PRGF

[Poverty Reduction & Growth Facility]

& Nepal

Nepal Rastra Bank
Research Department
International Finance Division

Poverty Reduction and Growth Facility (PRGF)
and
Nepal

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Foreword

With the objective of making poverty reduction and growth more central to lending operations in its poorest member countries, the International Monetary Fund (IMF) established the Poverty Reduction and Growth Facility (PRGF) arrangement in September 1999. The PRGF-supported programs are framed around the country-owned Poverty Reduction Strategy Paper (PRSP) prepared by the governments jointly with the civil society and other development partners, which provides the basis for targets and policy conditions in PRGF. An eligible country (based on the IMF's assessment on the country's per capita income and the cutoff point for eligibility to World Bank concessional lending) may borrow either up to a maximum of 140 percent or 185 percent of IMF's quota in normal or exceptional circumstances respectively, under a three-year arrangement. Under PRGF arrangement, the IMF can extend loans at an annual interest rate of 0.5 percent, with repayments made semiannually, over the period from 5½ to 10 years after the initial disbursement. Accordingly, on 14 November 2003, the IMF Executive Board approved a three-year PRGF arrangement to Nepal for an amount equivalent to SDR 49.9 million (about US$79.1 million) to support the country's economic reform programs. The period was later extended for one year to November 2007.

Against this backdrop, with a view to explore the professional, independent and analytical ideas on the need, importance, relevance, and impact of the PRGF supported programs in Nepal; we have brought this volume consisting of four scholarly works by the prominent resource persons. I believe that this volume will serve as an important reference material for those who have abiding interests on the issues related to the IMF supported programs.

In this connection, I would like to extend my sincere thanks to Mr. Alexander Pitt, Dr. Shankar Sharma, Mr. Tula Raj Basyal and Dr. Dandapani Poudel for contributing scholarly papers on the various aspects of PRGF arrangement in Nepal. Also, my special thanks go to Mrs. Shiba Devi Kafle, Director, Mr. Shaligram Dahal, Deputy Director, Dr Bishnu Prasad Gautam, Deputy Director, Dr. Dilli Ram

Pokhrel, Assistant Director and Mr. Satyendra Timilsina, Assistant Director of Research Department for their painstaking efforts in bringing this volume in the present form. Last but not least, I would appreciate Mr. Amar Ratna Bajracharya, Computer Supervisor, for his excellent support in the formatting and designing of this book.

Finally, I would like to mention that the views and opinions expressed in this book are those of the authors themselves and do not necessarily represent that of Nepal Rastra Bank.

Thank you.

July 2008

Trilochan Pangeni
Executive Director

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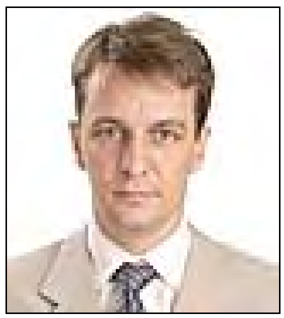
PRGF: Importance and Need in Nepal



Alexander Pitt
IMF Resident Representative, Nepal

The Poverty Reduction and Growth Facility

The Poverty Reduction and Growth Facility (PRGF) is the IMF's lending window for low-income countries (for terms of the PRGF, see Box 1). Like all support from the IMF, it is intended to alleviate balance of payments pressures and is not designed to support the government budget. The facility was established in September 1999 to make the objectives of poverty reduction and growth more central to the IMF's lending operations in its poorest member countries. The IMF had previously already provided concessional assistance to low-income members (including Nepal), but the PRGF enhanced this effort by integrating lending under this window more closely with a comprehensive policy framework, as outlined in Poverty Reduction Strategy Papers (PRSPs). PRSPs are prepared by governments with the active participation of civil society and development partners, and are then considered by the Executive Boards of the IMF and World Bank as the basis for concessional lending from each institution.[1] Support under the PRGF facility is provided for a three-year program of macroeconomic and structural policies as outlined in the PRSP. The targets and policy conditions under the program are drawn directly from the PRSP, and are therefore closely related to the member country's effort to reduce poverty and raise economic growth.

Key features of the PRGF include:

- *First, the principle of broad public participation and greater country ownership is central to the PRGF.* In this regard, discussions on the policies underlying PRGF-supported programs are more open, since they are based on the national PRSP. With increased national ownership, PRGF conditionality has become more parsimonious, focused on the Fund's core areas of expertise, and limited to measures that have a direct and critical impact on the program's macroeconomic objectives.

- *Second, PRGF-supported programs reflect more closely each country's poverty reduction and growth priorities.* Key policy measures and structural reforms aimed at poverty reduction and growth are identified and prioritized during the PRSP process, and if feasible, their budgetary costs are assessed. Countries' budgets under PRGF-supported programs reflect this analysis. Moreover, fiscal targets in PRGF-supported programs respond flexibly to changes in country circumstances and pro-poor policy priorities, while ensuring that the strategy can be financed in a sustainable, non-inflationary manner.

- *Third, PRGF-supported programs focus on strengthening governance in order to assist countries' efforts to design targeted and well-prioritized spending.* Of particular importance are measures to improve public resource management, transparency,

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[1] The PRSP also provides the basis for debt relief under the joint Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI).

and accountability. PRGF-supported programs also give more attention to the poverty and social impact of key macroeconomic policy measures.

Box 1: Terms of the PRGF

As of August 2007, 78 low-income countries are eligible for PRGF assistance. Eligibility is based principally on the IMF's assessment of a country's per capita income, drawing on the cutoff point for eligibility to World Bank concessional lending (currently 2005 per capita gross national income of $1,025).

Access to IMF resources under the PRGF—i.e. the amount that can be borrowed by the member—is committed for three years, with a possible extension of up to one year. A first installment of these resources is released upon approval of the arrangement by the IMF's Executive Board, and thereafter upon completion of regular reviews. Reviews are generally scheduled every six months.

Access under the facility is, like all access to IMF resources, based on the member's quota, or share in the IMF. In each case, the amount will depend on the country's balance of payments need—i.e. the shortfall of foreign exchange—, the strength of its adjustment program, and its previous and outstanding use of IMF credit. The maximum access, available under exceptional circumstances, is 185 percent of a member's quota. Maximum access under non-exceptional circumstances is 140 percent of quota. For a first-time user of the PRGF, access is generally expected at about 90 percent of its quota. Thereafter, access is expected to decline in subsequent arrangements. "Low-access" PRGF arrangements with a standard level of 10 percent of quota may be used for members with little or no immediate balance of payments need.

Loans under the PRGF carry an annual interest rate of 0.5 percent, with repayments made semiannually, beginning 5½ years and ending 10 years after the disbursement.

Concessional lending under the PRGF is administered by the IMF through the PRGF-ESF and PRGF-HIPC Trusts. The PRGF-ESF Trust borrows resources from central banks, governments, and official institutions generally at market-related interest rates, and lends them on a pass-through basis to PRGF-eligible countries. The difference between the market-related interest rate paid to PRGF-ESF Trust lenders and the rate of interest of 0.5 percent per year paid by the borrowing members is financed by contributions from bilateral donors and the IMF's own resources.

PRGF-supported programs are designed to cover only areas within the primary responsibility of the IMF, unless a particular measure is judged to have a direct, critical macroeconomic impact. Areas typically covered by the IMF include advising on prudent macroeconomic and financial policies and related structural reforms such as exchange rate and tax policy, fiscal management, budget execution, fiscal transparency, and tax and customs administration.

Reviews of the PRGF by IMF staff in 2002 and by the Independent Evaluation Office (IEO) of the IMF in 2004 confirmed that the design of the programs supported by PRGF lending has become more accommodating to higher public expenditure, in particular pro-poor spending. Building on this progress and in response to a 2007 IEO report on the IMF and Aid to Sub-Saharan Africa, the IMF in 2007 adopted principles to promote the full use of external aid while maintaining macroeconomic and debt sustainability. A review of PRGF program design by the Executive Board in September 2005 found that while macroeconomic outcomes in low-income countries had improved markedly in recent years, per capita income remained low. The review noted in particular, the importance of broad economic institutions for sustained growth and stability, and the need to manage carefully increased aid flows.

The Rationale for Nepal's PRGF Arrangement

The government and central bank of Nepal had requested and the IMF's Executive Board approved a PRGF arrangement in November 2003. This arrangement supported the implementation of the government's Tenth Plan, which covered the period from 2002/03 until 2006/07. With the overarching goal of reducing poverty, the plan rested on four pillars: (i) promotion of faster and pro-poor economic growth, (ii) equitable access to social and economic infrastructure and resources for the poor and marginalized groups, (iii) social inclusion and targeted programs, and (iv) improved governance. The Tenth Plan noted that the growth strategy needed to be rooted in macroeconomic stability, requiring a reduction of the domestically financed budget deficit over the medium term.

Discussions on the PRGF-supported program and the macroeconomic and structural policies it contained lasted through the summer of 2003. The program and its targets and conditions concentrated on macroeconomic management and on structural reforms within the IMF's areas of expertise supporting the implementation of the Tenth Plan. As is standard, the program covered a period of three years, with semiannual reviews of progress. Disbursements of IMF resources during that time were envisaged at 70 percent of Nepal's quota, or about $75 million, with an initial release of $10¾ million, and subsequent amounts as reviews were completed.

The PRGF assisted the government of Nepal at a time of increased economic strains against a backdrop of an intensifying internal conflict. While, thanks to rising remittances, the balance of payments need was only modest the overall macroeconomic situation was deteriorating as spending and with it the public sector deficit had increased. At the same time, economic reforms were difficult to implement.

The rationale for the PRGF arrangement therefore consisted not only in providing financial resources but also in supplying a framework for tackling emerging economic imbalances, and focusing and reinforcing the structural reform effort. An additional role was to provide the signaling that IMF support sends to third parties, in particular multilateral and bilateral donors. The role of the arrangement was to provide:

- *Financing.* The PRGF mobilized financial resources that contributed to filling the balance of payments gap and thereby maintain foreign exchange reserves at a comfortable level.

- *Macroeconomic policy framework.* Fiscal and monetary policies were aimed at protecting the balance of payments and maintaining an adequate reserve cover while mobilizing the resources required to implement the four-pillar strategy of the Tenth Plan. The **fiscal strategy** centered on three key elements: (i) mobilizing additional revenue, including through increases in the VAT rate; (ii) redirecting expenditure to social and key infrastructure sectors to reduce poverty and raise growth, and (iii) containing domestic borrowing to protect fiscal sustainability and macroeconomic stability. **Monetary policy** remained geared to supporting the peg to the Indian rupee which had served Nepal well given its close ties with India. However, prospective developments during the program period—including the phasing out of the multi-fiber agreement in 2005—were anticipated to warrant periodic review of the level of the peg. The **quantitative conditions** under the arrangement—i.e. the targets for macroeconomic policy variables under the control of the government and the Nepal Rastra Bank (NRB)—were set to deliver macroeconomic outcomes outlined above.

- *Structural reform effort.* Structural reform policies were designed to support the macroeconomic goals of the program and lay the basis for more rapid economic growth. The **structural conditionality** under the arrangement—i.e. policy reform measures not of a quantitative nature—constituted a critical element to secure the implementation of key measures required to achieve the goals of the program and the Tenth Plan. To mobilize additional funds, the strengthening of **revenue administration** was a central goal of the program. Reforms were undertaken in the Internal Revenue and Customs Departments, and the Large Taxpayers' Office was created to devote additional administrative resources to the largest taxpayers. **Financial sector reforms** were aimed at strengthening the NRB, improving financial sector legislation, fostering loan recovery, and restructuring commercial and development banks. Reforms in the **public sector** centered on privatizing or liquidating unviable enterprises and divestment from profitable ones to enhance their efficiency.
- *Signaling.* An on-track IMF arrangement generally provides a positive signal for donors to provide support as well, in particular budget support not tied to specific development projects.

