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Minutes of Executive Board Meeting 85/186

10:00 a.m., December 23, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. R. Ismael, Temporary
	M. Lundsager, Temporary
	L. Hubloue, Temporary
	S. Kolb, Temporary
	S. de Forges
	A. Mustafa, Temporary
	M. Sugita
	B. Goos
Huang F.	Yang W., Temporary
J. E. Ismael	
A. Kafka	
	R. Fox, Temporary
	S. King, Temporary
	O. Isleifsson, Temporary
	G. W. K. Pickering, Temporary
	P. E. Archibong, Temporary
	J. J. Dreizzen, Temporary
	J. E. Suraisry
	J. de la Herrân, Temporary
J. J. Polak	J. de Beaufort Winjholds
	A. V. Romuâldez
G. Salehkhou	O. Kabbaj
	A. Vasudevan, Temporary
	V. Govindarajan, Temporary
	I. Angeloni, Temporary

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

IBRD: A. Tsantis, South Asian Regional Office. Asian Department: R. C. Baban, B. Banerjee, D. M. Ripley, A. Salehizadeh, R. C. Williams. Exchange and Trade Relations Department: E. H. Brau, P. J. Quirk. Legal Department: F. P. Gianviti, Director Designate; J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, A. O. Liuksila. Research Department: R. R. Rhomberg, Deputy Director. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: T. Leddy, Deputy Treasurer; J. E. Blalock, W. L. Coats, Jr., Y. Kawakami, O. Roncevalles, G. Wittich. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: W.-R. Bengs, L. P. Ebrill, S. Ganjarerndee. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, S. Geadah, N. Haque, Z. b. Ismail, H. Kobayashi, M. Rasyid, J. Reddy, A. J. Tregilgas, H. van der Burg.

1. NEPAL - 1985 ARTICLE IV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation with Nepal together with a request for a 13-month stand-by arrangement in an amount equivalent to SDR 18.65 million (EBS/85/264, 12/3/85; and Cor. 1, 12/13/85). They also had before them a report on recent economic developments in Nepal (SM/85/326, 12/10/85; and Cor. 1, 12/13/85).

Mr. Ismael made the following statement:

> The authorities are generally in broad agreement with the appraisal and the thrust of policy recommendations contained in the staff report.
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> The Government's Sixth Plan--1980/81-1984/85--which aimed at achieving a faster real rate of growth than the average 2-3 perccent achieved during the period of the first five Development Plans--1956/57-1979-80--provided for a marked increase in development expenditures to be largely financed by concessional external assistance. Emphasis was placed on directly productive investments, particularly in agriculture and export-oriented cottage industries, and on alleviating the shortage of electricity, which posed a serious bottleneck to industrial growth. Consequently, economic developments in Nepal during the Sixth Plan period were broadly more favorable. Real GDP grew at an average annual rate of 4.1 percent, compared to 2.3 percent during the Fifth Plan period. The rate of inflation, which reached a peak of 14 percent in 1982/83, was contained at a more moderate level of 4 percent in 1984/85. These achievements have been obtained despite the fact that Nepal suffered a severe drought in 1982/83 which resulted in a decline of output, and a milder drought in 1984/85 which resulted in a slowdown of economic growth.
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> The improved growth performance, however, has been accommodated by an expansionary financial policies of the Government. In its aim to achieve the Plan's expenditures and investment targets, the authorities hae incurred successive budget deficits which were financed on a substantial scale by borrowing from the domestic banking system. Credit policy was also accommodative in respect of private credit demand. As a result, the increased import demand kept the current account deficits at about 7 percent of GDP. With a shortfall in foreign aid, and slow export growth, exacerbated by supply shortages, Nepal incurred an overall balance of payments deficit for the first time in 1983.
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> Economic performance in 1984/85 was generally unfavorable. Real GDP growth declined from a recovery rate of 7.4 percent in 1983/84 to 2.8 percent in 1984/85, largely as a result of drought which limited the growth of agricultural production--which forms

60 percent of GDP--to 1.7 percent as compared to 8.7 percent in 1983/84. Although the ratio of the overall budget deficit to GDP increased only slightly, to 8 percent, it was twice the average of such ratios in 1980/81-1981/82; moreover, the net financing of the deficit through the banking system rose to 3.4 percent of GDP. The external current account deficit remained at 7 percent of GDP which, however, resulted in an increase in the overall balance of payments deficit to SDR 47 million in 1984/85, from SDR 8 million in 1983/84.

In 1985/86--as the authorities began to embark on the Seventh Plan--1985/86-1989/90--which continues to aim for an average annual growth of real GDP of 4.5 percent, they recognized that such a high growth target could not be achieved with an unsustainable balance of payments position. Consequently, faced with the twin tasks of arresting quickly the sharp deterioration in the balance of payments, while at the same time strengthening conditions conducive to the stable growth, the authorities adopted a comprehensive economic program. The adjustment program, for which Nepal now seeks support from the Fund in the form of a stand-by arrangement, aims at reducing substantially the overall deficit in the balance of payments, while attaining a real growth of 4.5 percent, and containing domestic inflation to an annual average of 12 percent in 1985/86.

The authorities are aware that the fiscal imbalances of the last few years have been the main cause of the deterioration in the balance of payments. They have, therefore, accorded the highest priority to reducing the budget deficit for 1985/86. Accordingly, the overall budget deficit relative to GDP is projected to decline by 1.1 percentage points, to 6.9 percent in 1985/86; furthermore, financing of the deficit through the banking system relative to GDP will be reduced by 1.8 percentage points, to 1.6 percent.

The planned increases in revenues are well detailed in the staff report. One important source of revenues is the tax revenue. However, as the authorities believe that the rate levels of existing taxes are broadly appropriate, they have put more emphasis on tax administration in the present budget. In reflection of this effort, they have increased the employment of tax officers as well as the establishment of more tax offices. Another important source of revenues is the sale of government-held shares in public enterprises. The sale began in late 1984/85 but is being intensified in 1985/86 in line with the Government's policy to increase the efficiency and productivity of the management of these enterprises.

Further measures to broaden the tax base will be adopted in the 1986/87 budget. In this regard, the authorities have requested from the Fund technical assistance of a fiscal expert to assist them in formulating specific revenue measures for the 1986/87 budget. The fiscal expert would help the authorities in preparing a package of tax measures based on the recommendations of the March 1985 staff report. Specifically, the work would include an assessment of (1) the revenue impact of the tax proposals; (2) the administrative procedures associated with the introduction of new taxes and/or modification of existing taxes; and (3) the economic impact of the revenue package in terms of income distributions, growth, and resource allocation.

The important cuts in expenditures have been fully explained in the staff report. They show the authorities' determined efforts in this crucial area of restraining expenditures. Of great significance is the authorities' decision not to grant further salary increases to the civil service in 1985/86 and to restrict the intake of civil servants to the minimum necessary. Even more drastic is the restraint on domestically financed development expenditures for 1985/86. These cuts, however, relate mainly to lower priority projects and would not be applied in the case of local funds required for the implementation of aid-financed projects.

With regard to the public enterprises, the authorities intend to continue efforts started in 1983/84 to improve their management and financial positions. To this end, substantive price adjustments were made in 1984/85 and in early 1985/86, in line with the more flexible policy on administered prices introduced in 1983/84. Further increase in administered prices are expected to be undertaken during the program period. Direct budget subsidies, which are small, are extended mainly to ensure the adequacy of food supplies in the hills region. Besides providing a badly needed source of budgetary funds, the Government's policy of selling govenrment-held equities in public enterprises, is designed to make public enterprises more responsive to profit and market considerations.

Monetary policy for 1985/86 complements the authorities' adjustment efforts in the area of public finance. In line with fiscal restraint, monetay policy reflects a tighter stance. Measures taken by the authorities to moderate credit expansion to the private sector as well as the public sector, are well detailed in the staff report. At the same time, aware of the critical role palyed by domestic resource in economic development, the authorities are continuing their efforts to improve the institutional framework of the financial system so as to mobilize more domestic savings. In this regard the authorities will continue to implement the policy of expanding the financial sector. Accordingly, a bill authorizing the establishment of finance companies was passed recently.

Recognizing the need for adequate incentives for resource mobilization through the financial sector, the authorities are committed to pursuing a policy of maintaining positive real rates of interest; this policy will be closely monitored. At present, the authorities consider the level and structure of interest rates as broadly appropriate, especially in light of the Government's tight fiscal position. The authorities, however, will study the Fund's report on instruments in the financial sector and will take into consideration its key recommendations in future formulation of financial sector policies. The authorities also intend to review the structure of lending rates with the aim of reducing its complexity and as a step toward increasing the autonomy of commercial banks in setting lending rate levels.

