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EBS/86/182
Supplement 1

CONFIDENTIAL

September 8, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Nepal - Review Under Stand-By Arrangement - Revisions to Monetary Statistics and 1986/87 Credit Ceilings

The attached supplement to the staff report for the review under the stand-by arrangement for Nepal has been prepared on the basis of additional information. A revised draft decision on the stand-by arrangement appears on pages 3 and 4.

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, which is now proposed to be scheduled on Friday, September 12, 1986.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

NEPAL

Staff Report for the Review Under Stand-By Arrangement--Revisions to Monetary Statistics and 1986/87 Credit Ceilings

Prepared by the Asian Department

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

Approved by P. R. Narvekar and Eduard Brau

September 8, 1986

On August 26, 1986, and following the issuance of the staff report for the review under stand-by arrangement (EBS/86/182, 8/11/86), the authorities provided provisional monetary and credit data for the mid-July 1986 test date. From a review of these data, it emerged that the classification and valuation of certain Fund accounts in the monetary survey did not conform fully to Fund standard practice, either for mid-July 1986 or for the preceding period. Technical corrections were, therefore, necessary to the series for net foreign assets of the banking system (NFA), net domestic assets (NDA), and net credit to Government contained in the staff report. Ceilings on the latter two constitute performance criteria under the stand-by arrangement. As explained below, however, the changes involved in these corrections were small and have not affected the substance of the 1986/87 credit program. Thus, the assessment given in the staff appraisal contained in EBS/86/182 remains appropriate.

Changes resulted in consistently downward revisions of NDA, and revisions of net credit to Government that were not uniform in sign. With the exception of the April 1986 ceiling on net credit to Government, all corrected data for NDA and net credit to Government were still in excess of the ceilings (as would be revised to reflect the corrections) for January, April, and July 1986 (revised Table 1 and Appendix Table 7 of EBS/86/182). The extent of nonobservance in July 1986 amounted to 2.5 percent for NDA and 0.9 percent for net credit to Government, compared with the estimated overshooting of about 2 percent for both in the staff report.

As a result of the corrections, modest adjustments have been made to the letter of intent dated August 10, 1986 and to the credit ceilings for October 15, 1986 and January 15, 1987. The revised letter of intent, its attachment, and supporting information 1/ are appended to this supplement. A revised proposed decision appears on pages 3 and 4.

1. Revisions to monetary statistics

The following adjustments to the monetary statistics were made: (a) the Fund quota subscription, which had formerly been included in foreign liabilities, is now treated as an unclassified liability in "other items, net"; (b) Fund accounts for each fiscal year, starting mid-July, which had formerly been valued at exchange rates prevailing as of the preceding April 30, are now measured at current exchange rates; (c) the counterparts of the reserve tranche and a portion of the Fund quota subscription paid by the central bank, which had formerly been included in net credit to Government, are now included in "other items net."

2. Adjustments to data for 1985/86

As a result of these corrections, the level of NDA on July 15, 1985, on which the initial credit ceilings were based, was revised downward by NRs 137 million (1.3 percent). The level of NDA was also revised downward by NRs 54 million for January 15, 1986 and by NRs 27 million for April 15, 1986. The level of net credit to Government on July 15, 1985 was revised upward by NRs 21 million (0.3 percent), while the level was adjusted downward by 88 million for January 15, 1986 and by NRs 111 million for April 15, 1986.

3. Adjustments to 1986/87 credit ceilings

Corrected data for July 15, 1986, which are still preliminary but constitute the base data for the 1986/87 credit program, indicate that the levels of NDA and net credit to Government were lower on this date by NRs 67 million and NRs 60 million, respectively, than estimated in EBS/86/182 (8/11/86). Accordingly, the ceilings on NDA and net credit to Government for October 15, 1986 and January 15, 1987 as well as their targets for July 15, 1987 were adjusted downward by the corresponding amounts (revised Table 4 of EBS/86/182). In contrast, as the level of credit to nonfinancial public enterprises was higher by NRs 19 million than estimated in the staff report, the indicative ceilings on credit to nonfinancial public enterprises for these test dates and the corresponding target for July 15, 1987 were revised upward by that amount.

4. Overall balance of payments outcome in 1985/86

Taking into account corrected base data and the preliminary monetary data for July 15, 1986, it appears that the overall balance of

1/ Revised Tables 1 and 4, and Appendix Tables 5 and 7 of EBS/86/182 (8/11/86).

payments was in deficit of SDR 7 million in 1985/86, compared with the program target of a deficit of SDR 4 million and an estimated surplus of SDR 4 million presented in EBS/86/182 (8/11/86) (revised Appendix Table 5 of EBS/86/182). A large part of the revision (SDR 11 million) in the overall balance of payments outcome reflects a higher-than-expected revaluation loss in the stock of net foreign assets stemming from the depreciation of the U.S. dollar vis-a-vis other major currencies.

Revised Proposed Decision

The following revised 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 September 8, 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 September 8, 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 September 8, 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 September 8, 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 September 8, 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.

