FOR
AGENDA

EBS/87/37

CONFIDENTIAL

February 23, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Nepal - Staff Report for the 1986 Article IV Consultation and Review Under Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Nepal and the second review under its stand-by arrangement. Draft decisions appear on pages 24 and 25.

This subject has been tentatively scheduled for discussion on Wednesday, March 25, 1987.

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

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

NEPAL

Staff Report for the 1986 Article IV Consultation and Second Review Under the Stand-By Arrangement

Prepared by the Asian and Exchange and Trade Relations Departments

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

Approved by P.R. Narvekar and Manuel Guitian

February 19, 1987

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I. Introduction

The 1986 Article IV consultation discussions and second review under the stand-by arrangement were held in Kathmandu during December 4-20, 1986. Discussions were held with the Minister of State for Finance and Industry, the Governor of the Nepal Rastra Bank (NRB, the central bank), and other senior officials. The staff team consisted of Messrs. Szapary, Ishii, Teja (all ASD), Streefkerk (ETR), Frenkel (FAD), and Ms. Lee (secretary, ASD). Mr. van Til, the Fund's Resident Representative in Nepal at the time, and his successor, Mr. Thornton, assisted the mission. Mr. Reddy, Alternate Executive Director for Nepal, attended the meetings as an observer.

On December 23, 1985, the Fund approved a stand-by arrangement for Nepal for the period through January 22, 1987 in the amount equivalent to SDR 18.65 million, or 50 percent of quota (EBS/85/264, 12/3/85). During the first half of fiscal year 1985/86, 1/ the growth of credit to the public and private sectors was faster than envisaged under the program and the credit ceilings were exceeded for both January and April 1986 (Table 1). However, other major elements of the program were successfully carried out and the program's main objectives were being achieved. Beginning in May 1986, the Government introduced corrective measures on the credit side and in September the Fund approved a three-month extension of the stand-by arrangement, through April 22, 1987 (EBS/86/182, 8/11/86 and Supplement 1). At the same time, the remaining purchases were rephased and an additional review was included as a performance criterion; quantitative performance criteria for October 15, 1986 and January 15, 1987 were also set.

While net domestic assets of the banking system (NDA) remained below the ceiling for October 15, 1986, the subceiling on outstanding net bank credit to Government was exceeded. All other performance criteria were observed. The Government took several corrective measures in late 1986 and early 1987 which, in the staff's view, will bring the program back on track. Since the impact of these measures will be felt only in the second half of 1986/87, the authorities have requested an increase in the subceiling on net credit to Government for January 15, 1987, while leaving the existing ceiling on NDA unchanged. The attached letter, dated January 12, 1987 (Annex I), describes the Government's objectives and policies during the remaining period of the stand-by arrangement. 2/ So far, Nepal has purchased the equivalent of SDR 12.35 million under the arrangement, SDR 10.25 million in December 1985 upon approval of the arrangement and SDR 2.10 million in September 1986 upon completion of the first review under the arrangement

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

2/ In order to permit a modification rather than a waiver of the January 15, 1987 performance criterion on net credit to Government, the letter requesting the modification was circulated for the information of the Executive Board prior to January 15, 1987 (EBS/87/6, 1/14/87).

Table 1. Nepal: Quantitative Performance Criteria Under the Stand-By Arrangement 1/

	January 15, 1986		April 15, 1986		July 15, 1986		October 15, 1986		January 15, 1987	
	Ceiling	Actual	Ceiling	Actual	Ceiling	Actual	Ceiling	Actual	Original ceiling	Revised ceiling
	(In millions of Nepalese rupees)									
Net domestic assets 2/	11,485 (11,454)	11,672	12,045 (12,014)	12,709	12,720 (12,689)	12,995	13,098	12,808	13,523	13,523
(Excess over ceiling in percent) 3/	...	1.9	...	5.8	...	2.4	...	-2.2	...	...
Net credit to Government	6,833 (6,891)	6,918	6,977 (7,035)	6,984	7,233 (7,291)	7,418	7,600	7,734	7,765	7,900
(Excess over ceiling in percent) 3/	...	0.4	...	-0.7	...	1.7	...	1.8	...	...
	(In millions of SDRs)									
New external nonconcessional loans of 1-12 years' maturity contracted or guaranteed by the Government, cumulative through end of period 4/	10.0	—	10.0	—	10.0	—	10.0	—	10.0	10.0
	(In millions of Nepalese rupees)									
Memorandum item:										
Indicative ceiling on credit to nonfinancial public enterprises 5/	1,277 (1,289)	1,353	1,317 (1,329)	1,457	1,289 (1,301)	1,726	1,669	1,736	1,689	1,850
(Excess over ceiling in percent) 3/	...	5.0	...	9.6	...	32.7	...	4.0	...	...

Source: Data provided by the Nepalese authorities.

1/ Figures in parentheses indicate ceilings as they would be revised to reflect the technical corrections of monetary data (EBS/86/182, Supplement 1).
2/ Defined as M2 minus net foreign assets valued at exchange rates prevailing as of July 15, 1985; for the period after July 1986, net foreign assets are valued at exchange rates prevailing as of end-January 1986.
3/ Excess over ceilings as they would be revised to reflect the technical corrections of monetary data.
4/ Refers to loans contracted after September 30, 1985 and excludes a loan related to the prospective acquisition of two aircraft.
5/ Not performance criterion.

(Table 2). Provided that the performance criteria for January 15, 1987 are observed (credit data will become available in March), Nepal will be able to purchase the remaining amount (SDR 6.3 million) under the stand-by arrangement upon completion of the present review.

To maintain the momentum of their adjustment policies, the authorities have requested an arrangement under the structural adjustment facility (SAF) to start with fiscal year 1987/88. The staff held preliminary discussions on the policy framework of a possible SAF arrangement and a mission is scheduled to visit Kathmandu in May 1987 to conduct formal negotiations. The discussions on the SAF were joined by the members of a World Bank mission who were negotiating a Structural Adjustment Loan (SAL) with the authorities. The SAL negotiations have been completed recently and consideration of the loan by the Bank's Executive Board is expected in March 1987. The amount of the proposed loan is SDR 40.9 million to be disbursed over 18 months.

Nepal continues to avail itself of the transitional arrangements under Article XIV.

II. Background

Economic growth in Nepal has been only marginally ahead of population growth over the past decade and per capita income has remained low 1/. The largely agricultural economy is highly vulnerable to the vagaries of weather, and export performance is also strongly influenced by the fluctuations in world commodity prices. With slow export growth, rising import requirements have been mostly financed by concessional aid inflows. Until the early 1980s, Nepal had enjoyed a relatively comfortable external reserve position, but expansionary policies, mainly emanating from the public sector, had brought the balance of payments under considerable pressure and led to a rapid decline in reserves between 1982/83 and 1984/85.

Since 1985/86, the authorities have embarked on an adjustment program with the goal of reducing the immediate balance of payments pressure and creating conditions for higher growth and viable external payments position over the longer term. In its initial phase, the adjustment effort placed emphasis on restrictive financial policies as the authorities sought to stem the deterioration in the balance of payments by restraining domestic absorption. At the same time, policy reforms were initiated on a broad front, and included the adoption of a flexible exchange arrangement following a discrete devaluation (by 14.7 percent) of the Nepalese rupee in November 1985; an interest rate reform in May 1986; a tax package introduced with the 1986/87 budget;

1/ Per capita income, estimated at SDR 135 in 1985/86, is one of the lowest in the world.

Table 2. Nepal: Fund Position Under the Stand-By Arrangement, October 1986-April 1987

	Outstanding as of Mid-Oct. 1986	1986/87 Mid-Oct. to Mid-Dec.	Mid-Dec. to Mid-Mar.	Mid-Mar. to Mid-Apr.
	(In millions of SDRs)			
Transactions under tranche policies (net)		--	--	6.3
Purchases		--	--	6.3
Ordinary resources		--	--	6.3
Repurchases		--	--	--
Ordinary resources		--	--	--
Total Fund credit outstanding (end of period)	12.35	12.35	12.35	18.65
Under tranche policies	12.35	12.35	12.35	18.65
	(As percent of quota)			
Total Fund credit outstanding (end of period)	33.1	33.1	33.1	50.0
Under tranche policies	33.1	33.1	33.1	50.0

Source: International Monetary Fund.

and measures to improve the financial position of public enterprises, including the adoption of more flexible pricing policies.

These measures have led to a decline in the fiscal deficit and a substantial easing of balance of payments pressure. In recent years, there has also been a trend toward greater diversification of exports, with garments, carpets, and handicrafts gaining importance relative to the traditional exports of jute, jute goods, and rice. Aided by the world recovery, tourism has rebounded strongly in the last two years as the Government has placed new emphasis on developing the country's tourist potential. While these developments are encouraging, there is still much to be done for Nepal to create the conditions for more rapid and sustainable economic growth. The balance of payments remains structurally weak with import requirements greatly exceeding export earnings. Large investments in capital and human resources will be needed to overcome the impediments stemming from the country's geographic position, difficult terrain, and erratic weather. A main issue in this respect is the low level of domestic resource mobilization, which has not only led to the emergence of a large resource gap, but has also hindered the use of available foreign aid as the Government has been unable to generate enough resources to provide the necessary domestic counterparts to project aid. A related issue is weak project implementation, which has also severely hampered the utilization of foreign aid. Better project selection, a more liberal trade regime, a strengthening of the role of the price mechanism in resource allocation, and continued financial discipline are other key conditions for improving economic performance over the medium term.

At the time of the last consultation discussions, Executive Directors commended the authorities for the introduction of adjustment measures and urged them to address more forcefully the structural impediments to growth. In this connection, the need to enhance aid absorption capacity was stressed. It was noted that Nepal's tax/GDP ratio was relatively low and that new revenue measures were needed to increase resource mobilization. Concern was expressed about the rapid growth of regular expenditure and Directors underscored the importance of controlling the Government's overall wage bill. The need to improve the financial accounts of public enterprises was also emphasized. Finally, Directors observed that while Nepal's external debt service burden was modest, its capacity to service debt was limited and that the Government's cautious policy of external borrowing on nonconcessional terms should be maintained.

III. Developments in 1985/86 1/

Economic developments in 1985/86 were generally favorable. Growth recovered from drought, inflation was brought under control after a temporary acceleration following the November 1985 devaluation, and the overall balance of payments deficit was substantially reduced. All major macroeconomic targets of the program were broadly achieved (Table 3 and Annex II).

Real GDP grew by 4.2 percent in 1985/86, compared with 3 percent in the preceding year. Underlying this acceleration in growth was a virtual doubling of agricultural growth (Chart 1 and Appendix Table 4) as favorable weather and price prospects stimulated output. As measured by the consumer price index, average annual inflation jumped from 4 percent in 1984/85 to 16 percent in 1985/86, essentially as a result of the devaluation of the rupee. Since a large part of the goods entering the CPI are freely traded across the open border with India, any adjustment in the exchange rate is quickly transmitted to domestic prices.

Pending the fomulation of a comprehensive revenue package to be introduced with the 1986/87 budget, fiscal adjustment in 1985/86 was concentrated on expenditure, with the brunt of adjustment being borne by domestically financed development outlays. 2/ In line with the targets envisaged under the program, both the overall budget deficit (including grants) and its net domestic financing declined by about 1.5 percentage points of GDP. 3/ However, there were deviations from the program targets in some important respects (Chart 2 and Appendix Table 5). Mainly due to problems in tax collection, 4/ revenue fell short by about 9 percent, compelling the authorities to further restrain domestically financed expenditure. Foreign aid inflows were also lower than expected owing mostly to delays in project implementation, which in part reflected the stringency of domestic resources. In all, these developments led to larger-than-envisaged domestic bank borrowing by the Government in 1985/86 and the subceiling on net credit to Government

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1/ A detailed description of developments in 1985/86 is given in EBS/86/182, 8/11/86 and Supplement 1.

2/ In Nepal, government expenditure is divided into two major categories: regular and development expenditure. The former comprises mainly wages and salaries, purchases of goods and services, interest payments, and some subsidies and transfers, while the latter includes mainly capital expenditure, expenditures on operations and maintenance, some 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/ Excluding grants, the deficit declined by about 1 percentage point of GDP.

4/ The involvement of tax collection agents in the election process in May-June resulted in a tax revenue loss that could not be recouped.

