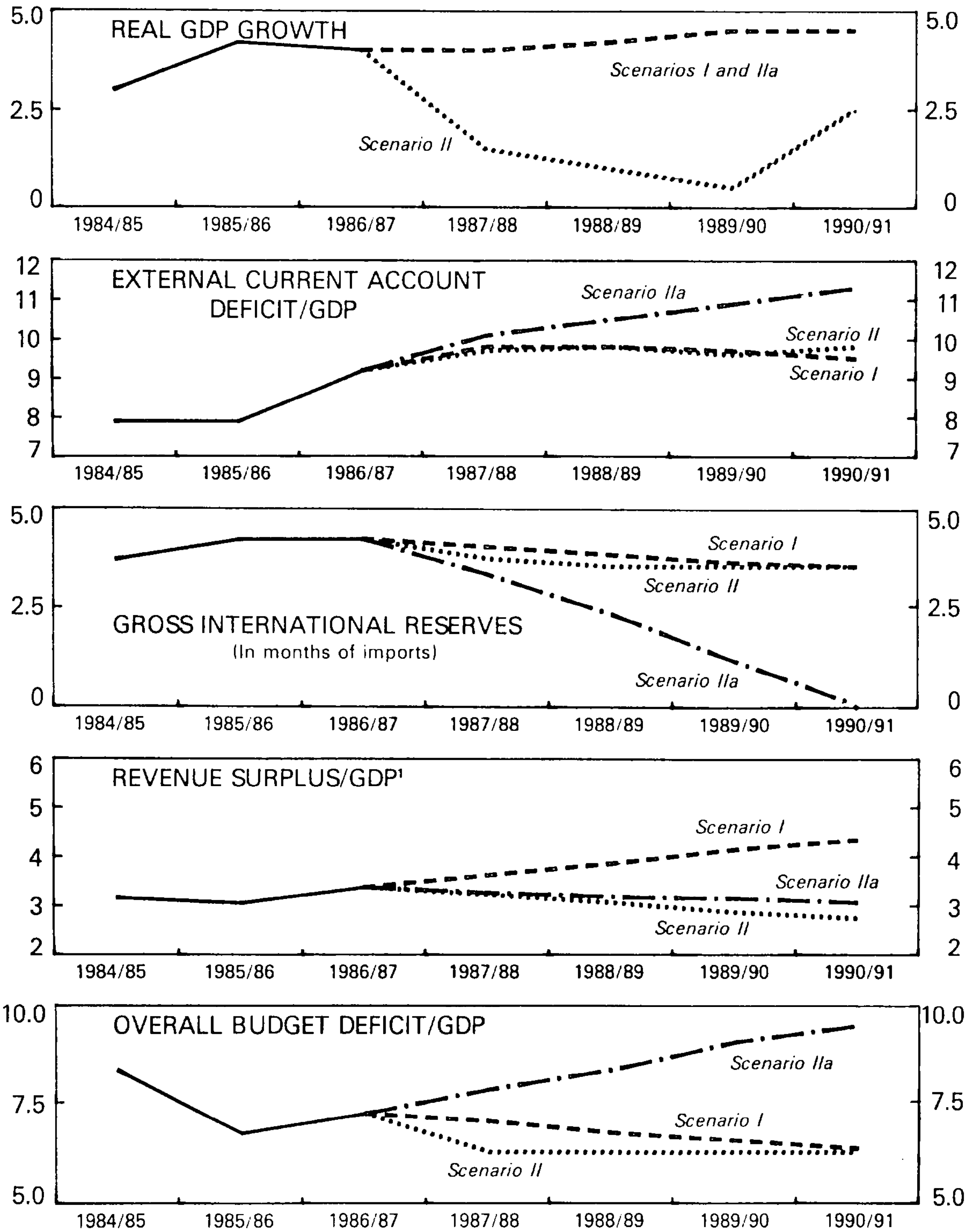
1/ The ratio excluding aid-financed imports would decline steadily from 3.1 percent in 1986/87 to 2.8 percent in 1990/91.

CHART 7

NEPAL

MEDIUM-TERM SCENARIOS, 1984/85-1990/91

(In percent, unless otherwise specified)



Sources: Data provided by the Nepalese authorities; and Fund and Bank staff's estimates.

1 Revenue surplus is defined as revenue less regular expenditure.

in relation to GDP by 2.4 percentage points in 1986/87 to 5.7 percent by 1990/91, thereby allowing development expenditure in relation to GDP to rise by 2.6 percentage points to over 16 percent by 1990/91. Nevertheless, the ratio of the overall budget deficit to GDP would steadily decline from 7.2 percent in 1986/87 to 6.3 percent in 1990/91. Most of the deficits would be financed by concessional foreign loans, with net domestic financing of the budget deficit reduced in relation to GDP from 2.0 percent in 1986/87 to 1.5 percent in 1990/91.

Scenario II shows that, in the absence of further efforts to increase domestic resource mobilization, improve aid utilization, and implement appropriate supply policies, real GDP growth would be constrained to the unacceptably low rate of 1.4 percent per annum. Both exports and imports in SDR terms would increase by 8 percent per annum (3 percent in real terms). Mainly owing to an increase in aid-financed imports, the ratio of the external current account deficit to GDP would rise by 0.5 percentage point to 9.7 percent in 1987/88 and would remain around that level through 1990/91; excluding aid-financed imports, the ratio would decline steadily from 3.1 percent in 1986/87 to 2.2 percent in 1990/91. The overall balance of payments, which is projected to shift to a deficit of SDR 4 million in 1987/88, would be in annual surplus of SDR 5-23 million during 1988/89-1990/91, consistent with the targeted external reserve level of 3.5 months of imports equivalent.

With respect to the budget, revenue in relation to GDP would decline slightly to 9.8 percent by 1990/91. With the assumed increase in regular expenditures, therefore, the revenue surplus in relation to GDP would decline from 3.3 percent in 1986/87 to 1.7 percent in 1990/91. This, together with the targeted reduction in the domestically financed budget deficit, would necessitate that the ratio of domestically financed development expenditure to GDP be halved to 2.6 percent by 1990/91. Thus, despite an increase in foreign-financed development expenditure, the ratio of total development expenditure would decline by about 2 percentage points to 12.2 percent by 1990/91. The overall budget deficit to GDP would also decline from 7.2 percent in 1986/87 to 6.2 percent in 1987/88 and would remain at that level through 1990/91.

Scenario IIa, also summarized in Chart 6, is a simulation of Scenario II, in which the authorities aim at accelerating real GDP growth to 4.5 percent (as in Scenario I) without, however, undertaking the additional adjustment/structural measures in Scenario I. The simulation result summarized in Scenario IIa indicates that, with such a policy of demand stimulus, the overall balance of payments would shift to a deficit of SDR 18 million by 1987/88 and that the deficit would widen rapidly to SDR 63 million. Gross international reserves would be completely depleted by end-1990/91.

These medium-term projections are highly sensitive to the underlying assumptions, in particular those related to weather and aid utilization. If these assumptions do not materialize, Nepal's medium-term prospects for sustained economic growth with balance of payments viability could be jeopardized even with the implementation of adjustment policies assumed in Scenario I. A deterioration in the terms of trade would also have serious implications for the medium term. According to the staff's calculation, a deterioration in the terms of trade by 1 percent per year would raise the ratio of the current account deficit to GDP in 1990/91 by about 2 percentage points in both Scenarios I and II.

V. Staff Appraisal

The implementation of the 1985/86 adjustment program was complicated by developments during the first four months of 1985/86, before the stand-by arrangement in support of the program was approved. External account pressures intensified in the early months of 1985/86, with the annualized overall balance of payments deficit in the first three months (through mid-October) reaching a level twice that of 1984/85. The continuation of excessive domestic financing of the budget deficit and a fully accommodative credit policy also contributed to inflationary pressures, with the underlying inflation rate accelerating by over 4 percentage points between July and November 1985. The situation was exacerbated by tightly administered import licenses and price increases in conditions of excess domestic demand and growing relative price imbalances.

Following the devaluation of November 30, 1985, the adjustment program was announced in late December. Thus, the economic program came into effect almost halfway through 1985/86. The authorities then moved decisively to tighten demand management in order to ensure a rapid strengthening of the external accounts. In the staff's view, although the initial policy response was somewhat delayed, and further adjustments were required, the authorities have made commendable efforts to bring the program back on track and this has yielded results that are quite encouraging. Although at a pace somewhat slower than the recovery rate originally expected, in part reflecting developments in the terms of trade, the economic recovery is proceeding, while the underlying rate of inflation has at least stabilized. The encouraging developments in nontraded goods prices, which reflect the recent tight demand management and wage restraint policies, have increased the relative profitability of the export sector. Export volume data suggest a positive response to the devaluation while the renewed confidence in exchange rate relationships resulted in capital repatriation. The weak reserve position has been strengthened as the overall balance of payments has shifted to a modest surplus. Indeed, the extent of the balance of payments turnaround is masked by the revaluation loss (in terms of SDRs) in the stock of reserves.

The additional adjustment measures taken recently were timely and will strengthen growth and balance of payments prospects in the period ahead. The domestic price adjustments for fertilizers will strengthen the financial position of the public entities involved and, indirectly, the budget, while discouraging the undesirable re-export of these commodities. The staff also attaches great importance to the major reform of interest rates, which should strengthen the financial sector, while promoting financial savings and improving their allocation. In addition, the interest rate reform marks an important step toward shifting monetary/credit management away from reliance on administrative guidelines and toward a more flexible system in which central bank (NRB) control is exerted through changes in the price and availability of bank liquidity.

