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Nepal: Second and Third Reviews Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Waiver of Performance Criteria and Extension of the Arrangement—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Nepal

In the context of the second and third reviews under the three-year arrangement under the Poverty Reduction and Growth Facility, requests for waiver of performance criteria and extension of the arrangement, the following documents have been released and are included in this package:

- the staff report for the Second and Third Reviews Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Waiver of Performance Criteria and Extension of the Arrangement, prepared by a staff team of the IMF, following discussions that ended on September 14, 2006, with the officials of Nepal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 27, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff statement of November 10, 2006 updating information on recent developments;

- a Press Release summarizing the views of the Executive Board as expressed during its November 10, 2006 discussion of the staff report that completed the review; and

- a statement by the Executive Director for Nepal.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Nepal*
Memorandum of Economic and Financial Policies by the authorities of Nepal*
Technical Memorandum of Understanding by the authorities of Nepal*
*Also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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NEPAL

Second and Third Reviews Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Waiver of Performance Criteria and Extension of the Arrangement

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by Steven Dunaway and Matthew Fisher

October 27, 2006

- A three–year PRGF arrangement (for an amount equivalent to SDR 49.9 million, 70 percent of quota) was approved by the Executive Board on November 19, 2003. The first review was completed on October 20, 2004.
- Discussions on the second and third reviews, and an extension of the PRGF arrangement were held in Kathmandu during August 31–September 14. The staff team comprised Messrs. Kalra (Head), Aisen, and Ginting (all APD), Mr. Narain (MCM), Mr. Beddies (PDR), and Ms. Abraham (Senior Administrative Assistant, APD). The mission was assisted by Mr. Pitt, Resident Representative. The mission coordinated closely with the resident Asian Development Bank (AsDB) and World Bank offices.
- The mission met with Finance Minister Mahat, Nepal Rastra Bank (NRB) Governor Bhattarai, National Planning Commission Vice Chairman Pokharel, senior government and NRB officials, and donor and civil society representatives.
- The Executive Board concluded the 2005 Article IV consultation on January 18, 2006. Directors commended the authorities for maintaining macroeconomic stability. Directors noted that Nepal's growth prospects depended on restoration of durable peace and improved security conditions. Directors encouraged the authorities to pursue PRSP structural reforms in key areas, including the financial sector, public enterprises, and governance to improve growth prospects and create conditions for poverty reduction.

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EXECUTIVE SUMMARY

The Koirala government is keen on early resumption of the Fund-supported program to help maintain macroeconomic stability, against a backdrop of major political developments. A ceasefire is in place and peace talks with Communist Party of Nepal (Maoist) have begun. The government has completed outstanding measures for second and third reviews (except introduction of an automatic pricing mechanism for oil products), expressed a strong commitment to reform implementation, and requested that the reviews be completed and PRGF arrangement be extended by one year to November 18, 2007.

Nepal's economic prospects are expected to improve if durable peace can be established and structural reforms are implemented. Real GDP growth is expected to increase to 3−4 percent in 2006/07, with a broad-based acceleration in non-agriculture activity. Underlying CPI inflation is projected to remain around 5−6 percent, in line with price developments in India. Over the medium-term, growth could be higher if key structural reforms are implemented, including in the areas of tax administration, financial and public sectors, and governance.

Macroeconomic policies are appropriate. The 2006/07 budget makes provisions for a significant scaling up of social sector and public investment programs on health, education, and rural infrastructure, prioritized along the lines of the Medium Term Expenditure Framework. A rebound in activity and reduced supply disruptions are expected to help revive revenue performance. The domestically financed deficit will remain contained. Monetary policy will remain geared toward maintaining the peg to the Indian rupee.

The key structural reform areas of the 2006/07 program are:

- Fiscal reforms to further raise revenue collection, reduce leakages, enhance audit, improve taxpayer services in the Inland Revenue and Customs Departments, and strengthen fiscal transparency.

- Financial sector reforms to improve the banking framework and loan recovery, further re-engineer NRB, and restructure troubled commercial and development banks.

- Public sector reforms to reduce flow losses of Nepal Oil Corporation and resolve accumulated suppliers' credits.

Staff recommends approval of the authorities' request for waivers for nonobservance of performance criteria, completion of second and third reviews, and extension of the arrangement. Notwithstanding risks to program implementation, primarily from difficulties in reaching a political consensus, the authorities' efforts deserve international support given their demonstrated commitment to reforms.

I. Introduction

1. **Major political developments have taken place in Nepal since the Executive Board concluded the Article IV consultation in January 2006**. A ceasefire is in place, and peace talks with Communist Party of Nepal (Maoist) have begun, effectively halting a decade long insurgency. Subsequent talks between the seven party alliance (SPA) government led by Prime Minister Koirala and top Maoist leader Prachanda are charting a roadmap for an interim constitution (with a significantly diminished role for the monarchy), management of combatants' arms, an interim government with the participation of CPN(M), and constituent assembly elections, although a timeframe is yet to be finalized.

2. **The Koirala government is keen on early resumption of the Fund-supported program to help maintain macroeconomic stability**. The Government of Nepal (GON) views the direction of reforms underlying Nepal's PRSP and PRGF arrangement as still relevant. PRSP/PRGF objectives include sound economic management, better expenditure prioritization, structural reform in major economic sectors, and improved governance to deliver conditions for sustained growth and poverty reduction. The authorities' preferred option for program engagement is continuation of the current PRGF arrangement (with suitable adaptation to current circumstances) to send an early, strong signal of policy continuity at a critical juncture, especially in view of their commitment to PRSP objectives. The authorities believe that these objectives are achievable as the parties in the SPA government consist of those that have either steered liberal reforms in the past or have implemented PRSP/PRGF policies. Moreover, in view of the Maoists' importance, the authorities, donors, multilaterals, and business groups have already engaged them on their political and economic agenda. To signal its commitment to PRSP/PRGF policies, the government has adopted an appropriate budget for 2006/07, met structural performance criteria for the second and third reviews under the PRGF arrangement (except the introduction of an automatic pricing mechanism for oil products), and expressed a strong commitment to further reform implementation.[1] With this, the authorities have requested that the outstanding reviews be completed, and the arrangement be extended by one year to November 18, 2007.[2]

3. **The international community has welcomed the peace process and has extended financial aid**. India has provided a sizeable aid package, including a budget grant of around US$20 million for 2006/07 and a concessional line of credit of US$100 million for project financing. Other donors have also promised higher aid, subject to absorptive capacity at the

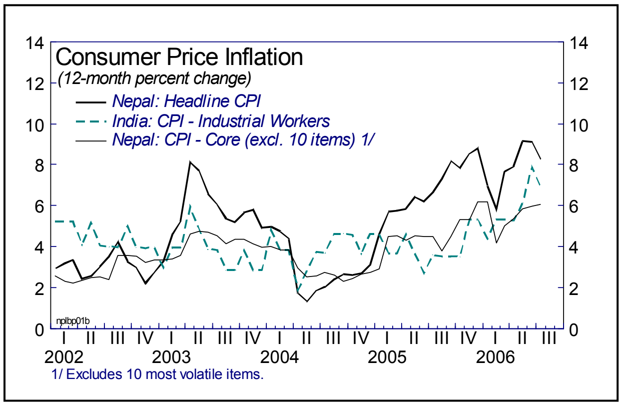
[1] Fiscal year begins mid-July.

[2] A progress report on Tenth Plan/PRSP implementation in 2004/05 was completed in June 2006. A Joint Staff Advisory Note is expected to be presented to the World Bank/IMF Executive Boards by early December.

local level. The AsDB approved a rural finance loan in October and is considering an education sector loan. The World Bank plans to expand its allocation for the Poverty Alleviation Fund to support the government, and would provide budget support through a Poverty Reduction Support Credit contingent on fiscal need and progress in structural reforms.

II. Economic Developments and Performance Under the PRGF Arrangement

4. **Growth and the fiscal position deteriorated in 2005/06 amidst the political turmoil**. Real GDP growth for 2005/06 is estimated to have declined to less than 2 percent, as the security and political situation disrupted manufacturing, tourism, and transportation (Table 1). Reflecting weak economic activity, revenue fell short of the budget target by 1½ percent of GDP. Security-related spending rose and development spending remained depressed (Table 2). With aid falling to record lows, the domestically financed deficit (at 1½ percent of GDP) was more than budgeted (¾ percent of GDP). Headline inflation rose to 8¼ percent (12-month basis) in mid-July, mainly on account of increases in food prices due to poor weather conditions and supply disruptions and higher international oil prices; underlying inflation (headline inflation excluding the ten most volatile items) remained in the 5−6 percent range, in line with price developments in India.[3] The current account (excluding official transfers) shifted into surplus as private remittances rose sharply, and international reserves rose to US$1¾ billion (6½ months of imports of goods and services) in mid-July (Table 4).



1/ Excludes 10 most volatile items.

5. **Since the first review in October 2004, macroeconomic stability has been maintained, and most quantitative performance criteria and indicative targets for the second and third reviews were met** (Table 5).[4] The overall and domestically financed fiscal deficits in 2003/04 and 2004/05 were lower than budgeted, in part due to difficulties in carrying out development activities, especially in the conflict-affected rural western and far western regions.

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[3] Underlying inflation is computed from headline inflation by excluding 10 most volatile items (about 35 percent of the CPI basket, mostly seasonal food items, fuel, and utilities).

[4] The authorities have requested a waiver for nonobservance of the floor on NFA for October 16, 2004. As regards the nonobservance of the continuous QPC on nonaccumulation of external payment arrears, the arrears that developed during 2005 were cleared and a waiver was granted by the Executive Board on January 18, 2006.

6. **Progress on structural reforms was slow due to political uncertainties, an unsettled security environment, and inertia in policy implementation**. As a result, completion of structural performance criteria (SPCs) for the second and third reviews was significantly delayed, and the reviews were not completed in 2005 as envisaged. In recent months, progress has been made on these SPCs as well and, with the exception of the introduction of an automatic pricing mechanism for oil products (for which understandings were reached on corrective measures, see ¶17, and MEFP ¶14), all other actions have been taken.[5] In particular, since April 2006, measures related to improvements in tax administration and international audit of loss making Nepal Oil Corporation (NOC) have been implemented (Tables 6 and 7, and MEFP ¶6).

III. Report on the Discussions

7. **The authorities outlined an economic program for 2006/07 consistent with PRSP/PRGF objectives**. The program is geared to maintaining macroeconomic stability through prudent macroeconomic policies. It also aims to further structural reforms in three macrocritical areas—tax administration and fiscal transparency; financial sector reforms; and NOC and the oil sector—where implementation could proceed based on a broad consensus within the SPA and with the Maoists.

A. Macroeconomic Outlook and Risks

8. **The authorities underscored that Nepal's economic prospects have improved**. The ceasefire and an improvement in the security situation should permit a rebound in economic activity, and there are initial indications that nonagricultural sector activity is reviving. With this, real GDP growth could rise to 3−4 percent in 2006/07 from under 2 percent in 2005/06, with a broad-based acceleration in non-agricultural sector activity (especially tourism, transportation, and services). Manufacturing activity may struggle to recover until labor disputes can be resolved, Maoist demands from businesses cease, and political uncertainties are resolved to create an environment for higher investment. Over the medium term, growth could be higher, if durable peace is established and key structural reforms are implemented, including in the core areas of tax administration, financial and

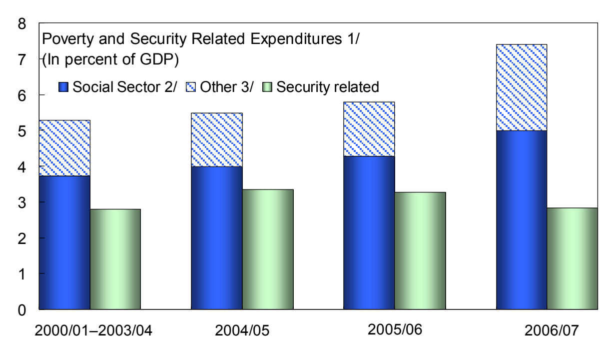
[5] In this context, the authorities have requested waivers for nonobservance of eight structural performance criteria (SPCs) related to: (i) implementation of a time-bound action plan to improve customs administration (two SPCs); (ii) full operationalization of the large taxpayer office in the Inland Revenue Department (two SPCs); (iii) implementation of a compulsory retirement scheme in the Nepal Rastra Bank; (iv) finalization of NRB's 2003/04 accounts by an international auditor; (v) finalization of 2003/04 accounts of the Nepal Oil Corporation (NOC) by an international auditor; and (vi) implementation of an automatic pricing mechanism for oil products. Actions related to SPCs (i)−(v) have now been implemented. For (vi), understandings have been reached on measures to reduce NOC losses and a revised time frame for introducing an automatic oil pricing mechanism (although a revised performance criterion has not been set).

public sectors, and governance (Table 8). With the exchange rate peg, underlying inflation should remain in the 5−6 percent range, comparable to Indian levels. As regards the balance of payments, continued strong remittances and higher aid flows are projected to offset trade deficits (in part due to higher imports as growth recovers) over the medium term and help maintain international reserve cover around 6 months of imports of goods and services.

9. **Risks exist to program implementation, and will dissipate only as the peace process gains further traction and political changes are in place**. The authorities candidly acknowledged that political considerations constrain the space for policy implementation. The eventual participation of the Maoists in the government is also likely to pose challenges. The Maoists have stated their commitment to private sector activity in their interactions with the Nepalese business groups and the international community, and they should be supportive of a number of PRSP policies, including higher social sector spending, transparency, and actions against large willful defaulters. Top Maoists leaders have also expressed publicly their willingness to work with multilateral institutions, as long as the policy agenda is driven by national priorities. However, their stance on specific policies remains unclear, and areas such as labor market reforms and privatization/liquidation of insolvent state-owned enterprises are expected to remain contentious for the foreseeable future.

B. Fiscal Policies

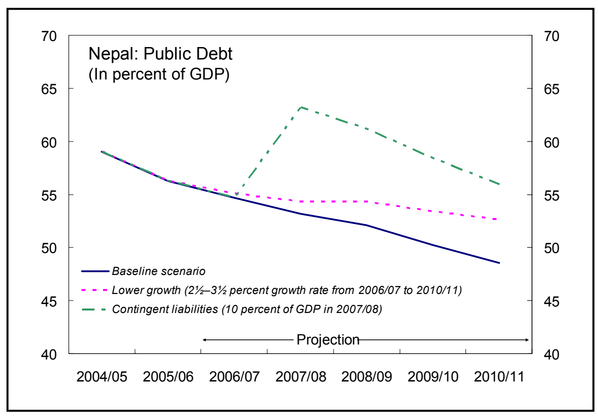
10. **The authorities have focused the 2006/07 budget on raising the level and improving the quality of public spending and raising the revenue-to-GDP ratio**. On the expenditure side, the budget makes provisions for a significant scaling up of social sector and public investment programs on health, education, and rural infrastructure, prioritized along the lines of the Medium Term Expenditure Framework. The allocation for security-related spending was reduced by ½ percent of GDP to 2¾ percent. Implementation capacity for increased local level investment remains weak, but is expected to be overcome partially by scaled-up grants for village development committees, where past experience with community and user groups' participation in project implementation has been favorable. On the revenue side, a rebound in activity and reduced supply disruptions are projected to boost revenue from 12¼ percent of GDP in 2005/06 to 13 percent of GDP in 2006/07 (collections for the first two months are provisionally estimated at 22 percent higher than the same period in 2004/05). A part of this increase would come from higher



Sources: FCGO and staff estimates.
1/ Data for 2006/07 is taken from the budget.
2/ Social sector includes health and education.
3/ Other includes drinking water and local development.

customs duty rates on selected imports and higher corporate and excise taxes on alcohol, beer, and cigarettes (about ⅓ percent of GDP). With the sharp rise in spending to meet development needs, only partly offset by revenue increases, the overall deficit (before grants) is expected to rise to 6¾ percent of GDP. External aid is projected to increase from 3¾ percent of GDP in 2005/06 to 6¼ percent, and the overall and domestically financed deficits (after grants) would be limited to 3 percent of GDP and 1½ percent of GDP, respectively. Notwithstanding these higher deficits compared to 2005/06, public debt is projected to remain on a downward trajectory over the medium term.

11. **Beyond 2006/07, the authorities intend to keep the budget focused on medium-term objectives**. These objectives are to raise resources to finance infrastructure and needed structural reforms while lowering the public debt-to-GDP ratio. A further increase in the revenue-to-GDP ratio to 13½ percent by 2008/09 is targeted from tighter administration and base broadening, including elimination of VAT exemptions and reducing customs and excise leakages. Spending on key social sector and infrastructure projects would rise as implementation capacity improves and security-related spending would be further curtailed as peace is reestablished. The overall and domestically financed deficits would be held to around 3 percent and 1½ percent of GDP, respectively. Sufficient room is provided for to meet the costs of reforms in the financial and public enterprise sectors. The bulk of these costs would be interest payments on recapitalization of insolvent commercial banks (the banks would be recapitalized with external assistance, most likely from the World Bank). In addition, the budget needs to provide for resolving outstanding liabilities of ailing state-owned enterprises. These costs are expected to be in the range of ¼–¾ percent of GDP. Excluding liabilities from financial sector and public enterprise reforms (expected to be in the range of 7−8 percent of GDP), the public debt-to-GDP ratio is projected to decline from 56¼ percent at end-2005/06 to around 50 percent over the medium term. In this context, the thrust of the debt sustainability analysis (DSA) presented in the 2005 Article IV staff report remains valid. While debt is projected to decline over the medium term, external vulnerabilities remain. Most external debt indicators remain below the policy-dependent indicative thresholds under the baseline scenario with the exception of NPV of debt-to-exports ratio (estimated at 165 percent at end-2005/06).[6]



[6] Debt Sustainability Analysis, IMF Country Report No. 06/44, Annex II. At that time, the NPV of debt-to-exports ratio was projected at 163¾ percent.

C. Monetary and Exchange Rate Policies

12. **The Nepal Rastra Bank (NRB) intends to maintain the exchange rate peg to the Indian rupee**. The peg reflects the substantial (and increasing) volume of current account transactions with India and has helped to anchor inflation expectations. The authorities also view the level of the peg as broadly appropriate notwithstanding the real exchange rate appreciation since early 2005 which reflects higher relative inflation in Nepal, as the real exchange rate has oscillated within 5 percent of its mean level between 2000 and mid-2006. In this context, the authorities agreed that structural reforms and infrastructure investments to reduce transportation and transactions costs (rather than changes in the level of the peg which have only a transitory effect on the real exchange rate) are key to improving external competitiveness. With this, broad money growth is projected at around 16 percent in 2006/07, assuming a small decline in velocity as confidence in the banking system improves and real GDP growth picks up to 3−4 percent. This would allow for real private credit growth of 8−9 percent, while accommodating the financing needs of the budget. The NRB intends to restrict reserve money growth to 16 percent and increase its net foreign assets by US$110 million (MEFP ¶10).

13. **Monetary management is complicated by growing liquidity in the financial system**. With estimated remittance inflows of around US$1½ billion in 2005/06, net foreign currency purchases to ease upward pressure on the exchange rate amounted to around US$300 million, with a substantial reduction in NRB T-bill holdings. Given the limited stock of T-bills remaining at the NRB's disposal, continued strong remittances and a pickup in aid inflows pose a significant challenge for monetary management in 2006/07. The mission suggested that the NRB could acquire an additional stock of T-bills from the Ministry of Finance to assist with liquidity management. The NRB could also explore additional policy options including allowing a larger volume of import payments to India to be made in convertible currencies (MEFP ¶11) and issuing NRB bills.

D. Structural Reforms

Fiscal Sector

14. **The authorities outlined a program of tax administration reform and their intention to enhance fiscal transparency**. With 2006/07 declared as a year to improve compliance, the focus of these measures will be on enhancing the operational efficiency of the Large Taxpayer Office (LTO) in the Inland Revenue Department and the Customs Department (Box 1). These measures include comprehensive audits of large taxpayers to strengthen enforcement, automation to improve taxpayer service, and computerization to step up data sharing within the revenue departments (MEFP ¶12). A significant rationalization of the tariff regime, including reductions in customs duties, consistent with WTO and other international commitments, will also be undertaken. As regards fiscal transparency, the government is committed to implementing recommendations made in the fiscal transparency

module of the IMF's Report on Standards and Codes. Specifically, the Fiscal Transparency Act is expected to be adopted in 2006/07 and a significant effort will be made to provide updated information on the financial condition of state-owned enterprises (MEFP ¶12).