Table 3. Nepal: Selected Economic and Financial Indicators, 1983/84-1986/87 1/

	1983/84	1984/85	1985/86 Program	1985/86 Prov. actual	1986/87 Program	1986/87 Revised proj.
	(Annual percentage changes; unless otherwise specified)					
National income and prices						
GDP at constant market prices	7.8	3.0	4.5	4.2	4.0	1.5
GDP deflator	5.0	6.2	12.0	14.3	9.5	12.0
Consumer prices: (annual average)	6.2	4.1	12.0	15.7	9.5	12.0
(July to July)	1.6	6.9	...	21.7	8.0	8.0
External sector						
Exports, f.o.b.	40.4	46.3	4.2	-7.8	7.5	-0.6
Imports, c.i.f.	-3.8	8.0	14.6	-0.2	11.5	--
Export volume	27.6	30.2	4.2	13.1	6.9	5.4
Import volume	-4.3	2.4	10.2	10.9	14.6	2.0
Terms of trade	9.5	6.5	-3.9	-9.4	3.3	-3.9
Real effective exchange rate 2/	-7.8	0.1	-10.7	-9.4	--	-10.8 3/
Government budget						
Revenue and grants	7.9	13.5	43.6	22.9	24.2	16.3
Of which: Revenue	18.5	15.7	27.4	16.5	23.2	19.9
Total expenditure, including net lending	5.1	13.2	25.6	12.2	23.2	15.9
Domestically financed expenditure	-1.7	17.1	12.8	2.5	16.8	12.4
Regular expenditure	10.9	29.1	33.3	20.6	12.8	15.8
Development expenditure	-10.0	7.5	-6.9	-15.1	22.4	7.8
Foreign-financed development expenditure	22.7	5.1	62.0	34.7	35.6	22.7
Money and credit						
Net domestic assets	18.6	36.6	22.0	25.0	16.8	16.7
Of which: Credit to Government (net)	27.4	29.2	12.3	14.3	10.0	10.8 4/
Credit to nonfinancial public enterprises	-16.1	22.0	11.8	48.3	4.0	10.1
Credit to private sector	17.7	27.4	28.3	24.7	23.8	20.2
Broad money	13.4	17.6	20.5	23.3	14.9	14.7
Income velocity (GDP/M2)	3.65	3.33	3.33	3.28	3.25	3.25
	(In percent of GDP; unless otherwise specified)					
External sector						
Current account balance: (excluding grants)	-7.2	-7.6	-8.9	-7.5	-9.0	-7.6
(including grants)	-3.5	-4.4	-4.7	-4.8	-4.3	-4.6
External debt (end of period)	12.5	18.0	23.1	22.4	27.5	28.9
Debt service 5/	4.2	4.7	4.6	5.3	5.3	5.5
Overall balance (SDR mn.)	-14.0	-50.0	-4.0	-1.0	12.0	5.0
Gross reserves (end of period; SDR mn.)	190.1	143.3	151.0	149.0	167.0	160.0
In months of imports of goods and services	4.7	3.2	3.1	3.5	3.5	3.7
Government budget						
Revenue and grants	11.0	11.4	14.0	11.8	12.9	12.1
Of which: Revenue	8.7	9.2	10.0	9.0	9.8	9.5
Total expenditure, including net lending	18.9	19.5	21.0	18.4	19.9	18.7
Domestically financed expenditure	12.4	13.3	12.8	11.4	11.7	11.3
Foreign-financed development expenditure	6.7	6.4	8.9	7.3	8.7	7.8
Overall balance: (including grants)	-7.9	-8.1	-6.9	-6.6	-7.0	-6.7
(excluding grants)	-10.2	-10.3	-10.9	-9.4	-10.2	-9.2
Domestic financing (net)	3.7	4.0	2.3	2.4	1.9	1.9
Of which: Banking system	2.5	3.5	1.6	1.9	1.4	1.4
(in millions of NRs)	1,080.0	1,467.0	800.0	927.0	800.0	800.0

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

1/ Fiscal year ended July 15.

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

3/ Twelve months ending in October 1986.

4/ The slightly higher rate of increase, as compared with the original program, reflects the actual outcome for the base date (July 15, 1986).

5/ As percent of exports of goods and services and private transfers receipts.

established under the stand-by arrangement was exceeded by 1.7 percent in July 1986.

Before the current stand-by arrangement went into effect at end-1985, domestic credit to both public and private sectors expanded rapidly (Chart 3 and Appendix Table 6). With the adoption of the adjustment program, the authorities tightened credit policy by issuing credit guidelines to commercial banks, and to ensure the effectiveness of these directives, monitoring was improved by requesting banks to provide weekly reports to the NRB. The authorities also introduced, in May 1986, an interest rate reform, allowing banks to set interest rates freely, with the exception that deposit rates were subject to certain minimum levels and a uniform maximum lending rate was set for most loans to priority sectors. The reform resulted in a 4 percentage point increase in the three-month fixed deposit rate and increases varying between 1 and 9 percentage points in lending rates (Appendix Table 7 and Chart 4). 1/ Following these measures, the growth of domestic credit decelerated sharply. Nevertheless, NDA was still 2.4 percent higher than the program ceiling in July 1986, owing to higher-than-expected credit expansion to the public sector. As noted, net credit to Government exceeded the subceiling somewhat, but the main factor behind the breach of the NDA ceiling was the faster-than-projected rate of growth of credit to nonfinancial public enterprises which, in turn, was driven mainly by the credit requirements of three enterprises. 2/ The unplanned expansion of NDA was, however, more than absorbed by higher demand for money, which permitted the net foreign assets position to improve more than envisaged under the program. 3/

The overall balance of payments improved in 1985/86, registering a deficit of SDR 1 million (the program target was SDR 4 million), compared with a deficit of SDR 50 million the year before (Chart 5 and Appendix Table 8). The improvement was even greater if account is taken of the large valuation losses stemming from the depreciation of the dollar against major currencies. Most of the improvement came from the

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1/ After the reform, fixed deposit rates ranged from 8.5 percent (three months) to 14 percent (five years) and the prime lending rates ranged from 13 percent to 21 percent. With no change in nominal interest rates since the reform and a decline in the rate of inflation, most key interest rates have become positive in real terms in the second half of 1986. For a detailed discussion of the interest rate reform, see EBS/86/182 (8/11/86).

2/ A new cement factory that commenced operation in 1985/86 and needed working capital; the Jute Development and Trading Corporation, which was unable to dispose of a large stock of raw jute owing to weak demand; and the Nepal Food Corporation, which continued to make losses on its foodgrain operations.

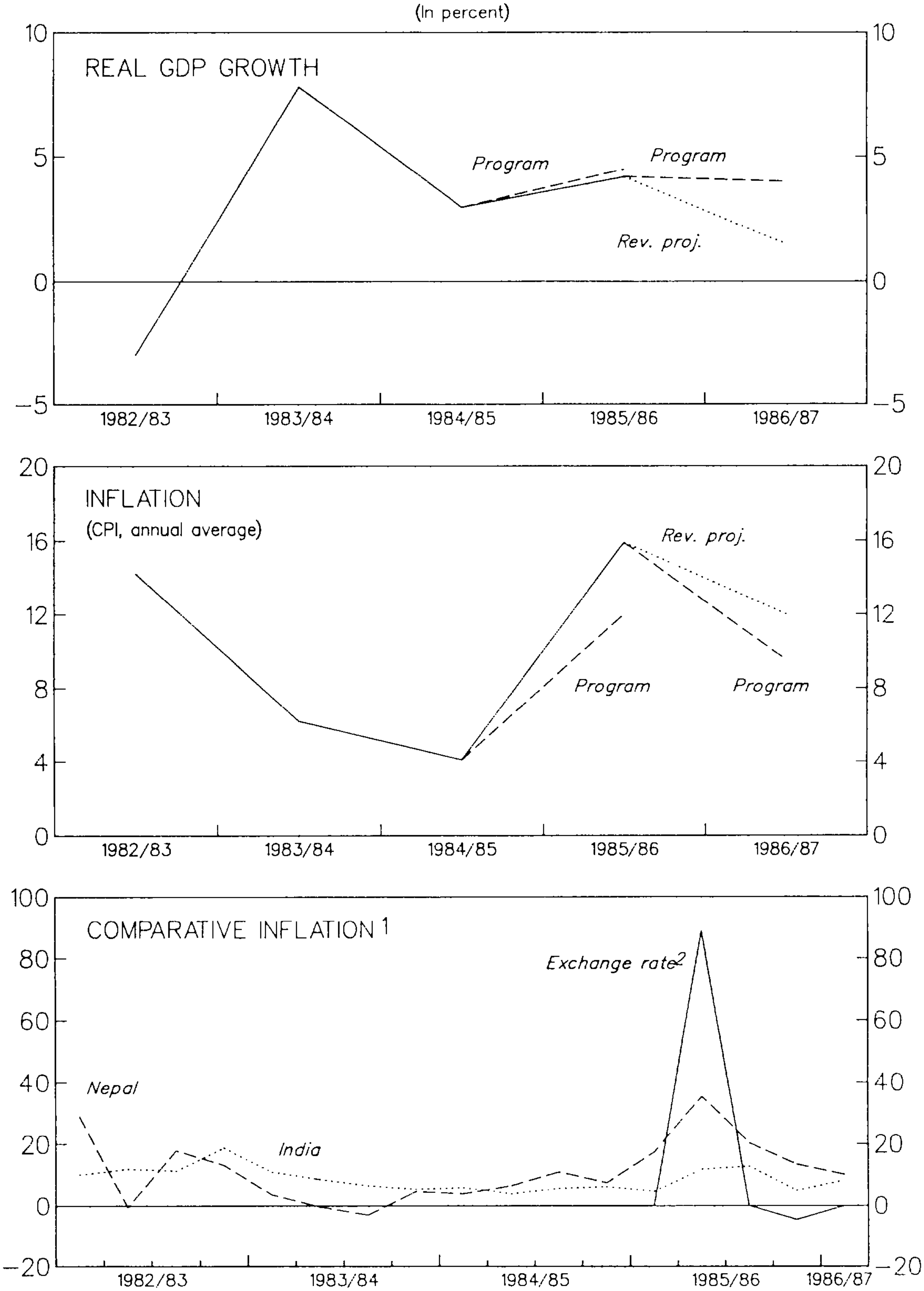
3/ The higher demand for money may be partly explained by the strong currency substitution in favor of the Nepalese rupee following the November 1985 devaluation.

CHART 1

NEPAL

GROWTH AND PRICE INDICATORS, 1982/83–1986/87

(In percent)



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

1 3 month annualized inflation of seasonally adjusted CPI.

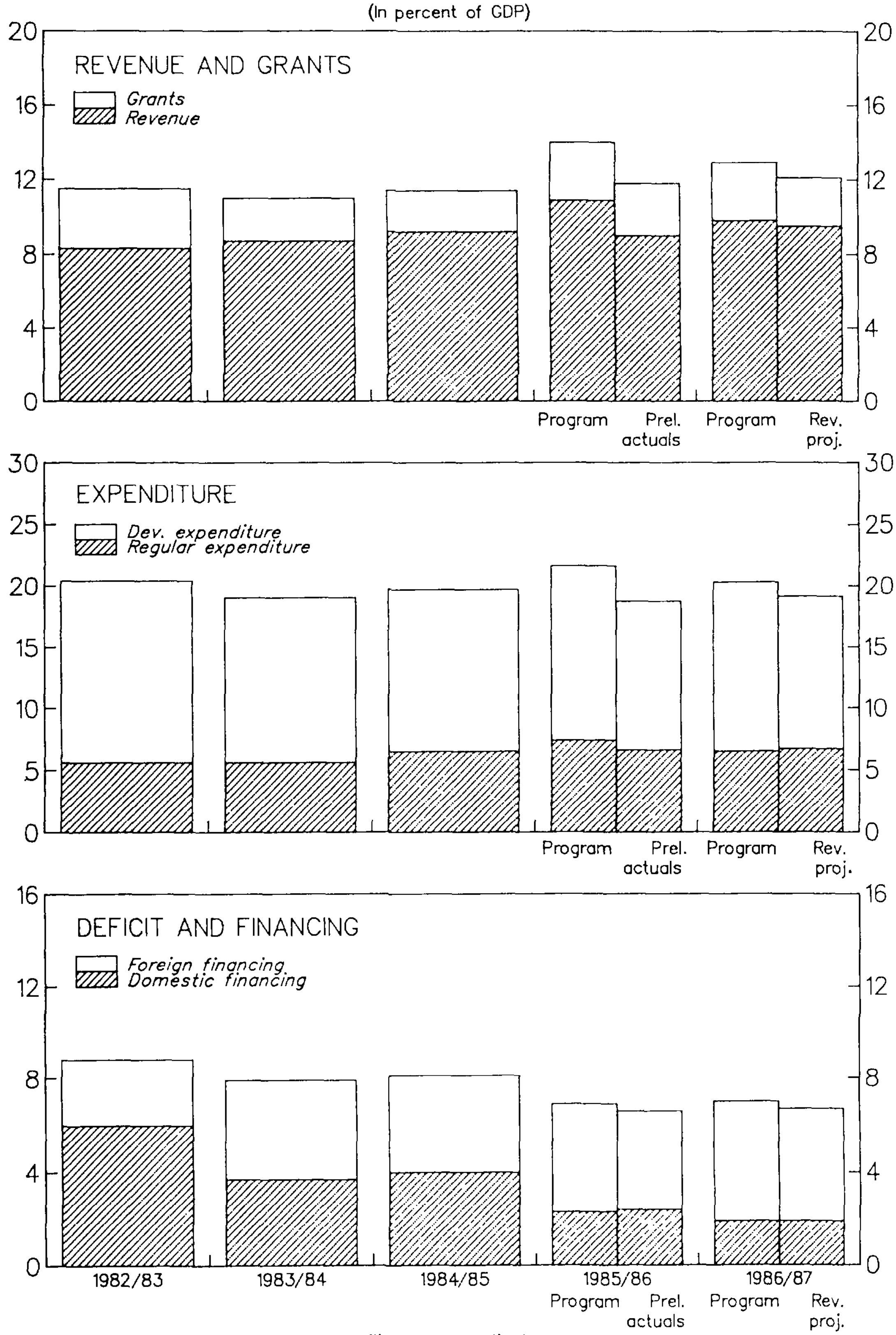
2 3 month annualized change of Nepalese rupees per Indian rupee.