Achievements of the PRGF

The PRGF was broadly successful in achieving its macroeconomic targets, though the structural reform agenda requires a longer-term intensive effort to fully achieve its objectives. While the fiscal adjustment in the run-up to and under the program was significant, structural reforms proved more difficult to tackle. To some extent, this can be attributed to broader political factors, including the assumption of direct rule by the king in early 2005, but also to the difficulty in countering powerful interest groups, as well as the reluctance of the key decision makers to undertake controversial measures. These factors led to numerous delays in program implementation and only partial disbursement of funds in the originally envisaged timeframe, to the extent that before April 2006 only one review was completed, with a delay of six months. Political circumstances and slow reform implementation also prevented the arrangement from playing its signaling role to the fullest extent possible. However, after *Jana Andolan II,* the new government made a determined effort to bring the program back on track, which made possible an extension of the IMF's commitment by one year, and the rescheduling of remaining reviews.

During the entire program period, progress was made in reaching the macroeconomic goals envisaged. Macroeconomic stability, the overarching aim, was preserved even during the civil war and in difficult political circumstances. Numerical targets were for the most part achieved, in some cases with significant margins. However, the structural elements of the fiscal program were achieved only partially, or later than initially envisaged.

- *Fiscal policy.* Domestically financed deficits remained below one percent of GDP (except in 2005/06 when revenue collection declined in the second half of the year), a tighter policy stance than planned. [2] This arose from the under execution of expenditure, in part in response to shortfalls in revenue and aid, and in part due to the inaccessibility for the government of remote areas of the country due to the insurgency.

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[2] All indications of GDP use the revised series of GDP released by the authorities in summer 2007, for which data are available from fiscal year 2000/01. For data before that, a revised series has been imputed.

- *Fiscal structural changes.* At the same time total revenue increased from 11 percent of GDP in 2002/03 to 11¾ percent in 2006/07, a smaller increase than the 1½ percentage points projected at the beginning of the program. The redirection of expenditure towards more pro-poor and pro-growth spending was only begun in 2006/07, when spending on health and education rose by about ½ percentage point to 4½ percent of GDP. However, the share of capital in total expenditure increased only marginally over the program period.

- *Monetary and exchange policy.* Inflation remained in line with Indian levels, and close to projections (except in 2005/06, when it rose to 8 percent, parallel to Indian developments), and growth of broad money and credit to the private sector were broadly as anticipated.

- *External sustainability.* At the same time, while the trade deficit deteriorated during the program period, rising remittances more than covered the widening gap, leading to an rise in international reserves from $1.2 bn at end-2002/03 to $2 bn at end-2006/07, well above projections, and maintaining coverage of imports of goods and services of about 6½ months.

Progress in implementing structural reforms was more uneven, and considerable delays occurred. Overall, in some areas, significant steps forward were taken, while in others reforms remained piecemeal and incomplete.

- *Revenue administration.* The establishment of the **Large Taxpayers' Office** (LTO) in January 2004 marked a significant step forward. Strong leadership has made the LTO a well-functioning administration, where technical assistance has fallen on fertile ground. The introduction of a performance incentive scheme in 2006 further strengthened the office. The LTO currently administers about 260 taxpayers, and generates about 17½ percent of tax revenues. There have also been other improvements in the **Internal Revenue Department** (IRD). Progress has been made in computerization and automation of the

IRD, but there has been significant taxpayer resistance to rolling out technical equipment. Furthermore, legal and administrative difficulties, as well as low taxpayer compliance, have created a large backlog of "ghost" taxpayers (nonfilers) that are registered but do not file returns. The administration of excise taxes has also remained difficult. Efforts to reform the **customs administration** have been less successful, due to inadequate donor support, insufficient leadership at several administrative levels, and the sheer complexity of the task. While the customs procedures at the largest border crossing at Birgunj were streamlined to some degree, further improvements in management practices and procedures are required. Similarly, the installation of the Wide-Area Network will need to be followed by an upgrade of the ASYCUDA system together with management action to utilize it effectively.

- *Financial sector reforms* (for a more detailed discussion see Chapter 4). The reform strategy in this area was based on three pillars: The **modernization of the NRB** was designed to focus the central bank on its core functions; improve several areas of NRB operations, including monetary operations, internal audit, and supervision; and modernize of personnel management. Progress in these areas has been mixed. Banking sector supervision, monetary operations and internal audit have gradually improved, partly with technical assistance from the IMF. However, much remains to be done. Some progress has also been made in disengaging the NRB from non-core activities, but personnel management continues to be hampered by rigid work practices, politically connected powerful labor unions, frequent transfers of staff, and shortage of staff with specialized skills. Overall, while some obstacles to more rapid reform are of a technical character, key impediments are more political in nature. **Reform of the legal framework** was intended to support improved supervision of the financial sector and facilitate its consolidation. As the number of financial institutions has increased dramatically over the past years, and new banking licenses having been issued recently despite a tightening of standards, supervision and consolidation have become more urgent. The Banking and Financial Institutions Act (BAFIA) has been revised to facilitate consolidation and strengthen supervision and was, at the time of writing, awaiting parliamentary approval. After initial successes, the **restructuring of the Nepal Bank Limited (NBL) and the Rastriya Banijya Bank (RBB)** has run into significant opposition on the part of labor unions which have demanded that one of the banks be no further managed by a foreign management team. While modern management practices have been introduced, branches closed, and payrolls reduced, the future of both banks is uncertain. Initially, both banks were expected to be privatized, but the shift in the political climate has made this option difficult. While these banks' balance sheets have been improved significantly, large, willful defaulters have to a large extent escaped their responsibilities, and the measures undertaken by the NRB and government—such as seizing passports—have to date yielded only limited results.

- *Public sector reform.* Reforms in the public sector span a wide range of area, including governance and the civil service, state-owned enterprises (SOEs), and the supply of fuel. The PRGF-supported program aimed to tackle only some of the key areas that have a direct impact on macroeconomic stability or the financial sector. A key and longstanding problem has been—and remains—the **pricing of fuel and reform of the market for petroleum products**. At the center is the fixing of prices for fuel and cooking gas by the government, and their unresponsiveness to changes in international petroleum prices. The program aimed to gradually increase prices to cost recovery levels, and then introduce an automatic formula to determine future price changes—in both directions, dependent on development in international oil markets. In the longer term, reform of the petroleum sector with a view of introducing more competition in the supply chain, and reform of NOC management would help contain prices. However, given the political sensitivity of the issue, the government was reluctant to take action, even as international oil prices increased, making the financial problem worse (for a more detailed discussion of the issue, see Box 2). The program also aimed at **reforming SOEs** that were unprofitable, either through privatization or liquidation. Most of the 36 SOEs are loss-making, including significantly the NOC, Nepal Electricity Authority, Nepal Airlines, and Nepal Food Corporation. Only the performance of Nepal Telecom (which has a monopoly in the fixed-line market and dominates the mobile telephony market) and several financial institutions (including the RBB, which continues to have a negative net worth) make the sector as a whole profitable. Under the program, six industrial enterprises were privatized or liquidated, relieving the public purse from covering their losses, and the restructuring of the bankrupt Nepal Industrial Development Corporation (NIDC) and Agricultural Development Bank of Nepal (ADBN) begun. In addition, efforts were made to improve the transparency of the NOC through regular audits of its finances.

Box 2: Petroleum Price Reform

Petroleum price reform is a longstanding issue in Nepal. Prices of petroleum products are not set by market forces, as they are for most products, but are fixed by the government. If, as has been and continues to be the case in Nepal, this administratively set price is lower than the costs at which petroleum products are imported and distributed, this obviously results in losses for the importer. Those losses need to be covered in the long run—the NOC has avoided this for several years by running up arrears with its supplier, the Indian Oil Corporation, and by obtaining, often with tacit government support, credit from domestic financial institutions. But such measures can only postpone the inevitable: someone has to pay eventually.

The subsidization of petroleum products tends to benefit disproportionately people with higher incomes. It is urban residents—who generally have higher incomes than the rural population—that use the bulk of the fossil fuels that are subsidized as such high cost to the general public. Residents of rural areas and the urban poor certainly also use some petroleum products—largely indirectly through public transport, including of consumer goods—but much less than owners of cars and motorbikes, and regular users of public transportation in cities, not to mention industrial users of gas, such as hotels and restaurants. While a case can be made to subsidize kerosene and cooking gas for poor private households, the amounts involved would likely be very small. The large amounts required to subsidize fuel for all consumers represent a real expenditure: while the run-up of arrears and incurring of domestic debt has postponed payment and thereby concealed the costs, the payments that the government will need to make eventually must be financed. Such financing will reduce resources available for other purposes, such as building much-needed infrastructure, financing the education of Nepal's future generations, and spending on healthcare for the poor.

Artificially low prices are a problematic issue in many countries, including in the region. However, in Nepal there are some specific characteristics that aggravate the situation. First, the somewhat haphazard approach to covering the losses of the NOC—not through a regular subsidy from the government budget but via accumulation of arrears, periodic loans from domestic financial institutions and the public pension fund, and ad-hoc transfers from the treasury—has created uncertainty and periodic disruptions of supply as the NOC moves from one liquidity crunch to the next. These disruptions carry a broader cost to the economy as enterprises have to interrupt production. Second, the porous border with India—where most petroleum prices are subsidized as well but until recently remained more expensive than in Nepal—implies that any significant price differential leads to smuggling on a large scale. It has been estimated that, during 2006, about 25 percent of petroleum products imported by Nepal have been smuggled back to India. This implies that, ultimately, Nepalese taxpayers are subsidizing Indian consumers.

The public discussion of petroleum pricing in Nepal has often centered around issues that are to some extent peripheral. The NOC has been accused of mismanagement causing high transport and overhead costs and thus being responsible for the losses. However, even while the transparency and accountability of the NOC can certainly be improved, the magnitude of its losses cannot be explained by administrative overhead and transport costs.

The reform agenda for fuel prices would contain three elements. first, prices would need to be raised to a level where they cover the costs that the NOC is incurring. This could be done either in one step, or in a series of small steps. At this point, limited targeted subsidies could be introduced, but these must be well-managed to ensure that they reach their intended beneficiaries. Second, an automatic pricing mechanism would need to be introduced to remove the decision about the level of petroleum prices from the political sphere and make it an exclusively technical issue. A large degree of transparency is needed to underpin this mechanism; both the formula and the variables that determine the price will need to be published to ensure the confidence of the public. A third element, not directly linked but useful to maximize efficiency of supply would be the liberalization of import, distribution, and prices of petroleum products. The liberalization of prices, however, need not imply that a pricing formula is not needed: by showing the prices that the NOC's is charging to dealers, it ensures transparency and increases competitive pressure on dealers, which helps ensuring efficiency in the distribution system and protecting consumer interests.

Overall, the framework of the PRGF proved a useful anchor for protecting macroeconomic stability and advancing reforms—though gradually—under very difficult conditions. The political background of the program was far from encouraging; the support of the IMF under these circumstances—when many donors scaled back their assistance—helped the NRB and the government not only to protect the credibility of its macroeconomic policymaking but also maintain momentum in the structural reform agenda in critical areas, such as broadening the revenue base and supervising the financial sector. These achievements are now forming the basis for further reforms. Similarly, the rapid revival of the program after the *Jana Andolan II*—the extension was approved by the IMF's executive Board within days of the signing of the Comprehensive Peace Agreement between the government and the CPN(M)—was an expression of support and confidence by the international community, and helped to buttress the new government in the critical and difficult transition phase.

Looking Ahead

In the period following the Constituent Assembly elections, the political agenda will likely remain dominant, but at the same time economic and development issues can be expected to gain greater prominence. The Three-Year Interim Plan maps out the government's strategy for the transition phase. Key goals of the plan are to raise broad-based and pro-poor economic growth, increase investment both in physical infrastructure and in social sectors, and promote good governance. In addition, special emphasis is expected to be given to targeted programs to promote social inclusion, to reconstruction of conflict-affected infrastructure, and to the provision of relief and reintegration to people affected by the recent conflict.

