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REPORT AND RECOMMENDATION  
OF THE  
PRESIDENT OF THE  
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT  
TO THE  
EXECUTIVE DIRECTORS  
ON A PROPOSED  
FIRST STRUCTURAL ADJUSTMENT CREDIT  
IN AN AMOUNT EQUIVALENT TO \$50 MILLION  
TO THE KINGDOM OF NEPAL

March 3, 1987

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KINGDOM OF NEPAL

FIRST STRUCTURAL ADJUSTMENT CREDIT

CREDIT SUMMARY

Borrower: The Kingdom of Nepal

Amount: SDR 40.9 million (US\$50 million equivalent)

Terms: Standard IDA terms

Credit Description: The proposed credit would support the Government's program of structural adjustment and stabilization. The program aims at increasing investment and economic growth by reducing controls, accelerating efficient use of domestic and foreign resources, and promoting exports. The principal elements of the program include: (i) macro-economic policies to strengthen the country's budgetary and external finances and maintain a realistic exchange rate; (ii) liberalizing foreign trade and industrial policies; (iii) reducing and improving the focus of government interventions in the agricultural sector; (iv) commencing the restructuring of public sector enterprises and improving their administration; and (v) improving the administration of development expenditures.

Estimated Disbursements: The credit would be disbursed in two tranches, a first tranche of SDR 20.45 million upon effectiveness and the second tranche of SDR 20.45 million after a performance review to be held in October 1987.

INTERNATIONAL DEVELOPMENT ASSOCIATION

REPORT AND RECOMMENDATION OF THE PRESIDENT  
TO THE EXECUTIVE DIRECTORS  
ON A PROPOSED DEVELOPMENT CREDIT OF SDR 40.9 MILLION  
(US\$50 MILLION EQUIVALENT)  
TO THE KINGDOM OF NEPAL FOR A  
STRUCTURAL ADJUSTMENT PROGRAM

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1. I submit the following report and recommendation on a proposed Development Credit for SDR 40.9 million (US\$50 million equivalent) on standard IDA terms to the Kingdom of Nepal to support the 1986/87 and 1987/88 Structural Adjustment Program of His Majesty's Government (HMG).

PART I -- THE ECONOMY

2. An economic memorandum (Report No. 5867-NEP) was distributed to the Executive Directors in December 1985. Economic data appear in Annex I.

A. An Overview

3. Nepal is one of the poorest countries in the world with a per capita income of about US\$160; life expectancy, infant mortality, and adult literacy rates are well below the South Asian norm and much of the country remains in abject poverty. Over the past two decades, real GDP growth has barely kept up with that of the population, which is now growing by 2.7 percent per annum, and more recently per capita food production has been falling.

4. The economy of Nepal comprises two geographically distinct regions -- the hills and the lowland terai which borders India. Historically the terai was the source of cereal surpluses which were exported to India and the hills. In recent years, however, a vicious circle has emerged as the poor performance of the hills economy, exacerbated by population pressure, has led to deforestation of slopes, loss of arable land, increasing food deficits and further pressure on marginal lands and migration to the terai. The consequent acceleration of soil erosion in the hills has contributed to downstream flooding and silting of rivers, which has contributed to the loss of agricultural production, both actual and potential, in the terai; combined with immigration the terai's exportable surplus has dwindled.

5. Much of Nepal's poor record in respect of growth and development derives from its meagre natural resource base and its landlocked position. Agriculture dominates the economy, accounting for 60 percent of GDP, 75 percent of exports, and 90 percent of employment. Moreover, much of the small industrial sector is agro-based. With irrigation facilities (which are largely rudimentary) covering only about one eighth of arable land, agricultural output is highly vulnerable to the weather.

6. Nepal shares a long and open border with India, is cut off and far separated from sea routes and is influenced in many respects by the Indian economy. Laws and regulations provide for a relatively free exchange between the two economies; geography and private traders make it inevitable. The implication of this is that economic conditions in India, and economic policies adopted by India, set the framework for the Nepalese economy. Nepal can have little or no influence over these factors which, conversely, influence Nepal significantly. In practical terms this means that Nepal's economic policies must, to a certain extent, accommodate this interrelatedness in a number of ways. For example, Nepal's prices are significantly affected by demand and supply conditions in India and by India's economic and financial policies. Since India is the largest market for Nepal's goods as well as the source of many Nepalese imports, conditions in India will inevitably influence Nepal's economic prospects. This integration is likely to grow once Nepal exploits its enormous potential to generate and market hydroelectricity to India and to provide dams that can more efficiently regulate the flow of rivers to the Gangetic Plain, improving the potential for irrigation while reducing the incidence of flooding. Clearly, Nepal's supply of goods and services to India will substantially increase its demands for goods and services produced there, given the limited convertibility of the Indian Rupee.

7. While geography and meager resource endowment have contributed to faltering economic performance, another important factor has been the limited capacity for managing the economy and administering the development program (see para 57). The system of production incentives has been inadequate and budgetary management has had many shortcomings. Weaknesses in public administration are reflected in a combination of low public sector investment as a percentage of GDP and the slow implementation of development projects.

#### B. Recent Economic Developments

8. The period 1981/82-1984/85 (Nepal's fiscal year runs from July 15 to July 14) witnessed a significantly higher rate of real GDP growth than that of the previous five years—3.4 percent per annum compared with only 2.1 percent per annum. However, annual growth fluctuated widely on account of drought. The overall level of investment averaged about 19 percent of GDP financed in approximately equal shares by domestic and foreign sources. Poor domestic budgetary revenue mobilization performance (with tax collection averaging 9 per cent of GDP), was reflected in an overall fiscal deficit averaging about 10 per cent of GDP. Domestic bank financing of the budget averaged about four per cent of GDP. Credit to the private sector and to public sector corporations to offset continuing losses also expanded substantially so that domestic credit expansion averaged more than 25 percent per annum in the latter years of this period.

9. The counterpart of this rapid domestic credit expansion emerged in a balance of payments deficit as Nepal's external position deteriorated substantially. While Nepal, historically, has had sizable current account

deficits, until recently these were covered by highly concessional foreign inflows. However, during 1982/83-1984/85, the cumulative balance of payments deficit of US\$120 million was financed principally by a draw-down of international reserves; gross reserves fell from about 8 months of imports at the end of 1981/82 to about 3 months at the end of 1984/85.

10. Most of Nepal's external debt has been contracted on highly concessional terms. While the ratio of external debt to GDP and the ratio of debt service payments to exports of goods, non-factor services and private remittances remain low, both have increased steadily in recent years. During the five-year period ending June 1985, the former rose from 10.1 percent of GDP to 14.2 percent and the latter from 1.9 percent to 6.2 percent of exports and remittances.

11. In the face of the continuing deterioration in both internal and external finances, the Government adopted a stabilization program in December 1985 and entered into a 14 month stand-by arrangement with the IMF. Principal elements of the program are: a devaluation of the rupee by 14.6 percent, with the exchange rate to be managed flexibly thereafter; tighter budgetary policies with the initial focus on expenditure restraint, then on revenue in 1986/87 fiscal year; reduced expansion of credit to Government and public enterprises; adjustments in administered prices; restraints on external borrowing; and import liberalization.

12. Economic and financial performance improved in 1985/86. As a result of good weather, agriculture rebounded. The introduction of a more liberal industrial licensing policy, as well as improved supplies of electricity, contributed to an expansion in the industrial sector and tourism receipts rose significantly. Real economic growth was 4.2 per cent. As anticipated, the impact of the devaluation and administered price adjustments was immediate and strong. Inflation accelerated from 17 percent in November 1985 to 34 percent in February 1986 on a twelve-month point-to-point basis. However, by late 1986 inflation had decelerated to below 10 percent, reflecting the tighter demand management policies and an improved supply situation. There were no wage adjustments in the Government sector, and private sector wage increases have been significantly less than the rate of inflation. As was intended, the overall budget deficit was reduced, and the share of domestic bank financing of the deficit was almost halved to 2 percent of GDP. The overall balance of payments showed dramatic improvement, recording a surplus of about US\$15 million compared to the approximately US\$53 million deficit of the previous year. In summary, the stabilization program has been effective in contributing to the correction of the external and internal financial imbalances in the economy.

PART II -- PROBLEMS OF ECONOMIC STRUCTURE

13. In the attached Letter of Development Policy (LODP) HMG identifies a number of areas of structural weakness in the economy. First, serious environmental degradation (especially in the ecologically fragile hills and mountains), a burgeoning population and pronounced dependency on the vagaries of monsoon agriculture which have worsened living conditions in rural areas. Second, macroeconomic management, although much improved since the inception of the stabilization program, will require continued remedial efforts in the areas of domestic resource mobilization and control of recurrent expenditures and inflationary financing. Third, structural weaknesses have also contributed to disappointing agricultural performance, exacerbated by excessive and poorly-directed public sector interventions. Financially weak agricultural institutions have not only been a drain on public sector finances but have failed to provide the services for which they were constituted; and excessive regulatory controls have also prevented more private sector initiative from taking place in agriculture. Fourth, inappropriate industrial and trade policies have been directed at encouraging manufacturing on the basis of low-cost imported inputs. The higher prices of these inputs in India and the long, virtually open border with that country have given rise to strong incentives for smuggling; however, the panoply of industrial and trade controls enacted to deter smuggling have paralyzed industrial development without stemming the incentive to smuggle. Fifth, structural weaknesses have also given rise to the poor performance of public enterprises, most of which are financially weak, and some of which are heavily indebted, proving to be a drain on the budget and the banking system. Sixth, weak public administration is a constraint to effective economic management. Seventh, management of development spending has slackened giving rise to a declining share of annual disbursements relative to the pipeline of aid commitments.

14. Nepal has been actively implementing a development program to deal with these problems for many years, but these efforts have not been successful. During the past year, HMG intensified its efforts to place the economy on a firmer path toward growth and development. In addition to policy actions undertaken with respect to the stand-by arrangement with the IMF, a number of other measures, described below, have been initiated. If growth and development are to be ensured, however, the basic structure of the economy will have to change; to accomplish this, it is necessary to set in motion a process that will simultaneously stimulate growth and the required structural change. Critical to the process will be improving the effectiveness of public sector management--by reducing interventions that are ineffective or counterproductive, and by doing more effectively those things the Government needs to do.

PART III -- THE GOVERNMENT'S ECONOMIC REFORM PROGRAM

This section discusses the Government's stabilization and structural adjustment program. IDA's role in supporting the reform program is discussed in the next section.

15. HMG's macroeconomic objectives over the medium term are to sustain a GDP growth rate in the range of 7-5 percent per annum while curbing inflation and strengthening the balance of payments. The growth objective is considered the minimum required to absorb new entrants into the labor force. Inflation is to be reduced from the current annual rate of around 10 percent to 5 percent by 1989/90. Gross international reserves will be maintained at 3.5 months of imports and the external current account deficit will average about 10 percent of GDP throughout the period to 1990/91. To achieve these medium-term objectives, demand management policies will be complemented by growth-oriented structural measures. The priorities are: (a) to increase resource mobilization to support a sizable increase in public sector investment; (b) to continue the financial reforms aimed at improving monetary control and resource allocation; (c) to promote agricultural production and preserve forests; (d) to stimulate non-agricultural growth through a more liberal industrial and trade regime; (e) to adjust the size of the public enterprise sector in line with a more selective role for state involvement while strengthening the finances of the remaining public enterprises; and (f) to improve the implementation of development projects. Consequently, HMG's structural adjustment program is focused on five main areas: macroeconomic policy; agricultural policy; industrial and trade policy; public enterprise policy; and development implementation. The structural adjustment policies are outlined in detail in the Letter of Development Policy (Annex V) and are summarized below (paras 17-66).

16. Consistent with greater emphasis on the private sector, the authorities have not defined a precise set of growth targets for individual sectors and subsectors toward which their policies will be directed. Instead, they have decided to follow policies that accommodate more efficient decentralized decision-making by fostering clearer market signals, and to recognize explicitly the major external constraints over which they have little or no control.

A. Macroeconomic Management

17. The measures agreed with the IMF, reflected in large part in the FY85/86 and FY86/87 Budgets -- devaluation with flexible exchange rate management; tighter fiscal policies; controlled credit expansion; adjustments in administered prices; restraints on external borrowing and import liberalization -- are designed to place the economy on a more sustainable growth path. The continuation of these policies is key to the success of the structural adjustment program (see para 8 of the LODP). The authorities envision continued close cooperation with the IMF in the form of Structural

Adjustment Facility (SAF) programs commencing in 1986/87. Within the policy framework, it is expected that the main economic aggregates will evolve along the lines set out in Table 1; Annex IV presents details on the projected evolution of the budget, the balance of payments and the national accounts over the period to 1990/91. These medium-term targets will be continuously monitored by the Government, IDA, and the IMF as a basis for determining the need for subsequent policy action and adjustments. Measures to achieve these targets by strengthening the performance of the agricultural, industrial and trade and public enterprise sectors and development implementation are discussed below.

18. By fiscal year 1990/91, HMG expects its economic and financial policies to: increase the rate of growth of real output to a sustainable average of about 4-5 percent per annum--compared to the fluctuating performance of recent years which averaged 3.4 percent; increase the level of investment to about 24 percent of GDP compared to 19.0 percent, and reduce the annual rate of inflation to about 5 percent compared to 10 percent. The agricultural sector growth rate is projected to be about 3 percent (which is slightly above the growth of population), and the non-agricultural sector, about 6 percent. This projected growth is expected to come from industry, tourism and exports. Under the foreseen scenario, the real growth rate of consumption per capita would increase steadily to about 1.5 percent compared to the 0.7 percent average during 1981/82 - 1985/86 (Table 1).

Table 1: NEPAL: SELECTED ECONOMIC INDICATORS

	<u>1981/82-1985/86</u> <u>AVERAGE</u>	<u>PROJECTED</u> <u>AVERAGE</u> (1986/87-1990/91)	<u>ESTIMATED</u> <u>1986/87</u>	<u>PROJECTED</u> <u>1990/91</u>
			<u>Growth Rate (% p.a.)</u>	
GDP	3.1	4.2	1.5	4.7
GDP/capita	0.7	1.7	--	2.2
Consumption/capita	0.7	1.0	--	1.5
Inflation	9.8	6.6	12.0	5.0
Exports (G,NFS)	4.2	5.1	1.6	6.9
Imports (G,NFS)	4.6	8.2	12.5	7.6
			<u>Share of GDP (%)</u>	
<u>National Accounts:</u>				
-Gross Investment	18.6	22.9	20.5	23.6
-Public Investment	7.1	8.1	8.1	8.5
-Domestic Savings	9.8	11.3	9.9	12.5
-National Savings	11.8	12.9	12.0	13.7
<u>Budget:</u>				
-Government Revenues	8.8	10.9	9.5	12.0
-Government Expenditures	20.0	21.5	19.4	22.9
-Development Expenditure	13.3	15.0	13.1	16.0
-Deficit	10.3	10.6	9.9	10.9
-External Finance	6.4	9.3	8.2	9.6
<u>External Accounts:</u>				
-Exports (G, NFS)	11.8	13.5	14.1	14.5
-Imports (G, NFS)	21.6	24.2	24.7	25.6
-Current Account	- 8.0	- 10.1	- 8.5	- 9.9
<u>Debt Service (Public and Public Guaranteed)</u>				
<u>Percent of:</u>				
Exports of Goods & Services	5.1	9.8	6.2	12.2
GDP	0.6	1.4	0.9	1.8
<u>Memorandum Items</u>			<u>U.S.\$ Millions</u>	
<u>Amount</u>				
Current Account	-200.0	-321.5	- 219.3	- 376.5
Debt Service (Public and (Public Guaranteed)	5.0	35.0	16.5	50.0

19. A major objective of macroeconomic policy will be to improve domestic resource mobilization, especially in the public sector. The government intends to increase Government revenue as a share of GDP from 9.0 percent in 1985/86 to more than 12 percent by 1990/91 through new revenue measures combined with actions to improve the elasticity and buoyancy of the tax system. Nepal has received substantial technical assistance from the IMF in this area in recent years, and a revenue mobilization program will be prepared in the spring of 1987, prior to the 1987/88 budget, as part of the first year's financial program under the SAF. At the same time, the government intends to limit the rate of growth of regular expenditure to about the growth rate of the economy. To achieve this target, an effort will be made to limit the growth of the wage bill taking into account the contribution to be made by natural attrition in certain areas, while paying due regard to the need to develop a more competent civil service. A further major target of policy is to increase the country's capacity to absorb long-term concessional assistance which should permit an increase in development spending to 16 percent of GDP (an increase of about four percentage points over 1985/86 -- see paras. 57-66 below for a detailed description of measures to improve development implementation). Although the overall fiscal deficit is expected to average about ten and one half percent of GDP over 1986/87-1990/91 (which is about the same as in the previous five years), it will be financed by large public sector surpluses and increased absorption of foreign assistance. These two sources of financing will rise to about 5 percent and 10 percent of GDP, respectively, compared to 2 percent and 6 percent during the earlier period. This will reduce domestic financing to about 1.5 percent of GDP, thus increasing the availability of domestic bank credit to the productive sectors.

