

Nepal: 2001 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

As required under Article IV of its Articles of Agreement, the International Monetary Fund conducts periodic consultations with its member countries. In the context of the 2001 Article IV consultation with Nepal, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 2, 2001**, 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 August 15, 2001.** 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 **August 31, 2001** updating information on recent developments.
- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during the August 31, 2001, Executive Board discussion** of the staff report that concluded the Article IV consultation.

The document listed below will be separately released.

Recent Economic Developments paper

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INTERNATIONAL MONETARY FUND

NEPAL

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with Nepal

Approved by R. Anthony Elson and Mark Allen

August 15, 2001

- At the conclusion of the 1999 Article IV consultation in February 2000, Executive Directors stressed the critical importance of accelerating key structural reforms to lay the foundation for high and sustainable growth as a basis for poverty alleviation.
- Discussions for the 2001 Article IV consultation were held in Kathmandu during November 16–30, 2000 and April 16–May 2, 2001. The staff team comprising Mr. Carter (head), Ms. Abdelati, Messrs. Lee and Baig (all APD), Mr. Kitabire (PDR), Mr. Ahsan (IBRD), and Ms. Godo (staff assistant, APD), was assisted by the Resident Representative, Mr. DeMilner. Local IBRD and AsDB staff also participated in the discussions. Mr. Low, Alternate Executive Director, attended the November mission, while Mr. Bhatta, Advisor to the Executive Director, attended the April mission. The team met Prime Minister Koirala, Finance Ministers Acharya and Mahat, National Planning Commission Vice-Chairman Ligal, Nepal Rastra Bank (NRB) Governors Dhakal and Rawal, other senior government officials and representatives of private business, donors, and opposition parties.
- Macroeconomic performance has been satisfactory in the past two years, but poverty remains a critical problem. The government has formulated a medium-term structural reform program based on the priorities and objectives identified in their draft Interim-PRSP. The government's program focuses on maintaining macroeconomic stability and stimulating growth by increasing agricultural productivity, removing the constraints posed by a weak and segmented financial sector, inefficient public sector operations, an inadequate legal framework, and poor governance.
- Following the death of nine members of the royal family on June 1, a new king was crowned and Parliament reconvened on June 29. However, civil strife escalated and conflicts within the ruling National Congress Party continued, culminating in the resignation of Prime Minister Koirala on July 19.
- Nepal accepted the obligations of Article VIII, Sections 2, 3, and 4 in May 1994, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.
- Major statistical weaknesses continue to limit economic analysis. A comprehensive program of technical assistance to address these weaknesses is under way by donors, including the Fund.
- The principal authors of the staff report are Jeremy Carter and Wafa Abdelati.

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I. BACKGROUND

1. **Nepal remains one of the poorest countries in the world, with two fifths of the population below the poverty line.**¹ Large segments of the poor survive in subsistence, living on fragile ecosystems, while much of the country lacks even the most basic infrastructure. There are also wide variations of poverty, based on the rural-urban divide, geography, ethnic group, and occupational caste. Key factors have been inadequate agricultural growth and a failure to develop sufficiently the nonagricultural sector to provide jobs and incomes for the rapidly growing population. Over the past three decades, Nepal's economy has been growing at an annual pace of about 4 percent, and output growth in the agricultural sector has been only 2.5 percent, not much above the 2.4 percent rate of population growth.
2. **Since Nepal opened up to the outside world several decades ago, donors have sought to improve economic conditions through extensive aid programs.** However, there has been relatively little supporting foreign investment in the economy, and many aid projects have faltered because of weak institutional capacity and poor public resource management in an environment of political uncertainty. The nonagricultural economy has developed in an uneven manner, reflecting the effects of the economy's strong ties to India. Land-locked but with a long, open border with her large neighbor, Nepal relies on India for most imports, and nationals from each country work in large numbers across the border. Many Nepalese private sector firms are closely linked with Indian businesses, and many of the manufacturing or other trade ventures that have been set up in the past years focus on taking advantage of the rigidities existing in the Indian economy. However, frequent changes in Indian trade policy have resulted in considerable adjustment costs for Nepalese companies, and discouraged investment.
3. **Nepal's primary challenge is to achieve and sustain higher growth levels in order to improve conditions for the poor.** A substantial reduction in the structural impediments to broad-based private sector-led growth would require a substantial increase in spending on education and infrastructure, as well as significant inflows of foreign capital over the long term, to tap the country's potential and eventually permit sufficiently fast growth. Improvements are also critical in the financial sector, where weaknesses impede efficient intermediation of savings into the financing of viable investments. Public sector inefficiencies, weak governance, and the overlapping of donor-driven projects have so far limited the impact of foreign aid on poverty alleviation. To address these concerns, the authorities are developing a comprehensive reform program, which places poverty reduction as the overarching objective, targeting a reduction of the proportion of the population living below the poverty line to 10 percent over the next two decades (Box 1).

¹ Official estimates indicate that poverty declined from 42 percent in 1995/96 to 38 percent in 2000/01, compared with the government's target of a 32 percent rate by 2001/02. Given current population growth rates, it would take Nepal two decades of 10 percent growth to reach the current IDA threshold.

Box 1. Nepal: Poverty Reduction Strategy Paper

The authorities' objective is to prepare one key poverty reduction strategy document by next year, endorsed fully by the government and all the major donor agencies. The full PRSP will form the core of the Tenth Five Year National Plan and would be presented to Parliament in late 2002. In the past, the government has presented its own five-year plan for economic development, while each of the main donor agencies drew up separate assistance strategy documents, often with conflicting priorities.

Consultation on the I-PRSP was extensive with all levels of civil society and donors. The I-PRSP was posted on the National Planning Commission's website on July 16, 2001 (www.npc.gov.np) and will be the subject of a final discussion at a donor group meeting in Kathmandu in September 2001.

The draft has identified the main causes of poverty as primarily:

- inadequate broad-based economic growth,
- poor performance by the agricultural sector, with low and decreasing productivity,
- poor rural infrastructure,
- insufficient provision of education and health services, especially in the rural areas, and
- a lack of sufficient priority to poverty reduction measures.

The main goal of the poverty reduction strategy is to reduce the percent of population living below the poverty line from 38 percent to 10 percent over two decades.

Key intermediate targets that have been established to support this objective include:

- overall GDP growth to increase to 6½ percent by 2003/04, with agricultural output rising by 4 percent each year,
- a reduced birth rate, while increasing life expectancy,
- diversification of tourism activities to rural areas,
- extension of electricity and irrigation to rural areas,
- nationwide road access,
- universal primary education, and
- fiscal decentralization.

The current version of the I-PRSP has not yet been linked to the budget allocations because of delays in preparing the ministerial submissions for the 2001/02 Budget and in developing the three-year budget allocation program.

The implications of the most recent political events have not been reflected, including weakened security and the disruption of banking, post and social services.

4. **Political events have complicated policy implementation in the past year.** Despite winning a clear majority in the May 1999 general elections, the Nepal Congress Party (NC) leadership has faced stiff opposition including from dissident factions within the party. The opposition obstructed all parliamentary proceedings in the winter session, and the ruling party lost its majority in the upper house of parliament in June 2001. The presentation of the 2001/02 Budget was delayed by six weeks following the slaying of the royal family in June, which also precipitated wide-scale demonstrations and further reduced confidence in the government. In July, Prime Minister G.P. Koirala resigned and was replaced by Sher Bahadur Deuba.

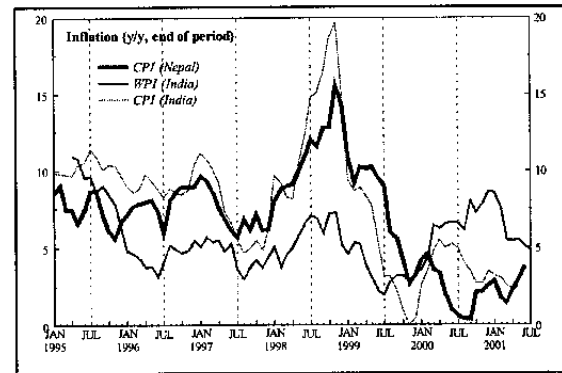
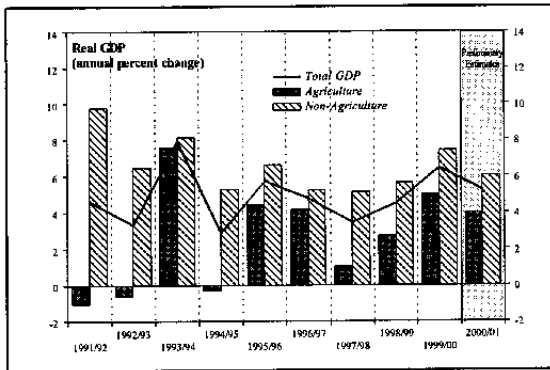
5. **The political situation has also been adversely affected by stepped-up activity by Maoist insurgents.** The insurgents, who have been waging a war against the constitutional monarchy and the system of multi-party democracy since the mid-1990s, had been active principally in the midwestern region of Nepal. More recently, however, the Maoists have encouraged “bandhs” (forced shut-downs), violent demonstrations, and deadly attacks on government officials, police, and other targets. Moreover, the insurgency has spread to the economically important Kathmandu valley, raising concern regarding the potential impact on tourism and manufacturing activity. A 1999 Conflict Assessment Report by the U.K. development agency (DfID) stressed the importance of strengthening development and poverty alleviation policies in conflict-affected areas, and the authorities have sought to take a number of steps in this regard.

6. **At the conclusion of the last Article IV consultation in February 2000, Executive Directors expressed the hope that the prevailing, stable macroeconomic conditions could provide a platform for accelerating structural reforms to improve Nepal’s development prospects and to reduce poverty.** Nepal’s earlier ESAF expired in October 1995, but structural reform efforts stalled due to political uncertainties during a succession of coalition governments. Recently, the majority-led Nepal Congress Party government has been seeking Fund support and continued project assistance from donors to support its reform program. There has been intensive discussion between the authorities and the staff on a possible PRGF arrangement, which would focus on several key elements of the government’s poverty reduction strategy, namely financial sector reform, public administration reform, and improvements in governance and the legal framework.² The staff has worked very closely on these issues with the World Bank, other donor agencies, and elements of civil society.

² Board presentation of the staff report for the Article IV consultation had been delayed in the expectation that it could be combined with a presentation of Nepal’s PRGF Request; however, given delays in the finalization of the program to be supported by the PRGF arrangement, it was decided to proceed with the completion of the Article IV consultation on a stand-alone basis.

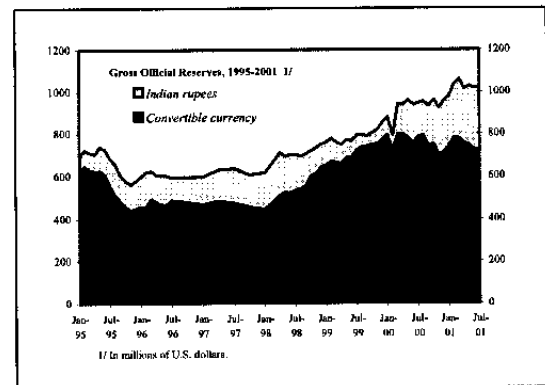
II. RECENT ECONOMIC DEVELOPMENTS

7. **Macroeconomic performance continues to be favorable, but not sufficient to reduce poverty significantly.** Growth slowed from 6½ percent in 1999/2000 to an estimated 5–5½ percent in 2000/01, but inflation remains subdued, below 4 percent (Table 1).³ The main reasons for the slowdown was weaker agricultural performance compared with the exceptionally strong growth in the previous year, the dampening effects of higher oil prices on export demand, lower tourist activity, and frequent work stoppages due to strikes and power shortages. A decline in food prices helped lower inflation to 2 percent despite the hike in domestic fuel prices at end-2000.



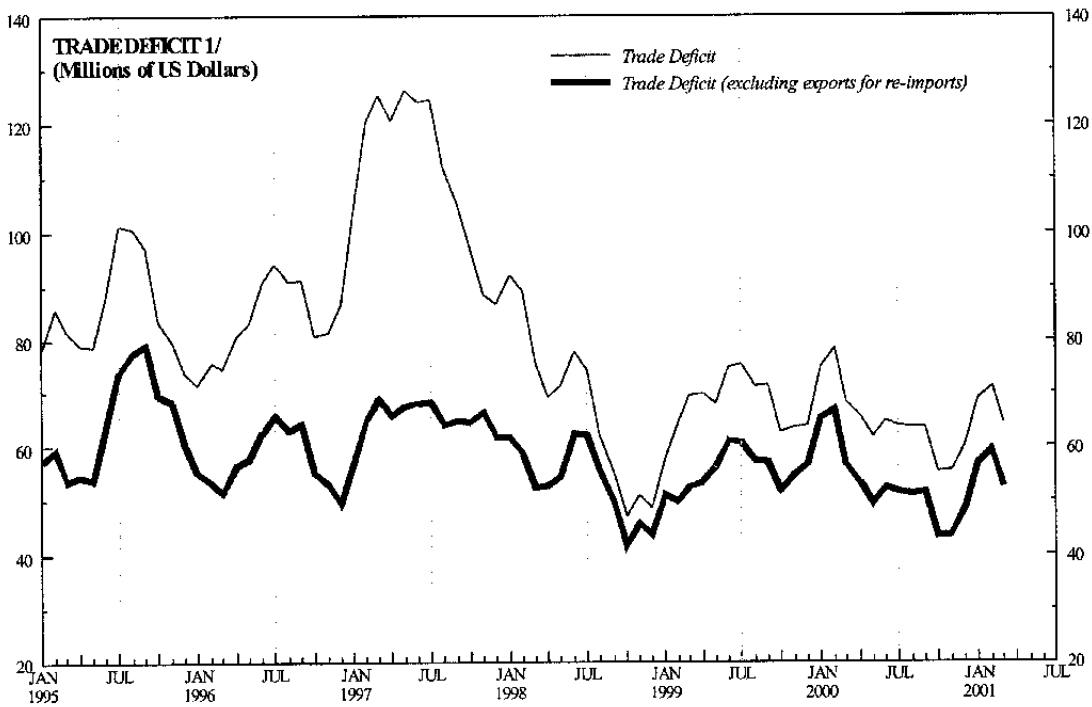
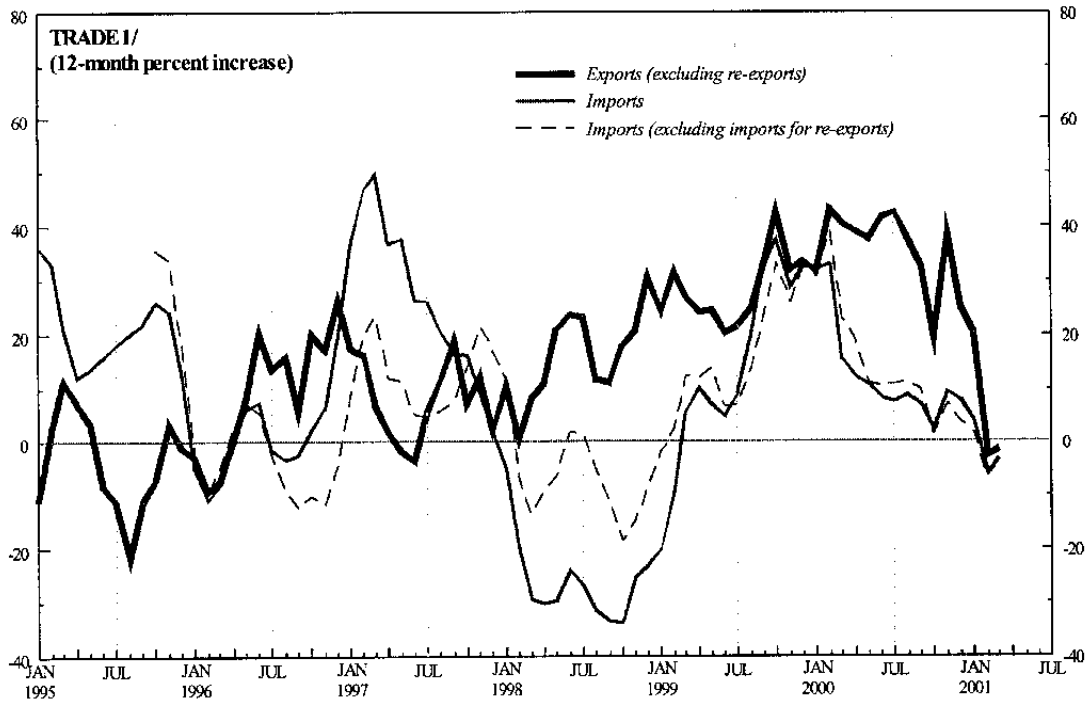
8. **The external position is broadly satisfactory—reserves have remained at comfortable levels and the debt service ratio is low because of the concessional nature of external debt.**