Box 1. Nepal: Tax Administration Reforms

With the tax structure assessed as broadly appropriate, reform efforts are focused on "tidying up" and strengthening administration.[1/] To assist the authorities, bilateral donors (including DANIDA, GTZ, and USAID) and the IMF have made recommendations and provided technical assistance to address identified weaknesses.[2/][3/]

The reform program for 2006/07 envisages:

- **Large Taxpayer Office**: The LTO will conduct comprehensive audits, including of excise returns of large taxpayers on a quarterly basis.
- **Customs Department**: As part of its new three-year reform program, the department is committed to improve information sharing among offices by establishing a wide area network (WAN) between headquarters in Kathmandu and the five largest customs offices by mid-March 2007. Automated system for customs data (ASYCUDA) functionality is also to be improved with assistance from AsDB and UNCTAD. In addition, the department will streamline customs clearance procedures at the largest customs point in Birgunj. Finally, the government is committed to take steps to obtain parliamentary approval of an amended Customs Act to rationalize the tariff regime, in time to be included in the 2007/08 budget.
- **Inland Revenue Department**: To address excise leakages, the department is committed to fully operationalize the excise sticker regime. The IRD will target a reduction of the VAT nonfiling rate from the current level of over 20 percent to 12½ percent by end-2006/07. Regarding income tax, the IRD will make electronic tax deduction at source (ETDS) for all large taxpayers after mid-January 2007 and extend computerization at the large taxpayer and retail levels to reduce under-invoicing.

[1/] J. King, and others, 2003, *Nepal: Next Steps in Tax Reform*, IMF Fiscal Affairs Department.
[2/] G. Holland, and others, 2004, *Nepal: Practical Steps in Revenue Administration Reform*, IMF Fiscal Affairs Department.
[3/] G. Ludlow and G. Holland, 2006, *Nepal: Progress on Revenue Administration Reforms*, IMF Fiscal Affairs Department.

Financial Sector

15. **The authorities agreed that much remains to be done in four broad areas**. First, despite progress in strengthening the regulatory and legal framework, gaps remain (Box 2). This compromises the overall soundness of financial institutions.[7] The licensing policy, aimed at increasing banking penetration outside Kathmandu, also contributes to fragility through a proliferation of financial institutions (including so-called development banks and finance companies).[8] A regulatory framework to facilitate mergers and acquisitions has yet to be established. Second, the NRB needs to make progress in strengthening its supervisory capacity. Third, the high level of nonperforming loans (NPLs) of two state owned/controlled banks (Nepal Bank Limited and Rastriya Banijya Bank) continues to be problematic and impedes effective financial intermediation.[9] Fourth, despite improvements in the legal framework and progress in loan recovery from small and medium size defaulters, loan recoveries from large, willful defaulters remain limited. In particular, defaulters have been able to use the judicial process to stall recoveries.

16. **Reflecting these priorities, the authorities' financial sector reform program for 2006/07 includes the following**:

- To improve the legal framework, facilitate consolidation, and strengthen the integrity of the financial system, the Banking and Financial Institutions Act (BFIA) will be revised, the NRB will provide guidelines for mergers and acquisitions, and an Anti-Money Laundering Act will be presented to Parliament (MEFP ¶13). The GON and NRB have made a public commitment to take action against willful defaulters, and penalties were specified through BFIA amendments in September 2006. The authorities are also committed to exploring stricter measures if these penalties (passport seizures and restricted access to government services) are unsuccessful in furthering loan recoveries.

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[7] Overall, at end-2005/06, 6 banks, 8 development banks, and 24 finance companies did not meet the minimum capital adequacy requirements, which were recently rolled back from 12 percent to 11 percent.

[8] These institutions are similar to commercial banks in their deposit and loan portfolios, but face lighter regulatory and capital requirements. Despite this, their NPL ratios show a rising trend, in part due to the recent deterioration in the investment climate.

[9] NBL and RBB represent more than half of banking system assets, and half of their loan portfolio is nonperforming. The negative net worth of NBL and RBB at end-2005/06 was Nrs. 6½ billion and Nrs. 18½ billion, respectively.

Box 2. Nepal: Financial Sector Reforms

Financial sector reforms in Nepal have focused on three main areas—improvements in the legal framework, strengthening the NRB, and restructuring of insolvent state-owned commercial and development banks. These reforms have been assisted by the World Bank through the Financial Sector Restructuring Program and by the Asian Development Bank. Progress has been made in these areas, including in the context of the PRGF arrangement. However, additional areas of concern have emerged which need to be addressed:

- **The multi-tiered licensing policy of the NRB provides opportunities for regulatory arbitrage and is a potential source of vulnerability**. In addition to 17 commercial banks, the NRB supervises 164 other financial institutions, including development banks, rural development banks, and finance companies. These latter institutions require a lower minimum capital and are supervised separately even though they can do the same business as commercial banks (including taking public deposits). In recent years, there has been a rapid increase in their numbers, with 15 new development banks commencing operations in the last three years. While these banks were set up to deepen financial access outside the Kathmandu valley, their relatively low asset growth could undermine this goal and contribute instead to further fragmentation of the banking system.

Nepal: Financial Institutions

	Banks			Development Banks			Finance Companies		
	Number	Assets		Number	Assets		Number	Assets	
		Nrs. billion	Percent change		Nrs. billion	Percent change		Nrs. billion	Percent change
January 2004	17	318.7	...	14	51.7	...	58	23.9	...
January 2006	17	431.0	35.2	29	57.8	11.8	63	33.8	41.4

Source: Nepal Rastra Bank.

- **Weaknesses are appearing in private commercial banks and other financial institutions as well**. Four private commercial banks did not meet capital adequacy requirements at end-2005/06, and three had NPLs in double digits. Many banks are closely held by promoter-led groups, and insider lending and multiple banking are sources of problems in the troubled banks. In addition, 8 development banks and 24 finance companies did not meet capital adequacy requirements at the end of first quarter of 2005/06, and two had negative net worth. The NPL ratio for both categories of institutions has displayed a rising trend over the past three years.

As Nepal heads towards 2010 when it would need to meet obligations to further liberalize the financial sector under WTO commitments, the reform agenda is extensive.

- **Amendments to the Banking and Financial Institutions Act are required to strengthen the legal and regulatory framework**. The authorities anticipate that the process of consolidation in the system will be facilitated by the planned move to Basel II in 2008 and the potential entry of foreign banks in 2010 under WTO commitments (at present only joint ventures are permitted). The existing system of creating different classes of banks needs to be reexamined. In addition to the application of "fit and proper" principles, business viability and ability to provide capital support should be taken into account while licensing all deposit-taking institutions.
- **Ongoing efforts to strengthen the supervisory system—on-site and off-site—need to be continued, with a focus on improving risk management practices in banks**. This needs to be supplemented with an enforcement regime which takes quick and decisive corrective action to ensure that banks meet prudential norms. In preparation for Basel II implementation and entry of foreign banks, NRB should benchmark its supervisory system against international best practice by conducting a detailed self-assessment against the Basel Core Principles of Effective Banking Supervision, and identify and address remaining gaps in its framework. A priority in this regard is strengthening capacity for risk assessment and early detection of weaknesses in the banking system. To ensure effective supervision of diverse financial institutions, delays in reporting and processing of off-site data should be eliminated.
- **The NRB needs to create a framework to facilitate resolution and transformation of financial institutions through exit, mergers and acquisitions**. This will facilitate consolidation in the banking system and promote the creation of well-capitalized banks able to withstand international competition.

- NRB "reengineering" plans focused on eliminating noncore functions, improving supervision over the financial system, and achieving compliance with international reporting standards. Understandings reached with the NRB under the arrangement include divestment of its shareholdings in selected financial institutions, a self-assessment against Basle Core Principles for Effective Bank Supervision, improved risk assessment and reporting in the financial system, and an international audit of its 2005/06 accounts.

- Steps for further restructuring of insolvent commercial and developments banks. The GON and NRB remain committed to restructuring of NBL and RBB under external management teams, to assist with loan recoveries, and to make preparations for privatization of the banks, with financial assistance from the World Bank under the Financial Sector Restructuring Program. To this end, the process of appointing privatization advisors for NBL is already underway and preliminary discussions on its recapitalization needs have been held.[10]

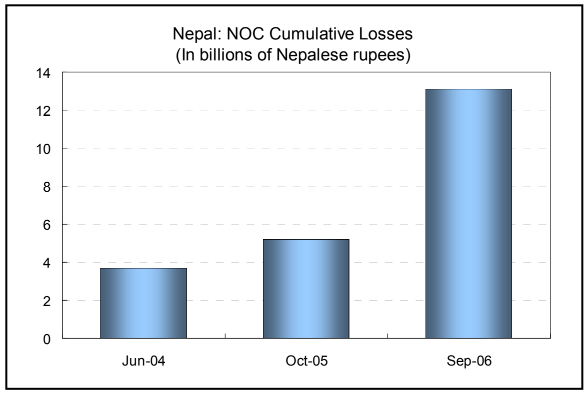
Nepal Oil Corporation and the Oil Sector

17. **Failure to raise domestic prices on a timely basis and operational inefficiencies have led to substantial losses for NOC**. In September 2006, these accumulated losses stood at Nrs. 13 billion (2¼ percent of GDP). Notwithstanding price increases of 20−70 percent during the period January 2005 to May 2006, NOC has continued to make losses due to delays in raising prices to cover supply and other costs (Box 3). In addition, NOC suffers from operational inefficiencies. To address these issues, the GON's Acharya committee has recommended corrective actions, including gradual increase in prices to eliminate flow losses. In this context, aviation fuel prices were raised in September and the draft Petroleum Sale and Distribution Act to liberalize the oil sector and further increase private sector participation was approved by the cabinet in October 2006. Price increases for other products have also been recommended and discussions are underway with Indian Oil Corporation to convert the suppliers' credits into a concessional loan. The government will cover additional flow losses transparently until such time as prices are raised to break even levels. These flow losses are projected at Nrs. 4−7 billion (¾−1 percent of GDP), and would add to the projected public debt to GDP ratio. Once flow losses are eliminated through price increases, an automatic pricing mechanism for oil products is to be introduced which would help increase private sector participation in the sector.

[10] Given the ongoing debate on the merits and modalities of asset management companies to help resolve NPLs in Nepal and the creation of asset resolution units within NBL and RBB, the structural benchmark for the third review (cabinet approval of asset management companies ordinance) has been dropped.

Box 3. Nepal: Nepal Oil Corporation Losses and Oil Pricing

With the steady rise in international oil prices and less than full pass through, Nepal Oil Corporation (NOC) has accumulated losses since December 2003. At mid-September, 2006 these losses stood at Nrs. 13 billion (2¼ percent of GDP). Of this, the bulk has been financed through supplier's credits from Indian Oil Corporation (IOC)—NOC's sole supplier. The remainder has been financed through domestic commercial bank borrowings and from the budget. Although domestic prices were raised by 20−70 percent during the period January 2005-May 2006, the increases were insufficient to eliminate flow losses.



With domestic prices of petroleum products insufficient to cover supply and other costs, NOC continues to make flow losses. NOC's monthly losses in September 2006 were Nrs. 640 million (1 percent of GDP on an annualized basis). Domestic prices are currently 20–45 percent below break even levels. The NOC also suffers from operational inefficiencies. Studies commissioned by the government suggest that NOC could reduce its handling losses (shrinkage allowance), and overhead costs by improving productivity.

Nepal: Pricing of Petroleum Products and NOC Losses1/

Product	Profit Per Liter (Nrs.)	Monthly Profits (Nrs. millions)	Share of Monthly Loss	Necessary Price Increase (In percent)
Petrol	-1.6	-11.4	1.8	2.8
Diesel	-8.6	-243.9	38.1	19.3
Kerosene	-10.5	-243.5	38.1	23.0
LPG 2/	-311.7	-175.6	27.4	43.4
Avation fuel	5.2	34.6	-5.4	0.0
Total loss	---	-639.8	100.0	---

Sources: Nepal Oil Corporation; and staff estimates.

1/ Ex-depot selling price in Kathmandu as of September 15, 2006.
2/ Per cylinder.

Successive expert committees have recommended reform measures for the oil sector and NOC. The latest of these is the Acharya Committee, which submitted its report to the government in September 2006. The main recommendations relate to: (i) timely price increases for oil prices to stem flow losses; (ii) depoliticization of price increases through the introduction of an automatic pricing mechanism; (iii) improving the operational efficiency of NOC; and (iv) greater private sector participation in the oil sector.

The government's program for 2006/07 envisages implementation of measures to reduce flow NOC losses to zero by mid-July 2007 and making provisions to finance flow losses during this period, while resolving the stock of suppliers' credits in discussions with IOC.

IV. HIPC/MDRI INITIATIVES

18. **The authorities remain ambivalent about participation in the HIPC initiative for which Nepal has been assessed to be eligible**. While recognizing that debt relief under the initiatives (especially the MDRI) could be substantial, their principal concern is a possible reduction in aid flows from key bilateral donors, so the authorities are weighing the costs and benefits of debt relief.

V. PROGRAM MONITORING

19. **The program will be monitored through semi-annual reviews for which quantitative and structural performance criteria have been proposed**. The authorities are requesting completion of the second and third reviews at this time, and extension of the arrangement by one year to November 2007 to implement understandings reached under the arrangement. In addition, they have requested that the remaining amount under the arrangement be rephased into two equal disbursements associated with fourth and fifth reviews (Table 9).

VI. STAFF APPRAISAL

20. **The achievement of durable peace would create conditions for higher, sustained growth and poverty reduction**. The economy has remained resilient in recent years, despite political uncertainties and an unsettled security environment, and macroeconomic stability has been maintained. In 2006/07, a modest increase in real GDP growth can be expected, especially as tourism and transportation rebound. In addition, manufacturing could revive if the cost of doing business can be reduced by resolving labor disputes and eliminating extortions from businesses. Over the medium term, Nepal could achieve growth rates upwards of 5 percent if there is continued macroeconomic stability and structural reforms are implemented in key areas, including the financial sector, public enterprises, and governance.

21. **Prudent fiscal policies and reforms remain key to maintaining macroeconomic stability and to achieving PRSP/PRGF objectives**. In this context, the 2006/07 budget—with its focus on social sectors and infrastructure spending in rural areas, a higher targeted revenue-to-GDP ratio, and low domestic financing—strikes the appropriate balance between being fiscally responsible while being responsive to development needs. Improvements in tax administration are key to raising the revenue-to-GDP ratio over the medium term by plugging leakages, broadening the tax base, and improving taxpayer services. Over the medium term, the budget should remain focused on raising revenue, reducing security-related spending, and mobilizing adequate external assistance to step up expenditure on social sectors and infrastructure, while placing the public debt to GDP ratio on a downward trajectory. Liabilities arising from financial sector and public enterprise reforms should be financed with external assistance. Staff welcomes the steps that the GON intends to take to increase fiscal transparency.

22. **Maintaining the exchange rate peg is appropriate and policies are geared to supporting this arrangement**. In 2006/07, coordinated efforts by the NRB and the MOF to place additional T-bills at the disposal of the NRB and possible liberalization of import payments mechanism with India are required for effective monetary management.

23. **Financial sector reforms have advanced in recent years, but much remains to be accomplished**. Improvements in the legal framework would set the stage for meeting WTO commitments to financial liberalization in 2010, facilitating consolidation, and raising financial sector integrity. Improving NRB supervision over the financial sector is an essential element of these reforms. The NRB's planned divestment in financial institutions would help free resources for core functions and help meet international reporting standards. Further steps are needed to improve the financial condition of NBL and RBB for their eventual privatization. Substantially increasing loan recovery from large, willful defaulters is critical to a timely resolution of the banks' nonperforming portfolio and to ensure that the banks can be privatized early and at low cost to the budget.

24. **NOC losses need to be addressed and steps taken to improve efficiency in the oil sector**. In this context, staff looks forward to implementation of the Acharya Committee recommendations and passage of the Petroleum Sales and Distribution Act. The increment in the public debt to GDP ratio from flow losses would be manageable over the medium term. Staff also urges the GON to take steps to reduce inefficiencies in NOC, including through greater private sector participation in the oil sector.

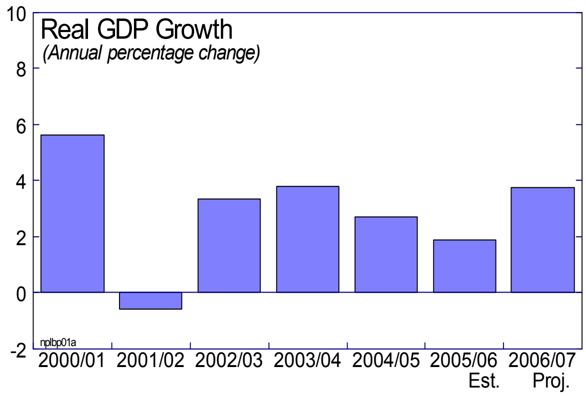
25. **Prospects for implementing the 2006/07 program are fair**. The government is composed of a coalition of political parties that have steered PRSP reforms in the past and is strongly committed to PRSP/PRGF reforms. Efforts have also been made by the government, donors, and civil society to persuade the Maoists that the PRSP reform agenda is in the best interest of Nepal. With these efforts and the program crafted to address macrocritical issues, it should be possible to garner a consensus on the reform agenda, especially as progress is made on political issues. The primary risk is that implementation of program measures could be delayed owing to difficulties in reaching a political consensus. The staff considers the risks to program implementation acceptable in view of the authorities' demonstrated commitment to reforms. The staff encourages the authorities to persevere with their efforts.

26. **The authorities' efforts and achievements—continued macroeconomic stability and further progress in structural reforms in 2006 under trying circumstances—merit international support**. With respect to the multiple waivers requested for completion of the second and third reviews, the nonobservance of the quantitative performance criterion on NFA of the NRB was minor. Non-observance of seven structural performance criteria was temporary. For the eighth structural performance criterion (which relates to the automatic pricing mechanism for oil products that was not observed and on which no further performance criterion is proposed), corrective actions have been taken by the authorities raising oil prices by 20−70 percent. Together with understandings reached on further

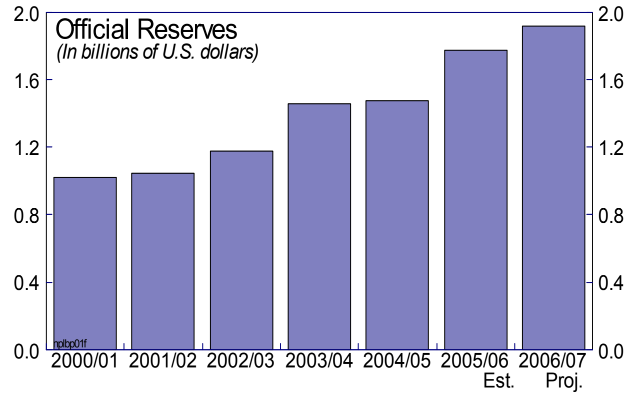
measures to address NOC losses (including price increases) and the introduction of an automatic pricing mechanism for oil products to meet program objectives, staff recommends approval of the authorities' request for waivers for nonobservance of performance criteria, completion of second and third reviews, and extension of the arrangement by one year to November 18, 2007.

Figure 1. Nepal: Economic Developments and Prospects

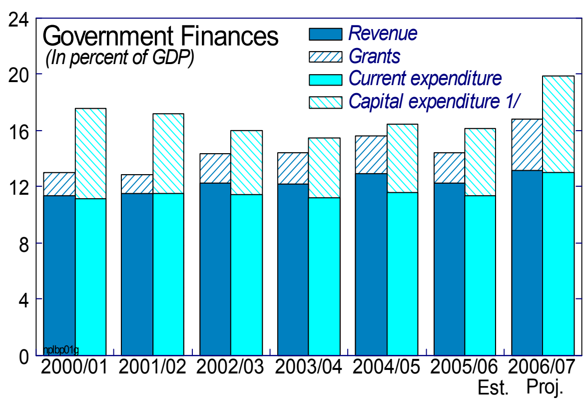
Nepal's growth prospects are expected to improve...