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

	1985			1986								
	July 15			January 15			April 15			July 15		
	Prelim.	EBS/86/182 (8/11/86)	Revised (9/5/86)	Ceiling (19/5/86)	EBS/86/182 (8/11/86)	Revised	Ceiling	EBS/86/182 (8/11/86)	Revised (9/5/86)	Ceiling	EBS/86/182 Est. (8/11/86)	Prelim. (9/5/86)
						(In millions of Nepalese rupees)						
Net domestic assets 2/	10,431	10,537	10,400	11,485 (11,454)	11,725	11,671	12,045 (12,014)	12,735	12,708	12,720 (12,689)	13,080	13,012
Net credit to Government	6,433	6,470	6,491	6,833 (6,891)	7,006	6,918	6,977 (7,035)	7,095	6,984	7,233 (7,291)	7,420	7,360
						(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	1,163	1,277 (1,289)	1,353 5/	1,331	1,317 (1,329)	1,462	1,457 5/	1,289 (1,301)	1,600	1,619

Sources: Data provided by the Nepalese authorities; EBS/85/264 and EBS/86/182 (8/11/86).

1/ This table replaces Table 1 of EBS/86/182 (8/11/86). Figures in parentheses indicate ceilings as would be revised to reflect the technical corrections of the base period data (July 15, 1985). The actual figure for net domestic assets on July 15, 1985 was lower by NRs 31 million and, that for net credit to government higher by NRs 58 million, 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 aircraft.

4/ Not performance criterion.

5/ Revised figure reported by the authorities after the issuance of EBS/86/182 (8/11/86).

Table 4. Nepal: Quantitative Performance Criteria, 1986-87 1/

	1986				1987	
	Mid-July 2/ Prelim.		Mid-Oct. Ceilings		Mid-Jan. Ceilings	
	EBS/86/182 (8/11/86)	Revised (9/5/86)	EBS/86/182 (8/11/86)	Revised (9/5/86)	EBS/86/182 (8/11/86	Revised (9/5/86)
	(In millions of Nepalese rupees)					
Net domestic assets	12,698	12,631	13,165	13,098	13,590	13,523
Net credit to Government	7,420	7,360	7,660	7,600	7,825	7,765
	(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 3/	10 3/	10 3/	10 3/
Memorandum items:						
Indicative ceilings on credit to nonfinancial public enterprises 4/	1,600	1,619	1,650	1,669	1,670	1,689

Sources: Data provided by the Nepalese authorities; and EBS/86/182 (8/11/86).
1/ This table replaces Table 4 of EBS/86/182 (8/11/86).
2/ Rebased figures. Net domestic assets are measured at the exchange rates prevailing as of end-January 1986.
3/ Excluding contracts related to the prospective acquisition of two aircraft.
4/ Not performance criterion.

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 EBS/86/182 (8/11/86)	1985/86 Revised est. (9/5/86)	1986/87 Program
Exports, f.o.b.	76	106	157	162	144	144	154
Imports, c.i.f.	-424	-408	-462	-505	-451	-451	-490
Aid imports	-86	-91	-92	-117	-105	-105	-138
Non-aid imports	-338	-316	-370	-388	-346	-346	-352
Trade balance	-348	-301	-305	-342	-307	-307	-336
Services (net)	109	88	79	88	81	81	83
Receipts	169	161	153	168	151	151	171
Payments	-59	-73	-74	-81	-80	-80	-89
Private transfers (net)	39	43	43	46	46	46	45
Receipts	41	46	45	48	50	50	
Of which: Private remittances	(37)	(38)	(39)	(38)	(39)	(39)	(40)
Payments	-2	-2	-2	-2	-4	-4	-5
Current account balance	-200	-170	-183	-209	-180	-180	-207
Nonmonetary capital movements	151	156	131	205	184	173	219
Official grants	77	73	85	99	87	87	107
Official capital (net)	62	89	62	106	81	81	90
Foreign loans	64	93	66	114	89	89	98
Amortization	-2	-4	-4	-8	-7	-7	-9
Structural adjustment loan (IBRD)	--	--	--	--	--	--	23
Other capital (net) 2/	25	17	-7	--	48	42	--
Valuation adjustments	-13	-14	-19	--	-32	-37 3/	--
Overall balance 4/	-49	-14	-53	-4	4	-7	12
Monetary movements	49	14	53	4	-4	7	-12
Assets (increase -)	64	16	46	-7	-11	--	-18
Liabilities	-15	-2	7	11	7	7	6
Of which: Fund credit (net)	-6	-4	-5	13	9	9	8
Trust Fund (net)	--	-1	-1	-2	-2	-2	-3
Memorandum item:							
Gross reserves	210	190	144	151	155	144	162

Sources: Data provided by the Nepalese authorities; and EBS/86/182 (8/11/86).

1/ This table replaces EBS/86/182 (8/11/86). Totals may not add up due to rounding.
2/ Including errors and omissions.
3/ Of this, SDR 21 million was accounted for by the revaluation loans in the stock of net foreign assets at the end of 1984/85.
4/ Defined as changes in net foreign assets in monetary survey.