- **The current account surplus is estimated to have declined slightly in 2000/01,** with the trade balance widening on account of the impact of the increased cost of oil imports and a slowdown in exports from the very high growth rate achieved in the previous year (in particular a slowing of the rapid expansion of pashmina sales) (Figure 1).
- **The services account surplus narrowed for a second consecutive year,** as strong growth in worker remittances was more than offset by disappointing levels of tourism (Table 2).
- **During 2000/01, gross official reserves were maintained at 5¼ months of imports (\$1.01 billion).** However, the size of these reserves held in the form of Indian rupees increased from \$160 million to \$300 million. This development reflected an increase in trade with India, in part



³ The Nepali fiscal year ends on July 15. Data for 2000/01 are preliminary estimates.

Figure 1. Nepal: Selected External Indicators, 1995-2001



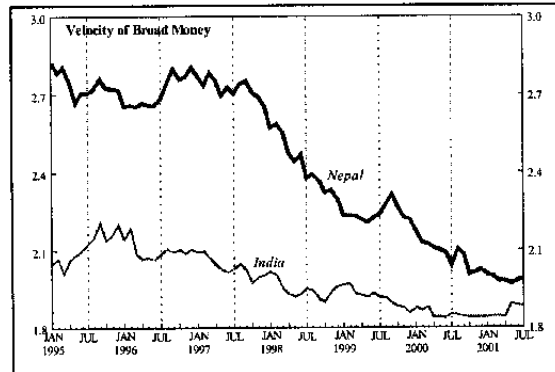
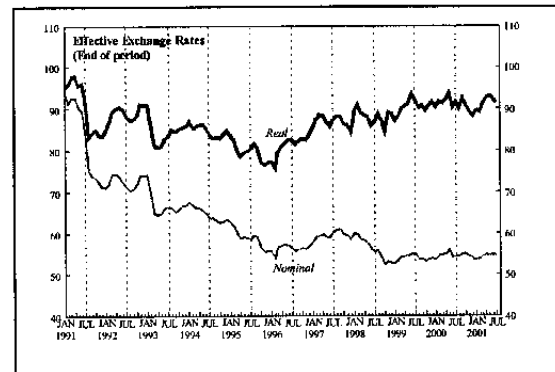
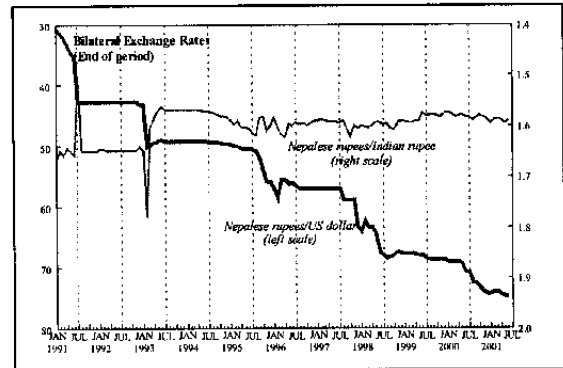
Sources: Data provided by the Nepalese authorities; and the IMF, International Financial Statistics.

1/ Three-month moving average.

because of efforts to circumvent Indian import duties levied on goods from other countries, and remittances from Nepalese workers in third countries channeled through India. A large part of imports from India requires dollar payment, while much of Nepalese exports to India and remittances of Nepalese workers in third countries are settled in Indian rupees.⁴

- **The external debt-to-GDP ratio has increased over the past two years** because of large aid disbursements related to hydropower and other investments. However, because of the concessional nature and long maturity of these loans, and the sharp increase in exports in 1999/2000, the debt service ratio was only around 5 percent at the end of 2000/01.

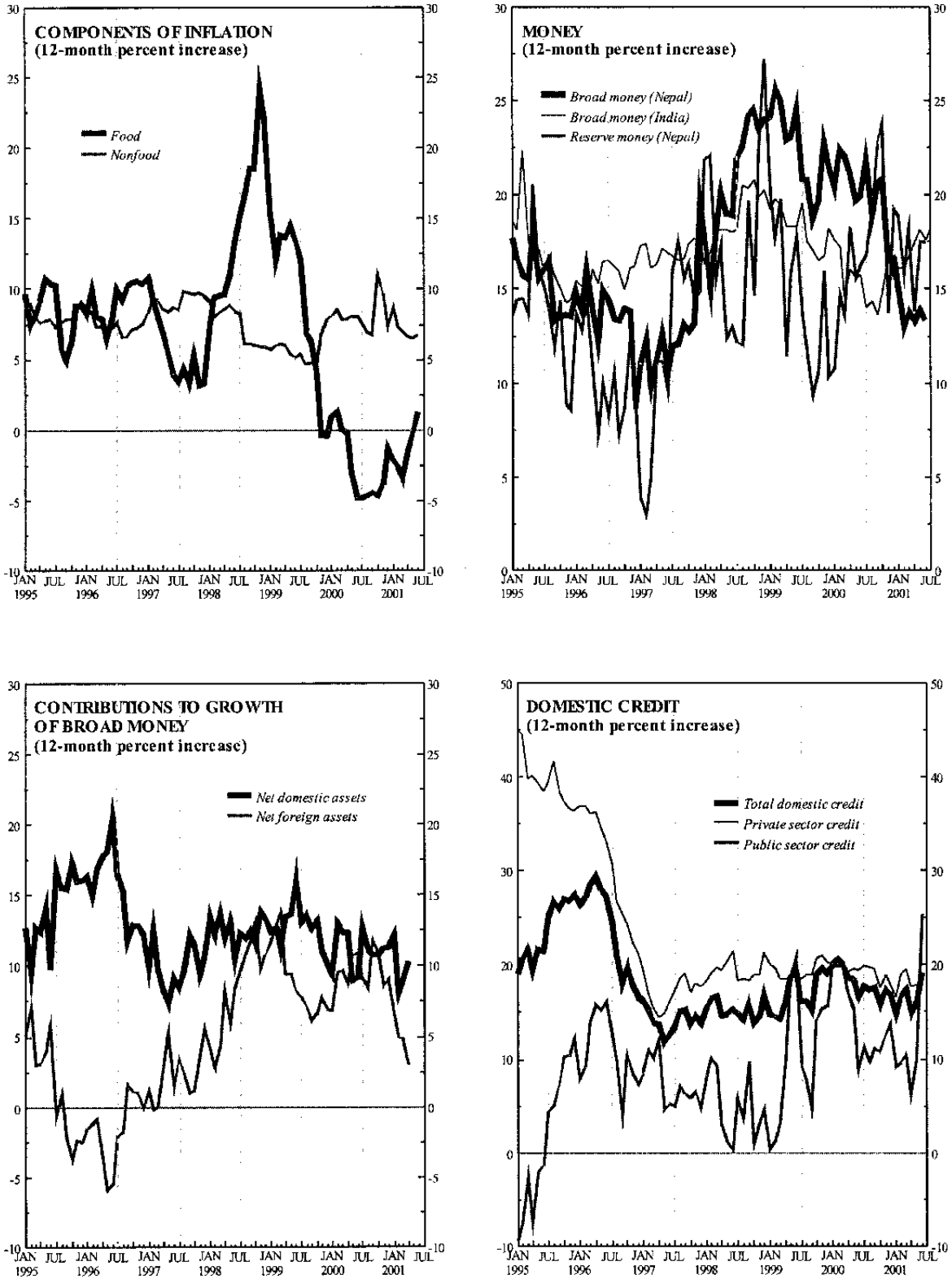
- **The Nepalese rupee—which has been pegged to the Indian rupee since 1993—has remained stable in real and nominal effective terms during the past year.** In particular, the exchange rate depreciated by only about 2½ percent in real effective terms during the 12 months ending in June 2001, mainly owing to the depreciation of the Indian rupee against the dollar and a favorable inflation differential against India. This differential, however, appears to mainly reflect temporary factors, including more modest adjustments of administered energy prices and favorable agricultural supply shocks in Nepal, rather than a structural difference in inflation trends.



9. **Monetary developments were generally in line with the authorities' indicative target.** During 2000/01, broad money growth, which had accelerated during the previous year to nearly 22 percent, was contained to 15 percent, within the authorities' 15–16 percent target range and in line with lower nominal GDP growth and the trend decline in velocity (Table 3, Figure 2). However, nominal interest rates eased

⁴ Recorded trade with India accounts for 51 percent of Nepali exports and 35 percent of imports, but the share of Indian trade is higher. Nepali importers benefit from an Indian excise refund scheme only if payment is made in U.S. dollars.

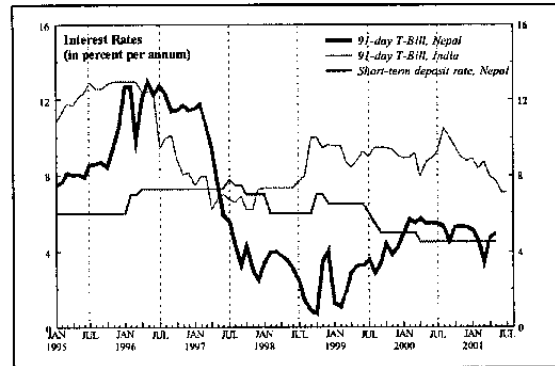
Figure 2. Nepal: Selected Financial Indicators, 1995-2001



somewhat, with the yield on treasury bills falling to 5 percent, partly in response to lower interest rates abroad, including India—nonetheless, debt market rigidities and other constraints continue to allow interest rates in Nepal to remain considerably lower than in India.

10. Balance sheet problems among the major banks and structural rigidities continue to affect interest rate spreads and bank reserve positions.

In particular, the two largest commercial banks—the state-owned Rastriya Banijya Bank (RBB) and the partly-private Nepal Bank Limited (NBL), representing roughly 60 percent of banking sector assets—have large stocks of nonperforming loans and recent reports have identified them as having significantly negative net worth. Problems in these specific institutions, as well as more widespread weaknesses in administrative and legal provisions for debt recovery, have limited both the ability and willingness of banks to lend and have contributed to a buildup of significant excess reserves. Accordingly, spreads between lending and deposit rates have remained wide at around 5 percent.

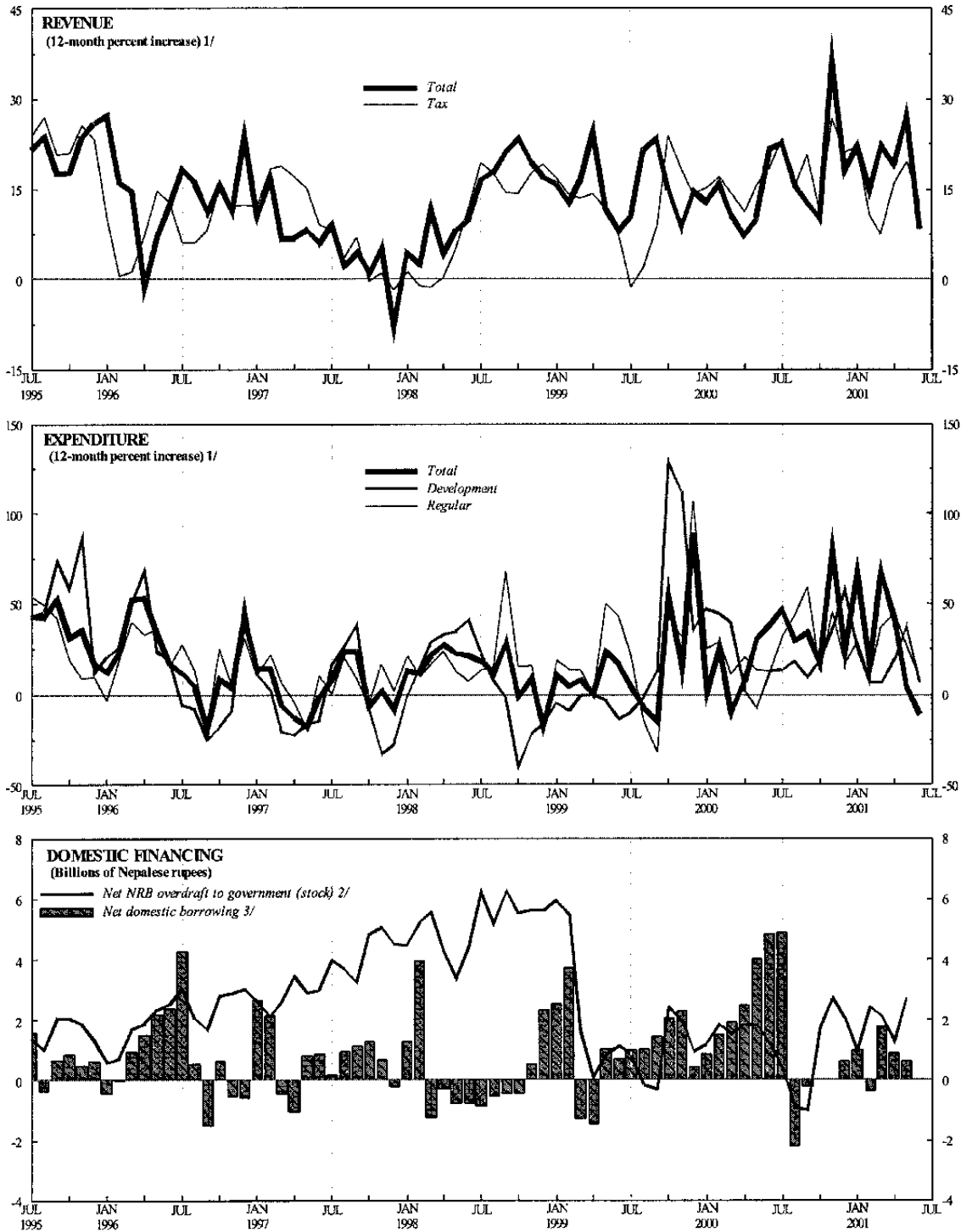


11. Some elements of fiscal performance have improved in the past two years, and the overall deficit remains sustainable because of aid flows; however, the structure of the budget is weak.