The decision to phase out the NRB's refinancing facilities for the ADBN and the Nepal Industrial Development Corporation in 1986/87 is also encouraging. However, to provide a firm basis for flexible credit management, the system of automatic refinancing facilities should be carefully reviewed with a view to giving the monetary authorities greater discretion. Further adaptations are also required in the interest rate structure to strengthen the tools of monetary and credit management. In particular, the interest rate on treasury bills should be freed and that on NRB overdrafts to Government raised to comparable levels as a matter of some priority, and treasury bills should, over time, be substituted for overdrafts in the NRB's portfolio. In addition, the interest rates on government long-term savings certificates and development bonds should be reviewed in light of evident problems in placing these instruments with the nonbank sector, and consideration should be given to the early development of instruments with maturities below the 10-15 years currently available.

With the alleviation of the immediate external strains, and with the program moving along the desired path, the authorities are now positioned to consolidate the stabilization gains while strengthening further the growth-oriented structural policies. In this regard, the staff is encouraged by the progress in the authorities' discussions with the World Bank staff for a first structural adjustment loan and, in general, with the donors' positive response to Nepal's adjustment policy initiatives. The degree of success in efforts to enhance Nepal's capacity to absorb external resources efficiently will have a very important bearing on medium-term growth prospects. But if success is to be achieved, and if the benefits of aid-financed projects are to be fully realized, Nepal will have to continue to strengthen considerably its own resource mobilization efforts. Indeed, the major policy conclusion arising from the medium-term scenarios is that the need for substantial and sustained improvements in domestic resource mobilization is at the very heart of Nepal's adjustment problem. In this regard, the revenue measures introduced with the 1986/87 budget are an encouraging step.

Given the definable limits on the speed of adjustment in the revenue mobilization area in a low-income country like Nepal, and the inevitable strains associated with the process, prudent restraint in managing regular expenditure should be given high priority to ensure that a growing share of resources is allocated to development purposes and visible progress achieved.

The fiscal program described in the Government's attached letter, together with the other policies contained therein, is aimed at moving the economy significantly further toward sustained higher growth with external viability and price stability over the medium term. Its emphasis on a core investment program, higher levels of operations and maintenance expenditures, and improvements in project monitoring and implementation, is consistent with the medium-term growth strategy discussed with the World Bank and endorsed by the aid donors. In the staff's view, its policy content is consistent with the attainment of the appropriate macroeconomic targets established for 1986/87. It would be prudent, in implementing the fiscal program, to limit the level of regular expenditure below the budgeted level in order to permit a higher level of development expenditures and to ensure adequate local currency counterpart funds for aid projects.

The staff would also urge the authorities to review closely the operations of each of the major nonfinancial public enterprises and to formulate, as part of the budgetary process, financial plans for them to ensure that these enterprises contribute adequately to the financing of Nepal's development program. In this regard, the staff greatly welcomes the action to reduce the fertilizer subsidy and would hope that this signals the beginning of a sustained effort to cut back sharply on the range of subsidies to public sector entities.

Finally, the staff would underscore the need for careful balance and coordination between external and domestic policies. It is important that Nepal's adjustment policies provide for maintenance of adequate relative prices both for successful management of the external accounts in the shorter term, and for strengthening the growth prospects of the traded goods sector in the medium term. Given the extent of openness of the economy of Nepal to India, this outcome will require perseverance in the implementation of restrained financial and wage policies and appropriate interest rates. The staff welcomes the authorities' intention to complement those policies with a flexible exchange rate management policy that offers additional assurances that both shorter- and medium-term external objectives will be achieved. Those policies together should lead to a strengthening of the structurally weak balance of payments and will permit measured progress toward import liberalization in support of the growth process. The measures to ease the application of quantitative import restrictions in 1986/87 is a welcome first step in this direction. The authorities should now formulate a medium-term program for phased reduction in reliance on quantitative import restrictions, shifting toward use of appropriate tariff levels as necessary.

The staff believes that the proposed three-month extension of the stand-by arrangement is warranted to fully achieve adjustments envisaged in the original program. With the extension of the arrangement, and given the recent strengthening of policy formulation, including measures to liberalize interest rates and imports, and to significantly increase domestic resource mobilization, the staff supports the authorities' request for a purchase upon completion of this review; this would require a waiver of the applicability of the quantitative performance criteria for July 15, 1986 in respect of which final data will not be available at the time of the completion of the review, i.e., on net domestic assets of the banking system and net domestic bank credit to Government for July 15, 1986. This waiver is being recommended in the context of the authorities' recent success in aligning domestic credit expansion close to the program path and in the expectation that this trend continued in July.

VI. Proposed Decision

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

1. Nepal has consulted with the Fund in accordance with paragraph 3 of the stand-by arrangement for Nepal (EBS/85/264, Sup. 2; 12/26/85) and paragraph 3 of the letter dated December 3, 1985 from the Minister of Finance of Nepal, in order to review the progress made by Nepal in implementing the program supported by the arrangement and to establish suitable performance criteria for the remaining period of the arrangement and has requested an extension of the period of the arrangement to April 22, 1987.

2. The letter dated August 10, 1986 together with the technical memorandum from the Minister of State for Finance and Industry of Nepal shall be attached to the stand-by arrangement and the letter dated December 3, 1985 with annexed memoranda shall be read as supplemented and modified by the letter of August 10, 1986 together with the technical memorandum.

3. Accordingly,

(a) the period of the stand-by arrangement is extended to April 22, 1987;

(b) purchases under the arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 12.35 million until December 15, 1986 and the equivalent of SDR 15.5 million until March 15, 1987;

(c) Nepal will not make purchases under the arrangement that would increase the Fund's holdings of Nepal's currency in the credit tranches beyond 25 percent of quota:

(i) during any period in which the data at the end of the preceding period indicate that the quarterly limit on net domestic assets of the banking system or the quarterly limit on net bank claims on the Government set out in the technical memorandum attached to the letter of August 10, 1986 is not observed; or

(ii) if Nepal fails to observe the limit on the contracting or guaranteeing of new nonconcessional foreign indebtedness set out in paragraph 22 of the letter of August 10, 1986; or

(iii) during any period after March 15, 1987 until the review of the progress of Nepal in implementing the program supported by the arrangement, contemplated in paragraph 23 of the letter of August 10, 1986 has been completed.

4. The Fund decides that the review contemplated in paragraph 3 of the stand-by arrangement is completed and that Nepal may proceed to make purchases under the arrangement, notwithstanding the nonavailability of all the data for the period ending July 15, 1986.

Table 5. Nepal: Balance of Payments, 1982/83-1986/87 1/

(In millions of SDRs)

	1982/83	1983/84	1984/85 Prov.	1985/86 Original program	1985/86 Revised est.	1986/87 Program
Exports, f.o.b.	76	106	157	162	144	154
Imports, c.i.f.	-424	-408	-462	-505	-451	-490
Aid imports	-86	-91	-92	-117	-105	-138
Non-aid imports	-338	-316	-370	-388	-346	-352
Trade balance	-348	-301	-305	-342	-307	-336
Services (net)	109	88	79	88	81	83
Receipts	169	161	153	168	151	171
Payments	-59	-73	-74	-81	-80	-89
Private transfers (net)	39	43	43	46	46	45
Receipts	41	46	45	48	50	50
Of which: Private remittances	(37)	(38)	(39)	(38)	(39)	(40)
Payments	-2	-2	-2	-2	-4	-5
Current account balance	-200	-170	-183	-209	-180	-207
Nonmonetary capital movements	156	152	131	205	184	219
Official grants	77	73	85	99	87	107
Official capital (net)	62	89	62	106	81	90
Foreign loans	64	93	66	114	89	98
Amortization	-2	-4	-4	-8	-7	-9
Structural adjustment loan (IBRD)	--	--	--	--	--	23
Other capital (net) 2/	17	-9	-17	--	16	--
Overall balance 3/	-44	-18	-53	-4	4	12
Monetary movements	44	18	53	4	-4	-12
Assets (increase -)	59	20	46	-7	-11	-18
Liabilities	-15	-2	7	11	7	6
Of which: Fund credit (net)	-6	-4	-5	13	9	8
Trust Fund (net)	--	-1	-1	-2	-2	-3
Memorandum item:						
Gross reserves	210	190	144	151	155	173

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

1/ Totals may not add up due to rounding.
2/ Including errors and omissions and valuation adjustments.
3/ Defined as changes in net foreign assets in monetary survey.

