FOR
AGENDA

EBS/85/264

CONFIDENTIAL

December 3, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Nepal - Staff Report for the 1985 Article IV Consultation and Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Nepal and a request from Nepal for a stand-by arrangement equivalent to SDR 18.65 million. Draft decisions appear on page 31.

This subject will be brought to the agenda for discussion on a date to be announced.

Mr. R. C. Williams (ext. 7610) or Mr. Baban (ext. 7316) is available to answer technical or factual questions relating to this paper prior the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

NEPAL

Staff Report for the 1985 Article IV Consultation and Request for Stand-by Arrangement

Prepared by the Asian and the Exchange and Trade Relations Departments

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

Approved by Tun Thin and Eduard Brau

December 3, 1985

Contents Page

Contents

Page

Tables in the Text

Appendices

Annexes

Charts

I. Introduction

Discussions for the 1985 Article IV consultation and the use of Fund resources were held in Kathmandu during September 4-18, 1985 with the Minister of Finance, the Governor of the Nepal Rastra Bank (the central bank) and officials of various agencies, including the Ministries of Finance, Agriculture, Industry, Commerce, and Supplies, the Planning Commission, the Nepal Rastra Bank, the Agricultural Development Bank of Nepal, and the Trade Promotion Center. The staff team consisted of Messrs. Richard C. Williams (Head), Roy C. Baban, Ali Salehizadeh, and Biswajit Banerjee, with Mrs. Clementina Colliflower (all ASD) as secretary. Mr. J. E. Ismael, Executive Director for Nepal, attended the meetings as an observer. A technical mission on the exchange system consisting of Messrs. Peter J. Quirk (Head, ETR) and David Burton (ASD), with Ms. Brenda Livsey-Coates (Paris Office) as secretary, visited Kathmandu during October 26-November 5, 1985. Mr. Reinold H. van Til, the Fund Resident Representative, assisted both missions.

In the attached letter dated December 3, 1985 the Minister of Finance requests a 13-month stand-by arrangement in the amount of SDR 18.65 million, equivalent to 50 percent of quota. All purchases would be from the Fund's ordinary resources. At present, Nepal has no Fund credit outstanding under either tranche policies or special facilities. Assuming that all purchases are made as scheduled, Nepal's total Fund credit outstanding will amount to SDR 18.65 million (50 percent of quota) as of mid-January 1987 (Table 1). Purchases would be phased as follows: SDR 10.25 million upon Executive Board approval of the program and four equal installments of SDR 2.1 million upon the satisfaction of performance criteria for mid-January 1986, upon the satisfaction of performance criteria for mid-April 1986 and the completion of the mid-term review by July 15, 1986, and upon the satisfaction of performance criteria for mid-July 1986 and mid-October 1986.

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

The lending of the World Bank Group to Nepal, though constrained by Nepal's limited aid absorption capacity, has played a significant role in the development process. About 35 percent of the World Bank Group's loans have been directed to agriculture. Another 45 percent has been directed to infrastructure, particularly in the transportation, telecommunications, and energy sectors. Two projects in agriculture and one in industry are under consideration.

The stand-by arrangement is provided in Annex I. Annex II contains the Letter of Intent of the Minister of Finance and the Memorandum of the Government of Nepal on Certain Aspects of its Economic and Financial

Table 1. Nepal: Fund Position During the Period of the Proposed Arrangement, 1985/86-1986/87

	Outstanding as of mid-Oct. 1985	1985/86	1986			1986/87
		Mid-Oct.-mid-Jan.	Mid-Jan.-mid-Apr.	Mid-Apr.-mid-July	Mid-July-mid-Oct.	Mid-Oct.-mid-Jan.
			(In millions of SDRs)			
Transactions under tranche policies (net)	--	10.25	2.1	2.1	2.1	2.1
Purchases	--	10.25	2.1	2.1	2.1	2.1
Ordinary resources	--	10.25	2.1	2.1	2.1	2.1
Repurchaes	--	--	--	--	--	--
Ordinary resources	--	--	--	--	--	--
Total Fund credit outstanding (end of period)	--	10.25	12.35	14.45	16.55	18.65
Under tranche policies	--	10.25	12.35	14.45	16.55	18.65
			(As percent of quota)			
Total Fund credit outstanding (end of period)	--	27.5	33.1	38.7	44.4	50.0
Under tranche policies	--	27.5	33.1	38.7	44.4	50.0

Source: International Monetary Fund.

Policies for 1985/86. Summaries of Nepal's relations with the Fund and the World Bank Group are provided in Annexes III and IV, respectively. Annex V contains basic data on the Nepalese economy. Annex VI contains a summary of statistical issues.

II. Background and Recent Economic Developments

1. Background

Nepal is one of the least developed countries in the world, with a per capita income of about SDR 145. It is landlocked, poorly endowed with natural resources, and faced with severe transportation and communication difficulties. Agriculture, which is concentrated in the Terai plains bordering India, accounts for about 60 percent of GDP. Its contribution to the economy is in fact much higher, as a substantial part of industry is agro-based. Given that only about an eighth of arable land is irrigated, agricultural production is highly vulnerable to adverse weather.

Nepal's balance of payments is structurally weak. Exports are concentrated in a narrow range of commodities and have grown more slowly than imports, with the ratio of exports to imports steadily declining from 49 percent to 35 percent during the decade ending 1984/85. 1/ Foreign grants and highly concessional loans finance a substantial part of imported goods and services. Adverse weather directly affects the balance of payments through reduced exportable surpluses and increased imported food requirements. To contain the demand for foreign exchange to available resources, imports from "third" countries (i.e., countries other than India) are subject to a number of restrictions. In contrast, trade with India, which accounted for nearly half of Nepal's total trade in 1984/85, is virtually free of restrictions and is further facilitated by the open border and the free convertibility between the Nepalese and Indian currencies in Nepal. 2/

During the period of the first five development Plans (1956/57-1979/80), investment was directed primarily at building social and economic infrastructure. Real GDP grew at an average of 2-3 percent, about the rate of population growth. With the aim of achieving a faster rate of growth, the Sixth Plan (1980/81-1984/85) provided for a marked increase in development expenditures, largely financed by concessional external assistance. The Sixth Plan placed more emphasis on directly productive investment, particularly in agriculture and export-oriented

---

1/ The fiscal year ends on July 15.

2/ Nepal's special trade and payments arrangements with India involve a restriction under Article XIV on the use by Nepalese (or Indian) residents of net currency balances acquired in bilateral transactions for the making of payments and transfers to third countries.

cottage industries, and on alleviating the shortage of electricity, which posed a serious bottleneck to industrial growth.

During the Sixth Plan period, the real growth outturn was more favorable, while inflation fluctuated within a wide range. Real GDP grew at a compound rate of 4.1 percent per annum, despite a severe drought in 1982/83 and a milder one in 1984/85. Inflation, which was fueled by external price shocks early in the Plan period and by domestic supply shortages in 1982/83, reached a peak of 14 percent in 1982/83, easing thereafter to more moderate levels (Table 2).

The improved growth performance has been accompanied by a sharp deterioration in the balance of payments since 1982/83. In that year, the decline in agricultural production depressed exports and necessitated additional food imports, causing the ratio of the external current account deficit to GDP to rise by 4 percentage points, to 9 percent. Despite the recovery of both domestic supply and exports in 1983/84 and 1984/85, sustained import demand fueled by expansionary financial policies (particularly in the latter year) kept the current account deficit at about 7 percent of GDP. In the three-year period 1982/83-1984/85, foreign aid did not fully offset the increased demand for foreign resources, and the overall balance, previously in surplus, recorded deficits. These deficits, which cumulatively amounted to about SDR 100 million, were financed by a drawdown in international reserves. Gross total reserves, which amounted to 12.2 months of non-aid imports in mid-1982, had declined to 4.8 months by mid-1985. 1/

Excess demand pressures during the Sixth Plan period were generated mainly by expansionary financial policies. As budgetary resources lagged behind expenditures, the Government resorted to borrowing from the domestic banking system on a substantial scale during all but the first year of the Plan period. This was exacerbated, particularly from 1983/84 onward, by an accommodative credit policy in respect of private sector credit demand.

2. Developments in 1984/85

The economic outturn in 1984/85 was generally unfavorable. Real GDP growth slowed down and, under the influence of expansionary financial policies, the balance of payments position deteriorated sharply. However, inflationary pressures continued to ease.

Real GDP growth declined from a recovery rate of 7.4 percent in 1983/84 to 2.8 percent in 1984/85, largely because drought limited the growth of agricultural production to 1.7 percent (8.7 percent in

---

1/ The adverse impact of recurring drought on agricultural exports and food imports has led Nepal to maintain comparatively high levels of reserves relative to non-aid imports.

Table 2. Nepal: Summary Indicators, 1980/81-1985/86

	1980/81	1981/82	1982/83	1983/84	1984/85 (Prel.)	1985/86 (Program)
			(Changes in percent)			
GDP and prices						
Real GDP	8.3	3.8	-1.4	7.4	2.8	4.5
GDP deflator	7.9	6.8	12.6	5.7	6.3	12.0
Consumer prices (annual average)	13.4	10.4	14.2	6.2	4.1	12.0
			(As percent of GDP)			
Government budget						
Revenue and grants	12.0	12.1	11.6	11.1	11.8	14.0
Of which: revenue	8.8	8.8	8.3	8.8	9.2	10.0
Expenditures	14.6	17.3	20.4	18.9	19.9	21.0
Current	4.6	5.0	5.7	5.5	6.7	6.9
Development	10.0	12.3	14.8	13.5	13.2	14.7
Domestically financed	(4.3)	(5.5)	(8.6)	(6.8)	(6.5)	(5.8)
Foreign financed	(5.7)	(6.8)	(6.2)	(6.7)	(6.7)	(8.9)
Overall balance (including grants)	-2.6	-5.2	-8.8	-7.8	-8.0	-6.9
Foreign financing	2.4	2.3	2.8	4.2	3.8	4.6
Domestic financing	0.2	2.9	6.0	3.6	4.2	2.3
Banking system	--	2.6	6.0	2.5	3.4	1.6
Overall balance (excluding grants)	-5.8	-8.5	-12.0	-10.1	-10.6	-10.9
			(Changes in percent)			
Money and credit						
Domestic credit	19.9	17.1	40.5	15.7	24.9	15.4
Public sector	12.7	31.4	80.1	14.5	26.8	12.4
Government, net	(0.3)	(63.3)	(98.4)	(23.0)	(27.9)	(12.4)
Nonfinancial public enterprises	(34.8)	(-11.2)	(35.4)	(-16.1)	(20.7)	(12.0)
Private sector	25.8	6.4	3.9	17.7	22.0	20.3
Broad money	19.3	18.2	23.6	13.4	16.8	18.2
Interest rate on one-year bank deposits 1/	12.0	12.5	12.5	12.5	12.5-13.5	...
External sector						
Exports, f.o.b. 2/	46.8	-6.6	-24.8	40.3	47.0	3.5
Imports, c.i.f. 2/	30.7	12.1	26.7	-3.8	10.5	12.1
			(As percent of GDP)			
Exports, f.o.b.	5.9	4.9	3.4	4.5	6.6	6.9
Imports, c.i.f.	16.3	16.3	18.8	17.1	19.0	21.5
Current account balance	-4.2	-5.1	-8.9	-7.1	-7.1	-8.9
(excluding aid-financed imports of goods and services)	(1.4)	(1.4)	(-2.1)	(-0.2)	(-0.1)	(0.2)
Overall balance (mn. SDRs)	13.0	33.9	-45.2	-7.9	-47.3	-4.0
			(In months of non-aid imports)			
Gross reserves						
Total	10.5	12.2	7.5	7.2	4.8	4.8
Official	7.4	9.2	5.3	4.7	2.5	2.6
			(In percent)			
Debt service ratio 3/	1.9	2.9	4.9	4.5	4.7	4.9

Sources: Appendix Tables I-IV; data provided by the Nepalese authorities; and Fund staff estimates.

1/ In percent; at end of period.

2/ In terms of SDRs.

3/ Debt service payments as percent of exports of goods and nonfactor services and private remittances.

1983/84). Agricultural production continued to increase, despite a 3 percent decline in foodgrain production, mainly as a result of the good performance of cash crops. 1/ Despite the marked deceleration in agricultural output growth, the growth of nonagricultural production declined by only 1 percentage point, to 4.5 percent. The increased resiliency in the latter to agricultural output fluctuations reflected in part some progress in industrial diversification made possible by the progressive increase in the supply of electricity during the Sixth Plan period.

As measured by the consumer price index, average annual inflation eased further from 6.2 percent in 1983/84 to 4.1 percent in 1984/85, as the food supply situation returned to normalcy. This outturn was achieved despite increases in certain administered prices during the year. In respect of price movements by commodity, the deceleration in the overall CPI index reflected mainly the 6 percent decline in foodgrain prices. In view of adequate foodgrain availability, the moderate decline in foodgrain production had no impact on foodgrain prices. In respect of price movements by region, the deceleration in the overall price index reflected the deceleration in the consumer price indices for the Terai and the Kathmandu Valley. The index for the Hills, in contrast, accelerated to 9 percent (6.5 percent in 1983/84), reflecting the heavier impact of increased transportation costs on this region.

Administered pricing policy, which has been more flexible since 1983/84, applies to key goods and services, including utilities, petroleum products, fertilizer, transportation, certain food items (coarse rice, milk, sugar, salt, and edible oil), cement, bricks, fuelwood, and timber. In October 1984, prices of petroleum products were increased by a range of 17-33 percent. At the same time, transportation fares were raised by 10 percent. In March 1985, electricity tariffs were raised by an average of 35 percent. In the following month, the price of sugar was raised by 16 percent.

The fiscal stance remained expansionary in 1984/85. While the ratio of the overall budget deficit to GDP rose only slightly to 8 percent, the level of this ratio was twice the average of such ratios recorded in 1980/81-1981/82, the first two years of the Sixth Plan period (Chart 1). 2/ Moreover, the pattern of financing of the overall budget deficit shifted away from foreign financing to domestic financing in 1984/85. In relation to GDP, foreign financing declined by 0.4 percentage point to 3.8 percent, while domestic financing increased by 0.6 percentage point to 4.2 percent. With lower sales of government securities to the nonbank public, in particular the National Provident

---

1/ Cash crops consist mainly of jute, oilseeds, sugarcane, tobacco, and potatoes.

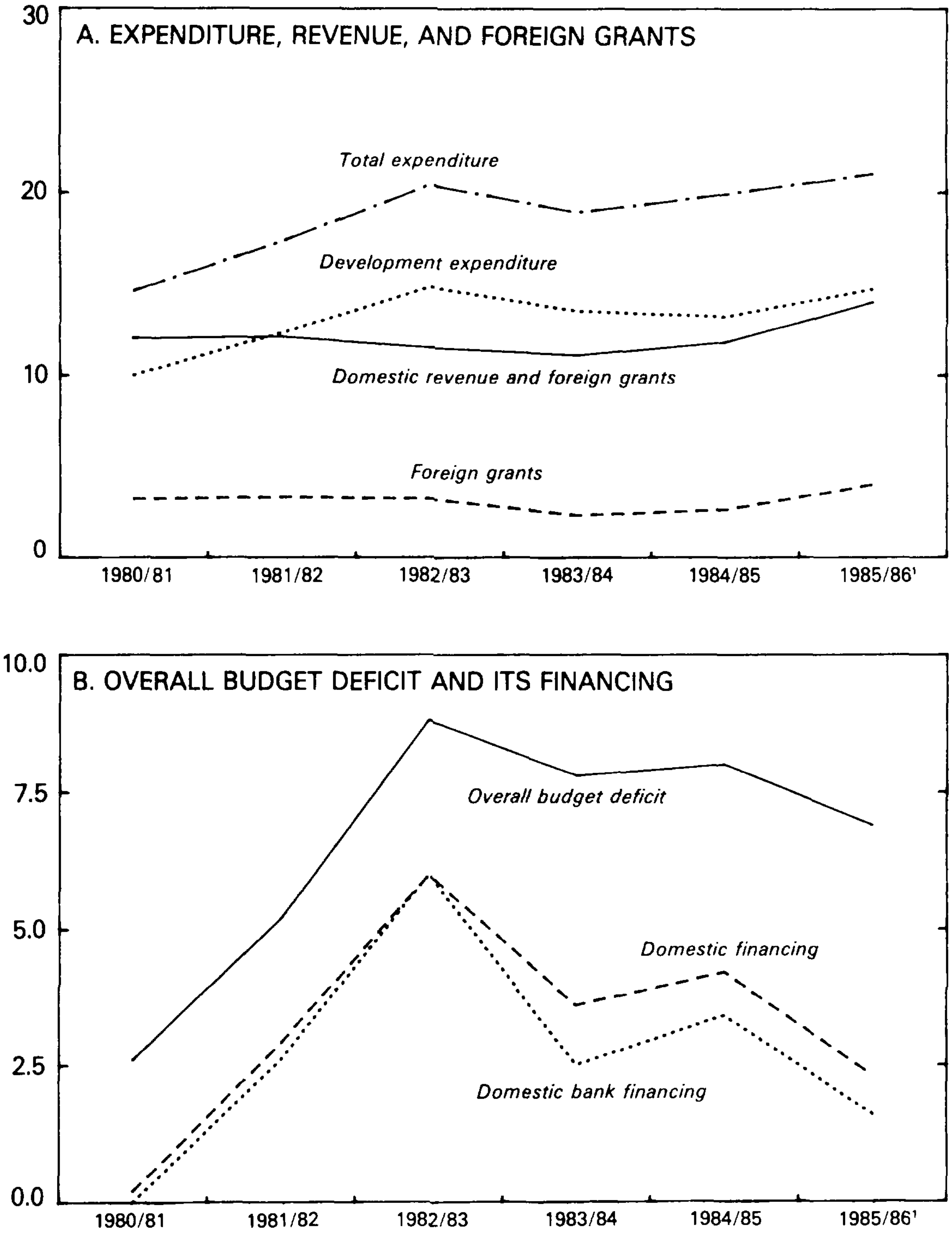
2/ The overall budget deficit excluding grants rose by 0.5 percentage point to 10.6 percent of GDP in 1984/85.