- After declining in the previous two years, **the overall central government deficit (before grants) is estimated to have widened to 6¾ percent of GDP in 2000/01, still below the original budget projection (Figure 3).**⁵
- However, while **net domestic financing** rose, it remained below 3 percent of GDP and public saving, which reached 1½ percent of GDP in 1999/2000, turned slightly negative during the past year.
- **Strong collection efforts brought significant improvements in the past two years, though tax revenues remained below 10 percent of GDP (Table 4).** Revenue collections in 2000/01 were much affected by the large number of lost working days, including because of the royal mourning period, which coincided with the critical year-end revenue collection period.

⁵ Local governments and off-budget funds are dependent on government transfers and cannot borrow. The staff estimates their earmarked revenues (taxes and fees) in 1999/2000 at only Nrs 2 billion (½ percent of GDP).

Figure 3. Nepal: Selected Fiscal Indicators, 1995-2001



Source: Data provided by the Nepalese authorities.

1/ Three-month moving average.

2/ The government's central bank overdraft balance was converted to treasury bonds in March 1999.

3/ Cumulative from start of fiscal year.

- **Current expenditures increased by 36 percent, higher than budgeted**, principally because of the impact of a large pay increase.⁶ Interest costs increased only modestly because of the large share of concessional financing and low nominal interest rates on government securities.
- **Continued slow project implementation and associated slower-than-anticipated disbursement of foreign grants resulted in a shortfall of 1¾ percent of GDP in development spending.** Capital spending is estimated to have reached 6½ percent of GDP, but there remain significant concerns regarding the quality of these outlays and little progress was made in streamlining projects.

12. **Although the government has set out a comprehensive structural reform agenda—which it hopes will be supported by donors, including the Fund—implementation has been uneven, partly reflecting political difficulties.**⁷

- **The legislative agenda was placed on hold because of the opposition’s blocking of the February-April parliamentary session:** the new central bank law, income tax law, and bankruptcy laws had been stalled, but these have now been tabled for the current parliamentary discussion.
- **Financial sector reforms have advanced, albeit at a slow pace.** The government published a broad-ranged and ambitious Financial Sector Strategy Statement in December 2000. New prudential regulations, based on international practice, came into force in July 2001 raising capital adequacy requirements and imposing tighter loan classification guidelines. Progress, however, on the World Bank-assisted program to address the problems of RBB and NBL was slow—they still operate with large levels of nonperforming loans, and no proper accounting or loan management.⁸

⁶ Although the final budget outcome is not available, there are reports that development spending allocations were used to cover the increased cost of teacher salaries.

⁷ The World Bank and AsDB have prepared financial sector projects focusing on banking supervision, regulatory framework, and restructuring (World Bank), nonbank financial institutions and corporate governance (AsDB). The IMF has assisted with central and commercial banking legislation and central bank operations, as well as with amending the income tax law. The AsDB is leading the work on civil service reform and agricultural sector reform. Of other note, DfID is supporting the work of the Public Expenditure Review Commission (PERC) and is financing a long-term privatization consultant and a financial management project at the Ministry of Finance. The Danish and German aid agencies (Danida and GTZ) are assisting the Inland Revenue Department.

⁸ Following an assessment by KPMG that the two largest banks (RBB state-owned, NBL minority state-owned) had negative net worth in the range of \$250–420 million (5–9 percent of GDP) in July 1998.

- **Public administration reforms also have proceeded slowly.** There have been notable improvements in expenditure monitoring and control, but the budget preparation process remains rudimentary. The establishment of a high-level PERC in September 2000 signaled the government's intention to tackle long-standing inefficiencies in the public sector.
- **The authorities have initiated a Voluntary Early Retirement Scheme (VERS) for the civil service** by providing lump-sum early benefits to approximately 2,000 civil servants.⁹ However, delayed completion of the civil service census precluded further progress toward developing a rationalization strategy.
- **Although the authorities have identified a large range of public enterprises in need of major restructuring, in the past two years only the national tea company was sold, and there were no liquidations.** Efforts to complete the sale of Butwal Power Company continue.

III. POLICY DISCUSSIONS

13. **Policy discussions centered on the authorities' medium-term policy framework and the key changes needed to accelerate economic growth and promote poverty reduction.** Specifically, the focus was on:

- **Improving public resource management** through redefining the role of the state and reforms to strengthen expenditure management and enhance revenue mobilization.
- **Promoting private sector development** by improving the enabling environment for both domestic and foreign investment, undertaking much-needed reforms in the financial sector, and further improving trade policies.
- **Addressing a range of overarching systemic issues**, including governance and institutional capacity, which affect performance of the economy at every level.

A. Policy Framework for 2001/02–2004/05

14. **The authorities' medium-term objective is to achieve and sustain annual growth of 6–6½ percent, bolstered by the implementation of structural reforms.** In addition to maintaining macroeconomic stability, this would require raising agricultural productivity as well as exploiting more fully Nepal's comparative advantage—tourism, hydropower, and a low-wage workforce.¹⁰ Faster growth would require: (i) increases in the level of gross

⁹ DfID had indicated that they would cover these costs in conjunction with a PRGF arrangement, once in place. The resulting increase in domestic financing would then be reversed in the following year.

¹⁰ Nepal has great potential for hydropower exports to India and only 15 percent of the population has access to electricity but projects in this area have proceeded slowly.

investment to accommodate the buildup of infrastructure and expanded private sector activity; (ii) continued export growth, spurred by economic restructuring; (iii) maintenance of low inflation and a comfortable reserve level; and (iv) continued foreign aid with improvements in project implementation and prioritization. This framework forms the basis for the mission's high growth scenario (see Annex V).

15. **The government's medium-term fiscal strategy seeks to boost tax revenue and improve the quality of expenditure to allow for higher social spending, and the containment of the domestic financing requirement.** There would be an increase in public savings and the overall deficit would decline gradually, as nonessential spending is reduced and both regular and development budgets concentrate on key priority areas. Tax revenues as a share of GDP would be targeted to reach more than 11 percent of GDP by 2004/05 through the broadening of the tax base. Total current spending would be constrained, while spending on rural education and health would be increased.¹¹ Aid would finance much of the increase in public expenditure; thus, the debt-service ratio would remain at around 5½ percent of GDP.

16. **The team supported this fiscal approach, noting that the overall deficit was not the critical constraint as long as aid continued to keep debt service costs low.** The overall deficit before grants (5–7 percent of GDP) would be sustainable at current growth rates. Grants constitute one-third of total foreign financing of the deficit, with the remaining two-thirds is in the form of concessional loans. Thus, although the public debt to GDP ratio has increased from about 50 percent to 57 percent in the past two years—owing to large loan disbursements for infrastructure projects—the external debt service ratio would remain low while domestic interest payments are expected to remain below 1½ percent of GDP. Interest payments would continue to be only about 12 percent of total revenue.¹²

17. **There could even be scope for relaxing the fiscal stance, if warranted to support the poverty reduction objective.** Key prerequisites, however, would be to ensure that higher spending could be efficiently utilized and that additional concessional foreign financing is secured, in order to avoid unsustainable debt levels. In particular, it would be essential to address weaknesses in governance and implementation capacity that have contributed to recent overruns in wage expenditure and persistent shortfalls in development spending.¹³

¹¹ Much of the recent increase in spending in the social sectors has reflected salary increases, and efforts will be needed to improve expenditures on supplies and materials in order to enhance the effectiveness of public expenditures in addressing the needs of the poor.

¹² Amortization payments associated with the increase in concessional lending in the past two years would come due in 2010/11 and beyond. The increase in debt service is expected to be modest given that the repayment period is 33–36 years.

¹³ Ongoing projects funded by the AsDB, which focus on civil service and governance reforms, are expected to help address these issues.

18. **These medium-term objectives are vulnerable to various risks, stemming from both adverse external events and from shortfalls in implementing the reform agenda.** The balance of payments could deteriorate if conditions in Nepal's main trading partner India worsen, or if the demand for Nepal's primary exports—garments, carpets, and tourism—is affected by a slowing of the world economy or a change in taste for Nepali goods and services. The outlook would also be worse if agricultural productivity does not increase and other reforms were stalled due to continued political uncertainty. Such an environment would likely limit prospects for the sharp increase in public and private investment anticipated under the high growth scenario, and as a result growth rates could be considerably lower, averaging about 3–4 percent of GDP. Official reserve accumulation would be much slower and the external debt service ratio could rise to nearly 7 percent of GDP (see the low growth scenario in Table 6 and Annex V).

B. Macroeconomic Policies for 2001/02

19. **The authorities expected growth to reach 6 percent in 2001/02 as business confidence improves and domestic security is significantly restored.** Economic activity is anticipated to be buoyed with the coming on stream of hydropower projects (which are estimated to have increased domestic capacity by 50 percent over the last two years) and a recovery in tourism back to the level of 1999. Inflation is expected to remain in the 4–5 percent range, provided world oil prices do not rise and there are no domestic food shortages. The current account is expected to move to a deficit of about 1½ percent of GDP reflecting a pick up in capital good imports for donor-financed projects. Reserves would be maintained in terms of imports. The team broadly endorsed the projection but cautioned that growth could be lower if agricultural production is adversely affected by the late monsoon, domestic disturbances do not subside, or the global economic slowdown affects export demand.¹⁴

Exchange Rate and Monetary Policies

20. **The mission broadly endorsed the authorities' policy of pegging the Nepalese rupee to the Indian rupee.** During the discussions, the authorities noted their view that both the pegged arrangement (as well as the current level of the exchange rate) remain appropriate, as it enabled Nepal to benefit from the close economic ties with India. The team agreed, observing that available indicators suggested that competitiveness had been maintained—in real effective terms, the exchange rate has remained broadly stable, average wages had not increased in real terms in either of the main export sectors, and the economy's recent export performance had been satisfactory.¹⁵ The apparent lack of pressure in the exchange market in the aftermath of recent political events also suggests market confidence in the arrangement.

¹⁴ Export growth in the garments sector—two thirds of which is directed toward North America—is vulnerable to the planned expiration of the MFA in January 2005.

¹⁵ It should be noted that gauging competitiveness trends in Nepal is complicated by the fact that the real effective exchange rate index is calculated using the wholesale price index for India, owing to the problems with regard to the reliability and timeliness of the Indian

21. **However, the mission expressed concern regarding the increase in the NRB's reserves held in the form of Indian currency.** These holdings had increased to roughly 30 percent of total reserves and were poorly remunerated and relatively illiquid. Against this background, the team encouraged the central bank to approach the Reserve Bank of India to arrange for their exchange into reserve currencies or to facilitate the NRB's participation in the Indian foreign exchange market.¹⁶ The NRB broadly shared the team's assessment, but noted that the situation would need to be resolved in a manner that avoided jeopardizing Nepal's close trade and other relations with India.

22. **The authorities explained that broader monetary policy objectives would continue to be framed in a manner consistent with the exchange rate peg.** This, in turn, meant ensuring that monetary growth was consistent with a domestic inflation rate that was broadly in line with that in India. Against this background, the NRB's financial program for 2001/02 had set the objective of containing broad money growth to 14–15 percent which, given real GDP growth of around 6 percent and the downward trend in velocity, would be consistent with inflation of around 4–5 percent.

23. **Although the mission endorsed these objectives, it stressed the importance of containing excess liquidity in the banking system.** In particular, reserve money growth had accelerated early in the financial year to well above the NRB's target because of higher-than-anticipated financing by the NRB of the government and strong growth in credit to the private sector, in the latter case possibly reflecting rollovers of nonperforming loans. Reserve money growth was estimated to have slowed by the end of 2000/01, once the government authorized the issuance of new debt instruments, which allowed a reduction in its overdraft with the NRB.

24. **Against this background, the mission and the NRB agreed that measures were needed to contain reserve money growth in the coming year.** The staff team endorsed the NRB's intention to mop up liquidity by selling its remaining treasury bills and encouraged action to improve debt management practices and to ensure that limits on the government's overdraft were applied on an intra-year basis. The staff and the NRB agreed that these efforts could require some further upward movement in interest rates—the mission suggested that yields on treasury bills could be expected to increase to at least 6½–7 percent in view of the prevailing inflation rate and market conditions.

25. **The mission also noted that the monetary program would need to be reviewed in the light of efforts to restructure the two large commercial banks.** The restructuring was expected to get underway in early 2002 and, coupled with recently introduced prudential

consumer price index. See Nepal—Recent Economic Developments, SM/00/24, February 4, 2000, for a more detailed discussion of competitiveness indicators.

¹⁶ The NRB's foreign exchange intervention, which is infrequent, is in U.S. dollars. Roughly one-quarter of the NRB's Indian rupee holdings is invested on a demand basis with the RBI, yielding around 4½ percent. The balance is invested in 91-day treasury bills. The NRB does not have direct access to the Indian foreign exchange market.

regulations, could affect the behavior of the monetary aggregates given the large size of these institutions' loan portfolios and deposit base.¹⁷ Against this background, the mission stressed the importance of steps to reduce lags and errors in reporting by the commercial banks, in order to ensure timely policy corrections.

Fiscal Policy and the 2001/02 Budget

26. **Discussions of the fiscal framework for 2001/02 took place during the early stage of budget preparations.** The mission and the authorities agreed that the budget should contain measures to increase the amount and effectiveness of development and social spending, while containing the domestic borrowing requirement through revenue enhancement. Against this background, the mission broadly endorsed the authorities' intention to contain the fiscal deficit to around 7 percent of GDP, which would be financed primarily by foreign grants and loans. This objective would be achieved by boosting revenues by 1 percent of GDP, principally from (i) extension of VAT to handicraft shops and other small businesses generating profits and a 10 percent capital gains tax on the sale of securities, (ii) higher excises on cigarettes and liquor, and (iii) improved tax administration.

27. **The mission noted the critical importance of improvements in the efficiency of the income tax, VAT, and customs administrations for meeting the overall fiscal objective.** The authorities responded that the recent merging of the VAT and Income Tax Departments into an Inland Revenue Department should yield considerable efficiency gains, especially with regard to taxpayer registration and audits. While customs collections had been adversely affected by problems with the invoice valuation system and the prevalence of informal and barter trade from Tibet, the latter situation had improved in April after army troops were mobilized to patrol the borders.

28. **The authorities noted that civil service reforms would underpin the expected containment of current expenditure.** Although wage costs had risen sharply in 2000/01, owing to a revision to the salary structure, personnel expenses were expected to decline in terms of GDP, with the implementation of the proposals of the PERC.¹⁸ These included (i) the transformation of the pension system into a funded scheme and an increase in the minimum number of years required for early retirement from the army and police; (ii) the abolition of low-grade posts and contracting out of related services;¹⁹ (iii) continued

¹⁷ For example, the anticipated write-off of nonperforming loans would be reflected in a contraction of bank assets, while capital injections could affect reserve money growth if not sterilized.