Table 6. Nepal: Central Government Budget, 1982/83-1986/87 1/

	1982/83	1983/84	1984/85 Revised Estimates	1985/86 Original budget	1985/86 Original program	1985/86 Revised estimates	1986/87 Budget proj.	1986/87 Staff proj.
	(In millions of Nepalese rupees)							
Revenue and grants	3,898	4,205	4,772	7,100	6,853	5,866	7,989	7,285
Revenue	2,808	3,328	3,849	5,175	4,903	4,485	5,615	5,525
Tax	2,430	2,737	3,151	4,264	4,183	3,752	4,756 2/	4,665 2/
Nontax	377	591	698	911	720	733	859	860
Grants	1,090	877	923	1,925	1,950	1,381	2,374	1,760 3/
Total expenditure	6,851	7,204	8,153	10,827	10,239	9,147	12,404	11,265
Regular	1,900	2,107	2,720	3,681	3,625	3,281	3,904	3,700
Of which: wages and salaries	(720)	(863)	(1,222)	(...)	(...)	(1,294)	(1,341)	(1,342) 4/
Development	4,982	5,164	5,489	7,486	6,954	5,993	8,746	7,811
Domestically financed	2,906	2,616	2,811	2,944	2,616	2,387	2,951	2,921
Foreign financed	2,076	2,548	2,678	4,542	4,338	3,606	5,795	4,890
Net lending	-31	-67	-56	-340	-340	-127	-246	-246
Overall balance	-2,953	-2,999	-3,381	-3,727	-3,387	-3,281	-4,415	-3,980
Excluding grants	-4,043	-3,876	-4,304	-5,652	-5,337	-4,662	-6,789	-5,740
Net foreign financing	938	1,604	1,699	2,459	2,258	2,066	3,175	2,880
Disbursements	986	1,671	1,755	2,617	2,388	2,225	3,421	3,130 3/
Amortizaton	-48	-56	-56	-158	-130	-159	-246	-250
Net domestic financing	2,015	1,395	1,682	1,268	1,130	1,215	1,240	1,100 4/
Banking system	2,028	939	1,441	770	800	950	800	800 4/
Other domestic	-13	456	241	498	330	265	440	300
	(In percent of GDP)							
Memorandum items:								
Revenue	8.4	8.7	9.4	10.6	10.0	9.2	10.1	9.9
Of which: Tax	(7.2)	(7.2)	(7.7)	(8.7)	(8.6)	(7.7)	(8.6)	(8.4)
Total expenditure	20.4	18.9	19.9	22.2	21.0	18.8	22.3	20.3
Of which: Domestically financed expenditure	(14.3)	(12.4)	(13.5)	(13.6)	(12.8)	(11.6)	(12.3)	(11.9)
Revenue surplus 5/	2.7	3.2	2.8	3.1	2.6	2.5	3.1	3.3
Overall balance	-8.8	-7.9	-8.3	-7.6	-6.9	-6.7	-7.9	-7.2
Net domestic financing	6.0	3.7	4.1	2.6	2.3	2.5	2.2	2.0 6/

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

1/ Totals may not add up due to rounding.
2/ Including new tax measures of NRs 415 million.
3/ Based on aid-disbursements projected by the Fund and World Bank staffs.
4/ Agreed program parameters.
5/ Defined as revenue less regular expenditure.
6/ Exactly 1.98 percent of GDP.

Table 7. Nepal: Monetary Survey, 1983-87

	1983 July	1984 July	1985/86 July	1985/86 October	1985/86 January	1985/86 April	1985/86 May (Preliminary)	1985/86 June (Preliminary)	1986/87 July (Est.)	1986/87 July (Rebased Est.)	1986/87 October (Ceilings)	1986/87 January (Ceilings)	1986/87 July (Targets)
	(In millions of Nepalese rupees) 1/												
Net foreign assets 2/	3,210	2,758	1,760	1,326	1,847	2,110	2,102	2,125	2,040	2,422 3/	2,345 3/	2,560 3/	2,710 3/
Net domestic assets 4/	6,013	7,697	10,537	11,297	11,740	12,735	13,217	12,960	13,080	12,698	13,165	13,590	14,770
Domestic credit	8,491	9,825	12,481	13,205	14,005	14,966	15,024	15,199	15,354	15,354	15,787	16,485	17,656
Government, net	4,090	5,029	6,470	6,757	7,006	7,095	7,165	7,362	7,420	7,420	7,660	7,825	8,220
Nonfinancial public enterprises	1,137	953	1,163	1,289	1,331	1,462	1,634	1,587	1,600	1,600	1,650	1,670	1,775
Private sector	3,264	3,842	4,848	5,159	5,668	6,409	6,225	6,250	6,334	6,334	6,477	6,990	7,661
Other items, net	-2,478	-2,127	-1,944	-1,908	-2,265	-2,231	-1,807	-2,239	-2,274	-2,656	-2,622	-2,895	-2,886
Broad money	9,223	10,455	12,297	12,623	13,587	14,845	15,319	15,085	15,120	15,120	15,510	16,150	17,480
	(Percentage change over the same month of previous year) 5/												
Net domestic assets	36.7	18.3	27.2	28.4	24.2	23.3	20.7	18.4	20.7	20.2	16.8	16.2	13.7
Domestic credit	32.9	14.5	25.4	29.2	27.7	26.0	25.3	23.7	23.4	23.4	20.5	18.3	15.2
Government, net	27.2	10.2	13.8	13.6	11.8	9.5	9.5	9.7	7.7	7.7	7.2	6.0	5.3
Nonfinancial public enterprises	4.0	-2.0	2.0	3.3	3.0	2.2	3.8	3.2	3.6	3.6	2.9	2.5	1.2
Private sector	1.7	6.3	9.6	12.3	12.9	14.4	12.0	10.8	12.1	12.1	10.4	9.7	8.8
Broad money	23.7	13.4	17.6	19.2	21.9	22.9	24.7	21.5	23.0	23.0	22.9	18.9	15.6

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

1/ Totals may not add up due to rounding.
2/ Valued at the exchange rates prevailing as of July 15, 1985.
3/ Valued at the exchange rates prevailing as of end-January 1986.
4/ Defined as broad money less net foreign assets measured at constant exchange rates.
5/ In relation to the broad money stock at the end of the previous period.

Table 8. Nepal: Structure of Interest Rates, 1986

	As of May 28,1986 (Pre-reform)	As of June 30, 1986
Commerical banks		
Deposits		
Savings	8.5	8.5
Time deposits (3 months)	4.5	8.5
Time deposits (6 months)	9.5	8.75
Time deposits (1 year)	12.5	12.5
Time deposits (2 years)	13.5	13.5
Loans		
Industry (priority purposes)	9.0-17.0 1/	15.0-18.0
Agricultural (priority purposes)	8.0-15.0 1/	15.0-16.0
Commercial loans and overdrafts	17.0	19.0-21.0
Agricultural Development Bank		
Cooperative and Sajhas	4.0-11.6	11.0-18.0
Others	8.0-15.0	13.0-20.0
Nepal Industrial Development Corporation		
According to type of industry	12.0-17.0	14.5-18.0
Government		
Treasury bills	5.0	5.0
Development bonds	10.5	10.5
National Savings Certificates	13.0	13.0

Source: Data provided by the Nepalese authorities.

1/ Banks were required to charge 2 percent less interest on loans to cottage industry and agricultural sectors of 18 remote districts.

Table 9. Nepal: 1986/87 New Tax Measures

New tax measures	Estimated Additional Revenue
1. Sales tax	NRs 106 million
The sales tax rate structure was simplified and the tax base was broadened. The sales tax previously had 17 rates on domestic transactions ranging between 1-20 percent, and 7 rates on imports ranging between 1-20 percent, with markups mostly in the 5-25 percent range on domestic production and reaching up to 200 percent on imports from countries other than India. The markup system on domestic production was discontinued and the number of rates was reduced to four, with an additional zero rate to be applied to basic food items, medicine, and other essential goods and services, such as water, firewood, and local mass transport, needed by lower-income groups. A high rate of 20 percent is charged on non-essential and luxury items and on other goods and services consumed largely by high-income groups. Rates of 5 percent, 10 percent, and 15 percent are charged on all other goods and selected services. 1/	
Telephone service is now subject to the general sales tax rate of 5 percent.	
2. Excise duty	NRs 22 million
The rates of excise duty on selected items, such as alcoholic beverages and soft drinks, were raised.	

Table 9. Nepal: 1986/87 New Tax Measures (continued)

	New tax measures	Estimated Additional Revenue
	A flat rate was introduced for rice and edible oil mills, which were previously levied different rates depending on capacity, while eliminating excise duty on some widely used construction materials and selected products mainly produced by cottage industries.	
3.	Income tax	NRs 63.5 million
	A reduced flat allowance for transportation, education and periodicals for purposes of personal income tax deductions was introduced, 2/ and the provision for withholding tax on interest, dividends and rental income was generalized.	
	A flat corporate tax rate of 40 percent was introduced for corporations, while allowing those corporations to deduct 20 percent of dividends from income tax and exempting cottage and village industries from income tax on profits up to NRs 100,000.	
4.	Tax on international trade	NRs 195 million
	The import duty on petroleum products was increased from NRs 3.3 to NRs 4.05 per liter for gasoline, from NRe 0.85 to NRs 1.6 per liter for diesel, and from NRs 4.4 to NRs 5.5 per liter for lubri cants.	(NRs 73.5 million)
	The list of imports not eligible for the 1 percent duty rate under the Industrial Enterprise Act was expanded, thereby increasing the number of imports subject to higher rates (5 or 10 percent).	(NRs 36 million)

Table 9. Nepal: 1986/87 New Tax Measures (concluded)

	New tax measures	Estimated Additional Revenue
	Duty rates on synthetic fibers and yarn were increased from 22 to 50 percent.	(NRs 29 million)
	Import duty on sugar was changed from an ad valorem rate of 11 percent to NRs 2,500 per ton (35 percent of present landed cost).	(NRs 19 million)
	Duties on certain imports such as jeeps, video cassettes, and television sets were increased.	(NRs 30.5 million)
	Duties on exports of logs, timber, and catacheu were increased.	(NRs 7 million)
5.	Property transfer tax	NRs 15 million
	The minimum property values were increased to more realistic levels.	
6.	Air flight departure tax	NRs 14 million
	An increase in the tax rate.	
7.	Other measures	NRs -0.5 million
	Increases in entertainment and vehicle taxes.	(NRs 2 million)
	Abolition of stamp fees	(Negative NRs 2.5 million)
	Total addition revenue	NRs 415 million

1/ For example, a 5 percent rate is charged on tea, vegetable oil, and soap; a 10 percent rate on acrylic yarn and chemicals; and a 15 percent rate on aviation fuel, paint and toilet soap.