Many of the challenges that the government and NRB face in implementing this plan are familiar ones. The reform agenda that was begun to be tackled under the Tenth Plan (and before) has not been completed; at the same time, new challenges are emerging: on the macroeconomic side, public revenues will need to be raised further to enable the government to fulfill the ambitious goals it has set itself. At the same time, the efficiency of expenditure needs to be raised, and transparency and controls enhanced to maximize the effectiveness of the public (including donor) resources deployed. Maintaining stability in the external sector, both regarding the exchange rate and the balance of payments, has been complicated by developments in global financial markets, and will continue to demand the attention of policymakers. On the structural reform front, managing the financial sector and shaping the instruments, legal and institutional, to do so has become more urgent—and more challenging—as the sector and its vulnerabilities are growing rapidly. Also, the NBL and RBB remain on the government's hands, and a durable solution needs to be found. Despite the changing political environment, the situation of the loss-making SOEs will need to be addressed, first and foremost of the NOC, but other institutions as well. These are only some of the issues that the country is facing looking ahead.

The IMF has in the past engaged with Nepal both in the framework of financial arrangements and through regular dialogue outside programs. This relationship has been a fruitful one, with significant successes in fostering Nepal's stability and economic development. To continue this successful cooperation going forward, the IMF stands ready to assist the government and NRB in meeting the challenges lying ahead.

Review of Nepal's Tenth Five Year Plan with Reference to PRSP

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Introduction

In September 1999, the IMF established the Poverty Reduction and Growth Facility (PRGF) to make the objectives of poverty reduction and growth more central to lending operations in its poorest member countries.

PRGF-supported programs are framed around comprehensive, country-owned Poverty Reduction Strategy Papers (PRSPs). PRSPs are prepared by governments with the active participation of civil society and other development partners. PRSPs are then considered by the Executive Boards of the IMF and World Bank as the basis for concessional lending from each institution and debt relief under the joint Heavily Indebted Poor Countries (HIPC) Initiative. The targets and policy conditions in a PRGF-supported program are drawn from the country's PRSP. Nepal was traditionally formulating the Five Year Plan and therefore requested the Fund and the Bank to consider the Tenth Plan (2002/03-2007/08) as the PRSP of the country.

The Tenth Plan[1] was formulated in a difficult situation. First, the country was involved in armed conflict. It constrained the ability of government agencies and development partners to carry out development activities. Government resources were increasingly used for combating security and violence. The cost of conflict was high in terms of human lives, destruction of property and infrastructure. Security expenditure increased and foregone development and economic activities have been considerable.

Second, the Tenth Plan was launched against the backdrop of a fragile economy. After a decade of fairly robust growth, Nepal's real GDP growth became negative (-0.6%) in 2001/02, for the first time in nineteen years mainly because of intensified conflict, bad weather conditions and the global recession.

Notwithstanding these constraints, the Government formulated the Tenth Plan with an objective of addressing the underlying causes of poverty while concurrently pursuing possible approaches to resolve conflict and restore law and order.

This paper by reviewing the main features provides an assessment of the performance and strategies of the Tenth Plan.

Main Strategies of the Tenth Plan

The objective of the Tenth Plan was to bring about a sustainable reduction in the poverty level in Nepal over the Plan period. To this end, the Plan formulated the "four pillar" strategy, which tried to address the main causes and determinants of poverty.

The "four pillar" strategy of the 10th Plan included: (i) achieving high and broad-based economic growth with special emphasis in agriculture; (ii) improving human development indicators focusing on quality and accessibility of social services; (iii) ensuring social and economic inclusion of the poor and marginalized and disadvantaged communities; and (iv) improving governance. Emphasis of the Plan

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[1] PRSP (Poverty Reduction Strategy Paper) and the Tenth Plan are used interchangeably in this paper. They are the same in the context of the Tenth Plan.

among other things, was on accelerated growth in rural economy, reduction in inequalities, accelerating human development, ensuring social and economic, and social inclusion of the marginalized group and deprived regions, and vigorously pursuing good governance both as a means of delivering better development results and ensuring social and economic justice. The main features of the four 'pillars' were as follows.

Broad Based Economic Growth: Experiences of developing countries show that it may be impossible to reduce poverty without high and equitable growth. As more than 80% of the population depends on farming, agriculture was targeted to grow at a rate higher than the previous trend. On the other hand, as the non-agriculture sector contributes more than 65% to GDP, its growth was further emphasized.

The growth strategies for agriculture identified were to modernize, diversify and commercialize crop and livestock production by increasing the access of farmers to modern inputs, technology and credit, which includes smooth supply of fertilizer, extension of irrigation facilities and expansion of rural agricultural roads and focusing on the demand-oriented research and extension.

To enhance the growth especially that of non-agriculture sector, the Plan emphasized (i) lowering trade related transport cost by completing and operationalizing inland container depots, (ii) infrastructure development (iii) simplifying procedures especially for investment and exports (iv) privatizing/restructuring public enterprises (v) improving corporate and financial governance including the improvement of auditing and accounting standards, (vi) financial sector development and (vii) making labor laws more flexible.

Maintenance of macroeconomic stability, which is crucial for creating conducive environment for promoting private sector development and market oriented economy was geared to focus to maintain fiscal discipline, improve public resource management, strengthen financial system, and sustain monetary and external stability.

Integration of the concept of sustainable development in all the development process for balancing environmental and population through community-based natural resource conservation, utilization and improvement was emphasized by the Plan. Air, water quality, and solid waste monitoring was planned to maintain environment and reduce human health hazards.

The main objective of this "pillar" was to address income poverty but was not sufficient to address the issue of human poverty.

Human Resource Development: The development of human resources, especially education, health, rural drinking water and sanitation is essential for both reducing poverty and improving the quality of life in rural areas.

The strategy for education development, in the Plan included; (i) improving the quality of education especially focusing at the primary level; (ii) ensuring easy access to education and reducing drop-out rates; (iii) expanding literacy programs; (iv) increasing the enrollment of girls; and (v) expanding vocational and technical education.

Similarly, the key objectives of the health sector were to (i) extend quality and essential health-care services to all, with a special emphasis to the deprived communities; (ii) ensure effective control of communicable diseases, such as malaria, tuberculosis and HIV/AIDS; and (iii) increase the accessibility of essential health care system.

Accessibility of drinking water and sanitation especially in rural areas was planned to be addressed through the participation of NGOs, CBOs and private sector in planning, implementing and maintaining water supply and sanitation schemes. Institutional mechanisms and approaches were further strengthened to facilitate the implementation of demand-driven community managed water supply projects.

Social inclusion and Targeted Programs: The Tenth Plan, instead of focusing only on targeted programs, intended to facilitate social inclusion by mainstreaming gender, ethnic and caste-related disadvantaged groups and backward communities. New programs were planned to ensure equitable access to resources and opportunities to these groups.

The major interventions were undertaken in these sectors included; (i) scholarship program to attract children from disadvantaged communities and areas; (ii) increasing female literacy program; (iii) emphasizing MCH programs; (iv) affirmative action to increase women's, dalit and janajati’s role in public offices and administration; (v) expediting rural access activities especially in the areas where district headquarters are not connected by road network; (vi) special program for income-generating activities including the implementation of Poverty Alleviation Fund for these groups and so on. In addition, the ongoing targeted programs like social mobilization and micro-credit programs and special programs designed and implemented for disadvantaged and deprived communities were further strengthened.

Good Governance: The Plan realized that the achievements of the targets set in the Plan can not be achieved if the implementation of the strategy is not given due consideration. The major component that will add to speedy implementation of the strategies is good governance. In the context of poverty alleviation, good governance is of particular importance for effective service delivery. To improve service delivery, efficiency of public service were planned to be improved and leakages reduced. The main elements of the Tenth Plan's strategies, in this context were governance reform including civil service reform and decentralization.

Civil service reform initiated in the Tenth Plan aimed to address the issue of streamlining the role of government and right sizing the bureaucracy, accordingly. To make the civil service more efficient, accountable and transparent, the recruitment, transfers and promotions were planned to be done by strengthening more merit-based criteria. Affirmative action program were proposed to recruit more women and people of deprived communities in the civil service. A comprehensive anticorruption strategy was approved and its action-plan was prepared for implementation. The Commission for Investigation of Abuse of

Authority, the main constitutional body for anti-corruption actions was proposed to be further strengthened.

Decentralization, which helps to bring development closer to the people, was proposed to be further expedited. The main actions under decentralization included the devolution of basic services (education, health, drinking water, agricultural extension, and rural infrastructures etc.), fiscal devolution, greater decentralization, establishment of local bodies' service commission and capacity building.

Special Characteristics of Plan

The Tenth Plan or the PRSP was prepared to reinvigorate the reform efforts, reduce poverty and achieve high and sustained growth. The PRSP had a number of strengths, which included; an appropriate focus on accelerating income and employment growth in rural Nepal, where a majority of the poor live, inclusion of alternative growth scenarios that take into account downside risks, and the introduction of explicit mechanisms to expedite reforms in critical areas to address and weak implementation track record. The joint staff assessment of IMF and the World Bank provided a detailed overview of Nepal's PRSP (IMF Report no. 3/361). Some of the comments were as follows:

The PRSP presented a comprehensive description of the levels and spatial distribution of poverty. The description is based on the surveys – the Nepal Living Standards Survey (NLSS) 1996, and the Demographic and Health Survey, 2001 and drew on insights from the Poverty Assessment completed in 1999 and the Human Development reports of 1996 and 2001 by the United Nations.

The analysis of the diagnostics of poverty was generally sound. The PRSP noted that poverty is largely a rural phenomenon, and there are strong regional differences with higher incidence in the mountains and remote areas. The PRSP was a product of an inclusive participatory process and marked a significant departure from traditional development planning.

The government presented a broad strategy for poverty reduction in its multiple dimensions – focusing on growth, particularly in rural areas, combined with an emphasis on social inclusion, improved governance, and better delivery of social and economic services. The strategy, although ambitious, was backed by the MTEF (introduced in 2002/03), which provided a crucial link to feasibility, indication how trade-offs were being handled in the face of resource constraints.

The PRSP highlighted indicative targets for the period of the Tenth Plan (ending 2006/07) in all areas covered by the MDGs. The PRSP stressed the authorities' commitment to sound macroeconomic management and structural reform implementation to foster growth and alleviate poverty.

The inclusion of alternative macroeconomic scenarios in the PRSP, which take into account risks to the medium term outlook, enhanced its flexibility. The PRSP scenarios form the basis of a "realistic" medium term macroeconomic framework.

The PRSP made clear that productivity gains and increased private sector activity are the key sources of broad based growth in all sectors. The PRSP also recognized that a strong financial system is critical for private sector growth and macroeconomic stability. It also acknowledged the importance of infrastructure development in facilitating private investment.

Key fiscal policy challenges were to improve revenue mobilization, prioritize spending and contain domestic borrowing. Monetary and exchange rate policies were recommended to remain geared to supporting the peg to the Indian rupee.

The PRSP's public expenditure program was appropriately based on the MTEF, which helped to prioritize expenditures. The MTEF currently covered all development spending and represented a significant improvement over past practices. Under the framework, development expenditures were prioritized in three categories (P1, P2, and P3) and a prioritization, approximately 40 percent of the development budget was allocated for social expenditures, 40 percent for infrastructure and the rest for agriculture development; and over 60 percent of the development budget was allocated to P1 projects with assured funding. To facilitate implementation of priority activities, budget allocations for agriculture/rural and human/social service delivery developments were protected under alternative growth scenarios.