CHART 1

NEPAL

BUDGETARY INDICATORS, 1980/81-1985/86

(As percent of GDP)



Sources: Appendix Table II; and data provided by the Nepalese authorities.
[1] Program.

Fund, the ratio of net government borrowing from the domestic banking system to GDP, which had generally been negligible prior to 1981/82, increased from 2.5 percent in 1983/84 to 3.4 percent in 1984/85.

The rate of growth of total expenditure tripled to 15 percent in 1984/85 thereby raising the ratio of expenditure to GDP by 1 percentage point to 19.9 percent. While development expenditure increased moderately for the second year in a row, the growth rate of regular expenditure 1/ tripled to 34 percent, largely reflecting increases in civil service salaries in the range of 37-71 percent in July 1984 (which was mainly responsible for the 42 percent increase in the government wage bill), a 30 percent increase in teachers' salaries in February 1985, 2/ and a 52 percent increase in interest payments. The increase in expenditure was nearly offset by increases in revenues and grants, permitting only a slight increase in the overall fiscal deficit relative to GDP as noted above. Mainly owing to improved tax administration, revenue rose by about half a percentage point of GDP to 9.2 percent. Grant utilization relative to GDP also improved, though by a smaller margin.

The authorities took a number of measures in the course of 1984/85 to promote savings through the financial system and to increase competition among commercial banks. In November 1984, the authorities introduced a more flexible interest rate policy. The administered deposit rates prevailing at that time were declared as minima and commercial banks were authorized to raise savings deposit rates by up to 1.5 percentage points and term deposit rates by up to 1 percentage point above the minimum deposit rates. Even in the absence of these measures, interest rate levels would have remained positive in real terms in view of the continuing easing of inflation (Chart 2). Earlier, in July 1984, the first commercial bank founded jointly by foreign and domestic entrepreneurs commenced operations. Negotiations for the establishment of two other such banks were in their final phases by the close of the fiscal year. With the aim of channeling more resources to the rural sector, the Agricultural Development Bank of Nepal (ADBN), the most important source of institutional finance for agriculture, was permitted early in 1984/85 to accept deposits in urban areas on the same basis as commercial banks. Moreover, to further enhance the flow of savings to the rural sector, the ADBN was authorized at the close of 1984/85 to float agricultural savings certificates with maturities of six and nine months and with a tax-free yield of 10 percent.

1/ The budget uses the term "regular" expenditure in lieu of "current" expenditure.

2/ Salaries of teachers in middle schools are treated as part of regular expenditure in the budget. Salaries of teachers at elementary and post-middle levels are treated as part of development expenditure.

Domestic credit policy was more expansionary in 1984/85 than in the previous year, and further steps were taken to strengthen administrative guidance over credit allocation. With the aim of sustaining the recovery in production, the Nepal Rastra Bank (NRB) at the outset of 1984/85 instructed the commercial banks to raise credit disbursements to "priority" sectors to 8 percent of total credit and to "productive" sectors (which include the "priority" sectors) to 25 percent of total credit. 1/ The NRB stipulated, but did not enforce, a regulation to the effect that the equivalent of shortfalls from these targets had to be deposited in non-interest bearing accounts at the NRB. In November 1984, the NRB advised the commercial banks to liberalize credit to operators of public transportation in view of the increase in the administered prices for petroleum products in the previous month. Also in November 1984, the NRB reduced the deposit margin on import letters of credit from 100 percent for a wide variety of goods to 30, 40, and 50 percent; the lowest rate, which applied to imports under World Bank programs, was reduced further to 10 percent in January 1985. Also, in January 1985, the NRB instructed commercial banks to extend loans not exceeding NRs 25,000 per individual to "educated unemployed persons" for investment purposes. Subsequently, in May 1985, the NRB reduced by 2 percentage points the minimum lending rates of commercial banks for the industrial and agricultural sectors and the minimum lending rates of the ADBN for cooperatives and village committees.

In view of the rapid growth of credit and the mounting pressures on the balance of payments, the NRB took measures to restrain bank credit expansion at the close of 1984/85. In June 1985, the NRB imposed a ceiling on bank overdrafts equivalent to the mid-April 1985 level. In the same month, the interest rate on certain commercial loans was raised from 17 percent to 19 percent and the deposit margin on import letters of credit for luxury goods was raised from 50 percent to 75 percent. Moreover, in early July 1985, the NRB required banks to lower their total credit outstanding from 81 percent to 75 percent of total deposit liabilities.

As these measures came too late to have a significant effect on the credit outturn for 1984/85, the growth of total domestic credit accelerated to 25 percent (16 percent in 1983/84). Buoyed by credit demand from both the Government and nonfinancial public enterprises, the rate of growth of credit to the public sector nearly doubled, to 27 percent. Moreover, reflecting the fairly robust growth of nonagricultural output and the substantial increase in the scale of external trade, the rate of growth of credit to the private sector also accelerated to 22 percent (18 percent in 1983/84). The marked surge in credit expansion led to a substantial reduction in the net foreign assets of the

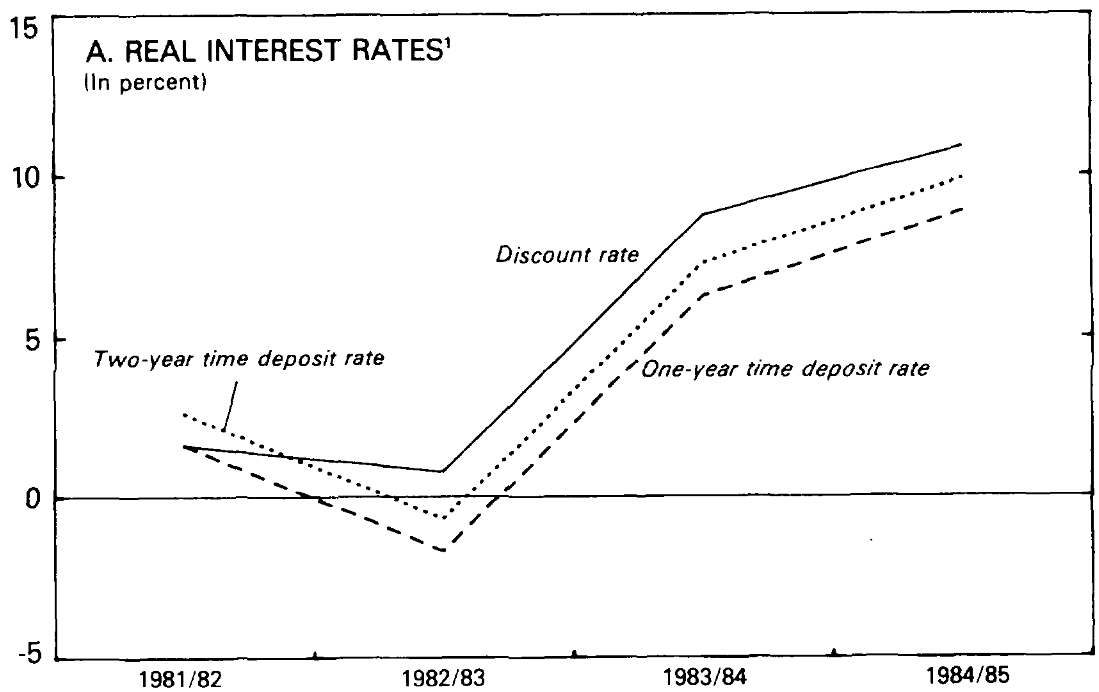
---

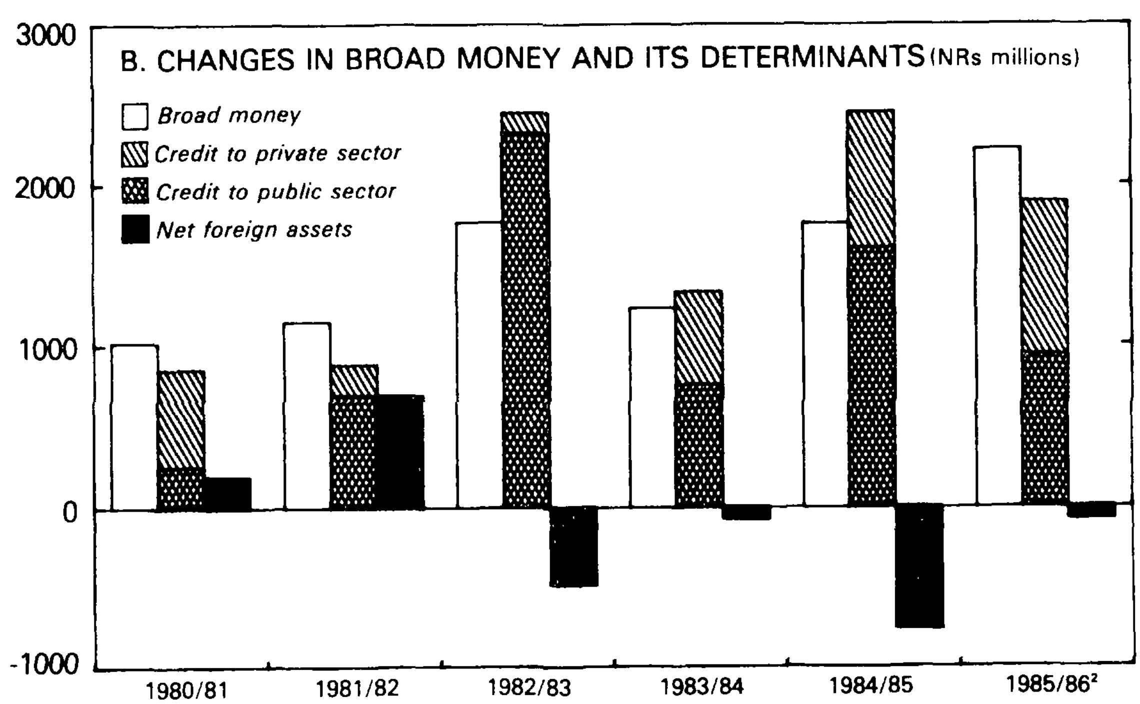
1/ "Priority" sectors consist of agriculture, cottage industries, and certain service industries, while the "productive" sectors additionally consist of export industries.

CHART 2

NEPAL

MONETARY INDICATORS, 1980/81-1985/86





Sources: Appendix Table III; and data provided by the Nepalese authorities.
[1]Average annual nominal interest rates less the average annual increase in Nepal's CPI.
[2]Program

banking system, and the growth of broad money accelerated only moderately, to 17 percent.

The overall deficit in the balance of payments rose from SDR 8 million in 1983/84 to SDR 47 million in 1984/85. This marked the third year in a row that an overall balance of payments deficit was recorded in lieu of the traditional surplus. The current account deficit remained at about SDR 170 million, equivalent to about 7 percent of GDP in both years (Chart 3). With the level of foreign grants and loans remaining virtually the same, most of the deterioration in the overall balance was traceable to a net outflow of SDR 40 million recorded under miscellaneous capital and errors and omissions. The NRB has estimated that about half of this outflow was attributable to leads and lags associated with the export-import operations of ready-made garment firms, which proliferated in 1984/85. These firms tended to obtain loans from the banking system to prepay for imported inputs, while repatriating export receipts with some lag, in conformity with Nepalese regulations that permit delays in the surrender of export receipts of up to six months from the date of exportation. Although there is no hard information on the remaining half of the outflow, it is believed to reflect a combination of unrecorded border trade, misvaluation of exports and imports, and capital flight.

The rapid expansion of the ready-made garment industry in 1984/85 raised the scale of both exports and imports substantially. In terms of SDRs, total merchandise exports rose by 47 percent, of which half was attributable to an increase in export volume, which, in turn, mainly reflected the rapid rise in recorded ready-made garment exports. Similarly, imports rose by 10 percent, about a third of which was attributable to inputs destined for the ready-made garment industry. Relative to GDP, exports and imports both rose by 2 percentage points, to about 7 percent and 19 percent, respectively.

Measures taken in 1983/84 to divert some import demand to India, in light of the perceived imbalance in official reserves in favor of Indian rupees, continued to have an impact in 1984/85. These measures, which were directed at imports from third countries, included more stringent import licensing, selective quotas, and the widening of the range of import licensing fees from 5-15 percent to 1-25 percent. The strength of these measures was such that official Indian rupee reserves, which amounted to SDR 41 million at the end of 1983/84, were virtually depleted by the close of 1984/85. At that stage, the NRB began selling convertible currency reserves in order to maintain adequate working balances in Indian rupees.

The diversion of import demand to India was complemented by measures aimed at stimulating exports to third countries. In November 1983, the authorities announced a reduction of export duties, the establishment of a scheme whereby exporters may retain 15 percent of convertible currency receipts for own imports, and the introduction of a cash subsidy of 10 percent of f.o.b. value, payable upon surrender of export receipts to the banking system. Under this scheme, NRs 12 million was paid out in 1983/84. The application of this scheme gave rise to a discriminatory multiple currency practice and was not approved by the Fund at the conclusion of the Article IV consultation in June 1984. The authorities suspended the application of this measure in July 1984.

The bulk of Nepal's external debt has been contracted on highly concessional terms. 1/ The ratio of total debt service payments to exports of goods and nonfactor services, which remains low (estimated at about 5 percent in 1984/85), has progressively increased as service payments on more loans have come on stream.

A fixed exchange rate of NRs 1.451 per Indian rupee was maintained from 1978 to November 29, 1985, despite the adoption in June 1983 of an exchange rate arrangement based on a trade-weighted basket. Since that month, frequent changes in the exchange rate of the Nepalese rupee vis-a-vis the U.S. dollar, the intervention currency, have prevented broken cross rates from re-emerging.

While the real effective exchange rate (REER) index indicates virtually no change in the external competitiveness of the tradable sector over the position of five years ago, other indices indicate a substantial deterioration in export competitiveness over the same period. The trade-weighted REER index has depreciated significantly in the last two years, reflecting the abatement of domestic inflation and nominal depreciations vis-a-vis convertible currencies (Chart 4). 2/ However, this movement has served only to compensate for the appreciation observed from mid-1980 to mid-1983. In contrast, movements in an index of the ratio of average export unit values to nontradable prices indicate a deterioration of export competitiveness of about 20 percent during 1980/81-1983/84. If the period is extended to include 1984/85, this figure declines to 8 percent because of the apparently transitory boom in jute goods prices. Analogous indices for important exports show a wide range of losses in competitiveness over the last five years: rice (21 percent); ghee (5 percent); jute goods (35 percent during four years ending 1983/84 and 11 percent during five years ending 1984/85); hides and skins (46 percent); and carpets (8 percent). These developments appear to have been important contributing factors to the slow secular growth of overall export volume.