2/ Deductions of 15 percent of personal income after Provident Fund contribution up to a maximum of NRs 3,000 per annum.

Table 10. Nepal: Medium-Term Prospects--Scenario I,1986/87-1990/91

	1986/87 Program	1987/88	1988/89	1989/90	1990/91
		Projections			
		(Annual percentage change)			
Output and prices					
Real GDP growth	4.0	4.0	4.2	4.5	4.5
Inflation (annual average)	9.5	6.0	5.0	5.0	5.0
External sector					
Exports, f.o.b.	6.9	9.9	10.5	11.0	11.3
Imports, c.i.f. 1/	8.6	11.7	9.2	8.8	8.6
Export volume	4.8	5.1	5.7	6.0	6.2
Import volume 1/	11.6	7.5	5.0	4.6	4.7
Terms of trade	4.8	0.6	0.5	0.7	0.7
Government budget					
Revenue	23.2	19.0	17.1	17.9	15.5
Regular expenditure	12.8	13.6	12.1	11.7	11.4
Development expenditure	30.3	13.8	13.3	13.5	12.2
	(In percent of GDP; unless otherwise indicated)				
External sector					
Exports, f.o.b.	6.8	6.8	6.8	6.8	7.0
Imports, c.i.f. 1/	21.6	21.9	21.8	21.7	21.5
Current account deficit 1/	9.1	9.8	9.9	9.7	9.5
(excluding aid imports)	3.1	3.1	3.2	3.0	2.8
External public debt	26.9	31.9	34.5	36.5	38.3
Of which: Fund credit 2/	(0.8)	(0.7)	(0.6)	(0.3)	(--)
(In percent of quota)	(50.0)	(50.0)	(42.4)	(20.2)	(2.8)
Debt service ratio 3/	5.2	6.7	9.7	10.5	9.5
Of which: Obligations due to the Fund 2/	(0.3)	(0.4)	(0.9)	(1.8)	(1.2)
Government budget					
Revenue	9.9	10.7	11.5	12.3	13.0
Regular expenditure	6.7	6.9	7.0	7.2	7.3
Revenue surplus 4/	3.3	3.9	4.5	5.2	5.7
Development expenditure 5/	14.1	14.5	15.0	15.5	15.9
Foreign aid disbursements	8.8	9.3	9.3	9.2	9.2
Overall deficit	7.2	7.0	6.7	6.5	6.3
(excluding grants)	10.3	10.6	10.6	10.4	10.2
Net domestic financing	2.0	1.8	1.7	1.6	1.5
		(In millions of SDRs)			
Exports, f.o.b.	154	169	187	208	231
Imports, c.i.f.	490	597	598	650	708
Current account deficit	207	295	270	291	314
Nonmonetary capital movements	219	306	281	306	333
Of which: Foreign aid disbursements	228	269	298	325	354
Overall balance	12	11	11	14	19
Gross reserves (end of period)	173	181	188	193	205
(In months of imports)	(4.2)	(4.0)	(3.8)	(3.6)	(3.5)

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

1/ Excluding the prospective acquisition of the two aircraft.
2/ Excluding Trust Fund.
3/ In percent of exports of goods and services and private transfers and including leasing payments arising from the prospective acquisition of the two aircraft.
4/ Defined as revenue less regular expenditure.
5/ Excluding net lending.

Table 11. Nepal: Medium-Term Prospects--Scenario II, 1986/87-1990/91

	1986/87 Program	1987/88	1988/89	1989/90	1990/91
		Projections			
		(Annual percentage change)			
Output and prices					
Real GDP growth	4.0	1.5	1.0	0.5	2.5
Inflation (annual average)	9.5	6.0	5.0	5.0	5.0
External sector					
Exports, f.o.b.	6.9	8.0	8.0	8.3	8.3
Imports, c.i.f. 1/	8.6	9.9	6.9	6.4	8.3
Export volume	4.8	3.3	3.3	3.3	3.4
Import volume 1/	11.6	5.8	2.7	2.3	4.1
Terms of trade	4.8	0.6	0.5	0.7	0.7
Government budget					
Revenue	23.2	6.8	5.9	5.4	7.4
Regular expenditure	12.8	13.6	12.1	11.7	11.4
Development expenditure	30.3	-1.8	5.0	3.5	5.5
	(In percent of GDP; unless otherwise indicated)				
External sector					
Exports, f.o.b.	6.8	6.8	6.9	7.1	7.2
Imports, c.i.f. 1/	21.6	22.1	22.2	22.4	22.6
Current account deficit 1/	9.1	9.8	9.8	9.6	9.8
(excluding aid imports)	3.1	2.9	2.7	2.3	2.2
External public debt	26.9	31.8	34.7	37.6	39.9
Of which: Fund credit 2/	(0.8)	(0.8)	(0.6)	(0.3)	(--)
(In percent of quota)	(50.0)	(50.0)	(42.4)	(20.2)	(2.8)
Debt service ratio 3/	5.2	6.7	9.9	10.9	10.0
Of which: Obligations due to the Fund 2/	(0.3)	(0.4)	(1.0)	(1.9)	(1.3)
Government budget					
Revenue	9.9	9.9	9.9	9.8	9.8
Regular expenditure	6.7	7.0	7.4	7.9	8.1
Revenue surplus 4/	3.3	2.8	2.4	2.0	1.7
Development expenditure 5/	14.1	12.8	12.7	12.5	12.2
Foreign aid disbursements	8.8	8.6	9.0	9.4	9.6
Overall deficit	7.2	6.2	6.2	6.2	6.2
(Excluding grants)	10.3	10.0	10.3	10.5	10.5
Net domestic financing	2.0	1.8	1.7	1.6	1.5
		(In millions of SDRs)			
Exports, f.o.b.	154	166	180	195	211
Imports, c.i.f.	490	588	575	612	663
Current account deficit	207	288	253	263	287
Nonmonetary capital movements	219	284	258	283	310
Of which: Foreign aid disbursements	205	246	275	302	331
Overall balance	12	-4	5	20	23
Gross reserves (end of period)	173	166	166	177	195
(In months of imports)	(4.2)	(3.7)	(3.5)	(3.5)	(3.5)

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

1/ Excluding the prospective acquisition of the two aircraft.
2/ Excluding Trust Fund.
3/ In percent of exports of goods and services and private transfers and including leasing payments arising from the prospective acquisition of the two aircraft.
4/ Defined as revenue less regular expenditure.
5/ Excluding net lending.

Table 12. Nepal: Targets, Policy Parameters, and Assumptions of Medium-Term Scenarios

	Scenario I	Scenario II
1. Targets		
Real GDP growth	Raise from 4 percent in 1986/87 to 4.5 percent in 1990/91	Projected
Inflation rate	Reduce from 9.5 percent in 1986/87 to 5 percent in 1990/91	Same as Scenario I
Gross international reserves	Maintain at least the equivalent of 3.5 months of imports	Same as Scenario I
2. Policies		
Supply policy	Strengthening of measures to stimulate production, with emphasis on export-oriented industries	None
Fiscal policy	Sustained sizable increases in development expenditure through greater mobilization of domestic resources (an increase in budget revenue by at least 0.7 percentage point of GDP per year) and enhanced aid utilization capacity. A containment of increases in regular expenditure to an annual average rate of 12 percent.	A containment of increases in regular expenditure to an annual average rate of 12 percent. A reduction in net domestic financing of the budget deficit in relation to GDP to 1.5 percent by 1990/91.

Table 12. Nepal: Targets, Policy Parameters, and Assumptions of Medium-Term Scenarios (continued)

	Scenario I	Scenario II
	A reduction in net domestic financing of the budget deficit in relation to GDP to 1.5 percent by 1990/91. Higher levels of expenditure for operations and maintenance. Strengthening of the financial position of public enterprises.	
Monetary/credit policy	Domestic credit expansion consistent with the growth, inflation, and external reserve targets. Further interest rate reforms, and maintenance of positive real interest rates for key bank loans and deposits.	Domestic credit expansion consistent with the inflation and external reserve targets, as well as projected real growth.
External policy	Further liberalization of the trade system. Flexible exchange rate management.	None

Table 12. Nepal: Targets, Policy Parameters and
Assumptions of Medium-Term Scenarios (concluded)

	Scenario I	Scenario II
3. Assumptions		
Weather condition	Favorable.	Same as Scenario I.
Restrictions on Nepal's exports by trade partners	No intensification.	Same as Scenario I.
Export prices	An annual average increase of 4.1 percent.	Same as Scenario I.
Imports	An annual average increase of 2.6 percent.	Same as Scenario I.
Aid disbursements	An annual average increase of 11.6 percent, with a shift toward quicker disbursing aid. About 70 percent of aid disbursements to be utilized for merchandise imports and service payments, and the remainder to cover local costs.	An annual average increase of 9.3 percent. About 70 percent of aid disbursements to be utilized for merchandize imports and service payments, and the remainder to cover local costs.
Service payments for two aircraft	The financial arrangements for the aircrafts to be delivered in September 1987 and a year later are the payments characteristics of a loan for 12 years, with grace period of 6 months and an interest rate of about 10 percent.	Same as Scenario I.