CHART 2

NEPAL

FISCAL DEVELOPMENTS, 1982/83-1986/87

(In percent of GDP)

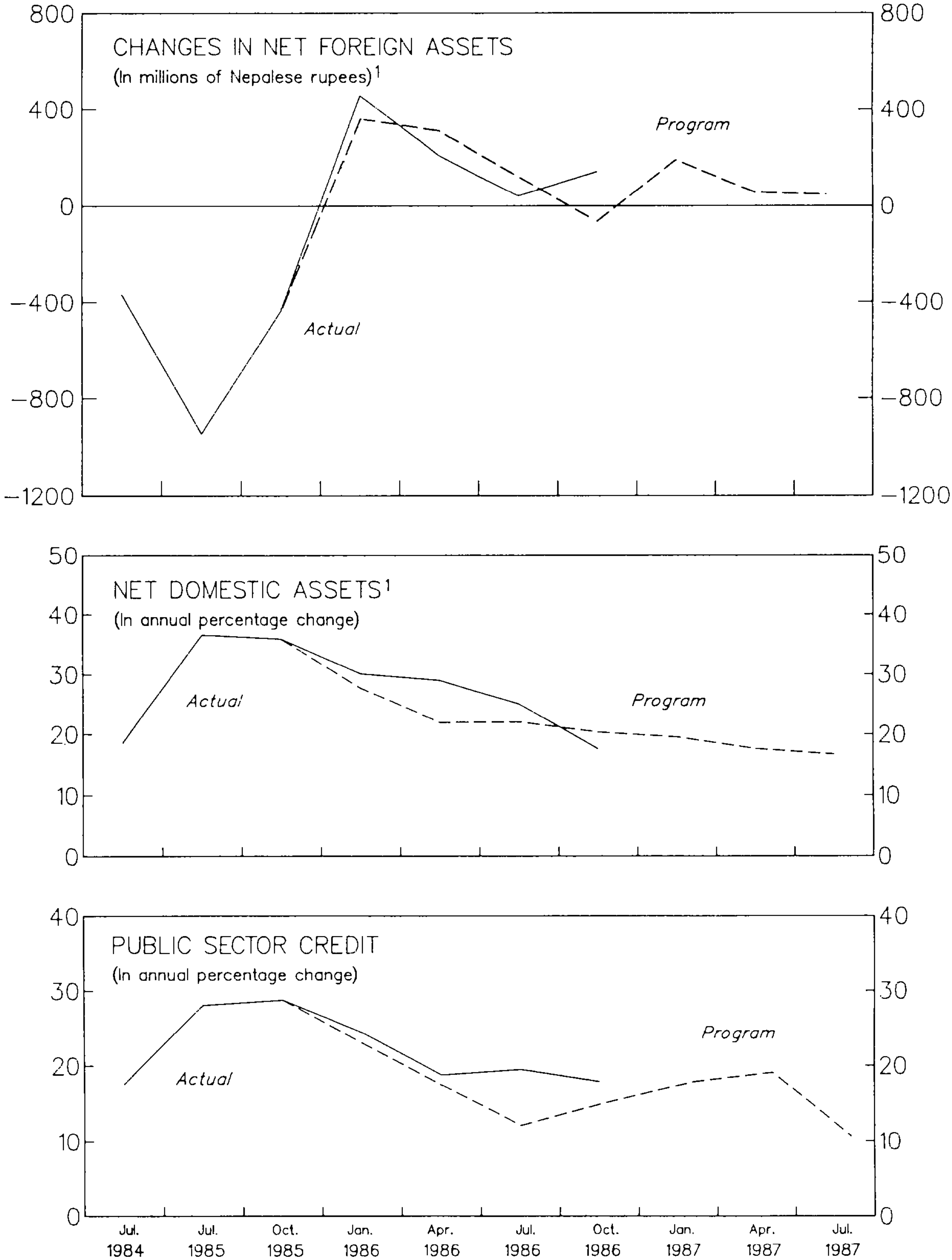


Sources: Data provided by the Nepalese authorities; and staff estimates.

CHART 3

NEPAL

MONETARY INDICATORS, 1984-87



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

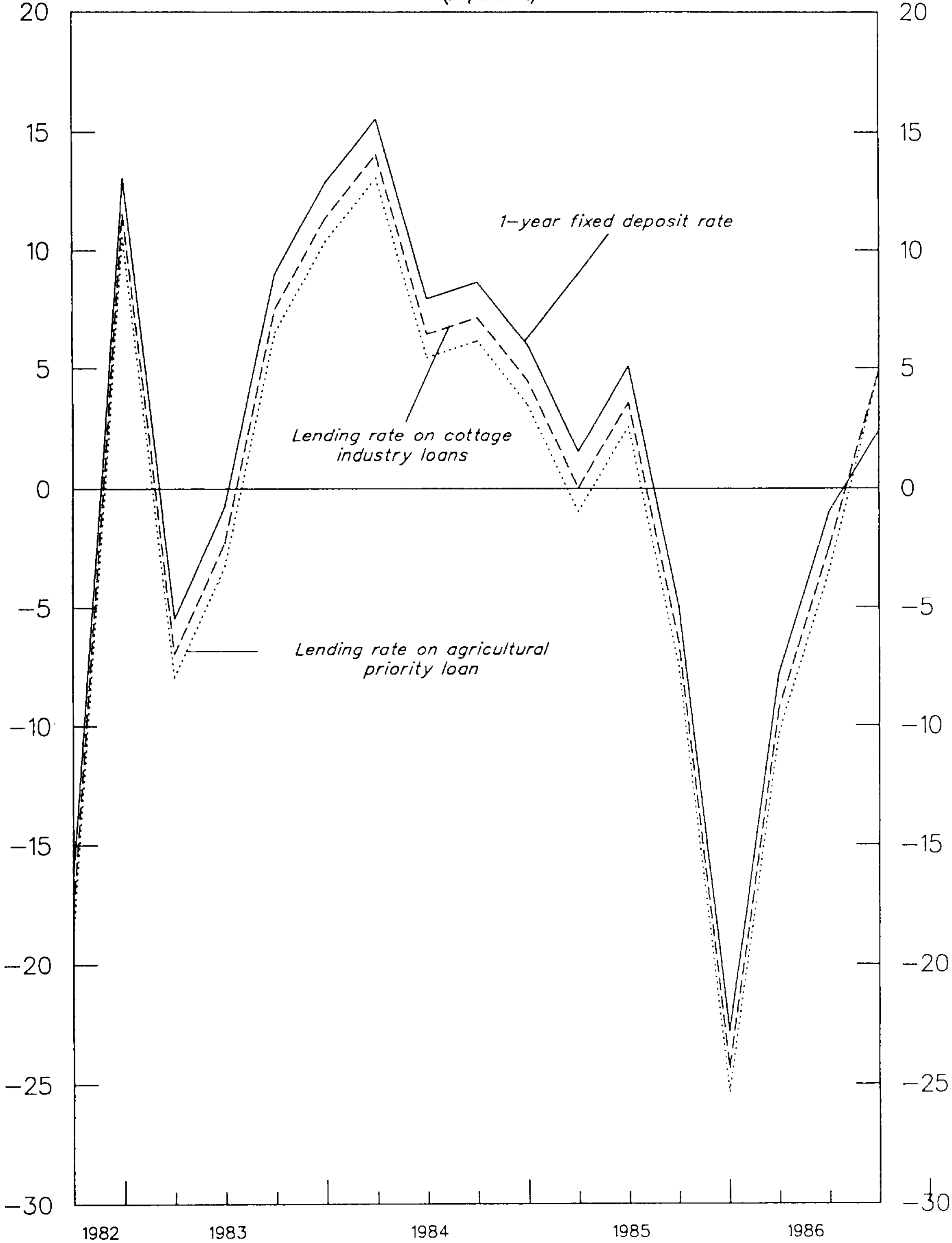
1 Measured at constant exchange rates.

CHART 4

NEPAL

SELECTED REAL INTEREST RATES, 1982–86[1]

(In percent)



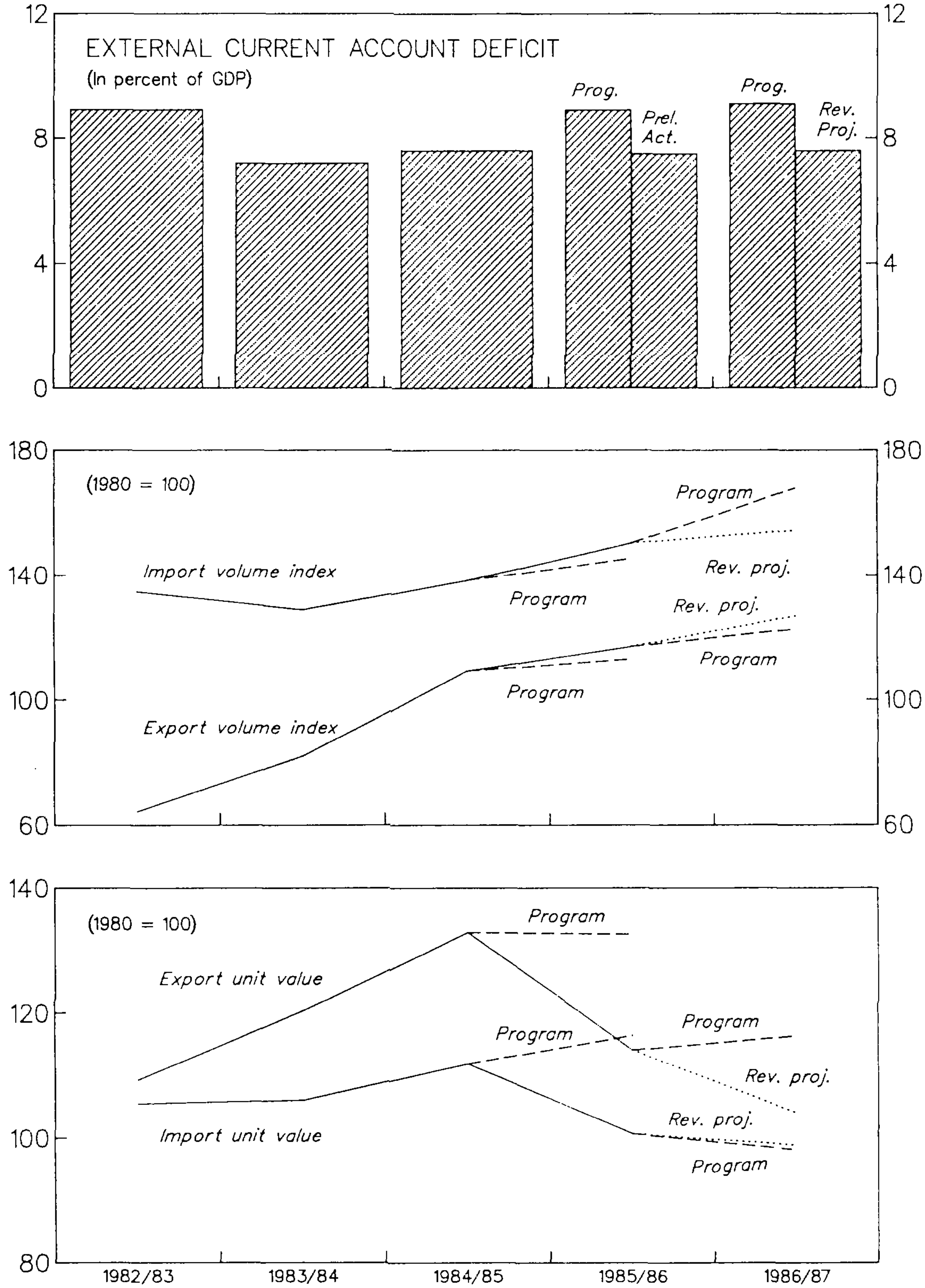
Source: Data provided by the Nepalese authorities.

[1] Measured by nominal rates minus quarterly changes in the seasonally adjusted consumer price index on an annualized basis.

CHART 5

NEPAL

EXTERNAL INDICATORS, 1982/83–1986/87



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

capital account as there was a large inflow of short-term private capital following the devaluation. The current account deficit (excluding grants) of SDR 174 million (7.5 percent of GDP) was smaller than programmed and was also lower than that in 1984/85 despite a 9 percent deterioration in the terms of trade. Export earnings declined, while import payments remained approximately unchanged, with aid-financed imports rising and other imports declining in response to the devaluation and the tightened financial policies. The consequent widening of the trade deficit was more than offset by an increase in net service receipts buttressed by a rise in tourism.

IV. The 1986/87 Economic Program and Report on the Discussions

For 1986/87, the objective of the authorities is to make further progress in strengthening the balance of payments, reducing the rate of inflation, and enhancing growth prospects. In the fiscal field, the emphasis has shifted from expenditure retrenchment toward domestic resource mobilization, and new policies have been initiated to bring about a long-term improvement in the financial position of public enterprises. With balance of payments pressures easing, the authorities have also been able to take some modest steps toward import liberalization.

Developments in 1986/87 have been adversely affected by the recurrence of drought in the Terai--a region accounting for the largest share of agricultural output--followed by flooding that damaged irrigation facilities. Foodgrain production is estimated to fall by almost 10 percent in 1986/87, not only eliminating all exportable rice surpluses, but also necessitating food imports. The Government has requested food aid and has received a positive response from several donors.

Real GDP is now projected to grow by only 1.5 percent, compared with 4 percent envisaged under the program. In spite of the anticipated shortfall in foodgrain production, inflation has continued to abate, declining to an annual rate of 10 percent during July-October 1986, broadly in line with the program target of 8 percent by the end of 1986/87. There were slippages in the implementation of the government budget during the first quarter of 1986/87, but, as discussed below, the authorities have taken corrective measures and the overall fiscal deficit and its net domestic financing are expected to be in conformity with the program targets.

Exports in the first quarter of 1986/87 were lower than expected, owing to weaker export prices, a virtual halt in rice exports, a poor export performance of hides and skins, and a sharp fall in exports of ready-made garments caused by delays in the allocation by the Nepalese authorities of the U.S. export quota among local producers. 1/ However, garment exports are expected to recover and the U.S. quota, which allows for a 6 percent annual growth in the volume of garment exports, is projected to be fully utilized. On this basis, exports are forecast to reach SDR 143 million in 1986/87, the same level as in the previous year, but 7 percent less than earlier envisaged. Reflecting sluggish domestic demand, imports are also projected to remain virtually unchanged from the previous year's level. With higher receipts from tourism, the current account deficit is projected to narrow to SDR 166 million, or about SDR 40 million below the program target. Nevertheless, the overall balance is forecast to show a smaller surplus (SDR 5 million as compared with a program target of SDR 12 million), owing to lower-than-expected aid utilization.