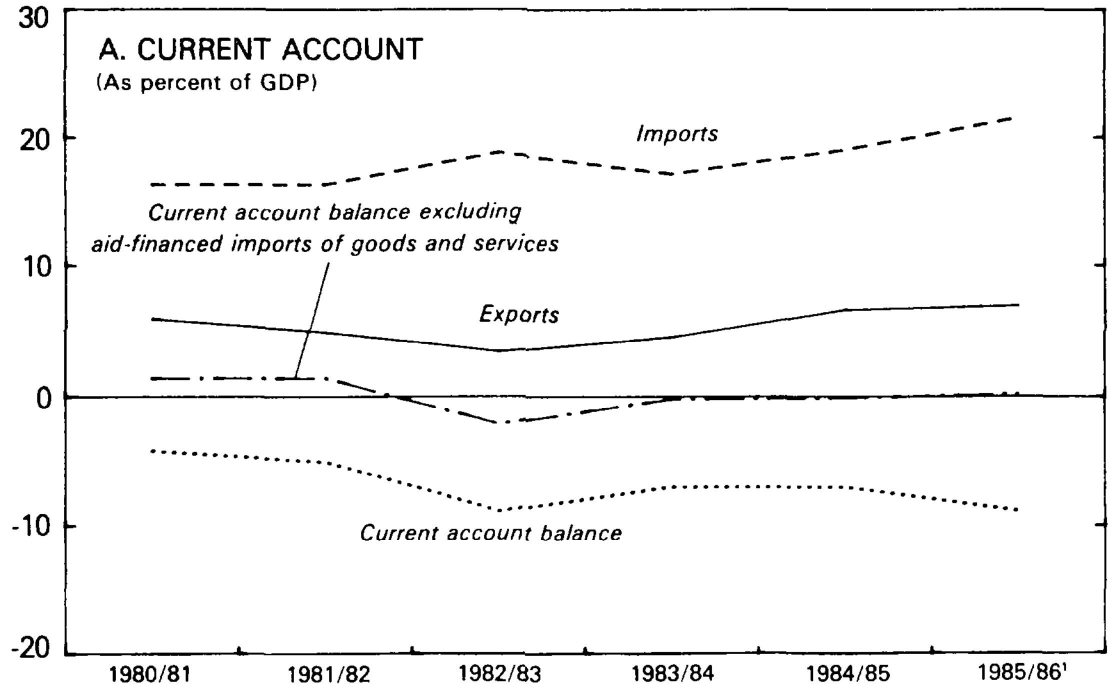
1/ Equipment purchases under some development projects are financed in part through suppliers' credits extended by certain donors in conjunction with concessional aid.

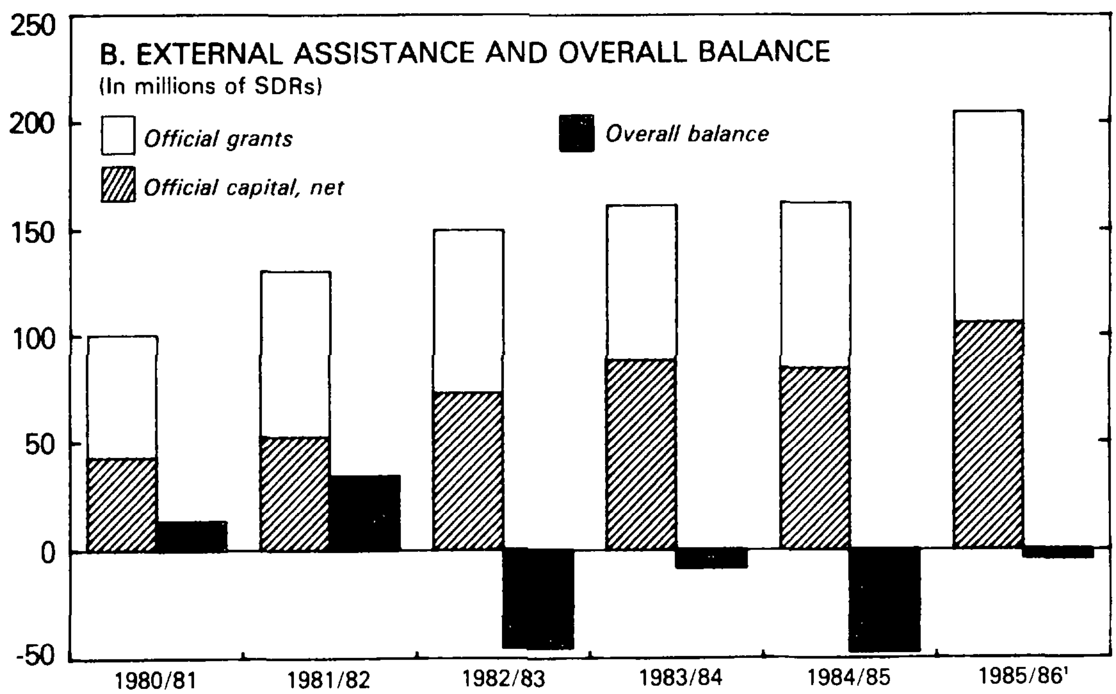
2/ The use of Nepal's consumer price index in the calculation of the REER index makes the latter highly sensitive to movements in foodgrain prices and, thus, to weather conditions. For this and other reasons, the REER index should be treated as only one of several indicators of external competitiveness.

CHART 3

NEPAL

BALANCE OF PAYMENTS INDICATORS, 1980/81-1985/86





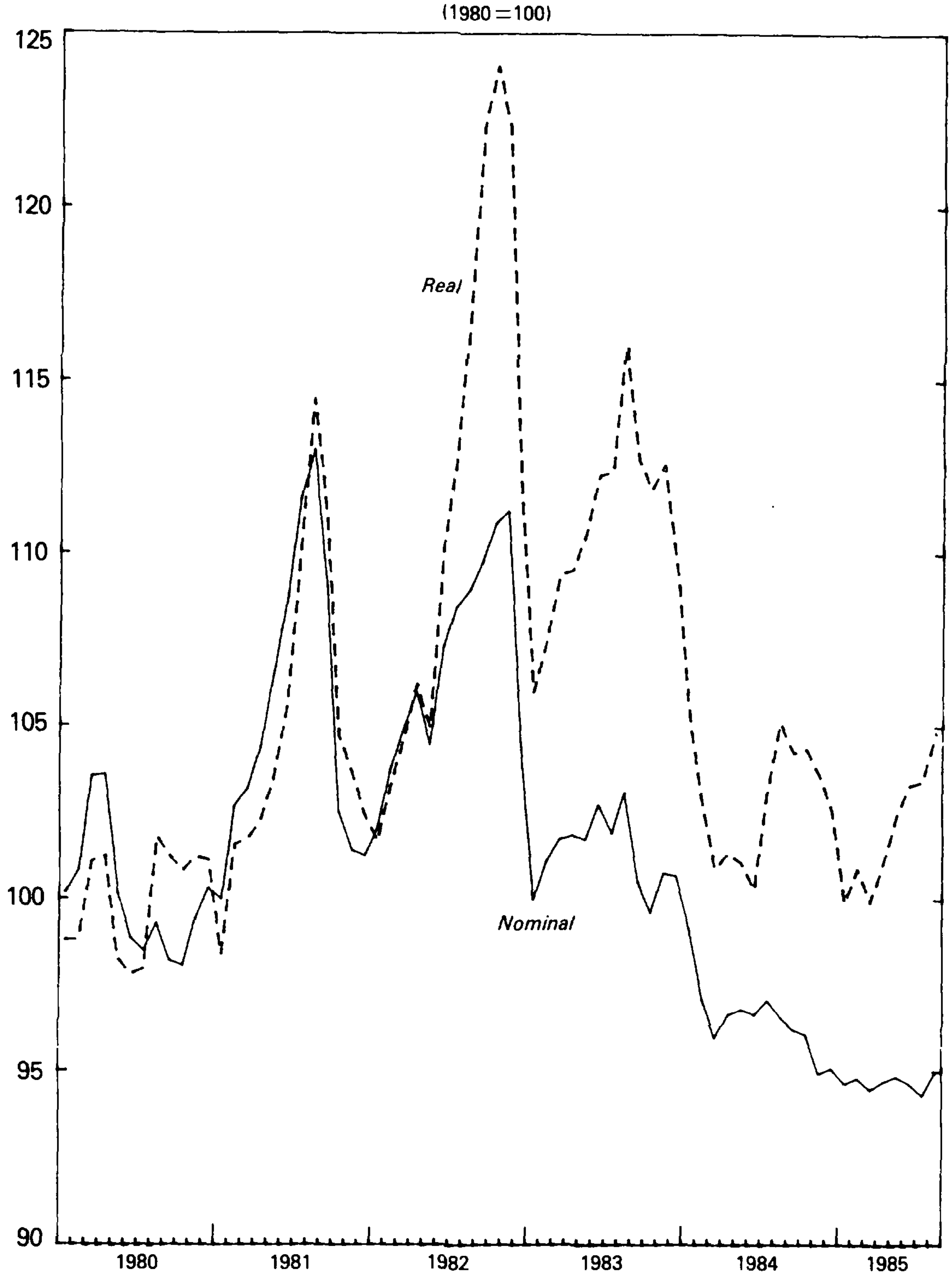
Source: Appendix Table IV.
[1]Program.

CHART 4

NEPAL

EFFECTIVE EXCHANGE RATE INDICES[1], 1980-85

(1980=100)



Source: IMF Data Fund.

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

III. Report on the Discussions and the Proposed Arrangement

In 1985/86, the authorities face the twin tasks of arresting quickly the sharp deterioration in the balance of payments, while strengthening conditions conducive to stable growth. Toward these ends, the authorities have adopted a comprehensive economic program, which is summarized in Appendix Table VI and described in the attached Letter of Intent (Annex II). This program includes, inter alia, more restrictive financial policies, an exchange rate depreciation of 14.6 percent (in foreign currency per Nepalese rupee) followed by more flexible exchange rate management, policies to stimulate production (particularly in the agricultural sector), measures to strengthen Nepal's capacity to utilize external aid, and some rationalization of the exchange and trade system. The policy thrust of this program appears to be generally in accord with the recommendations made by Executive Directors during the 1984 Article IV consultation completed in June 1984, when serious external and internal imbalances were also observed in the Nepalese economy.

The main quantitative objectives of the authorities' program for 1985/86 1/ are: to achieve a real growth rate of 4.5 percent (2.8 percent in 1984/85), to limit the overall balance of payments deficit to SDR 4 million (SDR 47 million in 1984/85), and to contain the inflation rate as measured by the consumer price index to about 12 percent on an average annual basis (4 percent in 1984/85). 2/ The objectives and performance criteria for the remaining part of the program period, which extends into 1986/87, will be set during the mid-term review which is scheduled to be completed by July 15, 1986.

1. Supply policies

Given the vulnerability of the agricultural sector to the vagaries of weather, the Seventh Plan (1985/86-1989/90) continues to place emphasis on increasing irrigation facilities, particularly in the Terai plain, and on improving maintenance and rehabilitation of existing facilities. During the Plan period, the authorities aim to increase the area under irrigation by an additional 235,000 hectares, equivalent to 8 percent of the area cultivated in 1984/85 for principal foodgrains and cash crops. In 1984/85, the number of hectares benefiting from irrigation, mainly through the use of shallow tubewells, was raised by 23,228, bringing the total additional land brought under irrigation during the last five years to 85,351 hectares.

In view of the growing self-sufficiency of farmers in high-yield seeds and the convenience of access to the seed market in India, the Agricultural Imports Corporation (AIC) has been reducing its role in the

---

1/ July 16, 1985 to July 15, 1986.
2/ The staff estimates that the underlying inflation rate has risen to about 8 percent in November 1985.

distribution of improved seeds. Following the declining trend observed in recent years, the AIC's distribution of improved seeds declined by 20 percent in tonnage in 1984/85. In contrast, the distribution of chemical fertilizer through the AIC is expected to increase at broadly the same rate as in recent years. Such distribution increased by 15 percent in tonnage in 1984/85, after increasing by 19 percent in the previous year. Notwithstanding these increases, the distribution of chemical fertilizers per hectare is still only about 10 kilograms, a relatively low level of usage by Asian standards.

The access of small farmers to institutional credit is being improved. The resource base of the ADBN has been expanded by its new authority to accept deposits in urban areas and to issue agricultural savings certificates. By virtue of financial incentives extended by the NRB, 140 new branches of commercial banks were established in the five years ending 1984/85, most of which were located in rural areas. The authorities intend to continue supporting the establishment of commercial bank branches in remote areas because such expansion has provided an alternative to traditional moneylenders, thereby increasing the availability of credit and lowering the corresponding cost.

While the authorities have been fixing minimum support prices for certain agricultural commodities since 1976/77, only since 1983/84 has there been a concerted effort to announce such prices prior to the respective planting seasons. The minimum support prices, which are generally quoted for coarse paddy, wheat, maize, sugarcane, and tobacco, have been determined on the basis of estimated costs of production, the adequacy of producer margins, and prices in India. The maintenance of support prices does not necessarily lead to actual procurement by official agencies. Rather, they provide a signal to the producers, who might otherwise be induced to sell at low prices during periods of harvest. In 1985/86, delays in the announcement of certain minimum support prices were incurred as the authorities awaited the announcement of Indian prices. While these delays have led to some uncertainty for producers, the open border makes it essential to harmonize Nepal's prices with those of India.

Under the aegis of the Industrial Enterprises Act (1982) and the Foreign Investment and Technology Act (1982), the authorities have adopted a new measure to encourage the reinvestment in Nepal of profits of foreign-owned or joint venture firms. Beginning in 1985/86, reinvestment that would raise installed capacity could be deducted from taxable income. So far, both acts have had a limited, though favorable, impact. In 1984/85, 15 joint ventures with an authorized capital of NRs 167 million were registered; the shares of foreign investors ranged between 25-90 percent. In the previous year, licenses were issued to five strictly foreign firms producing electric lamps, soybean drinks, wood products, dairy products, and iron products. In addition, joint ventures with a total authorized capital of NRs 441 million were registered.

During 1985/86, the authorities do not intend to issue licenses for new ready-made garment firms pending completion of a study on their operations. So far, most of these firms have been established by Indian entrepreneurs using mainly Indian labor. In view of the export potential of this industry and the relatively simple production process involved, the authorities are considering policies that would increase the participation of Nepalese capital and labor in this industry.

The recent discrete depreciation of the exchange rate and the maintenance of a more flexible exchange rate policy in the future is expected to lead to the expansion of the traded goods sector, with respect to which the World Bank staff has outlined a differentiated strategy. 1/ In the short- and medium term, the greatest potential for exports to India is seen to continue to lie in agricultural and processed agro-based goods, in view of India's comparative advantage over Nepal in industrial products. As for exports to third countries, Nepal is seen to have unexploited potential in exports of labor-intensive high value-to-weight handicraft and artisanal goods, such as carpets, metal sculpture, jewelry, leather goods, and garments. The skill base for the production of these goods is dispersed and export expansion would have a beneficial impact on income distribution. Assembling imported inputs for re-export along the East Asian model is not seen as a viable option, in view of high transporation costs and an inadequate base of relevant labor skills. In respect of import substitution, substantial scope is seen for reducing the import intensity of tourist services, particularly in the case of packaged food and beverages, hotel furniture, and textiles. Moreover, considerable potential is seen for import substitutes with low value-to-weight ratios, such as cement. For these items, transportation costs would provide a natural barrier against competition from abroad.

2. Demand management policies

a. Fiscal policy

The revised budget estimates for 1985/86 reflect the effects of three categories of adjustments made to the original budget that came into effect in mid-July 1985. First, adjustments were made to correct for the original budget's upward bias in respect of the feasible degree of mobilization of both domestic and foreign resources in the current year and, correspondingly, the expenditure level that such resources could support. Second, with the aim of mitigating balance of payments pressures emanating from the budget, the authorities have decided to adopt a tighter fiscal stance. This policy stance involves intensified domestic revenue mobilization, mainly through improvements in tax administration, and expenditure restraint, mainly through tighter controls on

1/ IBRD, Nepal: Recent Developments and Selected Issues in Trade Promotion, October 14, 1983.

non-aid financed expenditures. Moreover, net lending is expected to decline by the amount of sales of government-held shares in public enterprises. Third, adjustments were made to take account of the impact of the discrete depreciation announced in November 1985. Upward adjustments were made on recurrent and development expenditures to the extent of their import content, on tax revenues to reflect the expansion of the base of taxes on foreign trade, and on grants and other foreign financing.

Reflecting the above adjustments, the overall budget deficit relative to GDP is projected to decline by 1.1 percentage points, to 6.9 percent in 1985/86, inasmuch as revenue and grants are estimated to rise more than budgetary expenditure. 1/ Reversing the pattern observed in the previous year, foreign financing would provide a higher share of total financing; the projected level of foreign financing, equivalent to 4.6 percent of GDP (3.8 percent in 1984/85), is broadly consistent with World Bank staff estimates. The domestic financing requirement is projected to decline in relation to GDP by 1.9 percentage points, to 2.3 percent. Although sales of government securities are projected to be slightly lower than last year, additional net government borrowing from the domestic banking system is projected to decline in absolute terms (by 57 percent, to NRs 800 million) and in relation to GDP (by 1.8 percentage points, to 1.6 percent).

Reflecting the authorities' belief that the rate levels of exist ing taxes were broadly appropriate and their intention to adopt measures to broaden the tax base beginning with the 1986/87 budget, the contribution of discretionary measures to tax revenue mobilization in 1985/86 would be small. Thus, while tax revenues are estimated to rise by NRs 1,023 million (or, in relation to GDP, by 1 percentage point, to a level of 8.6 percent), only about NRs 60 million of this would result from discretionary measures. Of the remainder, NRs 220 million would result from tax administration measures, NRs 360 million from the built-in elasticity of the tax system, and NRs 383 million from the impact of the November 1985 exchange rate depreciation. The discretionary measures taken under the 1985/86 budget consist mainly of minor adjustments in the rates of existing taxes and the introduction of revenue stamp duties. 2/ As for non-tax revenues, a 5 percent increase is projected for 1985/86, mainly on the strength of projected increases in surpluses of departmental enterprises.