The authorities are aware of the structural weakness of the external sector in the economy. While external aid is expected to continue providing a substantial portion of Nepal's foreign resource requirements, there is a need to further stimulate exports and tourism, and import substituting activities. To this end, the authorities devalued the Nepalese rupee by 14.6 percent on November 30, 1985; the exchange rate vis-à-vis the Indian rupee had been de facto fixed for several years. They intend to manage the exchange rate with greater flexibility than in the past so as to maintain, at a minimum, the level of external competitiveness attained by the November 30 exchange rate adjustment. At the same time, the authorities have eliminated the cash export subsidy and the revenue stamp duty on foreign exchange purchase on November 30. The authorities also intend to ease their import policy in measured steps as the balance of payments improves.

The Nepalese authorities agree with the staff's medium-term projections. Barring any major exogenous shock and with sustained efforts in the fiscal and credit areas, Nepal should be able to achieve a viable external position in the medium term, including a buildup in external reserves. They stand ready, however, to take further adjustment measures if the objectives to be pursued in the medium term for the purpose of reaching a sustainable balance of payments position should be threatened.

Given the limited scope for raising domestic resources, the Nepalese authorities must continue to rely heavily on a sustained flow of concessional assistance, in order for Nepal to maintain a reasonable level of investment and growth in the economy. In this regard, they wish to express their sincere gratitude for the support which they have been receiving from donor countries and multilateral development institutions. They also wish to express their appreciation to the staff for the close collaboration they have enjoyed in working out the adjustment program for Nepal.

Mr. Govindarajan indicated that he could support the proposed decisions. With a per capita income of SDR 150, Nepal was one of the least developed countries in the world, and the authorities had for some time been making a strenuous effort to improve the lot of the people through a series of development plans. Under the recently completed Sixth Development Plan, the Nepalese economy had grown at a modest real rate of 2-3 percent. However, during the implementation of the Plan, certain imbalances had crept into the economy, owing both to exogenous factors and to expansionary financial policies of the Government. The latter had led to large budget deficits, which had been covered by borrowing from the banking system. Credit policy had been accommodating during the past several years, and the result had been increased current account deficits exacerbated by foreign aid shortfalls, slow export growth due to supply problems, and increased imports. The situation had been particularly visible in 1984/85 when growth in GDP had been only 2.8 percent, the overall budget deficit had reached 8 percent of GDP, and the external current account deficit had been 7 percent of GDP, resulting in a balance of payments gap of as much as SDR 47 million.

It was not surprising in the circumstances he had mentioned that the Nepalese authorities had decided to undertake comprehensive adjustment measures, which they saw as essential for the successful implementation of the Seventh Development Plan growth targets, Mr. Govindarajan continued. In that context, the proposed stand-by arrangement was welcome, as it would provide the necessary immediate balance of payments support as well as a framework for achieving the needed stable conditions to foster growth in the coming years. The main elements of the program seemed reasonable, although he would have placed somewhat greater emphasis on the need for tighter budgetary and monetary policy measures to stimulate production and on additional efforts to absorb external aid.

As the Nepalese authorities themselves seemed to be aware, fiscal imbalances had been the primary cause for the deterioration in the external account, Mr. Govindarajan remarked. It was thus understandable that in 1985/86, the authorities would be taking several steps to reduce substantially the overall budget deficit as well as the financing of that deficit through the banking system. To that end, the authorities should adopt more rigorous revenue raising measures, since revenues as a percentage of GDP were quite low. He noted from Mr. Ismael's opening statement that steps were being taken to tighten the tax collection system and that with the help of technical assistance from the Fund, further measures in 1986/87 would be adopted to broaden the tax base. He could endorse the three purposes outlined by Mr. Ismael regarding the work to be undertaken by the Fund expert in that regard. While the steps he had mentioned were welcome, the authorities should be prepared to undertake more comprehensive revenue measures in view of the importance of achieving fiscal balance.

On the expenditure side, the authorities had been restraining salary increases to civil servants and had limited expenditure on low priority projects, which clearly demonstrated their determination to undertake the appropriate expenditure cutting measures, Mr. Govindarajan observed. Continuation of a flexible policy on administered price adjustments and the sale of nonessential public enterprise shares were also welcome.

The authorities seemed to be agreed on the need for a tighter monetary policy, Mr. Govindarajan noted. Interest rate policy was in line with the staff recommendations, as was the authorities' commitment to improve the institutional framework of the financial system. Still, he had some doubts about the utility of continuing with high real interest rates. Chart 2 on page 32(a) of SM/85/326 showed that real interest rates had risen to nearly 10 percent in 1984/85 from a level of nearly zero in 1982/83. It was not clear, however, what impact those rates had on the level of savings and on private investment. Quite often in low-income countries, savings were income elastic rather than interest rate elastic, and he was not certain therefore whether the high real interest rates were serving any useful purpose in Nepal.

The recent devaluation of the rupee was a clear indication of the authorities' willingness to follow a flexible approach to exchange rate policy, Mr. Govindarajan considered. The steps taken by the authorities in withdrawing discriminatory export subsidies were welcome, as were the staff's medium-term outlook and conclusions. However, nearly 71 percent of the Seventh Development Plan would apparently need to be funded from external sources, and he wondered whether external savings in sufficient amounts would be available or whether a need for such savings had been taken into account in the staff's medium-term projections. He also wondered whether it was realistic to assume such a high level of absorption, given the somewhat lower funding from external resources of the previous two development plans. Finally, noting that the staff considered that Nepal's problems would require an adjustment effort through the medium term, he wondered whether consideration has been given to the possibility of an extended arrangement with the Fund.

Mr. Sugita observed that under the Sixth Development Plan, Nepal had succeeded in achieving a somewhat faster economic growth than in the previous plan period, with real GDP having grown by 4.1 percent on average. Unfortunately, that achievement had been accompanied by growing internal and external imbalances. The overall balance of payments had persistently been in deficit since 1982/83, and the deficit had grown to as much as SDR 47 million in 1984/85, reflecting large negative "errors and omissions." While it might be difficult to identify precisely the factors that had contributed to those errors and omissions, it was clear that they could be interpreted as an indication of a serious erosion of confidence in the economy. In the face of such difficulties, the authorities had recently taken corrective action. Monetary policy had been tightened, a number of administered prices had been increased, the exchange rate had been devalued, and some measures giving rise to multiple currency practices had been eliminated. Those steps in his view indicated the authorities' strong commitment to undertake the necessary adjustment measures.

A longer-term view of the economy suggested that the low savings ratio, poor export base and limited aid absorption capacity of the economy were the three major constraints limiting Nepal's growth potential, Mr. Sugita continued. It was reassuring to note that the authorities were ready to address those problems during the program period. While he recognized the difficulty of increasing savings in a country with a per capita GNP of only SDR 145, he continued to believe that domestic revenue mobilization was important both in relieving financial imbalances and enhancing long-term growth potential. He therefore welcomed the authorities' decision to implement substantial revenue measures beginning with the 1986/87 budget.

Ongoing financial reform should contribute to the effective use of savings through a channeling of funds to the banking system, Mr. Sugita remarked. Export promotion was not easy in Nepal, which was a landlocked country not well endowed with natural resources. However, Nepal had a large potential in the area of tourism and might be able to improve exports of labor-intensive, lightweight handicraft goods. In any event, flexible management of the exchange rate was indispensable to the realization of such potential.

There was a clear need in Nepal to enhance the aid absorption capacity of the economy so that undisbursed grant and loan commitments, which currently amounted to nearly $1 billion, could be fully utilized, Mr. Sugita said. The World Bank had made a number of specific recommendations in that regard that he hoped would be vigorously implemented by the authorities. Unless substantial progress was made to deal with the structural problems he had described, the staff's projection for a 4 percent medium-term growth rate--which was not particularly high in view of the 3.4 percent rate of growth in the population--would become difficult to achieve.