1. Fiscal policy

A main objective of fiscal policy under the program for 1986/87 was to step up development outlays through increasing revenue and containing regular expenditure. A tax package was introduced to raise revenue by 0.7 percentage point of GDP. Tax measures included a simplification and broadening of sales taxes; reduction in personal income tax deductions; the introduction of a flat corporate tax rate; and an increase in import duties on certain goods imported from third countries (other than India) and on petroleum products to absorb the windfall gains from the decline in international oil prices. 2/ To limit the growth of regular expenditure to no more than the projected growth of nominal GDP, the 1986/87 budget provided for no general increase in salaries for the third consecutive year and for no increase in the number of civil servants. On the other hand, the program envisaged an increase in development outlays of almost 2 percentage points of GDP, with two thirds of the increase coming from aid-financed expenditures. Reflecting an anticipated increase in aid utilization, the overall budget deficit was to rise as a ratio of GDP but its net domestic financing was to decline, with net domestic bank borrowing by the Government being limited to NRs 800 million (compared with NRs 927 million the year before).

During the first quarter of 1986/87, budgetary developments were less favorable than expected. Excluding revenue yielded by the introduction in July of an auction system of import licenses for a range of goods imported from third countries (such revenue was not included in the original budget), revenue fell short by about 12 percent, owing mainly to lower-than-anticipated receipts from import duties and sales taxes. Several factors have contributed to the shortfall in revenue. First, the uncertainties associated with the introduction of the auction system have delayed imports from third countries and shifted import

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1/ A quota on Nepalese garment exports was imposed by the United States for the first time in 1986.

2/ For details, see EBS/86/182.

demand toward goods from India, which are subject to much lower tariffs. Second, the increase in import duties on imports from third countries implemented at the beginning of the fiscal year also contributed to a shift in demand toward Indian goods. Third, the weaker-than-expected domestic demand reflecting the income effects of the drought was also a contributing factor. 1/ Finally, the revenue forecast in the program may have been too optimistic given the weaknesses in tax administration.

Expenditure was also lower than foreseen in the first quarter of 1986/87, as a somewhat higher-than-projected increase in regular outlays was more than offset by a slower growth in development expenditure due to delays in project implementation which also led to lower-than-expected aid disbursements. Nonbank domestic borrowing by the Government was less than anticipated, as the Nepal Provident Fund (NPF) and the National Insurance Corporation, the major sources of nonbank borrowing by the Government, undertook real estate investments and therefore reduced their purchases of government bonds. In all, these developments resulted in higher-than-programmed net domestic bank borrowing by the Government (NRs 316 million instead of NRs 182 million) during the first quarter of 1986/87, which led to an excess by 1.8 percent of the subceiling on outstanding net credit to Government in October 1986.

Effective mid-December 1986, the Government granted a uniform wage increase of NRs 100 per month per employee, representing an increase ranging from about 20 percent for the lowest-paid employees to 3 percent for those in senior positions. The effect of this decision is to raise the wage bill by 14 percent on an annual basis. The staff emphasized that to allow for adequate growth of development outlays and expenditure on operation and maintenance of completed projects, moderation in the growth of the Government's wage bill was essential, especially in light of the persistent shortfalls in revenue. The staff suggested that any future salary adjustment be linked to the introduction of an administrative reform presently under study which envisages, inter alia, a reduction in public sector employment through attrition and early retirement and a more extensive use of contractual labor. The authorities responded that since there had been no general salary increase for two and a half years, political pressure for a large salary adjustment had intensified. Their view was that by granting a wage increase now, the Government had placed itself in a better position politically to enforce wage restraint next year.

To offset the effects of the salary increase and the slippages in revenue, the authorities have taken new revenue measures with the

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1/ The output effect of the drought, which occurred in July-August 1986, is not translated into lower rural incomes until harvesting time in November-December. However, current spending would be affected by the anticipation of lower real incomes.

objective of limiting net credit expansion to the Government in 1986/87 to the amount originally envisaged under the program (Appendix Table 9). In December 1986, the auction system of import licenses was extended to all "commercial" imports from third countries whose licensing is administered by the Ministry of Commerce. 1/ The premia yielded by the auctions--essentially a tax on the rents of the import trade--accrue to the budget and are in addition to import duties and license fees. Furthermore, the Government recently increased the ex-factory prices of cigarettes for the purpose of calculating excise taxes; raised the import duty on gasoline to increase the price of gasoline to the level prevailing in India; 2/ increased the sales tax and the excise and import duties on a number of other products; and raised by 50 percent the airline landing fees, which were low by international standards. Together, these measures are estimated to yield an additional NRs 393 million (7 percent of projected total revenue) in 1986/87. 3/ The authorities also intend to advance the income tax payment due by the Nepal Oil Corporation which, however, would reduce revenue in the next fiscal year. Steps were also taken to improve tax collection, including the establishment of monthly collection targets for each revenue department against which its performance will be judged. As a safeguard against a possible shortfall in revenue, the Government has temporarily frozen outlays for several small locally administered and domestically

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1/ While imports from India are virtually free, imports from third countries are subject to quantitative restrictions. The licensing of imports from third countries is administered by various ministries. Each ministry receives a foreign exchange allocation under the annual foreign exchange budget. By end-user, imports are classified into five broad categories: industries; government offices; corporations, organizations, and missions; commercial; and personal. The same goods may be imported under several categories depending on the end-user. The Ministry of Commerce administers the licensing of "commercial" imports which include mostly consumer and intermediate goods, but also some raw materials. Foreign exchange allocated for commercial imports represent 12 percent of the total foreign exchange budget for 1986/87 (about 9 percent of total non-aid imports). For a description of the foreign exchange budget, see the forthcoming report on recent economic developments.

2/ At the time the attached Letter of Intent was signed by the authorities, the Government had envisaged an increase in the import duty on gasoline only at the start of the fiscal year 1987/88 and, in the meantime, planned to instruct the Nepal Oil Corporation to transfer to the budget the proceeds of the gasoline price increase. After further consideration of legal issues, the Government found it preferable to increase the import duty on gasoline effective mid-February.

3/ Of this amount, NRs 320 million is to come from the auction system. So far, two auctions were held, one in July and one in December 1986, each yielding about NRs 100 million in revenue. Auctions are planned to be held approximately every two months in the second half of 1986/87.

financed expenditure items, which the authorities indicated would not affect the operation and maintenance of essential infrastructure. Funds for these projects will be released only if there is adequate revenue. Finally, following completion of the NPF's recent investment in real estate, the authorities expect an increase in the coming months in the sale of government bonds to this institution.

With these measures, the authorities estimate that net domestic bank financing of the budget deficit in 1986/87 can be limited to the amount foreseen under the program. Both revenue and expenditure are projected to be lower than envisioned earlier (by 3 percent and 6 percent, respectively), with the overall budget deficit also projected to be smaller, due essentially to slower project implementation, which is reflected in lower aid disbursements.

The staff considers that these projections are attainable. However, the staff emphasized the importance of implementing measures to improve tax collection since this was an area where serious weaknesses persisted as evidenced by the continuous large shortfall in income tax collections. The staff also noted that to maintain the level of petroleum revenue, any future increases in the import prices of petroleum products should be promptly passed on to domestic consumers. The authorities indicated that their policy was to pass through import price increases and to avoid any significant price differential with India that could lead to smuggling.

With regard to the shortfall in aid disbursements, the staff observed that a key element of the Government's policy of increasing aid utilization and promoting faster economic growth should be to improve project implementation and monitoring. Some of the main problems in this area are inadequate accounting and auditing procedures, weak project management, excessive administrative intervention in procurement functions, and an imbalance between the number of activities undertaken and the available institutional and staffing capacity. These weaknesses have raised the unutilized pipeline of aid commitments to a current level of over $1 billion (40 percent of GDP). 1/ The authorities said that they had begun to address these problems with assistance from multilateral aid agencies; for instance, prototype monitoring systems were being introduced for large projects, better accounting frameworks were being developed, and steps were being taken to enable the Government to stop projects that were clearly unviable. This will be a long-term process and a key component of the World Bank's SAL program.

1/ This amount includes aid commitments for projects for which a financing package has not yet been finalized. To that extent, it overestimates the pipeline available for immediate use.

2. Public enterprises

The activities of nonfinancial public enterprises, which account for about 2 percent of GDP, have led to substantial operating losses in recent years, financed through the budget and increasing recourse to the domestic banking system. 1/ Recognition of this problem has led the Government to undertake several measures--including substantial increases in administered prices--to improve the efficiency of public sector enterprises and place them on a sounder financial footing. 2/ Despite these measures, the net wealth of most public enterprises remains negative, which is the major obstacle to implementing the Government's planned divestiture program. The authorities reiterated their intention to implement such a program, indicating that they had identified over 40 public enterprises that the Government may wish to sell in whole or in part. The Government has requested IFC technical assistance to help review the financial structure of public enterprises and make recommendations for restructuring.

The largest loss-making enterprise, representing the heaviest burden on the budget and accounting for an important share of bank credit to public corporations is the Nepal Food Corporation (NFC), which procures and distributes foodgrains to deficit areas. On account of its obligation to undertake subsidized sales, the NFC has sustained substantial losses in recent years. To reduce such losses, starting in 1986/87 the NFC has virtually eliminated the subsidized sale of foodgrains in the Kathmandu Valley. It also plans to discontinue sales in areas accessible by road, leaving the provision of foodgrains to these areas to the private sector. Further savings are to be realized by the divestiture of intra-district operations to local Sajhas (cooperatives). Though it will continue to make subsidized sales in remote parts of the country, in other areas the NFC will limit its activities to price stabilization, which will normally not entail financial losses. These measures are expected to reduce the NFC's losses by NRs 20-30 million in 1986/87. 3/

The staff noted that the present practice whereby a large part of the NFC's losses had been automatically financed by the domestic banking system had not been conducive to financial discipline and had also led to the accumulation of large claims on the books of commercial banks on which no interest was being paid either by the NFC or the Government,

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1/ Budgetary support to nonfinancial public enterprises in the form of subsidies, transfers, loans, and equity participation averaged about 10 percent of government expenditure over the last two years.

2/ Goods and services whose prices were increased during the past year included fertilizer, milk, sugar, cement, electricity tariffs, and transportation fares.

3/ For 1986/87, the NFC's losses are projected at NRs 70-80 million. In addition, the NFC obtains NRs 40 million transportation subsidy from the Government.

which had guaranteed the loans. The accumulation by banks of such nonperforming assets not only adversely affected the profit situation of banks, but also raised the level of credit extended to the public sector, thus increasing the possibility of crowding out the private sector. The staff recommended that, starting in 1987/88, the budget make specific provision for gradually clearing the government-guaranteed arrears of the NFC and that in the future, the NFC's operating losses arising from the subsidization of foodgrains should not be financed through the banking system but rather through explicit provisions in the budget for that purpose. Such a system should help promote financial disclipline by making the costs associated with the subsidies transparent.

The Agricultural Input Corporation (AIC), which distributes fertilizers at subsidized prices, has also incurred large losses that have been financed by transfers from the budget (the AIC no longer borrows from the banking system). In mid-1986, fertilizer prices were raised by 15-24 percent, bringing the level of prices in line with those prevailing in India. While this still involves a subsidy, the authorities stated that in the future their policy would be to maintain fertilizer prices at levels that would prevent their re-export. To improve efficiency and to reduce costs, private sector participation in the distribution of fertilizers had been increased significantly in 1986/87.

The Agricultural Development Bank of Nepal (ADBN) is primarily engaged in the provision of credit to small farmers. The staff noted that the major challenge facing the ADBN lay in improving its loan recovery rate that had been declining over the past five years. The authorities indicated that to turn the situation around, the ADBN raised interest rates to better reflect risk, had started compounding interest on arrears and, most importantly, had stepped up the prosecution of defaulters. A new provision for writing off bad debt had also allowed the institution to more realistically evaluate its performance.

3. Monetary policy

Domestic credit expansion continued to slow during the first quarter of 1986/87 and NDA was below the program ceiling by about 2 percent in October 1986. This was the result of a slower-than-anticipated expansion of private sector credit, attributable to sluggishness of private sector demand and perhaps, to a lesser extent, also reflected caution on the part of banks to ensure that they remained within the credit limits established by the NRB. 1/ In contrast, public sector credit grew faster than programmed. As discussed earlier, the

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1/ In early 1986, the credit limits for commercial banks established by the NRB were exceeded, in part because no limits were set at the branch level and branches of the two dominant (government-owned) commercial banks continued to accelerate their loan operations.

subceiling on net credit to Government was exceeded. In addition, the indicative ceiling on credit to nonfinancial public enterprises was also exceeded (by 4 percent), due primarily to the accumulation of accrued interest on overdue loans by the NFC as well as rice export companies presently undergoing liquidation. The authorities explained that this situation arose in part because banks had been authorized since the May 1986 interest rate reform to compound interest on arrears.

The monetary program for 1986/87 allows for a 15 percent increase in broad money, which is consistent with the Government's growth, inflation, and balance of payments targets and takes into account an expected decline in velocity as inflation subsides. Total domestic credit is projected to expand by 14 percent, slightly less than originally targeted, with public sector credit rising somewhat faster than envisaged earlier and private sector credit increasing more slowly reflecting weaker demand. Since the impact of the recent fiscal measures will be felt mainly in the second half of 1986/87, the authorities have requested an increase in the subceiling on net credit to Government for January 15, 1987 by 1.7 percent, approximately the same increase as the excess over the October 1986 ceiling. The authorities have also proposed to raise by 9.5 percent the indicative ceiling on credit to nonfinancial enterprises, which takes into account the fact that the recent increase in the price of rice sold by the NFC will reduce the latter's borrowing requirement only gradually throughout 1987 as rice procured during the winter is being sold to the public. No change in the NDA ceiling is proposed since weaker private sector demand for credit in the first quarter of 1986/87 has left sufficient room under the original NDA ceiling to satisfy the needs of the private sector.

To maintain the discipline of monitoring, the authorities have established indicative credit ceilings for April 1987. The authorities view these limits, which are not performance criteria, as a bridge in the credit program between the end of the stand-by arrangement and the first annual SAF program contemplated to start in July 1987. Given the uncertainties at the time of the discussions about the exact timing of disbursements under the World Bank's SAL, the April indicative ceiling on net credit to Government incorporates a safety margin to take into account any possible delays in these disbursements. The staff urged the authorities not to use this safety margin if there were no delays in the SAL disbursements.

