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Press Statement

IMF Mission, June 2005

An IMF mission headed by Mr. Hisanobu Shishido visited Nepal during June 13-18, 2005 to review the macroeconomic situation, assist the government in the preparation of the 2005/06 budget, and assess implementation of reforms agreed under the PRGF program.<sup>1</sup>

**The mission took note that both His Majesty's Royal Proclamation and the government's 21-point agenda express a commitment to continued economic reforms and honoring agreements with the donor community.** To establish the government's reform credentials, the mission stressed the critical importance of reinvigorating growth and development activities, while recognizing that due attention had to be paid to the difficult security situation. Both Vice Chairmen of the Council of Ministers and the Finance Minister expressed commitment to the economic reforms required to accelerate growth and reduce poverty and assured the mission that action would be taken on outstanding reforms.

**The mission emphasized that clear progress in reform implementation would help unlock further financial support from the IMF and donors.** There has been a significant slowdown in structural reform implementation and external financial assistance during the last year. In the mission's view, implementation of these reforms would ensure that the macroeconomic position is not jeopardized and that PRSP/PRGF reforms get back on track—i.e., completion of the second and third reviews of the PRGF-supported program. They would also contribute to revitalizing the economy and help mobilize donor resources by signaling that HMGN's macroeconomic policies are sound.

**Progress in reforms would help raise growth if the security situation does not deteriorate.** At this stage the mission projects real GDP growth could rise to 4 percent in 2005/06 after having fallen to around 2½ percent in 2004/05. These growth projections are subject to downside risks if the security situation deteriorates. Inflation is projected to remain around 5-6 percent, in line with price developments in India.

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<sup>1</sup> In November 2003, the Executive Board of the International Monetary Fund approved a three-year Poverty Reduction and Growth Facility (PRGF) program in support of the 10<sup>th</sup> Plan/Poverty Reduction Strategy Paper (PRSP) of His Majesty's Government of Nepal (HMGN). The loan totals approximately US\$70 million on concessional terms<sup>1</sup> and is to be disbursed in seven equal tranches over 2003-2006 following the completion of reviews of progress under the PRGF. The first tranche of \$10 million was disbursed in November 2003 when the loan was approved. The first review of the PRGF was completed in October 2004, when the second tranche of \$10 million was disbursed.

**Looking forward, the mission stressed that prompt actions are required in the following areas:**

- **Adoption of a 2005/06 budget consistent with the medium-term fiscal objectives of the PRSP/PRGF.**
  - This budget should remain focused on raising revenues, prioritizing spending in line with Nepal's Medium Term Expenditure Framework, striking an appropriate balance between development and security needs, and limiting domestic borrowing to sustainable levels.
  - Limiting domestic borrowing would require adequate budget support, including from multilateral agencies and bilateral donors through progress in reform implementation.
  - To improve tax administration, performance-based incentive schemes should be introduced at the Customs Department and at the Large Taxpayer Office of the Inland Revenue Department. Leakages in the excise regime need to be plugged. Export taxes should be reduced and fiscal transparency improved by merging the security levy into import duties.
  - Provide for a significant increase in the allocations for capital spending over the projected outcome for FY 2004/05 as a signal of HMGN's continued commitment to development activities, including in conflict-affected areas. Innovative methods to accelerate such spending – including through the use of community and users groups – while ensuring its quality, should be utilized. The mission also stressed the importance of a significant increase in the allocations for the social sectors, including education and health.
  - Provide for an appropriate balance between security and development spending. Any increase in current expenditures should be carefully scrutinized against medium term fiscal sustainability concerns.
- **Implementation of an automatic price adjustment mechanism for oil products.**

This would help eliminate the sizeable losses of the Nepal Oil Corporation and depoliticize oil price adjustments. The current price structure benefits Indian consumers through smuggling, results in losses that must be borne by Nepalese taxpayers, fuels corruption and does little to alleviate poverty.
- **Financial sector reforms** depend critically on recovery of the enormous non-performing assets of the public banks (around \$500 million) and moving promptly to their privatization.
- **Privatization** needs to be pursued vigorously to divest weak public enterprises in order to reduce their burden on scarce budget resources.

- **Civil service reform** to adopt merit-based recruitment and promotion is crucial in ensuring the civil service becomes more efficient and professional. The draft Civil Service Ordinance should be revised accordingly, and similar human resources reforms need to be adopted at the Nepal Rastra Bank.
- **Flexible labor legislation** that allows for ease of hiring and firing. If businessmen cannot adjust their workforce in the face of changing demand, they are unlikely to increase employment or undertake investment.

**The IMF mission could come back for further discussions on the PRGF following the adoption of a budget consistent with PRSP/PRGF objectives and completion of outstanding reform actions.**

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