¹⁸ During 2000/01, the average take-home pay for civil servants was increased by 34–54 percent. Basic wages were increased, ranging from 50 percent up to 100 percent for senior staff, offset by removal of most allowances, which had accumulated over the years in lieu of pay increases.

¹⁹ The lowest ranking civil servants now comprise over one third of all civil servants.

downsizing under the voluntary early retirement scheme (VERS); and (iv) the maintenance of a freeze on hiring and the elimination of vacant posts.

29. **The authorities cautioned, however, that some measures in the area of civil service reform would need to follow the budget.** For example, a cabinet decision would be needed to enforce the elimination of all vacant posts, and this would only follow the completion of the civil service census, expected by August 2001. Nevertheless, some reduction in the wage bill would be expected in 2001/02, since ministries were now required to verify their filled positions before release of the budgeted wage allocations. The mission stressed the importance of containing personnel-related outlays, suggesting that there seemed scope for reducing the generosity of the VERS scheme, and also cautioned that the Citizens Investment Fund, which would manage the pension contributions under the new system, would need to be subject to appropriate accountability and investment guidelines.

30. **The staff agreed that an increase in capital spending was justified in view of Nepal's development needs.** However, increased spending would need to be coupled with measures to ensure greater consistency between the development budget and implementation capacity, improved project prioritization, and the elimination of low-priority projects that were not critical for growth and poverty alleviation.²⁰ The newly established Poverty Alleviation Fund (PAF) should also be included in the budget process and subject to proper scrutiny and accountability. In addition, the mission noted that the significant shortcomings in the authorities' ability to monitor donor-financed projects within the fiscal year would need to be addressed to implement the PRSP effectively.²¹ The authorities agreed, noting that there was an urgent need to improve the timeliness of reporting on donor-financed projects. They also expected that development planning would be improved in the context of 2002/03 development budget, which would be presented on a three-year basis, reflecting an ongoing detailed review of development projects and social programs.

31. **The authorities also recognized the need to overhaul the management of public debt.** Legal restrictions constrained the government from issuing debt beyond statutory limits, and have forced it to rely excessively on overdrafts from the NRB, especially within the fiscal year.²² The mission stressed the importance of easing the debt limits, since large

²⁰ There is room for improving the management of the development budget both in terms of its allocation, and more importantly in implementation.

²¹ Serious shortcomings in the reporting of donor financing hamper within-year monitoring of budget implementation and balance of payments developments.

²² In particular, while the overdraft is limited to Nrs 1 billion on the last day of the fiscal year, this limit is often breached within the year, and preliminary estimates put the overdraft at above Nrs 5 billion in mid-July 2001.

overdrafts with the NRB had undermined the central bank's ability to undertake open market operations and to manage reserve money growth in line with its overall monetary policy objectives.

32. **The authorities agreed that additional fiscal measures would be taken if the budget was off track.** They explained that corrective action would now be feasible at the time of the Mid-Term Review in February 2002, since recent improvements in fiscal monitoring would allow an assessment based on full revenue data for six months, and expenditure information from the largest 20 districts for five months.

33. **In the event, the 2001/02 Budget, which was presented to Parliament on July 9, appears broadly in line with the earlier discussions (Box 2).** Despite the fact that economic prospects for 2001/02 have worsened somewhat and there have been expenditure pressures related to the security situation, the budget aimed to increase public savings to 1 percent of GDP and achieve an overall deficit, before grants, of 7 percent of GDP. The expected increase in revenues has been targeted, measures to streamline expenditure were announced, and many of the recommendations of the PERC were introduced. The budget took steps to accelerate the decentralization program by transferring management of primary schools and health care facilities to local governments, and to improve infrastructure policies by inviting and establishing private participation in power and telecommunications. A ways and means bill has been passed to authorize spending, pending the parliamentary approval of the budget.

34. **Nonetheless, several factors suggest that it may be difficult to achieve the budget targets.** Specifically:

- **The revenue targets appear somewhat ambitious.** Notably, the projected 23 percent increase in collections of VAT and income tax would seem difficult to achieve given the measures announced and the possibility that the 2000/01 disruption in collections will spill over into the current year. Moreover, the budget introduced a number of new tax concessions with an uncertain budgetary impact—including a duty reduction for “sick” industries and rebates of 80 percent and 50 percent on import duties for pashmina wool and cotton yarn.²³
- **There are risks of current expenditure overruns.** Personnel-related expenses may be difficult to contain given that steps appear not to have been taken to eliminate vacant positions, even in some pilot ministries, and modifications were not made to reduce VERS costs. The budget also introduced a number of credit schemes targeting the agriculture, industry, and export industries, which appear to run counter to the

²³ The duty reduction for sick industries is intended to reduce the cost of imported machinery and parts. However, the budget speech did not elaborate how the scheme will work and has been criticized by donors.

Box 2. Nepal: The 2001/02 Budget

The 2001/02 budget speech announced an overall fiscal deficit target (before grants) of 7 percent of GDP, a ¼ percent increase from last year. Improved tax administration measures, coupled with a special fee for strengthening security are expected to increase total revenue by 1¼ percent of GDP. Current expenditures are projected to remain around 11¾ percent of GDP, whereas the budget provides an increase of 1¼ percent of GDP in capital expenditures to 8 percent of GDP.

Revenue measures

- Merger of VAT and Taxation departments and creation of Inland Revenue Department.
- Introduction of 10 percent capital gains tax.
- Broadening of VAT.
- Extension of the Automated System for Customs Data to more customs posts.
- Increased import tariffs on milk, oil, and video equipment.
- Increased export taxes on vegetable ghee, plastic products, and copper wire.
- Special fee of 1 percent on customs duties and income tax payments for funding the Internal Security and Development Plan (ISDP).
- Increased excise taxes on cigarettes and liquor.

Expenditure measures

- Implementation of the recommendations of the Public Expenditure Review Commission for expenditure management, including civil service reform, pension system reform, and prioritization of development projects.
- Establishment of Poverty Alleviation Fund to bring various scattered poverty programs into a unified framework for efficient monitoring and evaluation of programs.
- Security spending increased to 2½ percent of GDP to cope with the worsening security situation.
- Health and education spending budgeted to reach 4½ percent of GDP.
- Spending on power sector to increase by 17½ percent over the estimated spending in 2000/01, including the completion of the Kaligandaki 'A' hydroelectricity project (Nrs 2.9 billion).

Low interest credit facilities

- **Agriculture sector:** interest rates lowered by (i) 1 percent for exportable farming and cash crops, (ii) 2 percent on credit extended by the Agricultural Development Bank to tea plantation areas, and (iii) 2 percent on credit for horticulture farming in areas receiving ISDP funding.
- **Industry:** a refinancing scheme at 7.5 percent interest for troubled, but qualified industries to be financed by a provision of Nrs 1.0 billion as source funds from the NRB.
- **Export promotion:** interest rates on export credits lowered by 1.5 percent in convertible foreign currency and by 1 percent in Nepalese currency.

Foreign investment & trade promotion

- Simplification of the licensing process, permitting foreign-based Nepalis to investment and repatriate profits, and allowing private sector participation in the forthcoming Special Industrial Zone.
- Simplification of the duty drawback scheme for exporters, including facilities to exporters whose duty drawback is overdue for several years.

Civil Service Reforms

- The minimum service period for volunteer retirement for army and police personnel will be extended from 16 to 20 years and the minimum age of eligibility extended from 40 to 45 years.
- Certain services, such as cleaning, gardening, and maintenance will be contracted out.

broad thrust of financial sector reform and do not seem to have received budgetary allocations to cover the associated interest subsidies.

- **The proposed increase in development spending—to 8 percent of GDP—may also exceed implementation capacity.** Moreover, while the budget espoused greater project prioritization, it did not provide the details of expenditure plans to suggest that the necessary pruning had taken place.²⁴

C. Structural Reforms

Financial Sector

35. **The team noted that bank restructuring and financial sector regulation and supervision were critical to the success of the government's reform program.** In this context, the mission welcomed the publication of the government's Financial Sector Strategy Statement, which outlines the main areas of focus for legislative, regulatory, supervisory, and institutional reforms. During the discussions, the team also encouraged the authorities to implement policies geared toward further opening up the banking sector to competition—the authorities subsequently increased the limit on foreign ownership of banks from 49 percent to 66 percent. However, foreign interest in Nepalese banks has been limited, and two foreign banks have recently sold their interests in the sector to Nepalese banks for strategic reasons.

36. **The authorities have taken halting steps to address the problems of the two large troubled banks.** In light of estimates—based on July 1998 accounts—that these two institutions had a negative net worth amounting to 5–9 percent of GDP, the authorities decided to insert independent management teams, financed by the World Bank. The authorities also indicated that recapitalization of the RBB and NBL would be considered only after the new management teams had completed a thorough review of the banks' viability and adopted a restructuring program.²⁵ In order to limit asset stripping before arrival of the new management teams, the authorities have issued directives to the banks that would require them to inform the NRB of transactions involving any large loans, recruitment or other major personnel changes, and otherwise strengthen their reporting mechanisms.

37. **The team welcomed these initiatives, but expressed concern over the delays in meeting the initial timetables for contracting the management teams.** Although the process was under way for the state-owned RBB, the technical evaluation of bids for the contract for the NBL (a majority privately-owned bank) did not meet the World Bank's procurement guidelines and will have to be restarted.²⁶ The mission cautioned against further

²⁴ Following the 2000 Public Expenditure Review, the World Bank is providing technical assistance in setting priorities and improving the structure of spending.

²⁵ The recurrent fiscal costs of recapitalization (projected at ½ percent of GDP) would be included in the budget from 2002/03 onwards.

²⁶ The final selection of the management teams is expected in September, and the teams could be in place by November 2001.

delays, which would risk increasing the fiscal costs of restructuring and adversely affecting the broader banking system.

38. **In April 2001, new regulations were introduced that established a code of ethics, enforcement procedures, and risk management guidelines.**²⁷ While welcoming these steps, the mission urged the NRB to resist apparent pressures from some banks to extend the timetable for their implementation and calls for their dilution. In particular, the team stressed the need to maintain the limits on connected lending and requirements for reporting of transactions with family relatives. Staff also emphasized the need to avoid conflicts of interest by discontinuing the practice of assigning NRB and government officials to the Boards of private financial institutions, and by phasing out NRB's equity participation in a wide range of financial institutions. To strengthen enforcement, the mission recommended that the NRB issue rules-based guidelines for remedial action in cases of non-compliance with the new regulations.

39. **A number of other pieces of financial legislation have been tabled for the current parliamentary session.** Building on World Bank and MAE/LEG technical assistance, a new central bank law has been proposed, which would increase the NRB's independence and more clearly define its role in the area of monetary policy. Also, new legislation governing deposit-taking institutions would replace existing overlapping laws and clarify and streamline regulations and reporting requirements. The Asian Development Bank (AsDB) also is providing assistance in amending the Insolvency and Secured Transactions Act, which would address the weaknesses in the legal enforcement mechanism and judicial capacity, and the Debt Recovery Act, which would help establish debt recovery tribunals to facilitate loan recoveries by banks. The mission strongly supported these legislative reforms, and encouraged the authorities to seek parliamentary passage as soon as possible.

40. **The mission argued for limits on lending to priority sectors by the central bank and commercial banks.** For example, commercial banks are required to direct 12 percent of their loans to "priority" small-scale borrowers, and these loans tend to be at lower-than-market-rates, given that the banks compete with development finance institutions that are able to provide subsidized credits. The central bank is likely to be required to recapitalize development finance institutions and provide subsidized credits to commercial banks in order to promote their lending to priority sectors. The mission cautioned that these regulations and practices distorted credit allocation in a manner that undermined overall economic efficiency and the strength of the financial sector, and was a nontransparent manner for delivering fiscal subsidies. The team suggested that, over the medium term, responsibility for such activities should be shifted to specialized agencies such as the development banks, whose quasi-fiscal activities should be clearly identified.

²⁷ The new regulations (i) establish bank licensing criteria; (ii) tighten definitions for the purpose of calculating the capital adequacy ratio and strengthen monitoring; (iii) limit large shareholding/controlling interests and cross-holdings in other financial institutions; (iv) set criteria for qualifications of directors and limit interlocking directorships; and (v) tighten exposure limits and single borrower limits.

41. **The authorities suggested that priority lending could be an effective method of addressing poverty, but indicated their willingness to review the current system.** As a first step, they agreed that it would be useful to prepare an accounting of the cost of priority/subsidized lending, which could be followed possibly by the preparation of a reform plan. This approach could be taken in tandem with efforts of the AsDB in their rural micro-financing project, which seeks to stem the growing losses of the regional development banks and to establish an efficient mechanism for the distribution of micro credit. Since the discussions, however, the 2001/02 budget introduced a number of new subsidized credit facilities without a clear budgetary allocation for interest subsidies.

Public Sector Reforms

42. **The authorities' public sector agenda focuses on tax administration reforms, public expenditure efficiency, civil service reform, and public enterprise restructuring and privatization.** The mission welcomed the attempt to set priorities for the development program through a comprehensive screening of projects, as well as streamlining government offices and reducing wasteful expenditures. Although progress has been achieved in improving expenditure monitoring and control, the team advised that fiscal transparency would be enhanced if the budget discussions incorporated the small, off-budget funds and local governments. The mission supported the work of DfID to accelerate privatization, which had slowed considerably in the past two years, and advised the authorities to develop a program to phase out budgetary transfers and directed lending to enterprises.²⁸

Governance and Legislative Reforms

43. **The team noted that, while progress has been made in recent months to enhance governance and legislative effectiveness, corruption and procurement problems persist.** Notable progress has been achieved in the area of fiscal transparency by greatly improving the coverage and scope of the budget presentation, but increased fiscal and public enterprise monitoring is essential. In particular, there is a need to enforce debt-servicing obligations by the public enterprises—several such agencies have defaulted on loans in the past. The team hoped that donor support would facilitate action on these fronts in the context of a strengthening of the Public Accounts Committee, which is investigating various public sector governance issues.

44. **The authorities have committed to further improving governance by strengthening public procurement procedures and combating widespread corruption in both the public and private sectors.** As a first step, the authorities have started to pay off arrears owed to the utility companies by the central and local governments. The team welcomed these efforts, but stressed the need to remove impediments to entrepreneurship and improve the regulatory framework, especially for foreign investment. A World Bank assessment found deficiencies in both the regulations themselves and their implementation—

²⁸ Out of 32 nonfinancial public enterprises, provisional estimates suggest 16 had operating losses in 2000/01 totaling Nrs 2.5 billion, or ½ percent of GDP, compared with only Nrs 0.5 billion in 1999/2000.

with companies facing conflicting requirements and very slow processing of applications. If the envisaged reform measures are to succeed, the political leadership will need to resist union interference in the public sector, which inhibited reforms in the past.