20. Strengthening the balance of payments is another major goal of policy. A continuation of the present policy of managing the exchange rate flexibly, paying due regard to movements in relative prices and overall indicators that reflect the strength of the external account, is an important element of HMG's policies--as are efforts to increase exports and provide incentives for efficient import substitution. Export growth is projected to increase by an average of about 5 percent a year in real terms. Particularly important to this outcome will be the expansion of two major exports: carpets and garments. These two exports, which provide major employment opportunities, have shown rapid growth in recent years, rising from US\$6 million in 1981/82 to US\$46 million in 1985/86. The continued growth of carpet exports, which face a rising demand, will be encouraged as raw wool has been placed under open general license. Four garment items have been placed under quota by the United States. However, the provisions for an annual increase in the quota, combined with the scope for upgrading quality and the production of additional items and the emerging markets in the EEC, will permit healthy growth in this sector. The recently-approved IDA-supported cottage and small industry project (Cr. 1696-NEP) is expected to provide additional stimulus to the export of carpets and garments as well as to the development of other small-scale industrial activities.

Additionally, expanding hotel accommodation and supporting services for tourism are expected to lead to a healthy growth in service earnings. Imports are expected to show a substantial rise as the result of improvements in the utilization of foreign aid and import liberalization. Reflecting Government's efforts to increase development expenditure and the absorption of long-term concessional assistance, the external current account deficit is projected to rise from its 1985/86 level of 8.2 percent to about 9.9 percent of GDP in 1990/91.

21. The projected current account deficits are sustainable in view of the large pipeline of concessional assistance and the expected continuation of commitments from the donor community in support of the program as well as accelerated disbursements. Implementation of a program of adjustment along the lines outlined above would imply that over the period 1986/87 through 1990/91, the cumulative external current account deficit would amount to US\$1.6 billion or an average of US\$320 million annually. Additionally, the authorities will need to allow foreign exchange reserves to build up by about US\$100 million over the period, for the country to maintain a reserve level equal to about three and one-half months of imports. After taking into account amortization of external debt, the external financing requirement amounts to about US\$1.8 billion. This requirement is expected to be financed by project-related aid disbursements of US\$900 million from the existing aid pipeline of about US\$1.1 billion, additional project and program related aid disbursements of US\$550 million from expected new commitments of about US\$1.8 billion over the period, and financing for aircraft. After these sources of financing are taken into account, a financing gap of about US\$250 million remains, of which US\$80 million will be over the next two years. It is proposed that IDA and the IMF provide financing to cover it through the proposed SAL of US\$50 million and US\$17 million of a three-year SAF of US\$22 million. The ADB and other bilateral donors have expressed strong interest in supporting the adjustment program. Current indications are that from US\$10-15 million of quick disbursing assistance from these sources will be available in the first two years of the program.

#### B. Agriculture and Forestry

22. Despite major investments in agricultural support services and inputs, crop production has continued to lag behind population growth. Agricultural production increased only by about 2.2 percent per annum between 1974/75 and 1985/86 while population grew by about 2.7 percent, thus leading to a progressively deteriorating food balance. Forest resources have also continued to decline rapidly with serious consequences for the country's environment and economy. Agricultural production needs to be raised on a sustained basis, at least in line with population growth (see para 25) and the trend of deforestation needs to be reversed. In agriculture, reform measures are needed to improve resource utilization and productivity. Measures will focus on (i) improving production incentives; (ii) enhancing the availability and reliability of services and inputs; and (iii) strengthening key public sector support agencies. At the same time,

measures are needed to provide incentives for the private sector to assume a greater role in Nepal's agricultural development. Communities and individuals also need to become actively involved in managing the country's forests.

23. Although the importance of assigning high priority to agriculture was recognized in previous five-year plans in which quantitative targets were established for the sector, the government's agricultural policy was not clearly articulated. The main thrust, moreover, was to maintain low and stable consumer prices for food in food deficit and urban areas. Consequently, agricultural support prices were kept low; to offset the resulting disincentive to farmers, inputs such as fertilizers, improved seeds and irrigation water were highly subsidized. With higher food and input prices prevailing in India, this policy of attempting to hold down consumer prices of food and of subsidizing fertilizer gave frequent rise to the leakage of crops and fertilizer across the open border. Moreover, the financial burden of this policy to the public sector and to the economy, although not well accounted for, was considerable. Costs of subsidization have not been explicitly provided for in annual budgets. Instead, much of these costs was borne by the two major public enterprises active in the sector -- the Agriculture Inputs Corporation (AIC) and the Nepal Food Corporation (NFC). The corporations were allowed to borrow excessively from the banking system because of liberal government guarantee of their borrowings which in turn contributed to the deterioration in internal financial stability.

24. Recently, however, HMG has adopted a policy of increasing private sector initiative in agriculture, reducing public sector involvement to a role of providing essential support functions, and making explicit provision in the budget for any subsidies or transfers that are considered essential to achieve social and economic objectives. At the same time, steps are being taken to put AIC and NFC on a sound financial and managerial footing; these are described in the Public Enterprise section below (see paras 54-56). Additionally, a greater effort is being made to upgrade irrigation facilities, to improve the effectiveness of agricultural extension and to improve the availability of agricultural credit. These areas are being addressed under development projects funded by IDA, ADB and several of Nepal's bilateral donors. UNDP and FAO are also providing technical assistance to strengthen sectoral institutions.

25. The structural adjustment program is expected to generate sustained real growth in agriculture of about 3 percent per annum on average by improving the direction, scope and effectiveness of public sector interventions to improve production incentives and the supply and reliability of modern inputs; by reducing the drain on public sector financial resources associated with current interventions in agricultural markets; and by improving policy and creating an institutional environment that will stimulate greater private initiative. The initial reforms focus on several key subsectors: fertilizer, seeds, foodgrain marketing, agricultural research, and private and community forestry (these are discussed in paras 23-32 of the LODP). As part of the

ongoing adjustment process, future reforms will be carried forward in these sectors and extended to others, such as irrigation and water management, institutional credit, extension and cooperatives.

26. **Fertilizer:** Timely availability of appropriate types of fertilizer has been a problem for farmers. Many fertilizers supplied have tended to be low in nutrient content and of poor agronomic utility. Fertilizer use has fallen far short of targets, because of ineffective marketing, smuggling to India (attributable to the past pricing of fertilizer lower than in India), and logistical difficulties. The AIC is the sole importer and wholesaler of fertilizers as there is virtually no inducement for private trade. Government restrictions on marketing channels and retail pricing have contributed to AIC's financial weakness.

27. The reform measures are aimed at: (a) increasing the supply and improving the timely availability of appropriate fertilizers; and (b) improving the economic returns on fertilizer use, as well as reducing the financial losses incurred by AIC (see para 54).

28. To improve the supply and timely availability of fertilizers throughout the country, a major thrust under the structural adjustment program will be to liberalize pricing and marketing arrangements for fertilizer. Price adjustments have not been timely nor adequate to compensate for cost increases or to prevent the unofficial sale of fertilizers to India. Prices on both sides of the Indo-Nepalese border are now being monitored regularly and wholesale fertilizer sales prices have been adjusted to eliminate the incentive to export fertilizer. Moreover, beginning in 1987/88, the government will allow AIC to adjust ex-AIC warehouse wholesale sales prices in the terai by up to 10 percent at a time, in response to cost increases or changes in the cross-border fertilizer price ratio without having to seek prior approval from the Ministry of Agriculture and/or the Cabinet. Fertilizer retailing and local wholesale distribution have recently been opened to both the agricultural cooperatives (Sajhas) and private dealers and licensing of private fertilizer dealers has been liberalized. With a view to increasing the incentive to engage in the fertilizer trade, the allowable retail trade margin will be increased by two percentage points from its present range of about 5 percent. AIC will also provide special discounts to retailers and local wholesalers for lifting fertilizers from AIC warehouses during the off-season.

29. To improve the supply and timely availability of fertilizers to the more remote and isolated parts of the country, in addition to the measures described above, the government intends to provide adequate budgetary allocations to AIC for the transport subsidy on fertilizers sold in the hills. Timely release of these funds to AIC to allow the deployment of adequate fertilizer throughout the country will be ensured.

30. Steps have been taken to improve economic returns to the use of fertilizer. Low-analysis fertilizers are being phased out. Efforts are also

underway to strengthen AIC's fertilizer demand forecasting, import and distribution programming. Extension services are also focussed on demonstrating more efficient application of fertilizer.

31. Seeds: Major constraints to the growth of Nepal's crop sector are: (a) the low use of quality seeds and unsatisfactory institutional, operational and financial arrangements for making improved seeds available to farmers in a timely manner; (b) inadequate legislation to provide the legal framework for regulating seed production, processing, certification and marketing; (c) the absence of a central authority to regulate production and trade in seeds, and (d) fragmented operational responsibility for seed research, production, multiplication, certification, processing and marketing.

32. The key objectives of reform in this subsector include: (a) improving the supply and timely availability of quality seeds, especially of major food grains, to farmers throughout the country; (b) providing a clear legal basis and effective institutional arrangements for all essential activities in the seeds sub-sector; (c) improving the operational and financial efficiency of the main institutions involved in the seeds sub-sector; and (d) expanding the capability of the existing seed production, testing, processing and marketing system, through increased utilization of private sector capacities.

33. A number of actions have already been initiated to address some of these problems. To improve the supply and timely availability of seeds, technical assistance to AIC for improving its capabilities in the production, processing and marketing of certified cereal seed has been secured from GTZ, and USAID is supporting a pilot project to test and demonstrate the feasibility of innovative methods for the production and supply of improved seeds in the hills. The procedures for establishing prices, commissions and premia paid to seed multipliers have been simplified, and there is no longer a limit on the quantity of seeds that AIC will purchase from an individual seed multiplier. A revised system of sales prices for certified cereal seeds and dealer incentives will become effective at the beginning of FY88.

34. To provide for clear and effective legal and institutional arrangements: (i) a draft National Seed Act and a proposal for establishing a National Seed Board with the authority and capability to formulate national seed policy and to coordinate, supervise and regulate its implementation have been prepared; and (ii) a proposal has been drafted for creating a financially and operationally autonomous National Seed Company. The National Seed Act will be submitted to Parliament during its next session, which runs from July through October 1987, and the National Seed Board will be established immediately after its enactment.

35. Actions to strengthen the operational and financial efficiency of the main public sector institution (AIC) involved in the seed sub-sector are described in para 54.

36. To expand the capability of the existing system of seed production, testing, processing and marketing, beginning in FY88, the Seed Division of AIC will be given substantially increased operational and financial autonomy within AIC to carry out its tasks. The government has already initiated a program for improving hill farmers' access to improved seed, based on unsubsidized production and marketing of seed by local farmers.

37. Foodgrain Marketing and Distribution: Although foodgrain trading in Nepal is predominantly a private sector activity, concern over food security has led to some public sector involvement in the foodgrain market through the operations of the NFC. NFC's activities have suffered, however, from lack of clear objectives and weak finances and management. NFC procures grains from domestic farmers, traders and millers and also handles the small amount of foodgrains that are officially imported. Domestic procurement has relied heavily on levies (a requirement that a certain amount of grain be sold at a below market fixed price) imposed on millers and exporters. Primary procurement, to support post-harvest producer prices, has been very limited. Sales, at prices well below market and cost, were mainly in the major urban markets with beneficiaries not generally representing the most needy. In the absence of full budgetary support, NFC's accumulated financial losses have been covered through bank borrowings. NFC's accounting system and practices are inadequate for effective management of the Corporation. In particular, the NFC needs to separate the accounts of its commercial operations from those of its welfare-oriented activities.

38. The key objective of food policy reform is to promote increased food security at less cost. This will entail: (a) providing effective producer incentives; (b) stabilizing consumer prices; (c) operating an effective foodgrain reserve stock and providing emergency food supplies when needed; and (d) strengthening the finances of NFC (paras 54 and 55).

39. Producer incentives are expected to become more effective with actions to phase out subsidized food grain sales and the recent discontinuation of levy procurement (paras 40 and 41). These actions will result in farmers being paid market prices rather than the artificially low officially administered prices prevailing in the past.

40. To phase out heavily subsidized foodgrain sales to urban consumers, an effective market-oriented consumer price stabilization system was started in the Kathmandu Valley in early 1987. This is a pilot operation for eventual replication in other major consumer centers. NFC now sells foodgrains in the Valley at prices that cover its costs and provide a de facto ceiling on market retail prices. In addition, HMG is preparing a detailed plan for identifying consumer groups vulnerable to chronic and/or severe seasonal food shortages and for distributing foodgrains to such target groups.

41. Procurement from domestic production is now exclusively through purchases at prices set in close proximity to those in effect in neighboring

Indian states. The practice of levies has been discontinued. Sufficient funding to NFC to ensure effective primary procurement operations during 1986/87 has been provided, and the authorities are committed to continue ensuring adequate funding in future years. Sajhas are now being utilized as agents for some of NFC's foodgrain procurement.

42. Agricultural Research: Nepal's agricultural research system has been institutionally fragmented, poorly funded and lacking clear objectives and priorities. It has also been hampered by inappropriate personnel policies, administrative regulations and procedures. Yet more effective agricultural research is vital in achieving sustained increases in agricultural production over the longer term. An essential precondition for effective operational and management reforms in this sector is the creation of an autonomous research planning, funding and coordination body at the national level, to set national research priorities, control funding for research, administer the national agricultural research system, monitor progress, establish meaningful career paths for researchers, and ensure effective linkages with other institutions, notably the extension service.

43. To improve coordination and management, HMG has recently taken the following steps: A National Agricultural Research Coordination Committee has been formed, chaired by the Secretary of Agriculture and comprising appropriate representation from the major institutions involved in, or concerned with, agricultural research; a permanent Secretariat has been established within the Ministry of Agriculture, and its staff positions will be filled by July 1987. The various research units under the Department of Agriculture have been combined into a National Agricultural Research Services Center, under the management of a Deputy Director General of Agriculture.