There were some suggestions to take steps to further improve public expenditure management. Specifically, the recommendations were (i) costing delivery of key activities (primary education, management of health posts, district hospitals to be transferred to local stakeholders) and ensuring adequate allocations for these activities starting in 2003/04; (ii) extending prioritization to regular expenditures; (iii) classifying spending into recurrent and capital; (iv) developing the fiscal decentralization framework and holding local institutions accountable for achieving targets; (v) implementing the Development Action Plan under the Country Financial Accountability Assessment and Country Procurement Assessment Report on a timely basis; and (vi) as discussed about, developing a comprehensive tracking system that covers public spending on all projects in the PRSP. Most of these suggestions were taken up in subsequent years of the Tenth Plan implementation.

The main focus of the PRSP on reinvigorating income and employment growth in rural areas through agricultural development was appropriate.

The strategy in education was pro-poor and aimed to be more realistic and credible. To improve access to and quality of primary education, the strategy consisted of the transfer of management of government schools to local communities and provision of blocks grants to these community-funded schools. At the level of higher education, one focus was on cost recovery to produce a skilled labor force.

The health strategy in the PRSP was underpinned by a comprehensive health reform agenda.

The PRSP made a welcome shift away from almost exclusive dependence on special targeted programs towards a consistent effort to "mainstream" the poor women, and excluded caste and ethnic groups by ensuring them access to regular sectoral programs.

Achievements of the Plan[2]

Socio-economic Performance: The assessment reveals that the formulation of the Tenth Plan was robust. However, the performance of the Plan was mixed. Significant progress was made during the period in the areas of MDG indicators including poverty, but the achievement on economic growth was disappointing.

The average annual GDP growth rate declined to less than 3.4% during the 10^{th} Plan period compared to about 5% in the 1990s. There was a substantial decline in economic activities including in the areas of industrial and services sector performance, which were the main driving forces of Nepalese economy in the 1990s. The reasons behind this low growth were mainly, intensified conflict, political uncertainty, *Terai* unrest, labor agitations, frequent *bandh* and lower trade performance. The economy was not able to operate in its full capacity.

Nepal's macroeconomic stability however, was under control, but the environment for investment did not improve. Fiscal management, in general, was under control. Revenue increase, together with declining development expenditures in real terms contributed in keeping fiscal deficit to 3.1% in 2005. However, the deficit has started increasing after 2005, mainly because of increase in non-budgetary expenses related to rehabilitation and election preparation expenses. Current expenditure increased significantly but capital expenditure, in real terms declined during the same period. Resource gap, measured be saving-investment differences, increased from 11% in 2002 to 18% in 2006. However, on the other hand Gross National Savings (GNS) increased, significantly mainly because of increasing remittances income.

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[2] Data in this section are derived from Economic Survey (various issues), Ministry of Finance, Government of Nepal, Three Year Interim Plan (2007/08-2009/10), National Planning Commission, 2007 and the Tenth Plan Annual Assessment Report, 2007.

The average annual inflation measured by the national consumer price index, recorded a rise of about 5.5% during the Tenth Plan period. However, it reached 8% in 2005/06 and close to 6.3% in 2006/07 mainly because of rise in petroleum product prices. Transport, communications and housing recorded some of the highest price rises during the Plan period.

Foreign trade, which was the engine of growth for the Nepalese economy during most of the 1990s, decelerated in recent years. Total exports during 2001/02 to 2006/07 increased by 5.3% per annum compared to the growth of 24.3% in the 1990s. The decline in exports was caused mainly by the political instability, bandh, Tarai unrest, appreciation of Nepalese currency, termination of MFA and increasing unit cost of production due to increased wages.

Similarly, import growth is estimated to be about 12.3% in the review period, compared to 19.9% in the 1990s. The main reasons for higher imports were appreciation of Nepalese currency vis a vis US dollar, decelerated growth of domestic output and increased remittances income. Increasing imports and decelerated exports has resulted in higher trade deficit. Export-import ratio as a percentage of GDP declined from 43.7% in 2002 to 32.4% in 2007.

Despite the slowdown in exports and increasing trade deficit, the current account and balance of payments position remained strong. Current account surplus which was at NRs. 18.2 billion in 2001/02 was estimated at NRs 8.2 billion in 2006/07. The surplus in current account has been observed primarily due to the high growth in the inflow of remittances.

The surge in remittances has also contributed positively in making the balance of payments favourable. The balance of payments position has been in surplus position since 2002/03 after a deficit of NRs 3.3 billion in 2001/02. In 2006/07, the balance of payments surplus was estimated to be NRs 9.0 billion in 2006/07. However, rising value of NRs vis. a vis. US dollar is also causing increasing trade deficits and also could have adverse impact on remittance earnings and foreign exchange reserves.

Development expenditure declined from about 9% of GDP in 2001 to about 6% in 2006. The development expenditure which grew by more than 10% per annum during 1990s, declined by about 2% per annum between 2001 and 2005. The main reasons for reduction in development expenditures were declining revenue surplus resulting mainly from increased regular expenditures (salary adjustments of public servants and increased security expenditures), increasing mainly because of rapid increase in remittances income, increase in agricultural wage rates, speedy urbanization, and implementation challenges for security reasons including reduction in the disbursements of Development Committees, which receive grant from the central Government, were also unable to spend the budget in the absence of elected VDC officials as well as the deteriorating security environment.

Despite politically difficult situation and the presence of armed conflict, many of the poverty and socio-economic indicators, in the 10^{th} Plan period were encouraging. The incidence of poverty fell from 42% in 1996 to 31% in 2004 reduction in dependency ratio during the same period.

Similarly, the Demographic Health Survey (2007) shows that net enrollment in primary school rose from 80.4% in the beginning of the Plan to 87.4% in 2007. Maternal mortality rate, child mortality rate and infant mortality rate declined, significantly during the Plan period (Table 1). Increased government expenditures in health and education (Table 2), increased investment from the private sectors in opening new schools as a result of liberal government policies, increased awareness of households and reduction in poverty are some of the reasons for the achievement of the social sector.

Table 1: Achievements of the Tenth Plan

Indicators	Ninth Plan End 2001/02	Tenth Plan End 2006/07
Overall Poverty Level (Percent of Population)	38	31
Real GDP Growth (at factor cost-percent p.a.)	3.7	3.4
• Agriculture	3.2	2.7
• Non-agriculture	3.9	3.8
Per-capita Income Growth (percent p.a.)	**1.3**	**1.1**
Social Indicators		
• Infant Mortality Rate (per thousand)	64.2	34
• Total Fertility rate %	4.1	3.1
• Maternal Mortality Rate (per 100000)	415	281
• Rate of contraceptive Users (in percent)	39.3	48
• Obstetric Services by Trained Manpower (percent)	13.0	23.4
• Net enrollment in Primary Level (above 6 years, percent)	80.4	87.4
• Drinking Water (population benefited, percent)	71.6	77
• Human Development Index (HDI)	0.466	0.534
Physical Infrastructure		
• Number of districts With Access to Roads	60.0	63
• Irrigated Area ('000 of hectors)	1121.4	1168.1
• Telephones (per '000 of Population	14.4	65.0
• Roads (kilometers)	16,947	17,609

Source: Economic Survey (various issues), Ministry of Finance, Government of Nepal and Three Year Interim Plan (2007/08-2009/10), National Planning Commission, 2007.

Good progress has been made in poverty reduction in all ethnic groups and development regions, but inequality increased mainly because of the increasing gap between middle class and the rich. Despite improvements, according to Nepal Living Standard Survey

(2003/04), disparities among the regions and various groups of people are still high and increasing.

Development expenditures in constant price in education and health increased by 16.5% and 18.9%, respectively during the Plan period compared to less than 1% in the economic sector. The total development expenditure increased only by 5.5% per annum during the same period.

Similarly, the number of governmental health facilities has increased, significantly. The number of health care institutions quadrupled in about ten year period. The median commute time to a health facility in rural areas fell by 50% to 50 minutes, between 1995/96 to 2003/04. Improvements in rural road infrastructures, increased public facilities and increased number of private health establishments. Expansion of private sector's participations in health sector resulted in increased health services to the people. Increased remittances income also resulted in higher household spending in health care.

Table 2: Development Expenditures by Economic Sectors in 2001/02 Constant Prices (2001/02-2006/07)

Budget Head	Expenditure growth % per annum
Constitutional Bodies	26.4
General Administration	0.2
Social Services	16.5
o/w Health	26.1
Education	18.9
Drinking Water	14.0
Economic Services	0.9
Miscellaneous	-64.3
Total	5.5

Source: Three Year Interim Plan (2007/08-2009/10), National Planning Commission, 2007.

In addition to higher government expenditures, accessibility of schools improved; the number of teachers increased; and the share of private schools in primary school enrollment more than doubled from 1996 to 2004.

Community Involved Service Delivery: In order to improve service delivery the Tenth Plan provided greater importance to the participation and involvement of the communities in initiating and implementing smaller projects. This was strengthened mainly by (i) increasing pro-poor expenditures (ii) enhancing the programmes initiated and implemented by the communities and (iii) expediting the process of decentralization.

There were mainly two reasons for expediting community participation in Nepal. First, in the community initiated and involved programmes, it was observed that the resources reach directly to the communities including poor and excluded and the service delivery becomes more effective and inclusive. Second, experience of Nepal shows that even if the implementation mechanism allows them to take decisions on what they want to achieve and how, then many kinds of development activities can be implemented successfully, even in the presence of armed conflict. This approach was implemented by increasing pro-poor expenditures, taking on projects that are local (decentralized), participatory and address to the basic needs of the poor and the excluded (income generation, delivery of health and education etc.). The results of these programmes have been encouraging.

Government deliberately increased pro-poor expenditures, which are basically rural focused programmes in education, health, agriculture, rural roads and electricity, community-based drinking water etc., to improve the access and quality of service delivery. Pro-poor expenditures increased from 30% in 2002/03 to 31.4% in 2004/05 and were estimated at 35% in 2005/06. In nominal terms the increase is about 78% in pro-poor expenditures from 2003 to 2006. Most of the pro-poor expenditure however, increased in the social sector.

The flow of fund to the programmes where the beneficiaries were involved in implementation increased from a low base of 1.8% of total expenditure in 2001/02 to five percent in 2004/05. The level of block grants especially that going to VDCs was also doubled in 2007.

Community participation has been commendable, especially in rural drinking water projects. All the major projects, Small Town Water Supply and Sanitation Sector Project, and Rural Water Supply and Sanitation Development Board—focus on a demand-driven, participatory cost-sharing approach. The projects were implemented by NGOs and CBOs.

The participatory model was also strengthened in irrigation. The irrigation policy aims at increasing user participation at all levels—from development including project identification, design and construction to operation and management. The policy also aimed to transfer operation and maintenance of small and medium irrigation systems, newly built or existing ones to user groups. Farmer groups, under the new scheme repaired and maintained canals irrigating about 12,500 ha in the first three years of the Tenth Plan.

Similarly, in health, one of the main strategies of the government was to hand over the management of health services to promote community ownership and oversight. The community management of health facilities was extended to 28 districts in 2005. Furthermore, Community Drug Programme was expanded to 25 districts. Under the programme, government provides seed money for procuring essential drugs to which the community also contributes. In this scheme, the service seekers benefit because they are able to purchase drugs at rates cheaper than the market and community management of the scheme ensures that the service is always available.

In a similar manner, the government has started transferring school management to the communities. The transferred schools have been able to enroll more students and improve the quality of education.

Participatory approach has also been promising in micro-hydro rural electrification schemes. By the first half of 2005, community run micro-hydro schemes were generating more than 8,830 KW of electricity through more than 1500 projects. The number of projects and the beneficiaries are increasing under this scheme.

The government has identified rural unemployment and low level of income as some of the major issues facing the poor and excluded groups. These groups generally are either illiterate or have very low level of education. They do not have easy access to basic services provided by the public sector. They also lack skills needed for benefiting from opportunities that are available in the economy. Because of these reasons many of these rural people are forced to migrate in search of work as manual labourers. The challenge is to help these population groups to acquire the skills, capital and other support to take up activities that would help them escape from poverty and deprivation.