The staff recommended that to improve resource allocation and to strengthen monetary management, the government securities market should be reformed. At present, there are three types of government securities available. A three-month treasury bill carries an interest rate of 5 percent, compared with 8.5 percent interest paid on three-month bank deposits. Even though interest income earned on government securities is tax exempt, the interest on treasury bills is not competitive and virtually all these bills are held by the NRB. The two other securities available are a 10-year development bond and a 15-year savings certificate. While they carry substantially higher interest rates, the length of their maturities coupled with the absence of an active secondary market make them unattractive to many investors. To overcome this handicap, the NRB guarantees the automatic rediscounting of government bonds held by commercial banks, which has at times frustrated effective monetary management. The staff recommended the abolition of the tax-exempt status of government securities and the introduction of bonds with a wider spectrum of maturities carrying market-related interest rates. Together with measures to develop a secondary market for government securities, this would enable the NRB to engage in open-market operations and to eliminate the automaticity of rediscounting of government bonds. The authorities were sympathetic to the recommendations of the staff and said that they were actively considering measures to reform the government bond market.

4. Industrial, trade, and exchange rate policies

An innovation in industrial policy involves the introduction in 1986/87 of a passbook system for the import of industrial raw materials. Under this system, import licenses are determined for each enterprise on an annual basis taking into account the previous year's production level and the current year's production program. The annual amount of import requirements thus determined is recorded in a passbook against which the issuance of licenses and the provision of foreign exchange are automatic. The introduction of the passbook system was accompanied by an increase of 25 percent (in SDR terms) in the amount of foreign exchange allocated for such purposes. The new system has simplified administrative procedures and has reduced uncertainties for producers regarding the timely availability of raw materials. The Government has also simplified the industrial licensing procedures in as much as industries having less than a 20 percent import requirement are now generally able to obtain industrial licenses automatically.

Regarding the recently introduced auction system of import licenses for "commercial" imports, the authorities said that while the main objective was to raise government revenue, the new system was also a step toward rationalizing the import regime. They stressed that the system had increased the transparency of import licensing, facilitated new entrants as evidenced by the considerable increase in the number of importers who participated in the auctions, and reduced pressure on public officials responsible for the allocation of import licensing. The authorities also indicated that the import of wool had been substantially liberalized in recent months by granting virtually unlimited licenses to carpet producers and said that they would place under Open General License (OGL) the imports of wool, gypsum, and iron billets in early 1987.

The staff noted that Nepal's import regime remained highly restrictive as virtually all imports from third countries were subject to quantitative restrictions. While the passbook and auction systems represented improvements over previous practices, ultimately, considerations of efficient resource allocation would require a substantial reduction in quantitative restrictions accompanied by an appropriate import tariff structure. The passbook and auction systems should be considered only as intermediate steps toward a more liberal trade regime. The authorities expressed concern that a removal on a broad scale of quantitative restrictions on imports would divert trade to India and lead to an exhaustion of Nepal's convertible currency reserves. In their view, the very substantial premia on certain items in the auctions were an indication of strong demand largely originating from India. 1/ They pointed out that in the past, experiments with OGL had led to considerable trade deflection, although they agreed that this occurred in part because of an inappropriate import tariff structure. The authorities indicated, however, that they were prepared to consider a reduction in quantitative restrictions cum tariff adjustments and requested technical assistance from the Fund in this area. In response, a staff mission with IBRD participation is scheduled to visit Kathmandu in early 1987.

To promote tourism, the Government has recently liberalized charter flights and intends to purchase an aircraft in 1987 and to lease another in 1988. 2/ The authorities indicated that these aircraft acquisitions would add to the profitability of the Royal Nepal Airlines Corporation (RNAC) and would generate sufficient foreign exchange earnings to cover the additional debt service payments. By leasing one aircraft, the airline company would retain flexibility as it could terminate the contract if air traffic did not meet expectations. Nepal's external debt service burden is relatively low as most of the external debt has been contracted on concessional terms. Even with the acquisitions of aircraft, the debt service burden will remain manageable (see next section).

The improvement in external competitiveness achieved by the November 1985 devaluation has been largely maintained (Chart 6). In May 1986, the authorities introduced a new exchange rate regime under which the Nepalese rupee is pegged, within margins, to a new basket of currencies in which the Indian rupee has a large weight. The authorities indicated that exchange rate flexibility will be pursued through this new regime with a view to maintaining competitiveness. They recognize that, given the high degree of openness of the Nepalese economy vis-a-vis India, frequent changes in the Nepalese rupee/Indian rupee exchange rate should be avoided by pursuing appropriately restrained financial and wage policies. In this respect, they noted that the inflation differential vis-a-vis India has been sharply reduced and that the current interest rate differential in favor of Nepalese rupee

1/ Some items yielded a premium as high as 160 percent.
2/ Financing of these acquisitions is being arranged with the guarantee of the U.S. Export-Import Bank.

CHART 6

NEPAL

EFFECTIVE EXCHANGE RATE INDICES, 1982–86[1]

(Dec. 1985–Feb. 1986 = 100)

Source: *IFS.*

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

assets, at about 2 percentage points, was sufficient to discourage speculative capital flows.

Nepal's restrictions on the making of payments and transfers for current international transactions are maintained in accordance with Article XIV except for the restriction on payments and transfers for current international transactions arising from the bilateral payments agreement with Poland, which is subject to Fund approval. The principal elements of exchange restrictions that Nepal maintains on third countries under Article XIV are a foreign exchange budget linked to the issue of licenses on imports, limits on foreign exchange allocations for most invisible payments, margins on letters of credit for some imports, and restrictions on the transfer of balances of Nepalese rupees for making current payments or transfers. 1/

V. Medium-Term Outlook

The two medium-term scenarios presented in this section underscore the need for structural measures to achieve a sustainable, higher rate of economic growth (Appendix Tables 10 and 11). In Scenario I, it is assumed that the Government would continue to implement adequate demand management policies as well as measures to reduce the structural impediments to growth, including measures to increase domestic resource mobilization, to improve project implementation and aid utilization, to increase the productivity of investment through better project selection, and to liberalize trade. In this scenario, following a recovery from drought in 1987/88, the annual growth of real GDP is projected at 4.5 percent, the rate of inflation at 5 percent, and gross international reserves would be maintained at the level equivalent to about 3.5 months of imports of goods and services. In Scenario II, the gross reserves and inflation targets are retained but it is assumed that adjustment would concentrate on financial restraint and no structural measures would be taken. This would result in significantly lower economic growth.

In Scenario I, revenue measures are expected to be taken each year with the objective of raising the revenue/GDP ratio by 0.7 percentage point per year. This, together with restraint on regular expenditure,

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1/ In the decision taken at the conclusion of the 1985 Article IV consultation, it was stated that a prescribed contractual limitation on the use of certain currencies for effecting withdrawal by nonresidents of foreign currency deposits constituted a restriction on payments and transfers for current international transactions subject to Fund approval under Article VIII. This conclusion had been based on an understanding that the limitation applied to nonresidents. It has since been clarified that the limitation applies exclusively to residents. Therefore, no restriction subject to Fund approval is involved because the restriction does not apply to international transaction.

would allow development expenditure to rise in relation to GDP by about 3 percentage points by 1991/92. Nevertheless, the ratio of the overall budget deficit (excluding grants) to GDP would fall by slightly less than 1 percentage point to 8.5 percent of GDP and the net domestic financing of the budget would decline to below 1 percent of GDP by 1991/92. The growth of export volume is expected to be about 7 percent per year--compared with an average annual rate of growth of less than 4 percent over the last five years--and the ratio of the external current account deficit to GDP (excluding grants) is projected to decline slightly to 7 percent by 1991/92. With improved aid absorption capacity due to higher domestic resource availability, better project implementation, and an anticipated shift toward quick disbursing aid, foreign aid disbursements are projected to grow by 11 percent per annum. The overall balance of payments is projected to be in surplus throughout the period under consideration, averaging about SDR 18 million per year. Largely owing to debt servicing of the planned acquisition of aircraft, debt service payments would increase from its current level of 5.5 percent of exports of goods and services and private transfer receipts to about 10.5 percent by 1990/91 and would decline thereafter.

Scenario II indicates that, in the absence of structural measures to increase domestic resource mobilization and to improve project implementation and aid utilization, real GDP growth would be constrained to the unacceptably low rate of less than 2 percent per year, that is, below population growth. Assuming that net domestic financing of the budget deficit would be restrained to protect reserves, and given a projected fall in the revenue/GDP ratio due to the low elasticity of the tax system, the ratio of development expenditure to GDP would decline by 3 percentage points by 1991/92. The external current account would decline in relation to GDP but this would reflect lower aid disbursements and a slow growth of imports. Simulation results of a variant of Scenario II indicate that if the authorities attempted to accelerate economic growth to 4.5 percent per annum without underlying structural reforms, a large and persistent financing gap would lead to complete depletion of international reserves by end-1989/90.

Apart from the aforementioned policy assumptions, the above medium-term projections are predicated on a number of key environmental assumptions: normal weather; a slight improvement in the external terms of trade following a projected deterioration in 1986/87; and no intensification of restrictions on Nepal's exports by trade partners. If any of these assumptions fails to materialize, the intended progress toward a higher growth path with balance of payments viability would be put in jeopardy.

Fund exposure is relatively low. Assuming that the amount of the present stand-by arrangement was fully drawn, obligations to the Fund (excluding Trust Fund loans currently totaling SDR 5.9 million) would account for only 3 percent of Nepal's total external debt at end-1986/87. Assuming disbursements under a possible SAF arrangement totaling SDR 17.5 million during the three years ending 1989/90, obligations to the Fund would gradually decline to 1.3 percent of total external debt by end-1991/92 in the case of Scenario I. At their peak level in 1990/91, debt service payments to the Fund would represent only 2 percent of exports of goods and services and private transfer receipts. This, together with the fact that Nepal's overall debt service burden is relatively low, should enable Nepal to service its obligations to the Fund on the basis of current and prospective commitments.

VI. Staff Appraisal

The adjustment program implemented by the Nepalese authorities under the current stand-by arrangement has brought about significant results in reducing internal imbalances and easing the immediate balance of payments pressure. The measures undertaken have been comprehensive, including a tightening of financial policies, as well as initiatives to increase domestic resource mobilization, improve financial intermediation, strengthen the financial position of public enterprises, and rationalize the import regime. During the first quarter of 1986/87, there were slippages in the implementation of the credit program, with credit to the public sector increasing faster than expected, although NDA expansion remained slightly below the program target. The authorities have forcefully reiterated their commitment to the objectives of the program and have taken corrective action, including new measures to raise revenue and steps to reduce the financial losses of public enterprises. In the staff's view, these measures will bring the program back on track in terms of short-term macroeconomic adjustment. However, Nepal's balance of payments remains structurally weak and longer term adjustment requires substantial efforts to increase domestic resource mobilization and to improve project selection/implementation and aid utilization. The recent initiatives to improve the allocation of resources through greater reliance on the price mechanism and the moves toward liberalizing imports also need to be strengthened.

Nepal's tax/GDP ratio is low and increased revenue effort must remain a top priority of the Government during the years ahead. In this respect, it is important to underscore that the newly introduced auction system of import licenses for certain goods subject to quantitative restrictions should not be regarded as a long-term source of revenue but rather an intermediate step toward a more liberal import regime. To the extent that an increase in import duties that is to accompany a reduction in quantitative import restrictions is inadequate, new sources of revenue will need to be found to replace revenue from the auction system. The elasticity of Nepal's tax system is low and the effort should also be directed toward improving tax administration and broadening the tax base. If tax elasticity is not significantly improved, the medium-term target of domestic resource mobilization will be difficult to achieve and the burden of fiscal adjustment will need to fall more heavily on expenditure, with its attendant adverse implications for development and growth.

The authorities are aware that domestic resource constraints necessitate cautious incomes policy and have explained that the mid-fiscal year salary increase would facilitate wage restraint in 1987/88. In view of the need to make room for increased development outlays, the staff urges the authorities to adhere to the objective established at the start of the adjustment program of not allowing regular expenditure to rise faster than nominal GDP, while allowing adequate growth in expenditure for the operation and maintenance of completed projects. Given the recent increase in salaries, this objective would leave no room for a further salary adjustment in 1987/88 unless government employment is reduced by accelerated retirement and attrition.

The decision to eliminate subsidized foodgrain sales in the Kathmandu Valley will reduce the losses of the Nepal Food Corporation and its need for domestic bank credit. To make the cost of food subsidies more transparent, the staff recommends that foodgrain subsidization be entirely financed through specific budgetary provisions rather than through automatic credit extension by the domestic banking system to the NFC. The accumulation of interest arrears by the NFC and the rice export companies vis-a-vis commercial banks have strained the profit situation of banks and the staff urges the authorities to make specific provisions in the 1987/88 budget to settle these arrears on loans which have been guaranteed by the Government.

To complement the interest rate reform introduced in 1986, the authorities are encouraged to improve the government bond market. In particular, consideration should be given to introducing securities with a wider range of maturities carrying market-related interest rates. Given the evident difficulties in placing the presently available government securities with the nonbank sector, measures that will enhance the attractiveness of government securities should now be accorded some priority. Such measures will help develop a secondary market that would give the NRB greater discretion in monetary management by enabling it to engage in open-market operations and to eliminate the automaticity of rediscounting of government bonds held by commercial banks.

The introduction of the passbook system for industrial raw materials, the auctioning of certain import licenses, and the liberalization of a few selected imports are welcome, albeit modest, moves toward greater liberalization and rationalization of the import regime. With a view to increasing efficiency, the Government should undertake more substantive steps toward a reduction in quantitative import restrictions accompanied by appropriate tariffs. To avoid trade deflection, import liberalization will of course need to take into account the openness of Nepal's economy vis-a-vis India. The staff welcomes that the gains in competitiveness achieved by the November 1985 devaluation of the Nepalese rupee have been largely maintained. Since Nepal's balance of payments remains structurally weak, the authorities should continue to vigorously pursue external and domestic policies that would maintain and indeed enhance competitiveness.