1/ In relation to GDP, the overall budget deficit excluding grants is projected to rise slightly to 10.9 percent.

2/ Revenue stamp duties were imposed on: air tickets; telecommunication bills; the issue and renewal of driving licenses and of vehicle registrations; the issue and renewal of firearm licenses; declaration forms for exports and imports; and purchases of foreign currency for personal reasons. Stamp duties on the last category of transactions were abolished in November 1985.

The authorities' efforts to strengthen tax administration cover a wide field. 1/ A number of measures taken relate to sales taxes, which are the single most important source of tax revenue. In mid-July 1985, sales taxes on imported raw materials and intermediate goods became payable at customs points, and payments could be credited against sales taxes payable at production points. Previously, all of the sales taxes due on taxable imports were not necessarily collected because some of these imports were destined to small firms not covered by the limited capacity of existing sales tax offices. Coincident with the establishment of this dual-point collection system, the number of sales tax offices and sales tax officers were increased significantly. Moreover, the base of the sales tax was changed from the ex-factory price to the producers' estimated retail prices, thereby subjecting ex-factory excise taxes and distribution costs also to sales taxes. The introduction of the dual-point collection system and the change in the tax base is projected to yield about NRs 80 million.

In respect of income taxes, the authorities are endeavoring to increase the efficiency of collection procedures relating to income taxes due from both businesses and individuals. The computerization of external trade data is expected to provide an additional gauge by which tax inspectors could estimate the true level of certain business incomes. Moreover, more business and individual returns will be subject to audit. It is estimated that these measures would yield about NRs 33 million. The authorities are studying the feasibility of introducing a new individual income tax assessment scheme for the civil service in the course of the fiscal year. To ensure that such a scheme does not involve undue costs, the paymasters of each ministry would be designated as administrators of the scheme in their respective ministries.

Incentives under the Industrial Enterprises Act are being subject to a number of administrative reforms in 1985/86. Financial penalties will be levied on firms that close at the end of tax holidays or which attempt to extend such holidays by reregistering under different corporate names or under different ownership. The length of tax holidays was made directly related to the degree of domestic value added. Furthermore, the number of industries designated as cottage industries was reduced; this measure, which would narrow the beneficiaries of higher tax incentives, particularly low import duties, is expected to yield about NRs 50 million.

With a view to reducing domestic costs associated with aid-financed projects, the authorities have instituted an important change in implementation procedures. Until tenders associated with a phase of a project are accepted, ensuring the disbursement of foreign funds, funds

---

1/ A number of tax administration initiatives described below contain features that may be considered as discretionary measures.

for related local expenses would not be released. In the past, local costs of projects have exceeded initial estimates because the hiring of local personnel and the acquisition of domestic goods proceeded even when the implementation of a project phase was uncertain or subject to indeterminate delays.

The sale of government-held shares in public enterprises, which began in late 1984/85, is being intensified in 1985/86. While the Government intends to retain a majority interest in public enterprises, it is expected that private shareholdings will increase the responsiveness of the management of these enterprises to market and profit considerations. In addition, these sales will provide an important, though temporary, means of reducing net lending. Offerings of shares of one public enterprise per month through 1985/86 are estimated by the authorities to yield about NRs 210 million, equivalent to about one third of the projected increase in tax and nontax revenues.

The authorities expressed confidence that, provided the assumptions regarding the scale of economic activity are borne out, and with vigilance on their part throughout the fiscal year to guard against slippages in tax administration, actual tax revenues will be in line with the revised estimates. As for equity sales, the authorities stated that the sales target was feasible, in the light of the rate of private sector purchases made so far.

Revised estimates for 1985/86 indicate a 77 percent increase in foreign grants, compared with a 25 percent increase in 1984/85. This marked acceleration, which reflects some lumpiness in grant-related projects, the recent devaluation, and some improvement in the utilization of committed but undisbursed grants, is in line with World Bank staff forecasts. Relative to GDP, foreign grants are expected to rise by 1.4 percentage points, to 4 percent.

The authorities have given high priority to the control of budgetary expenditures. The room for maneuver in respect of regular expenditure has narrowed considerably. Interest payments on domestic and external debts now form about one fifth of regular expenditures. Moreover, with the progressive completion of development projects, maintenance expenses have increased. In the light of these considerations, the authorities have decided not to grant further salary increases to the civil service in 1985/86, apart from those associated with changes in grade. Moreover, the growth of the number of civil servants, which had been rising at about 5 percent per annum, will be contained to a rate consistent with efforts to improve tax administration and project implementation. The authorities also deferred the purchase of real property to be used for official purposes, suspended the voluntary retirement program which encouraged retirements from the civil service through lump-sum payments, and effected selective cuts in budgetary allocations. As a result of these measures and adjusting for the effects of the November 1985 devaluation on the import component of regular expenditures, the rate of growth of such expenditures as a whole is expected to decline by a third, to 20 percent.

More drastic restraint is being exercised by the authorities on domestically financed development expenditure for 1985/86. Prior to the November 1985 devaluation, the authorities decided to cut budgetary allocations generally by 5 percent across the board, adopt specific cuts for projects that are totally domestically financed, defer the implementation of small locally administered projects, cut development grants to districts, and cancel some low-priority projects. As a result, domestically financed development expenditure reckoned prior to the devaluation is estimated to decline by 5 percent in nominal terms relative to the actual figure for 1984/85. Adjusting for the effects of the devaluation, such expenditure is projected to rise by 4 percent. Given an estimated inflation rate of about 12 percent, this implies a substantial decline in such expenditure in real terms, to about the 1981/82 level. The authorities stressed that a decline of this magnitude in domestically financed development expenditures would not unduly compromise the overall growth target because the cuts relate mainly to lower-priority projects. They also stressed that the general across the board cuts would not be applied in the case of local funds required for the implementation of aid-financed projects.

Foreign-financed development expenditure is projected to rise by 55 percent in 1985/86, leading the rate of growth of total development expenditure to accelerate to 30 percent. The relatively high rate of increase of projected foreign-financed development expenditure reflects some lumpiness in project expenditures, the recent devaluation, and some success in joint efforts by the authorities and donor agencies to improve the rate of aid utilization.

The financial position of public enterprises as a whole is expected to improve in 1985/86, thereby reducing their need for budgetary transfers and domestic bank credit. To increase managerial efficiency, the authorities have decided to base the assessment of performance of the managers of these enterprises partly on the financial situation of their respective firms. Moreover, further increases in administered prices were announced early in the fiscal year. In August 1985, electricity tariffs were raised by 22 percent. Subsequently, in September 1985, urban public transportation fares were increased by about 40 percent, and the price of milk was raised by 27 percent. The new Hetauda Cement Factory is expected to be able to retire some of its loans from the banking system, as output rises to capacity. Furthermore, by virtue of increases in domestic petroleum product prices in late 1984/85 and easing oil import prices, the Nepal Oil Corporation will also be able to repay some of its outstanding loans from the banking system.

The direct subsidies extended through the budget to public enterprises are expected to remain relatively small. These subsidies, which cover mainly the transportation costs incurred in the distribution of food by the Nepal Food Corporation and of fertilizer by the Agricultural Inputs Corporation, are expected to amount to about 1 percent of regular and domestically financed development expenditure in 1985/86, the same ratio recorded in the previous year. The authorities indicated that these subsidies are extended mainly to ensure the adequacy of food supplies in the Hills, where arable land is scarce and less fertile.

The net flow of funds to public enterprises provides a more comprehensive indicator of the burden that the operations of these enterprises place on the budget. The amount by which flows from the budget to public enterprises (consisting of share capital, loans, and operating and transport subsidies) exceed flows from public enterprises to the budget (consisting of indirect and income taxes, dividends, and debt service payments) amounted to about 8.2 percent of regular and domestically financed expenditure in 1983/84, compared with 7.4 percent in the previous year. The authorities indicated that this ratio was not expected to increase in 1984/85, for which data were not yet available, nor in 1985/86, when the position of public enterprises as a whole is expected to improve.

b. Monetary policy

The authorities' monetary program for 1985/86 reflects a tighter stance. The growth of total domestic credit of the banking system shall be limited to 15 percent (25 percent in 1984/85). The rate of credit expansion to the public sector as a whole would be more than halved to about 12 percent, reflecting the reduced financing requirements of the public sector in 1985/86. The rates of growth of net credit to the Government and to nonfinancial public enterprises are also projected to decline sharply to 12 percent, implying no increase in real terms. Credit to the private sector as a whole is projected to decelerate only moderately to 20 percent in 1985/86; however, taking into account the expected rate of inflation, the implied rate of increase in real terms would decline sharply. Given an estimated increase in broad money of 18 percent, which assumes a further decline in the income velocity of money mainly because of the continuing monetization of the economy, the authorities' credit policy would be consistent with the overall balance of payments target.

The adoption in 1984/85 of a range of 1-1.5 percentage points within which commercial banks may vary deposit rates provides a market-related instrument by which positive real interest rates could be maintained. Although the average annual inflation rate is expected to rise to 12 percent in 1985/86, key deposit rates would still imply real positive margins, albeit at substantially lower levels. The authorities have undertaken to widen the range of deposit rate flexibility by a further 2 percentage points during the program period, along with a rationalization of the rather complex loan rate structure.

The authorities are examining the appropriateness of the level of the interest rate on Treasury bills, which has been maintained at 5 percent for the purpose of containing debt service payments. This practice has had several consequences. It has limited the market for such securities to the commercial banks, which use them to fulfill the liquidity ratio requirement. In the absence of a wider market for government securities, open market operations could not be used effectively as a tool of monetary policy. Moreover, Treasury cash management at the margin has remained dependent on advances from the NRB, which has a greater monetary impact than equivalent sales of Treasury bills to the public. The interest rate on three-month deposits, the closest substitute for Treasury bills, has been set at an artificially low level to balance the low return received by commercial banks on Treasury bill holdings. As a result, there is an anomaly in the term structure of deposit rates, whereby the interest rate on liquid savings deposits is roughly double the rate on three-month term deposits.

With a view to attracting financial savings held abroad to the banking system, the NRB authorized commercial banks in August 1985 to accept current and term deposits in U.S. dollars and pounds sterling. Eligible depositors include Nepalese citizens working abroad, Indian and Bhutanese citizens working in countries other than Nepal and their respective countries, and other foreign citizens. Interest payable on term deposits, which shall accrue in foreign currency, was initially set by commercial banks at 1 percentage point below LIBOR. To enable some of the foreign exchange deposited to be used by the banking system, the NRB ruled that withdrawals may be made up to 70 percent in foreign currency and the remainder in Nepalese rupees at the prevailing exchange rate. While the limitation on the foreign exchange component of withdrawals by nonresidents has given rise to an exchange restriction, the staff considers the establishment of the foreign currency scheme as an appropriate means to support the balance of payments, which has been subject to extremely adverse pressures. It is still too early to assess the operation of this scheme.

Efforts to improve the institutional framework of the financial system are continuing. In September 1985, a bill was passed authorizing the establishment of finance companies. It is expected that a number of such companies would be in operation by the end of the fiscal year.

3. External policies

The adverse pressures on Nepal's external accounts mounted further in the first three months of 1985/86 (mid-July to mid-October 1985). Reserve losses during this period amounted to about SDR 20 million, about 14 percent of total gross reserves at the beginning of the fiscal year. 1/ With a view to arresting the deterioration in the balance of payments in the short term and to promoting the expansion of the traded goods sector in the medium term, the authorities depreciated the Nepalese rupee vis-a-vis the Indian rupee by 14.6 percent (in terms of units of foreign currency per Nepalese rupee) on November 30, 1985 and undertook to pursue a more flexible exchange rate policy. With this policy complementing the significant tightening of financial policies, it is expected that Nepal's external position would record an overall surplus during the rest of the fiscal year so as to limit the overall deficit to a moderate level for 1985/86 as a whole.

In 1985/86, exports are projected to rise moderately, mainly reflecting an increase in export volume. Mainly as a result of the recent exchange rate adjustment, the growth of non-aid imports is projected to decelerate from 13 percent in 1984/85 to 8 percent in 1985/86. Imports as a whole are projected to rise by 12 percent, partly reflecting the marked increase in the utilization of external aid. The increases in the surpluses in the services account and private transfers account is projected to cover only a small portion of the larger trade deficit. Because of this and the fact that nominal GDP would decline in SDR terms, the current account deficit is expected to widen by 1.8 percentage points of GDP, to 8.9 percent. 2/ With a 26 percent increase in projected external aid, the overall deficit is expected to be on the order of SDR 4 million (SDR 47 million in 1984/85). Accordingly, and assuming all scheduled Fund purchases are made, gross total reserves are estimated to increase by the close of the fiscal year by an amount sufficient to maintain the level of such reserves at nearly five months of non-aid imports.

Certain measures adopted recently have had the effect of selectively depreciating the rate at which transactions with third countries are conducted. The higher import license fees adopted in 1983/84, the 10 percent export subsidy introduced in the same year (suspended since 1984/85), and the revenue stamp duties on personal purchases of foreign currencies introduced in July 1985 all share this characteristic. The revenue stamp duties on purchases of foreign currency for personal transactions amounted to NRe 0.015 per Indian rupee and NRs 3 per U.S. dollar (or the equivalent in other currencies), or about 1 percent and 17 percent, respectively, over the corresponding exchange rates. The duty on Indian rupee purchases was not implemented. The duty on purchases of convertible foreign exchange constituted a discriminatory

---

1/ Some of this reserve loss may have been due to the building up of inventories of imported consumer goods in anticipation of a major holiday in October 1985.

2/ However, the current account balance excluding aid-financed imports of goods and services is projected to shift from a deficit equivalent to -0.1 percent of GDP in 1984/85 to a surplus equivalent to 0.2 percent of GDP in 1985/86.

multiple currency practice. Cognizant of the distortions which these measures have introduced, as well as their limited efficacy in containing overall balance of payments pressures, the authorities rescinded on November 30, 1985 the 10 percent export subsidy (suspended since July 1984) and the revenue stamp duties on personal purchases of foreign exchange. 1/ They intend to examine import license fees within a wider study of measures to further rationalize and liberalize the exchange and trade system.

In the discussions with the authorities, the staff team reiterated that Nepal's balance of payments difficulties were global in nature. In the last two years, official holdings of Indian currency reserves have declined rapidly in the wake of effective efforts to divert some import demand to India, with the result that the Indian rupee has become as scarce as other currencies held as reserves. In the staff's view, the improvement of Nepal's position vis-a-vis all trading partners would require that the authorities pursue a more flexible exchange rate policy, in addition to appropriate demand management and supply policies. Such an exchange rate policy would not only stimulate the expansion of the traded goods sector (in particular, the agricultural sector) and thus fundamentally strengthen the balance of payments in the medium term, but would also lay the groundwork for an orderly rationalization and liberalization of the exchange and trade system. This, in turn, would promote a more efficient allocation of resources in support of the growth process in Nepal. Reliance on demand management alone to achieve the necessary adjustment would involve a degree of restraint that would undercut Nepal's already modest growth potential. The authorities agreed with this assessment.

The service requirements on the public and publicly-guaranteed debt, which consists largely of concessional loans, is expected to remain at a manageable level in 1985/86. While the ratio of the external debt to GDP is projected to rise by 4 percentage points to 24 percent (reflecting a marked increase in external aid, the projected purchases from the Fund, and a decline of GDP in SDR terms), the debt service ratio 2/ is expected to remain at 5 percent. Any progress made by the authorities and donors to improve Nepal's capacity to utilize the nearly US$1 billion of undisbursed commitments would tend to increase these ratios. Under the program, the authorities have undertaken to limit nonconcessional public and publicly-guaranteed loans with maturities of 1-12 years contracted after September 30, 1985 to SDR 10 million (excluding a World Bank supported purchase of an aircraft by the national airline). Moreover, short-term borrowing will be limited to

---

1/ Estimates of revenues for 1985/86 have been adjusted downward by NRs 32 million to reflect the abolition of these revenue duties.

2/ Debt service payments over exports of goods and nonfactor services, and private transfers.

revolving loans traditionally required in the normal operations of the Nepal Oil Corporation.

4. Objectives and policies for 1986/87

The authorities have so far outlined their objectives and policies for 1986/87 in very broad terms. The overall objectives include a real growth target of 4.5 percent, a strengthening of the balance of payments, and a moderation of inflation. The authorities intend to continue their flexible exchange rate policy so as to strengthen the reserve position in the short term and to make further progress in the medium term towards a sustainable balance of payments and a more liberal exchange and trade system. Moreover, they intend to contain inflationary pressures through restraint in demand management. With appropriate budgetary measures in respect of both revenues and expenditures, the ratio of domestic bank financing of the budget to GDP is to be kept no higher than the level programmed for 1985/86. On this basis, the monetary program would permit an expansion of credit to the private sector consistent with the growth in economic activity.