44. To establish an appropriate and effective institutional framework for coordinating and managing national agricultural research, the Government will prepare by July 1987, a plan for the establishment, by the end of the Seventh Five Year Plan period, of an autonomous National Agricultural Research Board or Council -- with independent budget and financial procedures and personnel policies, and research programming, monitoring, review and evaluation systems; this agency will be created out of the nucleus provided by the Research Committee, Center and the research units of other entities currently under the administrative control of the Ministry of Agriculture.

45. Forestry: Nepal's economy and ecology depend crucially upon its forest resources, which are rapidly diminishing. The strategy in forestry is to introduce policy changes that will alleviate the burden on Government imposed by financial, staff and management constraints and to involve individuals and communities, to the maximum extent possible, in managing much of the effort to contain and reverse the trend of deforestation. This will form the central objective of the measures proposed for the first phase of adjustments in the forestry sector, and will be reinforced by specific follow-up in future IDA-financed projects.

46. By July 1987, the government intends to modify the existing legal and administrative regulations so as to allow legally constituted forest user groups to retain 100 percent of the revenues realized from Panchayat Protected Forests instead of having all proceeds collected by the Ministry of Finance to be returned only in part with considerable delay. Forest Users' Committees established at the Panchayat or Ward levels will be authorized to employ a member-secretary to conduct the Committee's day-to-day business, to hire laborers needed (e.g., nursery staff, forest watchmen, forest foreman), and to manage forests and related resources. Finally, the administrative regulations concerning the ownership and utilization of trees on privately owned land will be clarified by July 1987 to provide that landowners can grow, cut and sell trees planted on their land. The impact of these measures is anticipated to be very significant, as under the present system, the local population has had virtually no financial incentive to preserve the forests and no control over the management of forests.

#### D. Industry and Trade

47. Nepal's industrial sector contributes less than 10 percent to GDP and is characterized by small establishments. The growth rate of industry, excluding the fairly recent entry of carpet and garment production, has been about 2 to 3 percent per annum. The absence of development in this sector has been largely a function of two factors: the large, high cost, highly protected Indian economy to the south, and a policy aimed at maintaining a lower cost structure than that in India. For years Nepal maintained an overvalued exchange rate, and eschewed the effective use of tariffs; imports of non-Indian raw materials and capital goods were strictly licensed with a view to preventing deflection of these imports to India. However, these controls and regulations were largely ineffective in stopping trade deflection and instead retarded industrial development; in certain cases the linking of the issuance of import licenses to installed capacity has led to over investment in capacity. Trade in imports became quite profitable, and many new industries tended to be high in import content and low in domestic value added. Given the difficulties in administering the regulatory system, and the close ties of the economy with India, the authorities have decided to introduce policies which are easier to administer and which take into account the close links between the two economies. It is intended that trade policies will rely more on the maintenance of realistic relative prices (particularly vis-a-vis India) and less on Government regulations.

48. Nepal's revised industrial strategy, which is outward-looking, is to shift gradually to an industrial and trade regime that allows exporters to compete with foreign competitors on an equal footing and to equalize the levels of incentives for exports and import substitution activities. The four main strands of policy to achieve this are: (i) maintenance of a realistic exchange rate in combination with an appropriate system of industrial and export incentives; (ii) the guarantee of access to necessary factors of production and other inputs without undue price distortions; (iii) the removal of excessive regulatory controls while making effective use of

tariffs; and (iv) improvement in the efficiency of administrative arrangements required to operate the systems of incentives and essential controls. Within this policy framework, it is anticipated that there will be increased private investment in industry and that the growth of this sector will accelerate to about 6 percent per annum.

49. Recent measures include a commitment to maintaining a realistic exchange rate (see para 20). The authorities have also recently paid exporters the amounts owed under the previous (and subsequently abolished) system of cash export incentives, thus restoring some of the confidence lost in government policy when for fiscal reasons the authorities were not paying the incentive. Regarding the availability of inputs, the following measures have already been taken: (i) to liberalize interest rates and to eliminate previously existing anomalies in the structure of interest rates; (ii) to auction import licenses for a broad range of goods previously under quantitative restriction; (iii) to introduce a pass-book system for raw material imports thereby providing much-needed automaticity in the access of manufacturers to foreign exchange; and (iv) placing a number of important items (including wool) under open general license. Principal actions taken to remove excessive regulatory controls have been the conversion of the two lists of items free from industrial and export licensing to two lists of items subject to the two respective types of licensing, all other items being free. Recent improvements in the administration of the industrial and trade regime include the: (a) establishment of an export development committee composed of two-tiers, with Ministers at one level and their Secretary's at another; and (b) the timely allocation of the U.S. garment quota.

50. Actions that the authorities will be taking or initiating under the structural adjustment program by the time of the 1987/88 Budget include: (i) introducing incentives for exporters, including duty-drawback and tax exemptions; (ii) introducing a system of ad valorem tariffs characterized by seven bands ranging in value from zero to 100 percent (the structure of tariffs will be influenced, in part, by India's tariffs); and (iii) streamlining export and customs procedures by reducing the current redundancy of information requirements and other administrative burdens imposed on exporters and importers.

#### D. Public Enterprises

51. Nepal's 60 fully state-owned public enterprises (PEs) have not performed well (although 6 joint ventures have fared comparatively better). The PEs are distributed across a range of activities as follows: manufacturing (30); public utilities (7); finance and insurance (8); trading (8); and the social services (7). The PEs were established without the guidance of a coherent policy regarding appropriate criteria for public sector involvement. Indeed, many were set up at the insistence of donors who wanted separate administrative arrangements for their projects. Their poor performance can be attributed to rapid staff turnover in key positions, outside interference

in their operating affairs, and a lack of clear guidance regarding their role. Many of these entities have accumulated arrears and substantial indebtedness to the banking system. The government has recently adopted a policy for public enterprises that limits state involvement to the provision of essentially "public" goods and services, which for reasons of market imperfections or social attributes would unlikely be supplied on adequate terms by the private sector (Public Enterprise policy is discussed in paras 32-36 in the LODP).

52. Under the structural adjustment program, measures have already been taken to improve performance of the PEs and to bring the sector into conformity with its stated policy: (i) with a view to improving financial control over the PEs, HMG has recently set out a borrowing plan for each of them in respect of borrowings from the domestic banking system; and (ii) managers of the PEs have been given improved incentives through the introduction of a reward and penalty system. Under the structural adjustment program the following initiatives are also addressed: (a) reducing the size of the overall PE sector through closure and divestiture; and (b) improving the roles, management and financial and operating efficiency of the two PEs operating in the agricultural sector.

53. The Size of the PE Sector: The government intends to implement policies to reduce the size of the public sector through divestiture and closure. In early 1986, some 46 PE's were identified as suitable for divestiture in whole or in part. With the exception of one donor, donors who financed some of these PEs have indicated no objection to divestiture. An action plan to carry out the reform program will be drawn up by early 1987/88. It is intended that each PE will undergo a special review to identify measures either to improve the marketability of its shares, if it is to be sold, or its operational performance if it is to continue in the public sector. Technical assistance to facilitate the review is being arranged.

54. Agriculture Inputs Corporation: A detailed action plan and timetable has been prepared for reshaping AIC's role in the agricultural sector and for restoring AIC's financial viability, including measures to liquidate its accumulated debts. Several actions have already been initiated, or are about to be taken, to strengthen AIC's financial management. Under an agreement with the ADB, a program has been initiated to improve AIC's accounting system. AIC is expected to complete and submit to the Auditor General its outstanding accounts for 1985/86 by mid-October, 1987. The Auditor General's office will complete full audits of AIC's accounts for all years from 1982/83 through 1985/86 by January 31, 1988. For 1986/87 and subsequent years, audited accounts and financial statements will be available within 12 months after the close of the fiscal year. An action program has been initiated to ensure full payment by the Agricultural Development Bank of Nepal (ADBN) to AIC for fertilizers sold to Sajhas against ADBN coupons; in the future, full payment will be made within one month of the presentation of coupons to ADBN. In conjunction with a program to strengthen the management and finances of AIC, commencing with the 1987/88 budget, the Government will provide adequate

funds for the financial subsidy required by AIC to cover the excess of budgeted costs over revenues, where losses are being incurred in the carrying out of Government policy.

55. Nepal Food Corporation: Measures to adjust NFC's role to one that is consistent with the policy regarding PEs and to restore NFC's financial viability have been initiated. NFC's accumulated debts are to be converted into long-term Government bonds, carrying 8 percent interest per annum. HMG has also taken steps to encourage full payment to NFC, by 15 April 1987, by other public sector entities for foodstuffs delivered. For debtors unable to meet this obligation, time-bound programs for phased payment of their outstanding debts to NFC have been established.

56. Steps have also been taken to strengthen NFC's accounting capacity in the same manner and over the same time frame as for AIC (para. 54). Beginning with FY88, the Budget will provide sufficient financial resources in its annual budgets to compensate NFC for the costs of carrying out welfare-oriented functions. Improved and more appropriate accounting procedures for NFC are being developed and are expected to be in effect around the beginning of FY89.

#### E. Development Implementation

57. The main problems related to development implementation are: (i) too many activities undertaken in relation to institutional, manpower and budgetary capacity; (ii) weak project management; (iii) weak monitoring and control functions; (iv) inadequate accounting and auditing functions which in turn delay budgetary releases; (v) high rates of turnover among project staff; (vi) a local construction industry beset by management, financial and manpower problems; (vii) excessive intervention in procurement functions with attendant delays and inefficiencies; and (viii) inadequate provision of resources for operations and maintenance. These problems are in large measure attributable to the workings of the broader public administration. Although public administrative reform represents a major undertaking that will require concerted effort over many years, corrective actions (described in paras 58, 59, 60) have been taken by introducing program budgeting procedures and tighter financial monitoring. The measures taken under the structural adjustment program are aimed at: (a) improving the efficiency with which public resources are allocated to new projects and ongoing projects; (b) strengthening Government's control over the execution of the development program through better monitoring with follow-up actions; and (c) introducing better management accountability both regarding performance in meeting project targets as well as in the disposition of public financial resources.

58. In early 1986, HMG took several steps to improve the quality of its development program and the efficiency of project implementation. Through Gazette notification, the powers of project managers and senior ministry officials were augmented significantly to permit them greater autonomy regarding personnel management and spending decisions. Additionally, a Royal

directive provided for continuity on development projects by giving managers greater discretion over the retention of project staff. These actions were accompanied by a reduction in the number of development boards, which had often interfered with day-to-day management and had been the frequent cause of project delays. These changes have produced mixed results to date. While the measures seem to be ameliorating the problems of project staffing and staff turnover, project managers in a number of instances still seem reluctant to exercise their new authority regarding spending decisions. It is largely the lack of other reinforcing systems within the broader public administration combined with apparent risk-aversion on the part of many managers that has kept these directives from producing discernible changes in project management. The new rules are appropriate but can only be expected to produce results when other complementary reforms (e.g., performance evaluation systems, remuneration and promotion criteria linked to performance, improved job security, etc.) in the public sector are in place. The issues involved, however, are complex and highly interrelated, thus requiring additional study before specific recommendations can be appropriately made. Accordingly, a study of the scope for broader public sector administrative reform will be undertaken (para. 71).

59. Program budgeting procedures were introduced in early 1986 to improve the absorption of foreign aid, to raise the efficiency of development projects and to accelerate the timing of benefits from the development program. Consultants were hired to assist in this effort under a technical assistance project funded by UNDP. About fifty development projects in agriculture, irrigation and forestry (accounting for about 15 percent of development spending) were reviewed. This analysis provided a useful input to the process of allocating budgetary resources during preparation of the 1986/87 Budget. It resulted in a number of changes in the design and phasing of projects as well as in budget allotments to line ministries. The application of program budgeting procedures is being extended and refined.

60. Financial monitoring of 78 major development projects on the basis of monthly information reported on the release and expenditure of funds has been introduced. This action, which was initiated and will continue in the Financial Controller General's (FCG) Office, is an important first step to correct the inadequacy of current monitoring systems for development projects.

61. To improve the allocation of public resources, a "core" development program comprising about 70 percent of the 1987/88 development budget is being identified. The purpose of the core program is to identify a set of high-priority development activities which would be given priority to the allocation of budgetary funds. This is in contrast to the historical practice of undertaking many projects, irrespective of the strain put on the public sector's absorptive capacity. The core program will include allocations for O&M expenditures in agriculture, irrigation, forestry, power, transportation and education and projects of high priority, selected on the basis of the following criteria: (i) foreign aid content; (ii) nearness to

completion; (iii) economic efficiency; and (iv) strategic importance in the country's overall development program. The latter criterion will take into account investments in certain areas (e.g. cultural heritage) where economic benefits of are either difficult to estimate or inapplicable. This round of programming, which would be completed in time for the 1987/88 Budget, (i.e. by June 1987) will extend the program and budgeting activities to the key line ministries operating in the fields of agriculture, irrigation, forestry, power and transportation. Subsequent rounds (on cycle with the 1988/89 Budget onward) would aim at refining the application of procedures as well as improving the assessment of O&M requirements for education, irrigation and road transport.

62. Although the core program will not be fully identified until the Spring of 1987, the 78 key projects now being monitored by the FCG's Office (para 60) already cover a significant portion of the development budget (about 50 percent compared with the 70 percent to be ultimately covered by the core program in 1987/88). An overall implementation target for these projects taken collectively has been established for 1986/87 as part of a first effort by HMG to improve both the quality of development projects and the rate of project implementation. Additionally, a subset of 18 of the more important of these projects has been selected for both physical and financial monitoring. This exercise will not only provide the basis for assessing management performance regarding the development program, but will also guide the design and implementation of broader program monitoring and control systems being undertaken with technical assistance funded by UNDP.

63. HMG also intends to strengthen the National Planning Commission (NPC) and the line ministries with respect to their project evaluation capability. The government is considering the role that technical assistance can play in this effort and the UNDP has indicated its willingness to support such an effort.

64. The control of the development program will be strengthened by improving the scheduling of projects, the collection and dissemination of monitoring information and the taking of corrective action with appropriate follow-up. Each line ministry has recently established a unit to track projects to anticipate and resolve problems beyond the control of project managers. This will, inter alia, allow comparisons to be made between actual and targeted performance as well as between resources actually deployed and those originally scheduled, thus permitting distinctions to be made between performance attributable to managers and that caused by factors beyond managers' control. Additionally, an apex trouble-shooting unit has been established in the Cabinet Secretariat to review and resolve problems that transcend the authority of a single implementing ministry. Major procurement decisions and the extent to which these have followed established guidelines fall within the purview of this unit.

65. The government intends to improve the accountability of project managers in two ways. First, project managers will be expected to account

for deviations from expected performance in the light of information provided by the improved monitoring systems. And second, HMG will undertake to improve the accounting and auditing framework for development projects. To this end, UNDP funding has been secured for improving accounting systems and for training accountants and auditors over the next two years.

66. An additional action to be undertaken under the structural adjustment program to improve development implementation will be to improve the performance of the domestic construction industry. Technical assistance financed by UNDP will address the issues of: manpower training, contractor registration, contract procedures, equipment supply, payment to contractors, improving contractors' access to credit, supply of building materials, and domestic suppliers' access to foreign exchange. A program to address these issues will be designed and implemented over the course of HMG's 1987/88 fiscal year.