There are a number of programmes initiated by the Government of Nepal, especially during the Tenth Plan aimed at organising poor communities to prepare, implement and manage their development activities. One of the examples of these kinds of programme is the Poverty Alleviation Fund (PAF). The programme, which has been implemented in more than 50% of the districts by 2007, is focused on income generating and infrastructure sub-projects. Some of the programmes under this theme include agriculture and agro-forestry, livestock raising, manufacturing and cottage industry, trade and services. The infrastructure sub-projects of choice include micro-irrigation, village link roads, culverts, micro-hydro schemes, bridges, water supply, sanitation, extension, and rehabilitation of school and health post buildings.

Despite of the armed conflict in Nepal, decentralization, greater involvement of communities and increase in pro-poor expenditures all have helped to improve national level service delivery indicators. However, the programmes benefited small population groups and therefore, have to be replicated and scaled up for greater impact.

Challenges

The country's economic growth has remained low. Economic growth needs to be reinvigorated by increasing agriculture production and productivity and improving environment for investments. However, actual performance of the country is disappointing, mainly for two reasons3. They are weak institutions, which includes problems related with political instability, governance and industrial relations and poor infrastructure.

Excessive protective labor laws, trade facilitation, poor tax administration, high transaction costs in setting up a business, barriers to exit, weak law enforcement capacity of the government are some of the problems related with the investment climate. Similarly, the corruption is high and anti-corruption laws and their enforcement is weak in the country. Situation of law and order is deteriorating and business regulations are weak and ineffective.

Nepal's road density is one of the lowest even among the least developed countries. Similarly the country is suffering from severe load shedding. These infrastructures are crucial not only for increasing production and productivity of manufacturing and services sectors but also for agricultural activities.

The challenge is not only of accelerating growth, but also is of sharing the growth and prosperity more broadly across the population. Building social and human capital, creating employment opportunities and implementing affirmative actions to the excluded groups are probably the best ways for reducing inequality in the country.

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[3] Global Competitiveness Index, World Bank 2007 and Global Integrity Report 2007

Nepal's Financial and Public Sector Reform under PRGF Arrangements

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The International Monetary Fund (IMF) financial assistance to low-income member countries is provided through concessional lending under the Poverty Reduction and Growth Facility (PRGF), formerly known as the Enhanced Structural Adjustment Facility (ESAF), and through debt relief under the Heavily Indebted Poor Country (HIPC) supported program.

The PRGF program is based on the Poverty Reduction Strategy Paper (PRSP), which fully integrates poverty reduction and macroeconomic elements of the program. It also aims at ensuring greater degree of national ownership leading to a consistent policy implementation. The number of eligible countries for the PRGF program as of October 2007 was 78. Under the PRGF supported program, credit is provided at an interest rate of 0.5 percent to eligible low-income member(s) to support the overall growth and poverty reduction strategy based on integrated macroeconomic, structural and social policies. The loans are repayable in ten equal semiannual installments between 5 and ½ to 10 years after disbursement.

The HIPC initiative is to reduce the external debt burden of eligible country to a sustainable level. This initiative is limited to countries which are eligible for PRGF and International Development Association (IDA) loans with the conditionality of:

(a) Established strong track record of policy performance under PRGF and IDA-supported program; and,

(b) Being not capable in achieving a sustainable debt situation even after using fully the traditional debt relief mechanism.

However, Nepal has not yet decided to enter into the HIPC initiative.

Nepal, aiming at breaking the vicious circle of low growth, pervasive poverty, and insurgency, with a comprehensive reform agenda based on the Tenth Plan which was considered as the Poverty Reduction Strategy Paper (PRSP) entered into the PRGF program in 2003. The strategy in the PRSP included a four pillars framework of broad-based economic growth; social sector development; targeted program for the poor and deprived groups; and good governance. The policy actions in achieving the targeted goals were focused on macroeconomic stability; structural reform; sectoral policies; social sectors; and targeted poverty reduction.

With this backdrop, the PRGF arrangement was approved with the following equal installment of 10 percent of the country quota disbursement schedule.

Amount	Available Date	Conditions
SDR 7.13 million	November 2003	Upon Board approval
SDR 7.13 million	April 2004	Performance criteria and completion of the first review
SDR 7.13 million	October 2004	Performance criteria and completion of the second review
SDR 7.13 million	April 2005	Performance criteria and completion of the third review
SDR 7.13 million	October 2005	Performance criteria and completion of the fourth review
SDR 7.13 million	April 2006	Performance criteria and completion of the fifth review
SDR 7.13 million	October 2006	Performance criteria and completion of the sixth review

Source: Economic Survey, Government of Nepal, FY 2003/04.

The PRGF supported program as the medium-term framework focused on:

- higher growth in view to help reduce poverty;
- implementing fiscal strategy in mobilizing revenue, prioritizing expenditure, and reducing domestic financing;
- reforming the financial and public sectors for improving intermediation and resource allocation; and
- improving governance in reducing corruption, increasing accountability, and enhancing implementation capacity

In the PRSP the growth rate was targeted in a two tier system of lower case (4.3 %) and base case (6.2 %) scenario looking at the intensity of the internal conflict and the potential aspirations of the economy respectively. The medium-term framework was basically based on the lower case assuming a more realistic scenario. Likewise, the reduction in the poverty rate was targeted at 8-10 percentage points, among others.

The main thrust of the structural reform agenda under PRGF was focused on (i) financial sector reform; (ii) public sector reform; and (iii) improving governance. These reform programs were expected to support by the World Bank through financial sector technical assistance program and poverty reduction support credit (PRSC) and by Asian Development Bank (AsDB) under governance reform program (GRP) and public sector management program (PSMP).

Financial Sector Reforms: Under the Financial Sector Technical Assistance Program, **s**trengthening the Nepal Rastra Bank (NRB), improving the banking environment, and restructuring of two domestic commercial banks and development banks were envisaged. The total cost of the financial sector reform program (FSRP) as a combination of both the loans and grants assisted jointly by the IDA and DFID was equivalent to US $ 105.6 million. The major components of the project cost included in the category of goods; management contract / consultant services; training, workshop, study tour, and VRS payments. The FSRP was designed in two phases, and the first phase included:

(i) The re-engineering of NRB with the focus on sub-components like human resource management; banking operation and inspection; supervision of the management teams; accounting and auditing; support on research and information technology (IT), etc.;

(ii) Restructuring of the two big banks namely Nepal Bank Ltd.(NBL) and Rastriya Banijya Bank (RBB); and;

(iii) Capacity building in the financial sector focuses on banker's training Centre, Credit Information Bureau (CIB), financial journalism and coordination support team, etc.

Similarly, the second phase of the program included: (i) voluntary retirement scheme (VRS) in NBL and RBB; (ii) hiring sales / restructuring advisor; (iii) re-engineering of NRB including human resource, accounting, banking regulation and supervision, and IT up-gradation; and (iv) supporting management teams in NBL and RBB.

NRB Re-engineering: A brief review of the activities and achievements based on the available information in a sequential order may help to know the overall picture of the FSRP. For the re-engineering of NRB, the selected IOS Partners, an American consulting agency, started its work from March 2003 with a team of six members comprising four international and two national experts. The main job of the expert group was to expedite the above mentioned components and bring it into a concrete form. The NRB thereafter formed in-house steering committee, which was given responsibility to analyze and review the suggestions submitted by the IOS Partners and recommend to the bank management for its implementation.

The corporate re-organization model of NRB is designed based on the functional areas like monetary and foreign exchange policy; banking operations; regulation and supervision; and support services. In view to rightsizing and enhance professionalism, efficiency and productivity of the staff, altogether 571 staff opted for retirement in three phases of VRS. In order to put forth this effort, NRB reintroduced a two tire compulsory retirement policy either the completion of 30 years of service or 58 years of age, whichever comes earlier.

Staff compensation package for motivation; trainings for enhancing knowledge and skill; preparation and enactment of personnel byelaws; preparation and implementation of inspection and supervision manuals of international standard; adoption of international standard statutory audit; installation and improvement of appropriate system of IT/MIS; review of computerization status; restructuring NIFMIS procurement plan; dissemination of information regarding financial sector reform-through public relation officer; among others, are the major issues covered and performed under the first phase re-engineering program of NRB.

Similarly, in the second phase, a team of chartered accountants from NRB has submitted inception report and other periodic reports. Training on pre-procurement to the staff of NRB has been completed. The completed work of proto type developers has been certified by IT consultant. In the process of implementing the recommendation of

IOS Partners, an international consulting team was hired to develop supervisory capacity of NRB and was later terminated due to unsatisfactory performance. An international advisor was appointed to develop the human resource policy.

Re-structuring of Commercial Banks: Under the Financial Sector Restructuring Project (FSRP), the World Bank agreed to set up the benchmarks for performance indicators for the two banks after a rigorous discussion with the Government of Nepal and the management teams of the restructuring banks. As such, the selected indicators used to monitor and measure the performance on semi-annual basis had to be updated by the management teams. The indicators with respective major sub-heads were included as:

- Debt recovery (level of NPA and cash recovery of non-performing loan);
- Business/revenue growth (good loan, interest income, deposits and level of non-interest bearing deposit);
- Operating efficiency (spread, margin, operating income / assets ratio and cost / income ratio);
- Profitability (net profit before tax and return on assets);
- Staff efficiency (level, income per staff, staff expense to income, and staff cost as percent of operating cost);
- Capital fund (net worth, and loan loss provision);
- Computerization (share of deposit and loan), and;
- Discloser (audit statement and quarterly provision).

Nepal Bank Limited (NBL): The International Ceilidh Collective (ICC) Bank Management team consisting international bankers from Bank of Scotland appointed on July 22, 2002 initially for two years was extended several times up to July 21, 2007. The management team completed the financial analysis of the NBL and constituted several committees and task forces for creating and reinforcing internationally accepted norms and modalities in the bank. Similarly, policy guidelines for credit, credit decision and problem loans were formulated. As a result, more than Rs.8.9 billion was recovered in cash from the non-performing assets (NPA) category together with rescheduling / restructuring of about Rs.720 million as of mid January 2008. The bank introduced accounting manual and charts of accounts, regularized statutory audit and published quarterly financial statements. Moreover, accounting trainings, compensation package and career development for the staff, rationalization of branch network, and computerized banking services were some of the notable performances of the management team.

The largest component of the project was to support the VRS to right-size the number of employees with the intent of making the bank more worthy to sale/privatize. As a result of the various phases of the VRS implementation, the number of staff came down to 2927 from 5652. The bank also recruited some qualified and energetic staff. A total of 44 branches (44.4 percent of existing branches) were fully computerized and 33 branches started to provide Any Branch Banking Service (ABBS). The performance of the management team could be evaluated through the reduced level of NPA, which was 56.3 percent in 2003 and came down to 11.1 percent by mid-January 2008. The mandatory loan book write off of equivalent to Rs.4158 million in principal and Rs.8701 million in interest account also attributed to a significant effect on the decreased level of NPA.

Rastriya Banijya Bank (RBB): The management contract of the RBB was led by Bruce F. Henderson and his team. The team started the work on February 19, 2003. The contract was extended several times up to January 15, 2008. The management team prepared financial analysis, and zero-based budget plan and manual for the bank and implemented accordingly. In line with the international accounting standard, chart of accounts and accounting manual were prepared and implemented. The annual statutory audit was carried out and financial statements were published on a quarterly basis regularly.

All together 78 branches (68.4 percent of the existing branches) were computerized, interlinked with ABBS and ATM signaling a well approaching step towards a comprehensive modern IT/MIS system.

The bank has been able to record a sizable net profit since the FY 2003/04. The number of staff has been reduced to 3135 from 5422 through the implementation of various VRS. The bank, however, recruited fresh candidates in the areas of legal and IT. Similarly, the level of NPA which was more than 72 percent came down to 26.9 percent in mid-January 2008. Around 10 percentage point of the NPA was written off effect under the mandatory guideline of the NRB.