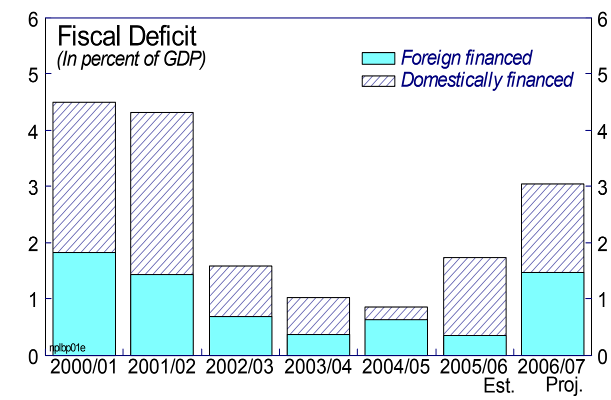
... and international reserves should remain at adequate levels.



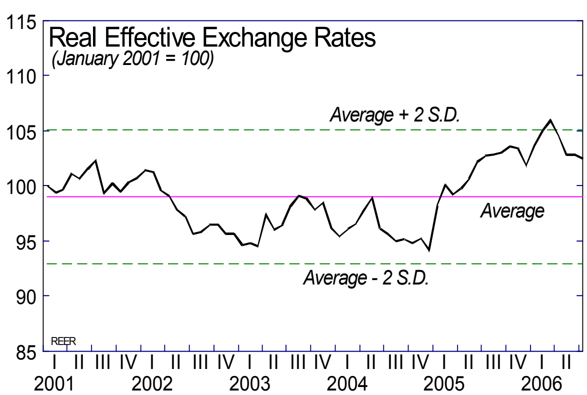
Revenue mobilization and development spending are expected to increase...



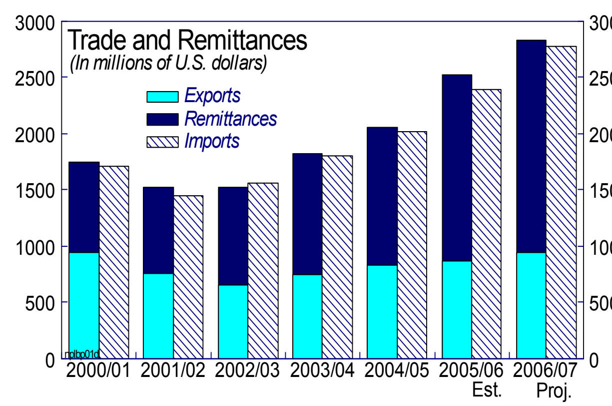
... and the overall and domestically financed deficits should remain contained.



The real effective exchange rate has remained broadly stable.



Remittance inflows are expected to stay strong, offsetting weak export growth and higher imports.



Sources: Nepalese authorities; IMF, *International Financial Statistics*; and staff estimates.
1/ Includes net lending.

Table 1. Nepal: Selected Economic Indicators, 2001/02–2008/09 1/

Nominal GDP (2004/05): US$7,477 million
Population (2004/05): 25.2 million
GDP per capita (2004/05): US$296.7
Poverty rate: 31 percent (2003/04)
Main exports: Textiles and clothing
Quota: SDR 71.3 million

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
					Est.		Projection	
	(Percent change)							
Real GDP at market prices	-0.6	3.3	3.8	2.7	1.9	3.7	4.5	5.0
CPI (12-month change)	3.5	6.1	2.0	6.6	8.3	8.3	5.0	5.4
CPI (period average)	2.9	4.7	4.0	4.5	8.0	8.3	6.0	5.2
GDP deflator	3.4	4.5	4.8	4.6	7.2	6.5	6.0	5.5
Fiscal indicators	(In percent of GDP)							
Total revenue	11.5	12.3	12.2	12.9	12.2	13.1	13.3	13.5
Total expenditure	17.2	16.0	15.5	16.5	16.2	19.9	19.5	19.5
Current expenditure	11.5	11.4	11.2	11.6	11.4	13.0	12.5	12.4
Capital expenditure and net lending	5.6	4.6	4.3	4.9	4.8	6.8	7.0	7.2
Overall deficit before grants	5.7	3.7	3.3	3.5	3.9	6.7	6.1	6.0
Overall deficit after grants	4.3	1.6	1.0	0.8	1.7	3.0	3.1	3.1
Domestic financing (net)	2.9	0.9	0.6	0.2	1.4	1.6	1.4	1.3
Public debt	69.5	66.5	65.2	59.0	56.2	54.7	53.2	51.8
Money and credit	(Percent change, end-of-period)							
Broad money	4.4	9.8	12.8	8.3	15.6	16.0	…	…
Domestic credit	8.7	12.0	9.8	13.9	8.8	15.3	…	…
Velocity	1.9	1.9	1.8	1.8	1.6	1.6	…	…
Interest rates	(In percent)							
91-day treasury bill (end-of-period)	3.8	3.0	1.5	3.9	3.3	…	…	…
Central bank refinancing	2–5½	2–5½	2–5½	1½–5½	1½–6¼	…	…	…
Loans to industry	7–14½	8½–14	8½–13½	8¼–13½	8–13½	…	…	…
Balance of payments	(In millions of U.S. dollars)							
Current account balance (excluding official transfers)	106	16	59	-19	45	16	-6	-42
In percent of GDP	1.9	0.3	0.9	-0.3	0.6	0.2	-0.1	-0.4
Trade balance	-694	-904	-1,053	-1,190	-1,526	-1,838	-2,019	-2,204
In percent of GDP	-12.6	-15.4	-15.6	-16.1	-19.1	-21.2	-21.4	-21.5
Foreign direct investment	-3.7	12.4	1.9	1.9	-6.5	26.8	30.8	35.4
In percent of GDP	-0.1	0.2	0.0	0.0	-0.1	0.3	0.3	0.3
Gross official reserves (end-of-period)	1,048	1,178	1,457	1,478	1,774	1,920	2,015	2,088
In months of imports of goods and services	7.0	6.6	7.3	6.2	6.5	6.4	6.1	5.9
Export value growth 2/	-18.4	5.6	14.7	11.2	4.0	8.5	12.9	12.4
Import value growth	-15.3	7.5	15.8	12.3	18.3	16.1	10.9	10.3
External debt/GDP (in percent) 3/	53.4	52.6	51.2	45.8	43.0	41.6	40.3	39.2
Debt service 4/	4.9	5.0	4.5	4.5	4.2	3.5	3.5	3.4
Exchange rate (Nrs per U.S. dollar, end-of-period)	78.3	75.1	74.5	70.7	74.4	...	...	...
REER (end-of-period; percent change; negative = depreciation)	-6.5	2.7	-2.6	7.4	-0.2	...	...	...
NEER (end-of-period; percent change)	-8.4	-1.2	-0.6	3.3	-5.5	...	...	...
Fund operations (outstanding loans at end-of-period; SDR millions)								
SAF/ESAF/PRGF	4.5	1.7	7.1	14.3	14.3	...	...	...
Nominal GDP at market prices (Nrs billions)	422.8	456.7	496.7	533.5	582.9	643.9	713.0	790.2

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

1/ Fiscal year begins mid-July.
2/ Excluding re-exports.
3/ Includes estimated short-term trade credits.
4/ In percent of exports of goods, services, and private transfers; including debt service to the Fund.

Table 2. Nepal: Summary of Government Operations, 2004/05–2008/09 1/

	2004/05			2005/06		2006/07	2007/08	2008/09
	Budget/ program	Revised budget	Outcome	Budget	Est. Jul.	Budget	Proj.	
				(In billions of Nepalese rupees)				
Total revenue and grants	83.7	87.3	83.3	98.9	84.1	108.2	116.6	129.6
Total revenue	68.3	71.9	68.9	80.3	71.2	84.5	95.1	106.6
Tax revenue	53.8	56.0	54.1	63.9	58.2	69.9	78.0	86.9
Nontax revenue 2/	14.6	16.0	14.8	16.4	13.1	14.5	17.1	19.7
Grants	15.4	15.4	14.4	18.7	12.9	23.7	21.5	23.0
Total expenditure	97.2	100.8	87.8	111.5	94.2	127.8	138.8	154.4
Current	67.6	70.1	61.7	75.9	66.3	83.8	89.0	97.9
Of which : interest payments	7.6	7.6	6.2	7.4	6.2	7.9	9.3	10.0
Capital and net lending	29.6	30.7	26.1	35.7	28.0	44.1	49.8	56.5
Overall balance before grants	-28.9	-28.9	-18.9	-31.3	-23.0	-43.4	-43.7	-47.8
Overall balance after grants	-13.5	-13.5	-4.5	-12.6	-10.2	-19.6	-22.2	-24.8
Financing	13.5	13.5	4.5	12.6	10.2	19.6	22.2	24.8
Net foreign loans	10.0	10.0	3.3	8.0	2.0	9.4	12.1	14.4
Gross disbursements	17.0	17.0	9.3	14.5	9.0	16.9	20.0	22.8
Amortization	7.0	7.0	6.0	6.5	7.0	7.5	7.9	8.4
Net domestic financing	3.5	3.5	1.2	4.6	8.1	10.2	10.2	10.4
Net NRB financing	0.5	...	1.7	...	-0.7	...	...	...
Net commercial bank	2.5	...	4.8	...	9.9	...	...	...
Net nonbank	0.5	...	-5.3	...	-1.1	...	...	...
				(In percent of GDP)				
Total revenue	12.7	13.3	12.9	13.6	12.2	13.1	13.3	13.5
Tax revenue	10.0	10.4	10.1	10.8	10.0	10.9	10.9	11.0
Nontax revenue 2/	2.7	3.0	2.8	2.8	2.2	2.3	2.4	2.5
Grants	2.8	2.8	2.7	3.2	2.2	3.7	3.0	2.9
Total expenditure	18.0	18.7	16.5	18.9	16.2	19.9	19.5	19.5
Current	12.5	13.0	11.6	12.8	11.4	13.0	12.5	12.4
Of which : interest payments	1.4	1.4	1.2	1.3	1.1	1.2	1.3	1.3
Capital and net lending	5.5	5.7	4.9	6.0	4.8	6.8	7.0	7.2
Overall balance before grants	-5.3	-5.3	-3.5	-5.3	-3.9	-6.7	-6.1	-6.0
Overall balance after grants	-2.5	-2.5	-0.8	-2.1	-1.7	-3.0	-3.1	-3.1
Financing	2.5	2.5	0.8	2.1	1.7	3.0	3.1	3.1
Net foreign loans	1.8	1.8	0.6	1.4	0.3	1.5	1.7	1.8
Gross disbursements	3.1	3.1	1.7	2.5	1.5	2.6	2.8	2.9
Amortization	1.3	1.3	1.1	1.1	1.2	1.2	1.1	1.1
Net domestic financing	0.7	0.7	0.2	0.8	1.4	1.6	1.4	1.3
Central bank financing	0.1	...	0.3	...	-0.1	...	...	...
Commercial bank financing	0.5	...	0.9	...	1.7	...	...	...
Nonbank financing	0.1	...	-1.0	...	-0.2	...	...	...
Memorandum items:								
Public savings	0.1	0.3	1.3	0.7	0.8	0.1	0.9	1.1
Primary balance	-1.1	-1.1	0.3	-0.9	-0.7	-1.8	-1.8	-1.9
Debt service	3.7	3.7	3.7	3.6	3.5	3.6	3.5	3.5
Domestic	1.9	1.9	2.2	2.1	1.9	1.9	1.9	1.8
Foreign	1.8	1.8	1.5	1.5	1.6	1.7	1.7	1.6
Public debt	60.0	60.0	59.0	59.2	56.2	54.7	53.2	51.8
Domestic	15.6	15.6	16.1	15.1	16.2	16.2	16.1	15.8
External	44.3	44.3	42.9	44.1	40.1	38.5	37.1	35.9
Education expenditure	3.3	3.3	3.2	3.6	...	3.5	...	...
Health expenditure	1.2	1.2	0.9	1.3	...	1.4	...	...
Nominal GDP (Nrs. billions)	539.9	539.9	533.5	590.8	582.9	643.9	713.0	790.2

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

1/ Fiscal years start mid-July. Table confined to central government operations as contained in the budget.
2/ Includes privatization receipts.

Table 3. Nepal: Monetary Accounts, 2003/04–2006/07

	2003/04	2004/05	2005/06	2006/07			
	Jul.	Jul.	Jul.	Oct.	Jan.	Apr.	Jul.
			Est.	Proj.	Proj.	Proj.	Proj.
Monetary authorities	(In billions of Nepalese rupees)						
Reserve money	94.4	96.5	110.1	112.9	117.4	120.8	127.7
Net foreign assets	108.2	103.9	131.6	133.9	136.1	138.4	141.4
Net domestic assets	-13.8	-7.3	-21.5	-21.0	-18.7	-17.6	-13.7
	(Annual percentage change)						
Reserve money	16.6	2.2	14.0	20.7	22.4	21.3	16.0
	(Change in percent of reserve money at start of period)						
Reserve money	16.6	2.2	14.0	20.7	22.4	21.3	16.0
Net foreign assets	25.4	-4.6	28.7	32.6	25.8	23.9	8.9
Net domestic assets	-8.8	6.9	-14.7	-11.9	-3.5	-2.6	7.1
Monetary survey	(In billions of Nepalese rupees)						
Broad money	277.3	300.4	347.2	351.8	368.0	381.4	402.8
Narrow money	94.0	100.2	114.2	115.0	117.0	123.7	130.9
Quasi money 1/	183.3	200.2	233.0	236.9	251.0	257.8	271.8
Net foreign assets	108.8	107.7	139.4	142.6	145.2	148.2	152.4
Net domestic assets	168.5	192.7	207.8	209.3	222.8	233.2	250.4
Domestic credit 1/	246.0	280.2	304.9	312.1	326.9	340.8	351.6
Public sector	60.3	70.5	77.6	79.6	82.3	85.0	87.6
Government 2/	57.4	63.9	73.1	75.1	77.8	80.5	83.1
Public enterprises	2.9	6.6	4.5	4.5	4.5	4.5	4.5
Private sector	185.7	209.7	227.2	232.4	244.6	255.8	264.0
Other items, net	-77.5	-87.5	-97.0	-102.8	-104.2	-107.6	-101.3
	(Annual percentage change)						
Broad money	12.8	8.3	15.6	13.9	14.9	15.8	16.0
Narrow money	12.2	6.6	13.9	12.4	12.9	13.9	14.7
Quasi money	13.1	9.2	16.4	14.6	15.8	16.7	16.6
Domestic credit	9.8	13.9	8.8	8.1	11.2	11.4	15.3
Public sector	-1.6	16.8	10.1	12.6	19.9	19.0	12.9
Government 2/	-1.8	11.3	14.5	15.9	23.0	23.1	13.7
Private sector credit	14.2	12.9	8.3	6.6	8.5	9.0	16.2
	(12-month change in percent of broad money at start of period)						
Broad money	12.8	8.3	15.6	13.9	14.9	15.8	16.0
Net foreign assets	7.1	-0.4	10.5	9.6	7.9	6.6	3.7
Net domestic assets	5.7	8.7	5.0	4.3	7.0	9.2	12.3
Domestic credit	9.0	12.3	8.2	7.6	10.2	10.5	13.5
Private sector	9.4	8.7	5.8	4.7	6.0	6.4	10.6
Memorandum items:							
Velocity of broad money	1.79	1.78	1.63	…	…	…	1.60
Broad money multiplier	2.94	3.11	3.15	3.12	3.13	3.16	3.15

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

1/ Commercial bank data are subject to revisions due to reporting lags.
2/ Central Government, adjusted for local government deposits.

Table 4. Nepal: Balance of Payments, 2000/01–2010/11

10/18/06 17:46	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
						Est.			Projection		
					(In millions of U.S. dollars, unless otherwise stated)						
Current account	270	249	150	200	160	190	335	278	256	181	93
Current account (excluding official transfers)	162	106	16	59	-19	45	16	-6	-42	-131	-220
Trade balance	-765	-694	-904	-1053	-1190	-1526	-1838	-2019	-2204	-2371	-2538
Exports, f.o.b.	945	754	653	748	832	865	939	1,059	1,190	1,331	1,482
Merchandise exports	758	618	653	748	832	865	939	1,059	1,190	1,331	1,482
Re-exports of oil 1/	187	136	0	0	0	0	0	0	0	0	0
Imports, f.o.b.	1,710	1,448	1,556	1,801	2,022	2,392	2,777	3,078	3,394	3,702	4,020
Oil products	338	288	242	273	370	465	540	559	568	582	606
Other imports	1,372	1,160	1,314	1,528	1,652	1,926	2,237	2,519	2,827	3,120	3,414
Services (net)	123	64	93	125	-28	-94	-59	-29	-27	-9	11
Receipts	404	319	341	465	361	366	451	483	518	556	598
Of which : tourism	159	113	151	246	145	132	192	212	235	260	288
Payments	281	255	248	340	389	459	509	512	544	565	586
Income	23	-8	-10	-23	23	68	97	101	105	109	113
Credit	74	56	58	52	108	158	178	183	188	194	200
Debit	51	64	68	75	85	90	81	82	84	85	87
Current transfers	889	887	971	1,151	1,356	1,742	2,135	2,225	2,382	2,452	2,507
Credit, *of which:*	908	913	1,000	1,209	1,405	1,807	2,208	2,305	2,470	2,549	2,614
General government 2/	108	143	135	141	180	145	319	284	298	312	312
Workers remittances	640	618	697	795	910	1,349	1,568	1,702	1,849	1,911	1,974
Recorded	130	165	234	381	607	1,177	1,395	1,545	1,712	1,806	1,906
Estimated	510	453	463	414	302	172	173	157	136	104	68
Debit	19	26	29	58	48	65	73	80	88	97	107
Capital account	84	74	69	20	22	43	46	50	55	60	65
Capital transfers	84	74	69	20	22	43	46	50	55	60	65
Of which : official grants	58	48	42	20	22	43	46	50	55	60	60
Financial account	-416	-426	-172	-298	-431	-61	-281	-323	-286	-215	-108
Direct investment	0	-4	12	2	2	-7	27	31	35	41	47
Portfolio investment	0	0	0	0	0	0	0	0	0	0	0
Other investment (net) 3/	-415	-422	-184	-300	-433	-54	-308	-353	-321	-256	-154
Of which : loans	102	39	40	37	46	28	128	160	186	202	214
Disbursements	163	105	111	115	128	124	228	264	296	318	331
Amortization	61	66	71	78	82	96	100	105	109	116	117
Errors and omissions 3/	100	143	84	285	259	126	0	0	0	0	0
Overall balance	38	41	132	206	10	298	101	5	25	25	50
Financing	-38	-41	-132	-206	-10	-298	-146	-95	-75	-65	-50
Change in reserve assets (-=increase)	-75	-28	-129	-279	-21	-296	-146	-95	-73	-61	-46
IMF purchases (net)	-5	-4	-4	8	11	0	0	0	-2	-4	-4
Other liabilities	42	-8	1	65	0	0	0	0	0	0	0
Exceptional financing	0.3	0.3	0.3	0.3	0.5	-1.7	0.0	0.0	0.0	0.0	0.0
Arrears to Austria (+ increase)	0.3	0.3	0.3	0.3	0.3	-1.5	0.0	0.0	0.0	0.0	0.0
Arrears to Belgium (+ increase)	0.0	0.0	0.0	0.0	0.2	-0.2	0.0	0.0	0.0	0.0	0.0
Financing gap 4/	…	…	…	…	…	…	45	90	50	40	0
Of which:											
IMF	…	…	…	…	…	…	36	15	0	0	0
					(In percent of GDP, unless otherwise stated)						
Memorandum items:											
Current account (excluding official transfers)	2.9	1.9	0.3	0.9	-0.3	0.6	0.2	-0.1	-0.4	-1.2	-1.8
Current account (including official transfers)	4.9	4.5	2.6	3.0	2.2	2.4	3.9	2.9	2.5	1.6	0.8
Total external debt 5/	50.1	53.4	52.6	51.2	45.8	43.0	41.6	40.3	39.2	38.2	37.2
Total PPG external debt	47.3	51.1	49.3	48.3	42.9	40.1	38.5	37.1	35.9	34.8	33.7
PPG debt service 6/	7.2	9.4	9.6	9.7	9.4	10.0	9.5	9.0	8.7	8.5	8.0
Debt service 7/	4.2	4.9	5.0	4.5	4.5	4.2	3.5	3.5	3.4	3.4	3.2
Stock of arrears (in millions of U.S. dollars)	0.3	0.6	0.9	1.2	1.7	0.0	0.0	0.0	0.0	0.0	0.0
Gross foreign assets (end of period)	1,423	1,371	1,462	1,772	1,853	2,205	2,400	2,516	2,598	2,669	2,725
Of which : central bank	1,020	1,048	1,178	1,457	1,478	1,774	1,920	2,015	2,088	2,149	2,195
(In months of imports of goods and services)	7.2	7.0	6.6	7.3	6.2	6.5	6.4	6.1	5.9	5.5	5.3
Nominal GDP (in millions of U.S. dollars)	5,564	5,501	5,870	6,732	7,391	8,009	8,667	9,420	10,247	11,142	12,116

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

1/ Nepal used to buy oil in the international market and re-export it to India for refinery. This activity ceased due to deterioration in NOC finances.
2/ Includes estimated NGO transfers.
3/ Large other investments and errors and omissions reflect data weaknesses in capital account, unreported remittances and informal trade.
4/ The financing gap in 2006/07 is expected to be closed through PRGF resources and support by MDB's, most notably the World Bank.
5/ Includes estimated private sector debt and short-term trade credits.
6/ As a ratio of exports of goods and services (excluding reexports of oil).
7/ As a ratio of exports of goods and services (excluding re-exports of oil) and private transfer and income receipts.