D. OTHER ISSUES

Trade and Capital Account Regulations

45. Nepal maintains a trade system that is broadly free of restrictions and has applied to join the WTO.

- Nepal has no substantive non-tariff barriers in place; the only ones in place are retained for religious, health, and security purposes.
- The tariff structure includes five basic standard rates (5, 10, 15, 25, and 40 percent); the simple average tariff rate remains at around 13 percent.
- In 2000, in a move intended to simplify the tax system, the authorities replaced excise duties on vehicles with two exceptional tariff bands (80 percent and 130 percent). The team urged the authorities to reverse the measure, since it undermined tariff rationalization.²⁹
- In the medium term, the government has stipulated its intention to reduce the number of tariff bands, in addition to lowering their levels. However, the authorities indicated that they could not take decisions on this issue without fully assessing the direction that India, its major trading/political partner, would take in this area given the possibility that large tariff differentials could promote smuggling.
- Nepal submitted to the WTO a Memorandum on the Foreign Trade Regime in August 1998; progress was made in bilateral negotiations with various WTO members, and the working party that deals with Nepal's accession met early this year.

46. Nepal's capital account remains closely regulated, particularly with respect to short-term capital flows and foreign commercial borrowing. The staff advised that liberalization of the rules governing foreign borrowing should await implementation of key structural reforms including measures to strengthen financial institutions and supervision.

Data Issues

47. Although the Nepalese authorities publish extensive data in a timely manner, there remain severe weaknesses in economic statistics that impair effective monitoring and policy formulation. The staff was encouraged, however, by recent improvements in the

²⁹ These high tariffs are at odds with Nepal's otherwise open trade regime, which has been rated two on the Fund's Aggregate Index of Trade Restrictiveness (with one being the most liberal and 10 most restrictive).

presentation of the fiscal accounts and the coverage and classification of the balance of payments statistics.

48. **The team recommended that the authorities provide adequate resources to the data compiling agencies and enhance effectiveness of the National Statistical Council in setting statistical priorities and ensuring coordination among the compiling agencies.**

A STA multisector mission in January 2001 assisted the statistical authorities with identifying and addressing methodological weaknesses as well as enhanced interagency coordination. The mission also assisted with the preparation of metadata required for Nepal's participation in the General Data Dissemination System (GDDS). The authorities agreed in principle with the mission's recommendations, but noted that considerable long-term technical assistance will be needed to support their limited technical and institutional capabilities (see Annex IV). A TGS mission in July provided advice on the establishment of a database of macroeconomic indicators.

IV. STAFF APPRAISAL

49. **Macroeconomic performance has been satisfactory in Nepal over the past two years, but the challenge remains to set the stage for strong growth and poverty alleviation.** Near-term prospects for growth and inflation appear broadly favorable while the external position should be sustainable with aid inflows sustaining reserves even as the current account remains in deficit. However, there are important downside risks to achieving a strong growth rate, associated with the adverse impact of the regional slowdown, lower agricultural production due to the late monsoon, and slower recovery in tourism. Moreover, reform and substantial foreign aid—in turn, requiring political stability and internal security—are needed to achieve and sustain growth rates sufficiently high to reduce poverty significantly.

50. **Encouragingly, the government has developed a comprehensive program of structural reforms that promises to lay the foundation for both growth and poverty reduction.** The program, based on a forthcoming I-PRSP, appropriately focuses on maintaining macroeconomic stability and removing the constraints on growth: a weak and segmented financial sector, inadequate revenue, poor provision of public services, and weak governance. The initial task facing the authorities, while completing the full PRSP, will be to continue with the broad participatory framework already in place and to link budgetary allocations to expected outcomes.

51. **Attainment of the authorities' objectives requires continued pursuit of prudent demand-management policies.** Nepal's close economic links with India and the latter's stable outlook continue to argue in favor of maintaining the peg to the Indian rupee. The strong performance of exports and the continued buoyancy of official reserves—albeit with a lower share of convertible currencies—also suggest that the level of the exchange rate remains broadly appropriate. However, the authorities are encouraged to find ways to adjust the currency composition of their reserves to improve the liquidity of these assets.

52. **The pegged exchange rate requires that monetary policy be broadly harmonized with that of India, and the staff endorses the NRB's financial program for 2001/02.**

However, it will be important to review the monetary program to avoid risks related to potential excess liquidity in the banking system, and to take into account the impact of the restructuring of the two large commercial banks, given the size of their loan portfolios and deposit base.

53. **The budget targets for 2001/02 and the planned increase in public savings are appropriate, but additional efforts will likely be needed to achieve them.** Increased tax auditing should help boost collections, but may be insufficient to deliver the targeted revenue levels. Steps may also be needed to ensure that overruns in some spending categories can be offset by savings in other line items. To achieve the desired increase in both the level and the effectiveness of capital spending, it will be necessary to implement tighter control over project spending and implementation.

54. **As soon as possible, the government should put into effect the remaining recommendations of the PERC for streamlining the civil service and prioritizing public expenditure within a three-year rolling budget.** Further efforts will be needed to improve expenditure control of the line ministries and local governments. The staff supports the ongoing review of the existing pension system, and the initiation of a new funded pension scheme. To improve transparency and accountability, mechanisms are needed to ensure full reporting of the Poverty Alleviation Fund, off-budgeted revenue, and foreign aid. To reduce the burden on the budget, the government should accelerate divestiture of small institutions while tackling the problems of the large, loss-making enterprises.

55. **Looking toward the medium term, the broad fiscal strategy should aim to mobilize higher tax revenues and improve the quality of expenditures,** providing scope for higher social spending. If additional foreign financing was secured, governance improvements achieved, and the feasibility of more effective social sector spending demonstrated, the fiscal stance could be relaxed. In this regard, rural education, health, and essential infrastructure would warrant both increased budget allocations and improved targeting. However, budget targets will also need to make adequate provision in future years for the fiscal cost of financial sector reform.

56. **The authorities' strategy to address the negative net worth of the two largest banks and the steps to improve the regulatory environment in the financial sector are welcome and overdue.** The authorities will need to overcome the administrative and other obstacles that are delaying recruitment of management teams for RBB and NBL. Some form of recapitalization will be necessary, but should only be undertaken when each bank has been properly restructured and its management improved. The proposed new central bank act will provide needed scope for increased independence, as well as introduce proper accounting, auditing and disclosure practices and strengthen the regulatory and oversight activities.

57. **The government should continue to ensure its open trade and investment regime and encourage access to world markets.** The authorities are urged to reverse the recent imposition of exceptional tariffs on vehicles and rationalize the tariff structure by reducing the number of bands. Efforts to enhance the performance of the financial sector and strengthen supervision should be pursued before opening up the capital account. Further simplifying the existing legal framework and improving governance will also be important.

58. **Although extensive data are compiled in a timely manner, there remain serious deficiencies in official statistics that impair effective monitoring and policy formulation.** The authorities are encouraged to implement the recommendations of the STA multi-sector mission and strengthen statistical legislation, survey methodologies, and data gathering. Considerable donor assistance will be needed to strengthen the limited capacities of the national statistical office over the long term.

59. **The staff recommends that the next Article IV consultation remain on the 12-month cycle.** The authorities have consented to the publication of the staff report.

Table 1. Nepal: Selected Economic Indicators, 1997/98–2001/02 1/

Nominal GDP (2000/01): US\$5,568 million
Population (2000/01): 23.2 million

	1997/98	1998/99	1999/00	2000/01 Estimate	2001/02 Projection
Growth (percent change)					
Real GDP at market prices	3.0	4.4	6.5	5.3	6.0
Savings and investment (percent of GDP)					
Gross investment	24.8	20.5	24.3	25.7	26.8
National savings	22.0	21.0	24.8	26.0	25.4
<i>Of which:</i> Public savings	1.3	0.9	1.4	-0.3	1.1
Prices (percent change)					
Consumer prices (end-of-period/12-month)	12.0	9.0	0.6	3.9	5.0
CPI (average)	8.3	11.4	3.4	2.2	5.0
GDP deflator	4.1	8.9	4.3	2.4	5.0
Government budget (percent of GDP)					
Total revenue	10.5	10.2	10.7	11.5	12.8
Total expenditure	16.8	15.4	15.5	18.2	18.7
Current expenditure	9.2	9.3	9.4	11.8	11.6
Capital expenditure and net lending	7.6	6.1	6.1	6.4	7.1
Overall deficit after grants	4.5	3.9	3.3	4.8	3.4
Overall deficit before grants	6.3	5.2	4.8	6.7	6.0
Domestic financing (net)	0.6	1.4	0.6	2.1	0.2
Money and credit (percent change; end-of-period)					
Broad money	21.9	20.8	21.8	15.0	15.0
Domestic credit	14.8	16.1	17.8	20.4	16.4
Interest rates					
91-day treasury bill (end-of-period)	2.4	3.1	5.4	5.0	...
Central bank refinancing	9.0	9.0	6½–7½	6½–7½	...
Loans to industry	13½–17	11½–17	10½–15½	7.0–15.0	...
External trade (percent change)					
Export value 2/	11.8	18.0	37.4	8.0	11.0
Import value 3/	7.1	-2.0	27.7	9.8	13.5
Balance of payments (U.S. dollars million)					
Current account balance (excluding grants)	-135	24	28	18	-87
(in percent of GDP)	-2.8	0.5	0.5	0.3	-1.4
Official grants and loans (net)	479	353	349	299	375
Overall balance	177	145	209	121	94
Other external indicators					
Gross official reserves (U.S. dollars million; end-of-period)	716	795	946	1,014	1,134
In months of imports of goods and services 4/	5.3	4.9	5.5	5.3	5.3
<i>Of which:</i> In convertible currencies	4.1	4.4	4.5	3.7	4.3
Public and public guaranteed debt/GDP (in percent)	49.7	50.3	56.6	58.8	56.3
Debt service 5/	6.7	5.9	4.7	5.2	5.0
National currency per U.S. dollar (end-of-period)	67.9	68.5	70.8	74.8	...
REER (end-of-period; percent change; - = depreciation)	-1.0	7.3	-2.2	...	...
NEER (end-of-period; percent change)	-7.8	-1.5	-0.7	...	...
Fund operations (outstanding loans at end-of-period; SDR million)					
SAF/ESAF	19.6	14.7	10.6	6.6	3.2
Nominal GDP at market prices (Nrs billion)	301	342	380	409	456

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

1/ Fiscal year ends July 15. Data reflect GDP deflator revisions made by the authorities for the period between 1997/98 and 1999/2000.

2/ Cumulative, excluding re-exports.

3/ Cumulative, excluding gold.

4/ Ratio is in terms of projected imports of goods and services.

5/ In percent of exports of goods, services, and private transfers; including debt service to the Fund.

Table 2. Nepal: Balance of Payments, 1997/98–2001/02

(In millions of U.S. dollars, unless otherwise indicated)

	1997/98	1998/99	1999/00	2000/01 Est.	2001/02 Proj.
Exports, f.o.b. 1/	856	763	971	1,029	1,100
Merchandise exports	445	525	722	779	865
Re-exports	411	238	250	250	235
<i>Of which: oil</i>	106	89	129	187	185
Imports, c.i.f.	1,551	1,390	1,713	1,855	2,075
<i>Of which: oil</i>	259	219	276	416	411
Trade balance	-695	-627	-742	-826	-975
Services (net)	205	313	273	231	262
Transfers (net)	355	338	497	613	626
Current account balance	-135	24	28	18	-87
Official current transfers	119	137	149	105	153
Current account balance (including grants)	-16	161	177	123	66
Capital transfers	255	143	103	74	81
Official and private loans (net)	167	134	127	143	163
Disbursements(official)	195	158	182	206	235
Amortization (official)	51	53	59	66	73
Foreign direct investment	11	9	3	6	12
Other investment, net	-144	-187	-185	-157	-189
Errors and omissions	-96	-115	-17	-69	-38
Overall balance	177	145	209	121	94
Financing	-177	-145	-209	-121	-134
Change in foreign reserves (- increase) 5/	-171	-162	-207	-153	-150
IMF purchases (net)	-7	-5	-5	-5	-4
Other liabilities, net 2/	1	22	3	38	20
Financing gap	0	0	0	0	40
Memorandum items:					
Current account (excluding grants; percent of GDP)	-2.8	0.5	0.5	0.3	-1.4
Current account (excluding gold trade)	-3.6	0.1	0.2	0.8	-1.1
Imports (percent of GDP)	31.9	27.6	31.2	33.3	34.6
Net Oil Imports	153	130	147	229	226
Current account (including grants; percent of GDP)	-0.3	3.2	3.2	2.2	1.1
Gross foreign assets (at current rates)	978	1,140	1,347	1,500	1,650
<i>Of which: central bank</i>	716	795	946	1,014	1,134
(in months of imports of goods and services)	5.3	4.9	5.5	5.3	5.3
<i>Of which: in convertible currencies</i>	4.1	4.4	4.5	3.7	4.3
Short-term debt as percent of gross foreign assets of NRB 3	35.9	32.2	35.8	41.5	45.5
Gross foreign assets as percent of reserve money	132	148	154	161	...
Debt service ratio 4/	6.7	5.9	4.7	5.2	5.0

Sources: Data provided by the Nepal Rastra Bank; and staff estimates.

1/ Includes re-exports of oil and gold.

2/ NRB and commercial bank assets and liabilities are calculated at period-end NRB buying rate.

3/ Short-term debt in the form of outstanding trade credits and amortization due the following year.

4/ In percent of exports of goods and services and private transfer receipts.

5/ Change derived from the monetary survey.