Financial Sector's Capacity Building-legislative Front: The legislative reform including the NRB Act, 2002 has not only provided sufficient independency but also created responsibility and accountability in the monetary and foreign exchange policy front, together with regulatory and supervisory role in the financial sector. Similarly, the establishment of Debt Recovery Tribunal and the Appellate Tribunal under the Financial Institution Debt Recovery Act, 2002 helped create mostly psychological impact in the loan recovery process. However, due to insufficiency/overvaluation of the pledged collateral in the referred loan cases, the performance of these institutions remained less than expectation.

The enactment of Banks and Financial Institutions Act (BAFIA) provided a single legislation with consistent and easy benchmarks for the functional behaviors of the whole deposit money banks/institutions. In addition to this, under the capacity building of the overall financial sector Public Debt Act, 2002, the Secured Transaction Act, 2006, Insolvency Act, 2006, amendment in the Foreign Exchange Regulation Act, 1962, Anti-money Laundering Act, 2008 and Banking Fraud Act, 2008 came into effect.

However, the establishment of much awaited institution: Asset Management Company (AMC) is yet to be realized. The NRB and the government are equally responsible for not showing the vigor in setting up the AMC rather than selecting an easy task of mandatory loan book write-off which became an instrument in upgrading the performance of the management contract teams in both the banks.

Regulatory Front: In order to maintain safe, sound and efficient financial system, the NRB has sufficiently improved the prudential regulation and supervision as per the international standard based on Basel Accord-I (1988). Similarly, the NRB is publicly committed to introduce the Basel Capital Accord -II from mid-July, 2008.

The credit information Bureau (CIB) is in operation by the private sector banks as a limited company. The CIB's byelaws are in effect to strengthen its functions and powers. As such, the black listing process for the loan defaulters has been made uniform for all the banks and non-bank financial institutions ensuring the system for better performance. The process of establishing new Bankers Training Center is being carried out by a team coordinated by the deputy governor of NRB after the termination of the foreign consultant in making the Center more effective and modern.

The auditing and accounting practices of NRB, RBB and NBL, and ADB/N were enhanced under the re-engineering program, within the management contract and performance contract respectively. The directives issued by NRB to all banks and financial institutions have clearly focused on building a prudent system regarding accounting policies, auditing procedures, disclosure requirements and long-form reports. In view to streamline the financial accountability structure, Government of Nepal conducted a study on Country Financial Accountability Assessment. The establishment of accounting board and auditing board would certainly help maintain the international accounting standard.

Various activities related to the training for financial journalist, study tour and training for DRT staff and logistic support for all major stakeholders (banking, DRT, judiciary, the federation of chamber of commerce and industry (FNCCI), government agency, media persons, multilateral agency, etc) for the conduction of seminar/workshops on various aspects of financial sector have been conducted.

For the smooth operation and monitoring of the reform program, a Top Level Coordination Committee (TLCC) was set up under the coordination of the vice chairman of National Planning Commission (NPC), which was later reformed and renamed as Economic and

Financial Sector Reform (EFCR) High Level Committee under the coordination of Finance Minister.

The Committee is responsible for coordinating government plans and programs dealing with policy issues for the successful implementation, monitoring the activities and achievements of economic and financial sector reform and providing policy guidelines on various issues. The NRB, as an implementing authority on behalf of the government for the overall financial sector reform, should be responsible for observing processes, evaluating performances, making suggestions and implementing policies through monitoring and surveillance committee under the coordination of the Chief of Banks and Financial Institutions Regulation Department of the NRB under the guidance of the EFCR. Similarly, there are other committees and teams that deal with the progress analysis of the large two banks, and procurement and financial issues within the program.

The process of hiring advisor for bringing the large two banks to the point of sale and proposal has been published to undertake proper due diligence, prepare prospectus and develop the road map for the banks. The request for proposal for the short listed company has been issued but the final outcome is yet to come. The extended contract prices have been approved on bank-wise basis with revised performance indicators in view to deepening the reform process in the two large banks for the improvement of operational capacity on a more commercial basis.

The performance indictors of the two big banks show the comparative performances and achievements under the management contract. It is obvious that the public sector banks are in trouble with a cumulative effect of the inefficiency of the management in the past with lacking responsibility and accountability together with corrupt and nonprofessional choice in the management. Since the immediate past, both banks have been continuing the loan recovery efforts with the support of NRB and government such as the action of blacklisting and confiscation of the passport of the defaulters. However, the recovery performance basically from the big defaulters has not been encouraging in spite of the stern actions as mentioned above.

Even in the small defaulters' loan cases, the overvaluation and sub-standard collaterals are the major problems. These defaulters are even enjoying interest waivers, whereas the holders of good quality collaterals are bound for relatively higher repayments. The following comparison of the two restructuring banks with the pre and post restructuring scenario reveals the performance on the whole.

Performance Indicators of NBL and RBB

(Rs. in million)

Particulars	**At the beginning of Management Contract**	**At the end of Management Contract**
1. Total Loans (2 + 3)		
- NBL	19, 252	15, 943
- RBB	26, 793	25, 297
2. Good Loans		14, 180
- NBL	8, 418	18, 505*
- RBB	7, 503	
3. Bad Loans		
- NBL	10, 834	1, 763
- RBB	19, 290	6, 792
4. Cash Recovery		
- NBL	-	8, 932
- RBB	-	12, 300
5. NPA (%)		
- NBL	56.3 %	11.1%
- RBB	72.0 %	26.9 %
6. Net Worth		
- NBL	(9, 554)	(6, 178)
- RBB	(19, 184)	(16, 831)
7. Deposits		
- NBL	35, 014	39, 977
- RBB	40, 007	54, 330

8. Investment		
- NBL	7, 151	15, 049
- RBB	5, 758	14, 661
9. Net Profit		
- NBL	(3, 071)	69.7
- RBB	(1, 733)	382
10. Loan Book Write-Off		
- NBL		
- Principal	-	4, 158
- Interest	-	8, 701
- RBB		
- Principal	-	3, 916
- Interest	-	9, 774
11. Number of Branches		
- NBL	134	99
- RBB	133	114

*Footnotes: The figures for the beginning of the management contract given in the table refer to mid July, 2002 in the case of NBL and mid January 2003 in the case of RBB whereas the end of management contract figures for both the banks refers to mid January, 2008. * Includes the rescheduled loan of Rs.1,083 million in case of RBB. Figures within parenthesis refer to negative value. – Refers either not available or not applicable.*

The restructuring of the Agriculture Development Bank has been initiated very recently under the financial assistance of the AsDB. The study of the overall performance of the Nepal Industrial Development Corporation (NIDC) has been completed.

Public Sector and Governance Reforms: As mentioned above, the structural reform was focused on the public sector reform and governance reform, among others. The medium term objective of the reforms was to create conducive atmosphere for higher economic growth by improving resource allocation, reducing corruption and increasing accountability. Such reforms were expected to be supported by the World Bank under Poverty Reduction Support Credit (PRSC) and AsDB's Governance Reform Program (GRP) and Public Sector

Management Program (PSMP). The objectives of the GRP included improvements in civil service efficiency, governance and reduction in corruption. The PSMP aimed at disengaging government from state-owned enterprises (SOEs) management and ownership, and strengthening public and corporate sector governance.

The major thrust of public sector reforms including governance was focused on:

- Making civil service more efficient;
- Rightsizing civil service employees;
- Ensuring better incentives for professional staff to increase accountability on policy implementation;
- Reducing government ownership in the economy through:
  – Privatization and restructuring of viable enterprises; and,
  – Liquidation of non-viable enterprises;
- Improving management, accountability and performance of SOEs;
- Initiating sales of shares in the profitable institutions and internal unbundling of the Nepal Electricity Authority;
- Assessing financial position and auditing of the Nepal Oil Corporation by an international firm as well as to open this sector to private competition;
- Intensifying anti-corruption drive by improving the institutional structure and capability of the Commission for Investigation of Abuse of Authority (CIAA) and Special Court;
- Preparing procurement assessment report for the transparency and reducing leakages in public procurement;
- Increasing local involvement in policy making and implementation to improve service delivery and accountability through decentralization; and,
- Reforming Labor Act, Company Act and Insolvency Act in improving regulatory framework for facilitating private sector.

The readily available public information in this regard is very hard to retrieve thus is actually difficult to draw inferences on the development of public sector reform under the PRGF supported program. However, some of the reforms have already been completed, leaving some others in progress. The formulation of Medium Term Expenditure Program (MTEF) to prioritizing the government development program as P_1, P_2, and P_3 and also the restructuring of the expenditure heads as recurrent, capital and principal repayment are the major milestone in the fiscal policy to ensure internationally accepted norms. Similarly, the adjustments of the tariff structure in the international trade in line with the commitment made in World Trade Organization (WTO) together with the structural reform in the custom offices are some reform efforts.

Several studies have recommended policy measures to reform Nepal Oil Corporation (NOC), but only few reform measures have so far been taken. Similarly, the problems of Nepal Airlines Corporation (NAC) have not been addressed so far whereas the recent issuance of shares to its employees and the general public is a starter of the reform in the Nepal Telecom.

The government of Nepal with the technical assistance of the AsDB initiated the Economic Policy Network (EPN) in 2004 to develop and institutionalize an open, responsive and result oriented economic policy formulation to support and consolidate economic policy reforms on poverty reduction strategy. Under four thematic groups, the focus was on the areas of macroeconomic management; trade; investment and employment; infrastructure development; tourism; agriculture and regional development. More than thirty studies have been completed, which could also be reference materials for policymakers for future reforms.

Similarly, the government of Nepal has been implementing the economic reform program with the Economic Reform Technical Assistance (ERTA) of International Development Association (IDA Grant H173-NEP) of the World Bank since 2005/06 to strengthen the public sector capacity to implement economic reforms. The total cost under the ERTA project is equivalent to US$ 3 million including

(a) $ 1 million for pre-identified activities and (b) $ 2 million for Challenge Fund activities. The major objectives of this economic reform program are to help improve service delivery, public sector management, social inclusion, reduce public sector intervention in the economy in order to lead the economy on a higher growth path. Altogether there are thirty sub-projects, twenty as the pre-identified sub-projects and ten sub-projects under the Challenge Fund. All these sub-projects are being implemented by the related government agencies including the preparation of the proposals.

Nevertheless, such projects may have a strong positive impact on the institutional drive for reform orientation. Some of the major sub-projects under the ERTA program include: capacity building of the FCGO for public financial management; strengthening revenue administration; good governance; community school management; unified civil service; capacity building of the CIAA; personal information system (PIS) through e-governance; public enterprise privatization; MTEF-VI formulation; quality improvement in audit; standardizing accounting system for public entities; distributive trade survey; self governance strengthening; public procurement monitoring; securities data management system; civil service training; etc. It is too early to assess the effectiveness and the impact on the whole since only a few sub-projects have been completed and the rest are ongoing.

Problems and Challenges

Financial Sector: Obviously, reform is a continuous process. Looking at the reform process and performance of the two banks as well as the re-engineering of NRB, among others, there are some signs of improvements, which further needs to keep continue. However, some structural and policy level problems like: the establishment of AMC; further stern actions against the willful defaulters; indications of unhealthy competition in the financial sector; strong obligation of maintaining standard NPA level even in the private sector banks/financial institutions; practicable and sustainable framework for the rural financial sector model to invigorate the rural economy; developing innovative instruments in exploring economic potentiality;

etc are still lacking. Such crucial issues should be the main agenda and need to be addressed for a sound and sustainable growth of the overall financial sector in the future.

Public Sector: Despite some policy and structural reforms at the public sector, the major issues like the efficient, dynamic and modern revenue collection system such as taxpayer-friendly; good governance to uproot the policy level and implementation level corruption; overall working environment and strong reward and punishment system; capacity building of the corruption control agencies; defined responsibilities and accountabilities of the civil servants; quality public service delivery; effective monitoring and evaluation system; effective privatization/restructuring of the state-owned enterprises; transparent and simplicity of the bureaucratic process; right man in right place are some of the fundamental problems to be addressed in the future agenda. As the reform in such issues can not be taken at once for all, there should be a robust mechanism and continued follow-up.