Table 5. Quantitative Performance Criteria and Indicative Targets

(In billions of Nepalese rupees; unless otherwise stated)

	Oct 16, 2004 PC	Jan 13, 2005 PC	Apr 13, 2005 IT	July 15, 2005 IT
Performance criteria (PC) and indicative targets (IT) 1/				
I. Floor on net foreign assets of the NRB		(In millions of U.S. dollars)		
1. IMF Country Report No. 04/329 2/	1,459.6	1,489.6	1,514.6	1,544.6
2. Adjusted 3/	1,461.1	1,492.6	1,518.4	1,493.8
3. Actual 4/	1,448.9	1,496.9	1,493.5	1,478.4
II. Ceiling on net domestic assets of the NRB				
1. IMF Country Report No. 04/329 5/	-20.1	-22.6	-16.1	-14.2
2. Adjusted 6/	-20.2	-22.8	-16.4	-10.4
3. Actual 7/	-20.4	-26.2	-18.9	-14.3
III. Ceiling on change in net domestic financing of central government budget. Cumulative from July 15, 2004				
1. IMF Country Report No. 04/329 8/	0.5	1.4	2.2	3.5
2. Adjusted 9/	0.4	1.1	2.0	7.5
3. Actual	-1.1	-2.8	-2.5	4.8
IV. Ceiling on short-term external debt contracted or guaranteed by the central government and NRB		(In millions of U.S. dollars)		
1. IMF Country Report No. 04/329	0.0	0.0	0.0	0.0
2. Adjusted	0.0	0.0	0.0	0.0
3. Actual	0.0	0.0	0.0	0.0
V. Accumulation of external payments arrears Continuous performance criterion during the program period		(In millions of U.S. dollars)		
1. IMF Country Report No. 04/329	0.0	0.0	0.0	0.0
2. Adjusted	0.0	0.0	0.0	0.0
3. Actual	1.3	1.3	1.3	1.3
Indicative targets (IT)				
VI. Ceiling on reserve money				
1. IMF Country Report No. 04/329	89.4	89.1	97.5	101.6
2. Actual	88.3	86.1	93.1	96.5
VII. Floor on central government revenue Cumulative from July 15, 2004				
1. IMF Country Report No. 04/329 10/	10.8	25.0	43.1	68.3
2. Adjusted 11/	10.8	25.0	43.0	68.1
3. Actual	12.8	29.7	46.0	68.9

1/ Mid-October 2004 and mid-January 2005 are performance criteria test dates. Figures for mid-April and mid-July 2005 are indicative targets.
2/ Net Foreign Assets (NFA) as defined in the Technical Memorandum of Understanding (TMU). Valued at program exchange rates; monetary gold valued at US$360 per oz. Adjusted upward/downward by excess/shortfall of foreign program financing. Details specified in the TMU.
3/ Valued at program exchange rates; monetary gold valued at program price (US$360 per oz.). Adjusted upward/downward by excess/shortfall of foreign program financing.
4/ Valued at program exchange rates; monetary gold valued at program price (US$360 per oz.).
5/ Net Domestic Assets (NDA) as defined in the TMU. Calculated as the difference between reserve money (VI.1.) and NFA (I.1). Adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign financing. Details specified in the TMU.
6/ Calculated as the difference between reserve money (V1.1) and NFA (I.2). Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing.
7/ Calculated as the difference between reserve money (VI.2.) and NFA (I.3).
8/ Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing. Adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the TMU.
9/ Adjusted upward/downward by shortfall/excess of privatization receipts. Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing. Details specified in the TMU.
10/ Adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the TMU.
11/ Adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the TMU.

Table 6. Nepal: Status of Structural Performance Criteria and Benchmarks for Second Review Under the PRGF Arrangement

Measures	Test Date	Implementation Date
Structural Performance Criteria		
A. Fiscal and Monetary Reforms		
1. Implement time-bound action plan to improve customs administration	November 15, 2004	October 2006
2. Fully operationalize the large taxpayers office (LTO) in the Inland Revenue Department	November 15, 2004	November 22, 2004
3. Implement new framework for monetary operations, including a liquidity-monitoring framework	November 15, 2004	November 15, 2004
B. Financial Sector Reforms		
1. Strengthen the Nepal Rastra Bank (provide for compulsory retirement scheme in NRB employee rules and regulations)	November 15, 2004	July 16, 2005
Structural Benchmarks		
1. Strengthen the Nepal Rastra Bank (revise human resources policies)	November 15, 2004	July 16, 2005
2. Prepare a time-bound action plan to strengthen Financial Management and Internal Audit Departments of NRB	November 15, 2004	November 15, 2004
3. Implement restructuring plans for NIDC	November 15, 2004	September 2004
4. Complete liquidation/privatization of two SOEs 1/	November 15, 2004	May 2006
5. Cabinet approval of amended Civil Service Ordinance	November 15, 2004	July 6, 2005
6. NRB to reconcile accounting data with program monitoring data	Quarterly test dates	Completed

1/ Bhaktpur Brick Factory and Nepal Rosin and Turpentine privatized.

Table 7. Nepal: Structural Performance Criteria and Benchmarks for the Third Review Under the PRGF Arrangement

Measures	Test Date	Implementation date
Structural Performance Criteria		
A. Fiscal Reforms		
1. Implement time-bound action plan to improve customs administration	January 15, 2005	October 2006
2. Fully operationalize the large taxpayers office (LTO) in the Inland Revenue Department	January 15, 2005	October 2006
B. Financial Sector Reforms		
1. Finalize audits of NRB's 2003/04 accounts by an international auditor	January 15, 2005	April 18, 2005
C. Public Sector Reform		
1. Finalize audit of NOC 2003/04 accounts by international auditor	February 15, 2005	June 15, 2006
2. Implement automatic pricing mechanism for oil products 1/	December 31, 2004	--
Structural Benchmarks		
1. Cabinet approval of Fiscal Transparency Ordinance 2/	January 15, 2005	Rescheduled
2. Amend BFI ordinance including for consistency with other legislation 3/	February 15, 2005	Rescheduled
3. Cabinet approval of Asset Management Companies Ordinance 4/	January 15, 2005	--
4. Implement restructuring plans for ADBN	January 15, 2005	March 16, 2006
5. Implement restructuring plans for NIDC 5/	January 15, 2005	--
6. Adopt Petroleum Products Sale and Distribution Ordinance 6/	February 15, 2005	Rescheduled
7. Complete liquidation/privatization of three SOEs 7/	January 15, 2005	--
8. NRB to reconcile accounting data with program monitoring data	Quarterly test date	Completed

1/ Not observed. SPC not reset. Revised understandings reached for 2006/07.
2/ July 15, 2007 (SB).
3/ July 15, 2007 (SPC) and August 15, 2007 (SB)
4/ Not rescheduled; as explained in text of staff report.
5/ Employee liabilities settled, including under VRS; Nepalgunj branch closed and debt related transactions shifted to headquarters.
6/ Cabinet approval October 2006; Submission to parliament (SB, January 15, 2007).
7/ Lumbini Sugar Mill privatized.

Table 8. Nepal: Medium-Term Macroeconomic Framework, 2004/05–2010/11

(In percent of GDP, unless otherwise indicated)

	2004/05 Est.	2005/06 Est.	2006/07	2007/08	2008/09	2009/10	2010/11
			Projection				
Real sector							
Real GDP growth (percent change)	2.7	1.9	3.7	4.5	5.0	5.5	5.5
Agriculture	3.0	1.7	2.6	3.5	4.0	4.5	4.5
Nonagriculture	2.1	2.8	4.3	5.0	5.6	6.1	6.1
GDP deflator (percent change)	4.6	7.2	6.5	6.0	5.5	5.0	5.0
Saving-investment balance							
Gross Fixed Investment	18.9	18.5	20.5	22.0	23.5	24.0	25.3
Public 1/	5.8	6.0	8.3	8.8	9.2	9.3	9.7
Private	13.2	12.5	12.2	13.2	14.3	14.7	15.6
Gross national savings (incl. income and transfers from abroad)	26.7	27.9	27.3	28.7	29.7	30.2	31.6
Fiscal sector							
Total revenue	12.9	12.2	13.1	13.3	13.5	13.6	13.8
Grants	2.7	2.2	3.7	3.0	2.9	2.8	2.6
Current expenditure	11.6	11.4	13.0	12.5	12.4	12.4	12.4
Capital expenditure and net lending	4.9	4.8	6.8	7.0	7.2	7.3	7.5
External sector							
Export value (percent change) 2/	11.2	4.0	8.5	12.9	12.4	11.8	11.3
Import value (percent change)	12.3	18.3	16.1	10.9	10.3	9.1	8.6
Current account balance (excluding official transfers)/GDP	-0.3	0.6	0.2	-0.1	-0.4	-1.2	-1.8
Overall balance/GDP	0.1	3.7	1.2	0.1	0.2	0.2	0.4
Financing gap (in millions of U.S. dollars)	0	0	45	90	50	40	0
Change in reserves (in millions of U.S. dollars)	-21	-296	-146	-95	-73	-61	-46
External debt/GDP (in percent)	45.8	43.0	41.6	40.3	39.2	38.2	37.2
Debt service ratio	4.5	4.2	3.5	3.5	3.4	3.4	3.2
Monetary sector							
Broad money (percent change)	8.3	15.6	16.0	...	...	...	...
Private sector credit (percent change)	12.9	8.3	16.2	...	...	...	...
Memorandum Item:							
Nominal GDP (Nrs. billions)	533.5	582.9	643.9	713.0	790.2	875.3	969.6

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

1/ Public savings and investment estimate derived from fiscal accounts.
2/ Excluding re-exports.

Table 9. Nepal: Proposed Schedule of Disbursements Under the PRGF Arrangement

Amount	Available Date	Conditions for Disbursement
SDR 7.13 million (10 percent of quota)	November 19, 2003	Disbursed.
SDR 7.13 million (10 percent of quota)	October 20, 2004	Disbursed.
SDR 14.26 million (20 percent of quota)	November 8, 2006	Observance of the mid-October 2004, mid-November 2004, December 31, 2004, mid-January 2005, and mid-February 2005 performance criteria and completion of the second and third reviews.
SDR 10.69 million (15 percent of quota)	April 15, 2007	Observance of the mid-January 2007, end-January 2007, mid-February 2007 and mid-March 2007 performance criteria and completion of the fourth review.
SDR 10.69 million (15 percent of quota)	October 15, 2007	Observance of the mid-July 2007 performance criteria and completion of the fifth review.

Table 10. Nepal: Projected Fund Transactions Under the PRGF, 2005/06–2010/11
(In millions of SDRs)

	2005/06	2006/07	2007/08	2007/08	2008/09	2009/10	2010/11
	Est.	Projections					
Total use of fund resources (UFR) outstanding	14.3	39.2	49.9	48.5	45.6	42.8	36.0
PRGF	14.3	39.2	49.9	48.5	45.6	42.8	36.0
PRGF							
Disbursements	0.0	25.0	10.7	0.0	0.0	0.0	0.0
Debt service	0.2	0.2	0.2	1.7	3.1	3.1	7.0
Repayments	0.0	0.0	0.0	1.4	2.9	2.9	6.8
Interest	0.2	0.2	0.2	0.3	0.2	0.2	0.2
Total debt service to the Fund	0.3	0.3	0.3	1.8	3.2	3.2	7.1
PRGF	0.2	0.2	0.2	1.7	3.1	3.1	7.0
Principal	0.0	0.0	0.0	1.4	2.9	2.9	6.8
Interest	0.2	0.2	0.2	0.3	0.2	0.2	0.2
Other SDR charges	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Memorandum items:							
Total UFR as a percentage of quota	20.0	55.0	70.0	68.0	64.0	60.0	50.5
Total UFR as a percentage of GDP	0.3	0.6	0.8	0.7	0.6	0.5	0.4
Debt service to the Fund as a percentage of exports of goods and services 1/	0.0	0.0	0.0	0.1	0.2	0.2	0.4

Sources: Fund staff estimates.

1/ Excluding re-exports of oil.

Table 11. Nepal: External Financing Needs and Sources, 2005/06–2010/11

(In millions of U.S. dollars)

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
	Est.			Projection		
Gross financing needs	349	229	207	227	312	387
External current account deficit (excl. official transfers)	-45	-16	6	42	131	220
Debt amortization	96	100	105	109	116	117
Repayments of arrears	1.7	0.0	0.0	0.0	0.0	0.0
Reserves accumulation	296	146	95	73	61	46
IMF repurchases and repayments	0	0	0	2	4	4
Financing sources	349	184	117	177	272	387
Foreign direct investment (net)	-7	27	31	35	41	47
Official creditors 1/	311	593	599	649	689	703
Other flows 2/	44	-436	-513	-508	-458	-363
Accumulation of arrears (exceptional)	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap 3/	…	45	90	50	40	0

1/ Includes both loans and grants.
2/ Includes all other net financial flows, and errors and omissions.
3/ Includes prospective IMF disbursements.

Table 12. Nepal: Millennium Development Goals, 1990–2015

	1990	1995	2001	2002	2003	2015
Eradicate extreme poverty and hunger	(2015 target = halve 1990 $1 a day poverty and malnutrition rates)					
Population below $1 per day (in percent)	...	37.7	...	...	...	18.9
Poverty gap at $1 per day (in percent)	...	9.7	...	...	...	...
Percentage share of income or consumption held by poorest 20 percent	...	7.6	...	...	...	...
Prevalence of child malnutrition (in percent of children under 5)	...	48.5	48.3	...	...	24.3
Population below minimum level of dietary energy consumption (in percent)	18.0	24.0	17.0	...	17.0	...
Achieve universal primary education	(2015 target = net enrollment to 100)					
Net primary enrollment ratio (in percent of relevant age group)	...	...	70.5	...	...	100
Percentage of cohort reaching grade 5 (in percent)	52.0	...	62.1	...	...	...
Youth literacy rate (in percent of ages 15–24)	46.6	54.6	61.6	62.7	...	...
Promote gender equality	(2005 target = education rate to 100)					
Ratio of girls to boys in primary and secondary education (in percent)	56.6	69.7	83.4	...	85.4	100
Ratio of young literate females to males (in percent of ages 15–24)	40.7	48.2	57.3	58.9	...	...
Share of women employed in the nonagricultural sector (in percent)	11.7	...	...	...	...	...
Proportion of seats held by women in national parliament (in percent)	6.0	3.0	6.0	6.0	6.0	...
Reduce child mortality	(2015 target = reduce 1990 under 5 motality by two thirds)					
Under 5 mortality rate (per 1,000)	143.0	114.0	91.0	83.0	82.0	47.7
Infant mortality rate (per 1,000 live births)	99.0	81.0	67.0	62.0	61.0	...
Immunization, measles (in percent of children under 12 months)	57.0	56.0	71.0	71.0	75.0	...
Improved maternal health	(2015 target = reduce 1990 maternal mortality by three fourths)					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	830.0	740.0	...	...	207.5
Births attended by skilled health staff (in percent of total)	7.4	9.0	10.9	...	...	...
Combat HIV/AIDS, malaria, and other diseases	(2015 target = halt, and begin to reverse, AIDS, etc.)					
Prevalence of HIV, female (in percent of ages 15–24)	...	...	0.3	...	0.5	0.2
Contraceptive prevalence rate (in percent of women ages 15–49)	...	28.5	39.3	...	...	...
Number of children orphaned by HIV/AIDS	...	...	13,000.0	...	...	...
Incidence of tuberculosis (per 100,000 people)	...	...	201.0	189.8	211.2	150
Tuberculosis cases detected under DOTS (in percent)	...	6.0	60.0	63.6	60.3	...
Ensure environmental sustainability	(2015 target = various 1/)					
Forest area (in percent of total land area)	32.7	...	27.3	...	...	30
Nationally protected areas (in percent of total land area)	...	7.8	7.8	8.9	8.9	10
GDP per unit of energy use (PPP$ per kg. oil equivalent)	2.6	3.3	3.9	...	3.8	...
CO2 emissions (metric tons per capita)	0.0	0.1	0.1	...	...	...
Access to an improved water source (in percent of population)	67.0	...	88.0	...	84.0	83.5
Access to improved sanitation (in percent of population)	20.0	...	28.0	...	27.0	...
Access to secure tenure (in percent of population)	...	...	...	...	...	...
Develop a global partnership for development	(2015 target = various 2/)					
Youth unemployment rate (in percent of total labor force ages 15–24)	...	...	...	...	...	...
Fixed line and mobile telephones (per 1,000 people)	3.2	4.1	13.9	15.1	17.8	...
Personal computers (per 1,000 people)	...	1.2	3.5	3.7	3.7	...
General indicators						
Population (in millions)	18.1	20.4	23.6	24.1	24.7	...
Gross national income (in billions of U.S. dollars)	3.9	4.4	5.6	5.5	5.9	...
GNI per capita (in U.S. dollars)	220.0	220.0	240.0	230.0	240.0	...
Adult literacy rate (in percent of people ages 15 and over)	30.4	36.0	42.9	44.0	...	...
Total fertility rate (births per woman)	5.3	4.6	4.3	4.2	4.1	...
Life expectancy at birth (in years)	53.6	56.3	58.9	59.9	60.2	...
Aid (in percent of GNI)	11.6	9.8	7.0	6.6	...	...
External debt (in percent of GNI)	45.1	54.9	48.2	53.3	...	...
Investment (in percent of GDP)	18.1	25.2	24.0	24.6	25.8	...
Trade (in percent of GDP)	32.2	59.5	53.8	44.9	45.4	...

Source: *World Development Indicators* database.

1/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environment resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking.

2/ Develop further an open, rule-based, predictable, nondiscriminatory trading and financial system. Address the special needs of the least developed countries. Address the special needs of landlocked countries and small island developing states.