A reduction in the Government's borrowing requirement from the domestic banking system was urgently needed to re-establish financial stability, Mr. Sugita commented. While progress made in the 1985/86 budget was welcome, further efforts would be needed on both the expenditure and revenue sides. Although a number of containment measures had been implemented, current expenditure was still estimated to grow by about 20 percent in 1985/86. Continued efforts would be needed to restrain the wage and salary bill by limiting both salary increases and new hirings to the minimum. He appreciated the authorities' decision drastically to cut, in real terms, the expenditures on domestically financed low-priority projects. On the revenue side, a number of measures had been adopted recently to strengthen tax administration; however, additional revenue measures would be needed in the next year's budget and beyond. He hoped that the major elements of the recommendations of the Fund technical assistance mission on revenues would be incorporated in such measures.

The degree of monetary restraint contemplated for 1985/86 seemed generally appropriate, given the projected rise in the inflation rate to about 12 percent as a result of the devaluation and price adjustments, Mr. Sugita noted. In view of the price projections, flexible interest rate policies to keep real rates at a positive level would be important. He was pleased to note that greater flexibility had recently been given to commercial banks in fixing deposit rates. Like the staff, he urged the authorities to consider raising the rates on treasury bills to market levels as soon as possible.

The current account deficit was projected to rise to about 8.9 percent of GDP in 1985/86, mainly due to the rise in aid-financed imports, but the overall balance was expected to be in much smaller deficit in 1985/86 than in the current year. Of course, that outcome would be heavily influenced by changes in errors and omissions, and the role of a flexible exchange rate policy would be important to forestall the re-emergence of unrecorded capital outflows. The authorities would also carefully have to monitor the level of external reserves in order to prevent any further depletion. Finally, he could support the proposed decisions.

Ms. Lundsager, noting the comprehensive measures included in the requested stand-by arrangement, remarked that the program could place Nepal firmly on an appropriate adjustment path. She could therefore support the request for a stand-by arrangement and would limit her remarks to mentioning those few areas where some additional adjustment effort might help the Nepalese authorities to achieve their medium-term goals.

Among the steps aimed at increasing the productive potential of Nepal, she viewed as significant the recent exchange rate adjustment and the authorities' commitment to a flexible management of the rate, Ms. Lundsager continued. At the previous Article IV consultation (EBM/84/100, 6/27/84), several Directors had emphasized the need for adjustment, the rationale for which had been strengthened by developments since that time. While the Chart on page 10b of the staff report seemed to indicate that the recent adjustment had eliminated the existing overvaluation of the currency, other indices implied that overvaluation was still sufficient to hinder rapid expansion of exports. In the circumstances, the authorities should manage exchange rate policy flexibly in both the near and medium terms in an effort to stimulate expanded production of exports. From the description of those products in which Nepal had a comparative advantage, it appeared that substantial capital investments were not required and that production could, therefore, respond rapidly to appropriate pricing signals.

The fiscal effort forming the basis of the adjustment program seemed broadly appropriate, Mr. Lundsager went on. While she would have preferred a more rapid reduction in the overall deficit, she could accept the programmed target in light of the increased foreign financing expected in 1985 and the resulting reduced projections for domestic financing. The emphasis placed on expenditure control, including the restraint on public sector wages and the priority given to domestic development spending was important. She wondered in that regard, however, whether there was a need to increase rather than simply maintain the budgetary allocation for domestic funding of predominantly foreign-financed projects, especially in view of the substantial aid pipeline--some $1 billion--and the authorities' desire to accelerate the utilization of already committed funds. The World Bank was providing useful technical advice to speed project implementation, but additional budgetary resources might be required as well. Also, given the presently low ratio of revenue to GDP, she welcomed the plan to broaden the tax base in the new fiscal year as well as the ongoing sale of some of the Government's equity in public enterprises, which should increase the operating efficiency of individual firms and, in combination with recent price increases, should reduce their drain on the budget. Nevertheless, the Government should consider full privatization of those entities not providing basic public utilities or services.

The increased monetization of the economy should aid the authorities in their effort to increase domestic savings, Ms. Lundsager observed. The emphasis on providing some real increase in credit to the private sector was also welcome. Of some concern was the adequacy of interest rates--which might turn out to be just marginally positive in real terms--if inflation increased to the expected level of 12 percent. According to the staff report, there had been substantial capital flight in FY 1984/85 and some SDR 20 million in reserves loss in the first three months of the current fiscal year. Attaining the targeted reduction in the overall payments deficit in 1985/86 would require substantial inflows for the remaining nine months of the fiscal year, two of which had already passed. The recent exchange rate adjustment might help, but it would take strong monetary measures to keep financial savings at home while dampening the demand for imports. The Nepalese authorities reportedly would widen the range of deposit interest rates, and she hoped that in light of the payments developments just mentioned, they would implement those measures in the near future. Also helpful would be increased flexibility in the interest rate on treasury bills.

In sum, Ms. Lundsager considered that the Nepalese authorities had made a strong beginning toward adjustment that was deserving of Fund support. She welcomed the authorities' commitment to take further adjustment measures as necessary to ensure attainment of the payments surpluses required over the medium term to shore up reserves and finance repurchases of the funds being provided under the requested stand-by arrangement. She was pleased to note the efforts of the authorities to stimulate foreign investment and the recent elimination of some exchange restrictions, and she could support the proposed decisions--including the amount of access and phasing--in light of the measures already implemented and the authorities' commitment to carry through.

Mr. Goos stated that he too was in broad agreement with the staff's assessment and recommendations and he was pleased to note that the authorities had recognized the need for comprehensive corrective measures and were willing to cooperate closely with the Fund in overcoming Nepal's rising economic problems, which appeared to have been caused mainly by inadequate economic policies, particularly on the demand side. That the measures envisaged under the program were generally in accordance with the recommendations of the Executive Board at the previous Article IV consultation with Nepal was welcome; the program held promise for a significant improvement in Nepal's overall economic situation, especially considering that important actions had already been taken and that the authorities, following the Letter of Intent, were ready to take any additional measures that might become necessary to achieve the program targets.

While he had no difficulty with the requested stand-by arrangement, including the proposed amount of Fund financing, he had some questions about the appropriateness of the extent of front loading, Mr. Goos continued. Some front-loading could certainly be justified in view of the prior actions taken, but he wondered whether scheduling more than 50 percent of the total credit available for purchase immediately following Board approval was not overdoing it.

As the staff had rightly noted, major efforts were needed to mobilize domestic revenue to contain the budget deficit under the Seventh Development Plan within prudent margins, Mr. Goos remarked. The authorities apparently intended to adopt new revenue measures beginning with the 1986/87 budget, but there seemed to be some uncertainty or even disagreement between the authorities and the staff about whether those measures should not place greater emphasis on discretionary steps in order to further strengthen the fiscal position and improve the elasticity of the tax system. It was also necessary for the authorities to intensify their efforts to mobilize domestic savings in order to create sufficient scope for meeting the remaining budgetary financing requirements. In that context, he supported the staff's recommendation to enhance the role of treasury bills as an added tool of monetary policy and as effective instruments of public sector financing. Toward that end, interest rates on treasury bills should be raised to market levels and measures should be adopted to develop a functioning market for such paper. He also shared the staff's recommendations to increase the bank rate for term deposits.

The projected sharp increase in foreign-financed development expenditures was impressive, the more so given Nepal's limited absorptive capacity, Mr. Goos commented. While encouraging the efforts of the authorities to strengthen that capacity, he hoped that they would not compromise the critical need to focus available financing on development projects that strengthened the growth potential of the economy without straining the budget through unduly high recurrent costs. In that context, he wondered whether the intended purchase of an aircraft would stand the test of a cost-benefit analysis. In any event, the authorities would be well advised to maintain close collaboration with the World Bank in implementing their development plan.

The more flexible stance of exchange rate policies in Nepal, including the recent devaluation and the abolishment of a number of multiple currency practices, were welcome Mr. Goos said. He was less enthusiastic about the recent introduction of the foreign exchange deposit scheme, which not only gave rise to an exchange restriction that was inconsistent with the established principles of the Fund but also raised the concern that it might detract from the critical need to maintain the exchange rate and domestic interest rates at levels conducive to foreign capital inflows. He was also less sanguine than the staff appeared to be about the potential of the scheme to attract foreign exchange inflows because the restrictions pertaining to the withdrawal of foreign exchange under the scheme could well impede its attractiveness to foreign depositors. In conclusion, he reiterated his support for the requested stand-by arrangement, subject to his query regarding the amount of front loading, and noted that the adjustment program was an important first step toward economic viability.

Mr. Suraisry observed that Nepal's economic difficulties had been due partly to bad weather and partly to expansionary financial policies. As a result, the balance of payments situation had deteriorated, and international reserves had fallen sharply. The 1985/86 adjustment program was aimed at addressing those difficulties, and its objectives were appropriate. To achieve them, the program must be implemented fully, and the adjustment effort must be carried well beyond the program period.