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Impact of PRGF-Supported Programs Aimed at Poverty Reduction and Economic Growth in Nepal

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1. Role of Foreign Aid

Foreign aid has played a crucial role in the economy of Nepal by channeling resources toward meeting a substantial share of the investment needs of the government. While the foreign borrowing constitutes a significant source of deficit financing, the foreign grants help supplement the development financing through mobilization of the non-debt resources for the government. The policy measures and other criteria that constitute the conditionalities of the aid mechanism aim at accomplishing the targeted performance of the aid, envisage fostering a sound investment climate in the economy, and focus on improving the resource generation and allocation pattern so as to improve the competitiveness of the economy and usher in a sustainable growth and development pattern in the country. So, the donor community would be enthusiastic to provide the assistance if it is satisfied that appropriate policy environment and sound implementation framework are in place so that the resources could be utilized as planned or desired. In this context, the donors would like to ensure whether the identified conditions or measures like those aimed at maintaining macroeconomic stabilization and addressing the pressing structural and sectoral reform initiatives are implemented by the aid recipient as designed and agreed for the particular aid component. These measures could comprise the time-bound quantitative performance criteria and indicative targets in the areas of the monetary and government finance, structural performance criteria in the fiscal and financial sectors, and structural benchmarks with respect to the reform activities. The Poverty Reduction and Growth Facility (PRGF) of the International Monetary Fund (IMF) and the Poverty Reduction Support Credit (PRSC), as part of the country-owned Poverty Reduction Strategy Paper (PRSP), of the International Development Association (IDA), the soft-loan window of the World Bank, specifically require such conditionalities fulfilled before assistance is agreed or amount disbursed by these institutions. The other bilateral or multilateral donors would also like such arrangements put in place as the condition for extending their aid package.

There are, however, concerns that the conditionalities attached with the foreign aid have focused more on attempting to address the structural issues of development like increasing the involvement and role of the private sector vis-a-vis that of the government. If the stiff conditionalities result in the short disbursement of the resources, some observers believe that the potentially significant role of foreign aid in contributing toward the economic growth and poverty reduction would be compromised. Given the prominent role of foreign aid in most of the sectors and areas of the economy, it could be assumed that the reduction in the foreign aid flows would hamper the growth of socio-physical infrastructure and other critical components of the development process in Nepal.

The Tenth Development Plan (2002-07) was developed as the PRSP for Nepal. The Plan had projected that 57.5 percent of the development expenditure under the desired growth projection (6.2 percent) would be financed through the foreign assistance. Such ratio under the normal growth projection (4.3 percent) was estimated at 67.1 percent. Foreign assistance as percent of the total expenditure (regular and development) was estimated at 26.6 percent under the desired growth scenario and 26.2 percent under the normal growth scenario. Government revenue as percent of the total expenditure was estimated at 63.6 percent under the desired growth scenario and 63.8 percent under the normal growth scenario. During the five-year period (2003–07), the actual foreign assistance mobilized as percent of the total actual expenditure averaged 20.6 percent as against the projections of 26.6 percent and 26.2 percent, as mentioned before. The actual government revenue as percent of the total actual expenditure during the period averaged 67.1 percent as against the projections of 63.6 percent and 63.8 percent. Thus, comparing the actuals with the projections in terms of the total expenditure, less foreign assistance and more revenue was mobilized. The expenditures were later reclassified as recurrent, capital and principal repayment. As per this classification, the foreign assistance financed an average of 77.2 percent of the capital expenditure during the Tenth Plan period.

The Three-Year Interim Plan–TYIP–(2007–10) projects that foreign aid will finance an average of 78.6 percent of the capital expenditure, 1.4 percentage point more than the Tenth Plan average. Likewise, the foreign aid as percent of the total expenditure is projected at 27.5 percent, 6.9 percentage point higher than the Tenth Plan average of 20.6 percent. The foreign grants and loans respectively represented 12.9 percent and 7.7 percent of the total expenditure during the Tenth Plan period. The TYIP has projected such ratios at 16.5 percent for the grants and 11 percent for the loans. The capital expenditure, which represented 27.6 percent of the total expenditure in FY 2006/07, is projected to rise to 35 percent during the TYIP period. On the other hand, the recurrent expenditure as percent of the total expenditure is projected to fall to 55.8 percent during the TYIP period from 60.9 percent in FY 2006/07. The government revenue as percent of the total expenditure during the TYIP period is projected at 62.4

percent, 4.7 percentage points less than the Tenth Plan average of 67.1 percent. This shows that the foreign aid would continue to remain an important source of financing the higher level of the capital budget of the government.

2. PRGF Process

Financing under the IMF's lending arrangements, which are similar to a line of credit, are approved by the IMF Executive Board to support a country's adjustment program. The arrangements require the members to observe specific terms and conditions in order to be eligible to receive a disbursement. The IMF lends under Stand-by and Extended arrangements and, at reduced rates, under the PRGF. This low-interest lending facility of the IMF was established in September 1999 to make the objectives of poverty reduction and growth more central to lending operations in the poorest member countries of the IMF. The PRGF-supported programs are underpinned by comprehensive country-owned poverty reduction strategies. As of August 2007, 78 low-income countries were eligible for the PRGF assistance. The eligibility is determined principally on the IMF's assessment of a country's per capita income, based on the eligibility to the concessional lending of the World Bank (in 2005, the threshold per capita gross national income was US$ 1,025). Loans under the PRGF carried an annual interest rate of 0.5 percent, with repayments made semi-annually, beginning 5.5 years and ending 10 years after the disbursement.

Under a three-year arrangement, the eligible country may normally borrow up to a maximum of 140 percent of its quota in the IMF although this may be increased to 185 percent of quota in exceptional circumstances. In each case, the amount will depend on the country's balance of payments (BOP) need, the strength of its adjustment program, and its previous and outstanding use of IMF credit. The expected average access under the initial three-year arrangement is 90 percent of quota. PRGF-eligible members with per capita income above 75 percent of the cutoff for concessional lending of the World Bank, or members borrowing on commercial terms, could combine the

PRGF arrangements with lending from the IMF's non-concessional Extended Fund Facility (EFF).

PRGF-supported programs are framed around comprehensive, country-owned PRSPs. The targets and policy conditions in a PRGF-supported program are drawn from the country's PRSP, which is being prepared by the member country through a participatory process involving domestic stakeholders as well as external development partners, including the World Bank and the IMF. The PRSPs describe the country's macroeconomic, structural and social policies and programs over a three-year or longer horizon to promote broad-based growth and reduce poverty. Besides, the PRSPs describe the associated external financing needs and major sources of financing. Interim PRSPs (I-PRSPs) summarize the current knowledge and analysis of a country's poverty situation, describe the existing poverty reduction strategy, and lay out the process for producing a fully developed PRSP in a participatory fashion. PRSPs would then be considered by the Executive Boards of the IMF and the World Bank as the basis for concessional lending from each institution and debt relief under the joint Heavily Indebted Poor Countries (HIPC) Initiative.

Reviews of the PRGF by the IMF staff in 2002 and by the Independent Evaluation Office (IEO) of the IMF in 2004 confirmed that the design of the programs supported by PRGF lending became more accommodating to higher public expenditure, in particular pro-poor spending. A review of PRGF program design by the Executive Board in September 2005 found that, while macroeconomic outcomes in low-income countries had improved markedly, the per capita income remained low. The review, in particular, noted the importance of broad economic institutions for sustained growth and stability, and the need to manage the increased aid flows carefully.

Among the key features, first, the principle of broad public participation and greater country ownership is central to the PRGF. In this regard, discussions on the policies underlying PRGF-supported programs are more open, since they are based on the nationally-owned PRSP. With increased national ownership, PRGF conditionality becomes more prudent, focused on the Fund's core areas of expertise, and limited to measures that have a direct and critical impact on the program's macroeconomic objectives. Second, PRGF-supported programs reflect each country's poverty reduction and growth priorities more closely. Key policy measures and structural reforms aimed at poverty reduction and growth are identified and prioritized during the PRSP process and, if feasible, their budgetary costs are assessed. Countries' budgets under the PRGF-supported programs reflect this analysis. Moreover, fiscal targets in PRGF-supported programs respond flexibly to changes in country circumstances and pro-poor policy priorities, while ensuring that the strategy could be financed in a sustainable, non-inflationary manner. Third, PRGF-supported programs focus on strengthening governance, in order to assist countries' efforts to design targeted and well-prioritized spending. Of particular importance are measures to improve public resource management, transparency, and accountability. PRGF-supported programs also give more attention to the poverty and social impacts of key macroeconomic policy measures.

PRGF-supported programs are designed to cover only areas within the primary responsibility of the IMF unless a particular measure is judged to have a direct, critical macroeconomic impact. Areas typically covered by the IMF include advising on prudent macroeconomic and financial policies and related structural reforms such as exchange rate and tax policy, fiscal management, budget execution, fiscal transparency, and tax and customs administration. When appropriate, the IMF draws on World Bank expertise in designing PRGF-supported programs, and the staffs of the Fund and the Bank cooperate closely on conditionality. The Bank staff takes the lead in advising the authorities in the design of poverty reduction strategies in areas such as poverty assessments, monitoring, structural and sectoral issues, social issues, and costing priority poverty-reducing spending.

The PRGF/PRSP process makes the structural reform of the economy as one of the major strategies. Such a reform would be extremely useful toward attaining success in the greater mobilization and the better utilization of the resource in addition to improving the health and stability of the economy. In this context, the IMF also organized in Washington, D.C. during February 28–29, 2008 a conference entitled Causes and Consequences of Structural Reforms so as to provide a forum for discussing theoretical and empirical research on the causes and consequences of structural reforms—especially in terms of their effect on growth, macroeconomic stability, and resilience to shocks. The conference covered the structural reforms very broadly, including reforms of domestic financial sectors, labor markets, product markets, trade and capital accounts, and the public sector. The deliberations shed light on how such reforms operated in practice, how they interacted with each other as well as with macroeconomic policies and political institutions across all segments of the IMF's membership, including industrial, emerging market, and low-income countries. The conference aimed at advancing understanding of these issues, especially in relation to the following topics: (a) new data sets for measuring financial, labor, product, trade, and public sector reforms, (b) determinants of structural reforms (including domestic political conditions, international linkages, exogenous shocks, and economic crises). (c) impact of structural reforms on economic growth and welfare, (d) timing and sequencing of structural reforms, and the consequences thereof, (e) interactions between structural reforms and macroeconomic policies, and (f) structural reforms and political institutions.

3. PRGF in Nepal

On November 14, 2003, the Executive Board of the IMF approved in-principle three-year SDR 49.9 million PRGF arrangement (representing 70 percent of Nepal's quota amounting to SDR 71.3 million) to support the country's economic reform process through July 2006. The period was later extended to November 2007. Following the World Bank's Executive Board review of Nepal's PRSP on November 18, 2003, the IMF Board's decision became effective whereby Nepal could draw an amount equivalent to SDR 7.13 million. (The press releases of the IMF and the IDA in this connection are given as Appendix I and Appendix II.)

Nepal sought to break a vicious cycle of low growth, pervasive poverty, and insurgency by implementing a comprehensive reform agenda outlined in the PRSP that focused on broad-based sustainable economic growth, social sector development, targeted programs for the poor and disadvantaged people, and good governance. The key elements of the PRGF-supported program in line with the PRSP were as follows:

On fiscal policy, the program aimed at boosting revenue and reducing domestic financing, while redirecting spending to social and key infrastructure sectors. By 2005/06, revenue was projected to increase by 1.25 percentage points to 13.5 percent of GDP, based on revenue administration reforms, increment in VAT rate, and rationalization of VAT and customs exemptions. Reductions in domestic borrowing would help maintain fiscal sustainability.