5. Performance criteria under the proposed program

The proposed stand-by arrangement is subject to quantitative performance criteria for January 15, April 15, July 15, and October 15, 1986 (Table 3). The performance criteria consist of ceilings on: (a) net domestic assets of the banking system; (b) net domestic credit of the banking system to the Government; and (c) the amount of nonconcessional borrowing contracted or guaranteed by the Government after September 30, 1985, excluding the amount relating to a World Bank supported purchase of an aircraft by Royal Nepal Airlines Corporation (RNAC). In addition, indicative ceilings apply to banking system credit to nonfinancial public enterprises. The release of the purchase related to the April 15, 1986 performance criteria will also require the completion of a mid-term review with the Fund by July 15, 1986. In the course of this review, the performance criteria for October 15, 1986 will be set. The review will focus inter alia on: the 1986/87 budget; exchange rate management; monetary and credit policy; progress in the rationalization of the structure of commercial banks' deposit and loan rates; and progress in the rationalization of the exchange and trade system.

IV. Medium-Term Prospects

The medium-term scenario presented in this section for 1986/87-1989/90 assumes the following conditions: relatively favorable weather; no deterioration in the terms of trade; sustained efforts to increase the capacity to absorb foreign aid; a restrained monetary policy; stringent control on the amount and composition of budgetary expenditures; the implementation, beginning in 1986/87, of staff recommendations

Table 3. Nepal: Quantitative Performance Criteria
Under the Proposed Arrangement, 1985-86

	1985		1986 Ceilings			
	Mid-July Prel.	Mid-Oct. Est.	Mid-Jan.	Mid-Apr.	Mid-July	Mid-Oct.
			(In millions of Nepalese rupees)			
Net domestic assets	10,431	10,869	11,485	12,045	12,720	1/
Net credit to Government	6,433	6,633	6,833	6,977	7,233	1/
			(In millions of SDRs)			
New external non-concessional loans of 1-12 years contracted or guaranteed by the Government cumulative through end of period	...	...	10.0 2/	10.0 2/	10.0 2/	1/
Memorandum item:						
Indicative ceiling on credit to nonfinancial public enterprises (NRs mn.)	1,151	...	1,277	1,317	1,289	1/

1/ To be set at the time of the mid-term review of the arrangement.
2/ Refers to loans contracted after September 30, 1985 and excludes a loan related to the prospective purchase of an aircraft.

regarding domestic resource mobilization described below; and maintenance of a more flexible exchange rate policy.

In their assessments of government finances during the Seventh Plan (1985/86-1989/90), the staffs of both the Fund and the World Bank concur that, if growth targets are to be achieved while strengthening the balance of payments, there will have to be major efforts to further mobilize domestic revenue and to utilize undisbursed grant and loan commitments, which now amount to nearly US$1 billion. In respect of domestic revenue mobilization, the authorities intend to implement major elements of Fund staff recommendations, which are supported by the World Bank staff, beginning with the 1986/87 budget. 1/ Given the low elasticity of the tax system, this process would lie at the core of any adjustment scenario for the medium term. In the absence of substantial revenue measures, the domestic financing requirements of the Seventh Plan would imply undue recourse to the banking system and a crowding out of the private sector from the credit markets, undermining the desired strengthening of the role of the private sector in the development process. As for project implementation, donors have in recent years significantly expanded their direct implementation assistance within aid packages, in view of the high and increasing level of undisbursed grants and loans. Moreover, the World Bank staff has recently made numerous recommendations, the adoption of which would contribute significantly to the enhancement of aid absorption capacity during the Plan period. These recommendations include: decentralization of authority and transfer of accountability to project implementation units; orderly turnover of staff at project sites; financial incentives for project officers stationed outside Kathmandu; procedural reforms to minimize delays in the release of local funds for aid-related projects; training programs to raise construction skills; improving inventory control of spare parts and building materials by a trading corporation; and improvements in procedures for monitoring project implementation.

Real GDP is expected by the staff to grow by 4.5 percent in 1985/86, mainly reflecting a recovery in agricultural production. During the subsequent four years, the staff scenario assumes an average annual growth rate of 4 percent; while this rate is nearly equivalent to the actual average annual rate recorded during the Sixth Plan period, it is projected to be achieved without a deterioration in the overall balance of payments (Table 4). Prior to the devaluation of the Nepalese rupee in November 1985, the underlying inflation rate was estimated at about 8 percent. With the devaluation and the increase in certain administered prices, the average annual inflation rate is projected to rise to 12 percent in 1985/86. Assuming no unusually severe supply shocks and appropriate demand management, the rate of inflation is

1/ Nepal: Prospects for Economic Adjustment and Growth (IBRD, October 15, 1985). A summary of Fund staff recommendations is contained in Appendix V.

Table 4. Nepal: Medium-Term Balance of Payments, 1984/85-1989/90

(In millions of SDRs) 1/

	1984/85 Prel.	1985/86 Program	Staff Scenario 1986/87	1987/88	1988/89	1989/90
Exports, f.o.b. 2/	156.9	162.4	176.5	191.8	208.5	226.6
Imports, c.i.f. 3/	-450.2	-504.8	-574.8	-566.6	-604.1	-644.2
Services, net	81.8	88.4	103.6	111.9	123.3	133.8
Private transfers, net	42.2	45.2	46.8	49.5	52.2	55.1
Current account balance	-169.3	-208.8	-247.8	-213.5	-220.2	-228.8
Official grants 4/	77.8	99.0	104.0	109.1	114.6	120.3
Official capital, net 4/	84.7	105.8	109.5	114.5	118.6	124.1
Other long-term capital 5/	--	--	45.0	--	--	-4.5
Miscellaneous capital and errors and omissions	-40.4	--	--	--	--	--
Overall balance 6/	-47.3	-4.0	10.6	10.1	13.0	11.2
Memorandum items:						
External public debt 7/						
In SDR millions	407.7	526.7	685.3	799.8	915.8	1,027.0
As percent of GDP	17.6	23.8	29.2	32.2	34.1	35.4
Debt service ratio 8/	4.7	4.9	6.4	6.3	6.9	8.8
Net reserves (in months of nonaid imports) 6/	3.3	2.9	2.9	3.3	3.3	3.3
Gross total reserves 6/						
In SDR millions	143.8	153.0	167.8	177.9	188.3	191.1
In months of non-aid imports	4.8	4.7	5.0 9/	4.9	4.8	4.6
Exports/GDP (In percent)	6.6	6.9	7.5	7.7	7.9	8.0
Imports/GDP (In percent)	19.0	21.5	24.5	22.8	22.9	22.6
Current account/GDP (In percent)	-7.1	-8.9	-8.6 10/	-8.6	-8.4	-8.0

Sources: Data provided by the authorities; and staff projections.

1/ Totals may not add up due to rounding.

2/ Export volume is projected to increase by 3.5 percent in 1985/86 and assumed to increase by 4.5 percent per annum thereafter. Export unit value is projected to remain stable in 1985/86, and assumed to increase thereafter by 4 percent per annum.

3/ The growth of the volume of non-aid imports (excluding inputs for the garment industry and the aircraft purchase) is projected on the basis of an income elasticity of 1.4 in 1985/86-1987/88 and 1.3 in 1988/89-1989/90, and a real GDP growth of 4.5 percent in 1985/86 and 4 percent per annum thereafter. Import unit value is projected to increase by 4 percent. Aid imports are assumed to be 55 percent of grants and loan disbursements. In 1986/87, imports include an aircraft purchase of SDR 45 million.

4/ Grants and loan disbursements are assumed to increase by 5 percent per annum in SDR terms from 1986/87 (consistent with World Bank projections).

5/ Related to purchase of one aircraft in 1986/87.

6/ Target after 1985/86.

7/ Includes net fund credit outstanding.

8/ Debt service payments (including payments to the Fund) as percent of exports of goods and nonfactor services and private remittances.

9/ Including the aircraft purchase, this figure would be 4.5 months of non-aid imports.

10/ Including the aircraft purchase, this ratio would be 10.6 percent.

assumed to decline to 6 percent in 1986/87 (roughly equal to the same average annual rate recorded during the Fifth Plan period) and to remain at that level through 1987/88-1989/90. Both export and import prices are assumed to rise on average by 4 percent per annum during the same period.

A number of other key assumptions were made for the period 1986/87-1989/90. Export volume was assumed to increase by 4.5 percent per annum. Merchandise imports under aid were assumed to be 55 percent of projected disbursements of grants and concessional loans. The forthcoming purchase of a commercial aircraft by RNAC is assumed to take place in 1986/87; the related commercial loan is assumed to have a maturity of 10 years, a grace period of 3 years, and an interest rate of 10 percent. Repayments of principal on this loan would therefore commence in 1989/90, the same year that the first repayments to the Fund would be due under the program. Another commercial aircraft is projected to be leased by RNAC in 1987/88. Imported inputs destined for the garments industry were projected to rise by 5 percent per annum. The volume of other non-aid imports was assumed to increase in line with an income elasticity of 1.4 in 1985/86-1987/88 and 1.3 in 1988/89-1989/90 (reflecting an assumption of progress in import substitution) and a relative price elasticity of unity. Grants and loan disbursements were each assumed to increase by 5 percent per annum in terms of SDRs. Moreover, a reserves target, which would broadly maintain gross total reserves at the 1984/85 level of nearly 5 months of non-aid imports was assumed.

Given these targets and assumptions, the scenario projects overall balance of payments surpluses of SDR 10-13 million in 1986/87-1989/90. The increase in debt service payments associated with the purchase of an aircraft mentioned above, and the proposed stand-by arrangement are mainly responsible for the increase in the debt service ratio from 6.9 percent in 1988/89 to 8.8 percent by 1989/90. The main conclusion that may be drawn from this scenario is that the achievement of import levels consistent with the growth target, together with the attainment of balance of payments surpluses in line with prudent reserve management, would require that the adjustment effort launched in 1985/86 be applied rigorously and continued in the years ahead.

The scenario outlined above involves a number of critical assumptions which, if not borne out, would have adverse implications for the medium term. Agricultural exports are highly sensitive to weather conditions and the performance of exports as a whole is sensitive to the degree of consistency of the incentives provided. The growth of non-aid imports is sensitive to the flexibility of exchange rate management, budgetary and public wage policies, and monetary and credit policies. A slackening in the stance of any of these policies would put into jeopardy the intended progress towards a more sustainable balance of payments. As the growth target implies a certain level of aid and non-aid imports, such a target also implies a certain rate of utilization of external assistance. Without a progressive increase in Nepal's aid absorptive capacity, a matter of concern to the staffs of the Fund and World Bank, a lower growth path would need to be assumed.

V. Staff Appraisal

During the period of the Sixth Plan (1980/81-1984/85), economic developments were broadly more favorable than during the previous Plan period, but serious problems emerged in financial management, which undermined Nepal's already structurally weak external position. On the one hand, the real growth achieved provided for modest increases in per capita income. Moreover, the nonagricultural sector has shown signs of increasing resiliency against weather-induced fluctuations in agricultural output, a development associated with the steady increase in the supply of electricity. On the other hand, the Government has emerged as a consistent and large borrower from the banking system, as domestic revenue and foreign aid utilization under the budget lagged behind government expenditure. The excessive demand pressures generated by the deteriorating fiscal position were exacerbated by an accommodative monetary and credit policy. Combined with recurrent weather-related supply shocks, these expansionary financial policies resulted in an overall balance of payments deficit in each of the last three years, causing a sharp drawdown of international reserves.

In 1984/85, the economic outturn was generally unfavorable. While inflation moderated, real GDP growth slowed down as drought adversely affected agricultural production. Furthermore, with expansionary financial and wage policies, the overall balance of payments deficit rose sharply. While efforts to divert import demand to India succeeded, thereby allowing a drawdown of Indian rupee reserves, this process has made the Indian rupee as scarce as other currencies held in reserve. These developments have thus clarified that Nepal's balance of payments difficulties are general in nature, and not related to transactions with particular countries only.

Against this background, the authorities have drawn up an economic adjustment program for 1985/86 which aims at reducing balance of payments pressures significantly, achieving a higher rate of growth, and containing the underlying rate of inflation. The main elements of this program include a discrete devaluation of the Nepalese rupee to be followed by a more flexible exchange rate policy, tighter budgetary and monetary policies, measures to stimulate domestic production, more intensive efforts to increase Nepal's capacity to absorb external aid, and some rationalization of the exchange and trade system. While this program is expected to ameliorate Nepal's short-term difficulties, particularly with respect to the balance of payments, the adjustment effort would need to be maintained in the medium term in order for per capita income to increase while progress is being made towards a sustainable external position.

A more flexible exchange rate policy is called for not only by Nepal's current economic circumstances but also over the medium term. Such a policy would be an indispensable component of an adjustment program involving demand restraint and sustained efforts to improve supply conditions, particularly in agriculture. As Nepal's external position improves, further steps should be taken to liberalize and rationalize the exchange and trade system. The abolition of the 10 percent cash subsidy on exports to third countries and of the revenue stamp duties on personal purchases of foreign exchange are consistent with this objective.

The authorities agreed on the importance of continuing to contain budgetary expenditures, while intensifying both the mobilization of domestic resources and strengthening Nepal's capacity to absorb external aid throughout the Seventh Plan period. According to projections by the staff of both the Fund and the World Bank, new revenue measures would be required to cover budgetary financing requirements under the Seventh Plan. The implementation of these measures, which would be mainly directed toward the expansion of the revenue base, would also be an indispensable element of the medium-term adjustment process. Under the program, the authorities have undertaken to implement substantial revenue measures beginning with the 1986/87 budget. Moreover, with the help of donor agencies and countries, the authorities intend to intensify efforts directed at increasing Nepal's absorptive capacity for external aid, the undisbursed commitments for which are large and mounting.

The implementation in 1984/85 of a number of institutional reforms in the financial sector bodes well for further progress in the mobilization of financial savings and, more broadly, for the efficiency of the financial intermediation process in Nepal. Commercial banks were given latitude, albeit limited, in fixing deposit rates. Under the program, the authorities intend to increase the degree of flexibility given to banks in setting deposit rates during the program period. The authorities will also review the administered schedule of bank loan rates with a view to making it more flexible and less complex. Its present structure has impeded the efficient allocation of financial resources through the banking system.

During the program period, a further increase in competition in the commercial banking field is expected. Two commercial banks jointly owned by foreign and domestic shareholders would be established in addition to the one which has commenced operations. Moreover, competition would be intensified as the ADBN exercises its new authority to accept deposits in urban areas on the same basis as commercial banks. Some further strengthening of the financial institutional structure is expected in the near future following the recent passage of a bill authorizing the establishment of finance companies.

As part of the process of liberalization and rationalization of the financial system, the staff recommends that groundwork be laid for the development of a market for Treasury bills, so as to eventually allow the NRB to conduct open market operations as an added tool of monetary policy. Toward this end, the interest rate on Treasury bills should be raised to market levels as soon as possible. With the bank deposit rate on three-month term deposits raised commensurately, the term structure of bank deposit rates would graduate more smoothly with length of maturity.

Certain measures taken in relation to public enterprises should help improve their management and financial positions. In line with the more flexible policy on administered prices introduced in 1983/84, substantive price adjustments were made in 1984/85 and, in anticipation of the program, in early 1985/86. Moreover, under the program, the authorities have undertaken to continue flexible pricing policies for public enterprises to complement the more flexible exchange rate policy. The adjustments under this policy should reduce the need for budgetary transfers to public enterprises as well as their need for credit from the banking system. Also, under the program, the authorities intend to increase the sales of government-held equity in public enterprises to private individuals. This should provide a badly needed, if temporary, source of budgetary funds. More importantly, it should make public enterprises more responsive to profit and market considerations, which should have a more lasting favorable impact on the budget.

The staff believes that the financial and economic policies described in the Minister of Finance's Letter of Intent constitutes an appropriate response to the economic difficulties Nepal is facing. Accordingly, the staff considers that the authorities' request for a 13-month stand-by arrangement in the amount of SDR 18.65 million, or 50 percent of quota, warrants Fund support.

Nepal's restrictions on the making of payments and transfers for current international transactions are maintained in accordance with Article XIV, with the exception of an exchange restriction described below that is subject to approval under Article VIII, Sections 2(a) and 3. While the staff considers the introduction of the foreign currency deposit scheme to be an appropriate means to support the balance of payments, which has been subject to extremely adverse pressures, the scheme gives rise to an exchange restriction in that the relevant regulations prescribe the use of an exchange restriction as a contractual term and condition preventing the withdrawal by nonresidents of foreign currency deposits at their full foreign exchange value. This scheme contains features that discriminate among currencies of Fund members and, in accordance with the policy set forth in Decision No. 6790-(81/43) of March 20, 1981, the Fund does not grant approval to the exchange restriction involved. The principal elements of exchange restrictions that Nepal maintains on payments to countries other than India under Article XIV are a foreign exchange budget linked to the issue of licenses on imports from third countries, limits on foreign exchange allocations for most invisible payments to third countries, margins on sight letters of credit for imports from third countries, and restrictions on the transfer of balances of Nepal's currency for making current payments or transfers to third countries.