#### F. Social Impact

67. The impact of Nepal's structural adjustment program on income distribution is expected to be positive. The estimated 60 percent of the country's population, which lives below the absolute poverty line and are engaged primarily in subsistence agriculture, are not closely linked with developments in the monetized sector of the economy. Thus, it is not anticipated that the necessary financial adjustment measures will have significant adverse effects on the poor. Moreover, HMG's stabilization and structural adjustment programs are consistent with raising per capita real consumption growth to double its present rate. The achievement of a three percent sustained growth rate in agriculture will have a significant impact in that sector, which occupies most of the population. Moreover, substantial benefit will result from the new policies which, inter-alia, are designed to improve the availability of inputs and research services. The non-agricultural sector, where growth is projected to be higher will also have relatively higher rates of consumption growth. Subsidized food programs will be more appropriately targetted to the poor and accounted for explicitly in the budget. The measures to encourage community involvement in the protection of the forests will significantly enhance both distributional and inter-generational equity.

68. On the other hand, some of the macroeconomic, industry and trade measures being introduced under the program (i.e. the introduction of higher tariffs and officially administered prices) are aimed at capturing excessive economic rents and transferring them from the current middle and high income beneficiaries to the budget, where, together with rising foreign savings inflows, they will be available to finance more investment and employment, as well as better operation and maintenance of key services and infrastructure. Although these measures may result in some dislocation of inefficient industries and reduction in incentives to engage in purely trading activities, concomitant unemployment effects are not expected to be severe as the industries likely to be adversely affected will in most cases be in

reality industries based on exporting to India goods with very low domestic value added and labor content. Moreover, this adjustment will be phased, while at the same time, the new measures will be expected to stimulate new investment and employment that will more than compensate for the dislocation. In particular, the employment opportunities that are expected to be generated by expanded carpet and garment manufacture will be significant and will benefit the poorer segments of the urban population. At the macro-economic level, tighter monetary and fiscal policies are already having the effect of reducing inflation and mobilizing financial savings. Finally, in the absence of a program, it can be expected that there would be continuation of low growth rates, declining per capita food availability and further environmental degradation.

#### PART IV -- THE STRUCTURAL ADJUSTMENT CREDIT

##### A. Background

69. The Bank began to consider a non-project lending operation for Nepal in the latter half of 1985 (Annex III presents the timetable of key events). It was clear that stabilization would need to be accompanied by additional measures to stimulate growth and structural change. At the January 1986 Aid Group meeting, the Bank discussed the possibility of a SAL with the authorities. Subsequently, the Bank provided the authorities an aide-memoire identifying a number of areas wherein a series of immediate actions, and agreement on future studies, could provide the basis for a SAL. In April and August 1986, missions visited Kathmandu to hold further discussions; an appraisal mission visited Kathmandu in late September which was followed by a post-appraisal mission in late November 1986. A Letter of Development Policy issued on February 24, 1987 provides the basis for this operation (Annex V).

##### B. Objectives and Description

70. The principal objective of the Credit is to provide immediate support for the Government's stabilization and structural adjustment program. After taking into account anticipated project-related flows of external assistance, a financing gap of about US\$80 million in 1986/87-1987/88 has been identified. It is proposed that this gap be filled primarily by IMF resources and the SAL. The SAL would be for SDR 40.9 million (US\$50 million equivalent) and would be disbursed in two equal tranches. While the measures taken so far are impressive and important, further substantial action will be required. The required structural changes will take some time, and imply complementary strengthening of Nepal's administrative and policy-making machinery to enable such a program to be implemented.

71. During negotiations, undertakings were reached that studies will be undertaken in parallel with this SAL to lay the foundation for subsequent SALs and/or sector loans. These would be drawn from the areas of: (a) agricultural development strategy with particular focus on the rural crisis

in the hills and mountains; (b) further refinement of industrial/trade strategy and policy with added focus on the potential for tourism and possible linkages with the power sector; (c) the scope for broader public administrative reform; and (d) studies to identify appropriate policies for energy pricing and energy trade. The studies will draw on the economic and sector work program of the Bank and on previous work already done; they will be action oriented and will also identify necessary institutional strengthening required to implement the recommendations therein.

### C. Coordination with the IMF and Other Donors

72. The International Monetary Fund. In preparing the proposed SAL, Bank and IMF staff collaborated closely through frequent consultations in Washington, overlapping missions in the field and close association between Resident Representatives of the respective institutions. Currently, Nepal has a stand-by arrangement with the IMF in an amount of SDR 18.65 million or 50 percent of quota. The arrangement is in effect through April 22, 1987. The stabilization program supported by the stand-by arrangement focuses on mobilizing additional domestic resources, restraining monetary and credit policies and, through the pursuit of a flexible exchange rate policy, strengthening the competitiveness of the traded goods sector. The broad areas of the conditionalities for the stand-by arrangement are complementary to the policy and institutional reform measures to be carried out under the proposed Credit, as well as to IDA's broader economic development policy objectives. As regards the Structural Adjustment Facility (SAF) a joint Bank/Fund mission visited Kathmandu in December 1986 to commence discussions of a draft Policy Framework Paper. It is planned that these discussions will be concluded in May 1987 with agreement reached on economic and financial policies during 1987/88-89/90.

73. Other Donors. IDA, UNDP, the ADB and bilateral donors cooperate closely in Nepal. The Bank and UNDP jointly convene regular donor meetings with the bilateral agencies in Kathmandu. Donors have expressed very substantial interest in the SAL, attach great importance to the structural adjustment effort, and have contributed valuable suggestions which have been taken into account in designing the program. The UNDP is providing financing for a number of technical assistance activities to support the SAL, the most important of which is to improve the administration of development expenditure. The Bank staff also maintains close contact with the ADB. A member of the ADB staff joined the April mission and other ADB staff consulted with that and subsequent missions. The ADB is supportive of the SAL and intends to consult closely with the Association in coordinating their lending program. The ADB has agreed to be executing agency for several UNDP financed technical assistance programs. As noted in Para. 21, a number of donors have expressed interest in providing finance to support the adjustment program.

**D. Credit Administration and Management**

74. HMG's SAL Financial Coordinating Committee, comprising representatives from the Foreign Aid Division of the Ministry of Finance and from the Nepal Rastra Bank, will have overall responsibility for the preparation and submission of withdrawal applications. This will include the collection and coordination of all supporting documentation including relevant letters of credit.

**E. Procurement, Disbursements and Retroactive Financing**

75. The proposed Credit would finance 100 percent of the foreign exchange cost of imports other than luxury and defense items. Not more than 20 percent of the proceeds of the Credit would be used to finance the import of any commodity or group of commodities falling within a single 2-digit Division of the Standard International Trade Classification (SITC), Revision 2.

76. Contracts for the import of goods by the private sector will be awarded on the basis of normal commercial practices of the purchaser. Purchase of imports of less than US\$1,000,000 equivalent by the Public Sector will follow the public sector's procurement regulations. Except for proprietary items, all imports from the public sector exceeding the above limit would be procured through international competitive bidding in accordance with Bank guidelines. Certain commonly traded commodities may be purchased through price quotations available from organized international commodity markets. Public sector contracts for proprietary items may be let on a negotiated basis subject to the prior approval of IDA. Goods would be sold to the final users at prices that reflect, inter-alia, the international prices of the goods, plus applicable customs duties and taxes.

77. Disbursements under the Credit would be facilitated by the establishment of a Special Account of SDR 8.18 million (\$10 million equivalent) in Nepal Rastra Bank. It is anticipated that most payments would be financed out of the proceeds of this Account. Applications for replenishment to the Special Account would be submitted when the amounts withdrawn exceeded 50 percent of the amount deposited into the Special Account (Authorized Allocation) or every three months whichever comes first. Disbursements against small contracts of less than \$400,000 but more than \$10,000 would be made on the basis of a modified statement of expenditure (SOE). This SOE would include (i) description of goods; (ii) country of origin; (iii) date and currency of payment; and (iv) beneficiary. Supporting documentation such as invoices, contract, bill of lading and evidence of payment will be retained by the SAL Financial Coordinating Committee for periodic examination by Bank staff. Expenditures for goods procured under contracts of US\$10,000 equivalent or less would not be eligible for financing from the Credit. Retroactive financing of US\$5 million equivalent would be provided for eligible expenditures incurred commencing January 1, 1987.

78. Local currency counterpart funds generated by the sale of foreign exchange provided by the Credit would be added to the budget and subject to normal public finance expenditure controls.

#### F. Tranching

79. Assuming satisfactory progress on the program, the proposed SAL would be disbursed from March 1987 to March 1988, supporting Nepal's 1986/87 and 1987/88 foreign exchange requirements. The first tranche of SDR 20.45 million (\$25 million) would be released upon Credit effectiveness in time to provide support in the financing of the 1986/87 program and the second tranche is expected to be released in November 1987 after a joint review by the government and IDA of progress under the program.

80. Prior to the proposed release of the second tranche it is expected that the Government would take the following actions (Annexes III and VI have details): a) achieve satisfactory progress in the implementation of macro-economic policies, including agreement with IDA on policies for 1987/88, including formulation of a Core development program; and in the implementation of the 1986/87 Development Budget; b) commencement of a program of tariff reform; c) introduction of flexibility in determining the administered wholesale prices of fertilizer coupled with increased incentives to fertilizer trading; d) improvements in the institutional arrangements governing seed marketing; e) strengthening the finances of the AIC and NFC; f) allowing local forest user groups to retain the proceeds from the sale of forestry products; and g) preparation of an action plan for reform of the PE sector.

#### G. Benefits and Risks

81. The main benefits are: (i) laying the foundation for more vigorous medium-term growth by establishing a firm macro-economic and financial framework, freeing industrial activity from excessive regulatory measures, improving the quality of services being provided by Government to the agricultural sector, and improving the rate of project implementation; (ii) providing the basis for sustained improvement in the balance on external account through a combination of macroeconomic, industrial and trade policies aimed at reducing price and regulatory distortions that are currently biasing the composition of economic activity in favor of producing goods with little value added and (iii) strengthening the public sector finances through a combination of additional fiscal measures and improved administration thereof, phased disengagement of the public sector from those economic activities that can be performed more efficiently by the private sector, the capturing and transferral to the budget of excessive economic rents from those agents who in the past have enjoyed monopoly power at the expense of the broader populace via the excessive regulatory apparatus and better targeting of social welfare programs with more explicit treatment in the budget of the true costs that these activities entail.

82. Two main risks exist. One is political. Notwithstanding endorsement of the country's structural adjustment program at the highest level, vested interests are significant and could thwart the sound execution of the program as the removal of economic distortions begins to encroach on prerogatives. However, a major feature of the SAL is to introduce processes within the public sector that not only are based on sound economic criteria and management methods but also that will be more open to scrutiny. The introduction of program budgeting, the improvement of program/project monitoring and control, and the enforcement of tighter accounting and auditing practices will improve and protect the stewardship of public sector resources. To the extent that strong support from the highest levels continues, the risk that countervailing forces may weaken the structural adjustment effort should be manageable. Another risk is administrative. In the past, Nepal has had difficulty in managing development projects because of the limited executing capacity and lack of accountability of the public sector. Superimposing the numerous policy actions required under a structural adjustment program on top of the public sector's existing work load runs the risk of overloading the system. To mitigate this risk, the program has been designed with an emphasis on decontrol and liberalization in which the state is reducing its role. Finally, if some of the components of technical assistance on which key areas of reform depend are delayed, this in turn could delay some of the associated policy actions. Close coordination between UNDP and IDA Resident Representatives and close cooperation with ADB are expected to keep this risk manageable.

#### PART V -- BANK GROUP OPERATIONS IN NEPAL

83. Bank Group operations in Nepal began in 1969 with an IDA credit of US\$1.7 million equivalent for a telecommunications project. Since then, 46 additional credits have been approved, bringing total IDA assistance to Nepal to US\$641.0 million equivalent, net of cancellations. Five sectors account for about 90 percent of IDA credits by amount: irrigation/agriculture (US\$251.4 million for 20 projects); water supply and sewerage (US\$46.8 million for three projects); power and energy (US\$168.0 million for four projects); telecommunications (US\$41.7 million for four projects); and highways (US\$67.0 million for three projects). The proposed credit would be the second to be approved in FY87, following the one for the Rasuwa-Nuwakot Integrated Rural Development Project. No Bank loans have been made to Nepal. IFC has made three investments in Nepal, the first in FY75 (US\$3.1 million) for the expansion of the Soaltee Hotel project in Kathmandu, the second in FY82 (DM 14.5 million) to Nepal Orind Magnesite Company for the mining and production of dead burnt magnesite, and a third approved in FY84, but not yet signed to Nepal Metal Company (DM 7.8 million), for a zinc/lead mining and concentrates project. Annex II contains a summary statement of IDA credits and IFC operations as of September 30, 1986.

84. The international community has provided considerable resources for Nepal's economic development. Utilization of this aid has been constrained,

however, by Nepal's limited absorptive capacity affecting the pace of project preparation and implementation. The Bank Group has provided assistance to HMG in project preparation through two Technical Assistance Credits (Gr. 659-NEP and 1379-NEP) and by acting as Executing Agency for a number of technical assistance projects financed by UNDP. Project completion reports have been prepared for eleven projects.

85. In recent years the Bank has focused its lending increasingly on agriculture, rural development, forestry, and human resource development. In allocating future IDA project resources to these areas, the basic approach will be to strike a balance between the necessary emphasis on quick and high-yielding investments in these sectors which is dictated by Nepal's precarious budgetary and balance of payments position, and an equally important commitment to those sectors where the impact cannot be felt immediately but which nevertheless are critical to the country's long-term development (e.g., public administration and human resource development). The primary objective of Bank lending in the agricultural sector is to increase production of foodgrains and to achieve larger agricultural surpluses for exports and import substitution. To that end, the Bank emphasizes actions and investment aimed at improving the supply of inputs and strengthening support services to maximize benefits from existing infrastructure and equipment. In forestry, the principal focus is to support reforestation efforts at the community level. In education and training, the objectives are to improve the quality of primary education as well as to increase the supply of trained technical manpower, and to promote greater efficiency in public administration.

86. Outside these areas of major emphasis, involvement will concentrate on areas where investments would complement growth in productive capacity. Accordingly, support in the power sector will be maintained. However, with Nepal's growing electricity demand, the larger generation projects that this implies will require financing on a larger scale than in the past. Therefore, in addition to providing financial resources, the Bank will act as a catalyst for mobilizing additional external resources in addition to providing technical assistance in the sector. In transport and communications, selective interventions will be designed to facilitate regional integration and improved rural access to markets and input supplies.

87. Project lending operations have addressed, with some success, a number of problems and constraints that transcend individual operations and sectors (e.g., cost recovery, accounts and audits, provision for operations and maintenance). However, this approach has been unwieldy and difficult to sustain where coordination across government agencies. The proposed SAL will be a valuable and essential complement to policy reforms addressed under project lending by providing breadth and flexibility in approach and direct involvement of central high-level decision makers.

88. The proposed SAL and the project lending operations are mutually supporting. For example, under recently approved irrigation and rural

development projects, progress has been made in the area of cost recovery. Two ongoing industrial projects have components under which important improvements in industrial incentives and export and import procedures will be introduced in line with the SAL's objectives of industrial and trade liberalization. A planned multimodal transport project will further enhance the movement of goods traded with India as well as of goods in transit through India from and to third countries. Lending operations in forestry and agricultural research are anticipated to provide detailed follow-through to the broader policy initiatives sought under the SAL in these areas. Moreover, the improved project accounting and auditing sought under the SAL, in addition to strengthening performance in the area of project implementation generally, can be expected to enhance rates of execution under ongoing and new IDA projects.