Table 7. Nepal: Monetary Survey, 1983-87 1/

	1983	1984	1985/86						1986/87				
	July	July	July	October	January	April	May	June (Prelim.)	July (Prelim.)	July (Rebased Est.)	October (Ceil-ings)	January (Ceil-ings)	July (Targets)
	(In millions of Nepalese rupees) 2/												
Net foreign assets 3/	3,215	2,845	1,897	1,459	1,916	2,124	2,172	2,167	2,043	2,424 4/	2,347 4/	2,562 4/	2,712 4/
Net domestic assets 5/	6,007	7,610	10,400	11,164	11,671	12,708	13,129	12,918	13,012	12,631	13,098	13,523	14,703
Domestic credit	8,345	9,820	12,550	13,192	13,966	14,846	14,992	15,079	15,206	15,206	15,639	16,337	17,508
Government, net	3,944	5,024	6,491	6,744	6,918	6,984	7,095	7,242	7,360	7,360	7,600	7,765	8,160
Nonfinancial public enterprises	1,137	953	1,163	1,289	1,353	1,457	1,674	1,587	1,619	1,619	1,669	1,689	1,794
Private sector	3,264	3,842	4,895	5,159	5,696	6,405	6,259	6,250	6,227	6,227	6,370	6,883	7,554
Other items, net	-2,338	-2,209	-2,149	-2,028	-2,296	-2,138	-1,863	-2,161	-2,194	-2,575	-2,541	-2,814	-2,805
Broad money	9,223	10,455	12,297	12,623	13,587	14,845	15,319	15,085	15,055	15,055	15,445	16,085	17,415
	(Percentage change over the same month of previous year) 6/												
Net domestic assets	37.3	17.4	26.7	27.9	24.2	23.6	24.1	18.6	21.2	21.0	17.5	16.3	13.8
Domestic credit	30.9	16.0	26.1	29.3	27.7	25.4	25.5	23.2	21.6	21.6	19.4	17.4	15.3
Government, net	25.2	11.7	14.0	13.6	11.3	8.9	9.1	9.2	7.1	7.1	6.8	6.2	5.3
Nonfinancial public enterprises	4.0	-2.0	2.0	3.3	3.2	2.1	4.1	3.2	3.7	3.7	3.0	2.5	1.2
Private sector	1.7	6.3	10.1	12.3	13.1	14.4	12.2	10.8	10.8	10.8	9.6	8.7	8.8
Broad money	23.7	13.4	17.6	19.2	21.9	22.9	24.7	21.5	22.4	22.4	22.4	18.4	15.7

Sources: Data provided by the Nepalese authorities; staff estimates; amd EBS/86/182 (8/11/86).

1/ This table replaces Appendix Table 7 of EBS/86/182 (8/11/86).
2/ Totals may not add up due to rounding.
3/ Valued at the exchange rates prevailing as of July 15, 1985.
4/ Valued at the exchange rates prevailing as of end-January 1986.
5/ Defined as broad money less net foreign assets measured at constant exchange rates.
6/ In relation to the broad money stock at the end of the previous period.

Kathmandu, Nepal

September 8, 1986

Dear Mr. de Larosière:

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, the performance criterion on net credit to Government was exceeded in January 1986, and the performance criteria on net domestic assets of the banking system (NDA) were exceeded in both January and April 1986. In spite of more recent measures to strengthen policy instruments and implementation, it was not 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 final 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 during November 1985-April 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. This trend continued during the remainder of 1985/86, and it is now estimated that abstracting from the revaluation loss of SDR 37 million, an overall surplus of about SDR 30 million was recorded in 1985/86 as a whole. 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 percent 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. Outstanding net credit to Government, which exceeded the program ceiling by 0.4 percent in January 1986, was somewhat below the program limit in April 1986. Reflecting these developments, by mid-April 1986, NDA had expanded to a level 5.8 percent above that foreseen in the program, even though the excess in mid-January had been only 1.9 percent. Nonetheless, the annual expansion of NDA had decelerated from 36 percent in October 1985 to 29 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 established, were revised downward by NRs 31 million for NDA and adjusted upward by NRs 58 million for net credit to Government. The NRB has taken the necessary steps to improve 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 2 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. As a result, net credit to Government, while exceeding the program limit by 0.9 percent, increased by about 13 percent in the fiscal year, less than half of the growth rate in 1984/85. The expansion of domestic credit decelerated to 23 percent, compared to the fiscal year peak of 31 percent in October 1985.

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 air flight 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 higher 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 1,669 million as of October 15, 1986 and NRs 1,689 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 25 percent estimated for 1985/86 to about 16 percent in 1986/87. With the growth of net credit to Government limited to about 11 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
The Managing Director
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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 September 8, 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		
Preliminary	13,012	7,360
Rebased estimates	12,631 1/	7,360
October 15, 1986		
Ceilings	13,098	7,600
January 15, 1987		
Ceilings	13,523	7,765

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.