

Appendix IV¹

Fund Relations Note

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International Monetary Fund
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IMF Concludes 2003 Article IV Consultation with Nepal

On August 22, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Nepal.²

Background

Nepal remains among the poorest countries in the world with almost 40 percent of the population living in poverty due to insufficient growth and inadequate targeting of the poor. During the 1990s, macroeconomic conditions remained broadly stable and the fiscal position was manageable, but growth was constrained by financial sector weaknesses, weak public sector management, and poor governance. In the financial sector, Nepal Rastra Bank (NRB) oversight is still weak, and intermediation is inadequate largely due to a banking environment in which loan default is endemic, especially by well-connected borrowers. Partly as a result of this, the two largest commercial banks now have large nonperforming assets. Similar problems exist at two large development banks. In the public sector, investment has been spread thinly over projects and enterprises suffer from weak management and accountability. More recently, intensified security problems and adverse external developments contributed to lower growth and the fiscal position has deteriorated since 2000/01.

The ceasefire agreed in January 2003 with the insurgents has renewed hopes for peace and efforts have been made to sustain the reform momentum. Progress in achieving lasting peace would facilitate poverty reduction and implementation of policies contained in the government's Poverty Reduction Strategy Paper (PRSP). However, political uncertainties persist as major political parties continue to maintain that the appointment of governments by the King since the dissolution of parliament is unconstitutional. The parties have also refused to join the peace talks.

¹ Note: This Appendix is as of July 25, 2003 and as such, the indicators deviate from the more updated indicators provided elsewhere in the document.

² 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.

GDP growth is estimated to be 2 percent in 2002/03. The ceasefire has helped restore some normality in the transport and service sectors and the decline in tourism may have halted. There are also signs that some exports and manufacturing production are rebounding. Inflation, which rose to about 7½ percent in mid-May (12-month basis) reflecting price developments in India, administrative price changes, and supply factors, is expected to moderate by early 2003/04.

The 2002/03 budget met revised targets set in a mid-term review. Based on weak revenue performance due to lower activity during the first half of the year and external aid shortfalls relative to the initial budget targets, the authorities revised the budget at mid-year. Specifically, the tax revenue target and external financing were revised down. To compensate for these shortfalls, total expenditure was also revised down and the revised budget set a net domestic financing target of 2 percent of GDP. Following the announcement of the ceasefire, economic activity picked up and revenue performance improved. However, capital spending was below the revised budget, reflecting continued implementation constraints at the local level. As a result, domestic financing was around 1¾ percent of GDP.

Monetary policy has been accommodative and the real effective exchange rate has depreciated. To help economic recovery, the NRB lowered cash reserve requirements by 1 percentage point in August 2002 and maintained a refinancing facility for lending to “sick” industries. Aided by the recovery in activity and monetary easing, private credit appears to have revived and higher remittances contributed to a rise in banking system foreign assets. However, reserve money growth has been curtailed, due largely to lower net credit to the government. Lending and deposit rates have declined somewhat. The Nepalese rupee has depreciated in real effective terms since early 2002, reflecting the peg to the Indian currency which has appreciated only somewhat against the weakening US dollar.

Balance of payments developments turned favorable in mid-2002/03 and external reserves are adequate. Large and increasing remittances helped buoy the current account. Garment exports began recovering in late 2002, while recorded exports to India declined, carpets and pashmina exports continued to stagnate, and imports increased with the recovery. The current account (excluding official transfers) is expected to move into a deficit of about percent of GDP, but with higher aid and other inflows official foreign exchange reserves are expected to rise to US\$1 billion (6¼ months of imports of goods and services).

In 2002/03, significant progress was made in financial sector reform implementation. The NRB took steps to reduce staffing through a voluntary retirement scheme (VRS). Progress was made in restructuring the two largest commercial banks, which had external management teams installed. The teams have prepared management plans, made progress in assessing the banks’ financial status, and proposed VRSs to reduce overstaffing. Some improvements have already taken place with success in loan recovery and branch rationalization, although loan recovery from well-connected borrowers continues to be difficult. Prioritization of budgetary spending improved, anti-corruption efforts were boosted, and public enterprise reform implementation and governance reforms progressed. To improve prioritization, a Medium Term Expenditure Framework was introduced with World Bank assistance to help align development spending with national and sectoral priorities. Administered price increases for petroleum products were announced in March 2003, although some price increases were rolled back under public pressure. Liquidation procedures were initiated for four public enterprises; preparations for the privatization of one enterprise were brought to an advanced stage.

Governance reforms progressed and anti-corruption efforts were boosted. The cabinet approved in September 2002 the elimination of 7,500 vacant civil service positions. To tackle corruption in public life, the

Commission for Investigation of Abuse of Authority and a newly established Judicial Commission initiated investigations against politicians and revenue officials perceived to have accumulated unaccountable assets. The Anti-Corruption Strategy was adopted.

Executive Board Assessment

Executive Directors stressed that to address the pervasive level of poverty in Nepal, growth needs to be raised significantly over the medium term through vigorous implementation of structural reforms, particularly in the financial and public sectors. In this regard, Directors welcomed the authorities' Poverty Reduction Strategy Paper (PRSP), which is founded on broad-based growth, social sector development, targeted programs for the poor and deprived groups, and improved governance. Directors looked forward to considering a Joint Staff Assessment of the PRSP in the near future. They encouraged the authorities to reach early agreement on a program that could be supported by the Poverty Reduction and Growth Facility to help achieve PRSP goals.

Directors welcomed the ceasefire agreement with the insurgents reached in January 2003. They underlined that continued peace was essential to help sustain the economic recovery currently under way. Directors also noted that progress in the peace talks and the build up of confidence should help relieve budgetary pressures for security spending.