Table 3. Nepal: Monetary Accounts, 1998–2001 and Targets for 2001/2002

	1998 July	1999 July	2000 July	2000 Oct	2001 Jan	2001 Apr	2001 June	2001 July	2002 July
	Provisional 1/						Projected	Target 2/	
Monetary authorities	(In billions of Nepalese rupees)								
Net foreign assets	46.4	52.6	65.3	68.4	71.1	74.1	75.3	75.7	84.2
Net domestic assets	-0.4	-0.4	-4.3	-3.1	-5.1	-6.8	-4.1	-6.1	-5.0
<i>Of which:</i> net credit to government	18.5	18.4	16.4	19.5	19.3	17.8	21.4	18.4	16.4
Reserve money	46.0	52.2	61.0	65.3	66.0	67.3	71.1	69.6	79.1
	(12 month change in percent of reserve money at start of period)								
Net foreign assets	29.0	13.6	24.2	30.3	35.5	41.2	43.4	17.1	12.1
Net domestic assets	-16.8	-0.1	-7.4	-5.2	-9.1	-12.3	-7.2	-3.0	1.5
Reserve money	12.1	13.5	16.8	23.7	18.9	13.8	17.5	14.1	13.7
Monetary survey	(In billions of Nepalese rupees)								
Net foreign assets	55.6	65.0	80.5	85.0	86.6	87.1	86.9	89.2	97.1
Net domestic assets	70.9	87.8	105.7	106.5	108.5	114.7	118.5	124.8	148.9
Domestic credit	112.8	131.0	154.3	160.6	165.2	170.9	180.8	185.8	216.3
Public sector	29.8	32.6	36.4	36.9	37.1	39.3	46.2	45.8	49.0
Government	28.8	31.1	34.6	35.3	35.4	37.6	44.4	43.8	46.8
Public enterprises	1.1	1.6	1.8	1.6	1.7	1.7	1.8	2.0	2.2
Private sector	83.0	98.3	117.9	123.6	128.2	131.6	134.6	140.0	167.3
Other items, net	-41.9	-43.2	-48.7	-54.0	-56.7	-56.2	-62.3	-61.0	-67.4
Broad money	126.5	152.8	186.1	191.5	195.1	201.8	205.4	214.0	246.1
Narrow money	45.2	51.1	61.0	63.5	64.9	67.8	69.3	68.9	77.9
Quasi money	81.3	101.7	125.1	128.0	130.1	134.0	136.1	145.1	168.2
	(Annual percentage change)								
Domestic credit	14.8	16.1	17.8	17.2	15.4	14.8	19.1	20.4	16.4
Public sector	5.8	9.4	11.6	10.8	9.1	6.2	26.0	25.8	7.0
Government	8.2	8.0	11.4	10.3	8.5	7.0	26.7	26.6	6.8
<i>Of which:</i> NRB	-1.9	-0.4	-10.8	-0.2	15.7	11.3	21.1	-0.2	6.1
Private sector	18.4	18.5	19.9	19.3	17.3	17.7	16.9	18.7	19.5
Broad money	21.9	20.8	21.8	21.6	15.2	13.3	15.0	15.0	15.0
Narrow money	17.4	13.1	19.4	20.0	14.1	15.4	20.2	13.0	13.0
Quasi money	24.6	25.1	23.0	22.4	15.7	12.2	12.5	15.9	16.0
	(12 month change in percent of broad money at start of period) 3/								
Net foreign assets	14.8	7.5	10.1	11.6	7.7	14.5	6.2	4.7	3.7
Net domestic assets	7.1	13.3	11.7	10.0	8.7	17.6	10.8	10.3	11.3
Domestic credit	14.0	14.4	15.3	19.4	22.4	26.1	32.6	16.9	14.3
Public sector	1.6	2.2	2.5	2.8	2.9	4.4	8.9	5.0	1.5
Private sector	12.4	12.1	12.8	16.5	19.5	21.8	23.7	11.9	12.8
Memorandum items:									
Velocity	2.38	2.24	2.04	2.02	2.02	1.99	1.98	1.91	1.85
Velocity (narrow money)	6.66	6.70	6.22	6.09	6.07	5.93	5.87	6.19	6.03
Money multiplier	2.75	2.93	3.05	2.93	2.95	3.00	2.89	3.07	3.11

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

1/ Commercial banking deposit and lending data is typically subject to upward revision due to some reporting lags.

2/ Assuming constant exchange rate in 2001/2002 at the July level of Nrs 75 per U.S. dollar.

3/ Excluding the impact of exchange rate changes on the value of net foreign assets and other items, net.

Table 4. Nepal: Summary of Government Operations 1997/98-2001/02 1/

	1997/98	1998/99	1999/00		2000/01		2001/02
	Actual	Actual	Budget	Actual	Budget	Estimate 2/	Budget 2/
(In billions of Nepalese rupees)							
Total revenue and grants	37.1	39.3	50.9	46.4	62.3	55.1	72.2
Total revenue	31.7	35.0	42.2	40.7	50.4	47.1	58.1
Tax revenue	25.9	28.8	34.7	33.2	42.5	38.8	47.2
Nontax revenue	5.8	6.3	7.5	7.6	7.9	8.3	10.9
Grants	5.4	4.3	8.7	5.7	11.8	8.0	14.1
Total expenditure	50.5	52.8	68.9	58.8	82.4	74.6	90.1
Current 3/	27.7	31.9	39.3	35.5	47.7	48.3	53.0
Wages and salaries	15.5	17.0	17.7	19.8	23.6	27.0	28.3
Interest payment	3.8	4.1	5.6	4.8	6.1	5.7	6.6
Other	8.4	10.9	16.0	10.9	18.0	15.6	18.1
Capital and net lending 3/	22.9	20.8	29.7	23.3	34.7	26.3	37.1
Overall balance before grants	-18.8	-17.7	-26.8	-18.1	-32.0	-27.5	-32.0
Overall balance after grants	-13.4	-13.4	-18.1	-12.4	-20.1	-19.5	-17.9
Financing	13.4	13.4	18.1	12.4	20.1	19.5	17.9
Net foreign loans	11.5	8.7	14.1	10.0	14.5	11.0	10.6
Gross disbursements 4/	14.2	11.9	18.6	13.7	19.8	15.9	16.4
Amortization	2.7	3.2	4.4	3.7	5.3	4.9	5.8
Net domestic financing	1.9	4.7	3.9	2.4	5.6	8.5	7.3
Net NRB financing	0.2	-0.1	0.0	-2.1	-0.3	2.0	...
Net commercial bank	2.5	2.4	2.5	5.5	2.5	7.2	...
Net nonbank	-0.8	2.4	1.4	-1.0	3.4	-0.7	...
Of which : privatization proceeds	...	...	...	0.1	...	...	...
(In percent of GDP)							
Total revenue	10.5	10.2	11.1	10.7	12.0	11.5	12.8
Tax revenue	8.6	8.4	9.1	8.7	10.1	9.5	10.4
Nontax revenue	1.9	1.8	2.0	2.0	1.9	2.0	2.4
Grants	1.8	1.3	2.3	1.5	2.8	2.0	3.1
Total expenditure	16.8	15.4	18.1	15.5	19.5	18.2	19.8
Current 3/	9.2	9.3	10.3	9.4	11.3	11.8	11.6
Of which : Wages and salaries	5.2	5.0	4.6	5.2	5.6	6.6	6.2
Capital and net lending 3/	7.6	6.1	7.8	6.1	8.2	6.4	8.1
Overall balance before grants	-6.3	-5.2	-7.0	-4.8	-7.6	-6.7	-7.0
Overall balance after grants	-4.5	-3.9	-4.7	-3.3	-4.8	-4.8	-3.9
Financing	4.5	3.9	4.7	3.3	4.8	4.8	3.9
Net foreign loans	3.8	2.5	3.7	2.6	3.4	2.7	2.3
Gross disbursements	4.7	3.5	4.9	3.6	4.7	3.9	3.6
Amortization	0.9	0.9	1.2	1.0	1.3	1.2	1.3
Net domestic financing	0.6	1.4	1.0	0.6	1.3	2.1	1.6
Central bank financing	0.1	0.0	0.0	-0.6	-0.1	0.5	...
Commercial Bank financing	0.8	0.7	0.7	1.5	0.6	1.8	...
Nonbank financing	-0.3	0.7	0.4	-0.3	0.8	-0.2	...
Memorandum items:							
Public savings (percent of GDP)	1.3	0.9	0.8	1.4	0.6	-0.3	1.1
Regular expenditure (percent of GDP) 3/	7.8	7.7	7.7	7.7	8.7	9.1	9.2
Development expenditure (percent of GDP) 3	9.0	7.7	10.4	7.8	10.8	9.1	10.6
Nominal GDP (billions Nrs)	300.8	342.0	381.4	379.7	421.6	409.3	455.5

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

1/ Fiscal years start on July 16. Table confined to central government operations as contained in the budget.

2/ Based on the Budget Speech 2001/02 presented to Parliament on July 9, 2001.

3/ Current and capital and net lending expenditures are based on new economic classification provided by the authorities and staff estimates. The traditional presentation is in terms of regular and development expenditures.

4/ Foreign financing assumes an additional \$20 million donor support to finance the VERS.

Table 5. Nepal: Vulnerability Indicators, 1996/97–2000/01

(In percent of GDP, unless otherwise indicated)

	1996/97	1997/98	1998/99	1999/00	2000/01
Official risk indicators					
Share of nonperforming loans (as percent of total loans)					
Rastriya Banjiya Bank 1/ 2/	40.0	36-45	...	...	...
Nepal Bank Ltd.	24.6	28-34	...	...	...
Financial sector risk indicators					
Public and public guaranteed debt 3/	61.8	62.6	64.7	70.1	72.1
Broad money (percent change, 12-month basis)	11.9	21.9	20.8	21.8	15.0
Private sector credit (percent change, 12-month basis) 4/	17.3	18.4	18.5	19.9	18.7
Share of deposits in broad money (percent)	78.6	81.0	83.0	83.0	82.8
Share of foreign currency deposits in total deposits (percent)	8.3	8.3	8.7	8.4	9.2
Market assessment indicators					
91-day Treasury bill yield (real, percent)	2.1	-4.8	-9.0	1.3	2.9
Stock market index (NEPSE Index, Feb. 12, 1994=100)	176.3	163.4	216.9	360.7	327.3
External indicators					
Exports (percent change, 12-month basis in US\$) 5/	92.9	-26.3	-10.8	27.3	6.0
Imports (percent change, 12-month basis in US\$) 6/	29.6	-11.3	-10.4	23.4	8.2
Current account balance (excluding grants)	-2.8	-2.8	0.5	0.5	0.3
Capital and financial account balance	3.1	6.0	2.0	0.9	1.2
<i>Of which</i> : Inward foreign direct investment	0.6	0.2	0.2	0.1	0.1
Gross foreign assets (in millions of US\$)	870	978	1,140	1,347	1,500
Central Bank short-term foreign liabilities (in millions of US\$) 7/	8.1	3.4	2.3	4.9	5.0
Central Bank foreign currency exposure 8/	1.2	0.5	0.3	0.5	0.5
Short-term foreign assets of commercial banks (in millions of US\$)	220	262	343	399	372
Short-term foreign liabilities of commercial banks (in millions of US\$)	119	126	161	184	209
Foreign currency exposure of commercial banks 8/	54.1	48.0	47.1	46.2	56.2
Gross official international reserves (in months of imports of goods and services)	4.4	5.3	4.9	5.5	5.3
Short-term debt 9/	3.6	5.3	5.1	6.2	7.6
Short-term debt to gross official international reserves 9/	27.2	35.9	32.2	35.8	41.7
Total external debt	50.5	53.8	54.2	61.5	65.1
<i>Of which</i> : Public sector debt	48.0	49.7	50.3	56.6	58.8
Total external debt to exports of goods and services	161	202	209	228	244
External interest payments (as percent of export receipts)	1.8	1.8	1.9	1.7	2.0
External amortization payments (percent of export receipts)	3.6	4.8	4.5	3.9	4.7
Exchange rate (NR per US\$, end of period)	56.8	67.6	68.5	70.8	74.8

Source: Data provided by the Nepalese authorities.

1/ Fund staff estimates.

2/ From *Special Audit Report* by an accounting firm, R. Bajracharya & Company.

3/ Consists of public and public-guaranteed external debt, domestic claims public sector by banking sector, and domestic credits to the central government by nonfinancial sector.

4/ Including private sector credit by NRB.

5/ Including re-exports.

6/ Including gold.

7/ Excluding SAF and ESAF.

8/ Foreign currency liabilities as a percent of foreign currency assets.

9/ Short-term debt in the form of outstanding trade credits and amortizations due in the following year.

Table 6. Nepal: Medium-Term Scenarios, 1997/98–2004/05

(In percent of GDP, except where indicated)

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
	Projections							
("High Growth" Scenario)								
Real sector								
Real GDP growth (percent change)	3.0	4.4	6.5	5.3	6.0	6.3	6.5	6.5
Agriculture	1.0	2.7	5.0	4.0	4.1	4.0	4.0	4.0
Nonagriculture	5.1	5.6	7.4	6.0	7.2	7.7	8.0	7.9
GDP deflator (percent change)	4.1	8.9	4.3	2.4	5.0	5.0	5.0	5.5
Real per capita GDP (percent change)	0.6	2.0	3.8	-1.5	3.3	3.7	3.9	4.0
National savings	22.0	21.0	24.8	26.0	25.4	25.0	24.6	25.4
Public 1/	1.3	0.9	1.4	-0.3	1.1	1.7	2.1	2.5
Private	20.7	20.1	23.4	26.3	24.2	23.3	22.5	23.0
Gross investment 2/	24.8	20.5	24.3	25.7	26.8	27.4	27.9	28.6
Public 1/	7.6	6.1	6.1	6.4	7.1	7.3	7.5	7.4
Private 2/	17.2	14.4	18.2	19.2	19.7	20.1	20.4	21.2
Fiscal Sector								
Total revenue	10.5	10.2	10.7	11.5	12.8	13.2	13.6	14.0
Grants	1.8	1.3	1.5	2.0	2.5	2.7	2.5	2.1
Current expenditure 4/	9.2	9.3	9.4	11.8	11.6	11.5	11.5	11.6
Capital expenditure & net lending 3/ 4/	7.6	6.1	6.1	6.4	7.1	7.3	7.5	7.4
Overall balance before grants	-6.3	-5.2	-4.8	-6.7	-6.0	-5.6	-5.4	-4.9
Overall balance after grants	-4.5	-3.9	-3.3	-4.8	-3.4	-2.9	-2.9	-2.9
Net foreign financing (including grants)	5.6	3.8	4.1	4.6	5.5	6.3	6.2	5.8
Net domestic debt financing	0.6	1.4	0.6	2.1	0.2	-1.0	-1.1	-1.2
Privatization proceeds	...	...	...	...	0.3	0.4	0.4	0.3
External sector								
Export value (percent change) 5/	11.8	18.0	37.4	8.0	11.0	12.0	12.0	12.0
Import value (percent change) 6/	7.1	-2.0	27.7	9.8	13.5	10.6	12.9	12.7
External current account balance	-2.8	0.5	0.5	0.3	-1.4	-2.4	-3.3	-3.2
Overall balance	3.6	2.9	3.8	2.2	1.6	1.9	2.0	2.0
Financing gap (million US\$)	...	...	...	0	40	30	35	20
Gross official reserves (millions US\$)	716	795	946	1,014	1,134	1,284	1,459	1,615
(in months of imports of goods and services)	5.3	4.9	5.5	5.3	5.3	5.4	5.5	5.3
(Of which : in convertible currencies)	4.1	4.4	4.5	3.7	4.3	4.6	4.7	4.7
Total external debt (millions US\$)	2,612	2,730	3,381	3,624	3,817	4,057	4,298	4,565
Total external debt	53.8	54.2	61.5	65.1	63.6	62.8	61.8	60.9
Debt service ratio	6.7	5.9	4.7	5.2	5.0	5.1	5.2	5.3
Monetary sector 7/								
Broad money (percent change)	21.9	20.8	21.8	15.0	15.0	16.3	16.5	17.0
Private sector credit (percent change)	18.4	18.5	19.9	18.7	19.5	23.1	19.9	20.1
("Low Growth" Scenario)								
Real sector								
Real GDP growth (percent change)	3.0	4.4	6.5	5.3	3.5	3.5	3.5	3.5
Agriculture	1.0	2.7	5.0	4.0	3.0	3.0	3.0	3.0
Nonagriculture	5.1	5.6	7.4	6.0	3.8	3.8	3.8	3.8
Real per capita GDP (percent change)	0.6	2.0	3.8	-1.5	1.2	1.2	1.2	1.2
Gross investment 2/	24.8	20.5	24.3	25.7	24.0	24.0	24.0	24.0
Fiscal Sector								
Public savings 1/	1.3	0.9	1.4	-0.3	0.3	0.5	0.5	0.5
Overall fiscal balance before grants	-6.3	-5.2	-4.8	-6.7	-6.7	-7.0	-7.0	-7.0
Net domestic financing	0.7	1.4	0.6	2.1	2.4	2.8	2.9	3.0
Net foreign financing (including grants)	5.6	3.8	4.1	4.6	4.3	4.2	4.1	4.0
External sector								
External current account balance	-2.8	0.5	0.5	0.3	-2.3	-3.2	-3.9	-3.6
Gross official reserves (millions US\$)	716	795	946	1,014	1,014	998	1,003	979
(in months of imports of goods and services)	5.3	4.9	5.5	5.5	5.3	4.8	4.6	4.0
(Of which : in convertible currencies)	4.1	4.4	4.5	3.9	4.1	3.9	3.7	3.2
Total external debt	53.8	54.2	61.5	65.1	61.9	61.4	61.0	60.6
Debt service ratio	6.7	5.9	4.7	5.2	5.7	6.0	6.4	6.8

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

1/ Public savings and investment estimate derived from fiscal accounts. Gross investment derived from national income accounts (adjusted).