It is proposed that the next Article IV consultation with Nepal be concluded by December 1986 in accordance with the standard 12-month cycle.

VI. Proposed Decisions

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

1985 Consultation

1. The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Sections 2 and 3, in concluding the 1985 Article XIV consultation with Nepal, and 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/...). The Fund urges the authorities to remove the exchange restriction that is subject to approval as soon as possible.

Stand-by Arrangement

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

2. The Fund approves the stand-by arrangement attached to EBS/85/264.

Table I. Nepal: Indicators of Output and Prices, 1980/81-1985/86

	1980/81	1981/82	1982/83	1983/84	1984/85 (Est.)	1985/86 (Program)
	(Percentage change from previous year)					
Real GDP	8.3	3.8	-1.4	7.4	2.8	4.5
Agriculture	10.4	3.5	-2.5	8.7	1.7	3.5
Of which: Foodgrains	(18.3)	(4.2)	(-10.2)	(20.2)	(-2.9)	(...)
Nonagriculture	5.5	4.2	0.4	5.5	4.5	5.7
Consumption	8.6	5.4	-1.0	5.8	2.7	...
Investment	4.3	-0.7	18.4	3.0	0.9	...
Total domestic demand	7.8	4.4	2.1	5.3	2.4	...
Inflation						
Nepal						
CPI						
Annual average	13.4	10.4	14.2	6.2	4.1	12.0
July to July	10.9	11.4	14.4	1.6	6.9	...
GDP deflator	7.9	6.8	12.6	5.7	6.3	12.0
India 1/						
CPI						
Annual average	12.0	10.3	9.5	11.3	5.7	...
July to July	13.5	6.9	13.2	8.1	5.1	...
WPI						
Annual average	15.8	5.1	4.8	9.5	6.7	...
July to July	11.0	1.9	6.9	10.0	5.5	...
	(As percent of nominal GDP)					
Investment	17.6	16.8	20.2	19.4	19.0	...
Domestic savings	10.9	9.5	9.1	10.4	10.5	...
Foreign savings	6.7	7.4	11.1	9.0	8.5	11.3

Sources: Central Bureau of Statistics, Nepal Rastra Bank, and staff estimates.

1/ Annual average on the basis of the Nepalese fiscal year.

Table II. Nepal: Government Budget, 1981/82-1985/86

	1981/82	1982/83	1983/84	1984/85 (Prel.)	1985/86 Original budget	1985/86 Program
	(In millions of Nepalese rupees) 1/					
Revenue and grants	3,661	3,898	4,219	4,939	7,100	6,852
Revenue	2,668	2,808	3,342	3,842	5,175	4,902
Tax	(2,219)	(2,430)	(2,751)	(3,159)	(4,284)	(4,182)
Nontax	(449)	(378)	(591)	(683)	(891)	(720)
Foreign grants	993	1,090	877	1,097	1,925	1,950
Expenditure	5,246	6,851	7,204	8,287	10,829	10,239
Regular	1,523	1,900	2,107	2,816	3,682	3,391
Development	3,727	4,982	5,164	5,528	7,486	7,188
Domestically financed	(1,668)	(2,907)	(2,590)	(2,729)	(3,074)	(2,850)
Foreign financed	(2,059)	(2,075)	(2,574)	(2,799)	(4,412)	(4,338)
Net lending	-4	-31	-67	-57	-340	-340
Overall balance (including grants)	-1,585	-2,953	-2,985	-3,348	-3,729	-3,387
Foreign financing (net)	694	938	1,604	1,604	2,459	2,257
Domestic financing (net)	891	2,015	1,381	1,744	1,270	1,130
Banking system	(799)	(2,028)	(939)	(1,405)	(770)	(800)
Nonbank sector	(92)	(-13)	(442)	(339)	(500)	(330)
	(Percentage change from previous year)					
Revenue and grants	11.9	6.4	8.2	17.1	43.8	38.7
Revenue	11.0	5.2	19.0	15.0	34.7	27.6
Tax revenue	8.7	9.5	13.2	14.8	35.6	32.4
Expenditure	31.5	30.6	5.2	15.0	30.7	23.6
Regular	20.5	24.8	10.9	33.7	30.8	20.4
Development 2/	36.5	33.7	3.7	7.0	35.4	30.0
	(As percent of GDP)					
Revenue and grants	12.1	11.6	11.1	11.8	15.1	14.0
Revenue	8.8	8.3	8.8	9.2	11.0	10.0
Tax revenue	7.3	7.2	7.2	7.6	9.1	8.6
Expenditure	17.3	20.4	18.9	19.9	23.0	21.0
Regular	5.0	5.7	5.5	6.7	7.8	6.9
Development 2/	12.3	14.8	13.5	13.2	15.9	14.7
Overall deficit (including grants)	-5.2	-8.8	-7.8	-8.0	-7.9	-6.9
Foreign financing	2.3	2.8	4.2	3.8	5.2	4.6
Domestic financing	2.9	6.0	3.6	4.2	2.7	2.3
Banking system	2.6	6.0	2.5	3.4	1.6	1.6
Overall deficit (excluding grants)	-8.5	-12.0	-10.1	-10.6	-12.0	-10.9

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

1/ Figures may not add exactly to totals due to rounding.
2/ Excluding net lending.

Table III. Nepal: Monetary Survey, 1980/81-1985/86

	1980/81	1981/82	1982/83	1983/84	1984/85 (Prel.)	1985/86 (Program)
	(Mid-July levels; in millions of Nepalese rupees) 1/					
Net foreign assets	2,415	3,097	2,611	2,540	1,781	1,709 2/
Assets	3,135	3,911	3,252	3,214	2,599	...
Liabilities	720	814	640	674	818	...
Domestic credit	5,161	6,043	8,491	9,825	12,274	14,163
Public sector	2,209	2,901	5,227	5,982	7,584	8,522
Government, net	(1,263)	(2,062)	(4,090)	(5,029)	(6,433)	(7,233)
Nonfinancial public enterprises	(946)	(840)	(1,137)	(953)	(1,151)	(1,289)
Private sector	2,952	3,142	3,264	3,842	4,689	5,641
Financial public enterprises 3/	(454)	(504)	(565)	(668)	(811)	(908)
Other private	(2,498)	(2,638)	(2,699)	(3,174)	(3,879)	(4,733)
Broad money	6,308	7,458	9,222	10,455	12,212	14,429
Narrow money	3,208	3,612	4,349	4,932	5,521	...
Quasi-money	3,100	3,847	4,874	5,524	6,692	...
Other items net	1,268	1,683	1,880	1,909	1,843	1,444 2/
Memorandum items:						
Average broad money	5,796	6,872	8,281	9,805	11,265	13,311
Income velocity of broad money (absolute number)	4.71	4.40	4.06	3.89	3.71	3.67
Government domestic bank borrowing (as percent of GDP)	--	2.6	6.0	2.5	3.4	1.6
	(Percentage change from previous year)					
Domestic credit	19.9	17.1	40.5	15.7	24.9	15.4
Public sector	12.7	31.3	80.1	14.5	26.8	12.4
Government, net	0.3	63.3	98.4	23.0	27.9	12.4
Nonfinancial public enterprises	34.9	-11.3	35.4	-16.1	20.7	12.0
Private sector	25.8	6.4	3.9	17.7	22.0	20.3
Financial public enterprises	5.8	10.9	12.3	18.2	21.3	12.0
Other private	30.3	5.6	2.3	17.6	22.2	22.0
Broad money	19.3	18.2	23.7	13.4	16.8	18.2
Narrow money	13.3	12.6	20.4	13.4	11.9	...
Quasi-money	26.3	24.1	26.7	13.3	21.1	...

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

1/ Totals may not add up due to rounding.
2/ Converted at the exchange rate prevailing at the beginning of the period.
3/ Includes the Agricultural Development Bank of Nepal and the Nepal Industrial Development Corporation.

Table IV. Nepal: Balance of Payments, 1980/81-1985/86

(In millions of SDRs)

	1980/81	1981/82	1982/83	1983/84	1984/85 (Prel.)	1985/86 (Program)
Trade balance	-190.0	-233.2	-347.7	-301.0	-293.2	-342.4
Exports, f.o.b.	108.2	101.1	76.0	106.7	156.9	162.4
Imports, c.i.f.	298.2	334.3	423.7	407.6	450.2	504.8
Services, net	75.0	93.1	109.4	87.8	81.8	87.6
Receipts	138.9	154.9	168.7	161.0	157.2	168.2
Of which:						
Travel	(51.9)	(56.8)	(56.5)	(35.0)	(40.6)	(44.0)
Investment income	(10.7)	(13.3)	(13.6)	(5.9)	(5.1)	(4.4)
Payments	64.0	61.8	59.3	73.2	75.4	80.6
Of which:						
Travel	(18.7)	(19.3)	(22.1)	(20.3)	(24.1)	(23.0)
Investment income	(3.6)	(4.0)	(6.0)	(6.4)	(8.1)	(10.5)
Private transfers, net	37.4	35.4	38.5	43.2	42.2	46.0
Receipts	38.6	37.0	40.7	45.6	43.6	48.1
Private remittance	(32.5)	(32.2)	(36.8)	(38.3)	(35.6)	(38.0)
Indian excise refund	(3.8)	(2.7)	(0.6)	(3.7)	(6.1)	(6.6)
Other	(2.2)	(2.1)	(3.4)	(3.5)	(2.0)	(3.5)
Payments	1.2	1.6	2.2	2.4	1.5	2.1
Current account balance	-77.6	-104.7	-199.8	-170.0	-169.3	-208.8
Official grants	57.8	78.2	77.0	72.6	77.8	99.0
Official capital, net	42.5	52.3	72.8	88.7	84.7	105.8
Miscellaneous capital and errors and omissions	-9.7	8.1	4.8	0.9	-40.4	--
Overall balance	13.0	33.9	-45.2	-7.9	-47.3	-4.0
Monetary movements						
Assets (increase -)	-48.8	-42.9	58.9	19.9	46.2	...
Liabilities	15.7	4.0	-14.6	-1.5	5.4	...
Valuation adjustment	20.1	5.0	0.9	-10.5	-4.3	...
Memorandum items:						
			(As percent of GDP)			
Exports, f.o.b.	5.9	4.9	3.4	4.5	6.6	6.9
Imports, c.i.f.	16.3	16.3	18.8	17.1	19.0	21.5
Current account balance	-4.2	-5.1	-8.9	-7.1	-7.1	-8.9
			(Changes in percent)			
Exports						
Value 1/	46.8	-6.5	-24.8	40.4	47.0	3.5
Volume 2/	22.8	-9.7	-28.7	42.5	24.0	3.5
Unit value 1/3/	19.5	3.5	5.4	-1.5	18.5	--
Imports						
Value 1/	30.7	12.1	26.7	-3.8	10.5	12.1
Volume 2/	11.6	8.6	24.7	-6.8	12.0	7.8
Unit value 1/4/	17.1	3.2	1.6	3.2	-1.3	4.0

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

1/ In SDRs.
2/ Calculated as a residual.
3/ Based on an index of unit values of selected exports.
4/ Based on an index of wholesale prices of major trading partners.

Nepal: Summary of the Main Tax Recommendations of the Fund Staff Technical Assistance Mission

The main tax measures proposed by the Fund staff technical assistance mission are as follows:

1. Income tax

a. Reduce the thresholds of personal tax exemptions and deductions;

b. Rationalize the company tax structure to one rate, abolish the additional tax on business income, and impose a tax on dividends paid to individuals;

c. Review income tax exemptions for the transport industry and income tax incentives under the Industrial Enterprises Act.

2. Import duties

a. Review the exemption of raw materials and machinery from import taxes; and

b. Rationalize the rate structure under an overall protection policy.

3. Sales tax

a. Eliminate the rate differentials between domestic and imported goods, as well as the rate differentials among imported goods by country of origin;

b. Impose higher rates on luxury consumer goods, whether domestically produced or imported; and

c. Include selected services in the sales tax base.

4. Excise tax

a. Increase excise duties on cigarettes and alcohol; and

b. Convert remaining specific excise tax rates to ad valorem rates.

5. Urban house and land tax

Reduce exemption thresholds, and update property valuations.

6. Agricultural land tax

Raise agricultural land tax rates, which are specific and have remained unchanged since 1967/68, and adjust the rates at periodic intervals.

Table VI. Nepal: Summary of the 1985/86 Program

	1984/85 Prel.	1985/86 Program
	(Percentage change)	
1. Assumptions and objectives		
Real GDP	2.8	4.5
GDP deflator	6.3	12.0
CPI (annual average)	4.1	12.0
	(Percent of GDP)	
Overall budget deficit	8.0	6.9
Domestic financing of budget deficit	4.2	2.3
Domestic bank financing of budget deficit	3.4	1.6
	(Percentage change)	
Domestic credit expansion	24.9	15.4
Growth of bank credit to public sector	26.8	12.4
Growth of net bank credit to Government	27.9	12.4
	(Percent of GDP unless otherwise indicated)	
Overall balance of payments (mn. SDRs)	-47.3	-4.0
Current account balance	-7.1	-8.9
Current account balance excluding aid-financed imports of goods and services	-0.1	0.2

Table VI. Nepal: Summary of the 1985/86 Program (cont'd)

2. Main elements of the program

a. Supply policies

Further increase in irrigation facilities and improved maintenance and rehabilitation of existing facilities. Continued announcement of minimum support prices for certain agricultural crops prior to planting seasons. Improvement of access of the rural sector to institutional credit through the expansion of the resource base of the ADBN and the establishment of new commercial bank branches in rural areas.

Encourage the reinvestment of profits of firms established under the Industrial Enterprises Act (1982) and the Foreign Investment and Technology Act (1982) through income tax incentives.

Encourage the expansion of the traded goods sector through a more active exchange rate policy.

b. Fiscal policy

Strengthen tax administration. Sales taxes: the establishment of a dual-point collection system; increase in the numbers of sales tax offices and sales tax officers; and change of the base of the sales tax from the ex-factory price to the producers' estimated retail prices. Income tax: increase the number of audits; computerization of external trade data which would provide an additional input for business income assessment; reduce income tax arrears by more vigorous canvassing of debtors.

Reform of incentives under the Industrial Enterprise Act. Tax holidays made to graduate with extent of value added. Levy of penalties on firms which close after end of tax holidays. Reduction of industries classified as cottage industries, which benefit from higher tax incentives.

Change in implementation procedures of aid-financed projects to reduce related local costs.

Restraint on regular expenditures. No salary increases for the civil service in 1985/86 apart from increases related to changes in grade. Selective cuts in budgetary allocations.

Table VI. Nepal: Summary of the 1985/86 Program (cont'd)

Restraint on domestically financed development expenditures. Across-the-board and selective cuts in allocations for low-priority projects.

Intensification of efforts to increase aid-absorptive capacity in light of World Bank recommendations.

Increases in administered prices of public enterprises and maintenance of the policy of flexibility in administered prices. Restraint on subsidies granted through public enterprises.

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

c. Monetary policy

Restraint on the expansion of bank credit to both public and private sectors.

Maintenance of key bank deposit rates at positive real levels.

Commercial banks authorized to vary deposit rates within bands; bands to be widened during program period.

Continuation of incentives for commercial banks to establish branches in rural areas.

Encourage the establishment of additional joint venture commercial banks.

Authorization of ADBN to float agricultural savings certificates in order to increase its resource base.

Authorization of establishment of finance companies to strengthen the institutional framework of the financial system.

d. External policies

Depreciation of the Nepalese rupee by 14.6 percent (in terms of foreign currency units per Nepalese rupee) on November 30, 1985, and maintenance of a more flexible exchange rate policy thereafter.

Table VI. Nepal: Summary of the 1985/86 Program (concluded)

Abolition of 10 percent cash subsidy for exports to third countries on November 30, 1985.

Abolition of revenue stamp duties on personal purchases of foreign currency on November 30, 1985.

Restraint on commercial external borrowing with maturities in the range of 1-12 years.

Authorization of commercial banks to accept deposits denominated in foreign currencies.

Increase in licenses for commercial imports from third countries.

Completion of a study on possible reforms in the exchange and trade system by April 1986.

Nepal--Stand-By Arrangement

Attached hereto is a letter, with annexed memorandum dated December 3, 1985 from the Minister of Finance of Nepal requesting a stand-by arrangement and setting forth:

(1) the objectives and policies that the authorities of Nepal intend to pursue for the period of this stand-by arrangement;

(2) the policies and measures that the authorities of Nepal intend to pursue until July 15, 1986; and

(3) understandings of Nepal with the Fund regarding a review that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Nepal will pursue for the remaining period of this stand-by arrangement.

To support these objectives and policies, the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period from December ..., 1985, until January ..., 1987, Nepal will have the right to make purchases from the Fund in an amount equivalent to SDR 18.65 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 12.35 million until March 15, 1986, the equivalent of SDR 14.45 million until June 15, 1986, the equivalent of SDR 16.55 million until September 15, 1986, and the equivalent of SDR 18.65 million until December 15, 1986.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Nepal's currency in the credit tranches beyond 25 percent of quota.