Directors commended the authorities' for maintaining broad fiscal stability to create conditions to support economic growth. Looking forward, Directors endorsed the authorities' fiscal strategy based on revenue mobilization, expenditure prioritization, and a reduction in domestic borrowing. They welcomed the 2003/04 budget as the first step in implementing this strategy. However, Directors called for a determined effort to meet the revenue targets and to resist spending pressures. To raise revenue over the medium term, Directors suggested cuts in exemptions, improvements in tax and customs administration, and increases in the VAT rate. Directors welcomed the steps taken to prioritize development spending to help achieve poverty reduction goals, including the introduction of a medium-term expenditure framework, and encouraged the extension of such efforts to all expenditures. Directors noted that the envisaged reductions in domestic borrowing would help maintain fiscal sustainability over the medium term, especially in view of potentially large contingent liabilities from financial sector and public enterprise reforms. Continued technical assistance in the fiscal area will help address capacity constraints.

Directors agreed that monetary and exchange rate policies should remain geared to supporting the exchange rate peg to the Indian rupee, stressing that the peg had served Nepal well given its close links with India. Looking forward, they noted that prospective external developments, such as the phasing out of the Multi-Fiber Agreement, would likely have implications for external competitiveness and the appropriate choice and level of the peg. Directors pointed to the need for policy measures to ensure that remittances are sustained, as well as for efforts to diversify Nepal's export base. They also noted that external competitiveness could be enhanced by measures to raise labor productivity and lower transport costs.

Directors commended the authorities for progress in financial sector reforms, but noted that much remained to be done. They stressed the need for strengthening Nepal Rastra Bank (NRB) supervision of the financial sector. The NRB should also improve performance incentives for skilled personnel, while encouraging separations at lower levels. Directors welcomed the appointment of external managers at the two largest insolvent commercial banks, and noted recent steps taken by the new managers to improve the financial condition of the banks. To help support these efforts and, more generally, to create a sound banking environment, Directors noted the authorities' intention to phase out priority sector lending requirements, and

emphasized the effective implementation of recently adopted debt recovery mechanisms, including the Debt Recovery Tribunal and blacklisting of loan defaulters.

Directors welcomed ongoing public sector reforms, including the elimination of vacant positions, the introduction of merit-based promotions, the decompression of the wage scale, as well as improvements in the public procurement process. Looking forward, Directors recommended the adoption of civil service accountability in order to improve policy implementation. They welcomed the public enterprise reform efforts that would lower government ownership in the economy and increase the enterprises' net budgetary contribution—through privatization and restructuring of viable enterprises and liquidation of unviable ones. Several Directors stressed that due regard should be paid to the pace and sequencing of these reforms. Also, an appropriate compensation scheme could help smooth implementation of workforce reductions.

Directors welcomed recent efforts to combat corruption, but emphasized the need to pursue forcefully those responsible for the misuse of public funds. Directors supported the authorities' plans to increase decentralization to enhance service delivery. However, they noted that the implementation of these measures should be accompanied by improved public sector governance and capacity building at the local level.

Directors supported measures to improve the business climate for private sector development through legal reforms and streamlining of administrative procedures to facilitate trade. They recommended revisions to labor legislation to make labor hiring more flexible and modifications to the Company and Insolvency Acts to allow more orderly and timely exit of unviable firms.

Directors commended Nepal for its open trade regime, and welcomed the authorities' efforts to gain early World Trade Organization (WTO) accession. Directors welcomed the elimination of the exchange restriction arising from quantitative limits on payments for personal travel. Directors encouraged the authorities to further improve statistics to enhance policy formulation and monitoring. They urged full implementation of Fund technical assistance recommendations.

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. The Staff Report for the 2003 Article IV Consultation with Nepal is also available.

Nepal: Selected Economic Indicators, 1998/99–2002/03 ^{1/}

	1998/99	1999/00	2000/01	2001/02	2002/03 Est. ^{2/}
	(Percent change)				
Output and prices					
Change in real GDP	4.5	6.1	4.8	-0.5	2.0
Change in CPI (end–period)	9.0	0.6	3.4	3.5	7.5 ^{3/}
	(Percent of GDP)				
Budgetary operations					
Total revenue	10.2	10.7	11.4	11.5	12.0
Total expenditure	15.4	15.7	17.6	17.2	16.7
Current expenditure	9.3	9.6	11.2	11.6	12.4
Capital expenditure and net lending	6.1	6.1	6.4	5.7	4.2
Overall deficit ^{4/}	3.9	3.5	4.5	4.3	2.4
	(Percent change)				
Money and credit					
Domestic credit	16.1	17.8	18.8	9.2	12.4
Broad money	20.8	21.8	15.2	4.4	8.1
	(In millions of U.S. dollars, unless otherwise indicated)				
External sector					
Exports, f.o.b. ^{5/}	763	971	942	754	670
Imports, c.i.f.	1,390	1,713	1,773	1,496	1,623
Current account ^{6/}	24	28	65	144	-32
(In percent of GDP) ^{6/}	0.5	0.5	1.2	2.6	-0.6
Overall balance	136	192	38	-31	27
Gross foreign assets	795	946	1,020	1,048	1,088
Rupees per U.S. dollar (end–period)	68.5	70.8	74.7	78.0	75.1

Sources: Nepalese authorities; and IMF staff estimates.

^{1/} Fiscal year ending July 15.

^{2/} As of July 25, 2003.

^{3/} Mid–May.

^{4/} After grants.

^{5/} Includes re–exports.

^{6/} Before grants.