He was pleased to note that the program had been designed to raise agricultural output and diversify the productive base of the economy, Mr. Suraisry continued. The measures taken to improve irrigation, enhance fertilizer distribution, and increase agricultural credit availability--together with the announcement of minimum support prices prior to plantation--were important steps in the right direction. In the industrial sector, the authorities were continuing to provide incentives for the private sector and foreign investment while encouraging the development of small cottage industries. They were also undertaking measures to ease the structural bottlenecks in project implementation that hindered the utilization of foreign aid. Those measures, which increased output, were welcome.

On the demand side, tighter fiscal and monetary policies were needed and, in that connection, he welcomed the recent measures aimed at raising revenue, Mr. Suraisry said. He also welcomed the dual point collection system of sales taxes. However, the tax structure remained inelastic and highly dependent on imports; hence, he was pleased to learn that some of the tax recommendations of the Fund technical assistance mission would be included in the 1986/87 budget. Still, there was scope for further improvement on the revenue side. As for expenditures, he was concerned about the large increase in public sector wages that had exceeded the inflation rate as well as increases in the industrial and construction sectors. Also of concern was the increased share of current expenditures in total outlays. As stated in the program, there was a need to reduce the growth in current expenditures and increase capital spending through the utilization of external aid if the efforts on the supply side were to be successful.

Transfers to the public sector enterprises had been an increasing drain on the budget, Mr. Suraisry noted. As indicated in Appendix Table 14 of the paper on recent economic developments in Nepal, net flows from the Government to the public sector enterprises had been increasing continuously in recent years. Measures taken to help improve the management and financial position of the public enterprises were appropriate, but further strenthening would be helpful. An important aspect of that effort was to make the public sector enterprises more responsive to profit and market considerations.

Monetary program targets for Nepal were appropriate, and their achievement should be facilitated by fiscal restraint, Mr. Suraisry considered. The reduction in credit to the Government would allow the banking system to satisfy the credit needs of the private sector without intensifying inflation and weakening the balance of payments. The extension of the financial system to rural areas should help the mobilization of savings and lead to more efficient allocation of resources. In that regard, Mr. Govindarajan had raised an important question relating not only to Nepal but to some other developing countries as well.

The authorities should be commended for their flexible exchange rate strategy, aimed at ensuring the external competitiveness of the economy, Mr. Suraisry commented. They had removed the exchange subsidy given to exporters, but further liberalization of the exchange system was needed, especially with regard to foreign exchange deposits. Finally, he could support the proposed decisions.

Mr. Salehkhou remarked that in spite of considerable natural and geographical constraints, Nepal had been able in the past five years to accelerate its economic development, in contrast to performance in the previous two decades when real GDP expansion had barely kept up with the country's population growth. Considering Nepal's low GDP per capita--which at SDR 145, was among the lowest in the world--growth performance under the previous Five-Year Development Plan was welcome. To a great extent, that performance reflected the availability of increased foreign financial assistance as well as the reorientation of the authorities' development efforts toward the strengthening of Nepal's productive base. By contrast, earlier development plans had concentrated on infrastructure and social projects.

Recent economic developments in Nepal had been marked by a significant financial deterioration, especially in the past three years, Mr. Salehkhou remarked. The authorities' expansionary policies, delays in the implementation of aid-financed development projects and, to a lesser extent, the drought-induced slowdown in real GDP growth in 1984/85 had all contributed to the widening of the fiscal and external current account deficits and to a considerable drawdown in Nepal's international reserves, which had been equivalent to 4.8 months of imports at end 1984/85, down from the equivalent of 12.2 months of imports three years previously. Moreover, 1984 had been marked by a strong acceleration in credit expansion as the increase in the public sector's recourse to domestic bank financing had almost doubled and the growth rate of credit to the private sector had accelerated from 18 percent to 22 percent. While the potential impact of credit expansion on inflation had been cushioned by the substantial reduction in net foreign assets of the banking system, the implications for domestic demand and pressures on the balance of payments did not seem sustainable over the medium term. Clearly there existed a need for more adjustment efforts to preserve and strengthen an appropriate growth environment in Nepal and to maintain the flow of foreign capital and transfers necessary for the economy's development.

The authorities' decision to adopt a comprehensive adjustment program and to seek Fund financial support for the first time, together with the substantial increase in foreign assistance, should enable Nepal to deal with the deteriorating trend of recent years without recourse to excessively harsh corrective measures, Mr. Salehkhou commented. Adjustment policies would however need to be implemented well beyond the proposed program period in order to allow for the required growth of per capita income in the context of a sustainable balance of payments position. To achieve the program's main objectives with respect to the balance of payments, growth, and inflation, particular attention should be paid to the implementation and monitoring of demand-management policies, especially with respect to bank financing of the public sector deficit and the improvement of Nepal's capacity to absorb foreign aid and loans. On the fiscal side, in addition to announced measures on tax administration, containment of current and capital expenditures--including salary and recruitment restraint--and increases in administered prices, a larger contribution of revenues was required in order to limit the burden of adjustment on development outlays. The significantly low level of government revenues in terms of GDP should allow for increasing the contribution of revenues to the curtailment of the fiscal deficit.

Nepal's capacity to absorb foreign assistance was equally crucial to the success of the proposed program, and the existence of some SDR 1 billion in undisbursed external aid and loans was indicative of the efforts required in that regard on the part of both the authorities and donor countries, Mr. Salehkhou observed. The recommendations of the World Bank for enhancing Nepal's absorptive capacity seemed to be in the right direction; their adoption would go a long way toward helping the authorities achieve the relatively ambitious growth objectives of the Seventh Development Plan. Considering the structural weaknesses of the economy's external sector, and in spite of the relatively favorable prospects for foreign assistance, there was a need to foster exports and tourism. The rationalization of Nepal's exchange and trade system should in that regard lead to a significant expansion of the traded goods sector and enhance the economy's external competitiveness. Finally, he could support the proposed decisions.

Mr. Wijnholds welcomed the adjustment policies outlined in the staff report as a first step toward correcting the payments imbalances that had developed in the economy over the past few years. The Fund's involvement in Nepal should be helpful, and the country should be able to implement the 1985/86 program successfully without administrative and other factors causing undue complications. That point was worth mentioning because of the country's limited absorptive capacity, which had contributed to an accumulation of undisbursed aid of about $1 billion, a rather large amount for such a small country. The limited absorptive capacity of Nepal had to do mainly with projects rather than with fiscal, monetary, and supply-side measures. He trusted that the staff was correct in assuming that Nepal had the administrative capability to carry out a Fund program successfully; nevertheless, like Mr. Goos, he wondered whether heavy front loading of disbursements under the proposed stand-by arrangement was really necessary, and he would appreciate hearing the staff's reasons for selecting such a schedule of disbursements.

Also of concern was the medium-term outlook covering the remainder of the decade of the 1980s, Mr. Wijnholds continued. From the table on page 25 of the staff report, one could see that Nepal's current account deficit would remain above 8 percent of GDP, decreasing only very slowly from the 8.9 percent forecast for the program year 1985/86. Although it appeared that a current account deficit of such magnitude could easily be financed from external aid, and although it was clear that the debt-service ratio would remain comfortable in the coming years despite a projected small rise, it was obvious that Nepal remained vulnerable to adverse circumstances, including poor weather conditions or a sudden increase in capital flight, as had occurred during 1985. Moreover, after 1989/90, the amortizations of the commercial loan to be received in 1986/87 would coincide with repurchases to the Fund, which might imply a rather steep increase in debt service payments. In the circumstances, continuing adjustment efforts by the authorities would be necessary over the coming years. As the staff report made clear, the cornerstone of adjustment under the program following the recent devaluation was a tighter fiscal policy, which could be achieved mainly by increasing the efficiency of the tax system and strengthening the tax base while restraining expenditure. In view of the importance of reducing the budget deficit, the Government should not rule out the possible need for revenue enhancing measures in the face of unforeseen circumstances, especially as government revenue as a percentage of GNP was rather low. In conclusion, he could support the proposed decisions.

Mr. Huang agreed with others that the Government of Nepal had made impressive efforts to promote economic development during the period of the Sixth Development Plan. In order to achieve a faster growth rate, they had provided for a marked increase in development expenditure that placed greater emphasis on direct productive investment and on increasing the supply of electricity, which had been a bottleneck to industrial growth. As a result, real GDP had grown at an average annual rate of 4.1 percent during the plan period, compared with a rate of 2.3 percent during the previous plan period. Per capita GDP measured in SDRs had also grown during the period.