3. Nepal will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Nepal's currency in the credit tranches beyond 25 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that:

(i) the quarterly limit on net domestic assets of the banking system set out in paragraph 16 of the attached memorandum dated December 3, 1985, or

(ii) the quarterly limit on net bank claims on the Government described in paragraph 16 of the attached memorandum dated December 3, 1985 is not observed; or

(b) if Nepal fails to observe the limit on the contracting or guaranteeing of new nonconcessional foreign indebtedness described in paragraph 20 of the attached memorandum dated December 3, 1985; or

(c) during any period after July 15, 1986, until suitable performance criteria have been established in consultation with the Fund pursuant to the review contemplated in paragraph 3 of the attached letter or, after such performance criteria have been established, while they are not being observed; or

(d) during the entire period of this stand-by arrangement if Nepal:

(i) imposes or intensifies restrictions on payments and transfers for current international transactions; or

(ii) introduces or modifies multiple currency practices; or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Nepal is prevented from purchasing under this stand-by arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and Nepal and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. Nepal will not make purchases under this stand-by arrangement during any period of the arrangement in which the member has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase.

5. Nepal's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Nepal. When notice of a decision of formal ineligibility or of a

decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Nepal and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Nepal, the Fund agrees to provide them at the time of the purchase.

7. Nepal shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

8. (a) Nepal shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Nepal's balance of payments and reserve position improves.

(b) Any reductions in Nepal's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

9. During the period of the stand-by arrangement, Nepal shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Nepal or of representatives of Nepal to the Fund. Nepal shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Nepal in achieving the objectives and policies set forth in the attached letter.

10. In accordance with paragraph 4 of the attached letter, Nepal will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 3 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Nepal has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Nepal's balance of payments policies.

Kathmandu, Nepal
December 3, 1985

Mr. J. de Larosiere
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Larosiere:

1. Enclosed herewith is a memorandum reviewing recent economic developments in Nepal and presenting our economic and financial program for 1985/86.

2. In support of this program, His Majesty's Government of Nepal wishes to request a thirteen-month stand-by arrangement from the International Monetary Fund in the amount of SDR 18.65 million, equivalent to 50 percent of quota.

3. His Majesty's Government of Nepal will reach understandings with the Fund not later than July 15, 1986 on policies and measures for the remaining period of its program extending into the fiscal year 1986/87.

4. We believe that the policies and measures described in the attached memorandum and those that we will formulate before July 15, 1986, will be adequate to achieve the objectives of our program, but we are prepared to take any further measures that may be required for this purpose. As stated in the attached memorandum, during the period of the stand-by arrangement, we will consult with the Fund on the adoption of any measures that may be appropriate.

Sincerely yours,

/s/
P.C. Lohani
Minister of Finance

Enclosure: Memorandum of His Majesty's Government of Nepal on Certain Aspects of Its Economic and Financial Policies for 1985/86

Kathmandu, Nepal
December 3, 1985

Memorandum of His Majesty's Government of Nepal on
Certain Aspects of Its Economic and
Financial Policies for 1985/86

1. Against the background of real growth which had just kept pace with population growth, Nepal launched its Sixth Plan (1980/81-1984/85) with the objective of increasing per capita income by 2 percentage points per annum. Relative to the previous Plan period, the outturn was broadly favorable, but the external accounts came under increasing pressure in 1982/83-1984/85. In 1982/83, shortfalls in domestic and external resource mobilization were compounded by drought-induced supply difficulties. Since that year, and in an attempt to maintain the pace of development, the Government resorted to substantial borrowing from the banking system, with total domestic demand outpacing resource availabilities. While an average annual growth rate of 4.1 percent (and 1.4 percent in per capita income) was achieved and inflationary pressures were contained during the Plan period, the overall balance of payments, traditionally in surplus, registered deficits in each of the three years through 1984/85. The cumulative deficit amounted to about SDR 100 million, of which about SDR 47 million was incurred in 1984/85. In relation to imports, gross official reserves fell from the equivalent of 7.4 months in mid-July 1982 to 2 months by mid-July 1985. In the absence of a comprehensive adjustment effort, Nepal's external position is likely to deteriorate further in 1985/86.

2. The objectives of the 1985/86 economic program are: to reduce substantially the overall deficit balance of payments (SDR 47 million in 1984/85), as a first step toward attaining a sustainable external position over the medium term; to attain a real growth of 4.5 percent (2.8 percent in 1984/85); and to contain domestic inflation, which is expected to rise mainly as a result of price adjustments, to an annual average of about 12 percent. To achieve these objectives, a number of measures affecting both the domestic demand and supply side of the economy have been and will be implemented.

3. Fiscal policies. The reduction of balance of payments pressures emanating from the budget is our highest priority. Consistent with this goal, we intend to intensify our efforts to mobilize domestic revenue, restrain both regular expenditures and domestically financed development expenditures, and increase our capacity to utilize external aid commitments. The budget's domestic financing requirement will be reduced by NRs 614 million to NRs 1,130 million in 1985/86. Of the total domestic financing, no more than NRs 800 million will be financed

by the banking system (NRs 1,405 million in 1984/85). In relation to projected GDP, net domestic bank financing of the Government would thereby decline by 1.8 percentage points, to 1.6 percent.

4. Discretionary revenue measures provided for in the 1985/86 budget, which refer mainly to adjustments in existing taxes and the introduction of revenue stamp duties, are expected to raise about NRs 60 million. The increase in tax revenue associated with tax administration measures (described in paragraph 5) and the growth of the economy are estimated at NRs 220 million and NRs 360 million, respectively. The direct revenue impact of the recent exchange rate adjustment, mainly through increases in sales tax and import duty collections, would amount to about NRs 383 million. Altogether, tax revenue is estimated to rise by NRs 1,023 million or by 1 percentage point of GDP. The sale of government-held equity in public enterprises, described in paragraph 10, is estimated to reduce net lending by about NRs 210 million.

5. A number of important tax administration measures are being put into place. In view of the large contribution of sales taxes to total revenues, the efficiency of its administration has been a main source of concern. To ensure that all taxable imported raw materials and intermediate goods are subject to sales tax, this tax was made payable beginning in 1985/86 at the customs point. These collections will be credited against the sales tax assessed at the production point. Moreover, the base of the sales tax has been changed from the ex-factory price to the producers' estimated retail price, in effect subjecting distribution costs and ex-factory excise taxes to sales taxes. Furthermore, the number of sales tax offices has been expanded so as to enable better and more timely assessments to be made, on the basis of audits. Income tax arrears have increased steadily to nearly NRs 415 million at mid-1985. A new income tax assessment scheme in the civil service designed to increase the efficiency of income tax collections is under study. This scheme will be administered by the paymaster of each ministry. Moreover, the computerization of customs data which is under way would provide accessible data to aid tax inspectors in spotting discrepancies between potential and reported business incomes. Loopholes in the Industrial Enterprises Act are in the process of being closed. Entrepreneurs who close firms at the end of tax holidays have been subject to financial penalties and vigilance will be exercised to ensure that tax holidays are not extended indefinitely through changes in ownership or in company names. Moreover, a bill has been passed to make the length of tax holidays dependent on value-added and to lower the cut-off point for determining what constitutes a cottage industry, which by law receives greater tax incentives. The Government is in the process of studying the March 1985 report of the IMF technical assistance mission on government finance during the Seventh Plan. Major elements of the report's recommendations will be reflected in the 1986/87 budget proposals.

6. Restraint will be exercised on regular expenditure, while providing for the adequate maintenance of completed development projects. The urgency of this restraint is underscored by the rising claims of interest on the public debt, which amounted to 18 percent of regular expenditure in 1984/85, and the increase in the salaries and wages of civil servants, which was the primary factor in the 42 percent rise of the wage bill in 1984/85. No further increases in salaries and wages are provided for in the 1985/86 budget, apart from increases associated with changes in grade. As a result of this measure and restraint on certain other expenditure, the increase in regular expenditure would be 20 percent in 1985/86, compared with 34 percent in the previous fiscal year.

7. In view of the limited capacity of the private sector to generate savings for investment, public capital formation has played a key role in the development of the economy. In turn, the chronic inadequacy of domestic saving has made the support of foreign saving, almost entirely in the form of grants and concessional loans, critical to our investment effort. In collaboration with the World Bank, the Asian Development Bank, and other institutions, we are intensifying efforts to increase our aid absorptive capacity by streamlining administrative and implementation procedures. At the same time, and in light of experience in recent years, the pace of nonaid-financed development expenditure shall be more closely controlled in the light of domestic revenue receipts. In 1985/86, prior to the November 1985 exchange rate adjustment, the Government decided to cut budgeted non-aid-financed development allocations by 5 percent across-the-board and to effect selective cuts, particularly in local government-administered projects. Moreover, new lesser-priority projects will be deferred. To minimize local costs associated with aid-financed projects, instructions have been issued to the effect that local expenditure should not be incurred before tenders have been accepted. As a result of these measures and adjusting for the impact of the change in the exchange rate, domestically-financed development expenditure is estimated to increase by only 4 percent in 1985/86, implying a substantial decline in real terms. Given external aid forecasts, total development expenditure in 1985/86 is projected to increase by 30 percent (15 percent in the absence of the recent exchange rate adjustment), compared with 7 percent in the previous year.

8. While the composition of aid-financed development expenditure is largely determined by prior agreement between the Government and donors and the diverse rates of progress in project implementation, the Government exercises discretionary power over the composition of domestically-financed development expenditure. In the event of any shortfalls in domestic revenue in 1985/86 below amounts currently projected, the Government will give priority to the provision of local counterpart funds to aid-related projects.

9. The emergence of substantial domestic financing requirements for the budget in recent years and the need to avoid excessive govern-

ment recourse to the domestic banking system have led to the introduction of national savings certificates, in addition to development bonds. The bulk of these certificates have been absorbed by institutional investors, particularly the National Provident Fund. The growing interest burden on government securities outstanding is a source of deep concern and has underscored the limits of substituting sales of securities for revenue measures. We intend to follow developments in this context closely.

10. In the last few years, the operations of public enterprises have placed an increasing burden on the budget. To reduce this burden and to increase the efficiency of these enterprises, a number of steps have been taken. Reference has already been made in paragraph 4 above to the sale of government-held equity in a number of enterprises to the private sector. So far, in 1985/86, shares of two corporations have been offered through the Securities Exchange Center and our intention is to offer shares of at least one public enterprise per month. While the Government intends for the moment to retain majority interest in these enterprises, expanded private ownership should increase their sensitivity to profit and market considerations. The recent decision to assess the performance of the management of public enterprises partly on the basis of the financial performance of their respective firms would serve the same end.

11. Since 1983/84, public enterprises have enjoyed greater autonomy in their administered pricing policies. Public enterprises operating in competition with the private sector are now free to set their prices. Public enterprises operating monopolies, such as public utilities, may propose price revisions to a price review board consisting of an independent expert and representatives from the ministry involved, the Ministry of Finance, and the enterprise itself. Our policy in respect of state monopolies is that price revisions should enable them at a minimum to break even in their current operations. Public enterprises, which traditionally operate with the aid of budgetary subsidies, such as the Nepal Food Corporation and the Agricultural Inputs Corporation, not only serve economic, but also social objectives. Nevertheless, the pricing policies of such enterprises will be managed with a view to minimizing the need for budgetary subsidies, the major part of which relates to the heavy cost of transportation of food and agricultural inputs to remote areas. In the course of 1984/85, substantial increases were announced for administered prices on dairy milk, sugar, cigarettes, bricks, cement, iron rods, fuelwood, and timber. Moreover, after remaining unchanged for several years, prices of petroleum products were increased by 17-33 percent and a policy of linking their domestic prices with international prices was adopted. It is therefore expected that the state oil corporation will generate a surplus in 1985/86 which can be used to retire part of its outstanding debt to the banking system. Furthermore, electricity tariffs were raised by an average of 35 percent in March 1985 and by an average of 22 percent in August 1985. In September 1985, city public transport

rates were raised by 40 percent and milk prices were raised by 27 percent. Public enterprise costs vary in sensitivity to import costs and our policy is that nontransient increases in the latter should be reflected without delay in administered prices to avoid any deterioration in enterprises' financial positions.

12. Monetary and credit policies. The financial system plays a critical role in our efforts to increase domestic resource mobilization and recent measures have been taken to increase its efficiency and its capacity to attract resources. To increase competition in the financial system, foreign banks, in joint ventures with domestic capital, have been permitted to establish branches in Nepal. One foreign bank already has commenced operations and two other joint ventures are expected to be established during 1985/86. In addition, the Agricultural Development Bank has been authorized to accept deposits in urban areas on the same basis as commercial banks. To further increase the deposit base of the commercial banks, they were authorized to accept U.S. dollar and pounds sterling deposits in August 1985.

13. To provide flexibility in the level and term structure of interest rates, the administratively determined deposit rates of the banking system were declared to be minima in November 1984 and banks were permitted to raise rates above those levels by up to 1.5 percentage points on savings deposits and 1 percentage point on fixed deposits. It is our intention to widen these bands by at least 2 percentage points in the course of the program period, at least 1 percentage point of which will be effected by the time of the review of this arrangement referred to in paragraph 22. We 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. With the exception of the three-month bank deposit rate (which is linked to the relatively low Treasury bill rate), all bank deposits currently provide for positive real yields which are necessary to encourage financial savings. It is our policy to maintain positive real interest rates and to monitor developments closely. The Government will study the 1985 report of the IMF technical assistance mission on instruments of the financial sector and will consider its key recommendations in the formulation of financial sector policies.

14. In view of the rapid increase in domestic credit in 1984/85, the Nepal Rastra Bank (NRB) has taken a number of measures to restrain private credit expansion, without curtailing credit availability to production sectors. In June 1985, the NRB raised the interest rate on certain commercial loans from 17 percent to 19 percent, raised the margin deposit rate on imports of luxury goods from 50 percent to 75 percent, and imposed a ceiling on bank overdrafts at the mid-April 1985 level. Moreover, in July 1985, banks were required to reduce their total credit outstanding (loans, advances, and investments) from 81 percent to 75 percent of total deposit liabilities.

15. The Government has drawn up a monetary program for 1985/86 consistent with the macroeconomic objectives of this arrangement. Assuming virtual maintenance of the income velocity of money, broad money is forecast to increase by 18 percent. Given the balance of payments target, this implies a deceleration in the growth of net domestic credit from 25 percent in 1984/85 to 15.4 percent in 1985/86. With the growth of net credit to the Government limited to 12.4 percent (28 percent in 1984/85) and that to the nonfinancial public sector limited to 12 percent (21 percent in 1984/85), the implied growth of credit to the private sector and the rest of the public sector would amount to 20.3 percent (22 percent in 1984/85).

16. For the purpose of monitoring the monetary program, quarterly ceilings will be set on net domestic assets, estimated at NRs 10,869 million as of October 15, 1985, as follows: NRs 11,485 million as of January 15, 1986; NRs 12,045 million as of April 15, 1986; and NRs 12,720 million as of July 15, 1986. Moreover, quarterly subceilings will be set on net bank credit to the Government estimated at NRs 6,633 million as of October 15, 1985 as follows: NRs 6,833 million as of January 15, 1986; NRs 6,977 million as of April 15, 1986; and NRs 7,233 million as of July 15, 1986. These ceilings and subceilings constitute performance criteria. The analogous ceiling and subceilings for October 15, 1986 will be set at the time of the review of this arrangement as described in paragraph 22 below. In addition, indicative subceilings on domestic credit to the nonfinancial public sector will be set as follows: NRs 1,277 million as of January 15, 1986; NRs 1,317 million as of April 15, 1986; and NRs 1,289 million as of July 15, 1986. The Nepal Rice Export Companies (NREC), which are in process of final liquidation, have NRs 400 million of obligations to domestic banks, which have been guaranteed by the Government of Nepal. It is possible that liquidation procedures will be completed during the course of 1985/86, so that the outstanding obligations of the NREC will be transferred to the Government's accounts with the relevant banks at some point in the period. This transfer will not give rise to any payments by the Government to the banks on these obligations in 1985/86. In future years, beginning in 1986/87, NRs 40 million will be included in the budget to service these claims. If the transfer of these obligations to the Government account is effected in 1985/86, the amount (up to NRs 400 million) will not be included in the subceiling on net credit to Government given above; these amounts will be included in the indicative subceilings on domestic credit to the nonfinancial public sector.

17. External policies. The adjustment program for 1985/86 represents our intention that sustained and substantial progress be made toward attaining a sustainable balance of payments over the medium term. 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-substitution activities. Moreover, there is a need to restore and maintain international

reserve adequacy within the framework of a program which will permit the further rationalization of the trade and payments system. Toward these ends, we 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 recent exchange rate adjustment.