PART VI -- RECOMMENDATION

89. I am satisfied that the proposed IDA Credit would comply with the Articles of Agreement of the Association. I recommend that the Executive Directors approve the proposed Development Credit.

Barber B. Conable  
President

Attachments

Washington D.C.

ECONOMIC INDICATORS - NEPALGNP PER CAPITA IN 1985: US\$160GROSS DOMESTIC PRODUCT IN 1984/85ANNUAL RATE OF GROWTH, 1974/75-1984/85  
(%, constant prices)

	<u>US\$ Mln.</u>	<u>%</u>
GDP at Market Prices	2,350	100.0
Gross Domestic Investment	486	20.6
Gross Domestic Saving	264	11.2
Resource GAP	-222	-9.4
Exports of Goods, NFS	302	12.8
Imports of Goods, NFS	509	21.6

3.0

OUTPUT, LABOR FORCE AND PRODUCTIVITY IN 1982/83

	<u>Value Added</u>		<u>Labor Force a/</u>		<u>Value Added</u>
	<u>US\$ Mln.</u>	<u>%</u>	<u>Mln.</u>	<u>%</u>	<u>Per Worker</u>
					<u>US\$</u>
Agriculture	1,286	56	6.3	91.0	204
Industry	277	12	0.2	3.0	1,385
Services	725	32	0.4	6.0	1,813
Total/Average	2,282	100	6.9	100	331

GOVERNMENT FINANCECENTRAL GOVERNMENT

NRs. Mln.

	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u>	<u>1985/86</u>	<u>% of GDP</u>
						<u>1985/86</u>
Current Receipts	2,668	2,805	3,346	3,850	4,481	8.7
Regular Expenditures	1,627	1,900	2,107	2,720	3,281	6.0
Current Surplus	1,041	905	1,239	1,130	1,200	2.7
Development Expenditure	3,727	4,982	5,164	5,489	5,993	12.1
External Assistance (Net)	1,688	2,028	2,492	2,609	3,446	6.9

MONEY, CREDIT AND PRICES

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
	(Million NRs. outstanding mid-July)					
Money and Quasi Money	6,308	7,459	9,222	10,456	12,297	15,120
Bank Credit to Government	1,263	2,062	4,090	5,029	6,470	7,420
Bank Credit to Public Enterprises	946	840	1,137	953	1,163	1,600
Bank Credit to Private Sector	2,952	3,142	3,264	3,842	4,848	6,343
Money and Quasi Money as % of GDP	21.7	22.9	27.4	27.4	29.3	30.4
General Price Index (1974/75 = 100)	145.9	161.2	184.1	195.6	198.6	230.3
Annual Percentage Changes in:						
General Price Index	13.4	10.4	14.2	6.2	1.5	16.1
Bank Credit to Government	-0.4	57.1	93.8	24.2	27.9	14.7
Bank Credit to Public Enterprises	33.3	1.0	44.0	-18.9	20.8	37.6
Bank Credit to Private Sector	26.9	2.4	3.7	16.9	22.1	30.1

Note: All conversions to US dollars in this table are at the average exchange rate prevailing during the period covered.

Fiscal year data are for Nepalese fiscal year, July 16 - July 15.

a/ Total labor force; unemployed are allocated to sector of their normal occupation.

b/ Includes mining, manufacturing, construction and utilities.

	1982/83	1983/84	1984/85	1985/86	MERCHANDISE EXPORTS 1984/85		
	(US\$ Million)					US\$ Min.	%
<b>BALANCE OF PAYMENTS</b>							
Exports	250.4	275.0	302.1	328.2	Agricultural products	91.7	59
Merchandise f.o.b	82.3	112.1	154.5	160.2	Manufactures	63.7	41
Non-factor Services	168.1	162.9	147.6	168.0	Total	155.4	100
Imports	521.6	505.1	524.1	590.6	<b>EXTERNAL DEBT, DECEMBER 31, 1985</b>		
Merchandise c.i.f	459.0	428.2	437.0	501.6		US\$ Min.	
Non-factor Services	62.6	76.9	87.1	89.0	Public Debt, inc. guaranteed	527.3	
Resource Gap	271.2	230.1	222.0	262.5	Non-Guaranteed Private Debt	-	
Net factor Income	13.0	6.2	0.2	-0.5	Total Outstanding & Disbursed	527.3	
Net Current Transfers	41.7	45.4	42.8	51.2	<b>DEBT SERVICE RATIO for 1984/85</b>		
Current Account Deficit	216.5	178.6	179.0	211.9	Public Debt, inc. guaranteed	5.0	
Official Grant Aid	95.3	90.5	75.0	96.8	<b>IBRD/IDA LENDING, September 30, 1986</b>		
Net M&LT Loans	67.0	78.9	71.6	91.2		US\$ Min.	
Disbursements	69.9	83.5	76.6	99.0	Outstanding & Disbursed	241.9	
Repayments	2.9	4.6	5.1	7.8	Undisbursed	396.0	
Capital Flows N.E.I.	1.1	-5.5	-20.5	38.9	Outstanding, incl. undisbursed	637.9	
Overall Balance	-53.1	-14.7	-53.0	15.0	<b>IDA</b>		
					Outstanding & Disbursed	241.9	
					Undisbursed	396.0	
					Outstanding, incl. undisbursed	637.9	
<b>RATE OF EXCHANGE</b>							
From March 20, 1978 to September 18, 1981	From September 19, 1981 to December 16, 1982	From December 17, 1982 to May 31, 1983	June 30, 1984 <sup>a/</sup>	December 31, 1984			
US\$1.00 = NRs 12.00 NRs 1.00 = US\$ 0.083	US\$1.00 = NRs 13.2 NRs 1.00 = US\$ 0.076	US\$1.00 = NRs 14.3 NRs 1.00 = US\$ 0.070	US\$1.00 = NRs 16.4 NRs 1.00 = US\$ 0.061	US\$1.00 = NRs 18.0 NRs 1.00 = US\$ 0.056			
March 31, 1985	June 30, 1985	September 30, 1985	December 31, 1985	June 15, 1986			
US\$1.00 = NRs 18.1 NRs 1.00 = US\$ 0.055	US\$1.00 = NRs 18.1 NRs 1.00 = US\$ 0.055	US\$1.00 = NRs 17.3 NRs 1.00 = US\$ 0.058	US\$1.00 = NRs 20.9 NRs 1.00 = US\$ 0.048	US\$1.00 = NRs 21.2 NRs 1.00 = US\$ 0.047			

<sup>a/</sup> Since June 1, 1983, the Nepal Rastra Bank announces the exchange rate daily, based on a trade-weighted basket, with the US dollar as the intervention currency. The rate shown here is the mid-rate on the date indicated.

STATUS OF BANK GROUP OPERATIONS IN NEPALA. STATEMENT OF IDA CREDITS (as of September 30, 1986) a/ & b/

<u>No.</u>	<u>Year</u>	<u>Borrower</u>	<u>Purpose</u>	US\$ million (net of cancellations)	
				<u>IDA</u>	<u>Undisbursed</u>
Nineteen credits fully disbursed				144.2	
812	1978	Kingdom of Nepal	Irrigation (Sunsari-Morang)	30.0	1.1
856	1979	Kingdom of Nepal	Irrigation (Narayani Zone)	14.0	1.7
939	1979	Kingdom of Nepal	Second Rural Development	11.0	6.8
1008	1980	Kingdom of Nepal	Community Forestry	17.0	8.3
1055	1980	Kingdom of Nepal	Irrigation (Mahakali)	16.0	9.1
1059	1981	Kingdom of Nepal	Third Water Supply & Sewerage	27.0	7.5
1093c/	1981	Kingdom of Nepal	Irrigation (Babai)	3.5	0.2
1100c/	1981	Kingdom of Nepal	Agricultural Extension & Res.	17.5	6.8
1101c/	1981	Kingdom of Nepal	Hill Food Production	8.0	4.8
1191c/	1982	Kingdom of Nepal	Cottage & Small Industries	6.5	0.1
1198c/	1982	Kingdom of Nepal	Second Education	14.3	10.0
1260c/	1982	Kingdom of Nepal	Petroleum Exploration Promotion	9.2	4.1
1316c/	1983	Kingdom of Nepal	Irrigation VI-Bhairawa-Lumbini	16.0	11.0
1339c/	1983	Kingdom of Nepal	Cash Crop Development	6.0	2.6
1379c/	1983	Kingdom of Nepal	Technical Assistance II	6.0	5.3
1400c/	1984	Kingdom of Nepal	Second Forestry	16.0	17.0
1452c/	1984	Kingdom of Nepal	Karnali Preparation	11.0	9.8
1463c/	1984	Kingdom of Nepal	Primary Education	12.8	11.9
1478c/	1984	Kingdom of Nepal	Marsyangdi Hydroelectric Power	107.0	114.9
1515c/	1985	Kingdom of Nepal	Third Highways	47.5	53.2
1534c/	1985	Kingdom of Nepal	Agric. Manpower Development	8.4	9.8
1535c/	1985	Kingdom of Nepal	Industrial Development	7.5	9.1
1570c/	1985	Kingdom of Nepal	Agricultural Extension II	7.2	8.9
1588c/	1985	Kingdom of Nepal	Telecommunication IV	22.0	25.1
1696d/	1986	Kingdom of Nepal	Second Cottage & Small Indus.	10.0	10.5
1715d/	1986	Kingdom of Nepal	Narayani III Irrigation	24.5	26.2
1727d/	1986	Kingdom of Nepal	Rasuwa Nuwakot Rural Dev. II	19.1	20.1
Total,				639.2	396.0
of which has been repaid				1.3	
Total now outstanding b/				637.9	
Total now held by IDA				637.9	
Total undisbursed					396.0

a/ No Bank loans have been made to Nepal.

b/ Prior to exchange adjustments.

c/ IDA 6th and 7th Replenishments Credits, principal amounts shown in U.S. dollar equivalent at date of negotiations, as shown in President Reports, and undisbursed amounts shown U.S. dollar equivalent are valued at the exchange rate applicable on the date of this statement.

d/ Not yet effective.

**B. STATEMENT OF IFC INVESTMENT (as of September 30, 1986)**

<u>Year</u>	<u>Obliger</u>	<u>Type of Business</u>	<u>Amount (US\$ million)</u>		
			<u>Loan</u>	<u>Equity</u>	<u>Total</u>
1975	Soaltee Hotel (Pvt) Ltd.	Hotel	2.0	0.4	2.4
1982	Nepal Orind Magnesite (Private) Limited	Mine and process magnesite ore	7.2	-	7.2
			—	—	—
	Total commitments now held by IFC		9.2	0.4	9.6

NEPAL

STRUCTURAL ADJUSTMENT CREDIT

SUPPLEMENTARY DATA SHEET

Section I: Timetable of Key Events

(a) Request from HMG for IDA assistance to design Structural Adjustment Program	January 1986
(b) Identification mission	April 1986
(c) Pre-appraisal mission	July 1986
(d) Appraisal mission	September 1986
(e) Post-appraisal mission	November 1986
(f) Negotiations	January 1987
(g) Planned date of Effectiveness	April 1987
(h) Target date for Second Tranche release	October 31, 1987

Section II:

- (a) Before effectiveness, the Government would establish a Special Account at the Rastra Bank to receive proceeds of the proposed credit.
- (b) Before release of the second tranche, the main actions that HMG would undertake are:
- i) achieve satisfactory progress on implementation of the program to be determined on the basis of a review of HMG's economic development policies including, but not limited to, those policy and institutional improvements described in the LODP;
  - ii) review and agree on 1987/88 Budget policies including identification and agreement on a core development program for the 1987/88 Budget;
  - iii) achieve satisfactory progress in implementing the key development projects being monitored;
  - iv) formulate and introduce a program of income, sales and excise tax reforms;

- v) convert the tariff structure to a system of about 7 bands ranging from 0 to 100 percent;
- vi) increase the permissible trading margin on fertilizer by two percentage points; authorize AIC to increase wholesale fertilizer prices at any time, without prior government approval, by up to 10 percent to meet cost increases or to reduce any price differential with India;
- vii) implement a simplified cereal seed sales pricing system, including elimination of subsidy on seeds;
- viii) provide greater financial autonomy to the Seed Division of AIC and transfer within AIC responsibility for seed distribution and marketing from the Sales and Procurement Division to the Seed Division;
- ix) establish a National Seed Board;
- x) submit to the Auditor General's office complete final accounts for AIC and NFC for all financial years through 1985/86;
- xi) provide sufficient budgetary allocation to compensate NFC for the costs of carrying out welfare-oriented functions on behalf of HMG;
- xii) allow Panchayats' and Wards' forest user groups to retain 100 percent of revenues from forest activities;
- xiii) prepare an action plan for closure, divestiture and/or managerial reform of the PEs.

Table 1: NEPAL: GOVERNMENT BUDGET  
(In NRs million)

Annex IV

	Actual		Prelim.	Rev. Est.	Projected				
	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
Current Receipts:	2805.0	3345.7	3850.3	4481.0	53,76.0	6596.5	7638.4	8768.8	10050.6
Tax Revenue	2421.1	2737.0	3151.2	3752.0	4326.0	5524.1	6460.7	7470.2	8619.1
Direct Taxes	446.6	545.9	563.3	647.0	745.0	831.8	972.6	1124.3	1309.0
Indirect Taxes	1974.5	2191.1	2587.9	3105.0	3581.0	4692.3	5488.1	6345.8	7310.1
Non-Tax (Adj.)	383.9	608.7	699.1	729.0	1050.0	1072.4	1177.7	1298.6	1431.5
Non-Tax Receipts (Unadj.)	417.8	675.8	766.6	869.0	1310.0	1352.4	1479.7	1623.6	1781.5
Loan Repayments received	-33.9	-67.1	-67.5	-140.0	-260.0	-280.0	-302.0	-325.0	-350.0
Regular Expenditures (Adj.)	1900.2	2107.0	2720.2	3781.7	3799.8	4531.1	4980.3	5467.8	6080.6
Regular Expenditures (Unadj.)	1997.1	2273.5	2906.0	3603.3	4202.6				
- Loans and Investment	-3.3	0.0	-11.1	-13.3	-13.8				
- Payments of Principal	-93.6	-166.5	-174.7	-308.3	-389.0				
Surplus for Development Exp.	904.8	1238.7	1130.1	1199.3	1576.2	2065.5	2658.1	3301.5	3970.0
Development Exp. and Net Lending	4951.5	5096.7	5432.3	5865.9	7153.8	8940.8	10167.3	11580.3	13071.3
Development Expenditure	4982.1	5163.8	5488.7	5992.6	7400.0	9206.8	10455.3	11891.3	13407.3
Net Lending	-30.6	-67.1	-56.4	-126.7	-246.2	-266.0	-288.0	-311.0	-336.0
Overall Balance	-4046.7	-3858.0	-4302.2	-4666.6	-5577.6	-6875.4	-7509.1	-8279.3	-9101.3
Total Receipts	2805.0	3345.7	3850.3	4481.0	5376.0	6596.5	7638.4	8768.8	10050.6
Total Expenditures	6851.7	7203.7	8152.5	9147.6	10953.6	13471.9	15147.6	17048.1	19151.9
Financed by:									
External Sources	2028.4	2492.0	2609.1	3446.2	4640.0	5868.3	6490.9	7199.9	8013.2
Grants	1090.1	876.6	923.4	1380.8	1760.0	2504.4	2778.8	3125.3	3471.0
Loan Disbursements (net)	938.3	1615.4	1685.7	2065.4	2880.0	3363.9	3712.1	4074.6	4542.3
Loan Disbursements (gross)	985.8	1670.9	1754.9	2224.9	3130.0	3616.7	4015.4	4436.4	4968.1
Repayments	-47.5	-55.5	-69.2	-159.5	-250.0	-252.8	-303.3	-361.8	-425.9
Domestic Borrowing (net)	2015.6	1369.5	1694.1	1220.4	937.6	1007.1	1018.2	1079.4	1088.1