APPENDIX I: NEPAL—FUND RELATIONS

(As of September 30, 2006)

I. **Membership Status**: Joined 9/06/61; Article VIII, Sections 2, 3, and 4 in May 1994.

II. General Resources Account:	**SDR Million**	**Percent Quota**
Quota	71.30	100.00
Fund holdings of currency	71.31	100.02
Reserve position in Fund	0.00	0.00

III. SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	8.10	100.00
Holdings	6.06	74.78

IV. Outstanding Purchases and Loans:	**SDR Million**	**Percent Quota**
PRGF arrangements	14.26	20.00

V. **Financial Arrangements**:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
PRGF	11/19/03	11/18/06	49.91	14.26
PRGF	10/05/92	10/04/95	33.57	16.79
SAF	10/14/87	10/13/90	26.11	26.11

VI. **Projected Obligations to Fund** (in millions of SDRs; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal				1.43	2.85
Charges/Interest	0.06	0.15	0.15	0.15	0.14
Total	0.06	0.15	0.15	1.57	2.99

VII. **Exchange Rate Arrangement**

In February 1993, Nepal unified its exchange rate and eliminated the multiple currency practice associated with the previous dual exchange rate arrangement. In October 1997, the exchange arrangement of Nepal was reclassified as that pegged to a single currency unit from pegged to a currency composite. Currently, all merchandise imports (except for a few goods restricted for security or related reasons) are freely available through an open general license system, with foreign exchange provided through the banking system at the market exchange rate. Nepal's exchange system is free of restrictions on the making of payments and transfers for current international transactions. As of September 30, 2006, the exchange rate for the Nepalese rupee (Nr) was US$1=Nrs. 73.6.

VIII. Safeguards Assessments

A safeguards assessment of the NRB was completed on September 2, 2002. The assessment concluded that substantial risks exist in the area of external and internal audits, and the internal control system of the NRB. A safeguards monitoring assessment was completed in October 2004. Staff findings and recommendations were reported in IMF Country Report No. 02/205. The NRB is making progress in the implementation of these recommendations, which is being monitored under the current PRGF arrangement.

IX. 2005 Article IV Consultation

The Executive Board discussed the staff report for the 2005 Article IV consultation (IMF Country Report No. 06/44) on January 18, 2006. Nepal is currently on a 24-month consultation cycle, subject to the provisions of the July 15, 2002 decision on consultation cycles (Decision No. 129794-(02/76) as amended).

X. Technical Assistance Since 2001

Department		Purpose	Date
MFD	-	Accounting	10/04, 4/05, 9/05, 11/05, 7/06
	-	Central bank and banking reform	12/01–3/02
	-	Internal Audit	10/04, 1/05, 4/05, 9/05, 11/05, 7/06
	-	Monetary policy	6/03
	-	Monetary operations	Continuous
	-	Foreign exchange reserves management	5/03, 10/04, 11/05, 7/06
FAD	-	Implementation of a large tax payer unit	10/03
	-	Review of tax policy and VAT administration	5/03
	-	Tax and customs administration reform	10/03
	-	Follow up on the LTO and customs administration reform	8/04, 6/06
LEG	-	Redrafting of income tax laws	3/00, 7/01
STA	-	Multisector statistics	1/01
	-	Balance of payments statistics	4/02, 12/02, 10/03, 4/04
	-	Producer price statistics	1/02, 1/03, 4/04, 1/05
	-	Monetary statistics	7/03
		National accounts	7/06

XI. Resident Representative

Mr. Alexander Pitt replaced Mr. Sukhwinder Singh in August 2006.

APPENDIX II: NEPAL—RELATIONS WITH THE WORLD BANK GROUP

(As of September 28, 2006)

A. Partnership in Nepal's Development Strategy

Since the late 1990s, Nepal's poverty reduction agenda has been held back by formidable challenges—the persistent political instability, the escalation of the Maoist insurgency and the global economic slowdown. Nevertheless, amidst the turbulence, a group of committed, reform-minded Government officials and technocrats began implementing reforms in earnest in late 2001. These initiatives formed the basis for the first Immediate Action Plan (IAP) adopted by the Government in June 2002. For a while, reform efforts flourished in a number of areas, including the financial sector, public expenditures, the fight against corruption, infrastructure regulatory environment and decentralized delivery of public services.

The reform group had been building on the successful experience with the IAP in moving the reform process forward. In developing the 2003 Poverty Reduction Strategy (PRS)—formally sent to the World Bank and IMF in July 2003—the scope of reform was broadened and a more integrated approach was adopted within a medium-term perspective.[11] The PRS spells out specific development targets, foremost among which is the reduction of the overall poverty ratio from about 40 percent to 30 percent by the end of FY07.[12] The strategy revolves around four key pillars: (i) achieving sustainable and broad-based economic growth with an emphasis on the rural economy; (ii) accelerating human development through improved delivery of basic social services and economic infrastructure; (iii) ensuring social and economic inclusion of the poor, marginalized groups and less developed regions; and (iv) vigorously pursuing good governance to achieve better development results, and ensure social and economic justice. While there had been considerable progress towards implementing the PRS, during the unprecedented instability since February 2004, the reform efforts and momentum have suffered greatly.

In implementing the 2003 Country Assistance Strategy (CAS) considered by the Board at the same time as the PRS, the Bank is leading the policy dialogue in the structural and institutional areas. The Bank has been engaged in intensive dialogue in the formulation of

[11] The PRS was discussed by the Boards in November 2003 following a joint staff assessment carried out by the two institutions. Subsequently, three PRS Progress Reports have been issued by the authorities—in May 2004, June 2005, and June 2006.

[12] This target has nearly been met with recent analysis showing that the incidence of poverty in Nepal fell from 42% (1995–96) to 31 (2003–04), with urban areas experiencing greater reductions than rural areas in the depth and severity of poverty.

reform efforts towards rationalization of public expenditures, establishment of a framework conducive to private sector growth, decentralization for better service delivery, targeted assistance to vulnerable groups and improving governance. To support these measures, the Bank's Board approved the first Poverty Reduction Support Credit I (PRSC I) along with the CAS and PRS. Although the Bank's strategy had envisioned a series of PRSCs, such support has not materialized given the developments, most notably the slowdown in the reform efforts.

B. IMF-World Bank Collaboration in Specific Areas

Areas in which the Bank leads and there is no direct IMF involvement

The areas in which the Bank leads the policy dialogue and there is no direct IMF involvement are the social sectors, infrastructure and environment. In the social sphere, the Bank continues to assist Nepal's efforts to analyze poverty following up on the 1999 study: ***Poverty at the Turn of the Twenty-First Century***. The Bank provided technical assistance (TA) in conducting the Nepal Living Standards Survey II (NLSS II) during 2003/04 that updated household level information on trends in consumption, poverty, and their determinants. The TA also helped to strengthen the country's capacity to undertake regular household surveys that will facilitate poverty comparisons over time and to conduct social impact analyses. The NLSS II has been a key input into the two annual PRS progress reports, as well as the Bank's comprehensive poverty report—***Nepal: Resilience Amidst Conflict—An Assessment of Poverty in Nepal, 1995–96 and 2003–04***.

In ***education***, the Bank and numerous other donors are actively supporting Nepal's well-formulated ten-year primary education reform program. IDA along with Denmark, Finland, Norway and the UK have established a joint financing arrangement whereby donor funds are pooled with public sector budgetary resources to support implementation of the program. IDA support (approved in August 2004) is provided through the ***Education for All*** project which employs a sector-wide approach (SWAp).

The Bank has encouraged Nepal's decentralization efforts to achieve more efficient delivery of public services. It has played a pivotal role in supporting the transfer of public schools to community management. The Bank's dialogue is accompanied by financing in the form of the ***Community School Support*** Learning and Innovation Loan (LIL) to improve accountability of primary schools, build capacity of communities to manage schools and develop the roles of teachers, local officials and education offices within the devolved framework.

In ***health***, the Bank has been supporting the devolution of sub-health posts to local communities, and the development of a sector-wide reform strategy. A ***Health Sector Operation***—approved by the Board in September 2004—supports the program. Key reform priorities include addressing the problems of inadequate financing and inefficient public spending, weak institutional capacity, and over-centralized planning and management, weak delivery mechanisms and inequitable access to services. To support both human health and animal health, the Bank has been discussing an ***Avian Influenza Control Project*** that will likely be approved in the coming months.

To help generate broad-based growth, the Bank supports investments in key ***infrastructure*** sectors by financing projects in ***Road Maintenance and Development, Rural Access Improvement and Decentralization, Power Development, and Telecommunications Sector Reform***. At the same time, project finance is supporting decentralization to improve service delivery in most of these sectors by promoting grassroots-driven, bottom-up planning and community-based management. The Road Maintenance and Development Project (RMDP) supports key sectoral policy reforms by establishing a Roads Board and Road Fund to assure a stable source of funding for maintenance expenditures, while also promoting motorable access to isolated regions. The Rural Access Improvement and Decentralization Project (RAIDP) helps to improve governance and service delivery for rural infrastructure, while at the same time promoting agricultural and rural economic growth, and generating employment through direct project investments in rural transport infrastructure.

The Power Development Project (PDP) is helping to develop the country's hydropower potential to meet electricity demand, improve access of rural areas to electricity services and promote private sector participation. The Telecommunications Sector Reform Project supports sectoral policy reforms in addition to the provision of greater rural access to telecommunications services through the introduction of a private operator.

While many of the Bank's investment/sector operations mentioned above also support ***social inclusion***, a more direct initiative in this area that received Bank support in recent years is the Poverty Alleviation Fund (PAF). The PAF channels resources to grassroots levels, creating a mechanism for continuity and coordination of donor programs for poverty reduction. Bank financing for the PAF project (approved in FY04) is supporting the implementation of the fund in six pilot districts.[13] In addition, the Bank is assisting Nepal in gaining a better understanding of the institutional underpinnings of caste, ethnic and gender-based social and economic exclusion and how these affect poverty outcomes and the options for policy and institutional reform through a recently completed social and gender analysis: ***Unequal Citizens: Gender, Caste and Ethnic Exclusion in Nepal***.

[13] In the near future it is envisioned that additional IDA grant financing would be approved to expand the program to a total of 17 districts.

In responding to ***environmental management**,* Bank assistance is focused on helping Nepal articulate an effective strategy for environmental conservation, management and capacity building. A Country Environmental Analysis is being carried out and will be completed in FY07.

Areas in which the Bank leads and its analysis serves as input into the IMF program

The Bank takes the lead in assisting Nepal with ***public expenditure analysis***. The Bank's FY00 Public Expenditure Review (PER) provided analytical support for developing the strategy on public expenditure reform. Together with the United Kingdom Department for International Development (DfID), the Bank's intensive dialogue and technical assistance have been supporting the reforms, including the development of a credible Medium Term Expenditure Framework (MTEF). This framework has applied since FY04 to the prioritization of the development budget to ensure efficient budget allocations for priority projects. As Nepal implements its PRS, the MTEF will help the public sector translate the PRS priorities into fiscal realities.

Public expenditure analysis remains an integral part of the Bank's analytical and advisory (AAA) work program, consisting of an ongoing: (i) PER that focuses on evaluating the implementation of the MTEF; and (ii) Public Finance Management (PFM) Review (to be completed in FY07) that will examine the fiscal space for development activities and cross-sectoral allocation of public spending and service delivery.

To complement the economic analysis, studies on the public sector's framework for financial accountability and procurement—the Country Procurement Assessment Review (CPAR) and the Country Financial Accountability Assessment (CFAA)—were conducted jointly by the Bank and the Government. Additionally, in response to technical assistance and training needs on public expenditure management, decentralization and enhancement of financial accountability, the Bank is providing support through Institutional Development Fund (IDF) grants or other sources.

Should there be a reinvigoration of the reform process, the Bank in the future would contemplate additional development policy lending linked to the government's short-term program. In the meantime, to assist in the reform effort the ***Economic Reform Technical Assistance (ERTA) Project*** is providing TA to help implement aspects of all the PRS pillars. The Bank's AAA program places emphasis on the need to address the challenges and bottlenecks to broad-based growth. In addition to the Development Policy Review: ***Restarting Growth and Poverty Reduction*** (DPR completed in June 2004), key studies on rural sector development and labor are envisioned to help prioritize future policy reforms.

With respect to ***governance***, in implementing both the 1998 and 2003 CASes, the Bank has consistently and firmly focused on helping Nepal address its fundamental constraint to development—poor governance. Albeit accompanied by intensive dialogue, the Bank's strong limited lending stance during FY99–FY02 (less than US$25 million per year) may have provided some impetus to the wave of reforms initiated in the early 2000s. The public expenditure reform program which has benefited from the Bank's analytical work and policy dialogue is facing up to the challenge of improving not only efficiency but also governance. The program includes measures to fight corruption, ensure civil service accountability, and enhance transparency of public financial management and the procurement framework. Bank support for decentralization includes analytical assistance on the fiscal decentralization framework and promotion of the expanded roles of local bodies. Following the completion of the CPAR and CFAA, IDF grants are providing the means for strengthening relevant public sector institutions and implementing main policy recommendations. The FY07 PFM Review will also comprise a CPAR and a CFAA aimed at assessing the efficiency of public finance management practices for delivering value for money and accountability.

Areas of shared responsibility

The Bank and the IMF—together with other external development partners—provided assistance in the preparation of the PRS and subsequent two PRS Progress Reports. In addressing the PRS pillar on good governance, the Bank and the IMF are assisting in the area of ***civil service reform*** through policy dialogue and TA towards ensuring an autonomous and professional civil service as well as fiscal sustainability.

The Bank and the IMF are partners in providing analytical support to Nepal on ***international trade***, which is key to attaining broad-based growth. The Bank lead the work with a Trade and Competitiveness Study which helped identify major constraints to further integrating the country into the multilateral trading system in a manner that is supportive of the PRS. The IMF contributed to the study by assessing macroeconomic policy and its potential impact on trade performance. In turn, the study is helping the IMF design its technical assistance program on tax policy, including import tariffs taking into account Nepal's WTO accession.

Financial sector reform is a prerequisite for successful implementation of the IAP and PRS. Since the mismanagement of key financial institutions was a major element of poor governance, the progress on financial sector reform has been the litmus test of political commitment to governance reform. The Bank and the IMF are helping to strengthen the Central Bank's authority and regulatory capacity, improve the financial health of the two largest banks, restructure the state banks, and upgrade the legislative and institutional framework for the financial sector. The Bank financed the comprehensive assessment of the two largest banks and undertook a comprehensive Financial Sector Study in 2002. The ***Financial Sector Technical Assistance*** project supports the restructuring and reengineering of the Central Bank, introduction of professional management teams into the two large ailing commercial banks (the- first step toward eventual restructuring of those banks), capacity building towards enhanced credit information, improved public awareness of financial sector issues and upgrading of staff training in financial institutions. The ***Financial Sector Restructuring*** project—for which Bank financing was approved in FY04—supports further strengthening of the Central Bank and deepening the reform process within the two large ailing commercial banks. In FY05, a Legal Financial Review was completed providing a snapshot of the legal and judicial environment for financial sector growth and development. In addition, an on-going study on Access to Finance (to be completed in FY07) is helping to gain a better understanding of: (i) the financial performance of the micro-finance sector; and (ii) whether the current legal and regulatory framework is an obstacle to the sector's growth.

Areas in which the IMF leads and its analysis serves as input into the Bank program

The IMF leads the policy dialogue on maintaining sound macroeconomic policies as is the case with most Bank/IMF member countries. The PRGF-supported program serves as the macroeconomic policy anchor for ensuring successful implementation of the IAP/PRS and the Bank's program of support.

The IMF leads in encouraging reforms that are critical to the maintenance of macroeconomic stability, primarily on fiscal matters, such as maintaining sustainable domestic borrowing while allocating resources to priority sectors. Also, the IMF is taking the lead on the revenue side by setting realistic targets for increasing domestic revenues and advising on tax policy and administration.

Areas in which the IMF leads and there is no direct Bank involvement

The areas in which the IMF leads and the Bank is not directly involved are monetary policy, exchange rate regime, balance of payments, and related statistical and measurement issues.

C. World Bank Group Strategy and Lending Operations

The Country Assistance Strategy (CAS). In November 2003, the Board considered a new Country Assistance Strategy (CAS), which discussed the rationale for implementing a 'base case' lending program equivalent to approximately US$190 million annually. Given the nature of the country's ongoing reforms, the CAS Progress Report (CAS PR) prepared in 2002 had already presented the justification for moving to a base case scenario that included implementing a programmatic approach to financial assistance. However, given the slowdown in the reform efforts over the past couple of years, new commitments have been significantly below what was envisioned in the base case program. The CAS PR is planned for February 2007.

The Lending Program. In FY04, credit approvals—for a total of US$186.0 million—included PRSC I, Financial Sector Restructuring Project, Second Rural Water Supply and Sanitation and Poverty Alleviation Fund. In FY05, IDA financing was approved for the

Education for All Project, the Health Sector Program, the Rural Access Improvement and Decentralization Project, and the Economic Reform Technical Assistance Project for total new commitments of US$135 million. Given the instabilities of the past year, no new commitments were entered into in FY06.

Bank Assistance Program in Nepal. As of September 28, 2006, IDA's lending portfolio consisted of twelve projects with a total commitment of US$422 million and a total undisbursed balance of US$249 million (Table 1).

Economic and Sector Work. The 200*3 Country Assistance Strategy* (Report No. 26509−NEP, 11/24/2003) was discussed by the Bank's Board in November 2003. Recently completed economic and sector work includes *Nepal Development Policy Review: Restarting Growth and Poverty Reduction* (June 2004), *Unequal Citizens: Gender, Caste and Ethnic Exclusion in Nepal* (June 2005), *Nepal Decentralized Organizations Study* (March 2004), *Urbanization and Service Delivery in the Context of Decentralization: A Review of the Issues for the Kathmandu Valley* (December 2004), *Legal Financial Review* (February 2005), *North South Transport Corridor Options* (August 2004), and *Nepal: Resilience Amidst Conflict: An Assessment of Poverty in Nepal, 1995–96 and 2003–04* (June 2006).

Table II.1. World Bank Operations

As of September 28, 2006

	IDA Amount	Undisbursed [1/]	Board Date
(In millions of U.S. dollars, net of cancellations)			
Road Maintenance and Development	54.5	9.9	2000
Telecommunications Sector Reform	20.4	10.2	2002
Financial Sector Technical Assistance	16.0	7.9	2003
Community School Support	5.0	2.1	2003
Power Development	74.8	75.2	2003
Poverty Alleviation Fund	15.0	8.5	2004
Financial Sector Restructuring (Phase II)	75.5	22.8	2004
Rural Water Supply and Sanitation II	25.3	19.7	2004
Health Sector Program	50.0	33.3	2005
Education for All	50.0	28.7	2005
Rural Access Improvement and Development	32.0	28.8	2005
Economic Reform Technical Assistance	3.0	1.9	2005
Total	421.5	248.9	

[1/] Credit accounting is in SDRs. As these figures are in U.S. dollar, exchange rate fluctuations may result in undisbursed balances greater than the principal amounts.

IFC's Activities in Nepal. As of August 31, 2006, the IFC-held portfolio in Nepal is US$58.7 million in two power generation projects, one tourism project and one leasing company. Given the security situation, opportunities for new investments and TA have been limited, but IFC is currently considering new investment opportunities in infrastructure and the financial sector. In the immediate future, IFC will focus on technical assistance for SMEs through the regional multi-donor technical assistance facility for SME development—the South Asia Enterprise Development Facility (SEDF)—based in Dhaka. This facility—funded by IFC in partnership with Canada, Netherlands, Norway, United Kingdom, Asian Development Bank (ADB) and the European Union (EU)—will deliver TA programs in Nepal to increase SMEs' access to financing, improve the business environment for SMEs and develop supply chains involving SMEs.

Questions on IDA may be referred to Ms. Tinsley (458–4920) or to Ms. Gekis (458−4865) for questions on IFC.

APPENDIX III: NEPAL—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Lending Program

As of August 31, 2006, cumulative lending to Nepal was $2.2 billion, comprising 109 loans, covering projects in agriculture and natural resources, education, energy, finance, industry and trade, law, economic management and public policy, transport and communication, and water supply, sanitation and waste management. On August 10, 2006, AsDB approved a grant of $55.2 million for the Road Connectivity Sector I project. For the period 2006–09, 13 projects amounting to $418.8 million are tentatively programmed.

Undisbursed funds of $506.05 million represent 77 percent of the total net loan amount as of August 31, 2006.