Nepal's exchange system includes an exchange restriction arising from a bilateral payments arrangement with a Fund member, which is subject to Fund approval under Article VIII, Section 2. The staff does not recommend approval of this restriction at this time.

The authorities have requested an increase in the January 15, 1987 subceiling on net credit to Government established as performance criterion under the stand-by arrangement, while leaving the original ceiling on NDA unchanged. They also believe that an increase in the indicative ceiling on credit to nonfinancial enterprises, which is not a performance criterion, is warranted. The staff believes that since the impact of the fiscal and other measures introduced recently will be felt mainly in the second half of 1986/87, the modifications are warranted and would not jeopardize the objectives of the program. Accordingly, the staff recommends that the performance criterion on net credit to Government for January 15, 1987 be modified as requested.

It is recommended that the next Article IV consultation with Nepal be held on the standard 12-month cycle.

VII. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

A. 1986 consultation

1. The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Section 2(a) and in concluding the 1986 Article XIV consultation with Nepal, in the light of the 1986 Article IV consultation with Nepal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance Over Exchange Rate Policies).

2. Nepal's exchange restrictions as described in EBS/87/37, are maintained in accordance with Article XIV, Section 2, except that the restriction on payments and transfers for current international transactions arising from the bilateral payments arrangements with a Fund member is subject to approval under Article VIII, Section 2(a). The Fund urges Nepal to eliminate the restrictive features of this bilateral payments arrangement as soon as possible.

B. Review under the stand-by arrangement

1. Nepal has consulted the Fund in accordance with paragraph 3(c) (iii) of Decision No. 8391-(86/155), adopted 9/12/86, completing the first review under the stand-by arrangement for Nepal and paragraph 23 of the letter dated September 8, 1986 from the Minister of State for Finance and Industry, in order to assess performance under the program supported by the arrangement.

2. The letter dated January 12, 1987 from the Minister of State for Finance and Industry shall be attached to the stand-by arrangement and the letters dated December 3, 1985 and September 8, 1986 shall be read as supplemented and modified by the letter dated January 12, 1987.

3. Accordingly, the subceiling on net credit to the Government referred to in paragraph 3(a) (ii) of the stand-by arrangement shall be, for January 15, 1987, as specified in paragraph 9 of the letter dated January 12, 1987.

4. The Fund decides that the review contemplated in paragraph 3(c) (iii) of Decision No. 8391-(86/155), adopted 9/12/86, is completed and that no further understandings are necessary. Accordingly, Nepal may proceed to request purchases under the stand-by arrangement.

Table 4. Nepal: Indicators of Output and Prices, 1982/83-1986/87

	1982/83	1983/84	1984/85	1985/86 Prov. actual	1986/87 Proj.
	(Percentage change from previous year)				
Real GDP	-3.0	7.8	3.0	4.2	1.5
Agriculture	-1.1	9.5	2.4	4.7	-0.2
Nonagriculture	-5.8	4.9	4.0	3.4	4.4
Inflation					
Nepal					
CPI					
Annual average	14.2	6.2	4.1	15.7	12.0
July to July	14.4	1.6	6.9	21.7	8.0
GDP deflator	12.3	5.0	6.2	14.3	12.0
India 1/					
CPI					
Annual average	9.5	11.3	5.6	7.3	...
July to July	13.2	8.1	5.1	8.6	...
WPI					
Annual average	4.8	9.5	6.8	4.7	...
July to July	6.9	10.0	5.7	4.0	...
Exchange rate 2/					
Annual average	--	--	--	11.3	...
July to July	--	--	--	15.9	...
	(As percent of nominal GDP)				
Consumption	90.9	89.7	88.8	90.1	89.7
Investment	20.1	19.4	20.7	19.0	19.5
National savings	11.2	12.2	13.1	11.5	12.0
Net factor income from abroad	(2.1)	(1.9)	(1.9)	(1.6)	(1.7)
Domestic savings	(9.1)	(10.3)	(11.2)	(9.9)	(10.3)
Foreign savings	8.9	7.2	7.6	7.5	7.6

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

1/ Annual average on the basis of the fiscal year.
2/ Nepalese rupees per Indian rupee. Positive figures represent depreciation of the Nepalese rupee.

Table 5. Nepal: Central Government Budget, 1983/84-1986/87

(In millions of Nepalese rupees)

	1983/84 Actual	1984/85 Actual	1985/86 Program	1985/86 Prov. actual	1986/87 Program	1986/87 Revised proj.
Revenue and grants	4,205	4,772	6,853	5,866	7,285	6,821
Revenue	3,328	3,849	4,903	4,485	5,525	5,376
Tax	(2,737)	(3,151)	(4,183)	(3,755)	(4,665)	(4,326)
Nontax	(591)	(698)	(720)	(730)	(860)	(1,050)
Grants	877	923	1,950	1,381	1,760	1,445
Total expenditure	7,204	8,153	10,239	9,147	11,265	10,597
Regular	2,107	2,720	3,625	3,281	3,700	3,800
Development	5,164	5,489	6,954	5,993	7,811	6,997
Domestically financed	(2,616)	(2,811)	(2,616)	(2,387)	(2,921)	(2,572)
Foreign financed	(2,548)	(2,678)	(4,338)	(3,606)	(4,890)	(4,425)
Net lending 1/	-67	-56	-340	-127	-246	-200
Overall balance (deficit -):						
Including grants	-2,999	-3,381	-3,387	-3,281	-3,980	-3,776
Excluding grants	-3,876	-4,304	-5,337	-4,662	-5,740	-5,221
Net foreign financing	1,615	1,699	2,257	2,066	2,880	2,720
Disbursements	1,671	1,755	2,387	2,225	3,130	2,980
Amortization	-56	-56	-130	-159	-250	-260
Net domestic financing	1,384	1,682	1,130	1,215	1,100	1,056
Banking system	1,080	1,467	800	927	800	800
Other domestic	315	215	330	288	300	256
Memorandum item:						
Total wage bill	1,413	1,612	...	1,724	...	1,874

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

1/ Comprising mainly loan repayments from public enterprises.

Table 6. Nepal: Monetary Survey, 1984-87 1/

	1984	1985	1986				1987				
			July		October		January		April	July	
	July	July	Program	Actual	Program	Actual	Program	Revised program	Program 2/	Program	Revised Program
	(In millions of Nepalese rupees)										
Net foreign assets	2,620	1,898	2,128 3/	2,165 3/	2,347 4/	2,335 4/	2,562 4/	2,574 4/	2,640 4/	2,712 4/	2,695 4/
Net domestic assets 5/	7,835	10,399	12,689	12,995	13,098	12,808	13,523	13,523	14,480	14,703	14,695
Domestic credit	9,820	12,549	14,874	15,245	15,639	15,689	16,337	16,370	17,300	17,508	17,450
Public sector	5,977	7,654	8,592	9,143	9,269	9,470	9,454	9,750	10,050	9,954	10,118
Government (net)	5,024	6,491	7,291	7,418	7,600	7,734	7,765	7,900	8,100	8,160	8,218
Nonfinancial public enterprises	953	1,163	1,301	1,726	1,669	1,736	1,689	1,850	1,950	1,794	1,900
Private sector	3,842	4,895	6,282	6,102	6,370	6,219	6,883	6,620	7,250	7,554	7,332
Other items (net)	-1,985	-2,150	-2,185	-2,250	-2,541	-2,881	-2,814	-2,847	-2,820	-2,805	-2,755
Broad money	10,455	12,297	14,817	15,160	15,445	15,143	16,085	16,097	17,120	17,415	17,390
	(Percentage change over the same month of previous year)										
Memorandum items:											
Net domestic assets	18.6	36.6	22.0	25.0	20.3	17.6	19.5	19.5	17.6	16.8	16.7
Domestic credit	17.7	27.8	18.5	21.5	18.5	18.9	17.0	17.2	16.5	14.8	14.5
Public sector	17.6	28.1	12.3	19.5	15.4	17.9	14.3	17.9	19.1	8.9	10.7
Government (net)	27.4	29.2	12.3	14.3	12.7	14.7	12.2	14.2	16.0	10.0	10.8
Nonfinancial public enterprises	-16.1	22.0	11.8	48.3	29.5	34.6	24.8	36.7	33.9	4.0	10.1
Private sector	17.7	27.4	28.3	24.7	23.5	20.6	20.8	16.2	13.2	23.8	20.2
Broad money	13.4	17.6	20.5	23.3	22.4	20.0	18.4	18.5	15.4	14.9	14.7

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

1/ Components may not add up to totals due to rounding.
2/ The original program did not incorporate targets for April 1987.
3/ Valued at exchange rates prevailing as of July 15, 1985.
4/ Valued at exchange rates prevailing as of January 31, 1986.
5/ Defined as broad money less net foreign assets.

Table 7. Nepal: Structure of Interest Rates, 1986 1/

(In percent per annum)

	As of May 28, 1986 (Pre-reform)	As of November 30, 1986
Refinancing facilities of Nepal Rastra Bank		
To commercial banks		
Export bills	12.0-13.0	11.0
Industrial sector	5.0-18.0	11.0
Agricultural sector	4.0-11.0	11.0
Service sector	11.0	11.0
Development bonds	12.0	12.5
To Agricultural Development Bank of Nepal	5.0	... 1/
Commerical banks		
Deposits		
Savings deposits	8.5	8.5
Time deposits		
3 months	4.5	8.5
6 months	9.5	8.75
1 year	12.5	12.5
2 years	13.5	13.5
3 years	...	13.65
4 years	...	13.75
5 years	...	14.0
Loans		
Industry	9.0-17.0 2/	15.0-19.0 2/
Agriculture	8.0-15.0 2/	15.0-20.0 2/
Services	15.0	15.0
Export bills	8.0-14.0	15.0-16.0
Commercial loans and overdrafts	17.0	17.0-21.0
Agricultural Development Bank of Nepal		
To cooperatives	4.0-11.6	13.0-18.0
To others	8.0-15.0	15.0-20.0
Nepal Industrial Development Corporation	12.0-17.0	14.5-18.0
Government securities		
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/ Eliminated at the time of the interest rate reform introduced on May 29, 1986.
2/ Banks were required to charge 2 percent less interest on loans to cottage industry and agricultural sectors of 18 remote districts.

Table 8. Nepal: Balance of Payments, 1982/83-1986/87 1/

(In millions of SDRs)

	1982/83	1983/84	1984/85	1985/86 Program	1985/86 Prov. actual	1986/87 Program	1986/87 Revised proj.
Exports, f.o.b.	76	107	156	162	144	154	143
Imports, c.i.f.	-424	-408	-440	-505	-439	-490	-440
Aid imports	-86	-91	-84	-117	-89	-138	-108
Nonaid imports	-337	-316	-356	-388	-350	-352	-331
Trade balance	-348	-301	-285	-343	-296	-336	-297
Services (net)	108	87	61	88	84	83	90
Receipts	169	161	154	168	161	169	169
Payments	-60	-74	-93	-81	-77	-86	-79
Private transfers (net)	39	43	43	47	38	46	41
Receipts	41	46	45	49	45	51	48
Of which: Private remittances	(37)	(38)	(39)	(38)	(36)	(40)	(38)
Payments	-2	-2	-2	-2	-6	-5	-7
Current account balance	-201	-171	-181	-209	-174	-207	-166
Nonmonetary capital movements	155	157	130	205	172	219	170
Official grants	88	86	76	99	62	107	65
Official capital (net)	62	75	72	106	84	90	84
Foreign loans	(65)	(80)	(77)	(114)	(93)	(98)	(94)
Amortization	(-3)	(-4)	(-5)	(-8)	(-9)	(-9)	(-10)
Structural Adjustment Loan (IBRD)	--	--	--	--	--	23	21
Other capital (net) 2/	5	-5	-17	--	26	--	--
Overall balance	-46	-14	-50	-4	-1	12	5
Monetary movements	46	14	50	4	1	-12	-5
Assets (increase -)	59	20	47	-7	-6	-18	-10
Liabilities	-13	-6	4	11	7	6	6
Of which: Fund credit (net)	-6	-4	-5	13	9	8	8
Trust Fund (net)	--	-1	-1	-2	-2	-3	-3
Memorandum item:							
Gross reserves	210	190	143	150	149	167	159

Sources: Data provided by the Nepalese authorities; and staff estimates.
1/ Components may not add to totals due to rounding.
2/ Including errors and omissions and valuation adjustments.

Table 9. Nepal: Main Additional Revenue Measures, 1986/87

(In millions of Nepalese rupees)

Revenue Measures	Date of Effectiveness	Estimated Additional Revenue in 1986/87
1. Increase in ex-factory prices for cigarettes by an average of 13 percent	December 1986	30
2. Increase in import duty on gasoline and the base price for the sales tax	February 1987	15
3. Increase in sales taxes and excise and import duties in selected items 1/	February 1987	20
4. Increase in airline landing fees by 50 percent	January 1987	8
5. Introduction of an auction system for import licenses	July and December 1986	320 2/
Total		393

Source: Data provided by the Nepalese authorities.

1/ Including cement, iron rods, alcoholic beverages, cigarettes, and synthetic fiber.
2/ Receipts from the auctions in July and December 1986 amounted to NRs 97 million and NRs 101 million, respectively.