Nepal--Fund Relations
(As of June 30, 1986)

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 41.85 million (112.20 percent of quota)
(c) Fund credit:	SDR 10.25 million (27.5 percent of quota)
Of which: Credit tranche purchases (ordinary resources)	SDR 10.25 million (27.5 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:	
(i) Duration:	From 12/23/85 to 1/22/87
(ii) Amount:	SDR 18.65 million
(iii) Utilization:	SDR 10.25 million
(iv) Undrawn balance:	SDR 8.4 million
(b) Previous stand-by and extended arrangements during the last 10 years:	None
(c) Special facilities:	None

IV. SDR Department

(a) Net cumulative allocation:	SDR 8.1 million
(b) Holdings:	SDR 0.0779 million or 1 percent of net cumulative allocation
(c) Current Designation Plan:	Not applicable.

Nepal--Fund Relations (continued)
(As of June 30, 1986)

V. Administered Accounts

(a) Trust Fund loans:
(i) Disbursed: SDR 13.7 million
(ii) Outstanding: SDR 8.2 million
(b) SFF Subsidy Account: Not applicable.

VI. Overdue Obligations to the Fund

Not applicable.

VII. *Country has not used Fund resources to date*

Not relevant.

(B) Nonfinancial Relations

VIII. Exchange Rate Arrangement: On June 1, 1983, Nepal introduced an arrangement under which its currency is 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. On June 1, 1986, the exchange rate was changed to NRs 1.6808 per Indian rupee.

IX. Last Article IV Consultation: December 23, 1985; Decision No. 8158 (85/186). Staff discussions were held during September 4-18, 1985 (EBS/85/264, 12/3/85; and SM/85/326, 12/10/85). The Executive Board adopted the following decision:

Nepal--Fund Relations (continued)
(As of June 30, 1986)

"1. The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1985 Article XIV consultation with Nepal, in the light of the 1985 Article IV consultation with Nepal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

"2. The restrictions on the making of payments and transfers for current international transactions are maintained by Nepal in accordance with Article XIV, with the exception of the exchange restriction arising from a prescribed contractual limitation on the use of certain foreign currencies for effecting withdrawals by nonresidents of foreign currency deposits, which is subject to approval under Article VIII, Sections 2(a) and 3 (see EBS/85/264 and SM/85/326). The Fund urges the authorities to remove the exchange restriction that is subject to approval as soon as possible."

X. Technical Assistance:

(a) CBD: For four months in 1983, the Fund provided an advisor for 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

Nepal--Fund Relations (concluded)
(As of June 30, 1986)

investments in December 1984 and its report was sent to Nepal in April 1985.

(b) Fiscal: A mission in August 1984 reviewed government finances during the Seventh Plan (1985/86-1989/90) and its report was sent to Nepal in March 1985. A mission visited Kathmandu from February 22 to March 9, 1986 to: (1) help the authorities design a package of tax and other revenue measures that could substantially increase revenue in the short term; and (2) examine the scope for tax reform in the medium term.

(c) Exchange rate A technical mission on the exchange system visited Kathmandu during October 26-November 5, 1985. A follow-up mission visited Kathmandu during May 12-21, 1986 to assist in introducing a greater degree of flexibility in exchange rate management.

(d) Other: The Bureau of Statistics provided technical assistance on money and banking statistics in March 1982.

XI. Resident Representative/Advisor: The Fund provided staff members as Resident Advisors during 1977-July 1980 and from September 1981 to October 1985. In November 1985, Mr. van Til's title was changed from Resident Advisor to Resident Representative.

Nepal: Relations with the World Bank Group

Bank operations in Nepal began in 1969 with an IDA credit equivalent to $1.7 million for a telecommunications project. Since then, 37 additional projects have been approved, bringing total IDA assistance to the equivalent of $597.4 million. No Bank loans have been made to Nepal but IFC has made three loan/equity investments in the country totaling $9 million. To address the underdevelopment of the country's economic infrastructure, the Bank Group has allocated some 45 percent of its resources for Nepal to the transportation, telecommunications, and power and energy sectors. Agriculture, a sector that contributes about 60 percent of GDP, has accounted for 35 percent of Bank Group operations. Two projects in agriculture (Rural Development III and Narayani III Consolidation) and one project in industry (Cottage and Small Industry II) are under consideration.

The Bank Group's lending to Nepal so far has been modest compared with the country's total development requirements. 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 in irrigation 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 performance, rapid population growth, and scarcities of skilled labor) through a combination of project lending, technical assistance, and economic and sector work.

Technical assistance: The World Bank currently provides a staff member as resident representative. It also has been providing technical assistance in industrial finance and policy, rural, and cottage industry development. Under the Bank's new program of nonreimbursable technical assistance, one staff member joined the Ministry of Finance in June 1983 to assist in establishing a Development Project Monitoring and Evaluation System.

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 on the Seventh Plan review in November 1984 and one on manpower training assessment in January 1985.

Nepal--Lending by the World Bank Group 1/

(In millions of U.S. dollars)

Sectoral lending	IDA	IFC	Total	Of which: Undisbursed
Agriculture	113.3	--	113.3	68.4
Irrigation	94.5	--	94.5	30.5
Education	32.8	--	32.8	26.3
Water supply	46.8	--	46.8	10.3
Industry	18.0	9.0	27.0	9.2
Transportation	67.0	--	67.0	51.10
Telecommunication 2/	21.8	--	21.8	--
Power and energy	168.0	--	168.0	123.9
Other	13.2	--	13.2	5.2
Total	575.4	9.0	584.4	324.9 3/

Source: Data provided by the World Bank.

1/ As of May 31, 1986. No IBRD loans have been made to Nepal.

2/ Includes $22 million for Telecommunications IV approved by the IDA Board on April 30, 1985 but not yet signed.

3/ Adjusted for changes in U.S. dollar/SDR exchange rate as of approval and disbursement dates of IDA credits.

Nepal--Summary of the 1986/87 Program
Targets/Policy Parameters

	1984/85	1985/86		1986/87
	Actual	Program	Revised estimate	Program
I. Targets and objectives				
		(Percentage change)		
Real GDP	3.0	4.5	4.2	4.0
GDP deflator	4.0	12.0	14.5	9.5
CPI (annual average)	4.1	12.0	15.5	9.5
		(Percent of GDP)		
Overall budget deficit	8.3	6.9	6.7	7.2
(Excluding grants)	(10.5)	(10.9)	(9.6)	(10.3)
Net domestic financing of budget deficit	4.1	2.3	2.5	2.0
Of which: Banking system	3.5	1.6	1.9	1.4
		(Percentage change in relation to the broad money stock at the end of the previous period)		
Net domestic assets (at constant exchange rates)	27.2	18.6	20.7	13.7
Net credit to Government	13.8	6.5	7.7	5.3
Credit to nonfinancial public enterprises	2.0	1.0	3.6	1.2
Broad money	17.6	18.0	23.0	15.6
		(Percent of GDP; unless otherwise specified)		
External current account balance	-7.9	-8.9	-7.9	-9.1
(Excluding aid-financed imports)	-3.9	-3.9	-3.3	-3.1
Overall balance of payments (In millions of SDRs)	-52.8	-4.0	4.0	12.0
Gross international reserves (in months of imports)	3.7	3.6	4.1	4.2

Nepal--Summary of the 1986/87 Program
Targets/Policy Parameters (continued)

II. Main Elements of the Program

1. Supply policies

Further increase in irrigation facilities and improved maintenance and rehabilitation of existing facilities. Increased provision of technical services and agricultural inputs, including fertilizer. Improved access of the rural sector to institutional credit through the expansion of the resource base of the Agricultural Development Bank of Nepal and by the increase in commercial bank branches in rural areas.

More liberal industrial and import licensing policies.

Exemption of import duty and sales tax for ready-made garment industries.

Specific export promotion measures discussed with the World Bank, to encourage the expansion of the export sector and to enhance the efficiency of import substitution activities.

2. Fiscal policy

a. Introduction of new tax measures estimated to yield additional revenues of about NRs 415 million, or over 0.7 percent of projected GDP in 1986/87. The major measures include: the simplification of the sales tax structure and broadening of the tax base; imposition of the sales tax on telephone service; an increase in excise duty rates on selected commodities; the reduction of personal income tax deductions and a generalized withholding tax on interest, dividends, and rental income; the introduction of a flat corporate tax; increases in import duties on petroleum products, sugar and synthetic fibers and yarn; an expansion of the list of imports not eligible for the 1 percent duty rate; increases in the minimum property values to more realistic levels; an increase in the air flight departure tax; and an increase in the entertainment and vehicle taxes.

b. Further improvement of tax administration, through increased efforts to identify and register potential taxpayers, improved assessment and collection procedures, computerization of taxpayer records, improved management of staff, and a creation of a unified revenue service.