It was regrettable that serious difficulties had emerged in the financial management of the economy that had contributed to undermining the Government's already structurally weak external position, Mr. Huang continued. Those difficulties had resulted from excessive demand pressures, which had been related to expansionary financial policies; however, they had also been attributable to a considerable extent to the supply shortage due to adverse weather. Poor weather conditions had not only led to a reduction in output in 1983 and a slowdown in real GDP growth in 1985; they had also directly affected the balance of payments through a reduced export surplus and increased imported food requirements. The combination of supply shocks and excessive demand pressures had resulted in an overall balance of payments deficit for the past three years and a sharp drawdown in international reserves.

The Nepalese authorities were apparently determined to overcome their economic difficulties and had rightly drawn up an economic adjustment program for 1986, Mr. Huang observed. The policies proposed under the program constituted in his view an appropriate response to Nepal's economic difficulties. It was important for Nepal to overcome its structural weaknesses through an economic restructuring program, development of which should be a matter of priority in the Seventh and Eighth Development Plan periods.

In conclusion, his chair appreciated the adjustment efforts made by the Nepalese authorities and their cooperative attitude toward the Fund as expressed in the letter from the Minister of Finance, Mr. Huang remarked. Nepal's temporary financial difficulties warranted some sympathy from the institution, and its adjustment efforts deserved support. He could thus go along with the authorities' request for a 13-month stand-by arrangement in the amount of SDR 18.5 million.

Mr. Mustafa remarked that it was clear from the staff report that the task of sustaining stable economic growth in excess of population growth had proved more difficult in Nepal than in most developing countries. Nepal was a landlocked country, poorly endowed with natural resources and facing severe transportation difficulties. Moreover, the dominant position of agriculture and agro-based activities in the economy had heightened vulnerability to weather conditions and subjected overall economic activity to large fluctuations. The difficulties posed by such constraints for economic growth and stabilization efforts were clearly significant. Nevertheless, Nepal had benefited over the recent period from modest increases in per capita income, following a marked increase in development expenditure since 1980. However, the economic outturn for 1984/85 had been largely unfavorable, owing mainly to the impact of adverse weather conditions on agricultural production. The slowdown in economic activity, coupled with the pursuit of expansionary growth-oriented financial policies, had given rise to excessive demand pressures and a deterioration in the external payments position. As a result, the authorities had reoriented their strategy toward economic stabilization and had adopted the stand-by program described in the staff paper to restore balance of payments viability and strengthen sustainable growth conditions.

The particular circumstances of Nepal suggested that priority be given to accelerating economic growth and furthering economic diversification, especially given Nepal's low per capita income and vulnerability to adverse weather conditions, Mr. Mustafa continued. In that context, he welcomed the attention paid to supply policies under the proposed stand-by arrangement, although it was clear that efforts to improve supply conditions needed to be broadened and sustained beyond a one-year arrangement. The emphasis on adding new irrigation facilities and improving existing ones should lead to an increase in the area under irrigation and reduce dependence on rain-fed agriculture. Other measures to stimulate agricultural production included the planned increase in distribution of chemical fertilizer, efforts to increase the availability of credit to small farmers, and the announcement of support prices of crops prior to the planting seasons. Steps had also been taken, or were being contemplated, for stimulating nonagricultural, particularly industrial, production. However, while such supply measures were expected to make a significant contribution to the economy, a sustained increase in per capita income would require adequate foreign aid flows for some time to come, together with increased aid absorptive capacity.

The stance of fiscal policy in Nepal had been tightened under the program to reduce excess demand pressures in the economy and to mitigate their consequent impact on the balance of payments, Mr. Mustafa commented. Significant reductions were planned in both the overall budget deficit and bank financing of the deficit relative to GDP. Increases in revenues were expected to be realized from improved tax administration, while net lending would be reduced through the sale of government-held shares in public enterprises. On the expenditure side, restraint was to be exercised through tighter controls on nonaid financed expenditures, especially in the areas of the wage bill of the civil service and domestically financed development expenditure. Measures had also been undertaken to improve the management and financial position of public enterprises so as to reduce the need of those enterprises for budgetary transfers.

Monetary policy under the program had also been tightened to further compress excess demand pressures in the economy, Mr. Mustafa noted. The growth of total domestic credit in the banking system would be reduced considerably under the program, reflecting a 50 percent cut in the rate of expansion to the public sector and a somewhat smaller cut in credit to the private sector. Recent changes had led to positive interest rates in real terms and, as Mr. Ismael had noted, the authorities were committed to pursuing a policy of maintaining positive real rates of interest. The strengthening of the financial institutional structure through the establishment of new institutions was also expected to promote domestic resource mobilization.

Nepal's external sector had come under increasing pressure in recent years because of the emergence of excess demand in the economy resulting from the pursuit of expansionary financial policies, Mr. Mustafa said. While Nepal's balance of payments was structurally weak, the problems of the external sector over the medium term appeared to be manageable through appropriate economic adjustment. The significant depreciation of the exchange rate that had been undertaken by the authorities, together with the tightening of fiscal and monetary policies, were expected to arrest the deterioration in the balance of payments and set the stage for a turnaround in the near future. Finally, because the stand-by program represented a significant adjustment effort, it warranted Fund support.

Mr. Fox considered that the Nepalese authorities' objectives of faster growth, a strengthened balance of payments, and containment of inflation were commendable; and the program in support of those objectives seemed sound. Moreover, the program contained some important elements that should lay the foundation for a more sustainable performance in the medium term, and he could therefore support the proposed stand-by arrangement decision. However, he would welcome staff comment on a number of specific points.

On the fiscal side, the planned revenue increase in 1985/86 relied heavily on the assumed pickup in activity and once-off sales of shares in public enterprises, Mr. Fox continued. Neither was a substitute for more wide-ranging fiscal reform and, like other speakers, he urged the authorities to implement quickly the improvements in tax administration envisaged for the current year's program and to search for ways of intensifying the revenue effort in the following year's budget.

A sharp pickup in concessionally financed development expenditure was crucial to faster output growth, but an increase on the scale envisaged risked a major increase in the debt service ratio which, while low at present, was rising quickly, Mr. Fox commented. He wondered whether the staff felt that imposing a limit on the pace at which the $1 billion backlog in undisbursed aid might be spent--similar to the more conventional ceiling on new nonconcessional debt--would have been useful in helping to keep the debt service ratio within bounds. He would also be interested in knowing how the overall debt service ratio compared with the ratio of convertible currency debt service to convertible currency exports, perhaps a more meaningful indicator of potential strain on the balance of payments.

Excluding aid-financed imports, the current account was projected to move from small deficit to small surplus in 1985/86, Mr. Fox continued, and the overall balance during the period was expected to fall sharply; however, that was entirely due to the assumed turnaround in "miscellaneous capital and errors and omissions." Some discussion of the matter could be found on page 46 of SM/85/326, but there seemed little evidence to justify a return to balance.

While welcoming the first steps toward liberalizing the exchange and trade system, Mr. Fox said that he found it odd that the staff could describe the exchange restriction associated with the foreign currency deposit scheme as "an appropriate means to support the balance of payments," while at the same time failing to propose approval of the scheme. He would welcome some explanation of that apparent inconsistency and hoped that progress toward the removal of the restriction could be made by the time of the midterm review of the stand-by arrangement.

With a rise in inflation, real interest rates would decline from their present significantly positive level unless nominal rates changed, Mr. Fox said. Nominal interest rates on one-year deposits had changed very little for the past several years, as shown in Table 2 of the staff report; and, while banks' flexibility in setting those rates was to be increased during the program period, there remained considerable room for more flexibility. In sum, the authorities had taken a number of important actions aimed at helping to secure an improved financial position in the short term. However, those were to be seen as only first steps on the road to medium-term external viability, and he looked forward to a continuation of the adjustment effort in the following year's budget.

The staff representative from the Asian Department remarked that international interest rates--including interest rates in India--and the scarcity of funds were relevant factors in establishing deposit rates in Nepal. Without taking a position on whether rates in Nepal were too high or too low, he could state that real interest rates had increased between 1983 and 1985, mainly reflecting the reduction in the rate of inflation as well as some adjustment in nominal interest rates. The recent decision by the Nepalese authorities to widen the range of deposit rate flexibility during the program period was not intended "to raise relevant interest rates"; rather, the wider range had been meant to prevent rates from falling to negative levels during the program period. The authorities shared the view of the staff that, over time, interest rates should become less administered and more market determined. If the configuration of supply and demand was such that rates rose within the higher range adopted by the authorities, the result would be real interest rates on 1-2 year deposits of 1-2 percent.