Table 2: NEPAL: BALANCE OF PAYMENTS  
In US\$ millions

Annex IV

	Actual			Prelim.	Rev. Est.	Projected				
	1982/83	1983/84	1984/85			1985/86	1986/87	1987/88	1988/89	1989/90
Exchange Rate = NRs per US\$	13.796	15.259	17.777		19.329	22.000	22.000	22.000	22.000	22.000
Merchandise Exports f.o.b.	82.3	112.1	154.5		160.2	182.0	202.8	225.0	251.2	281.9
Merchandise Imports c.i.f.	459.0	428.2	437.0		501.6	540.5	665.7	742.5	760.0	839.9
Trade Balance	-376.7	-316.1	-282.5		-341.5	-358.5	-462.9	-517.4	-508.9	-558.0
Non-Factor Services (net)	105.5	89.0	60.5		79.0	86.8	97.9	109.2	121.6	135.1
NFS Exports	168.1	162.9	147.6		168.0	181.1	201.6	222.2	245.0	270.1
NFS Imports	62.6	73.9	87.1		89.0	97.9	107.7	117.4	128.2	140.2
Resource Balance	-271.2	-227.1	-222.0		-262.5	-271.6	-365.0	-408.2	-387.3	-422.9
Investment Income (net)	13.0	3.2	0.2		-0.5	-0.9	-7.0	-14.0	-21.5	-23.9
Receipts	14.7	6.2	5.3		3.1	3.6	7.0	7.0	6.8	6.5
Payments	1.7	3.0	5.1		3.6	4.5	14.1	21.0	28.3	30.4
Private Transfers (net)	41.7	45.4	42.8		51.2	53.2	60.8	63.8	67.0	70.3
Receipts	44.1	47.8	44.7		55.6	59.1				
Repayments	2.4	2.5	1.9		4.4	5.9				
Current Account Balance	-216.5	-178.6	-179.0		-211.9	-219.3	-311.3	-358.4	-341.8	-376.5
Official Grants	95.3	90.5	75.0		96.8	126.5	129.9	151.8	171.2	192.0
Official Capital	67.0	78.9	71.6		91.2	105.2	152.9	177.5	194.1	211.9
Disbursements	69.9	83.5	76.6		99.0	115.8	164.4	191.2	210.5	231.2
Amortization	2.9	4.6	5.1		7.8	10.6	11.5	13.8	16.4	19.4
Miscellaneous Capital	1.1	-5.5	-20.5		38.9	0.0	55.0	55.0	0.0	0.0
Overall Balance	-53.1	-14.7	-53.0		15.0	12.4	26.5	25.9	23.5	27.4

Table 3: NEPAL: NATIONAL ACCOUNTS

(Rs. million)

	Actual			Rev. Est.	Projected					
	1982/83	1983/84	Prelim. 1984/85		1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
GDP (market prices)	33761.0	38184.0	41738.0	49710.2	56510.6	63495.3	69470.2	76226.2	83639.1	
GDP (factor cost)	31934.0	36059.1	39231.0	46705.0	52990.9	58866.5	64051.5	69956.5	76333.3	
Indirect Taxes	1974.5	2191.1	2587.9	3105.0	3581.0	4692.3	5488.1	6345.8	7389.5	
- Subsidies	-147.5	-66.2	-80.9	-99.8	-61.3	-63.5	-69.5	-76.2	-83.6	
Resource Gap (M-X)	3741.4	3511.4	3945.9	5074.0	5975.4	8031.0	8981.0	8520.4	9303.7	
Imports (G+NFS)	7196.0	7661.0	9043.0	11416.5	13963.7	16926.3	18820.7	19436.4	21448.7	
Exports (G+NFS)	3454.6	4195.7	5373.0	6342.5	7988.3	8895.2	9839.8	10915.9	12145.0	
Resources Available = Uses	37502.4	41695.4	45683.9	54784.2	63099.4	70287.7	76948.1	83127.8	91195.7	
Total Consumption	30703.0	34247.0	36772.0	45339.3	50901.3	56601.9	61759.6	67214.6	73204.0	
Private Consumption	28309.3	31905.9	33601.5	41572.3	47365.9	50950.8	55507.3	60125.5	65258.3	
Government Consumption	2393.7	2341.1	3170.5	3767.0	3534.4	5651.1	6252.3	7089.0	7945.7	
Total Investment	6799.0	7402.0	8636.0	9444.9	11584.7	14924.4	16691.6	17532.0	19738.8	
Private Investment	4103.5	4621.7	5697.5	6528.4	6978.3	10098.8	11099.2	11205.2	12671.3	
Government Investment	2695.5	2780.3	2938.5	2916.5	4606.4	4825.6	5592.3	6326.8	7067.5	
Memorandum Items:										
Domestic Savings (Ig+Ip-RG)	3057.6	3890.6	4690.1	4370.9	5609.3	6893.4	7710.6	9011.6	10435.2	
Net Factor Income	179.3	94.6	2.8	-10.0	-20.0	-154.8	-306.9	-473.0	-526.1	
Net Current Transfers	575.7	692.2	760.9	989.0	1170.0	1336.6	1403.4	1473.6	1547.3	
National Savings (DS+NFY+Tfp)	3812.6	4677.4	5453.8	5349.9	6759.3	8075.2	8807.1	10012.2	11456.3	
Government Savings	-82.2	378.1	-160.6	-366.0	585.8	-410.9	-120.7	23.3	372.7	
Private Savings	3894.8	4299.3	5614.4	5715.9	6173.5	8486.0	8927.8	9988.9	11083.6	
Foreign Savings	2986.4	2724.6	3182.2	4095.0	4824.4	6849.2	7884.5	7519.9	8282.5	

Table 4: NEPAL: GOVERNMENT BUDGET  
(as a percent of GDP)

Annex IV

	Actual		Prelim.	Rev. Est.	Projected				
	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
Current Receipts:	8.31	8.76	9.22	9.01	9.51	10.39	11.00	11.50	12.00
Tax Revenue	7.17	7.17	7.55	7.55	7.66	8.70	9.3	9.80	10.30
Direct Taxes	1.32	1.43	1.35	1.30	1.32	1.31	1.40	1.48	1.57
Indirect Taxes	5.85	5.74	6.20	6.25	6.34	7.39	7.90	8.33	8.74
Non-Tax (Adj.)	1.14	1.59	1.67	1.47	1.86	1.69	1.70	1.70	1.71
Non-Tax Receipts (Unadj.)	1.24	1.77	1.84	1.75	2.32	2.13	2.13	2.13	2.13
Loan Repayments received	-0.10	-0.18	-0.16	-0.28	-0.46	-0.44	-0.43	-0.43	-0.42
Regular Expenditures (Adj.)	5.63	5.52	6.52	6.60	6.72	7.14	7.17	7.17	7.27
Regular Expenditures (Unadj.)	5.92	5.96	6.96	7.25	7.44				
- Loans and Investment	-0.01	0.00	-0.03	-0.03	-0.02				
- Payments of Principal	-0.28	-0.44	-0.42	-0.62	-0.69				
Surplus for Development Exp.	2.68	3.24	2.71	2.41	2.79	3.25	3.83	4.33	4.73
Development Exp. and Net Lending	14.67	13.35	13.02	11.80	12.66	14.08	14.64	15.19	15.63
Development Expenditure	14.76	13.52	13.15	12.06	13.09	14.50	15.05	15.60	16.03
Net Lending	-0.09	-0.18	-0.14	-0.25	-0.44	-0.42	-0.41	-0.41	-0.40
Overall Balance	-11.99	-10.10	-10.31	-9.39	-9.87	-10.83	-10.81	-10.86	-10.90
Total Receipts	8.31	8.76	9.22	9.01	9.51	10.39	11.00	11.50	12.00
Total Expenditures	20.29	18.87	19.53	18.40	19.38	21.22	21.80	22.37	22.90
Financed by:									
External Sources	6.01	6.53	6.25	6.93	8.21	9.24	9.36	9.46	9.60
Grants	3.23	2.30	2.21	2.78	3.11	3.94	4.00	4.10	4.15
Loan Disbursements (net)	2.78	4.23	4.04	4.15	5.10	5.30	5.36	5.36	5.45
Loan Disbursements (gross)	2.92	4.38	4.20	4.48	5.54	5.70	5.78	5.82	5.94
Repayments	-0.14	-0.15	-0.17	-0.32	-0.44	-0.39	-0.42	-0.46	-0.49
Domestic Borrowing (net)	5.97	3.59	4.06	2.46	1.66	1.59	1.45	1.40	1.30

Table 5: NEPAL: BALANCE OF PAYMENTS

(as a percent of GDP)

	Actual			Rev. Est.	Projected				
	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
Merchandise Exports f.o.b.	3.36	4.48	6.58	6.23	7.09	7.03	7.13	7.25	7.42
Merchandise Imports c.i.f.	18.76	17.11	18.61	19.51	21.04	23.06	23.51	21.94	22.09
Trade Balance	-15.39	-12.63	-12.03	-13.28	-13.95	-16.04	-16.39	-14.69	-14.68
Non-Factor Services (net)	4.31	3.56	2.58	3.07	3.38	3.39	3.46	3.51	3.55
NFS Exports	6.87	6.50	6.29	6.53	7.05	6.98	7.04	7.07	7.11
NFS Imports	2.56	2.95	3.71	3.46	3.67	3.59	3.58	3.56	3.55
Resource Balance	-11.08	-9.01	-9.45	-10.21	-10.57	-12.65	-12.93	-11.18	-11.12
Investment Income (net)	0.53	0.13	0.01	-0.02	-0.04	-0.24	-0.44	-0.62	-0.63
Receipts	0.60	0.25	0.22	0.12	0.14	0.24	0.22	0.20	0.17
Payments	0.07	0.12	0.22	0.14	0.18	0.49	0.66	0.82	0.80
Private Transfers (net)	1.71	1.81	1.82	1.99	2.07	2.11	2.02	1.93	1.85
Receipts	1.80	1.91	1.90	2.16	2.30	0.00	0.00	0.00	0.00
Repayments	0.10	0.10	0.08	0.17	0.23	0.00	0.00	0.00	0.00
Current Account Balance	-8.85	-7.14	-7.62	-8.24	-8.54	-10.79	-11.35	-9.87	-9.90
Official grants	3.90	3.62	3.19	3.76	4.92	4.50	4.81	4.94	5.05
Official Capital (net)	2.74	3.15	3.05	3.55	4.09	5.30	5.62	5.60	5.57
Disbursements	2.86	3.34	3.26	3.85	4.51	5.70	6.06	6.08	6.08
Amortization	0.12	0.19	0.22	0.30	0.41	0.40	0.44	0.47	0.51
Miscellaneous Capital	0.04	-0.22	-0.88	1.51	0.00	1.82	1.72	0.00	0.00
Overall Balance	-2.17	-0.59	-2.26	0.58	0.53	0.83	0.80	0.68	0.70

Table 6: NEPAL: NATIONAL ACCOUNTS

(as a percent of GDP)

	Actual		Prelim.	Rev. Est.	Projected				
	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
GDP (market prices)	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00
GDP (factor cost)	94.59	94.44	93.99	93.95	93.77	92.71	92.20	91.78	91.27
Indirect Taxes	5.85	5.74	6.20	6.25	6.34	7.39	7.90	8.33	8.84
- Subsidies	-0.44	-0.17	-0.19	-0.20	-0.11	-0.10	-0.10	-0.10	-0.10
Resource Gap (M-X)	11.08	9.20	9.45	10.21	10.57	12.65	12.93	11.18	11.12
Imports (G+NFS)	21.31	20.06	21.67	22.97	24.71	26.66	27.09	25.50	25.64
Exports (G+NFS)	10.23	10.99	12.87	12.76	14.14	14.01	14.16	14.32	14.52
Resources Available = Uses	111.08	109.20	109.45	110.21	110.57	112.65	112.93	111.18	111.12
Total Consumption	90.94	89.69	88.10	91.21	90.07	89.14	88.90	88.18	87.52
Private Consumption	83.85	83.56	80.51	83.63	83.82	80.24	79.90	78.88	78.02
Government Consumption	7.09	6.13	7.60	7.58	6.25	8.90	9.00	9.30	9.50
Total Investment	20.14	19.39	20.69	19.00	20.50	23.50	24.03	23.00	23.60
Private Investment	12.15	12.10	13.65	13.13	12.35	15.90	15.98	14.70	15.15
Government Investment	7.98	7.28	7.04	5.87	8.14	7.60	8.05	8.30	8.45
Memorandum Items:									
Domestic Savings (Ig+Ip-RG)	9.06	10.19	11.24	8.79	9.93	10.86	11.10	11.82	12.48
Net Factor Income	0.53	0.25	0.01	-0.02	-0.04	-0.24	-0.44	-0.62	-0.63
Net Current Transfers	1.71	1.81	1.82	1.99	2.07	2.11	2.02	1.93	1.85
National Savings (DS+NFY+Tfp)	11.29	12.25	13.07	10.76	11.96	12.72	12.68	13.13	13.70
Government Savings	-0.24	0.98	-0.38	-0.74	1.04	-0.65	-0.17	0.03	0.45
Private Savings	11.54	11.26	13.45	11.50	10.92	13.36	12.85	13.10	13.25
Foreign Savings	8.85	7.14	7.62	8.24	8.54	10.79	11.35	9.87	9.90

Dear Mr. Conable

Introduction

1. Notwithstanding three decades of development effort which has been supported by the international donor community, Nepal's per capita income is still about US\$160. Over the past 15 years real GDP growth has barely kept up with the growth of population and such social indicators as life expectancy, infant mortality, and adult literacy have remained unacceptably low. Even more worrisome is the fact that in recent years per capita food production has been falling.

2. Much of Nepal's difficulties in achieving a better record in respect of growth and development derive from its meagre resource base and its landlocked position. However, while geographical factors and poor resource endowment have hindered economic performance, the system of production incentives has been inadequate and distorted, and budgetary management has had many shortcomings.

3. In the first half of the 1980s, these factors and a difficult external environment led to increasingly poor economic performance. Although the Sixth Plan (1980/81-1984/85) witnessed an average annual real GDP growth rate of 4.1 percent, the annual performance fluctuated widely on account of the vagaries of weather. Financial indicators increasingly pointed to the emerging difficult situation. Domestic savings was low, and the expansion of bank credit to both the Government and the rest of the economy was high. This contributed to a substantial deterioration in the balance of payments, as a cumulative deficit of over US\$100 million was incurred during 1982/83-1984/85. While most of Nepal's external debt has been incurred on highly concessional terms, in recent years the ratio of such debt to GDP and the debt service ratio rose substantially. During the five years ending June 1985 the former rose from 10.1 percent of GDP to 17.6 percent and the latter measure rose from about 2 percent to about 5 percent.