Nepal--Summary of the 1986/87 Program
Targets/Policy Parameters (concluded)

c. Restraint on regular expenditures. Containment of the increase in the wage bill to about 4 percent by retaining the freeze on wages and salaries of civil servants and preventing an increase in the number of civil servants.

d. In light of World Bank recommendations, appropriate levels of expenditure for operations and maintenance and intensification of efforts to increase aid absorptive capacity.

e. Reduction in subsidies and transfers to public enterprises through the maintenance of flexible pricing policy. With respect to chemical fertilizers, domestic sales prices will be maintained at levels that will prevent their re-export.

f. Sales of government-held shares in public enterprises to private sector.

3. Monetary/credit policy

a. Restraint on the expansion of bank credit.

b. Maintenance of positive real interest rates for key bank loans and deposits.

c. Phasing out of the access to the Nepal Rastra Bank's refinancing facilities by the Agricultural Development Bank of Nepal and the Nepal Industrial Development Corporation.

4. External policies

a. Flexible exchange rate management to complement restrained financial and wage policies.

b. Reduction in quantitative import restrictions. Import licenses for a range of all industrial inputs are granted as per the capacity and needs of domestic industries.

c. The introduction of an auction system for registered traders to obtain licenses to import a range of consumer goods from countries other than India.

d. Restraint on short-term (with a maturity of less than one year) and nonconcessional external borrowing with maturities of 1-12 years.

Kathmandu, Nepal

August 10, 1986

Dear Mr. de Larosiere:

1. The Memorandum of His Majesty's Government of Nepal on Certain Aspects of its Economic and Financial Policies for 1985/86, dated December 3, 1985, described a comprehensive economic adjustment program designed to rapidly eliminate the pressures on the external accounts that emerged in 1984/85 and to strengthen the conditions conducive to stable growth and balance of payments viability over the medium term. In support of this program, the Government requested a stand-by arrangement with the Fund in the amount equivalent to SDR 18.65 million for the period through January 22, 1987.

2. The pace of adjustment in the domestic credit area has been somewhat slower than envisaged, partly as a result of some delays in finalizing the program (December 1985). Consequently, there were departures from the performance criteria on net credit to Government and on net domestic assets of the banking system (NDA) in January and April 1986 and in spite of more recent measures to strengthen policy instruments and implementation, it has not been possible to bring the financial program fully back on track by the end of fiscal year 1985/86 (ending July 15, 1986). It thus has become apparent that, if the economy is not to be burdened unduly, a slightly longer period will be required to achieve some of the adjustments envisaged in the program. Accordingly, we would like to request that the stand-by arrangement from the Fund be extended to April 22, 1987 and that Nepal be permitted to proceed to make purchases under the arrangement upon the completion of the review, notwithstanding that all the data for the period ending July 15, 1986 will not be available by that time.

3. While some adjustment measures were implemented more slowly than originally envisaged, and there were departures from some of the quantitative policy limits of the program in 1985/86, substantial progress was made in policy formulation and in achieving the program's objectives in respect of the balance of payments and of economic growth. The policies of His Majesty's Government of Nepal for 1986/87 will consolidate the gains achieved in 1985/86 and strengthen further the balance of payments, while sustaining growth and moderating inflation significantly. The broad objectives and policies and the quantification of these policies for the remainder of the proposed period of the arrangement are described below.

4. Following the devaluation of the exchange rate on November 30, 1985 and the subsequent announcement of the economic adjustment program, the overall balance of payments turned around sharply from a large deficit in the first quarter (August-October) of 1985/86 to an almost equivalent surplus in the second quarter (November 1985-January 1986) on the strength of increased service receipts from tourism, a reflow of short-term private capital, some dampening of import pressures and an acceleration of foreign aid disbursements. The overall position thus was virtually in balance in the first half of 1985/86 and a modest surplus was recorded during the following four months, through May 1986, as exports to countries other than India continued to accelerate. It is now estimated that an overall surplus of about SDR 4 million was recorded in 1985/86 as a whole (SDR 53 million deficit in 1984/85)--in spite of a sharp deterioration in the terms of trade--compared with the program target of a small deficit. Under the impact of the devaluation and the upward revision in the administered prices of certain essential goods and services, inflation (measured by changes in the consumer price index) accelerated to an annual rate of 19.8 by April 1986 (11 percent during the year ending November 1985). However, with the subsequent tightening of financial policies, inflation decelerated somewhat in May and that process is expected to have continued through the end of the fiscal year, with the inflation rate decelerating to about 16.5 percent by the end of the period. Aided by favorable weather, timely adjustments in procurement prices of major foodgrains and cash crops, more liberal industrial licensing policy on export-oriented and import-substituting industries, and improvement in the electric power supply, real GDP is estimated to have increased by 4.2 percent in 1985/86 (3 percent in 1984/85).

5. The economic program for 1985/86 assigned a high priority to reducing quickly and sharply the overall balance of payments deficit as a first step toward attaining a viable external position over the medium term. In line with this policy priority, and in support of the desired impact on the external accounts of the change in relative prices, His Majesty's Government adopted a restrained fiscal policy stance in 1985/86. The extent of the fiscal adjustment in 1985/86 is reflected in the ratios to GDP of the overall budget deficit (including grants) as well as its domestic financing requirement, which are both estimated to have declined by 1.6 percentage points, in relation to 1984/85. The estimated overall deficit was, moreover, smaller than foreseen in the program. However, due to the significant shortfall in disbursement of foreign aid, the domestic financing of the budget deficit, in particular financing through the banking system, exceeded the program target. Another factor straining fiscal management in the year was a notable revenue shortfall. Reflecting a substantial increase in receipts from taxes on international trade following the November 1985 devaluation, tax revenues rose sharply during the first two months of 1986 and as recently as April were projected to increase by 23 percent for the fiscal year. However, that projection had to be scaled sharply back as a result of poor tax collections in May and the first half of June, largely attributable to the involvement in the election process of a

substantial number of revenue agents; the revenue loss could not be made up during the course of the remaining weeks of the fiscal year. It is estimated that domestically financed expenditure increased by only 2.5 percent, compared with a 12.8 percent planned increase, and its ratio to GDP declined by 1.9 percentage points, in relation to 1984/85. Every effort was made to contain regular expenditure (including a freeze on wages, salaries and the number of civil servants) to levels even below those programmed and such expenditure is estimated to have been 9 percent less than targeted in the program. Nevertheless, given the magnitude of the revenue shortfall, a very heavy additional adjustment burden was placed on domestically financed development expenditure, which is estimated to have declined by 15 percent in relation to 1984/85 (a 7 percent reduction envisaged in the program). With these additional cuts and the shortfall in external aid utilization, total development expenditure is estimated to have declined by about 7 percent in real terms (a 9 percent increase in nominal terms).

6. The planned sale to the public of government-held equity in a number of enterprises during 1985/86 encountered some difficulties. In some cases, the enterprise's weak capital base and/or profitability record made the shares relatively unattractive to potential buyers; in some others, legal problems developed because private shareholders could not agree on the Government divestiture. His Majesty's Government considers that in the case of some of these enterprises, the problems are resolvable in a reasonably narrow time frame, while in others financial restructuring and major internal reforms may be necessary. The Government intends to pursue vigorously the sale of such shares in the present fiscal year, although the scale of these operations is likely to be more modest than originally assumed.

7. Adjustments in administered prices are made periodically to reflect changes in import and/or domestic production costs to ensure that the financial position of the enterprises involved--in many cases public enterprises--is not undermined, and to avoid a direct or indirect additional burden on the budget. The policy of His Majesty's Government, described in the Memorandum on Certain Aspects of its Economic and Financial Policies for 1985/86 (December 3, 1985), is that nontransient increase in import costs should be reflected without delay in administered prices. The Memorandum also described a number of upward adjustments in administered prices taken in anticipation of the devaluation of November 30, 1985. Subsequently, the domestic price of sugar was increased by 19 percent on December 23, 1985. The prices of cement, iron rods and corrugated sheets are mainly market determined, but to some extent also administered when these commodities are supplied by public corporations. The price of cement was adjusted by 6 percent. In the case of iron rods, the price charged by the public corporation remained higher than the market price. Since the devaluation, corrugated sheets have been supplied entirely by the private sector. As discussed further below, upward adjustments in prices of fertilizers came into effect on May 21, 1986. Administered prices of major items, which have not been increased, were those for petroleum products.

8. In the case of petroleum products, the pricing decision was complicated by a number of factors: the sharp decline in international prices; the existence of some prior purchase contracts by the Nepal Oil Corporation at prices well above current international prices; the change in domestic prices in India with which Nepal shares a long, open border; and a study of upward adjustments in import duty rates as a revenue measure for the 1986/87 budget. More recently, the terms of import contracts of the Nepal Oil Corporation have been renegotiated on more favorable terms, thus improving its financial position. In light of these factors, the Government is currently reviewing the structure and adequacy of the domestic prices of petroleum products. It is the Government's policy that the windfall arising from the decline in international petroleum prices will be captured wholly by the public sector. A significant portion of this gain will accrue to the Government via the increase in import duty rates provided for in the 1986/87 budget.

