

# OED Précis



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## Structural Adjustment in Nepal

*In the 1980s, Nepal launched a modernization program, which the World Bank supported through two structural adjustment credits (SALs). An OED audit\* of the second SAL finds that many of the program's initiatives have begun to take root, especially in opening up foreign trade and liberalizing the financial sector, helping to increase private investment. But government changes and trade disputes with Nepal's major trading partner plagued implementation, and wavering government commitment and poor donor coordination limited the program's institution-building efforts.*

*The audit notes that for the recent benefits to last over the long run, the reforms need to be extended and deepened, especially in improving public resource management and establishing adequate regulation and supervision of the banking system. For the reforms to continue, government ownership of the program becomes key—an element that could be facilitated through improved donor coordination and the involvement of line ministries and government agencies in program design.*

### Project context and goals

Foreign assistance supports roughly two-fifths of Nepal's government spending. Like other assistance agencies, the World Bank has had difficulty implementing projects in Nepal. Weak institutional capacity, wavering government commitment, and fragmented authority among ministries, combined with highly centralized dis-

cretionary authority, continually slow progress in investment projects.

The Bank's first structural adjustment credit (SAL I) was launched in 1986, partly in the hope that it would mobilize stronger political support than investment projects had done. SAL I emphasized sound macroeconomic management, effective management of public finances, support for agriculture and light manufacturing, liberalization of trade, and a start at reforming public enterprises.

The adjustment loan did indeed succeed better than previous credits. In 1989 the Bank followed up with SAL II, even though at the time, Nepal did not face a balance of payments emergency. The loan was designed to consolidate and reinforce the earlier operation: to revamp the tax system, rationalize the management of development spending, restructure two large state-owned banks and open up the financial sector, improve the distribution of fertilizer, and make irrigation more effective.

### Design and implementation

SAL II was designed as a fast-disbursing \$60 million credit. It was structured to disburse in three tranches, instead of the usual two, giving Bank staff leverage to press for reforms during the implementation period.

But the design of SAL II had several problems. The credit was approved before the preparation of the important irrigation and financial sector components was complete. As a result, it was necessary to rely on technical assistance before firming up action plans, which led to vague conditionality. And although the credit addressed important problems, line ministries and agencies whose support was essential for successful implementation were not involved in designing the loan and hence felt little ownership of the program.

While the foreign trade component was well thought out, measures to strengthen the tax system and to eliminate waste and inefficiency in the management of public resources were not. The action program in the financial sector consisted largely of studies, because of inadequate knowledge of the measures needed there. And some potentially effective conditions (af-

*\*Performance audit report, "Nepal: Second Structural Adjustment Credit," by Luis Landau. Report No. 14813. June 30, 1995. Performance audit reports are available to Bank executive directors and staff from the Internal Documents Unit and from Regional Information Services Centers. Précis written by Pat McNeess.*

fecting fertilizers, irrigation, and banking) were formulated in vague terms. Fortunately, however, effective supervision helped to overcome these weaknesses, bringing about some degree of implementation of the needed reforms.

Unexpected problems plagued implementation. A dispute with India in early 1989 seriously disrupted trade, creating shortages and losses in output. A revolution in mid-1990 and a succession of administrations after that made continuity of policies increasingly difficult. And part of the technical assistance from donors was wasted because of donors' disputes over jurisdiction and Nepal's weak institutional capacity to absorb the assistance.

It is thus remarkable that despite the plethora of problems, many of the reforms were implemented and the credit was fully disbursed (albeit with delays). The Bank's continuing dialogue with successive administrations had helped to develop among many officials a growing understanding of the need for structural reform. The program's most important successes were in helping to liberalize trade (domestic and international) and the financial sector.

## Results

The reforms stimulated an expansion of private enterprises engaged in export-oriented manufacturing, commerce, tourism, and banking. Although serious problems remain, important achievements were also realized in finance and agriculture.

In finance, the restructuring of the Nepal Bank helped it become

solvent. The program also helped strengthen the role of privately owned banks and financial institutions. In 1995, ten joint ventures and private banks were operating in Nepal, compared with three before the program. There were 24 nonbanking finance companies, mostly leasing and mutual funds, compared with a handful before. The banks offer loans to creditworthy borrowers in trade, tourism, and manufacturing, and are introducing modern banking technologies and practices. By contrast, the other large state-owned bank (Rastriya Banijya Bank), which did not go through restructuring, remains technically bankrupt. And inadequate prudential regulations and weak bank supervision threaten the stability of the banking sector.

Responding to the progress made in freeing the fertilizer distribution system, the number of private dealers rose fivefold between 1989 and 1992. But restrictions and other controls still favor official traders. The program had some success in convincing the government to shift from large- to small-scale irrigation projects. And farmers were allowed some involvement in the management of local water resources. But too little of the irrigation budget is spent on operating, rehabilitating, and maintaining the irrigation system.

Although the achievements have been significant, the shortcomings show the need to deepen the reforms. For example, the tax structure remains inelastic and dependent on many low-yield specific taxes and on domestic customs levies that interfere with local trade. The management of public resources has not improved and many projects of doubtful justification compete for

funds and attention with a few high-priority investment operations that take a long time to be completed.

## Lessons

Given the extremely adverse conditions in Nepal during 1989-92, the adjustment programs' achievements were noteworthy. The experience offers some important lessons:

- *To increase the government's ownership of reforms, the line ministries and other government agencies need to participate more fully in the design of reforms. Better aid coordination is urgently needed. Efforts to better coordinate donor activities have not succeeded, so resources are wasted, efforts are duplicated, and jurisdiction is disputed, undermining aid effectiveness. Better donor coordination could be facilitated by increasing the role of the Bank's resident mission.*
- *The Bank should not call for reform without good knowledge of the measures needed. If the SALs had been more thoroughly prepared, conditionality might have been better defined, calling for more specific measures such as a new value-added tax, reduced subsidies, or specific banking reforms, rather than for studies. Conditionality was ambiguous because reforms were called for before problems in the financial and irrigation sectors were fully understood. Given the well-known difficulty of implementing projects in Nepal, the Bank should have called for actions that were feasible despite the country's institutional weakness and the limited political support for measures that affect vested interests.*

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