The Need for Stabilization and Structural Change

4. In the face of the continuing deterioration in both external and internal accounts HMG adopted a stabilization program in December 1985 which has been supported by an 18 month stand-by arrangement with the International Monetary Fund. Principal elements of our program are and have been: a devaluation of the rupee by 14.7 percent, with the exchange rate of the rupee to be managed flexibly with due regard to changes in relative prices and other balance of payments indicators; tighter budgetary policies with the initial focus on expenditure restraint, to be followed by revenue measures; reduced expansion of credit to government and public enterprises; a very

substantial liberalization of interest rates; adjustment in administered prices; restraints on external borrowings and import liberalization. In addition to these measures HMG also embarked on a number of other policy initiatives in the area of public administration and the management of the public enterprises with a view to further supporting the stabilization effort.

5. Our efforts at stabilization have been successful. Real output rebounded in 1985/86 reflecting not only good weather but an improved supply of imported inputs. While inflation picked up, as expected, subsequent to the devaluation, by the end of the fiscal year it had begun to moderate substantially. A tight policy on the wage front has served to consolidate the gains of devaluation. Better budgetary policies were reflected in a reduced fiscal deficit and, most importantly, a halving of domestic bank financing of the deficit which has allowed more credit for the finance of directly productive activities. The balance of payments turned around substantially as a modest surplus was posted compared to the previous year's deficit of US\$50 million.

6. HMG fully intends that the present stabilization program and other initiatives are fully implemented so as to provide the necessary preconditions for orderly decision making by economic units. If growth and development are to be ensured, however, the structure of the economy will have to change. Nepal's economy is beleaguered by numerous structural problems. First, serious environmental degradation (especially in the ecologically fragile hills and mountains), a burgeoning population and pronounced dependence on the vagaries of monsoon agriculture have contributed to a multi-faceted rural crisis. Second, macroeconomic management needs to be strengthened further, and requires special effort to improve performance in the areas of domestic resource mobilization and control of recurrent expenditure and inflationary financing. Third, inadequate control in managing development spending. Fourth, our public administration needs to be strengthened further to support the country's development effort. Fifth, regarding industry and trade, policies which have sought to maintain a low cost economy and at the same time prevent trade deflection, have, inter-alia, given rise to a large number of controls which have provided unwarranted profits to traders and little incentive to productive industrial investment. Sixth, a substantial number of financially weak and, in some cases, heavily indebted public enterprises have not performed well and are a drain on the budget and the banking system. Seventh, agricultural policies also need to be improved in order to stimulate food and other agricultural production. Financially weak sectoral institutions have not only been a drain on public sector finances but have failed to provide the services for which they are mandated. Moreover, there is substantial scope for increasing the role of the private sector.

7. As a first step the policies for which we seek IDA's support focus on the areas of: macro-economic management; development expenditures; trade and industry; agriculture and forestry; and public sector enterprises. In the paragraphs below I will outline the policies which HMG intends to pursue in the near- and medium- term.

#### Macro-economic Policies

8. It is the intention of HMG that the current stance of macro-economic policy to promote growth with stability be continued. In that spirit it is our intention to continue to seek the support of the IMF after the expiry of the current stand-by arrangement. Over the medium-term we hope to be able to achieve a rate of growth of real output of 4.5 percent per annum by the end of the Seventh Plan and to reduce the rate of inflation to about 5 percent per annum. An important element of policy is to increase the level of investment and development expenditures (which includes operations and maintenance). The projected rise in development expenditures by four percentage points to 16 percent of GDP will be financed by both increased utilization of concessionary foreign assistance and domestic resources. At the same time, we intend to maintain the overall fiscal deficit at no more than 11 percent of GDP through 1990/91 and to reduce domestic financing to about 1.5 percent of GDP by improving the utilization of foreign assistance. This will require a major domestic revenue mobilization effort and we intend to increase these revenues, through a combination of new measures and improved administration, to 12 percent of GDP from the present level of 9 percent. Drawing upon past technical assistance it is our intent to introduce a package of fiscal reforms in the FY87/88 Budget — this will include the reform of trade, excise, sales and income taxes. At the same time we plan to limit the growth rate of regular expenditures to that of the economy. Notwithstanding the upcoming three year review of salaries it is our intention that the share of wages in the regular budget will soon return to its present level; it is our intention to strive to reduce the share by containing the size of the civil service payroll through a judicious policy of allowing natural attrition, while at the same time paying due regard to provide adequate salaries. As regards the balance of payments it is our intention to continue to manage the exchange rate flexibly with due regard to movements in relative prices, and the need to increase the production of tradable goods and to strengthen the overall balance of payments position.

#### Development Expenditure Policies

9. During the period ahead we intend to implement policies to improve the management of individual projects and strengthen program/project control structures. We intend to achieve the latter through policies to improve

guidance though improved project selection, program budgeting and work planning based on standard setting. Improved information flows leading to review and corrective action will take place through the installation of monitoring units and a system of reporting and referral to decision makers. Internal discipline will be improved through improved financial accountability and evaluation of managers based on monitoring.

10. During the first part of FY87 we have taken a number of steps to improve development administration. These include the introduction of programming and budgeting in the Ministry of Finance during the 1986/87 Budget preparation period; delegation of more authority to project managers and other senior government officials regarding personnel management and spending; and organizing local donor aid coordination in consultation with the World Bank and UNDP resident representatives.

11. More recently we have installed a trouble-shooting unit in the Cabinet Secretariat. Prototype monitoring systems have been installed to measure progress in this fiscal year in advance of the more comprehensive system which will be installed later. In order to promote and ensure progress toward efficient development spending in the present fiscal year a list of key, foreign-financed projects, have been identified and an overall, spending target for them established, as a basis for determining that a concerted effort is being made to improve global development expenditure performance. Actions to improve their execution will be monitored and work programs for major projects have been drawn up. To ensure that increased spending is resulting from improved management, a sub-set of the key development projects has been identified for prototype monitoring and control using the work breakdown structure (WBS) system. This will allow monthly reporting on resources deployed and progress made against work plans.

12. To improve project auditing and accounting, TORs and the UNDP project document have been prepared in conjunction with the Financial Controller General (FCG) and Auditor General (AG). On the basis of the preliminary findings of this technical assistance, HMG intends to make an assessment of available accounting staff, including the private sector, in terms of quantities of persons and skill levels relative to the need for staff in the FCG's and AG's offices. We further intend to develop an action plan for upgrading, training new staff and for deputing staff to development projects. The plan would also provide for any additional actions identified during the assessments required, to improve the accounting and auditing functions for development projects. This will ensure that project accounts are submitted to the FCG on time and that submission of audited reports to IDA comply with dated covenants.

13. With a view to strengthening the domestic construction industry we have agreed on guidelines for TORs for consultants to develop an action plan. This plan will address the issues of manpower training, contractor registration, contracting procedures, equipment supply, payment, access to credit, etc.

14. During the course of this SAL, and in any case by the time of the formulation of the 1987/88 Budget, we will adopt economic management policies to achieve the objectives of this program, including identifying a core development program. This program would comprise about 70 percent of the development budget and be developed through the newly introduced program budgeting function in the line ministries. The core program would contain a list of facilities to be operated and maintained in six sectors as well as a list of high priority projects selected on the basis of the following criteria: foreign aid content; nearness to completion; economic efficiency; and strategic importance in the country's overall development program.

15. We also intend to strengthen the AG and FCG offices through, inter-alia, the provisions of TA in order to improve audit procedures for all IDA projects. This will ensure that project accounts are submitted to the FCG on time and that submission of audited reports to IDA comply with dated covenants.

#### Industry and Trade Policies

16. Our industrial sector remains small and undeveloped. Although we provide incentives which include, inter-alia, tax holidays and sales tax and import duty concessions there has been little real development in this sector. A major reason for this is that Nepal's tariff structure has not been appropriately aligned with its major trading partner. As a result there has been incentive to re-export, especially in the area of raw materials and intermediate goods and luxury goods. This has created a strong incentive to trade rather than invest in productive industry. Although a large panoply of controls and regulations has been set up to discourage this trade, they have not been successful nor have they increased the profitability of such trade. Such industry as has been set up is heavily biased toward high import content and low domestic value added; issuance of import licenses for goods on the basis of installed capacity has resulted in incentives to overinvest in capacity for which there is no domestic market. With support from the Asian Development Bank and in consultation with the private sector we have reviewed our industrial policy. We are currently reviewing our industrial policy with a view to reducing direct controls and licensing. We anticipate that the new policy will be issued by the end of this fiscal year.

17. Foreign trade with India, our largest trading partner, is generally free. We have recently taken measures to reduce restrictions on foreign trade with other countries. In the area of export licensing we have abandoned the practice of announcing a list of items free from export licensing and have changed to announcing a list of items requiring export licenses with all others remaining free. Items remaining subject to license are certain strategic goods, such as foodgrains, and other items which are subject, from time to time, to export controls in India and consequently covered by a protocol in the Trade and Transit Treaty which provides that Nepal will endeavor to prevent this type of trade deflection. In these cases licenses will be freely given when the bonafides of Nepal origin are established.

18. A principal objective of policy is to introduce more liberal import policies. At the beginning of this fiscal year we introduced a passbook system of automatically granting import licenses for goods subject to licensing on the basis of their installed capacity. This was an improvement over the previous system which called for the periodic issuance of such licenses and thus gave rise to uncertainties. Moreover, we have introduced a system of auctioning import licenses for goods subject to quantitative restriction. It is also our intention to begin converting the current passbook system to an open general license system. At the same time the introduction of higher tariffs will aim inter-alia at reducing the incentive to re-export. This process will take some time. However, as a first step, effective February 1987 we are placing raw wool, gypsum and iron billets under open general license. At the same time, to strengthen the new liberalized trading environment, we intend to increase substantially the penalties for deflection of trade and contravention of the exchange and trade laws of Nepal.

19. The steps to liberalize the industrial and trade environment should contribute directly to our export promotion campaign. Technical assistance is being secured from UNDP to improve our export policies and procedures. This would cover customs (for imports also) and licensing procedures, access to duty free imports including efforts to set up the EPZ, and further rationalization of export licensing and other procedures. Moreover, we have recently established a two-tier export development committee, chaired by the Governor of the Rastra Bank and including the Secretaries of Commerce, Finance and Industry which will meet periodically -- with a secretariat to be provided by the Trade Promotion Center. Finally, two of our principal export industries have been subject to significant vagaries with respect to imported inputs (carpets) and market shares (garments). With a view to guaranteeing the timely and adequate stock of imported wool for carpets we have recently placed wool under open general license. As regards garments we have introduced a policy from late 1986 of allocating the garment quotas well before the end of the Gregorian calendar year, that is by November 1, for the following year.

20. Under our new industrial policy, we have recently moved to liberalize industrial licensing. Whereas previously most industries were subject to license, now cottage industries and those with imported raw material requirements that do not exceed 10 percent of total requirement will not be subject to license. Firms with raw material import requirements that range from above 10 to 40 percent of total requirement and do not exceed Rs 2 million will be subject to license. However, issuance of licenses for this category will be automatic upon review of the bonafides of their technical specifications. Firms having raw material import requirement of greater than 10 percent or Rs 2 million will be licensed as in the past. These measures will substantially increase the number of industries free from licensing.

21. Switching to a simplified system of tariffs is a key element of our adjustment policy. During the course of this SAL, it is our intention to introduce a series of 7 tariff slabs, ranging from 0 percent to 100 percent. An important principle in setting the tariff bands on third country imports is that they will be set with a view to reducing the incentive to re-export them. With a view to harmonizing this objective with our intent to gradually achieve an appropriate rate of real effective protection, fiscal incentives, such as duty draw backs will be introduced. While in principle it is the intent that all commodities should fall within the bands, certain luxury items will remain above the bands and certain commodities which are being taxed to support an administered price, such as POL products, will remain above the ceiling.

22. Finally, with regard to fiscal incentives, we have received substantial advisory assistance with respect to tax policy as it effects both government revenues and incentives. It is our intention during the course of this SAL to draw up an action plan taking into account the advice that we have received from the IMF, the ADB and the IBRD and our private sector. This plan is reflected in our industrial policy statement as well as in our fiscal planning; it will also assist us in our efforts to increase substantially government revenue collections.

#### Agriculture and Forestry Policies

23. Despite considerable and rapidly rising investments in the agricultural sector, crop production has failed to keep pace with population growth. Major causes of this trend include organizational and institutional weaknesses in supporting agencies, the absence of a consistent policy framework and sometimes ineffective operational follow-up. Therefore, in this sector our adjustment policies call for: strengthening the effectiveness of public sector institutions charged with supporting agriculture; reducing, if not eliminating, the drain on public sector finances caused by

such entities as the Agricultural Inputs Corporation (AIC) and the Nepal Food Corporation (NFC); rationalizing the direction and scope of public sector interventions; and making increased use of the private sector to further agricultural development, diversification and growth.

24. An important first step in improving the effectiveness of both AIC and NFC is to strengthen their finances and their financial management. Thus we intend to prepare and implement a time-bound plan to restore the financial viability of both institutions. Technical assistance programs have already been initiated to help improve the accounting systems of both corporations. We intend that AIC will complete its overdue accounts for 1984/85 and 1985/86 within the next few months. In addition we have taken steps to liquidate AIC's debts and to ensure that it is paid for fertilizers sold to the rural cooperatives (Sajhas). Adequate provision of funds will be made in HMG's 1987/88 Budget to cover the difference between AIC's budgeted costs and expected sales revenues. NFC's accounting capacity has already been significantly strengthened; an important aspect of this concerns the adoption of practices to allow a clear distinction between NFC's commercial operations and its social welfare responsibilities. We expect NFC to submit final accounts for all years through 1985/86 very shortly and to henceforth submit accounts within six months of the close of the financial year. We have also taken measures to ensure full and prompt payment to NFC by other public sector entities for foodstuffs delivered to them by November 1987. Similar to the provision to be made for AIC, beginning with HMG's 1987/88 Budget adequate provision will be made to compensate NFC fully for carrying out welfare functions on behalf of HMG; additionally, NFC will be provided with sufficient operating funds to undertake its day-to-day operations.

25. Improving the effectiveness of fertilizer procurement and distribution throughout the country is an important goal of our structural adjustment policies. Among major issues being addressed are nutrient content and agronomic suitability of fertilizers imported, finances and pricing, and improvements in the distribution system. Substantial quantities of fertilizer have been imported into Nepal which are low in nutrient content, have high unit transport costs and are of doubtful utility on most of Nepal's soils and crops. Our farmers, however, have grown accustomed to this fertilizer. While eliminating such imports in one year is not feasible, therefore, it is our intention to phase out the imports of such fertilizer financed by our own resources and to request donors to finance fertilizers more appropriate to Nepal.

26. Consistent with our ongoing efforts to strengthen AIC's financial and operational management and to promote the economic use of fertilizer, we have introduced more flexibility into fertilizer pricing. These measures include: clarification of the criteria for determining the structure of fertilizer

wholesale prices in different regions; regular monitoring of fertilizer prices on both sides of the Indo-Nepal border and, if significant differences exist, prompt adjustment of fertilizer wholesale prices with a view to eliminating the incentive for unauthorized fertilizer exports; and empowering AIC to automatically adjust prices by up to 10 percent if incentives to smuggle begin to emerge or costs increase. As regards the distribution of fertilizer, we have in recent years been relying increasingly upon the private sector. Its share in total distribution is estimated to have increased from less than 3 percent in 1983/84 to 25 percent in 1985/86. To improve fertilizer availability throughout the country we are now licensing private traders to engage in fertilizer distribution in all parts of the country on both a wholesale and retail basis. Consistent with this, we will increase the permissible retailers' margins in FY88, so as to provide better incentives, and by Sajhas provide financial incentives for off-season purchases from AIC. Our cooperatives, the Sajhas, represent an important part of our national institutional structure. In the past they have relied primarily upon profits made from trading in fertilizer to finance their activities. It is our intention to frame a plan to reduce their dependence upon fertilizer related activities, to the extent mandated by the growing role of the private sector, and to help them find alternative means to finance their activities.