18. The 10 percent cash subsidy on exports to third countries, which is aimed at reducing the cost differential between transport costs on exports to India and those to third countries, resulted in payments of NRs 27 million in 1983/84. No payments had been made in 1984/85 in view of the Government's decision to remove the administration of this discriminatory subsidy from the banking system. The revenue stamp duties on purchases of foreign exchange outside the limits provided for under existing rules and regulations (NRe 0.015 per Indian rupee and NRs 3 per U.S. dollar or the equivalent in other convertible currencies) were introduced in July 1985 but not applied on purchases of Indian rupees. On November 30, 1985, as the balance of payments support functions of the cash export subsidy and the revenue stamp duty on foreign exchange purchases had been taken over by the change in the exchange rate, the Government announced on that date the elimination of both measures.

19. The scarcity of convertible foreign exchange holdings has resulted in the maintenance of controls on the issue of licenses for nonaid-financed imports from the convertible currency area in accordance with official priorities. The Government intends to ease the availability of import licenses in measured steps as the balance of payments responds to the adjustment measures being implemented. In the immediate period, we will avoid any intensification of restrictiveness of import licensing in lieu of more fundamental measures aimed at easing balance of payments pressures. For 1985/86, and based on our present assessment of foreign exchange availabilities, we estimate that about SDR 160 million of import licenses for commercial nonaid-financed imports in convertible currencies will be issued, which represents an increase of 13 percent over the total in 1984/85.

20. Most of Nepal's public and publicly-guaranteed external debt, which amounted to about SDR 410 million (18 percent of GDP) at mid-July 1985 has been contracted on highly concessional terms. Nevertheless, for certain public projects, including some financed in part by international lending agencies and/or bilateral donors, there is a component of commercial loans for equipment. Up to September 30, 1985, such borrowing approved and/or contracted for five projects amounted to the

equivalent of US$53.7 million. 1/ These projects are of high priority and will have a favorable impact on the balance of payments over time. The World Bank and/or Asian Development Bank are participating in some of them. With the coming on stream of service payments on more loans, the ratio of such payments to receipts from exports of goods and non-factor services has increased steadily, reaching 5 percent by 1984/85, and it is important that any borrowing on nonconcessional terms continue to be limited to very high priority projects which will strengthen the external accounts. While the level of this ratio remains manageable, it underscores the need to use foreign loan receipts efficiently as well as to promote exports vigorously. It is planned that the Royal Nepal Airlines Corporation (RNAC) will acquire in late 1985/86 or early 1986/87 one passenger jet aircraft. This will add to the profitability of the RNAC and strengthen Nepal's foreign exchange earnings. The decision on the type of aircraft to be acquired is under study by a special commission, so that the amount and terms of the associated commercial borrowing are not known at this time. Nevertheless, it is likely that the amount involved for the aircraft and spare parts will be in the range of US$40-48 million. Priority will be given to servicing this debt by RNAC from its operating profits, prior to the distribution of profits to its shareholders, including His Majesty's Government of Nepal. If the amount proves to be greater, the Government will consider a compensating reduction in other commercial borrowing included under the ceiling described below. To avoid exacerbating the debt service burden, the Government will refrain from contracting or guaranteeing additional nonconcessional loans in the 1-12 year maturity range in excess of SDR 10 million in 1985/86, excluding amounts already contracted as of September 30, 1985 and the funding for one jet aircraft for RNAC should the purchase materialize in 1985/86. Moreover, short-term external borrowing will be contained to revolving loans traditionally required in the normal operations of the Nepal Oil Corporation.

21. The objectives for 1986/87 are set forth in the Seventh Plan, including a targeted growth of real GDP of 4.5 percent. Financial policies for 1986/87 will be formulated consistently with some moderation of inflation, while the underlying balance of payments is strengthened. In this regard, the exchange rate will continue to be managed flexibly to ensure further progress toward a more liberal exchange and trade system and toward balance of payments sustainability over the medium term, and to strengthen the reserve position in the

---

1/ These include: a telecommunications project (Phases III and IV) jointly financed by the World Bank, Belgium, France and Finland; a terminal building at Tribhuwan Airport financed by the Asian Development Bank, with the understanding that cost overruns will be financed by His Majesty's Government of Nepal; a feasibility study for a hydro-power project at Seti, which will itself be financed with concessional aid funds; an integrated textile factory at Butwal; and, a fire and tube factory in the Gurkha District.

nearer term. Inflationary pressures will be kept in check by restraint in demand management. With concrete efforts to mobilize additional resources while restraining current expenditure, the domestic financing of the budget deficit, and, in particular, the portion financed through the banking system in relation to GDP, should be no higher, and possibly lower, than that projected for 1985/86. On this basis, the fiscal program would permit expansion of credit to the private sector consistent with the growth in economic activity.

22. Conclusions. His Majesty's Government of Nepal believes that this program represents a significant adjustment effort. It, therefore, requests a stand-by arrangement from the International Monetary Fund in an amount of SDR 18.65 million for a period of 13 months. The Government believes the policies and measures described above are adequate to achieve the objectives of the program but will take any additional measures that may be necessary for this purpose. During the period of the stand-by arrangement, the Government will consult with the Fund on the adoption of any measure that may be appropriate in accordance with the policies of the Fund on such consultation. In particular, we will focus in these consultations on the progress being made in the implementation of the program described above and on any policy adaptations judged to be appropriate for the achievement of the objectives of the program. In the course of the review of the program, to be held no later than July 15, 1986, the Government will reach understandings with the Fund on performance criteria for the period of the program extending into fiscal year 1986/87.

Nepal: Technical Memorandum on Domestic Assets/Credit Ceilings

In paragraph 16 of the Memorandum of His Majesty's Government of Nepal on Certain Aspects of its Economic and Financial Policies for 1985/86, the authorities' economic program for 1985/86 provides for quarterly ceilings on net domestic assets of the banking system and quarterly subceilings on net credit to Government as follows:

	1985		1986		
	July 15 (Actual)	Oct. 15 (Est.)	Jan. 15	Apr. 15 (Ceilings)	July 15
	(In millions of Nepalese rupees)				
Net domestic assets	10,431	10,869	11,485	12,045	12,720
Net credit to Govt.	6,433	6,633	6,833	6,977	7,233

As indicated in paragraph 16 of the Memorandum, amounts transferred to the accounts of the Government with domestic banks up to NRs 400 million on account of the liquidation of the Nepal Rice Export Companies are excluded from the subceilings on net credit to the Government. When, and if, such transfer is effected in 1985/86, His Majesty's Government of Nepal will notify the Fund staff, and such amounts will be shown separately in reporting the monthly data on the monetary survey.

For the purposes of this program, net domestic assets of the banking system are defined as the difference between the outstanding stock of broad money (M2) and net foreign assets. The stock of net domestic assets at end-1984/85 was NRs 10,431 million, as shown above. In calculating net domestic assets during the program period, net foreign assets shall be expressed in terms of local currency at the exchange rate prevailing at end-1984/85 (i.e., NRs 18.069 = SDR 1). In calculating net claims on Government, any items originally denominated in foreign currency shall also be converted at the exchange rate prevailing at end-1984/85.

The relevant ceiling and subceiling for the period of the program after July 15, 1986 will be agreed in the context of the mid-term review.

ANNEX III

Nepal--Fund Relations
(As of October 31, 1985)

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 31.6 million (84.7 percent of quota)
(c) Fund credit:	None
(d) Reserve tranche position:	SDR 5.7 million
(e) Current operational budget:	Not applicable.
(f) Lending to the Fund:	Not applicable.

III. Current Stand-by or Extended Arrangement and Special Facilities

Not applicable.

IV. SDR Department

(a) Net cumulative allocations:	SDR 8.1 million
(b) Holdings:	SDR 0.12 million or 1.5 percent of net cumulative allocations
(c) Current Designation Plan:	Not applicable.

V. Administered Accounts

(a) Trust Fund loans:	
(i) Disbursed:	SDR 13.7 million
(ii) Outstanding:	SDR 9.6 million
(b) SFF Subsidy Account:	Not applicable.

Nepal--Fund Relations (continued)
(As of October 31, 1985)

VI. Overdue obligations to the Fund

Not applicable.

VII. Country has not used Fund resources to date

Not relevant.

(B) Nonfinancial Relations

VIII. Exchange Rate Arrangement: On June 1, 1983, Nepal introduced an arrangement under which its currency is pegged to a basket of currencies of major trading partners. (On November 30, 1985, the exchange rate was changed from NRs 1.451 to NRs 1.700 per Indian rupee.)

IX. Last Article IV consultation: June 27, 1984; Decision No. 7743 (84/100). Staff discussions were held during March 26-April 6, 1984 (SM/84/117, 5/23/84; and SM/84/129, 6/8/84). The Executive Board adopted the following decision:

"The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with Nepal, in the light of the 1984 Article IV consultation with Nepal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

Nepal maintains a multiple currency practice as described in SM/84/117 and SM/84/129. The Fund encourages Nepal to eliminate the multiple currency practice as soon as possible."

Nepal--Fund Relations (concluded)
(As of October 31, 1985)

X. Technical Assistance:

(a) CBD: For four months in 1983, the Fund provided an advisor for cost-of-living indices. The same advisor is expected to take up another assignment for five months starting in February 1986. A mission reviewed the financial system in December 1984 and its report was sent to Nepal in April 1985.

(b) Fiscal: A mission in August 1984 reviewed government finances during the Seventh Plan (1985/86-1989/90) and its report was sent to Nepal in March 1985.

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

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

Nepal: Relations with the World Bank Group

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

The Bank Group's lending to Nepal so far has been modest compared to the country's total development requirements. The main constraint on the utilization of increased aid has been Nepal's limited absorptive capacity, affecting the pace of project preparation and implementation. Over the next several years, the Bank will seek to strike a proper balance between the necessary emphasis on quick-and-high yielding investments (such as in irrigation and cottage industries) which is dictated by Nepal's precarious budgetary and balance of payments position, and an equally important commitment to longer-term developmental and institutional issues (such as public administration inefficiencies, poor project planning and implementation performance, rapid population growth, and scarcities of skilled labor through a combination of project lending, technical assistance, and economic and sector work.

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

Recent economic and sector missions: The most recent economic mission visited Kathmandu during May/June 1985. In addition, the World Bank has sent a number of sector missions in recent years, including a mission on the Seventh Plan review in November 1984 and one on manpower training assessment in January 1985.

Nepal--Lending by the World Bank Group 1/

(In millions of U.S. dollars)

Sectoral lending	IDA	IFC	Total	Of which: Undisbursed
Agriculture	113.3	--	113.3	70.7
Irrigation	94.5	--	94.5	36.7
Education	32.8	--	32.8	26.4
Water supply	46.8	--	46.8	15.4
Industry	18.0	9.0	27.0	8.9
Transportation	67.0	--	67.0	47.4
Telecommunication 2/	43.8	--	43.8	23.1
Power and energy	168.0	--	168.0	121.3
Other	13.2	--	13.2	5.1
Total	597.4	9.0	606.4	355.0 3/

Source: Data provided by the World Bank.

1/ As of September 30, 1985. No IBRD loans have been made to Nepal.
2/ Includes $22 million for Telecommunications IV approved by the IDA Board on April 30, 1985 but not yet signed.
3/ Adjusted for changes in U.S. dollar/SDR exchange rate as of approval and disbursement dates of IDA credits.

NEPAL

Basic Data 1/

Area:	140,797 square kilometers
Population (mid-1984 est.):	16.2 million
Population growth rate (1978-83):	3.4 percent
GDP per capita (1983/84):	SDR 145

	1980/81	1981/82	1982/83	1983/84	1984/85 (Prel.)	1985/86 (Program)
	(Changes in percent)					
GDP and prices						
Real GDP	8.3	3.8	-1.4	7.4	2.8	4.5
Of which: agriculture	10.4	3.5	-2.5	8.7	1.7	3.5
nonagriculture	5.5	4.2	0.4	5.5	4.5	5.7
Nominal GDP	16.9	10.8	11.1	13.6	9.3	17.0
Implicit GDP deflator	7.9	6.8	12.6	5.7	6.3	12.0
Consumer prices (annual average)	13.4	10.4	14.2	6.2	4.1	12.0
Central Government						
Revenue and grants	23.4	11.9	6.4	8.2	17.1	38.7
Of which: revenue	30.2	11.0	5.2	19.0	15.0	27.6
Expenditures	19.2	31.5	30.6	5.2	15.0	23.6
Current	(19.8)	(20.5)	(24.8)	(10.9)	(33.7)	(20.4)
Development	(18.3)	(36.5)	(33.7)	(3.7)	(7.0)	(30.0)
Money and credit 2/						
Domestic credit	19.9	17.1	40.5	15.7	24.9	15.4
Public sector	12.7	31.4	80.1	14.5	26.8	12.4
Government, net	(0.3)	(63.3)	(98.4)	(23.0)	(27.9)	12.4
Nonfinancial public enterprises	(34.8)	(-11.2)	(35.4)	(-16.1)	(20.7)	12.0
Private sector	25.8	6.4	3.9	17.7	22.0	20.3
Broad money	19.3	18.2	23.6	13.4	16.8	18.2
Income velocity of money (absolute number)	4.71	4.40	4.06	3.89	3.71	3.67
External sector (in SDR terms)						
Exports, f.o.b.	46.8	-6.6	-24.8	40.3	47.0	3.5
Imports, c.i.f.	30.7	12.1	26.7	-3.8	10.5	12.1

NEPAL

Basic Data (cont'd)

	1980/81	1981/82	1982/83	1983/84	1984/85 (Prel.)	1985/86 (Program)
	(In millions of SDRs)					
Balance of payments						
Exports, f.o.b.	108.2	101.1	76.0	106.7	156.9	162.4
Imports, c.i.f.	-298.2	-334.3	-423.7	-407.6	-450.2	-504.8
Services and private transfers (net)	112.4	128.5	147.9	131.0	124.0	133.5
Current account balance	-77.6	-104.7	-199.8	-170.0	-169.3	-208.8
Official capital (net) and grants	100.3	130.5	149.8	161.3	162.5	204.8
Overall balance	13.0	33.9	-45.2	-7.9	-47.3	-4.0
External public debt						
Total outstanding (including Fund credit) 2/	199.1	237.6	279.5	396.1	407.7	526.7
Debt service ratio 3/	1.9	2.9	4.9	4.5	4.7	4.9
Official international reserves 2/						
Gross	158.2	202.3	148.4	125.0	73.1	83.1
Of which: Indian rupees	(47.2)	(63.2)	(77.8)	(40.9)	(12.1)	(...)
Net	125.7	165.8	122.7	91.2	47.7	43.7
Gross in months of non-aid imports	7.4	9.2	5.3	4.7	2.5	2.6
	(In percent)					
Ratios to GDP						
Investment	17.6	16.8	20.2	19.4	19.0	...
Domestic saving	10.9	9.5	9.1	10.4	10.5	...
Government revenue	8.8	8.8	8.3	8.8	9.2	10.0
Government expenditure	14.6	17.3	20.4	18.9	19.9	21.0
Government overall deficit	2.6	5.2	8.8	7.8	8.0	6.9
Domestic bank financing of government deficit	--	2.6	6.0	2.5	3.4	1.6

NEPAL

Basic Data (concluded)

	1980/81	1981/82	1982/83	1983/84	1984/85 (Prel.)	1985/86 (Program)
	(In percent)					
Ratios to GDP (concluded)						
Exports	5.9	4.9	3.4	4.5	6.6 4/	6.9
Imports	16.3	16.3	18.8	17.1	19.0	21.5
Current account deficit	4.2	5.1	8.9	7.1	7.1	8.9
External public debt 2/	10.1	11.3	12.9	17.5	17.6	23.8

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

1/ Data relate to fiscal years ending mid-July, unless otherwise indicated.
2/ End of period.
3/ Percent of exports of goods and nonfactor services and private remittances.
4/ Includes exports of ready-made garments amounting to 0.7 percent of GDP.

Nepal--Statistical Issues

1. Coverage, currentness, and reporting of data in IFS

		Latest Data in November 1985 IFS
Real Sector	- National Accounts (aggregate GDP only)	1984
	- Prices (consumer)	July 1985
Government Finance	- Deficit/Surplus	1982
	- Financing	1982
	- Debt	1978
Monetary Accounts	- Monetary Authorities	June 1985
	- Deposit Money Banks	May 1985
External Sector	- Merchandise Trade (Value)	July 1985
	- Balance of Payments	1984
	- International Reserves	September 1985
	- Exchange Rates	September 1985

2. Outstanding statistical issues

General: During the past year, the reports of the IFS correspondent have been somewhat irregular.

Real sector: The data on the consumer price index, used in the work relating to the Information Notice System, are currently received on the Report Form. They could, however, be cabled regularly, using the cable code system.

Government finance: Data on outstanding foreign debt, by instrument and holder, are very uncurrent.

Monetary accounts: Data on other financial institutions have not been furnished yet.

External sector: A reconciliation of the trade data reported to the Balance of Payments Division with those reported to the General Economy Division of the Bureau would be helpful.