Loans by the Asian Development Bank, 1969–2006

(As of August 31, 2006)

	1969–2000	2001	2002	2003	2004	2005	2006
	Approved						
Loans	(In millions of U.S. dollars)						
Agriculture and natural resources	656.23	0	0	20	70	0	0
Education	61.1	19.6	30	0	20	0	0
Energy	364.4	0	0	0	0	0	0
Finance	7.3	0	0	0	0	0	0
Industry and trade	129.18	0	0	0	0	0	0
Law, economic and public policy		30		35	0	0	0
Transport and communication	236.86	46	0	0	20	0	55.2
Water supply, sanitation and waste management	224	0	0	39	0	0	0
Multisector	127.06	0	30	0	0	0	0
Total approved	1,806.13	95.6	60	94	110	0	55.2
Gross disbursements	1,220.60	57.3	28.2	33.5	22	43.7	33.8
Total approved	96.6	4	3.9	4.06	3.18	2.04	3.77
Gross disbursements	54.1	5	3.9	4.17	4.2	3.6	1.9

Technical Assistance

Since 1968, AsDB has provided Nepal with technical assistance in most sectors. As of August 31, 2006 total technical assistance consisted of 256 projects totaling $119.2 million. There are currently 33 ongoing TAs and 2 JFPR projects.

Private Sector Operations

At the end of 2005, cumulative approvals for 4 private sector projects in Nepal amounted to $58.64 million. AsDB's outstanding exposure for three private sector projects in Nepal amounted to $32.2 million as of December 31, 2005, representing approximately 1.9 percent of AsDB's total private sector exposure. The AsDB's public sector lending and technical assistance program have also been helping Nepal to create a more conducive policy and legal environment for private sector development.

APPENDIX IV: NEPAL—STATISTICAL ISSUES

Economic and financial data are adequate for surveillance, although there is scope for improvement. Nepal provides core data to the Fund and releases data in government and central bank publications. Nepal has been a participant in the General Data Dissemination System (GDDS) since May 2001. Metadata were initially posted on the Dissemination Standards Bulletin Board in May 2001 and last updated in August 2005. A multisector statistics mission visited Kathmandu in January 2001.

Real Sector

The Central Bureau of Statistics (CBS) compiles **national accounts** using the *1968 SNA*. These include GDP by industry (current and constant prices) and by expenditure categories (current prices), and gross national income and savings. There are shortcomings due to lack of comprehensive and regular data sources. The limited source data suffer from inconsistencies, lags in availability, and insufficient detail. There are shortcomings in record keeping by agencies and access to records is not timely due to processing lags. Reflecting source data problems, compilation methods rely heavily on fixed ratios derived from surveys or ad hoc assumptions—i.e., household consumption expenditure estimates are based on the extrapolation of the 1995/96 benchmark living standard survey. STA missions in April 2005 and July 2006 provided support to the development of quarterly national accounts (QNA) and the rebasing of the annual national accounts to 2000/01 from 1994/95. These missions and other developments are within the context of a broader Asian Development Bank (AsDB) project aimed at strengthening the national accounts.

The **consumer price index** (CPI) uses outdated weights from the 1995/96 household expenditure survey. The CPI covers only urban areas and the consumption basket refers only to a subset of the population as it excludes: the upper and lower two income deciles; single person households; households with more than eight persons; and households obtaining more than 50 percent of consumption from own production or less than 50 percent of their income in cash. The national index is obtained by aggregating regional indices using population weights instead of the recommended expenditure weights. The **wholesale price index** (WPI) was developed by the NRB and first published in July 2001. The weights for the WPI, based on 1999/2000 data, were derived using a commodity flow approach and the prices related to the first commercial transaction point. However, compilation methods need improvement to implement weekly or bi-weekly price collection; the number of price quotations should be increased; and procedures for adjusting for quality differences require implementation. The CBS, with STA assistance, is developing a monthly **producer price index** (PPI) series, to replace the manufacturing price index, based on unit values rather than actual transaction prices. The new price index is expected to provide better deflation of national accounts data and a more accurate measure of industrial sector inflation.

Fiscal Sector

A revised **budget classification** system, introduced in 1996/97 and subsequently refined, has substantially improved fiscal statistics, in particular the division between current and capital spending. However, fiscal data by functional and economic classification are provided on an irregular basis with varying degrees of coverage. In addition, large amounts are still allocated to the contingency account, and monthly reporting of development spending excludes amounts directly paid by donors. Moreover, a number of fees collected outside the budget and the operations of local governments are not reported in the annual budget.

More timely data on **revenue and expenditure** are needed for effective fiscal control. A financial management project is underway and a system of 'flash' reporting covering selected districts that account for the bulk of expenditure is being developed. Further improvement of fiscal data collected by the Financial Comptroller General's Office would permit the Ministry of Finance (MoF) to monitor more effectively actual revenue collections and expenditures, and to provide assessments during the course of the fiscal year. Such improvements will require further computerization in MoF regional offices, as well as donor financing and additional TA.

Consolidated accounts for the **public enterprise sector** are not compiled on a regular basis, and financial reporting by many individual enterprises is subject to long delays. Fund staff has assisted the authorities in processing surveys of public enterprises.

The Nepal Rastra Bank (NRB) reports data regularly for publication in the *Government Finance Statistics Yearbook.*

Monetary Sector

Monetary data provided by the NRB have been subject to revisions with a substantial lag (up to 12 months), complicating program monitoring. **Money and banking statistics** missions visited Kathmandu during April/May 1999 and March 2000 to assist in improving timeliness, compilation procedures, and the coverage of the financial system. The 2001 multisector mission recommended implementation of the residency criterion, instead of the currency basis, to distinguish foreign and domestic accounts. The mission also encouraged the NRB to improve procedures for aggregating balance sheet data to account for late reporting by commercial bank branches, which had led to underestimations for broad money. In August 2002, the NRB informed STA about the introduction of new reporting forms for commercial banks, the implementation of which initially resulted in delayed transmissions of aggregated data on banks to STA. Nepal's country page in the October 2006 *IFS* shows data for the monetary authorities, deposit money banks, and interest rates with a six-month lag. However, some components of data on deposit money banks are still not reported, preventing the publication in *IFS* of key aggregates such as claims on private sector, demand deposit liabilities, and money.

The July 2003 monetary and financial statistics mission noted that the NRB has implemented some key guidelines of the IMF's *Monetary and Financial Statistics Manual,* notably on the sectorization of the economy and categorization of financial assets and liabilities. The mission made high-priority recommendations regarding the following important shortcomings: (1) inadequate staff and computer resources; (2) interdepartmental data discrepancies on foreign reserve data; (3) late reporting of commercial banks and other banking institutions; (4) inaccurate estimation for late reporting commercial bank branches; (5) large interbank discrepancies; and (6) incorrect recording of repurchase agreements. The mission also recommended that the authorities consider the establishment of a Statistics Department in the context of NRB's ongoing reorganization. The authorities have started to report monetary data to STA using the new Standardized Reporting Forms.

Balance of Payments

A peripatetic Statistical Adviser conducted a series of missions in recent years. Despite improvements, net errors and omissions remain large. Work is underway to improve the estimation of workers' remittances, and the data sources for private capital flows. Further work is needed to improve the recording of oil transactions, grants, foreign direct investment, short-term inflows, and other private capital flows. In September 2003, the authorities began publishing the balance of payments in the format recommended by Fund technical assistance, but some other recommendations have not yet been fully implemented. Staffing is being increased.

Exports and imports data compiled by the NRB, the Customs Department, and the Trade Promotion Center (overseas trade only) exhibit discrepancies. Export and import price indices are not compiled, information on trade volumes is unavailable, and the NRB continues to estimate unrecorded trade. Staffing in the Customs Department is being strengthened.

Incomplete and conflicting data on government **external grants and loans** complicate estimating foreign financing. The NRB monitors cash disbursements and repayments, but most commodity aid and direct payment are excluded. MoF reporting is also incomplete and not timely. With technical assistance from the United Kingdom's DFID, a new database with comprehensive data on disbursements, payments, and the stock of outstanding government debt has been developed and is currently being refined. However, reporting of direct external grants remains a problem.

Nepal—Table of Common Indicators Required for Surveillance

(As of October 11, 2006)

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	Sept. 2006	Sept. 2006	D and M	W and M	D and M
International reserve assets and reserve liabilities of the Monetary Authorities[1]	Sept. 2006	Sept. 2006	W	W	M
Reserve/base money	Jul. 2006	Sept. 2006	M	M	M
Broad money	Jul. 2006	Sept. 2006	M	M	M
Central bank balance sheet	Jul. 2006	Sept. 2006	M	M	M
Consolidated balance sheet of the banking system	Jul. 2006	Sept. 2006	M	M	M
Interest rates[2]	Sept. 2006	Sept. 2006	W and M	W and M	W and M
Consumer price index	Aug. 2006	Sept. 2006	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Sept. 2006	Sept. 2006	W	W	W
Revenue, expenditure, balance and composition of financing[3] – central government	Sept. 2006	Sept. 2006	W	W	W
Stocks of central government and central government-guaranteed debt[5]	2003/04	Jun. 2005	A	A	A
External current account balance	2004/05	Jun. 2006	Q/A	Q/A	A
Exports and imports of goods and services	2004/05	Jan. 2006	M	M	M
GDP/GNP	2004/05	Jun. 2006	A	A	A
Gross external debt	2004/05	Jun. 2006	A	A	A

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

ATTACHMENT I

October 26, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. de Rato:

The Government of Nepal held discussions with IMF staff during August 31–September 14, 2006 on the program supported by the Poverty Reduction and Growth Facility (PRGF). The purpose of this letter and the attached Memorandum of Economic and Financial Policies (MEFP) is to inform you of the progress in implementing the program and set out the policies for the period ahead. In addition, we request waivers for the nonobservance of performance criteria and completion of second and third reviews. We also request an extension of the arrangement by one year to November 18, 2007, and rephasing of the remaining undisbursed amount.

Despite the difficult political environment, Nepal has maintained macroeconomic stability and most quantitative performance criteria (QPCs) under the second and third reviews were met. In this regard, we request a waiver for the nonobservance of the floor on NFA for October 16, 2004. As regards the nonobservance of the continuous QPC on nonaccumulation of external payment arrears, the arrears that developed during 2005 have been cleared and a waiver was granted by the IMF Executive Board on January 18, 2006. Moreover, key structural reform measures were delayed beyond target dates. In this regard, we request waivers for nonobservance of eight structural performance criteria (SPCs) related to: (i) implementation of a time-bound action plan to improve customs administration (two SPCs); (ii) full operationalization of the large taxpayer office in the Inland Revenue Department (two SPCs); (iii) implementation of a compulsory retirement scheme in the Nepal Rastra Bank (NRB); (iv) finalization of NRB's 2003/04 accounts by an international auditor; (v) finalization of 2003/04 accounts of the Nepal Oil Corporation (NOC) by an international auditor; and (vi) implementation of an automatic pricing mechanism for oil products. Actions related to SPCs (i)−(v) have now been completed. For (vi), understandings have been reached on a revised time frame for introducing an automatic oil pricing mechanism along with measures to reduce NOC losses.

The government is fully committed to the reform agenda detailed in the 10th Plan/PRSP, which aims to reduce poverty through private-sector led growth and social inclusion. We believe that policies and measures described in the MEFP are adequate to achieve the objectives of the program, but the government stands ready to take any additional measures that may be required. The government will consult with the IMF in advance of the adoption of any such measures or on any revision of the understandings reached on policies in accordance with the IMF's procedures for such consultations. It will also provide the IMF with information required to assess progress in implementing the program. The government intends to make this letter, the MEFP, and the staff report on the reviews available to the public and authorize their posting on the IMF website subsequent to Board completion of the reviews.

Sincerely yours,

/s/ /s/

Ram Sharan Mahat
Minister of Finance

Bijaya Nath Bhattarai
Governor, Nepal Rastra Bank

Attachments
Memorandum on Economic and Financial Policies
Technical Memorandum of Understanding

NEPAL—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES UNDER THE PRGF ARRANGEMENT, 2006/07

1. **Nepal is at an important juncture after the people's movement of April 2006**. On the political front, the Government of Nepal (GON) is making a determined effort to further the peace process and restore participatory democracy. The government is in close contact with the Communist Party of Nepal (Maoist) to further cement the ceasefire, and is discussing the formation of a government with their participation to decisively end the armed conflict that has beset Nepal for over a decade. Discussions are also underway for elections to a constituent assembly and formation of representative institutions at the central and local levels. To this end, Prime Minister Koirala and Mr. Prachanda (Chairman, CPN(M)) have written to the United Nations to assist with monitoring human rights, the ceasefire and combatants' arms, and fair conduct of constituent assembly elections.

2. **On the economic front, new opportunities for socioeconomic transformation have emerged, and people's expectations for growth and an improvement in their living standards are high**. To seize these opportunities and meet public expectations, the GON is firmly committed to achieving the goals of Nepal's 10th Plan/ Poverty Reduction Strategy Paper (PRSP), which remain appropriate. The PRSP which was finalized in July 2003 lays out Nepal's objectives and policy agenda for 2002−07 and continues to guide the policies of the seven party alliance (SPA) government. This agenda has been supported by the Poverty Reduction and Growth Facility (PRGF) arrangement which was approved by the IMF's Executive Board in November 2003. This memorandum reviews progress achieved under the PRGF arrangement since the completion of the first review in October 2004. Progress on the broader objectives of the PRSP for 2004/05 was most recently reviewed in the "Assessment of the Implementation of the Tenth Plan/PRSP" which was finalized in June 2006. Preparations are under way at the National Planning Commission to review performance during 2005/06. Looking forward, this memorandum outlines economic and financial policies for 2006/07 in support of which the GON is requesting completion of the second and third reviews and an extension of the PRGF arrangement to November 2007.

3. **The GON has taken steps to bring the program back on track and remains firmly committed to implementing policy understandings reached under the PRGF arrangement**. To set the stage for completion of the reviews and extension of the arrangement, key structural reform actions for the reviews have been completed. For actions that have not been completed, either compensatory measures have been taken or understandings have been reached on a revised timeframe. Specifically, all structural performance criteria (SPCs) for the reviews (with the exception of the introduction of an automatic pricing mechanism for oil products) have been implemented. Measurable progress has also been made on structural benchmarks (SBs). Most quantitative performance criteria (QPCs) and indicative targets (ITs) for reviews were also met. For those SPCs that were completed with a delay and the QPC that was not met, the GON is requesting waivers from the IMF's Executive Board.

I. ECONOMIC DEVELOPMENTS AND ACHIEVEMENTS

A. Macroeconomic Developments and Policies

4. **Macroeconomic stability was maintained during 2004/05 and 2005/06**. Notwithstanding political uncertainties, an unsettled security situation, poor weather conditions, and external shocks, real GDP growth averaged 2¼ percent during 2004/05−2005/06. Underlying CPI inflation averaged 4½ percent, broadly in line with price developments in India. International reserves rose from US$1½ billion at end-2003/04 to over US$1¾ billion at end-2005/06, supported by robust private remittances, even as foreign aid inflows declined.

5. **Macroeconomic policies remained appropriate**. The overall and domestically financed deficits were lower than programmed in 2004/05. While revenues fell short of the revised budget target, development spending remained constrained by the unsettled security environment. In 2005/06, revenues fell short of the budget target by 1½ percent of GDP (GON format) as political uncertainties rose and growth slowed. Aid declined further. Even though development spending also remained constrained, the (net) domestically financed deficit was higher than budgeted by ½ percent of GDP. Monetary and exchange rate policies of the Nepal Rastra Bank (NRB) remained firmly geared to maintaining the exchange rate peg to the Indian rupee.

B. Structural Reforms

6. **The GON and NRB have reinvigorated reform implementation after a slowdown in 2005 and early 2006**.

Fiscal Reforms

- **Tax administration**: Performance indicators have been developed and performance-based incentive schemes were introduced on a pilot basis in the Large Taxpayer Office (LTO) and the model customs office at Sirsiya Dry Port in October 2006. The Customs Department has prepared a valuation database to more accurately assess declarations. With these actions, the outstanding actions related to full operationalization of the LTO in the Inland Revenue Department (IRD) and implementation of a time-bound action plan to improve customs administration have been completed.

- **Fiscal Transparency**: The fiscal transparency module of the IMF's Report on Observance of Standards and Codes (ROSC) was completed, and a draft Fiscal Transparency Act has been prepared.

Financial Sector

- **NRB "re-engineering:"** The NRB amended its employee rules and regulations to make provision for a tenure-based Compulsory Retirement Scheme (CRS) at end-2004/05 and a staff reduction of 19 was achieved with the CRS to further right size the NRB. The audit of NRB's 2003/04 accounts by an international auditor was finalized in April 2005. In addition, an audit of 2004/05 accounts was finalized in May 2006. The international audit firm gave a qualified opinion on both these accounts, while noting that the quality of the accounts had improved and that progress had been made towards meetings IFRS standards. To address the remaining qualifications and spur improvements in the Internal Audit and Financial Management Departments, the NRB Board has requested the Auditor General to allow an international audit of NRB's 2005/06 accounts.

- **Restructuring of commercial and development banks**: The commercial banks under external managers (Nepal Bank Limited and Rastriya Banijya Bank; NBL and RBB, respectively), made operating profits in 2005/06, reduced their NPLs, improved lending practices, and made substantial progress in computerization of their branches. Substantial progress was made with the restructuring of Agricultural Development Bank of Nepal (ADBN), including through a voluntary retirement scheme to reduce excess staff, changes in the management team, and reconstitution of its board of directors. Restructuring of Nepal Industrial Development Corporation (NIDC) also progressed with rationalization of its branch network, staff reduction, and preparation of an asset valuation report.

Public Sector Reforms

- To create space for private sector activity, **state-owned enterprises** (SOEs) Bhaktpur Brick Factory, Lumbini Sugar Mill, Nepal Rosin and Turpentine, Hetauda Textile Factory, and Nepal Coal Limited were privatized or are in the process of liquidation; and to reduce contingent liabilities of the budget, Cottage and Handicrafts Emporium was liquidated during 2004/05−2005/06. To improve their operating efficiency, an internal unbundling of Nepal Electricity Authority was completed in 2004/05, and Nepal Telecommunications Corporation was transformed into a company in 2004/05.

- Although the SPC related to the introduction of an automatic pricing mechanism for oil products could not be met by end-December 2004, to address the losses of **Nepal Oil Corporation (NOC)**, prices of petroleum products were raised by 20−70 percent during January 2005 and May 2006. Notwithstanding the price increases, NOC has continued to make substantial losses due to rising international oil prices and its operating inefficiencies. A financial review of NOC's 2003/04 accounts by an international accounting firm was finalized in June 2006 to accurately assess its financial condition. To address operational deficiencies noted in this report and the accumulated losses of NOC, the GON has appointed a committee which submitted its report and recommended corrective actions in late September. Meanwhile, the draft Petroleum Sale and Distribution Act to liberalize the oil sector and further increase private sector participation was approved by the cabinet in October 2006.

Regulation, Private Sector Development, and Governance

- To clarify the regulatory framework for private sector activity, Secured Transactions, Company, Securities, and Insolvency Acts were adopted in September/October 2005. Parliament is also discussing the draft Procurement, Governance, and Civil Service Acts.

II. Macroeconomic Objectives and Policies for 2006/07

A. Macroeconomic Objectives

7. **Economic activity is expected to recover somewhat in 2006/07**. Real GDP growth is expected to increase to 3−4 percent. While agriculture output growth is likely to remain dampened due to erratic weather conditions and manufacturing may still take some time to recover from unsettled labor market conditions, tourism and construction appear to be making a strong rebound. Underlying CPI inflation is projected to remain around 5−6 percent, in line with price developments in India. The current account is projected to remain in surplus with continued strong remittance inflows.