27. Crop production is also constrained by inadequate supply and the very low rate of use of quality cereal seeds. Improvement in this sector requires a broad range of actions with respect to institutions, operations and financial arrangements. The key objectives of structural reform in this subsector include: improving the supply and timely availability of quality cereal seeds; providing a clear legal basis and effective institutional arrangements for all essential institutions involved; and expanding the capability of the existing seed production, processing and marketing system, including through increased utilization of private sector capacities. Key elements of change will be the adoption of a National Seed Act to provide the legal framework and basis for regulating seed production, processing, certification and marketing and the creation of a national authority to regulate the seeds industry and trade.

28. Foodgrain marketing and distribution is another area where we intend to effect substantial changes. Although foodgrain trading in Nepal is overwhelmingly a private sector activity, increasing concerns over potential threats to food security have led to some public sector involvement. The objective of adjustment in this sector is to promote increased foodgrain security throughout the country and to achieve this more effectively and at a lesser cost than in the past. An important precondition for this is to improve the financial and operational efficiency of NFC, and we have detailed

measures to achieve this above. Beyond that, we intend to adopt a number of measures which will improve operations in this sector.

29. With respect to domestic foodgrain procurement by NFC, we have already discontinued procurement through levies; henceforth, all procurement from domestic production will be exclusively through purchases at or above procurement prices announced prior to sowing/planting and set with due regard to those in effect across the border. As noted above, we have already made provision for sufficient operating funds to NFC to ensure effective primary procurement operations during 1986/87, and we intend to ensure adequate funding in the future. To make procurement more efficient at the farmgate level, we are now also utilizing Sajhas as intermediaries in NFC's foodgrain procurement.

30. NFC foodgrain sales in the Kathmandu Valley have long taken place at subsidized prices and to the population at large, rather than to clearly identified needy target groups. We have already begun to implement a program for operating an effective consumer price stabilization program in the Kathmandu Valley, replacing the current practice of subsidized year-round sales, as a pilot operation for future replication in other major consumer centers. It will be extended to all other accessible areas in two additional phases. An important aspect of this program is that NFC's market sales (e.g., excluding food distribution under specific relief and welfare programs) will take place at prices that fully cover domestic unit costs. Furthermore, we have begun work on preparing a detailed plan for identifying consumer groups vulnerable to chronic and/or severe seasonal food shortages and for distributing foodgrains to them.

31. Agricultural research in Nepal has been fragmented, inadequately funded, without clear objectives and priorities, and subject to inappropriate administrative procedures. As a first step toward the eventual creation of an autonomous research planning, funding, and coordination body at the national level, which would set national research priorities, control funding and provide the necessary incentives for research and coordination with other institutions, we have established a National Agricultural Research Coordination Committee (NARCC), supported by a permanent secretariat, with adequate permanent staff and other resources. In addition we have established a National Agricultural Research Services Center (NARSC) to manage agricultural research activities in accordance with the guidelines and priorities established by NARCC. We also intend to prepare a plan for establishing, by the end of the Seventh Plan period, an autonomous National Research Board or Council, to be created out of the nucleus provided by NARCC, NARSC and the research units of other entities currently under the administrative control of the Ministry of Agriculture.

32. Nepal's forestry resources are rapidly diminishing. Given the limits on HMG's financial and human resources, it is essential to involve the population at the local level in efforts to manage the country's forestry resources. We have already taken various steps to facilitate this, but have found that there still are important disincentives which need to be eliminated. Accordingly, we intend to modify the existing legal and administrative regulations concerning revenue collection so as to allow legally established forest user groups at the Panchayat or Ward level to retain the entire revenues realized from the sale of forest products extracted from Panchayat Protected Forests under their management immediately upon the realization of such revenues. Moreover, we intend to authorize these forest user groups to employ a paid member-secretary to conduct day-to-day business, and hire laborers needed (e.g., nursery staff, forest watchmen, forest foremen) to manage forests and related assets and facilities under their care. We also will take steps to provide the necessary clarification of legal and administrative provisions concerning the ownership and utilization of trees on privately-owned land.

#### Public Enterprise Policies

33. Nepal's public enterprises represent a very mixed group of undertakings and they have generally performed poorly. During the immediate period ahead we plan to focus on measures to improve the operating efficiency and strengthen the finances of the AIC and the NFC. Consistent with HMG policy in this sector—which is that most of these industries should be sold in whole or part and that only those industries occupying a non-commercial or natural monopoly position should continue to be operated in the public sector—we intend to implement a number of other measures to begin to reduce the size of this sector and strengthen its managerial capacity and finances. We have classified most of the existing corporations into those which are to be sold, in whole or part, and those to be retained in the public sector. For those PEs which remain in the public sector and require subsidies there will be explicit budgetary provision. Furthermore, to guide future decisions in this area we plan to formulate by early 1987/88 a policy to guide any new investments in and by public enterprises and their operation.

34. Recently, with a view to gaining better control over the finances of the PEs we have adopted a new policy of limiting severely the issuance of government guarantees for PE borrowings from the banking system. This will curb the use of bank credit by PEs and ease the task of the financial management of the economy as well as disciplining the PEs. Henceforth, PEs will have annual credit plans and the Government will limit its guarantee only to the amount in the annual plan.

35. With a view to increasing the efficient management of the PEs, Government has for the last two fiscal years established criteria for applying as to awards and penalties to PE managers on the basis of their performance. We are currently determining the awards and penalties to be applied and intend to implement these accordingly. This should enhance the management of the sector.

36. During the course of this SAL we intend to prepare an action plan to be supported with technical assistance for closure, partial or complete divestiture, and/or management and financial reform of the PEs. It is envisioned that these plans will be formulated for each PE and that they will include specific time-bound recommendations with respect to finances, management and steps to lead to divestiture or closing if that is the case. Recommendations with respect to finances will include, inter-alia, changes required to adjust the prices charged by natural monopolies to at least break-even levels.

37. Finally, studies will be undertaken in the period ahead to lay the foundation for subsequent policy and institutional reforms. These might be in the areas of agricultural development strategy; further analysis of industrial and trade policy (including tourism), and possible linkage with the power sector; public administration reform; financial sector reform; and the issue of the pricing trade in energy.

38. It is the belief of His Majesty's Government that the policies set out above provide the basis for a strong program of structural adjustment as well as reflecting our commitment to a process which will spread over a number of years. We look forward to the support of IDA and to working with you and your colleagues in the years ahead.

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(Bharat Bahadur Pradhan)  
State Minister for Finance  
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His Majesty's Government  
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## POLICY MATRIX 1/

<u>Policy Area and Objectives</u>	<u>Action Taken</u>	<u>Action To Be Taken</u>	<u>Timing</u>
<p><b>I. <u>Macroeconomic Policy</u></b>            To promote balanced growth by achieving the following targets with respect to GDP by 1990/91:            hold fiscal deficit to 11%            hold domestic financing to 1.5%            raise development spending to 16%            raise government revenue to 12%            hold regular spending to about 7%            raise government surplus to 5%            raise foreign aid use to 10%</p>	<p>a. initiated talks on double taxation agreement with India;</p> <p>b. introduced sales tax credit system on imports of raw materials;</p> <p>c. established separate sales tax offices in six major industrialized urban centres and created a post of deputy director in the tax department for sales tax collection and supervision;</p> <p>d. revised and improved existing tax laws, conducted workshops to train officers and junior technicians joining revenue department;</p> <p>e. established separate office in the ministry under the joint secretary for non-tax revenue collection;</p> <p>* f. liberalized interest rate policy, authority to commercial banks to set own interest rates on deposits and lending subject to minimum;</p> <p>g. changed system of minimum reserve requirements to include minimum deposit provision;</p> <p>* h. imposed ceilings on net domestic assets and credit expansion by monetary authority;</p> <p>i. licences given to two new commercial banks with foreign partners; and</p> <p>* j. devalued by 14.7% and adopted a currency basket system to manage the exchange-rate.</p>	<p>a. continue sound macroeconomic policies</p>	<p>prior to 2nd tranche</p>
<p><b>II. <u>Development Expenditure Policy.</u></b>            To increase steadily the level quality of investment and O&amp;M expenditures through improvements in project identification,</p>	<p>a. in January 1986, gazette and notification gave more authority to project managers and other senior government officials re personnel management and spending;</p>	<p>a. program budgeting procedures applied on all project in agriculture, irrigation, forestry, power, and transportation in detail and rudimentary analysis</p>	<p>to be monitored</p>

1/ \* Denotes actions under IMF program.

management, and resource control.

- b. increased utilization of foreign aid from 6.9% of GDP in 1985/86 to around 8.2% in 1986/87;
- c. prior to the 1986/87 budget, P&B exercise started in MoF for agriculture, irrigation and forestry.
- d. 78 (about 50% of Development Budget) projects being monitored on the basis of budgetary release;
- e. 13 projects of the 78 being monitored on the basis of both physical and financial performance through prototype monitoring systems;
- f. consultants have been selected and have started work on extending the coverage of P&B methods and introducing improved program monitoring and control systems and procedures; and
- g. guidelines for terms of reference have been agreed for consultants to design a program of action to strengthen accounting and auditing functions within HMG.

### III. Industrial and Trade Policy

To move toward a more liberal policy regime for industry, exports and imports

- a. in February 1986, 23 industrial items were freed of requirement for industrial licensing;
- b. agreed with IDA on criteria for significant liberalization of industries free from industrial licensing;
- c. FY1986/87 budget introduced trade taxes; revised tariff rates on imports of raw materials. New rates range from 1% to 5% and 10% according to type of raw material imported and nature of;

of all other projects.

- b. "Core" development program formulated. prior to 2nd tranche;
- c. program monitoring and control systems installed. to be monitored
- d. improved practices introduced and HMG capacity strengthened in accounting and auditing. to be monitored
- e. achieve satisfactory performance in respect of implementing the 13 key development projects being monitored financially and physically. prior to 2nd tranche
- f. consultants to be selected to strengthen accounting and auditing functions within HMG; to be monitored

- a. formulation and introduction of a program of income, sales and excise reforms; Covenant: by July 15, 1987
- b. implementation of industrial policies in conformity with issued policy statement; to be monitored
- c. conversion of the tariff structure to be system of 7 bands ranging from 0-100%; Covenant: by July 15, 1987

d. draft industrial strategy paper prepared and reviewed within government, discussed with ADB and IDA, industrial seminar convened;

e. converted list of items free from export industrial licensing to list of items requiring license, all others free;

f. introduction of OGL began;

g. initiated a system of auctioning import licences on imports subject to quantitative restrictions;

h. introduced pass-book system for industrial raw material imports;

i. established a two-tier export development committee;

j. introduced a mechanism for allocating US garment quotas before the start of each year;

d. implementation of program to improve and streamline procedures for implementing export and import policies; to be monitored

**IV. Agricultural Policy**  
**Fertilizer:**

To increase supply and timely availability of appropriate fertilizers; improve economic returns on investment in fertilizers; reduce losses

a. AIC's accounts for 1984/85 completed and submitted to the Auditor General;

b. a time-bound action plan prepared for strengthening AIC's financial viability;

c. introduction of a comprehensive program to improve the pricing and distribution of fertilizer;

d. provide financial incentives to Sahas and private dealers for off-season purchases from AIC;

e. draft statutes for National Seed Board and draft Seed Act prepared and being reviewed;

f. simplify cereal seed purchase pricing procedures and increase dealer incentives.

g. rationalize purchase of cereal seeds;

h. provide for repurchase of seeds;

a. increasing the retail trading margins by 2 percentage points and semi-annual review of wholesale fertilizer prices; Covenant: by October 15, 1987

b. specific provision in the budget defraying the excess of budgeted costs over revenues. to be monitored

c. implementation of a simplified cereal seed sales pricing system, including elimination of subsidy on seeds; Covenant: by Oct. 15, 1987

d. provision of greater financial autonomy to the Seed Division of AIC and transfer within AIC of responsibility for seed distribution and marketing to the Seeds Division; Covenant: by Oct. 15, 1987

e. establishment of a National Seed Board; Covenant: by Oct. 15, 1987

**Seeds:**

To improve supply and timeliness especially for major foodgrains; improve efficiency of main institutions in the seed sector; promote greater private sector participation to expand existing seed production, marketing and processing system.

i. prepare proposal to revise cereal seed sales prices;

f. designation of farms for the production of foundation seed. to be monitored

g. initiation of a program for improving hill farmers' access to seeds; to be monitored

h. introduce smaller, more appropriate bags for the transportation and marketing of certified cereal seeds; to be monitored

Foodgrain Marketing and Distribution

Increased food production and security throughout the country through stabilization of consumer prices, provision of incentives.

j. prepared and initiated work on a time-bound action plan to restore the financial viability of NFC.

i. submission to the Auditor General's office of complete final accounts for AIC and NFC for all financial years through 1985/86; Covenant: by Oct. 15, 1987

k. initiated steps to strengthen NFC's accounting including the separation of accounts for commercial activities and those associated with government's social welfare programs;

l. initiated a time-bound action plan for other public sector entities to bring current their overdue obligations to NFC;

j. provision of sufficient budgetary allocation to compensate NFC for the costs of carrying out welfare-oriented functions on behalf of HMG; second tranche

m. abolished foodgrain procurement levy;

n. involvement of the Sajhas in NFC's food grain procurement;

k. preparation of a detailed plan for identifying consumer groups vulnerable to chronic and/or severe seasonal food shortages and for distributing foodgrain to such target groups; to be monitored

o. initiated a market-oriented consumer price stabilization program in the Kathmandu Valley;

l. completion by the Auditor General's Office of audits for AIC and NFC accounts for the years from 1982/83 through 1985/86; Covenant: by Jan. 31, 1988

Research:

To improve the management of the agricultural research activities, expedite development and testing of improved technology and improve utilization of trained manpower

p. established a National Agriculture Research Coordination Committee, a permanent secretariat and a National Agricultural Research Services Center with a plan for staffing these bodies.

m. preparation of a plan for establishing by the end of the 7th Plan, an autonomous National Research Board or Council; to be monitored

**Forestry:**

To improve the role of the panchayats in developing, managing and using local forestry resources

**V. Public Enterprise Policy**

To limit the scope of public enterprise activity and improve efficiency of remaining PEs.

- a. physical and financial targets set at beginning of fiscal year and performance evaluated quarterly
- \* b. increased prices of commodities (sugar and fertilizer) to reduce subsidy;
- c. floated shares of some public enterprises;
- d. categorized PEs as whether they are to be retained, sold in part or sold outright;
- e. introduced control of PE borrowings.
- n. allow forest user groups to retain 100% of revenues from forest activities. prior to 2nd tranche
- o. preparation of an action plan for closure, divestiture and/or managerial reform of the PEs; prior to 2nd tranche
- p. implement the 1984/85 and 1985/86 award and penalties for PE managers. to be monitored