A more important issue than the level of real interest rates in Nepal was the impact such rates would have on investment, the staff representative continued. In an economy like that of Nepal, as in many other developing countries, the problem was not so much the cost of funds as their availability, a determination that was not easy to make in Nepal, especially since much of the financing in the rural sector, for example, took place in the informal markets, and it was clear that the rates of interest in those markets were considerably higher in real terms than typical market rates. All other things being equal, if there was a supply response on the financial savings side--and there was some reason to hope that such a response would occur--real interest rates generally were likely to fall in Nepal over time.

Several speakers had raised questions on the availability of aid, the staff representative recalled. On the commitments side, between $900,000 and $1 billion in aid was in the pipeline, and the World Bank had asked creditors to provide annual commitments of new aid on the order of $300 million per year. The Bank staff was recommending to creditors that, after the current year, there should be a sizable increase in the proportion of nonproject aid--some $100 million per year--which could be disbursed more quickly. The Fund staff had been rather more pessimistic than the Bank staff in its medium-term projections for aid disbursements, in part because it had made no assumptions about program aid, although the staffs of the Fund and the World Bank were in agreement on the likely level of aid in fiscal year 1985/86. More would be known after mid-January 1986 about the willingness of donors to provide funds; thus far, they had been forthcoming and supportive of Nepal, and he had every reason to suppose that they would continue to support the Nepalese economy, on the basis of the important measures being undertaken by the authorities.

The possibility of an extended arrangement for Nepal had by no means been excluded, the staff representative continued. However, because the staff had not had much experience in working closely with the Nepalese authorities on a program, the feeling had been that it would be sensible to begin with a one-year program and to make a judgment at the end of that period about the progress that had been made.

A large part of the financing for Nepal's development effort would be coming from abroad, although a significant increase in domestic resource mobilization would also be necessary, the staff representative said. Nepal should not be incurring significant amounts of foreign financing on nonconcessional terms, and prudence also had to be exercised in any assessment of its acess to Fund resources, especially as the Government was undertaking a longer-term structural adjustment effort. It was hoped that creditors would respond favorably to the adjustment efforts of the Nepalese authorities, although they would likely want to take some time to see how the program was proceeding. The staffs of the Fund and the World Bank had been working closely on Nepal's case, and it was clear that the Fund could be of assistance in helping to support an increase in reserves and to provide the authorities with an appropriate macroeconomic framework; at the same time, the World Bank and the Asian Development Bank would have to be very active in Nepal. At the end of the program period, it would be much easier to make a judgment about what precisely should be the role of the Fund in the medium term, in light of the authorities' success in implementing the program and in light of the creditors' response to that success.

Some Directors had mentioned that it might be difficult to mobilize additional domestic savings and to increase the ratio of savings to GDP in an economy where the per capita income was as low as that in Nepal, the staff representative noted. The staff foresaw some increase in domestic savings in 1985/86, as well as an increase in the investment ratio, with a larger inflow of funds from abroad. The domestic savings ratio at present was relatively small in Nepal, at about 2.3 percent of GDP in 1984/85. World Bank projections indicated an increase in the ratio by nine tenths of 1 percentage point through an increase in public sector savings, and while that increase might appear modest, it was significant in relation to the starting point. It was to be hoped that over time there would be a favorable response of the private sector as well as financial sector deregulation, and that the position of the public sector enterprises would be strengthened.

In response to a question by Ms. Lundsager, the staff representative observed that it was always difficult to define with precision "the best" exchange rate at any given point in time. However, the action taken on November 30, 1985 had at least returned the rate against the currencies of Thailand and Bangladesh to what it had been prior to their recent exchange rate actions. It was clear from the indications of the authorities that they were not judging policies on the basis of a real effective exchange rate alone, but were looking at other indicators, including export response and import demand. Moreover, if pressure on the rate should occur, and in line with medium-term developmental considerations, the authorities had assured the Executive Board that they were prepared to manage their rate flexibly.

The authorities had moved forward relatively quickly in putting together the program described in the staff report. The discussions with the staff had taken place several weeks following passage of the 1985/86 budget and thus at a time when the authorities were not in a position to introduce new revenue measures, the staff representative commented. There was no doubt in the authorities' mind that additional increases in revenue through taxes would be appropriate at some stage; and, indeed, the authorities had requested technical assistance from the Fund to help them implement major new revenue measures in the 1986/87 budget. The main response in the current program had naturally been to make cuts on the expenditure side; but the program was straddling two budgets, and the staff was looking for a package of measures in the new budget that would produce additional revenue to Rs 300-325 million per year. The kind of new revenue package about which the staff was talking was one it was hoped would result from the Fund technical assistance report on fiscal matters and from World Bank staff discussions with the authorities.

In response to those who had queried the increase in aid disbursements, the staff representative observed that part of the increase was due to the impact of the devaluation. There was some lumpiness in ongoing projects requiring larger amounts of funds, and there was a higher proportion of faster disbursing, nonproject assistance that had been provided by creditor countries.

On the need for new revenue measures to improve the debt service ratio, the major concern of the staff was the possible continuation of the tendency to borrow on commercial terms, the staff reepresentative stated. Indeed, in a recent period, the authorities had borrowed approximately SDR 50 million on commercial terms, although part of that amount had been due to the fact that creditors had chosen to package their aid funds to Nepal in such a way that aid projects had attached to them a certain amount of suppliers' credit. So long as such packaging continued, some of the borrowing on commercial terms would continue; however, the debt service ratio was not the major constraint in a country like Nepal. Looking ahead, one could see that a very large proportion of aid financing was on highly concessional terms, and, certainly, the debt service ratio per se did not reflect the kind of structural problems for Nepal's balance of payments management that would become a feature if commercial borrowing were to continue to increase at the pace that it had in the past. It was of course possible that the debt service ratio in convertible currencies was more relevant, although his own assessment suggested that that was not the case. Debt servicing for Nepal in Indian rupees was thus particularly relevant; indeed, if there was an area of disagreement over the years with the Nepalese authorities, it was related to whether or not a global balance of payments problem existed.

Some Directors had questioned whether the "errors and omissions" numbers would be reduced to zero, the staff representative recalled. By their very nature, "errors and omissions" should be reduced sharply. At least half of the number related to transactions through the ready-made garment industry where, at present, new licenses for nonresidents were not being granted, and where the devaluation, the maintenance of a flexible exchange rate policy, and the impact on expectations of a considerably tightened credit policy was being felt. Some of the transactions of the garment industry were as much current account transactions as capital account transactions.

On the question of exchange restrictions in Nepal, the staff representative noted that the notion of a foreign currency deposit scheme to capture some savings of Nepalese citizens residing abroad was a reasonable one and it should not detract from the authorities' need to manage the balance of payments carefully and pay due attention to exchange rate management. However, they had arranged the scheme in such a way that it gave rise to an exchange restriction because nonresident depositors could withdraw only 70 percent of deposits in foreign exchange and 30 percent in local currency.

Like a number of Directors, the staff was concerned about real interest rates in Nepal, which was why he was pleased that the authorities had agreed to additional flexibility and to an increase in the band within which commercial banks were permitted to increase their rates if the market should lead them in that direction. Finally, the purchase of a commercial aircraft for World Nepal Airlines was a matter that had been discussed at great length with the authorities and with World Bank staff members who in their report had not noted any great increase in the capacity of the airline to expand. He agreed with those who felt that an expansion in Nepal's present circumstances should not be a high priority matter; however, some of the airline's equipment was outdated and had not been appropriately maintained, and what was being discussed was a replacement aircraft rather than an additional one. For safety and other reasons, the purchase of such an aircraft seemed reasonable, and the World Bank staff had agreed on that point. The only uncertainty concerned the timing of the purchase. His own view was that it would be preferable to wait until the next fiscal year when domestic resources were stronger; in the meantime, the authorities might consider leasing one or two aircraft to meet their needs.

The staff representative from the Exchange and Trade Relations Department, commenting further on the possibility of an extended arrangement with Nepal, agreed that the Fund staff and the Nepalese authorities needed some experience in operating under an arrangement; and a one-year arrangement would help serve that purpose. Nonetheless, the possibility of an extended arrangement as a follow-on program existed.