B. Fiscal Policies

8. **The 2006/07 budget aims to raise and improve the quality of public spending, raise the revenue-to-GDP ratio, and limit domestic borrowing**. On the revenue side, a rebound in activity and reduced supply disruptions are expected to help revive revenue performance to 13⅓ percent of GDP. A part of this increase would come from higher customs duty rates on selected imports and higher corporate taxes and excises on alcohol, beer, and cigarettes. The budget makes provisions for a significant scaling up of social sector and public investment programs on health, education, and rural infrastructure, prioritized along the lines of the Medium-Term Expenditure Framework. The allocation for security-related spending was reduced by ½ percent of GDP to 2¾ percent. Implementation capacity for increased local level investment remains weak but is expected to be overcome partially by scaled-up grants for village development committees, where past experience with community and user groups' participation in project implementation has been favorable. With the rise in spending to meet development needs, the overall deficit (after grants) is expected to rise to 5½ percent of GDP. External aid is projected to increase from 3¾ percent of GDP in 2005/06 to 6¼ percent, and the gross domestically financed deficit would be limited to Nrs. 18 billion (2¾ percent of GDP).

9. **Beyond 2006/07, the GON intends to remain focused on its medium-term objectives of raising resources to finance infrastructure and needed structural reforms**

while lowering the public debt-to-GDP ratio. A further increase in the revenue-to-GDP ratio to 13¾ percent by 2008/09 should be possible from tighter administration and base broadening, including elimination of VAT exemptions and reducing customs and excise leakages. As implementation capacity improves, it would be possible to raise spending on much needed social sector and infrastructure projects, mainly through higher external aid while further reducing security-related spending to lower levels as the peace is firmly reestablished. The overall deficit (after grants) would be limited to 5¼ percent of GDP, while the gross domestically financed deficit could be progressively lowered to 2½ percent of GDP. This would leave room to meet the costs of further reforms in the financial and public enterprise sectors.

C. Monetary and Exchange Rate Policies

10. **The NRB's monetary and exchange rate policy will remain geared toward maintaining the peg to the Indian rupee**. The peg has served Nepal well given close ties with India. In addition, the level of the exchange rate peg is appropriate. Consistent with this objective, broad money growth is projected at around 16 percent in 2006/07, assuming real GDP growth of 3−4 percent and a small decline in velocity. This would accommodate the projected domestic financing needs of the budget while allowing real private sector credit growth of 8−9 percent. Reserve money growth is projected at 16 percent, with a targeted increase in the NRB's net foreign assets (NFA) of US$110 million.

11. **The NRB will take steps to further improve monetary operations and its internal processes**. To address excess liquidity in the financial system, the NRB will explore options for allowing a large volume of import transactions with India, including by the NOC, to be made in convertible currencies, and approach the MOF to issue a stock of T-bills (which could be placed in a separate government account at the NRB) to assist with liquidity management. To strengthen the legal basis for repo operations, the NRB Board will approve by January 15, 2007 a Master Repo Agreement for the NRB and commercial banks. To address IFRS noncompliances noted in the 2004/05 NRB accounts and further improve the internal audit and financial management departments, the Auditor General has agreed to appoint an international firm to audit NRB 2005/06 accounts as well.

D. Structural Reforms

12. **The GON and NRB are determined to press ahead with structural reforms in three macrocritical areas in the context of the PRGF arrangement**. More broadly, the GON is committed to improving service delivery to the public and to improve governance, consistent with the overall objectives of Nepal's PRSP. To this end, the GON intends to maintain a continuous dialogue with all stakeholders to ensure that these objectives are met.

Fiscal Reforms

- **Tax administration**: The GON will make a strong effort to further reforms to raise revenue collection, reduce leakages, enhance audit, and improve taxpayer services in the Inland Revenue and Customs Departments. To help improve revenue administration, the MOF intends to request further IMF and other donor assistance.

    - *Inland Revenue Department*: The LTO will conduct a comprehensive audit of at least 80 large taxpayers in 2006/07. In addition, to assess the extent of excise leakages, the MOF has instructed the LTO to conduct quarterly audits of excise returns of large taxpayers, effective immediately. The first such audit will relate to mid-October, 2006. In addition, the excise sticker regime will be fully operational by April 15, 2007. The IRD is conducting a study of VAT nonfilers, based on which the proportion of nonfilers will be reduced from the current level of over 20 percent to 12½ percent by end-2006/07. As regards income tax, the IRD will make compulsory electronic tax deduction at source (ETDS) for all large taxpayers after January 15, 2007, and for Kathmandu-based government offices after July 15, 2007. As part of IRD's Compliance Year efforts, computerization will be extended significantly at the large taxpayer and retail levels to reduce underinvoicing.

    - *Customs Department*: The MOF has approved a new three-year reform program for the Customs Department. As part of this action plan, and in line with IMF recommendations, the department will establish a wide area network (WAN) between the headquarters in Kathmandu and the five largest customs offices by March 15, 2007 to improve information sharing among the offices. In this context, efforts are underway to improve ASYCUDA functionality with AsDB and UNCTAD assistance. The department will also streamline customs clearance procedures at the largest customs point in Birgunj. To rationalize the tariff regime, steps will be taken to gain parliamentary passage of an amended Customs Act in time for inclusion in the 2007/08 budget.

Fiscal Transparency

- **Consistent with public demand, the GON will significantly improve fiscal transparency**. The draft Fiscal Transparency Act will be forwarded for parliamentary passage in 2006/07. In addition, to assess contingent liabilities of the budget at state-owned public enterprises, the MOF and other line ministries will request the Auditor General to update the statutory audited accounts of four enterprises for 2005/06 by April 15, 2007.

E. Financial Sector

13. **Steps will be taken to improve the banking framework and loan recovery, further NRB re-engineering, and help restructure troubled commercial and development banks**.

- **Legal framework**: To improve the legal framework for financial sector activity, a revised Banking and Financial Institutions Act (BFIA) will be finalized. Cabinet approval for the act will be sought by July 15, 2007. Also a draft Anti-Money Laundering Bill to strengthen the integrity of the financial system will be presented to Parliament by January 15, 2007. While the revised BFIA will provide an opportunity to consolidate the legal framework, in the interim, the NRB will issue guidelines by January 15, 2007 under the existing BFIA to clarify the procedure for mergers and acquisitions to facilitate consolidation among financial sector institutions. To prevent the entry of weak institutions in the financial sector, the NRB will strictly implement its licensing policy, including the application of "fit and proper" criteria, especially with respect to source of initial capital, integrity and suitability of promoters, and business viability plans.

- **Loan recovery**: The GON is determined to take action against willful defaulters and intends to impound their passports and restrict access to public services, as stated in the 2006/07 budget speech and incorporated in recent amendments to the BFIA. The GON and the NRB expect that this would push large willful defaulters to regularize their financial relation with creditors, especially NBL and RBB. In the event that such actions do not yield adequate results, the NRB will review blacklisting directives to explore the possibility of criminal action against willful defaulters.

- **NRB "re-engineering**:**"** To focus the NRB on its core functions and to address noncompliance with IFRS standards, the NRB will divest its shareholding in the Non-Life Insurance Division of Rastriya Beema Sansthan, the Citizen Investment Trust, and at least two rural developments banks by July 15, 2007. At the same time, a strong effort will be made to strengthen NRB supervisory capacity to ensure that the central bank is well placed to meet the challenges of financial sector liberalization as part of WTO commitment in 2010. To this end, the NRB will conduct a self-assessment of its compliance with Basel Core Principles for Effective Banking Supervision by January 15, 2007, and intends to request IMF technical assistance to review the results. Based on this review, the NRB will address gaps in the supervisory framework. To enhance off-site supervision, the NRB will develop a manual for analyzing data submission by development banks and finance companies by March 15, 2007. The supervision department will develop an early warning system based on off-site data and pursue effective communication of risks to senior management.

- **Commercial banks**: With restructuring of NBL and RBB by external managers in its third year under the Financial Sector Reform Program with assistance from the World Bank, the GON is now looking ahead to the next phase. The NRB has begun preparations for eventual privatization of the banks, with external assistance. These preparations are in early stages, and various modalities are under consideration, including sale to strategic investors after NPLs in the banks have been reduced to a manageable size.

F. Nepal Oil Corporation

14. **To address NOC losses, the GON will gradually adjust upwards prices of oil products** to ensure that NOC will reduce flow losses to zero by mid-July 2007 with an automatic pricing mechanism for oil products being introduced at that time. In the meantime, suitable measures to finance flow losses have been devised. The GON is also discussing suitable arrangements with Indian Oil Corporation to resolve accumulated suppliers' credits.

III. Program Monitoring

15. **The program will be monitored using the definitions, data sources, and frequency of monitoring set out in the attached Technical Memorandum of Understanding (TMU)**. The government will make available to Fund staff all core data, appropriately reconciled and on a timely basis, as specified in the TMU.

16. **Performance criteria**. Table 1 shows quantitative performance criteria and benchmarks until mid-July 2007. In addition, the nonaccumulation of external payment arrears will constitute a continuous performance criterion, as will the standard injunctions against overdue financial obligations to the IMF, imposition or intensification of restrictions on current payments, introducing or modifying multiple currency practices, conclusion of bilateral payments agreements inconsistent with Article VIII, and imposition or intensification of import restrictions for balance of payments purposes. Structural performance criteria and benchmarks for the fourth and fifth reviews are identified in Tables 2 and 3.

17. **Program review**. The fourth review of the program under the PRGF arrangement is expected to be completed by mid-April 2007. This review will focus on: (i) the implementation of administration reforms at the Inland Revenue and Customs Departments; (ii) financial sector reform; (iii) safeguards issues; and (iv) progress in oil sector and SOE reform. The fifth review under the arrangement is expected to be completed by mid-October 2007.

18. **The NRB and GON are committed to accurate data reporting under the PRGF-supported program**. In this context, the NRB intends to follow through fully with IMF recommendations to improve its financial accounts, internal audit, and financial management made in the context of the Safeguards Assessment.

Table 1. Nepal: Quantitative Performance Criteria and Indicative Targets

(In billions of Nepalese rupees, unless otherwise stated)

	Jul. 17, 2006 Est.	Oct. 17, 2006 Proj.	Jan. 14, 2007 (PC)	Apr. 13, 2007 (IT)	Jul. 15, 2007 (PC)
Performance criteria (PC) and indicative targets (IT) 1/					
I. Floor on net foreign assets of the NRB (in millions of U.S. dollars) 2/ 3/	1,842.7	1,852.7	1,882.7	1,912.7	1,952.7
II. Ceiling on net domestic assets of the NRB 2/ 4/	-28.1	-26.1	-23.8	-22.7	-18.8
III. Ceiling on change in net domestic financing of central government budget 4/ 5/ Cumulative from July 17, 2006	...	2.0	4.7	7.4	10.2
IV. Ceiling on contracting or guaranteeing of new nonconcessional medium- and long-term external debt by the central government and NRB Cumulative from July 17, 2006 (in millions of U.S. dollars) 6/	...	0.0	0.0	0.0	0.0
V. Ceiling on short-term external debt contracted or guaranteed by the central government and NRB (in millions of U.S. dollars) 6/	0.0	0.0	0.0	0.0	0.0
VI. Accumulation of external payments arrears Continuous performance criterion during the program period (In millions of U.S. dollars)	0.0	0.0	0.0	0.0	0.0
Indicative targets (IT)					
I. Ceiling on reserve money	110.1	112.9	117.4	120.8	127.7
II. Floor on central government revenue 7/ Cumulative from July 17, 2006	...	14.7	36.9	57.4	84.5

1/ Mid-January 2007 and mid-July 2007 are performance criteria test dates. Figures for mid-April 2007 are indicative targets.
2/ Valued at the program exchange rates. Monetary gold valued at program prices (US$600 per oz.).
3/ Adjusted upward/downward by excess/shortfall of foreign program financing. Details specified in the Technical Memorandum of Understanding (TMU).
4/ Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing. Details specified in the TMU.
5/ Adjusted upward/downward by shortfall/excess of privatization receipts. Details specified in the TMU.
6/ External debt as in the TMU.
7/ Adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the TMU.

Table 2. Nepal: Proposed Structural Performance Criteria and Benchmarks for Fourth Review of the PRGF Arrangement

Measures	Timing
Structural Performance Criteria	
A. Fiscal Sector Reforms	
1. Large Taxpayer Office (LTO) to conduct comprehensive audit of large taxpayers 1/	January 15, 2007
2. Inland Revenue Department (IRD) to reduce VAT nonfilers to 15 percent or less of registered VAT taxpayers	January 15, 2007
3. Customs Department to establish Wide Area Network (WAN) for headquarters and at least five large customs offices	March 15, 2007
B. Financial Sector Reforms	
1. NRB to divest all of its shareholding in Non-Life Insurance Division of Rastriya Beema Sansthan and Citizen Investment Trust	February 15, 2007
2. NRB to conduct a self-assessment of compliance with the updated Basel Core Principles for Effective Supervision	January 15, 2007
3. Auditor General to appoint an international auditor for NRB 2005/06 accounts	January 31, 2007
C. Nepal Oil Corporation and Public Enterprises	
1. Finalize audit of NOC 2005/06 accounts in accordance with international standards	March 15, 2007
Structural Benchmarks	
1. IRD to make compulsory electronic tax deduction at source (ETDS) and fiscal printer for all large taxpayers	January 15, 2007
2. Submission to Parliament of draft Petroleum Sales and Distribution Act	January 15, 2007
3. Submission to Parliament of draft Anti-Money Laundering Act	January 15, 2007
4. Cabinet approval of Customs Act amendments prepared by the Customs Department	January 15, 2007
5. NIDC to implement rationalization and divestment instructions of MOF	January 15, 2007
6. NRB to issue guidelines for mergers and acquisitions of banks and financial institutions 2/	January 15, 2007

1/ LTO to conduct audit of income tax and VAT returns, and customs and excise declarations of 2005/06 for at least 30 large taxpayers. LTO to conduct quarterly audit of excises for large taxpayers (mid-October filing).
2/ The guidelines are expected to specify the regulatory framework, enabling procedures, conditions for approval, and actions in case of contravention.

Table 3. Nepal: Proposed Structural Performance Criteria and Benchmarks For Fifth Review of the PRGF Arrangement

Measures	Timing
Structural Performance Criteria	
A. Fiscal Sector Reforms	
1. Large Taxpayer Office (LTO) to conduct comprehensive audit of large taxpayers 1/	July 15, 2007
2. Inland Revenue Department (IRD) to reduce VAT nonfilers to 12.5 percent or less of registered VAT taxpayers	July 15, 2007
3. Customs Department to implement single-window customs clearance at Birgunj customs office	July 15, 2007
B. Financial Sector Reforms	
1. Cabinet approval of revised Banking and Financial Institutions Act 2/	July 15, 2007
2. NRB to divest all its shareholding in at least two rural development banks	July 15, 2007
3. Finalize audit of NRB 2005/06 accounts by an international auditor	July 15, 2007
Structural Benchmarks	
1. Submission to Parliament of amendments to Customs Act	April 15, 2007
2. Submission to Parliament of draft Fiscal Transparency Act	July 15, 2007
3. Submission to Parliament of revised Banking and Financial Institutions Act	August 15, 2007
4. IRD to make compulsory ETDS for Kathmandu-based government offices	July 15, 2007

1/ LTO to conduct audit of income tax and VAT returns, and customs and excise declarations of 2005/06 for a cumulative number of at least 70 large taxpayers. LTO to conduct quarterly audit of excises for large taxpayers (mid-January and mid-April filings).

2/ The revised act is expected to address gaps in the supervisory and regulatory frameworks identified by the assessment against the Basel Core Principles, ensure consistency with provisions of the Company Act, and bring bank insolvency and resolution frameworks under the purview of the BFIA.

NEPAL—TECHNICAL MEMORANDUM OF UNDERSTANDING FOR PRGF ARRANGEMENT

October 26, 2006

This memorandum sets out the framework for monitoring the PRGF-supported program for 2006/07. It specifies quantitative performance criteria and indicative targets and the content and frequency of the data to be provided for monitoring the financial program. All foreign currency nondollar denominated quantities under the program will be converted into U.S. dollars at program exchange rates specified in Table 1.

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Net Foreign Assets of Nepal Rastra Bank

1. **Net foreign assets (NFA) of the Nepal Rastra Bank (NRB)** is defined as the difference between the market value of gross foreign assets and liabilities, at program exchange rates. Gross foreign assets of the NRB consist of monetary gold, foreign currency balances at the NRB, foreign exchange balances held outside Nepal, foreign securities (valued at market prices), foreign bills purchased and discounted, IMF reserve position and SDR holdings. Excluded from gross foreign assets will be participation in international financial institutions and holdings of precious metals other than monetary gold. Gross foreign liabilities are all foreign currency denominated liabilities and use of Fund credit.

2. **The NFA floor will be adjusted** downward/upward by the shortfall/excess of the identified foreign program financing as set out in Table 2. Foreign program financing is defined to include adjustment loans from multilateral creditors other than the Fund, budget support from bilateral creditors, loans (if any) from private creditors (including commercial banks) and rescheduling of medium- and long-term public and publicly-guaranteed debt (exceptional financing).

B. Net Domestic Assets of NRB

3. **Net domestic assets (NDA) of the NRB** is defined as the difference between reserve money and rupee value of NFA of the NRB, at program exchange rates. NFA of the NRB is defined in Section A above; reserve money is defined in Section C.

4. **The NDA ceiling** will be adjusted downward/upward by the excess/shortfall of the identified foreign program financing as set out in Table 2. External program financing received for financial and public sector reforms over the amounts identified in Table 2 would not lead to a downward adjustment of the NDA ceiling. The upward adjustment in the ceiling due to a shortfall in external program financing compared to Table 2 would be capped at Nrs. 5 billion (around 1 percent of GDP).

C. Reserve Money of the NRB

5. **Reserve Money (RM) of the NRB** consists of currency in circulation outside the NRB, deposits of commercial banks at the NRB, and other private sector deposits at NRB. As of July 17, 2006, RM stood at Nrs. 110.1 billion.

D. Net Domestic Financing of the Central Government Budget

6. **Net domestic financing (NDF) of the budget is defined as net credit to the central government (NCG) by the banking system (NRB), and deposit money banks (DMBs) and net change in holdings of treasury bills and other government securities by the nonbank sector**. The flow NDF of the budget would be the cumulative change in book value from July 17, 2006 in the sum of the following government debt instruments: (i) treasury bills; (ii) development bonds; (iii) national and citizen savings certificates; (iv) special bonds (including duty drawback bonds); and (iv) loans and advances from the NRB and deposit money banks (DMBs) *minus* government deposits with NRB and DMBs. This stock stood at Nrs. 93.6 billion at July 17, 2006. Central government is defined here to include line ministries, departments and public institutions.

7. **The ceiling on net domestic financing** will be adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign program financing as set out in Table 2. External program financing received for financial and public sector reforms over the amounts identified in Table 2 would not lead to a downward adjustment of the NDF ceiling. The upward adjustment in the ceiling due to a shortfall in external program financing compared to Table 2 would be capped at Nrs. 5 billion (around 1 percent of GDP). The ceiling on net domestic financing will be adjusted upward/downwards by 100 percent of the amount of any shortfall/excess in privatization receipts beyond the programmed amounts (Table 3). The ceiling on net domestic financing will be adjusted upward for onlending operations to cover flow losses of Nepal Oil Corporation.

E. Central Government Revenue

8. **Central government revenue** is defined as reported in the treasury accounts (economic classification), excluding principal repayments to the budget by corporations and including privatization receipts. The floor on central government revenue is cumulative from the start of the fiscal year. The central government revenue benchmark will be adjusted upward/downward by 100 percent of the excess/shortfall in privatization receipts.

F. Contracting or Guaranteeing of New Nonconcessional External Debt

9. **Contracting or guaranteeing of new medium- and long-term nonconcessional external debt** is defined as contracting or guaranteeing new nonconcessional external debt by the central government and the NRB with an original maturity of more than one year (valued at program exchange rates as defined in Table 1). Nonconcessional debt is defined as borrowing containing a grant element of less than 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates (CIRR). For maturities of less than 15 years, the grant element would be calculated based on six-month CIRR averages, while for maturities longer than this, the grant element would be based on ten-year CIRR averages. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274–(00/85), August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are credits extended by the IMF and financing from the World Bank and Asian Development Bank (AsDB), and government counter guarantees on project loans from both the World

Bank and AsDB, as well as changes in indebtedness resulting from rescheduling operations or rollovers. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee issued.