Table 10. Nepal: Medium-Term Prospects--Scenario I, 1986/87-1991/92

	1981/82-1985/86 Average	1986/87 Revised est.	1987/88	1988/89	1989/90	1990/91	1991/92
			Projections				
	(Annual percentage change)						
Output and prices							
Real GDP growth	3.1	1.5	6.0	4.2	4.5	4.5	4.5
Inflation (annual average)	10.1	12.0	6.0	5.0	5.0	5.0	5.0
External sector							
Exports, f.o.b.	5.9	-0.6	13.5	10.8	11.2	11.3	11.3
Imports, c.i.f.	8.1	--	11.1 1/	8.9 1/	8.8	8.7	8.9
Export volume	3.8	5.4	8.4	6.6	7.0	7.1	7.2
Import volume	7.9	2.0	6.3 1/	5.7 1/	5.6	5.5	5.5
Terms of trade	1.8	-3.9	0.1	0.9	0.8	0.8	0.8
Government budget							
Revenue	13.3	19.9	20.6	16.9	16.8	16.3	16.0
Regular expenditure	*21.0*	*15.8*	*12.4*	*9.4*	*9.7*	*9.7*	*9.7*
Development expenditure	17.0	16.8	20.3	11.1	12.9	15.4	15.0
	(In percent of GDP; unless otherwise specified)						
External sector							
Exports, f.o.b.	5.1	6.6	6.7	6.8	6.9	7.0	7.1
Imports, c.i.f.	18.0	20.2	20.3 1/	20.2 1/	20.0	19.8	19.7
Current account deficit							
(Excluding grants)	7.3	7.6	7.5 1/	7.3 1/	7.2	7.1	7.0
(Including grants)	3.8	4.6	4.4 1/	4.1 1/	3.8	3.7	3.4
External public debt	15.2	28.9	33.0	36.4	32.5	38.4	39.2
Of which: Fund credit 2/	(0.4)	(0.9)	(1.1)	(1.1)	(0.9)	(0.6)	(0.5)
(In percent of quota)	(28.3)	(50.0)	(70.0)	(76.6)	(71.1)	(53.0)	(47.0)
Debt service ratio 3/	4.1	5.5	6.7	9.0	10.4	10.6	8.9
Of which: Obligations due to the Fund 2/	(1.4)	(0.2)	(0.3)	(0.8)	(1.6)	(2.0)	(0.4)
Government budget							
Revenue	8.8	9.5	10.2	10.9	11.6	12.3	13.0
Total expenditure (including net lending)	18.8	18.7	19.6	19.8	20.1	20.7	21.6
Regular expenditure	5.8	6.7	6.7	6.7	6.7	6.7	6.7
Development expenditure	13.1	12.4	13.2	13.4	13.8	14.6	15.3
Foreign aid disbursements	6.4	7.8	8.0	8.1	8.1	8.1	8.2
Overall deficit							
(Excluding grants)	10.0	9.2	9.3	8.8	8.5	8.6	8.6
(Including grants)	7.3	6.7	6.7	6.1	5.7	5.6	5.6
Net domestic financing	3.8	1.9	1.8	1.3	1.0	0.9	0.8
	(In millions of SDRs)						
Exports, f.o.b.	117	143	182	179	199	222	247
Imports, c.i.f.	409	440	534	578	579	629	885
Current account deficit (excluding grants)	166	166	227	238	208	226	244
Nonmonetary capital movements	152	170	237	251	225	248	275
Of which: Foreign aid disbursements	(152)	(180)	(205)	(226)	(249)	(275)	(303)
Overall balance	-14	5	9	13	17	22	31
Gross reserves (end of period)	192	159	174	187	201	217	246
(In months of imports of goods and services)	(4.9)	(3.7)	(3.6)	(3.6)	(3.5)	(3.5)	(3.6)
Total external debt outstanding (end of period)	348	628	793	959	1,084	1,216	1,364
Concessional loans 4/	339	609	723	847	982	1,128	1,287
Fund credit 2/	9	19	26	29	27	20	18
Aircraft loans 5/	--	--	44	84	76	68	60
Debt service payments	13	20	27	40	51	56	52
Of which: Obligations due to the Fund 2/	(4)	(1)	(1)	(4)	(8)	(11)	(2)

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

1/ Excluding the prospective acquisition of an aircraft amounting to SDR 46 million. Including this acquisition, the ratio of the current account deficit to GDP would be higher by about 2 percentage points.

2/ Excluding Trust Fund, but including an SAF arrangement.

3/ In percent of exports of goods and services and private transfers and including debt service payments arising from the prospective leasing of a second aircraft.

4/ Including Trust Fund loans.

5/ Including leasing charges.

Table 11. Nepal: Medium-Term Prospects--Scenario II, 1986/87-1991/92

	1981/82-1985/86 Average	1986/87 Revised proj.	1987/88	1988/89	1989/90 Projections	1990/91	1991/92
			(Annual percentage change)				
Output and prices							
Real GDP growth	3.1	1.5	2.5	1.0	1.0	1.0	2.0
Inflation (annual average)	10.1	12.0	6.0	5.0	5.0	5.0	5.0
External sector							
Exports, f.o.b.	5.9	-0.6	10.1	7.6	7.4	7.0	6.8
Imports, c.i.f.	8.1	—	9.5 1/	0.7 1/	4.1	4.5	6.4
Export volume	3.8	5.4	5.3	3.5	3.4	3.1	2.8
Import volume	7.9	2.0	4.7 1/	-2.2 1/	1.1	1.5	3.3
Terms of trade	1.8	-3.9	0.1	0.9	0.8	0.8	0.8
Government budget							
Revenue	13.3	19.9	7.4	4.5	4.3	4.5	5.5
Regular expenditure	21.0	15.8	8.6	6.0	6.0	6.0	6.0
Development expenditure	17.0	16.8	11.5	-8.9	-0.7	2.3	2.2
			(In percent of GDP; unless otherwise specified)				
External sector							
Exports, f.o.b.	5.1	6.6	6.7	6.8	6.9	7.0	7.0
Imports, c.i.f.	18.0	20.2	20.7 1/	19.6 1/	19.3	19.0	18.9
Current account deficit							
(Excluding grants)	7.3	7.6	7.8 1/	6.5 1/	6.0	5.7	5.5
(Including grants)	3.8	4.6	4.6 1/	3.4 1/	2.9	2.7	2.6
External public debt	15.2	28.9	33.8	37.2	38.3	39.1	39.6
Of which: Fund credit 2/	(0.4)	(0.9)	(0.8)	(0.7)	(0.3)	(0.1)	(--)
(In percent of quota)	(28.3)	(50.0)	(50.0)	(43.1)	(24.1)	(6.0)	(--)
Debt service ratio 3/	4.1	5.5	6.8	9.4	11.0	11.4	9.7
Of which: Obligations due to the Fund 2/	(1.4)	(0.2)	(0.3)	(0.9)	(1.7)	(2.2)	(0.5)
Government budget							
Revenue	8.8	9.5	9.4	9.3	9.1	9.0	8.8
Total expenditure (including net lending)	18.8	18.7	19.0	17.2	16.5	16.0	15.5
Regular expenditure	5.8	6.7	6.7	6.7	6.7	6.7	6.7
Development expenditure	13.1	12.4	12.7	10.9	10.2	9.9	9.4
Foreign aid disbursements	6.4	7.8	8.3	7.2	7.0	6.8	6.5
Overall deficit							
(Excluding grants)	10.0	9.2	9.6	7.9	7.4	7.1	6.9
(Including grants)	7.3	6.7	6.8	5.2	4.8	4.6	4.4
Net domestic financing	3.8	1.9	1.9	1.3	1.0	0.9	0.8
			(In millions of SDRs)				
Exports, f.o.b.	117	143	157	169	181	194	207
Imports, c.i.f.	409	440	526	529	504	525	548
Current account deficit	166	166	227	206	157	156	151
Nonmonetary capital movements	152	170	237	215	171	175	179
Of which: Foreign aid disbursements	(152)	(180)	(205)	(189)	(196)	(201)	(208)
Overall balance	-14	5	9	8	13	17	15
Gross reserves (end of period)	192	159	165	169	175	185	197
(In months of imports)	(4.9)	(3.7)	(3.5)	(3.5)	(3.5)	(3.5)	(3.5)
Total external debt outstanding (end of period)	348	628	786	918	1,001	1,086	1,177
Concessional loans 4/	339	609	723	819	916	1,016	1,118
Fund credit 2/	9	19	19	16	9	2	--
Aircraft loans 5/	--	--	44	84	76	68	60
Debt service payments	13	20	27	40	50	55	50
Of which: Obligations due to the Fund 2/	(4)	(1)	(1)	(4)	(8)	(11)	(2)

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

1/ Excluding the prospective acquisition of an aircraft amounting to SDR 46 million. Including this acquisition, the ratio of the current account deficit to GDP would be higher by about 2 percentage points.

2/ Excluding Trust Fund.

3/ In percent of exports of goods and services and private transfers and including debt service payments arising from the prospective leasing of a second aircraft.

4/ Including Trust Fund loans.

5/ Including leasing charges.

Kathmandu, Nepal
January 12, 1987

Dear Managing Director,

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, and our letter dated September 8, 1986 described a comprehensive economic adjustment program aimed at achieving sustained economic growth, reducing inflation and strengthening the balance of payments position. In support of this program, the Government obtained a stand-by arrangement from the Fund in the amount equivalent to SDR 18.65 million for the period through April 22, 1987.

2. The measures implemented under the program have brought about considerable stabilization gains. After registering large deficits during the three years ended in 1984/85, the overall balance of payments was in virtual equilibrium in 1985/86 and a further improvement is forecast for 1986/87. The rate of inflation, after accelerating temporarily in the wake of the devaluation of the Nepalese rupee in November 1985, declined substantially to an annual rate of about 6 percent during the three months ended in October 1986. For 1986/87 as a whole, a rate of inflation of around 10 percent is projected, compared with about 20 percent in 1985/86. To a large extent, these favorable developments were the result of our efforts to improve the fiscal situation through both revenue and expenditure measures. However, economic growth, which recovered to 4.2 percent in 1985/86, has suffered a severe setback in 1986/87 due to drought; foodgrain production is estimated to fall by about 9 percent. Consequently, the growth rate of real GDP is now projected to be just 1.5 percent in 1986/87.

3. As explained below, due to a combination of several factors, bank borrowing by the Government has been greater than projected during the first quarter of 1986/87 and the ceiling on net credit to Government set for October 15, 1986 was exceeded by a small amount. In addition, the indicative ceiling on credit to nonfinancial public enterprises was also somewhat exceeded. However, net domestic assets of the banking system (NDA) were below the ceiling, reflecting sluggish private sector demand for credit. In spite of the slippage in control of public sector credit, the Government remains committed to the broad objectives of the program and we have initiated a series of corrective measures. Since the impact of most of these measures will be felt only in the second half of the fiscal year, it is unlikely that the Government will be able to meet the ceiling on net credit to Government for January 15, 1987.

Accordingly, we request a modification of that ceiling. The objectives and policies during the remainder of the stand-by arrangement are described in the following paragraphs.

4. The Government will continue the process of fiscal adjustment which led to a substantial improvement in the budgetary performance in 1985/86, when the overall deficit (excluding grants) declined by about 1 percentage point of GDP and its net domestic financing was reduced by about 1.5 percentage points of GDP. Our objectives for the fiscal year 1986/87 are to substantially increase revenue, restrain expenditure, and to further narrow the budget deficit and its domestic financing in relation to GDP. At the beginning of the fiscal year, we introduced a wide range of new tax measures. Although we have achieved considerable progress in the fiscal operations in the first quarter of the fiscal year, the results were somewhat less favorable than expected. Revenue increased by less than projected due mostly to a shortfall in import duties and sales taxes. This reflected mainly lower domestic demand due to the income effects of the drought and the restrained financial policies of the Government. Furthermore, uncertainties associated with the introduction of an auction system in July 1986 for import licenses have delayed imports and hence revenues. While regular expenditure has been running slightly above the program target, domestically financed development outlays have been slower than projected. At the same time, the demand of the nonbank sector for government securities was low. These factors have led to larger than expected bank borrowing by the Government.

5. Despite the less favorable budgetary outturn in the first quarter of 1986/87, the Government remains committed to achieving the original fiscal targets under the program for 1986/87. In order to limit the fiscal deficit (excluding grants) to less than 10 percent of GDP and the net bank borrowing by the Government to NRs 800 million, we have adopted a number of revenue and expenditure measures. On the revenue side, the most important measure was the introduction of an auction system of licenses for commercial imports which is expected to generate additional revenue of at least NRs 320 million in 1986/87. In addition, the price of gasoline will be increased by NRs 2 per liter by January 20, 1987. This will bring the price of gasoline in Nepal in line with that prevailing in India. At the same time, we instructed the Nepal Oil Corporation (NOC) to transfer the entire proceeds of the increase in price to the budget. The additional revenue from this measure is estimated at NRs 40 million annually. In order to increase revenue from excise and sales taxes on cigarettes, we recently raised the ex-factory prices for tax purposes. This should yield additional revenue of about NRs 100 million per year. With the decline in world oil prices, the financial position of the NOC has already improved substantially. In order to generate more revenue for the 1986/87 budget, we intend to

advance the tax payment by the NOC and to transfer a significant part of its after-tax profits to the budget during the second half of the fiscal year. We expect the financial position of a number of public enterprises to improve and thus anticipate an increase in the payments of dividends and the settlement of overdue interest. To improve revenue collection from water service charges, we transferred the collection responsibility from the irrigation to the land revenue department which is better suited for this task. Furthermore, we announced a 50 percent increase, effective January 15, 1987, in the airline landing fees which were low by international standards; this is expected to yield about NRs 16 million additional revenue per year. Finally, to improve tax collection, we have set monthly collection targets for each revenue department against which performance of the department will be judged.

6. On the expenditure side, we have temporarily frozen certain less essential domestically financed expenditure for which funds will be released only if there is adequate revenue. The effect of this measure will be partly offset by an increase in wages and salaries of NRs 100 per month per employee as of mid-December 1986, which will increase the total wage bill for the fiscal year 1986/87 by NRs 140 million. However, an increase in salaries was necessary to maintain the morale of civil servants given that salaries had not been adjusted for two and a half years despite a sharp increase in the cost of living. Our objective remains to contain the growth in the Government wage bill in order to make room for higher development expenditure. In line with this objective, the recent wage increase will be taken into account when formulating our 1987/88 budget. Regarding the financing of the budget deficit, we expect that there will be a significant increase in the coming months in the sale of government savings certificates to the Provident Fund Corporation and insurance companies.