In response to those who had questioned the phasing of purchases under the proposed program, the staff representative observed that Nepal had no outstanding use of Fund credit. The first purchase provided under the arrangement was therefore equivalent to slightly more than the first credit tranche; according to the conditionality guidelines, of course, neither performance criteria nor phasing of purchases was applicable to the first credit tranche, which accounted for the apparent front-loading in Nepal's case.

Mr. Govindarajan agreed with the staff's logic in proposing a one-year rather than extended arrangement at the present stage. However, it was clear from the staff's reply that the terms of Fund lending were rather harsh, and there was a need for an interest subsidy account or some other mechanism to soften the rates at which the Fund provided resources. Moreover, Nepal in particular would seem to be a good case for use of Trust Fund reflows, once the guidelines for the use of such reflows were developed.

Mr. Ismael noted that the Nepalese authorities were fully committed to pursuing rigorous adjustment efforts aimed at correcting the existing imbalances in the budget and the external current account. They fully realized that the expansionary policies of the past few years could not be sustained without adequate domestic resources and private sector participation. In that regard, in his recent address to the nation, His Majesty the King had stated the following:

> What has become quite clear is that the Government and the government institutions alone cannot bring the country's development to a scale which we desire. We have to extend all possible encouragement to the private sector and encourage production through remunerative pricing in the task of mobilization for the purpose of comprehensive development.

The Chairman made the following summing up:

> Executive Directors were in broad agreement with the appraisal in the staff report for the 1985 Article IV consultation with Nepal, and they supported Nepal's request for a stand-by arrangement. While noting the adverse impact of weather conditions, Directors expressed the view that overly accommodating financial policies were the major contributors to the large overall deficits in the past three years. They commended the authorities for the recent introduction of adjustment measures to alleviate the immediate internal and external imbalances, a necessary first step for moving the economy toward a path of stable and sustainable growth in the medium term, and they urged the authorities to address more forcefully the structural impediments to growth of the Nepalese economy.

Directors welcomed the authorities' intention to pursue a more flexible exchange rate policy following the adjustment announced at the end of 1985. The consistent implementation of such a policy was seen to be essential to improving export competitiveness and prospects for efficient import substitution, and would provide additional stimulus to the growth of the traded goods sectors, including agriculture and light manufacturing, and of tourism.

Directors observed that growing fiscal deficits were an immediate source of the external imbalance in recent years, and they noted the authorities' decision to tighten budgetary policy in the short term through improvements in tax administration and restraint in expenditure. Rigorous pursuit of improvements in tax administration would be necessary if the revenue targets for 1985/86 were to be realized and if the revenue base was to be expanded in the medium term. In that connection, it was noted that Nepal's tax/GDP ratio was relatively low, and the authorities were encouraged to carefully consider the fiscal policy recommendations in the March 1985 Fund technical assistance report. Noting that greater efforts toward domestic resource mobilization would be a key to moving the economy toward a path of sustainable growth over the medium term, Directors welcomed the authorities' intention to implement substantive new revenue measures beginning with the 1986/87 budget.

Concern was expressed about the rapid growth in expenditures in recent years, in particular current expenditures, and Directors underscored the importance of controlling the overall salary bill by limiting wage increases and the number of employees. They also welcomed the authorities' efforts to set priorities for public sector investments and to pay close attention to the potential impact of investments on the current expenditure requirements of the budget.

In addition to measures to strengthen the fiscal accounts, the operation of public enterprises should be rationalized and their financial position improved. In that regard, Directors welcomed the initiatives to improve the financial position of public enterprises through the implementation of a more flexibly administered pricing policy, improvements in incentives for managerial efficiency, and an increase in private sector participation in the state enterprises.

Directors stressed that the tighter monetary and credit policies envisaged for 1985/86 were essential if the authorities were to attain the domestic and external objectives of the program and also to counteract private capital outflows. Although some Directors expressed concern that interest rates might be too high in real terms, most urged the authorities to extend the increased flexibility introduced for bank deposit rates to other lending rates in order to improve resource allocation through the financial system. They recommended that the interest rates on treasury bills and on bank deposits of similar maturity be raised to market levels, especially in light of the possibility of rising inflation, and they stressed the importance of ensuring that interest rates remain positive in real terms. Some Directors questioned the usefulness of the foreign exchange deposit scheme, emphasizing that potential inflows through that mechanism should not divert attention from the need to manage the exchange rate flexibly.

It was emphasized by Directors that, given Nepal's limited resources at the present stage of the economy's development, an efficient and timely use of external assistance would be an indispensable complement to domestic resource mobilization efforts. They noted that the large and growing level of undisbursed aid clearly signaled the need for an intensification of efforts by the Nepalese authorities and donors to increase Nepal's aid absorption capacity. In that regard, a number of Directors noted that the World Bank's recent economic report on Nepal contained several specific recommendations on measures to enhance aid absorption, and they hoped that the Nepalese authorities would give those recommendations careful and timely consideration.

It was observed that, partly in conjunction with aid-financed projects, external borrowing by Nepal on commercial terms had been increasing. While the burden of debt service on the external accounts was still relatively modest, Nepal's capacity to service such debt was quite limited. The cautious policy in respect of commercial borrowing under the adjustment program should be sustained, while greater efforts should be made to utilize available concessional aid. Directors noted that the vulnerability of Nepal's external position, as illustrated in the projected continuation of large current account deficits in the medium term, required Nepal to pursue its development objectives in the framework of cautious adjustment policies.

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

The Executive Board then took the following decisions:

Nepal - 1985 Article IV Consultation

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 (EBS/85/264, 12/3/85 and SM/85/326, 12/10/85). The Fund urges the authorities to remove the exchange restriction that is subject to approval as soon as possible.

Decision No. 8158-(85/186), adopted
December 23, 1985

Nepal - Stand-By Arrangement

1. The Government of Nepal has requested a stand-by arrangement for the period from December 23, 1985 to January 22, 1987 in an amount equivalent to SDR 18.65 million.

2. The Fund approves the stand-by arrangement set forth in EBS/85/264, Supplement 2.

Decision No. 8159-(85/186), adopted
December 23, 1985

2. SDR VALUATION BASKET - REVISED GUIDELINES FOR THE CALCULATION OF CURRENCY AMOUNTS

The Executive Directors considered a staff paper on the rounding procedures for the revised SDR basket (SM/85/30, Sup. 2, 12/19/85) and containing further calculations requested by some speakers at an earlier discussion (EBM/85/182, 12/16/85).

Mr. Polak considered that the staff paper provided Directors with all the information they needed to agree on rounding procedures, which should make unnecessary the Board meeting scheduled for December 31. There was one judgment made by the staff in its paper to which he could not subscribe, however, and that was the indication that all solutions were mathematically acceptable. He himself could not describe as mathematically acceptable a solution like the one that had turned up in a previous staff paper in which the French franc and the Japanese yen had been presented with totally different degrees of precision. In general, the staff was perhaps overly concerned with the total number of digits that would appear in the Fund's press release of December 31, 1985.

All Directors would no doubt agree that if the calculations could produce amounts of currencies rounded to two significant digits that would fall within the accepted one half of 1 percent tolerance, the matter would be resolved, Mr. Polak continued. Of course, some might feel that two digits with a 1 percent tolerance would also be acceptable; and, indeed, such an approach would be his own preference as a next best solution. After that, he would prefer to move to a three-digit solution for every currency, which would certainly work. Choosing a solution that produced two digits for some currencies and three digits for others was not in his view appropriate; if such figures were published, they would cry out for an explanation. In sum, if the calculations did not produce two significant digits for all currencies, it would be best to move to a general three-digit approach, which would not raise any questions.

Mr. Sugita stated that his position had not changed since EBM/85/182. He preferred the minimum digit approach, with most currencies rounded to two digits and one or two currencies possibly rounded to three digits within half a percentage point of tolerance. He could not agree to widening the limits of tolerance to 1 percentage point. If his preference did not muster sufficient support, he would not be opposed to the uniform-digit approach or the constraint approach, so long as a conclusion was reached at the present meeting or, if a meeting was to be held on December 31, its purpose would be limited to a review of the results rather than a renewed discussion of the approach. In sum, his preference was for Option 1 in Table 1 of the supplementary paper. He could not accept Options 4 or 2 and was neutral with respect to Option 3.