9. During the first quarter of 1985/86 (August-October 1985), domestic bank credit continued to expand strongly (increasing 31 percent during the year ending mid-October 1985) on account of both a marked pickup in private credit demand and increased borrowing by the public sector. Following the announcement of the adjustment program in December 1985, the Nepal Rastra Bank (NRB, the Central Bank) in early January 1986 issued credit guidelines to commercial banks designed to limit the various categories of domestic assets consistent with the April credit ceilings. However, those guidelines proved not to be fully effective in slowing expansion of bank credit to the private sector and to nonfinancial public enterprises in the period through mid-April 1986. On an annual rate basis, the expansion of private sector credit accelerated from 34 percent in October 1985 to 37 percent in April 1986. Although the expansion of credit to nonfinancial public enterprises, which had accelerated sharply to 38 percent by October 1985, was reduced to 22 percent by April 1986, it was still significantly higher than the growth envisaged in the program. The Government's position vis-a-vis the banking system improved considerably in the six-month period ending April 1986, but not to the full extent of the unexpected excess in bank borrowing in the first quarter of the fiscal year. As a result, outstanding net credit to Government, which exceeded the program ceiling by 2 percent in January 1986, was 1.2 percent above the program limit in April 1986. Reflecting these developments, by mid-April 1986, NDA had expanded to a level 4.8 percent above that foreseen in the program, even though the excess in mid-January had been only 1.3 percent. Nonetheless, the annual expansion of NDA had decelerated from 36 percent in October 1985 to 28 percent in April 1986 and this, together with the devaluation in late November 1985, had yielded a marked improvement in the balance of payments in the six-month period. In assessing credit developments in relation to the ceilings, it is necessary to take into account that the base period data (for July 15, 1985), on which the credit ceilings were established, were revised upward in December 1985,

by NRs 106 million for NDA and NRs 37 million for net credit to Government. The base period was also the closing of the fiscal year, and the final data were subject to audit, which required the modest change from the unaudited data. The NRB has subsequently taken the necessary steps to expedite the reporting of monetary data for purposes of monitoring the implementation of the domestic credit program.

10. The authorities have remained in close contact with the Fund staff in recent months on domestic credit and fiscal developments and the course of policy action. Following the April result, the NRB reformulated and tightened its direct credit guidelines for the commercial banks, taking steps to ensure that the banks themselves instituted the necessary guidance and control over their branch network to ensure the effectiveness of the new policy directives. At the same time, monitoring procedures were strengthened through provision for more frequent reports from banks on major account totals; provisional estimates on total credit developments are now available with a lag of four weeks. In May 1986, credit to the private sector declined by about 3 percent, which almost offset the modest expansion of credit to Government and the continuing credit expansion to nonfinancial public enterprises, some of which (e.g., the Jute Development and Trading Corporation) are facing special problems. The authorities decided to essentially freeze private sector credit at the average April-May level during the remainder of the fiscal year and to bring down modestly the level of credit to nonfinancial public enterprises. With respect to the Government, sales of savings certificates to the nonbank private sector were accelerated and expenditure commitments other than wages and salaries were frozen in the closing weeks of the fiscal year. On this basis, net credit to Government, while exceeding the program limit by 2 percent, is estimated to have increased by about 15 percent in the fiscal year, almost half of the growth rate in 1984/85. The expansion of domestic credit is estimated to have decelerated to 23 percent, compared to the fiscal year peak of 31 percent in October 1985. Taking into account the stronger than forecast demand for money, it is estimated that with these policy adjustments, the overall balance of payments surplus of about SDR 4 million through May 1986 was being sustained for the whole fiscal year.

11. His Majesty's Government has been mindful of the need to strengthen the structure of the financial system to enhance its capacity to capture an increasing level of financial savings, to improve the allocation of lending resources, and to permit the effective conduct of monetary and credit policy. With these factors in mind, and to assure appropriately positive real interest rates, a sweeping reform of interest rates was put into effect on May 29, 1986. Ceilings on bank deposit interest rates were abolished, and the rates of 8.5 percent for savings deposits and 12.5 percent for one-year fixed deposits were established to be minimum rates. The rates of fixed deposits with a maturity of less than one year were also freed, subject to the requirement that they need to be at least at the level of the interest rate on savings deposits. A higher, uniform concessional lending rate of 15 percent (maximum) replaced seven lower rates previously applied to various operations

defined to be in "productive" and "priority" sectors. All other bank lending rates were freed. The NRB refinancing facility for commercial banks was applied only to those sectors for which the concessional lending rate is stipulated. The range of subsidized refinancing rates charged by the NRB on its lending operations was adjusted upward to 11 percent. Recent interest rate developments should tend to dampen the strong private sector credit demand while stimulating the flow of financial savings. Moreover, with the freeing of bank interest rates, the NRB will be in a better position to conduct monetary policy through reserve money and liquidity management operations, including the provision of its refinancing facilities, while gradually reducing reliance on direct credit guidelines. The interest rates on treasury bills and on NRB overdraft facilities to the Government are still well below market-related rates. A major consideration here is the already heavy burden of interest payments in government expenditure. Nevertheless, these will be kept under careful review, given the need to further strengthen the instruments of monetary policy and to fully rationalize the structure of interest rates.

12. The improvement in external competitiveness achieved by the devaluation of November 30, 1985, together with tightened demand management, has contributed to the marked improvement in the overall balance of payments position in 1985/86. External reserves rose notably in the months following the devaluation and are projected to increase to the equivalent of 4.2 months of imports in 1985/86, somewhat higher than the program target level. During 1986/87, His Majesty's Government will continue to implement policies to strengthen the balance of payments and growth prospects. External aid is expected to continue providing a sizable portion of Nepal's external resource requirements, and steps are being taken to enhance Nepal's capacity to absorb highly concessional assistance for high priority projects. Nevertheless, in support of longer-term growth objectives, there is a need to further rationalize and liberalize the trade system and, within a framework of external reserve adequacy, this will require sustained efforts to stimulate exports and tourism and import-substituting activities. With pursuit of such policies, and continuation of restrained demand management and wage policies, His Majesty's Government believes that a growth rate of 4 percent can be achieved in 1986/87, the average annual inflation rate reduced to 9.5 percent (from 15.5 percent), and an overall balance of payments surplus of SDR 12 million attained.

13. His Majesty's Government accords the highest priority to achieving the growth objectives of the Five-Year Plan in a framework of external account viability and reasonable price stability. This will require a sizable and sustained increase in investment, in which the public sector will have to play a leading role, and in the requisite mobilization of savings, both domestic and foreign. Accordingly, it intends to intensify its efforts to mobilize revenue for the budget, strictly restrain regular expenditures, and increase its capacity to utilize external development aid. On this basis, it is planned to increase the ratio of development expenditure to projected nominal GDP by 2.5 percentage

points above the estimate for 1985/86 while reducing further the budget deficit to be financed domestically to no more than 2 percent of GDP. This, in turn, will permit a reduction in Government net borrowing from the banking system, a target for which has been established at NRs 800 million (1.4 percent of GDP) for 1986/87.

14. In the fiscal year 1986/87, His Majesty's Government introduced a wide range of new tax measures including most of those recommended by a recent Fund technical assistance mission. We estimate that these measures will yield additional tax revenues of about NRs 415 million during 1986/87, equivalent to over 0.7 percent of projected GDP. There are several features to the new tax measures which we included in the 1986/87 budget. The domestic sales tax previously had 17 rates ranging from 1 to 20 percent, with different markups applicable to the tax base for various items. We reduced the number of rates to four and eliminated the markup system in order to ease administration. To broaden the sales tax base, we included telephone services under the general sales tax rate. Regarding excise tax, we introduced a flat rate for rice and edible oil mills and increased the rates on selected items, e.g., soft drinks and alcoholic beverages, while eliminating excise duty on some widely used construction materials and selected products produced by cottage industries. With respect to income tax deductions, we introduced a flat allowance for transportation, education, and periodicals, and generalized the provision for withholding tax on interest, dividends and rental income. We also introduced a flat (40 percent) corporate tax rate, combined with a 20 percent withholding tax on dividends, while exempting cottage and village industries from income tax on sales up to NRs 100,000. With respect to the property transfer tax, we increased the minimum property values to more realistic levels. Increases in the airflight departure tax rates, as well as adjustments in vehicle and entertainment taxes, will also provide additional revenue. These measures together should yield some NRs 220 million additional revenue out of the NRs 415 million.

15. With the present domestic prices of petroleum products, referred to in paragraph 8 and the level and trend in landed costs, there will be a large and growing revenue surplus from sales of petroleum products in the period ahead. In this regard, we increased import duties on petroleum products (gasoline, diesel, and lubricants) by a substantial amount to generate an additional revenue of NRs 73.5 million for the budget, while still allowing for a significant strengthening of the financial position of the Nepal Oil Corporation. We also expanded the list of imports not eligible for the 1 percent duty rate, thereby increasing the number of imports subject to higer duty rates. This measure, together with increases in duties on selected imports as well as on some exports, is expected to yield about NRs 121.5 million in 1986/87.