2/ Historical totals include changes in stocks.

3/ For 2000/01, capital and development includes partial cost of voluntary retirement scheme. Staff estimate for 2001/02, not the budget target.

4/ From 2002/03, current includes interest cost of restructuring bonds and capital includes remaining cost of voluntary retirement scheme.

5/ Excluding re-exports.

6/ Excluding gold.

7/ Excludes balance sheet impact of restructuring RBB and NBL.

Table 7. Nepal: Social Indicators

	Latest single year			Same Region/Income Group		
	1970-75	1980-85	1993-98	India	South Asia	Low Income
Total population, mid-year (millions)	12.8	16.5	22.9	979.7	1,304.6	3,536.4
Growth rate (percent annual average)	2.4	2.6	2.0	1.4	1.5	1.4
Urban population (percent of population)	5.0	7.8	11.3	27.8	27.7	30.5
Total fertility rate (births per woman)	6.3	6.1	4.4	3.2	3.4	3.1
Total labor force (millions)	...	7	11	439	585	1,085
Females in labor force (percent)	...	39	40	32	33	38
Labor force participation rate	...	48	48	43	43	50
Poverty						
National headcount index	...	...	42	35	...	...
Urban headcount index	...	...	23	31	...	...
Rural headcount index	...	...	44	37	...	...
Income						
GNP per capita (U.S. dollars)	120	170	210	440	430	520
Consumer price index (1995=100)	17	35	125	132	131	136
Food price index (1995=100)	...	33	113	132	...	...
Income/consumption distribution						
Gini index	...	...	36.7	37.8	...	...
Lowest quintile (percent of income or consumption)	...	...	7.6	8.1	...	...
Highest quintile (percent of income or consumption)	...	...	44.8	46.1	...	...
Public expenditure						
Health (percent of GDP)	...	...	1.3	0.6	0.8	1.3
Education (percent of GNP)	1.5	2.6	3.2	3.2	3.1	3.2
Social security and welfare (percent of GDP)	0.1	0.1	0.3	...	...	...
Net primary school enrollment rate (percent of age group)						
Total	...	60	78	77	77	86
Male	...	80	93	83	83	89
Female	...	37	63	71	70	82
Gross secondary school enrollment						
Total	12	27	32	49	...	...
Male	19	39	45	59	...	...
Female	4	14	18	39	...	...
Adult literacy (percent)	...	22	33	55	53	60
Female literacy	...	...	22	43	41	51
Access to safe water (percent of population)						
Total	8	24	59	81	77	69
Urban	85	78	61	85	83	80
Rural	5	20	59	79	70	66
Access to electricity (percent)	...	...	15	54	...	...
Population per physician	...	30,221	13,617	2,459	2,500	...
Population per hospital bed	...	5,719	4,308	1,503	1,429	1,152
Immunization rate (percent under 12 months)						
Measles	...	34	85	81	81	80
DPT	...	32	78	90	87	82
Child malnutrition (percent under 5 years)	69	...	57	53	53	...
Life expectancy at birth (in years)						
Total	43	49	58	63	62	63
Male	44	50	58	62	62	62
Female	43	48	58	64	63	64
Mortality						
Infant (per thousand live births)	160	125	77	70	75	68
Under 5 (per thousand live births)	234	180	107	83	89	92
Adult (15-59)						
Male (per 1,000 population)	482	376	273	215	220	235
Female (per 1,000 population)	476	395	309	204	213	208
Maternal (per 100,000 live births)	...	...	540	410	...	...

Sources: Staff reports, EDSS, World Bank 2000 World Development Indicators CD-ROM.

Nepal: Relations with the Fund

(As of June 30, 2001)

I. Membership Status: Joined 9/06/61; Article VIII

II. General Resources Account:	SDR Million	% Quota
Quota	71.30	100.0
Fund holdings of currency	65.56	91.9
Reserve position in Fund	5.75	8.1

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	8.10	100.0
Holdings	0.03	0.4

IV. Outstanding Purchases and Loans:	SDR Million	% Quota
ESAF arrangements	7.83	11.0

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ESAF	10/05/92	10/04/95	33.57	16.79
SAF	10/14/87	10/13/90	26.11	26.11
Stand-by	12/23/85	4/22/87	18.65	18.65

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

	Overdue 06/30/01	Forthcoming				
		2001	2002	2003	2004	2005
Principal	--	1.7	3.4	2.2	0.6	
Charges/Interest	--	<u>0.2</u>	<u>0.3</u>	<u>0.3</u>	<u>0.3</u>	<u>0.3</u>
Total	--	1.9	3.7	2.5	0.9	0.3

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 presently free of restrictions on the making of payments and transfers for current international transactions.

Exchange rate: \$1=75.03 Nepalese rupees (as of July 10, 2001).

VIII. Last Article IV Consultation

- (a) Staff discussions were held in Kathmandu in November 1999.
- (b) The Executive Board discussed the staff report (SM/00/22) on February 18, 2000.

IX. Consultation Cycle

Nepal is on the standard 12-month consultation cycle.

X. Technical assistance since 1996

Department	Purpose	Date
MAE -	Debt management and monetary operations.	10/96
-	Bank supervision and compliance with Basel guidelines.	6/99
MAE/ LEG -	Reform of Central Bank and Depository Institutions Legislation.	7/00
FAD -	Technical assistance in VAT administration.	1/98, 3/98
LEG -	Redrafting of income tax laws.	3/00, 7/01
STA -	Assistance in improving the compilation and reporting of the monetary statistics.	11/97, 4/99, 3/00
-	Long-term residential advice on coverage and classification of balance of payments statistics.	11/97-5/98
-	Multisector statistics mission.	1/01
-	Database of macroeconomic statistics.	7/01

XI. Resident Representative/Advisor

The Fund has provided staff members as resident representatives since 1977. Mr. Lawrence DeMilner began his term in August 1999.

Nepal: Relations with the World Bank Group

The World Bank's strategy is designed to assist Nepal in making progress towards poverty alleviation. The Country Assistance Strategy (CAS) of December 1998 aims at (a) bringing resources closer to the beneficiaries, where they are most likely to be productively used and (b) collective donor action to foster the stronger governance needed to reduce waste and mismanagement, while (c) further improving economic and fiscal management. The level of future assistance will be determined by progress in overall economic management and institutional reform. The Bank's current dialogue with the Government is focused on economic management issues, governance, and structural and financial sector reforms.

Since its first operation in Nepal in 1969, IDA has approved 73 credits for Nepal totaling over \$1.6 billion. In FY00 a Road Maintenance and Development Project was approved, while in FY01 there were no new operations. The current IDA portfolio consists of eight credits for a total committed value of \$173 million. Projects in the telecommunications, finance, power, urban and rural water, and health sectors are at various stages of preparation and discussion with the Government.

As of June 30, 2001, IFC's commitments in Nepal included \$49 million in loans, concentrated primarily in the power sector. MIGA's portfolio in Nepal consists of three guarantee contracts with a net exposure of \$19.1 million, mainly in the infrastructure sector.

Lending by the World Bank Group, FY 1995 – 2001 (In millions of U.S. dollars)							
	1995	1996	1997	1998	1999	2000	2001
IDA (net)	71.8	75.1	50.0	42.9	47.5	31.4	30.6
Disbursements	78.6	82.4	58.4	52.5	59.0	46.1	47.3
Amortization	6.8	7.3	8.4	9.6	12.3	14.7	16.7
IFC							
Disbursements	0.0	1.5	8.0	13.2	11.6	11.5	7.2
Total Loans	78.6	83.9	66.4	65.7	70.6	57.6	54.5

Source: Data provided by the World Bank

The Bank has been providing technical assistance in energy planning, road infrastructure, irrigation, industrial finance, cottage industry, municipal development, planning and financial management, and remote area access. Recent non-lending activities of the Bank in Nepal include a Private Sector Assessment (6/01), an Education Sector Strategy (4/01), a Power Sector Development Strategy (3/01), a Decentralization Study (10/00), and a Public Expenditure Review (11/99). In FY02, a Financial Sector Study will be completed and work on decentralization issues and growth will be initiated.

Nepal: Relations with the Asian Development Bank

Lending Program

As of June 30, 2001, total commitments by the Asian Development Bank (AsDB) consisted of 94 loans amounting to \$1.8 billion covering projects in agriculture (including forestry), energy, transport, industry, social infrastructure, and tourism. Undisbursed funds of \$329 million represent about 56 percent of the total net loan amount as of June 30, 2001. For the period 2001–04, 16 projects amounting to \$417 million are tentatively programmed.

Loans by the Asian Development Bank, 1969–June 2001 (as of June 30, 2001) (In millions of U.S. dollars)				
	1969–1998 Approved	1999 Approved	2000 Approved	June 2001 Approved
Agriculture and natural resources	748.4	--	11.0	--
Energy	314.4	50.0	--	--
Finance and Industry	130.7	--	7.3	--
Social infrastructure	137.1	--	1,550.0	--
Transport and communications	224.7	--	--	--
Others	27.6	--	--	--
Total commitments	1,582.9	50.0	173.3	--
Gross disbursements	1,042.2	70.4	91.4	17.7
Technical Assistance Projects				
Total commitments	87.6	4.5	1.3	2.3
Gross disbursements	45.5	9.7	4.7	3.8
Source: Data provided by the Asian Development Bank.				

Technical Assistance

Since 1968, the AsDB has provided Nepal with technical assistance in most sectors. Recent assistance includes support for Strengthening the National Statistical System, Company, Insolvency, and Secured Transactions Law Reform, Second Secondary Education Sector, Agriculture Sector Performance Review, Management Reform and Efficiency Improvement for the Nepal Electricity Authority, Corporate and Financial Governance, Institutional Support for Governance Reforms and Second Rural Infrastructure Development. As of June 30, 2001, total technical assistance commitments consisted of 220 projects—84 of which were in preparation for loans—for a total of \$98.9 million.

Private Sector Operations

As of June 30, 2001, the AsDB has provided five private-sector loans in Nepal: two in industry, two in hydropower, and one in tourism. Direct investments have involved \$49.5 million in loans and \$3.3 million in equity for a total of \$52.8. Moreover, the AsDB has been working through its lending and technical assistance program to create a policy and legal environment in Nepal that promotes private sector development.

Nepal: Statistical Issues

The authorities provide the core minimum data to the Fund (attached table) and release data through government and central bank publications. At present, however, the lack of consistent data reporting hampers effective economic analysis and policy implementation in a number of areas. Recently, a multi-sector statistics mission visited Kathmandu in January 2001 to conduct a comprehensive assessment, and prepared recommendations and an action plan to bring Nepal's macroeconomic statistics in line with international standards.

1. In the past, **balance of payments accounts** consistently exhibited large and volatile entries under net errors and omissions (as much as 5 percent of GDP). As a follow-up to the 1995 Fund mission in balance of payments statistics, a statistical advisor was stationed in Kathmandu for a six-month period in 1997–98 to provide further technical assistance in compiling balance of payments statistics, including implementation of the recommendations of previous technical assistance. As a result, methodologies were developed to improve the recording of grants, workers' remittances, and re-exports. These revised estimates were presented in the 1998 staff report and substantially amended the current account balance and reduced net errors and omissions; but further work is needed to improve recording of oil transactions. The staff team encouraged the authorities to also use the new coverage of the balance of payments when reporting official data to the Fund, and in publications. Further efforts are also needed to improve estimates of foreign direct investment, short-term inflows, and other private capital flows.

2. Data on **exports and imports** are compiled by the central bank, the Customs Department, and the Trade Promotion Center (overseas trade only), and there are discrepancies among them. Price indices for exports and imports are not compiled, and no information is available on trade volumes.

3. Incomplete and conflicting data on **external grants and loans** to the government make it difficult to anticipate trends in the availability of foreign financing. Data collected by the central bank monitor trends in cash disbursements and repayments, but exclude most commodity aid and direct payment by donors, while the Ministry of Finance (MOF) reporting is incomplete and often not timely. With technical assistance from DfID, a new database providing comprehensive account of disbursements, payments, and the stock of outstanding government debt has been developed and is currently being refined. However, reporting of grants paid directly by donors remains a problem.

4. **Monetary data** provided by the central bank have been subject to revision with a substantial lag (up to 12 months), making timely program monitoring difficult. A **money and banking statistics** technical assistance mission visited Nepal during April/May 1999 and again during March 2000 to assist in improving data timeliness, compilation procedures, and the coverage of the financial system. The 2001 multi-sector mission recommended to implement the residency criterion, instead of the currency basis, in distinguishing foreign from domestic accounts. The mission also encouraged the Nepal Rastra Bank (NRB) to improve the procedures for grossing-up balance sheet data to account for late reporting of commercial bank branches, which had led to the consistent underestimation of the broad money.

5. The new **budget classification** system introduced in 1996/97, and improvements introduced in the past year, have substantially improved fiscal statistics, in particular the division between current and capital spending. However, fiscal data by functional and economic classification is only provided on an annual basis; some classification problems remain with large amounts attributed to the contingency account, and monthly reporting of development spending excludes amounts directly paid by donors. Additionally, a number of fees are collected outside the budget and the operations of local governments are not reported in the annual budget.

6. More timely data on **revenue and expenditure** developments are needed for effective fiscal control. A financial management project is under way and a system of 'flash' reporting covering selected districts that account for the bulk of expenditure is being developed. It is critical that further progress is made in improving data collected by the Financial Comptroller General's Office be organized in a manner that will allow the MOF to effectively monitor actual expenditures and revenue collections and provide assessments during the course of a fiscal year. This will require additional donor funding of technical assistance and computerization in the MOF regional offices.

7. 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 have assisted the authorities in processing surveys of public enterprises; however, further assistance in survey design and processing may be needed.

8. The Central Bureau of Statistics (CBS) compiles **national accounts statistics** following the 1968 version of the System of National Accounts. These statistics cover estimates of gross domestic product (GDP) by industry of origin at current and constant prices, estimates of GDP by expenditure categories at current prices, and current price estimates of gross national income and savings. However, questions remain about their reliability. The accuracy of these data is hampered by the lack of sufficient primary statistics in several areas, including the important agricultural sector. Current statistics on many service activities are virtually nonexistent. In addition, there is an urgent need for a survey of construction activity. A comprehensive census of manufacturing establishments is normally conducted every five years, but the latest available census was for 1991/92. Although sample surveys covering manufacturing establishments with 10 or more persons are conducted annually, the survey results are not satisfactory due to a lack of procedures to update the sample frame which is usually based on the latest census. The estimates of household consumption expenditures are derived residually. The CBS conducted a household budget survey in 1995/96, and the result of this survey could be used to compile household consumption expenditure. A careful review of saving and investment data is needed and an explanation of large annual accumulation of changes in stocks. Wage data in agriculture and manufacturing are practically nonexistent.