G. Contracting or Guaranteeing of Short-Term External Debt

10. **Stock of short-term external debt outstanding** is defined as debt with original maturity of up to one year owed or guaranteed by the NRB and central government (valued at program exchange rates as defined in Table 1). The term debt is defined as set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274–(00/85), August 24, 2000), but excludes normal import-related credits.

H. Accumulation of External Payment Arrears

11. **The program's performance criterion on nonaccumulation of external payment arrears is continuous throughout the program period**. External payments arrears are defined as overdue payments (interest and principal payments) on short-term debt in foreign currencies with an original maturity of up to and including one year (spot, money market, letters of credit) and medium- and long-term debt contracted or guaranteed by the central government. As of September 30, 2006, there were no external payment arrears.

II. Data Reporting Requirements

12. For the purpose of monitoring the performance under the program, data will be provided in the format shown in Tables 4–9. 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 letter. All the program monitoring data would be provided by the Ministry of Finance and the NRB. In addition, a written reconciliation of NRB program data (NFA, NDA and Reserve Money) with the accounting records will be prepared for all test dates under the PRGF arrangement. Data on gross foreign assets and gross foreign liabilities would be provided at market prices and program exchange rates. All the data relating to the above programmed targets will be furnished within eight weeks after the end of each test date.

Table 4. Net Foreign Assets of Nepal Rastra Bank
Table 5. Balance Sheet of Nepal Rastra Bank
Table 6. Net Domestic Financing of Central Government Budget
Table 7. Central Government Revenue
Table 8. Contracting or Guaranteeing of New Medium- and Long-Term Nonconcessional External Debt by the Central Government and NRB
Table 9. Contracting or Guaranteeing of Short-Term External Debt by the Central Government and NRB

Table 1. Program Exchange Rates and Gold Prices 1/

Foreign currency	Foreign Currency/U.S. Dollar
Nepalese rupee	75.0
Indian rupee	46.45
SDR	0.68
Japanese yen	117.0
Euro	0.80
Pound sterling	0.55
Gold prices (U.S. dollars per ounce)	600.0

1/ Currencies not shown here will be converted first into U.S. dollars using official exchange rates used by the IMF's Finance Department on July 17, 2006.

Table 2. Program Foreign Financing, 2006/07
(In millions of U.S. dollars)

	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Foreign financing (cumulative)	32.9	45.7	50.2	73.5

Table 3. Program Privatization Receipts, 2006/07
(In millions of Nepalese rupees)

	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Privatization receipts (cumulative)	0.0	0.0	495	1,978

Table 4. Net Foreign Assets of the Nepal Rastra Bank, 2006/07 (In millions of U.S. dollars)				
	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Net foreign assets 1/				
Assets				
Foreign exchange				
Monetary gold				
Reserve position in the Fund				
SDR holding				
Liabilities				
Deposits				
CSI credit accounts				
ESAF/PRGF				

1/ At program exchange rates and prices.

Table 5. Balance Sheet of the Nepal Rastra Bank, 2006/07 1/ (In billions of Nepalese rupees)				
	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Net foreign assets				
Assets				
Liabilities				
Net domestic assets				
Claims on public sector				
Net credit to government				
Claims on government 2/				
Less: Deposits				
Claims on public enterprises				
Claims on private sector				
Claims on commercial banks				
Other items (net)				
Reserve money				
Currency outside banks				
Currency held by banks				
Bankers' deposits				
Private sector deposits				

1/ For program monitoring purposes.
2/ Excluding IMF promissory notes.

Table 6. Net domestic financing of the Budget, 2006/07
(In millions of Nepalese rupees)

	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Net claims on government (stock)				
Banks				
NRB (net)				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				
Loans and advance				
Less: Deposits				
DMBs				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				
Nonbanks				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				

Table 7. Central Government Revenue, 2006/07
(In millions of Nepalese rupees)

	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Total revenue (GON)				
Less: Principal repayment by corporations				
Total revenue 1/				
Tax revenue				
Taxes on goods and services				
VAT/sales tax				
Excise taxes				
Others				
Taxes on international trade				
Import taxes				
Indian excise refund				
Export taxes				
Agriculture reform fee and other				
Taxes on income and profits				
Taxes on property				
Nontax revenue 1/				
Charges, fees, and fines				
Sales of goods and services				
Dividends				
Royalty and fixed asset sales				
Interest receipts				
Other				

1/ Excluding principal repayments by corporations.

Table 8. Contracting or Guaranteeing of New Nonconcessional Medium- and Long-Term External Debt by the Central Government and the NRB

(In millions of U.S. dollars)

Date	Creditor	Project	Date of Agreement	Currency	Maturity Period	Grace Period	Interest Rate	Amount	Disbursement

Table 9. Contracting or Guaranteeing of New Short-Term External Debt by the Central Government and the NRB

(In millions of U.S. dollars)

Date	Creditor	Project	Date of Agreement	Currency	Maturity Period	Grace Period	Interest Rate	Amount	Disbursement

Statement by the IMF Staff Representative
November 10, 2006

1. This statement reports on developments since the staff report was circulated to the Executive Board on October 27, 2006.

2. **On November 8, the government and the Communist Party of Nepal (Maoist) reached a wide ranging political agreement**. As part of the agreement, the Maoists will locate their forces in identified cantonments. They will also place under United Nations monitoring their arms in return for an equal number of government arms placed under similar monitoring. Other elements of the agreement include the formation of an interim parliament and government with the participation of the Maoists by December, on the way to constituent assembly elections in June 2007. The structure of the constituent assembly and modalities for the election have also been agreed. The international community has welcomed the agreement.

Press Release No. 06/251
FOR IMMEDIATE RELEASE
November 13, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Second and Third Reviews Under Nepal's Three-Year PRGF Arrangement and Approves US$21.2 million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the second and third reviews of Nepal's economic performance under the three-year Poverty Reduction and Growth Facility (PRGF) Arrangement which enables Nepal to draw an amount equivalent to SDR 14.3 million (about US$21.2 million) under the arrangement. Completion of these reviews will bring total disbursements under the program to SDR 28.5 million (about US$42.5 million).

The Executive Board also approved a request for waivers for the non-observance of a quantitative performance criterion related to the second review, and eight structural performance criteria related to the second and third reviews. The Board also decided to extend the current PRGF arrangement by one year to November 18, 2007.

The Executive Board approved the three-year arrangement on November 19, 2003 (see Press Release No. 03/202) for amount equivalent to SDR 49.9 million (about US$74.3 million).

Following the Executive Board's discussion of Nepal, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"Nepal's Poverty Reduction Strategy Paper provides a sound basis for achieving higher growth and poverty alleviation and the PRGF-supported program envisages continued reform implementation in the fiscal sector, financial sector, and public enterprises. These reforms, together with durable peace and political stability, will underpin strong economic growth, a durable reduction in poverty, and help achieve the Millennium Development Goals. In this context, the recent political agreement between the government and the Communist Party of Nepal (Maoist) is encouraging.

"To maintain macroeconomic stability, the authorities' medium-term fiscal objectives are to raise the revenue-to-GDP ratio, improve the efficiency of public spending, and contain domestic borrowing. Achieving these objectives requires strengthening tax administration to reduce leakages, enhancing audit, and improving taxpayer services. Prioritization of expenditures under the Medium Term Expenditure Framework would help to raise allocations for priority sectors, increase poverty-related development spending, and strengthen fiscal transparency. A strong effort is required to improve implementation capacity at the local level so that development spending targets are achieved.

"The authorities envisage a continued implementation of financial sector reforms as a key element of the PRGF-supported program. These reforms include improvements in the legal and regulatory framework, strengthening Nepal Rastra Bank, and restructuring of troubled commercial and development banks. Strong efforts will be put in place to increase loan recovery from large, willful defaulters to improve the financial condition of the ailing commercial banks.

"Public sector reforms focus on reducing losses of the Nepal Oil Corporation (NOC) and resolving accumulated supplier's credits. In addition, the transparency and efficiency of the oil sector will be improved with the preparation of NOC audited accounts in accordance with international standards and the adoption of the Petroleum Sales and Distribution Act.

"Notwithstanding difficult circumstances, it is encouraging to note the authorities' commitment to reforms and their established track record of policy implementation," Mr. Kato said.

Statement by Hooi Eng Phang, Executive Director for Nepal
November 10, 2006

Introduction

1. The Nepalese authorities would like to thank Mr. Kalra and his team for the constructive policy dialogue in Kathmandu during the recent PRGF review mission. The authorities are in broad agreement with the staff's appraisal of the macroeconomic performance of Nepal and policy initiatives to accelerate economic growth and combat poverty. The authorities welcome the staff's policy advice on both macroeconomic and structural reforms as detailed in the Memorandum of Economic and Financial Policies under the PRGF Arrangement for 2006/07. Reflecting the importance that the authorities attach to the program, the recent cabinet meeting decided to request for a one year extension of the PRGF arrangement that was approved in November 2003.

Recent Political Developments

2. The recent political development in Nepal has been momentous. The historic People's Movement of April 2006 has ushered in a new phase of democratic polity. The House of Representatives (parliament) has been restored on the back of the popular movement. The Seven Party Alliance (SPA) has formed the Government. The Government of Nepal (GON) is currently pursuing a two-pronged approach aimed at ending the decade-long conflict for long-term political stability and economic reforms for sustainable, higher rate of economic growth and reduction of poverty.

3. In pursuance of the political agenda, the GON is holding summit level talks with the Communist Party of Nepal (Maoist)- CPN (M). The summit level talks are focused on the formation of an interim constitution, interim parliament, arms management and elections to a constituent assembly. The successful conclusion of the summit level talks is expected to end the decade long conflict and bring lasting peace to the country. The GON and the CPN (M) have requested the United Nations (UN) to assist in monitoring the peace process and fair conduct of constituent assembly elections. In response to the request, the UN Secretary General's personal representative is currently in Kathmandu monitoring the situation.

4. Although the principal agenda of the GON is political, the popular movement of April has also raised peoples' expectations. The authorities feel that it is important to meet the peoples' aspirations through economic reforms. The SPA government has adopted the Tenth Plan/PRSP (2002-2007) as the basic framework for pursuing economic reforms to meet the peoples' aspirations for sustainable growth and poverty reduction. In addition, the PRSP addresses some of the Millennium Development Goals (MDG) that the GON is committed to

attaining by 2015. The authorities are also committed to implementing structural reform measures as documented in the PRGF program.

Recent Economic Developments and Outlook

5. Notwithstanding a decade-long conflict and political tensions, some of the macroeconomic fundamentals remained strong, ensuring overall macroeconomic stability. Prudent macroeconomic management and robust world economic growth contributed to this. However, economic growth remained sluggish owing to the conflict. Real GDP at producers' price grew by 1.9 percent in 2005/06 compared to a growth of 2.7 percent in 2004/05. Besides the conflict and the absence of elected local bodies, unfavorable weather conditions also contributed to slower economic growth.

6. On the price front, although pressure existed, inflation remained at a single digit level. The year-on-year (y-o-y) annual average consumer price inflation increased to 8 percent in 2005/06 compared to 4.5 percent in 2004/05. The adjustment of domestic oil prices, albeit partial in the wake of elevated international oil prices, and a rise in food prices contributed to a surge in overall prices.

7. On the external front, while merchandise exports remained vulnerable, the overall balance of payments (BOP) was resilient on the back of increased workers' remittances. The growth rate of merchandise export was lower in 2005/06 compared to 2004/05. Less-than-satisfactory performance of the two major overseas exportable items, namely woollen carpets and readymade garments, and decelerated growth of exports to India in the second half of the year on account of imposition of additional duty of 4 percent by India on Nepalese exports constrained overall export growth in 2005/06. However, import growth remained significant due to the increased imports of consumer goods as well as industrial raw materials.

8. A widening gap in the merchandise account was counterbalanced by a significant surplus in the transfers account. Workers' remittances increased significantly to about US$1.3 billion in 2005/06. In terms of GDP, workers' remittances increased to about 17 percent in 2005/06 compared to about 12 percent in 2004/05. The current account remained in surplus as did the overall BOP. A significant surplus in the BOP resulted in an increased accumulation of reserves by the Nepal Rastra Bank (NRB) to close to US$1.8 billion at the end of 2005/06 from US$1.5 billion in 2004/05.

9. Going forward, the Nepalese authorities continue to attach the topmost priority to maintaining macroeconomic stability, accelerating economic growth and implementing structural reforms. The authorities are of the view that without accelerating structural reforms and maintaining macroeconomic stability, it would be difficult for Nepal to move towards a higher growth trajectory. Given the current political transitional period, achieving these objectives would also be challenging.

10. Erratic weather conditions continue to dampen agricultural growth. Strong trade union activities, fragile political conditions and weak external demand are hampering a pick-up in the manufacturing sector but the services sector is expected to witness a turnaround. Against the backdrop of the current challenges and the changed political context, the Nepalese economy is expected to register a modest growth of 4 to 5 percent in 2006/07.

11. Risks to inflation continue to exist. A full pass-through of high and volatile international oil prices to domestic oil prices has not yet taken place, reflecting a suppressed inflationary situation. The lifting of the oil subsidy is likely to add pressure on prices but the recent fall in global oil prices is likely to ease the inflation outlook. The tight monetary policy stance of the NRB is also likely to anchor inflationary expectations. Besides these factors, Indian prices, which are expected to remain moderate, are likely to contain Nepalese prices to around 6 percent in 2006/07.

12. Nepalese merchandise exports will remain dampened in 2006/07. Given the improved security situation, a recovery in tourism is expected. Workers' remittances will continue to grow. A satisfactory level of surplus in the BOP is projected, resulting in reserve accumulation of US$125 million.

Fiscal Policy

13. Notwithstanding a difficult security situation, Nepal has been able to maintain fiscal discipline. The fiscal deficit was 1.7 percent of GDP in 2005/06, an increase from 0.8 percent in 2004/05, due mainly to lower revenue collection. A significant lowering of customs duties on some items and a fall in dividends from government corporations, tourism fees, and royalties dampened revenue collection in 2005/06. Consequently, revenue collection declined to 12.2 percent of GDP in 2005/06 from 12.9 percent in 2004/05. Overall, government expenditure remained controlled. Over the period, security expenses rose, leading to an increase in recurrent expenditure at the cost of capital spending. Nevertheless, the fiscal deficit remained lower than those of other South Asian countries and net domestic borrowing remained low at 1.5 percent of GDP in 2005/06.

14. Looking ahead, the budget for 2006/07 is geared towards meeting expectations of higher growth. The budget aims at improving the quality of government spending in terms of increased allocation for capital expenditure. It also aims at increasing revenue collection through the adjustment in revenue rates, improved revenue collection from VAT, and improvements in tax administration. Increased economic activities are also expected to enhance revenue collection.

15. Overall, the fiscal deficit in 2006/07 is expected to be slightly higher. Increased foreign loans are expected to finance a part of the fiscal deficit while net domestic financing is projected to remain at about 1.5 percent of GDP.

Monetary and Exchange Rate Policies

16. The central objective of both monetary and exchange rate policies is to maintain the pegged exchange rate regime. The currency peg to the Indian rupee has served Nepal well in maintaining macroeconomic stability. The Nepalese authorities are in agreement with the staff's assessment that the current level of the exchange rate peg is appropriate. A slight inflation differential between Nepal and India caused a marginal real appreciation of the Nepalese rupee vis-à-vis Indian rupee in recent months. The real exchange rate (RER) of the Nepalese rupee with the Indian rupee is expected to revert to a neutral position as Nepalese prices are trending towards convergence with Indian prices.

17. The NRB announced its annual monetary policy for 2006/07 on July 23, 2006. The focus of monetary policy has been to curb inflation. Broad money is projected to grow by 16 percent in 2006/07. In line with the expected increase in economic activities, bank credit to the private sector is projected to expand by 16.2 percent in 2006/07.

18. The NRB is relying on open market operations to modulate liquidity. Sale auction, purchase auction, repo auction and reverse repo auction are the key market-based monetary instruments. To mop up liquidity emanating from increased workers' remittances, the NRB has decided to offload government treasury bills from its holding. The liquidity monitoring and forecasting framework (LMFF) has been put in place to guide open market operations.

Structural Reforms

19. Over the period of three years, a number of structural reforms relating to the public and financial sectors were initiated. On the fiscal front, a large tax office (LTO) in the Inland Revenue Department (IRD) has been operationalised. The government has also drafted the Fiscal Transparency Act.

20. Five state-owned enterprises were privatized or liquidated. Nepal Telecommunication Corporation was also converted into a public limited company. To improve the financial position of Nepal Oil Corporation (NOC), prices of petroleum products were raised by an average of 35.7 percent in 2005/06. The international audit firm has reviewed NOC's accounts for 2003/04. Recently, the GON appointed a committee to look into ways of addressing the operational deficiencies of NOC. The committee submitted its report on September 21, 2006. With a view to increasing private sector participation, a bill relating to the sale and distribution of petroleum has been presented to the parliament for enactment.

21. On the financial sector front, a number of measures aimed at modernizing the central bank were introduced. In this regard, the NRB amended its employment rules and regulation with a view to introducing tenure based Compulsory Retirement Scheme (CRS) to improve efficiency and productivity. International auditors finalized NRB's accounts for 2003/04 and 2004/05 and the Auditor General has approved the NRB Board's request to allow its 2005/06 accounts to be audited by international auditors. Foreign management teams placed in two

state-owned commercial banks have made some progress in improving the financial health of the banks. A significant staff reduction also took place in these two banks. On the legal front, secured transactions, company, securities and insolvency Bills were enacted.

22. Looking ahead, the Nepalese authorities are committed to further accelerating structural reforms. On the fiscal front, the LTO will undertake a comprehensive audit of at least 80 large taxpayers in 2006/07. Likewise, the LTO will also conduct quarterly audits of excise returns of large taxpayers. The GON has also decided to conduct a study of VAT evasion. On the income tax front, the GON is committed to making compulsory electronic tax deduction at source for large taxpayers. To improve information sharing, the GON has decided to establish a wide area network (WAN) between the headquarters in Kathmandu and the five largest customs offices.

23. On financial sector reforms, the authorities are committed to further accelerating legal reforms. Enactment of a revised Banking and Financial Institutions Act (BFIA) and Anti-Money Laundering Bill are in the pipeline. One of the major issues in the financial sector is the settlement of non-performing loans. The GON and the NRB are determined to take appropriate action against willful defaulters. To concentrate on its core functions and avoid conflict of interest, the NRB has decided to divest its shareholding in some of the financial institutions. To identify and fill gaps in its supervisory capacity, the NRB is committed to conducting a self-assessment of its compliance with Basel Core Principles for Effective Banking Supervision.

24. Most of the quantitative performance criteria (QPC) under the second and third reviews were met. In this context, the authorities would like to request a waiver for the nonobservance of the floor on NFA for October 16, 2004. As regards structural performance criteria (SPC), the authorities also would like to request waivers for the delayed implementation of SPCs. For all except one of these SPCs, corrective actions have recently been taken as stated in the Staff Report. On implementing an automatic pricing mechanism for oil products, the government intends to implement the revised understandings. The Nepalese authorities would also like to thank the IMF Executive Board for granting a waiver on January 18, 2006 for unintentional non-observance of the QPC on the non-accumulation of external payment arrears.

Conclusion

25. A decade long conflict and concomitant political tension sapped the Nepalese economy, slowing the growth process and impeding efforts to reduce poverty. The task of accelerating economic growth and reducing poverty remains challenging. The recent political change has offered Nepal an opportunity to accelerate the economic growth process. As Nepal is in political transition, the authorities are determined to seize this opportunity to make concerted efforts to accelerate structural reforms aimed at enhancing economic efficiency. However, the efforts of the Nepalese authorities alone are not sufficient.

Therefore, the Nepalese authorities would like to solicit the support of the international community in their endeavors to accelerate economic growth and reduce poverty.

26. The Nepalese authorities remain committed to transparency and therefore consent to the publication of the staff report on the review, the LOI and the memorandum. In conclusion, the authorities would like to reiterate their appreciation to the donor community for their continued assistance and support.