16. The intention also is to restrain growth in regular expenditures, while allowing for adequate growth in expenditure categories related to operations and maintenance of completed development projects. In these circumstances, the Government sees no viable alternative to retaining

the freeze on wages and salaries of civil servants in 1986/87, as well as preventing an increase in the number of civil servants. On this basis, it is planned that the total wage bill will increase by less than 5 percent in nominal terms, thus declining significantly in real terms. The Government is also reviewing carefully the level of transfers to various deficit agencies and public enterprises, as well as various subsidies which directly or indirectly impinge on the budget, with a view to markedly reducing their weight in budgetary expenditure over time. With respect to deficit public enterprises, adequacy in pricing policies, improved managerial standards and financial practices, and restraints on their access to banking system credit, should provide incentives for reform.

17. Some public enterprises which traditionally operate with the aid of budgetary transfers and subsidies, such as the Nepal Food Corporation and the Agricultural Inputs Corporation, serve not only economic, but social objectives as well. The transfers/subsidies through the budget finance a major part of the heavy cost of transportation of food and agricultural inputs to remote areas. In the case of chemical fertilizers, the transport subsidy provided for in the budget represents only a small portion of actual subsidies in support of the fertilizer program in Nepal. The bulk of the subsidy represents the sale of fertilizer by the Agricultural Inputs Corporation to farmers at prices which until recently were about 40 percent below landed costs (at international prices) across the range of products. Most of the fertilizers are received under foreign assistance, and their provision at subsidized prices is designed to stimulate the use of fertilizers in Nepal in a program worked out with the donors concerned. Nevertheless, in view of the sizable magnitude of these subsidies, and in the light of serious budgetary constraints, a careful review of fertilizer pricing was undertaken. On May 21, 1986, the domestic sales prices of chemical fertilizers were increased by 20-29 percent to bring them in line with selling prices in India, in order to prevent the re-export of these commodities. However, in light of a strong intervening decline in international prices of fertilizers, in late July, the Government reduced the domestic sales prices by 5 percent across the board. Nevertheless, at current international prices, the per unit reduction in fertilizer subsidies in 1986/87 still will be substantially greater than that originally envisaged, and net receipts from sales of fertilizers are estimated to increase by an equivalent of about 2 percent of GDP. Given transportation costs, the small price differential with India would not lead to the re-export of fertilizers. The Government intends to maintain the domestic sales prices of fertilizers at levels that will prevent their re-export. The Government has instructed the Agricultural Development Bank to step up its collection efforts to recover a larger portion of fertilizer loans to farmers so that the Agricultural Inputs Corporation is repaid and can increase its contribution to the counterpart fund in the budget.

18. In collaboration with the World Bank, the ADB, the UNDP and bilateral donors, the Government has intensified, and will continue to

intensify its efforts to increase Nepal's aid absorptive capacity by streamlining administrative and implementation procedures. Development expenditure to be financed with domestic resources will be carefully screened in terms of priorities and cost effectiveness and the scale of such expenditure continue to be closely monitored in the light of domestic revenue performance. Domestically financed development expenditure currently is projected to increase by 24 percent in 1986/87. In the event of any revenue shortfalls in 1986/87 below projected amounts, the Government will give priority to the provision of adequate local counterpart funds to aid-related projects so as not to unduly delay their completion.

19. Monetary/credit policy for 1986/87 is to be conducted in a manner consistent with the growth and balance of payments objectives and with the planned sharp reduction in the rate of inflation mentioned in paragraph 12. Achievement of these objectives will be pursued by enhancing the ability of the banking system to attract deposits, while keeping the level of bank credit at levels commensurate with those resource flows. Accordingly, the authorities have drawn up a quarterly monetary program for 1986/87 consistent with the target for net foreign assets of the banking system. Within the framework of this program for the whole fiscal year, limits have been established in respect of net domestic assets of the banking system (NDA) and net bank credit to the Government for October 15, 1986, and January 15, 1987, as shown in the attachment to this letter. In addition, indicative ceilings on the stock of domestic credit to the nonfinancial public enterprises will be set as follows: NRs 1,650 million as of October 15, 1986 and NRs 1,670 million as of January 15, 1987. Taking into account the effects of the interest rate reform on the demand for money, and the overall balance of payments objective, the annual rate of growth of net domestic assets should decelerate from 24 percent estimated for 1985/86 to about 16 percent in 1986/87. With the growth of net credit to Government limited to 10.8 percent, and a targeted growth rate for credit to the nonfinancial public enterprises of a similar size, the permissible growth of credit to the private sector (including the public financial institutions) would amount to about 21 percent in 1986/87.

20. With the improvement in Nepal's external competitiveness from the November 1985 devaluation and subsequent changes in international currency relationships, and given the high degree of openness of Nepal's economy, restrained demand management policies, as described above, are the essential ingredients in the program to achieve the overall balance of payments objective in 1986/87. Those policies will, however, be complemented by appropriately flexible exchange rate management. In this regard, the Government announced that with effect from June 1, 1986, the Nepalese rupee would henceforth be pegged to a basket of currencies, including the Indian rupee. The Nepal Rastra Bank, which was given the authority to implement exchange rate policy within the framework of this new regime, will closely monitor the adequacy of the rate in the period ahead. Policy will be guided by a number of considerations including progress toward the overall balance of payments

targets, trends in trade flows and capital movements, as well as developments in Nepal's external competitiveness.

21. The total SDR value of import licenses issued for nonaid-financed imports from third countries was somewhat less in the first eight months of 1985/86 than in the same period a year ago. This outcome partly reflects the impact of the devaluation on import demand and the influence of tightened domestic credit policies, but it also reflects the continued restraint on license approvals in the light of foreign exchange availabilities. Continued flexibility in exchange rate management and other measures to strengthen the balance of payments, together with the growing volume of foreign aid, will permit some liberalization and rationalization of the trade and payments system. Due to the limited availability of foreign exchange, nonaid imports from third countries, including essential inputs, are subject to quantitative restrictions. Export and import-substituting industries would directly benefit from a reduction in restrictions on essential inputs. As part of its policies to strengthen the growth prospects of the industrial sector, the Government plans to gradually reduce reliance on quantitative import restrictions. As a starting point, in 1986/87 licenses for all industrial inputs have been granted as per the capacity and needs of these industries. The notification to this effect was issued after the presentation of the 1986/87 budget. In addition, the Government has introduced an auction system for licenses to import a range of consumer goods by registered traders. This measure is designed to regulate the demand for these licenses and is also expected to generate considerable revenue for the budget.

22. Most of Nepal's public and publicly guaranteed external debt has been contracted on highly concessional terms, although a component of commercial loans for equipment is contracted for certain public projects, including some financed in part by international lending agencies and/or bilateral donors. For 1985/86, the Government has refrained from contracting or guaranteeing new nonconcessional loans (maturities of 12 years or less) beyond those approved and/or contracted up to September 30, 1985 for five projects and the funding for one jet aircraft for the Royal Nepal Airlines Corporation (RNAC). These contracts/guarantees were identified in the Memorandum of December 3, 1985. In May 1986, an agreement for delivery of two commercial jet transports over the next two fiscal years was signed, the first of which would be received in 1987/88. The possibility of a third aircraft is under study. The Government intends to purchase the first aircraft and to lease the second. The nonconcessional loan, equivalent to SDR 50 million, for the aircraft purchase will have a maturity of about 12 years and carry an interest rate of about 8 percent per annum. These acquisitions will add to the profitability of the RNAC and strengthen Nepal's foreign exchange earnings. Priority will be given to servicing this debt by RNAC from its operating profits prior to the distribution of profits to its shareholders, including His Majesty's Government of Nepal. To avoid exacerbating the debt service burden, the Government will strictly limit the uptake of medium-term external debt during

1986/87. In this regard, the Government intends to refrain from contracting or guaranteeing additional nonconcessional loans in the 1-12 years maturity range in excess of SDR 10 million in the remaining period of the stand-by arrangement. Moreover, short-term external borrowing will be contained to revolving loans traditionally required in the normal operations of the Nepal Oil Corporation.

23. His Majesty's Government believes that the policies and measures described in this letter are adequate to achieve the objectives of the program, but will take any additional measures that may become appropriate for this purpose. During the remaining period of the arrangement, the Government will consult with the Fund on the adoption of any measures that may be appropriate in accordance with the Fund's policies on such consultations. In this connection, the progress made under the program will be reviewed no later than March 15, 1987.

Sincerely yours,

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

Mr. Jacques de Larosiere
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NEPAL

Technical Memorandum on Domestic Assets/Credit Ceilings

In paragraph 19 of the letter to the Managing Director of the International Monetary Fund from the Ministry of State for Finance and Industry dated August 10, 1986, the Government's economic program for 1986/87 provides for ceilings on net domestic assets of the banking system and on net credit to Government for October 15, 1986 and January 15, 1987 as follows:

	Net Domestic Assets	Net Credit to Government
	(In millions of Nepalese rupees)	
July 15, 1986		
Estimates	13,080	7,420
Rebased estimates	12,698 1/	7,420
October 15, 1986		
Ceilings	13,165	7,660
January 15, 1987		
Ceilings	13,590	7,825

1/ This is valued at the exchange rates prevailing at end-January 1986 and used as a base for ceilings for October 15, 1986 and January 15, 1987.

For the purposes of this program, net domestic assets of the banking system are defined as the difference between the outstanding stock of broad money and net foreign assets. In calculating net domestic assets during the program period, net foreign assets shall be expressed in terms of local currency at the exchange rates prevailing at end-1984/85. For the period after July 15, 1986, net foreign assets shall be expressed in terms of local currency at the exchange rates prevailing at end-January 1986.