9. The **consumer price index (CPI)** was recently revised following completion of the 1995/96 household expenditure survey. The weights used for calculation of the CPI were updated and coverage was expanded. The revised series was first published in May 2000.

10. The **wholesale price index (WPI)** was developed by the NRB and first published in July 2001. The weights for the WPI, based on data for 1999/2000, were derived using a commodity flow approach and the prices related to the first commercial transaction point. However, the index compilation method should be improved to implement weekly or bi-weekly price collection; increase the number of price quotations; and implement adjustment procedures for quality difference.

Nepal: Core Statistical Indicators
(As of July 17, 2001)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	External Current Account Balance	Central Government Balance	GDP/ GNP	External Debt
Date of latest observation	7/06/01	07/5/01	5/15/01	5/15/01	5/15/01	5/15/01	6/01	5/01	4/01	6/15/01	1999/00	1999/00
Date received	07/9/01	07/9/01	07/2/01	07/2/01	07/2/01	07/17/01	7/16/01	7/03/01	6/28/01	07/09/01	8/00	8/00
Frequency of data 1/	D	W	W	W	M	W	M	M	M	W	A	A
Frequency of Reporting 1/	W	W	W	W	M	W	M	M	M	W	A	A
Source of data 2/	A	A	A	A	A	A	A	A	A	A	A	A
Mode of reporting 3/	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C	E/C
Confidentiality 4/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of publication	D	M	M	M	M	W	M	M	Q	Q	A	A

1/ D-daily; W-weekly; M-monthly; Q-quarterly; or A-annually.

2/ A-direct reporting by central bank, ministry of finance, or other official agency (by Res. Rep, except Exchange Rates); N-official publication or press release; P-commercial publication; C-commercial electronic data provider; or E-EIS.

3/ E-electronic data transfer; C-cable or facsimile; T-telephone; M-mail; or V-staff visits.

4/ A-for use by the staff only; B-for use by the staff and the Executive Board; C-unrestricted use; or D-embargoed for a specific period and thereafter for unrestricted use.

Nepal: Illustrative Medium-Term Scenarios

1. **The Government's development strategy targets the eventual eradication of widespread poverty in Nepal by accelerating economic growth, including through enhancing the role of the private sector and improved delivery of public services.** On this basis, the staff has prepared two medium-term scenarios. The "High Growth Scenario" is predicated on the maintenance of political and macroeconomic stability and adherence to a comprehensive program geared toward removing the key structural impediments to high and sustained growth. The "Low Growth Scenario" assumes a slowing of reform and reflects the potential adverse impact of continued political strife on macroeconomic stability. However, it should be recognized that, even under the high growth scenario, significant strides in reducing poverty would be achieved only over the longer term.

"High Growth" Scenario

2. **The high growth scenario is based on full implementation of the government's program of reform.** The principal elements of this scenario include: (i) increasing annual economic growth to 6–7 percent; (ii) reducing and maintaining inflation to 5 percent; (iii) raising domestic savings; and (iv) maintaining a comfortable level of reserves. Sustained high growth would require a strong expansion of agricultural production based on higher utilization of fertilizers, expansion of year-round irrigation, and extension of the road network, as well as a take off in nonagricultural activity. A significant increase in public and private gross investment (to 28½ percent) would result from several hydro-power and road construction projects, which would require mobilizing external savings, including in the form of private capital. To ensure that rising external current account deficits can be financed on a sustainable basis, the public sector's contribution to domestic savings would need to increase significantly (to at least 2½ percent of GDP). Imports are projected to rise sharply in the initial years as a result of the need for imported capital goods, and to settle at a lower level by 2004/05. Foreign aid levels are expected to increase, but not dramatically, and the overall balance of payments is expected to remain in surplus. Gross official convertible currency reserves would be anticipated to remain at about 4 months of imports of goods and services.

"Low Growth" Scenario

3. **Without sustained macroeconomic stability and aggressive implementation of key structural reforms, economic growth could slow to 3 percent and the objectives of increasing per capita incomes and reducing poverty would remain elusive.** Continued political unrest could result in lower private investment and reduced tourism receipts, and this would be expected to have an immediate impact on growth in 2001/02. At the same time, failure to increase agricultural productivity would not only result in continued low and uneven agricultural output, but also dampen domestic demand and the growth of non-agricultural production. Moreover, even with expenditure restraint, the absence of measures to increase the tax effort, in combination with dwindling donor assistance, would likely result in higher domestic bank financing of the overall fiscal deficit, higher inflation, and lower public savings. With lower official capital inflows, gross official reserves would be set on a declining path and the sustainability of the exchange rate regime would eventually be called into question. In addition, while total external debt as a share of GDP would fall in line with the likely decline in foreign financing, the debt service ratio would be higher than in the reform scenario, reflecting lower exports. Above all, the absence of high and sustained economic growth would result in even higher poverty levels over the medium term.

**Statement by the IMF Staff Representative
August 31, 2001**

1. **This statement provides an update of information that has become available since the release of the staff report (SM/01/260, 8/16/01).** The statement covers the political situation, recent macroeconomic data, trade policy, and privatization. This information does not alter the thrust of the staff appraisal.

2. **Since becoming Prime Minister in July 2001, Sher Bahadur Deuba has sought to engage the Maoist movement in talks, due to start this week.** Prime Minister Deuba has called on the rebels to abandon the idea of setting up a republic in Nepal. Several imprisoned Maoist leaders have been freed, and the government has announced possible radical land reforms and alcohol restrictions that have featured in the agenda of the Maoist group. Thus, on August 16, Prime Minister Deuba announced a freeze on land transactions until the government introduces new land reform laws that aim to bring about an equitable distribution of land. The announcement drew mixed reactions from the opposition parties, who have threatened to hold up the budget debate. There has been widespread concern among the business community, and reports of customers withdrawing deposits from some financial institutions.

3. **Recent data for July suggest that macroeconomic developments for the fiscal year 2000/01 have been broadly in line with estimates provided in the staff report.**
 - **As measured by the Consumer Price Index, the rate of inflation was 3.4 percent in the 12 months through July 2001,** while the wholesale price index increased by 4.6 percent during the same period.

 - **Preliminary trade data for 2000/01 indicate that exports increased by 8 percent (same as the staff's estimate), and non-oil imports declined by 2 percent** (the staff estimate in the report pointed to a marginal increase), suggesting a slightly smaller trade deficit than presented in the staff report.

 - **The overall budget deficit (before grants) for 2000/01 is now estimated at Nrs 28 billion (6.8 percent of GDP),** slightly wider-than-earlier projected, because of revised revenue data.

4. **The Nepalese government is holding discussions on the Nepal-India Trade Treaty that expires December 5, 2001.** India has given a formal notice to Nepal for re-negotiation of two clauses—value addition and rules of origin. The most critical issue relates to increasing exports of certain Nepali products. The Indian side has reportedly proposed either quantitative restrictions or minimum requirements for the domestic value added related to these items.

5. **After a series of delays in the privatization of the Butwal Power Company, on August 17 the Ministry of Finance opened the sole qualifying financial bid of a joint Norwegian-Nepali group, to purchase 75 percent of the state-owned shares. Finalization of the bid, valued at \$10 million, should be completed soon.**



INTERNATIONAL MONETARY FUND

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FOR IMMEDIATE RELEASE
September 21, 2001

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2001 Article IV Consultation with Nepal

On August 31, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Nepal.¹

Background

During the past decade, Nepal has grappled with daunting economic and social challenges. Poverty remains widespread, with nine out of every ten Nepalese living in rural areas and depending on subsistence farming. Nepal's primary goal has been to achieve and sustain higher levels of growth in order to improve conditions for the poor. However, growth has been impeded by weak infrastructure, low saving and investment rates, fiscal constraints and inefficient public resource management.

Nevertheless, the macroeconomic performance of the Nepalese economy has been satisfactory during the past two years. Overall real GDP growth (at market prices) surged from 4½ percent in 1998/99 (fiscal year ending July 15) to 6½ percent in 1999/2000, led by improved agricultural performance and strong exports. Growth is estimated to have eased to 5½ percent in 2000/01, owing to the dampening effects of higher oil prices and a marked decline in tourism due to domestic disturbances. Consumer price inflation fell to under 1 percent in the 12 months to mid-2000 and remained below 4 percent during the following year, with abundant food supplies offsetting the effects of higher energy prices.

The external position was generally favorable in 1999/2000 and 2000/01, with the current account close to balance and a steady increase in reserves. The current account (excluding grants) registered a small surplus of ½ percent of GDP in both years as strong growth in

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the August 31, 2001 Executive Board discussion based on the staff report.

remittances compensated for the deterioration of the trade deficit. The overall balance remained strong despite declines in capital transfers and foreign direct investment (FDI). Aided by strong exports and increased remittances, gross official reserves reached \$946 million in 1999/2000 and \$1,014 million in 2000/01, equivalent to five months of imports in both years.

Recent monetary developments were in line with the authorities' target. The growth rate of broad money decelerated to 15 percent in the 12 months to July 2001 after approaching 22 percent in 1999/2000. Private sector credit increased by 20 percent during 1999/2000 and by about 17 percent in the 12 months to July 2001, owing to the strength of the economy. Nominal interest rates declined during the past two years, with the yield on treasury bills falling to 5 percent. The spread between lending and deposit rates remained high at 5 percent, reflecting weaknesses in the banking system.

Fiscal performance was generally favorable. The overall deficit (before grants) declined to 4¾ percent of GDP in 1999/2000. The fiscal position improved in 1999/2000 as the ambitious revenue targets were nearly achieved and current expenditures were contained. However, the overall deficit widened to 6¾ percent of GDP in 2000/01, owing to a significant overrun in the current expenditure budget, even though domestic revenue remained close to the budget target. With lower-than-anticipated disbursement of foreign grants and concessional loans, net domestic financing rose from ½ percent of GDP in 1999/2000 to 2 percent of GDP in 2000/01.

Progress in the area of structural reform was limited. The financial performance of public sector enterprises continued to be disappointing, with virtually no progress on the privatization of public sector entities. Although the government formulated and published its financial sector strategy, developments in the financial sector were overshadowed by uncertainties surrounding two large ailing banks. Similarly, while notable progress was achieved in improving the timeliness and coverage of fiscal accounts, the budget formulation process remained weak. Nonetheless, steps were taken to initiate civil service reforms and develop a comprehensive poverty reduction strategy.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They observed that macroeconomic developments in Nepal during the past two years have been broadly satisfactory, despite difficult political circumstances. Growth was accelerating, inflation was declining, and international reserves remained at a comfortable level. Directors agreed that the primary challenge facing the authorities will be to achieve strong growth on a sustainable basis to reduce the continued high level of poverty. This will require comprehensive structural reform and substantial foreign aid, together with political stability and internal security.

Directors welcomed the authorities' adoption of a reform agenda, which focuses on maintaining macroeconomic stability and removing structural impediments to growth. These impediments include inadequate provision of public services, an ineffective and segmented financial sector, and weak governance. Directors looked forward to seeing this agenda addressed in the forthcoming Interim PRSP and PRGF program.

Directors welcomed the emphasis of the 2001/02 budget on revenue improvements and high priority development spending, but emphasized that achievement of the budget targets and the planned increase in public savings will likely require efforts additional to those included in the

budget. Noting last year's shortfalls in revenue collection, they cautioned that the planned improvements in tax auditing might be insufficient to attain the targeted revenue levels. Directors also urged the authorities to take steps to ensure that possible overruns in some spending categories are offset by savings in other items, while safeguarding priority social sectors. They noted that tighter control over project implementation will be necessary to achieve the desired increase in the level and effectiveness of environmentally sustainable capital spending.

Over the medium term, Directors encouraged the authorities to strengthen revenue mobilization and improve the targeting of budget allocations so as to allow for higher social spending. They also underscored the importance of incorporating in budget targets in future years the fiscal cost of bank restructuring. They noted that mechanisms are needed to ensure full reporting of the Poverty Alleviation Fund, off-budget revenue, and foreign aid.

Directors urged the authorities to continue the process of streamlining the civil service and prioritizing public expenditures. The ongoing review of the pension system was welcomed, but Directors noted that further efforts will be needed to improve expenditure control of state and local governments and strengthen wage discipline in the public sector. They also recommended that the authorities step up the divestiture of small institutions and tackle the growing problems of inefficient and loss-making enterprises, in order to reduce the burden on the budget.

Directors agreed that the exchange rate peg to the Indian rupee remains broadly appropriate. They supported Nepal Rastra Bank in its focus on maintaining monetary conditions that are consistent with the pegged exchange rate. Directors encouraged the authorities to take steps to improve the liquidity of official reserves; and to lower excess liquidity in the banking system and contain central bank financing of the budget.

Directors encouraged the authorities to maintain an open trade and investment regime and access to world markets.

Directors highlighted the urgency of addressing the balance sheet problems of the two largest banks. They looked forward to the installation of new management teams in these banks as soon as possible, noting that their recapitalization would need to be preceded by proper restructuring under the new management. Directors also welcomed the proposed bank legislation which will increase the independence of the central bank, strengthen its regulatory and oversight activities, and introduce proper accounting, auditing, and disclosure practices.

There are significant weaknesses in official statistics that impair effective monitoring of the economy and policy formulation. Directors encouraged the authorities to implement the recommendations of the Fund's multi-sector statistics mission and improve the macroeconomic database by strengthening statistical legislation and institutional capacity.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Nepal: Selected Economic Indicators, 1997/98-2000/01 1/				
	1997/98	1998/99	1999/2000	2000/01 Est. 2/
	(Percent change)			
Output and prices				
Change in real GDP	3.0	4.4	6.5	5.3 3/
Change in CPI (end-period)	12.0	9.0	0.6	3.4
	(Percent of GDP)			
Budgetary operations				
Total revenue	10.5	10.2	10.7	11.3
Total expenditure	16.8	15.4	15.5	18.2
Current expenditure	9.2	9.3	9.4	11.8
Capital expenditure and net lending	7.6	6.1	5.3	6.4
Overall deficit 4/	4.5	3.9	3.3	4.9
	(Percent change)			
Money and credit				
Domestic credit	14.8	16.1	17.8	18.6
Broad money	21.9	20.8	21.8	14.9
	(Millions of U.S. dollars, unless otherwise indicated)			
External sector				
Exports, f.o.b. 5/	856	763	971	1,029
Imports, c.i.f.	1,551	1,390	1,713	1,855
Current account 6/	-16	161	177	123
(in percent of GDP) 6/	-0.3	3.2	3.2	2.2
Overall balance	177	145	209	121
Gross official reserves	716	795	946	1,014
Rupees per U.S. dollar (end-period)	67.9	68.5	70.8	74.8

Sources: Nepalese authorities and IMF staff estimates.

1/ Fiscal year ending July 15.

2/ Based on latest data as of August 30, 2001.

3/ Staff estimate. The authorities' provisional estimate is 5.8 percent.

4/ After grants.

5/ Includes re-exports.

6/ Includes grants.