Mr. Suraisry observed that his preference was for Option 4; however, since the yen was one of the currencies in the SDR basket, and since Mr. Sugita was opposed to expanding the margin of tolerance, he wondered whether it was feasible or even appropriate to talk about Option 4 any further.

The Deputy General Counsel remarked that the decision and guidelines established in 1980 applied automatically unless the Board wished to change them; and the change required a 70 percent majority.

Mr. Suraisry remarked that, in the circumstances, his preference was for Option 4; if that were not acceptable, he could go along with Option 2.

Ms. Lundsager agreed with Mr. Sugita that Option 4 in Table 1 was not acceptable. She would much prefer to keep the limit of tolerance to one half of 1 percentage point. Before choosing from the remaining options, she wished to hear some of the comments of her colleagues, although she noted that from a strictly mathematical point of view, it did not seem to matter which of the options was chosen; the issue was only one of presentation.

The staff representative from the Treasurer's Department observed that the rounding of the currency amounts implicitly accepted some element of imprecision in the determination of the basket. However, the degree of precision of the currency amounts in and of themselves, rather than the deviation from the initial unrounded calculations, was also a matter of concern to Mr. Polak. The staff felt that that latter concern was more a matter of presentation than of mathematical accuracy. All of the calculations presented by the staff were mathematically acceptable in the sense of reflecting accurately the constraints imposed on the calculations, and it was up to the Executive Board to decide which constraints would be adopted--namely, from among the four options presented in Table 1 of the supplementary paper (SM/85/320, Sup. 2, 12/19/86).

Mr. de Forges stated that like others, he would prefer the two-digit approach, although Mr. Polak's remarks on the importance of proper presentation had convinced him that if rounding to two significant digits was not possible, he would go along with rounding to three significant digits for all currencies.

Mr. Goos agreed that the question was mainly one of presentation, and he tended to agree with Mr. Polak's concern about the degree of precision with which different currencies in the basket had been presented. In general, he continued to have a preference for Option 1, but could also go along with Option 3. Like Mr. Sugita, Ms. Lundsager, and others, he would have difficulty going along with Option 4, which introduced a margin of tolerance of 1 percentage point.

Mr. King stated that he, too, would have difficulty with Option 4. Of those he could accept, his order of preference was Option 2, Option 3, and Option 1.

Mr. Romuáldez said that he could go along with the arguments put forward by Mr. Polak and therefore tended to favor Option 2 or, if necessary, Option 3. Like others, he would not be able to accept Option 4.

Mr. Pickering stated that his preference was, first, for Option 4 and then for Option 2. It was his understanding from the staff paper that, on the unlikely assumption that it was not possible to find a solution even at three significant digits, the next move would be to four significant digits if Option 2 were agreed. He would appreciate confirmation of his understanding.

The staff representative from the Treasurer's Department remarked that it was for all practical purposes improbable that a solution could not be found whereby all currencies were rounded to three significant digits. However, he confirmed Mr. Pickering's understanding of the next move under Option 2 if a uniform three-digit solution could not be found.

Ms. Lundsager stated that her first preference was for Option 2, the uniform-digit approach, basically for the reasons suggested by Mr. Polak. As a second best solution, she could go along with Option 1.

Mr. Ismael remarked that he preferred Option 4, followed by Option 2.

Mr. Archibong commented that his order of preference was also Option 4 and then Option 2.

Mr. de la Herrán noted that his choice was, first, for Option 2 and then for Option 4.

Mr. Hubloue said he could go along with either Option 2 or Option 1.

Mr. Isleifsson stated that the preference of his chair was, first, for Option 4 and then for Option 2.

Mr. Angeloni said that he sensed that Mr. Polak's difficulty with different degrees of precision in the numbers would not be obviated by the adoption of Option 2--the uniform-digit approach--but only through the adoption of a different number of digits for some of the currencies, such as might occur under Option 3. Indeed, Option 2 might improve the precision uniformly for all currencies but would not resolve the question of different precisions of different currencies in relative terms.

The staff representative from the Treasurer's Department observed from Table 1 of the supplementary paper, that unrounded figures produced by the calculations would clearly show different degrees of precision in the way in which they were presented, even though they were all carried out to six significant digits. Moving to a uniform-digit approach would maintain the difference in those degrees of precision, although the variance could widen if an approach were employed in which some numbers were rounded to two significant digits and others were rounded to three significant digits. If the constrained approach were adopted, the aim would be to minimize the difference in the degree of precision with which the currency amounts were presented while allowing for a difference in the number of significant digits for different currencies.

Mr. Goos noted that he was perhaps in the minority in supporting Option 3. Nevertheless, under Option 2, the outcome for the pound sterling seemed awkward; and Option 3 should lead to a more elegant presentation.

The Acting Chairman observed that the weight of views seemed to be toward Option 2, although the required 70 percent majority had not yet been reached.

Mr. Isleifsson and Mr. Vasudevan stated that they could go along with Option 2 if that would help in the achievement of a 70 percent majority.

Mr. Polak said that it was his understanding that no 70 percent majority was required, since Directors were only searching for a way of applying a formula already agreed.

The Deputy General Counsel remarked that when the method of calculation had been agreed five years ago, several variations had been put forward, including one understood as the uniform-digit approach. The Board had been asked to adopt guidelines for the calculations needed to arrive at the precise currency amounts in the SDR basket using the currency weights and average exchange rates as determined under Decision No. 6631-(80/145) GS so that the staff could make these calculations automatically without returning to the Executive Board for further guidance. The procedure for the valuation of the SDR every five years was intended to operate automatically to arrive at the new currency basket unless the Executive Board decided otherwise by the appropriate majority. The aspect of the method of calculation in question had been adopted in 1980 as part of the procedure of valuation and would continue to apply unless the Executive Board wished to apply a different method of determining the precise currency amounts from the percentages. Decisions with respect to the valuation of the SDR could be taken only by qualified majorities. To adopt a different method for the purpose would require a 70 percent majority.

Mr. Polak noted that the guidelines were not precise about how to move from two significant digits for all currencies to three significant digits for some of the currencies.

The Deputy General Counsel replied that the guidelines stated that "the significant digits to which currency amounts would be expressed may exceed two for any one or more currencies but not exceed four for any currency." The memoranda on the subject had been explained at the time that the intention was for a minimum-digit solution consistent with the minimum deviations. His recollection was that there had been no discussion of that matter in the Board as the final proposal had been adopted on a lapse of time basis; the discussion had taken place informally with Executive Directors outside the Board room.

The Executive Board then took the following decision:

1. Under all circumstances, the currency units will be determined in a manner which would ensure that the value of the SDR calculated on December 31 on the basis of the new basket will be the same as that actually prevailing on that day.

2. The currency amounts calculated for the new basket will be expressed in two significant digits provided that the deviation of the percentage share of each currency in the value of the SDR, resulting from the application of the average exchange rates for October-December, from the percentage weight as determined under paragraph 3(c) of Executive Board Decision No. 6631-(80/145), adopted September 17, 1980, is the minimum on average and will not exceed one half percentage point for any currency.

3. If a solution cannot be obtained by the application of the principles set forth in 2 above, the calculation shall be made applying the same principles but expressing the amount of each currency in three significant digits, and if no solution is found with three significant digits then the calculation shall be made applying the same principles but expressing the amount of each currency in four significant digits.

4. If more than one solution is found in the calculation at the level of two, three, or four significant digits, the solution that has the smallest average deviation will be employed.

Decision No. 8160 -(85/186) G/S, adopted
December 23, 1985

3. POLAND - MEMBERSHIP COMMITTEE

The Executive Directors considered the proposal by the Acting Chairman for the establishment of a membership committee to consider the application of Poland for membership in the Fund.

The Executive Board then took the following decision:

The Executive Board, under Rule D-1, decides to establish a committee to proceed with the formal investigation, to obtain all relevant information, and to discuss with the Government of Poland any matters relating to its application for membership in the Fund (EBD/81/295, 11/10/81).

The Committee shall consist of Mr. Lundstrom, Chairman, Mr. Dallara, Mr. de Groote, Mr. de Maulde, Mr. Finaish, Mr. Mtei, Mr. Nebbia, Mr. Polak, and Mr. Sengupta.

Adopted December 23, 1985

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/185 (12/20/85) and EBM/85/186 (12/23/85).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 85/40 are approved. (EBD/85/316, 12/16/85)

Adopted December 20, 1985

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/316 (12/19/85) is approved.

APPROVED: AUGUST 14, 1986

JOSEPH W. LANG, JR.
Acting Secretary