7. The Government has recently taken measures to reduce the losses of major public enterprises that have exerted pressure on the budget and bank credit in recent years. Starting in 1986/87, the Nepal Food Corporation (NFC)--which procures and delivers foodgrains to target groups in deficit areas--has virtually halted subsidized sales in the Kathmandu Valley. Further, savings are being realized through the gradual transfer of intra-district operations to local cooperatives. The NFC also plans to discontinue sales to areas accessible by truck, leaving such sales to the private sector and concentrating its efforts in high hill and remote areas. These measures are expected to reduce the losses of NFC by about NRs 20-30 million in 1986/87. The Agricultural Inputs Corporation (AIC), which distributes seeds and fertilizers, increased fertilizer prices by 15-24 percent in mid-1986. As a result, the AIC expects to break even in 1986/87. The AIC also plans to hand over fertilizer distribution to Sajhas (cooperative societies) and the private sector. The Agricultural Development Bank of Nepal (ADBN) has initiated several measures to increase loan recovery,

including the prosecution of defaulters, compounding of interest on arrears, and an increase in lending rates from 10-18 percent to 15-20 percent in May 1986. Furthermore, the ADBN's accounts have been placed on a more realistic basis by provisioning for bad debt. The ADBN expects to pay all arrears due to the AIC by the end of the present fiscal year, which in turn will allow the AIC to reduce its arrears to the Government.

8. In addition to reducing the financial requirements of the public sector, the Government has taken several measures in 1986 to improve monetary control and to moderate the growth of credit. In April 1986, the Nepal Rastra Bank (NRB) strengthened controls on the banking activities of commercial banks and significantly improved its monitoring capability. Furthermore, the NRB's refinancing facility at a special concessional rate to the ADBN was eliminated at the time of the introduction of the major interest rate reform in May 1986. The expansion of domestic bank credit declined from a peak of 31 percent in the year ended in mid-October 1985 to 19 percent during the year ended in mid-October 1986. As a result, the outstanding level of NDA remained 2.2 percent below the ceiling established for October 15, 1986 under the stand-by arrangement, although net credit to Government exceeded the ceiling by 1.8 percent and the indicative ceiling on credit to nonfinancial public enterprises was exceeded by 4 percent. The latter was due largely to the accumulation of accrued interest on overdue loans by the NFC and the rice export companies presently under liquidation, rather than the provision of new loans.

9. Within the framework of our growth, inflation and balance of payments objectives for the fiscal year 1986/87, we intend to limit the level of NDA for January 15, 1987 to NRs 13,523 million, the ceiling established as performance criterion under the stand-by arrangement. For net credit to Government, a limit of NRs 7,900 million has been established for January 15, 1987, which is NRs 135 million, or 1.7 percent higher than the ceiling established under the stand-by arrangement. Accordingly, a modification of this performance criterion is requested. In addition, an indicative ceiling of NRs 1,850 million has been set for January 15, 1987 on credit to nonfinancial public enterprises.

10. To achieve our objectives for 1986/87, we have also established the following indicative ceilings for April 15, 1987: NRs 14,480 million for NDA; NRs 8,100 million for net bank credit to Government; and NRs 1,950 million for credit to nonfinancial public enterprises. With the growth of net credit to Government limited to about 11 percent during 1986/87 and that of credit to public enterprises targeted at 10 percent, the expansion of credit to the private sector is projected at 20 percent, which is expected to satisfy private sector demand.

11. Reflecting both the impact of the devaluation on November 30, 1985 and the financial policies adopted under our adjustment program, the balance of payments improved markedly in 1985/86, registering an overall deficit of only SDR 1 million, compared with a deficit of SDR 50 million in the previous year. As a result, external reserves increased to the equivalent of 3.5 months of imports of goods and services by the end of 1985/86. For 1986/87, a further improvement in the balance of payments is projected, mostly on account of higher exports of carpets, garments and jute products, and a strong performance of tourism. The current account deficit (excluding grants) is expected to be about 7.5 percent of GDP and the overall balance of payments is projected to show a surplus of about SDR 5 million.

12. The Government considers the present exchange rate arrangement, whereby the Nepalese rupee is pegged, within margins, to a basket of currencies including the Indian rupee, as satisfactory. The improvement in external competitiveness from the November 1985 devaluation of the rupee has been largely maintained. The Government recognizes that, given the high degree of openness of Nepal's economy vis-a-vis India, restrained financial and wage policies, together with an appropriate interest rate policy, are indispensable to achieve the balance of payments objectives. These policies will continue to be complemented by flexible exchange rate management in order to maintain competitiveness.

13. In 1986/87, the Government has taken several important steps toward liberalizing trade and improving the efficiency of the import regime. First, in December 1986, the auction system of import licenses was extended to cover a substantially larger number of goods. Aside from generating considerable revenue for the Government, the auction system has increased the transparency and efficiency of the system of import licensing, reduced administrative impediments in this area, and facilitated new entrants. Second, the Government introduced a passbook system for the import of raw materials by domestic industries, under which import licenses are issued on an annual basis. The passbook system has considerably improved the timely provision of raw materials, reduced uncertainty about their availability, and lowered the administrative costs of obtaining raw materials and discouraged their re-export. Moreover, to increase the overall availability of raw materials to industries, the amount allocated under the foreign exchange budget to the Ministry of Industry, which administers the passbook system, was increased by 25 percent to SDR 83 million in 1986/87. Third, to stimulate the carpet industry, the Government recently initiated a more liberal licensing system for wool imports.

14. Most of Nepal's public and publicly guaranteed external debt has been contracted on highly concessional terms and Nepal's external debt service burden is relatively low. In May 1986, an agreement for

delivery of two commercial aircraft over the next two fiscal years was signed, the first of which will be received in 1987/88. The Government intends to purchase the first aircraft and to lease the second. These acquisitions, which will be self-financing, will promote tourism, add to the profitability of the Royal Nepal Airlines Corporation (RNAC), and increase Nepal's foreign exchange earnings. As a further step to encourage tourism, the Government has recently liberalized charter flights to Nepal. To avoid an undue increase in debt service obligations, the public sector will 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 limited to revolving loans traditionally required in the normal operations of the NOC.

15. 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.

Sincerely yours,

(Sgd.) B.B. Pradhan
Minister of State for Finance
and Industry

The Managing Director
International Monetary Fund
Washington, D.C., 20431

Nepal: Summary of Quantitative Targets of the 1985/86 and 1986/87 Programs

	1984/85	1985/86		1986/87	
	Actual	Program	Prelim. actual	Program	Revised projection
			(Percentage change)		
Real GDP	3.0	4.5	4.2	4.0	1.5
GDP deflator	6.2	12.0	14.3	9.5	12.0
CPI (annual average)	4.1	12.0	15.7	9.5	12.0
(July-July)	6.9	...	21.7	8.0	8.0
Net domestic assets 1/	36.6	22.0	25.0	16.8	16.7
Net credit to Government	29.2	12.3	14.3	10.0	10.8
Credit to nonfinancial public enterprises	22.0	11.8	48.3	4.0	10.1
Broad money	17.6	20.5	23.3	14.9	14.7
			(Percent of GDP; unless otherwise indicated)		
Overall budget deficit					
(Excluding grants)	10.3	10.9	9.4	10.2	9.2
(Including grants)	8.1	6.9	6.6	7.0	6.7
Net domestic financing of budget deficit	4.0	2.3	2.4	1.9	1.9
Of which: Banking system	(3.5)	(1.6)	(1.9)	(1.4)	(1.4)
External current account deficit					
(Excluding grants)	7.6	8.9	7.5	9.0	7.6
(Including grants)	4.4	4.7	4.8	4.3	4.6
Overall balance of payments					
(In millions of SDRs)	-50	-4	-1	12	5
Gross international reserves					
(In months of imports of goods and services)	3.2	3.1	3.5	3.5	3.7

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

1/ Defined as broad money minus net foreign assets measured at constant exchange rates for 1985/86-1986/87.

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

I. Membership Status

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

(A) Financial Relations

II. General Department

(a)	Quota:	SDR 37.3 million
(b)	Total Fund holdings of Nepalese rupees:	SDR 43.95 million (117.8 percent of quota)
(c)	Fund credit:	SDR 12.35 million (33.1 percent of quota)
	Of which: Credit tranche purchases (ordinary resources)	SDR 12.35 million (33.1 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 4/22/87
	(ii) Amount:	SDR 18.65 million
	(iii) Utilization:	SDR 12.35 million
	(iv) Undrawn balance:	SDR 6.3 million
(b)	Previous stand-by and extended arrangements during the last 10 years:	None
(c)	Special facilities during the past two years:	None

IV. SDR Department

(a)	Net cumulative allocation:	SDR 8.1 million
(b)	Holdings:	SDR 0.05 million or 0.6 percent of net cumulative allocation
(c)	Current Designation Plan:	Not applicable.

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

V. Administered Accounts

(a) Trust Fund loans:	
(i) Disbursed:	SDR 13.7 million
(ii) Outstanding:	SDR 5.9 million
(b) SFF Subsidy Account:	Not applicable.

VI. Overdue Obligations to the Fund

Not applicable.

(B) Nonfinancial Relations

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

VIII. 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 January 31, 1987)

VIII. Last Article IV Consultation (contd.)

"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."

IX. Technical Assistance:

(a) CBD:

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

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

(b) Fiscal: A mission in August 1984 reviewed budget projections embodied in the Seventh Plan (1985/86-1989/90) and recommended tax reform and expenditure measures. A mission visited Kathmandu from February 22 to March 9, 1986 to: (1) help the authorities design a package of tax and other revenue measures; and (2) examine the scope for tax reform in the medium term. A member of the fiscal panel, who participated in the mission, stayed in Kathmandu for an additional three months to advise on the implementation of recommendations in the area of tax administration.

(c) Exchange rate: A technical assistance mission on the exchange system visited Kathmandu during October 26-November 5, 1985, and a follow-up mission visited Kathmandu during May 12-21, 1986 to assist in the introduction of a more flexible exchange rate management.

(d) Other: A mission from STA visited Kathmandu during November 13-29, 1986 to review the treatment and valuation of Fund accounts and to improve the currentness and coverage of monetary data.

X. Resident Representative/ Advisor: The Fund has provided staff members as Resident Advisors/ Representatives since 1977. The current Resident Representative is Mr. Thornton who took up his assignment in February 1987, replacing Mr. van Til who left Kathmandu in December 1986.

Nepal - Relations with the World Bank Group

Bank operations in Nepal began in 1969 with an IDA credit equivalent to $1.8 million for a telecommunications project. Since then, 45 additional credits have been approved, bringing total IDA assistance to the equivalent of $651 million. No IBRD loans have been made to Nepal but IFC has made three loan/equity investments totaling $9 million. To address the underdevelopment of the country's economic infrastructure, the Bank Group has allocated some 43 percent of its resources for Nepal to the transportation, telecommunications, and power and energy sectors. Agriculture, forestry and irrigation sectors that contribute about 60 percent of GDP account for about 38 percent of Bank Group operations.

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

Technical assistance:

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

Recent economic and sector missions:

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

Nepal - Relations with the World Bank Group (concluded)

Structural Adjustment Loan

Negotiations on a SAL have been recently completed. The amount of the loan is SDR 40.9 million to be disbursed in two tranches over a period of 18 months. Executive Board consideration of the loan is expected in March 1987.

Nepal: Lending by the World Bank Group 1/

(In millions of U.S. dollars)

Sectoral lending	IDA	IFC	Total	Of which: Undisbursed
Agriculture	132.4	--	132.4	83.2
Irrigation	119.0	--	119.0	48.4
Education	32.8	--	32.8	20.8
Water supply	46.8	--	46.8	7.2
Industry	28.0	9.0	37.0	19.3
Transportation	67.0	--	67.0	52.5
Telecommunications	43.8	--	43.8	25.1
Power and energy	168.0	--	168.0	127.6
Other	13.2	--	13.2	5.2
Total	651.0	9.0	660.0	389.2 2/

Source: Data provided by the World Bank.

1/ As of November 30, 1986. No IBRD loans have been made to Nepal.
2/ Adjusted for changes in U.S. dollar/SDR exchange rate as of approval and disbursement dates of IDA credits.

Nepal - Statistical Issues

1. Outstanding Statistical Issues

a. Monetary accounts

A technical assistance mission visited Nepal (November 13-27, 1986) to review procedures used for compiling monetary statistics, and its report is expected to be completed in March 1987.

b. Government finance

The 1986 Government Finance Statistics Yearbook (GFSY) contains data through 1984/85; however, data on financing are incomplete for 1984/85. The GFSY does not contain data on capital expenditures and lending minus repayments on a functional basis and on total expenditure on an economic basis. Provision of these data would greatly enhance the analytical usefulness of Nepal's presentation in the GFSY.

The data presented in IFS are the same as in the GFSY; data in the January IFS reflect the most recent data in the GFSY.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Nepal in the January 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Nepal Rastra Bank, which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in January 1986 IFS
Real Sector	- National Accounts	1984/85
	- Prices (consumer)	September 1986
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1984/85
	- Financing	1983/84
	- Debt	July 1985

Nepal - Statistical Issues (concluded)

Monetary Accounts	- Monetary Authorities		June 1986
	- Deposit Money Banks		June 1986
	- Other Financial Institutions		n.a.
Interest Rates	- Discount Rate		Q4 1983
	- Bank Deposit Rate		June 1986
	- Bank Lending Rate		Q1 1985
	- Bond Yield		n.a.
External Sector	- Merchandise Trade:	Values	August 1986
		Prices	n.a.
	- Balance of Payments		Q4 1985
	- International Reserves		October 1986
	- Exchange Rates		November 1986