The program's monetary and exchange rate policies would remain geared to supporting the fixed exchange rate arrangement with the Indian rupee. The fixed exchange rate has served Nepal well given close ties with India. The program envisaged that the level of the exchange rates would be kept under review in the light of the external developments, such as the phasing out of the Multi-Fiber Arrangement since January 1, 2005, with its likely risks and challenges for the export growth. Over the medium-term, competitiveness would be enhanced by reforms to reduce labor and non-labor input costs.

The strategy for the structural reform agenda would focus on financial and public sector reforms, and improving governance. Reforms in these areas would create conditions for higher growth by improving intermediation and resource allocation, reducing corruption, and increasing accountability.

- Financial sector reforms involved central bank strengthening, improved legislation and loan recovery, and restructuring of commercial and development banks.
- Public sector reforms included reforming the civil service to make it more efficient; privatization/liquidation of unviable enterprises and divestment from the profitable ones to enhance their efficiency.
- Governance reforms would involve steps to combat corruption and efforts to decentralize delivery of social services.

As the first of the seven installments of the PRGF arrangement, an amount equivalent to SDR 7.13 million was released on November 19, 2003. Another installment amounting to SDR 7.13 million was released on October 20, 2004. Hence, before November 2006, only SDR 14.26 million (28.6 percent of the total) was released through these two installments. No amount was released during 2005 due to lack of progress in pursuing reforms and demonstrating credible commitment to macroeconomic stability. The subsequent progress since attained in these directions made further releases possible, amounting to SDR 14.26 million on November 17, 2006, SDR 10.69 million on June 13, 2007 and, following the completion of the fifth and final review, SDR 10.69 million (US$ 16.9 million) on November 9, 2007. The amount drawn under the PRGF thus totaled SDR 49.9 million (US$ 79.1 million).

Nepal: History of Lending Arrangements from May 1, 1984 to December 31, 2007

(In Thousands of SDRs)

Facility	Date of Arrangement	Date of Expiration or Cancellation	Amount Agreed	Amount Drawn	Amount Outstanding
PRGF Commitments	Nov 19, 2003	Nov 18, 2007	49,900	49,900	49,900
PRGF Commitments	Oct 05, 1992	Oct 04, 1995	33,570	16,785	0
Structural Adjustment Facility Commitment	Oct 14, 1987	Oct 13, 1990	26,110	26,110	0
Standby Arrangement	Dec 23, 1985	Apr 22, 1987	18,650	18,650	0
		Total	**128,230**	**111,445**	**49,900**

4. PRSP/PRSC in Nepal

Peace and political stability would sustain the reduction in the level of poverty and help achieve social sector development. Attainment of the millennium development goals (MDGs) required scaling up of resources and priority allocations in the respective sectors. Devolution of more tasks and functions to the local bodies and communities would be needed for effective service delivery at the grassroots level. Governance reform would foster more transparency in the functioning of the government and containing corruption. With these considerations as part of the discussions of the Country Assistance Strategy (CAS), the Executive Board of the World Bank envisioned a series of annual Poverty Reduction Support Credits (PRSCs) in order to support the implementation of Nepal's PRSP. The PRSC I, in the amount of US$ 70 million, approved on November 18, 2003 with closing date on November 1, 2004, was the first in this series. The PRSC aimed at (a) economic growth generation, (b) service delivery improvements, (c) social inclusion promotion, and (d) governance improvements. The targeted thematic outcomes of the PRSC were (a) participation and civic engagement, (b) regulation and competition policy, (c) administrative and civil service reform, (d) decentralization, and (e) public expenditure, financial management and procurement. The amount of the first PRSC was disbursed in 2003. It has a grace period of 10 years and the maturity of 40 years. Among the sectoral components were the (a) public administration, law and justice (40 percent), (b) health and other social services (15 percent), (c) education (15 percent) (d) water sanitation and food protection (15 percent), and (e) finance or banking (15 percent). The PRSC II was originally planned for September 2004 but its processing could not occur due to the unfavorable impact of the changed political scenario on the reform implementation.

The first phase of reforms supported by PRSC I included selective key reforms that directly contributed to pro-poor growth by improving the effectiveness of growth-enhancing public investments besides adopting measures for improving the investment climate. The PRSC also supported reforms in improving service delivery and assisted the government in developing annual benchmarks consistent with the broad reform objectives of the PRSP. The fiscal and technical resources necessary to accelerate the devolution of management of primary schools and health posts to the local communities were an integral component of the PRSC support to improve service delivery. The PRSC also supported Nepal's efforts to promote social inclusion by improving the effectiveness of targeted programs, improving access to schooling for excluded groups, and encouraging civil service diversity. In the area of governance, the emphasis was on fostering the effectiveness of the civil service, strengthening anti-corruption and accountability institutions, contributing to the functioning of key agencies, and improving financial management including its transparency and procurement practices.

5. PRGF and its Impact

The positive outcomes of the PRGF are quite evident. Nepal has been successful in maintaining an environment of macroeconomic stability, even in the current stage of transition so critical for determining her future course of political transformation and socio-economic development. The economy experienced broad macroeconomic stability as reflected in the controlled level of the inflation (internal stability) and the surplus in the BOP as well as the comfortable level of the foreign exchange reserve (external stability). The fiscal deficit was under control and the government's total outstanding debt, both in amount and as percent of the GDP, came down as a result of the decline in the foreign debt liability.

Inflation: The rate of inflation was 4 percent in FY 2003/04, 4.5 percent in FY 2004/05, 8 percent in FY 2005/06, and 6.4 percent in FY 2006/07. The relatively higher inflation in FY 2005/06 reflected the supply-side shocks, generally beyond the normal purview of the domestic policy exercises. It is projected to remain at 6.5 percent in the current FY 2007/08.

BOP and Foreign Exchange Reserve Level: The BOP surplus amounted to Rs 4.36 billion in FY 2002/03, Rs. 16 billion in FY 2003/04, Rs. 5.7 billion in FY 2004/05, Rs.25.6 billion in FY 2005/06, and Rs. 5.9 billion in FY 2006/07. The foreign exchange reserve level remained comfortable at Rs. 108.2 billion in mid-July 2003, Rs. 130.2 billion in mid-July 2004, Rs. 129.9 billion in mid-July 2005, Rs. 165 billion in mid-July 2006, and Rs. 165.1 billion in mid-July 2007. Reflecting the external stability, the foreign exchange reserve level in terms of the US dollar was US$ 1.44 billion in mid-July 2003, US$ 1.76 billion in mid-July 2004, US$ 1.85 billion in mid-July 2005, US$ 2.23 billion in mid-July 2006, and US$ 2.55 billion in mid-July 2007. The foreign exchange reserve in mid-July 2007 was sufficient for 10.3 months' merchandise imports and 8.5 months' merchandise and service imports.

Economic Growth Rate: The slow economic growth has remained an acute problem area for the economy in the recent years. In FY 2002/03, the first year of the Tenth Five-Year Plan, the growth rate was 3.9 percent followed by 4.7 percent in FY 2003/04, 3.1 percent in FY 2004/05, 2.8 percent in FY 2005/06, and 2.5 percent in FY 2006/07. The growth rate during the five years thus averaged 3.4 percent; lower than the low-case growth projection (4.3 percent) of the Tenth Plan. During the five years prior to FY 2001/02 (namely, FY 1996/97 through FY 2000/01), the growth rate had averaged 4.9 percent. The growth rate during the earlier five-year period (FY 1991/92 through FY 1995/96) had averaged 5 percent. It can be observed that the growth rate started to slow when the development activities of the government as well as the investment process in the private sector suffered as the conflict intensified. The export also witnessed setbacks due to the imposition of the quantitative restrictions in the export market in addition to the end of the garments quota and the qualitative considerations of the Nepalese export. Stoppages of the vehicular traffic and forceful closure of the institutions as the pressure tactic to fulfill the demands of the agitating groups disturbed the normal movement of the goods and people and the business as usual, negatively affecting the investment, output, employment and productivity in the country. The overall environment for the economic growth and development thus became unfavorable.

Poverty Ratio: Despite the slower economic growth, the poverty situation improved during the period. The Nepal Living Standards Surveys conducted in FY 1995/96 (NLSS I) and FY 2003/04 (NLSS II) showed the ratio of population below the poverty line falling from 41.76 percent in FY 1995/96 to 30.85 percent in FY 2003/04. The NLSS II attributed the growth in the farm income, non-farm income and remittances to such reduction in the poverty. Reduced level of poverty even in the situation of widespread conflict and adverse business and development climate reflected a very favorable indicator for the economy of Nepal.

Gross Capital Formation: The gross capital formation as percent of GDP was 19.9 percent in FY 2002/03, 20.3 percent in FY 2003/04, 19.9 percent in FY 2004/05, 20.9 percent in FY 2005/06, and 18.4

percent in FY 2006/07. Political transition and the related disturbances also affected the investment climate in the country. The share of the government in the gross capital formation declined from 15 percent in FY 2002/03 to 13 percent in FY 2006/07. This shows unfavorable investment climate in general and large disturbance for the expansion of the government investments in particular.

Revenue Mobilization: There is a positive note with respect to the growth in the mobilization of revenue, especially in the recent period. The government revenue had amounted to Rs. 56.2 billion in FY 2002/03, Rs.62.3 billion in FY 2003/04, Rs.70.1 billion in FY 2004/05, Rs.72.3 billion in FY 2005/06, and Rs. 87.7 billion in FY 2006/07. The revenue growth in FY 2006/07 was 21.3 percent and the revenue/GDP ratio was 12.2 percent. For the current FY 2007/08, the target for the revenue growth is 18.2 percent and the revenue/GDP ratio is targeted at 13 percent. Revenue financed an average of 64 percent of the total expenditure during FY 1999/2000 compared to the ratio of 67.5 percent during FY 2003/04-2006/07, when the PRGF was under implementation. Thus, the PRGF period was associated with the strength and sustainability of the fiscal operations.

Foreign Grants: The foreign grants amounted to Rs. 11.3 billion each in FY 2002/03 and FY 2003/04, Rs.14.4 billion in FY 2004/05, and Rs.13.8 billion in FY 2005/06. The revised estimate for FY 2006/07 was Rs. 15.9 billion. For the current FY 2007/08, the target for the grants is Rs. 27.5 billion. Foreign grants financed an average of 9.8 percent of the total expenditure during FY 1999/2000 compared to the ratio of 12.8 percent during FY 2003/04-2006/07, when the PRGF was under implementation. This shows the positive role of the PRGF in the mobilization of greater amount of resources in the form of grants.

Capital Expenditure: The capital expenditure under the budget amounted to Rs. 22.4 billion in FY 2002/03, Rs.23.1 billion in FY 2003/04, Rs.27.3 billion in FY 2004/05, and Rs.29.6 billion in FY 2005/06. The revised estimate for FY 2006/07 was Rs. 36.4 billion. Regarding the situation for the current FY 2007/08, the capital expenditure compared with the revised estimates for FY 2006/07 has been targeted to grow by 51.9 percent. Such growth rate in FY 2006/07 was 56.1 percent. The capital expenditure, which had comprised 26.7 percent share in the total expenditure in FY 2005/06 and 27.6 percent share in FY 2006/07, is projected to constitute a share of 32.7 percent in FY 2007/08. Also, due to the pressure on the recurrent expenditure which as percent of the total expenditure rose from an average of 58.5 percent in FY 1999/2000 to 60.9 percent in FY 2003/04-2006/07, the share of the capital expenditure reduced from 32.9 percent in FY 1999/2000 to 26.7 percent in FY 2003/04-2006/07.

Fiscal Deficit: The fiscal deficit/GDP ratios were 3.3 percent in FY 2002/03, 2.9 percent in FY 2003/04, 3.1 percent in FY 2004/05, and 3.8 percent in FY 2005/06. Because of the responsible budgetary operations even in a difficult situation, the government was able to confine the fiscal deficit/GDP ratio to 4.1 percent in FY 2006/07, though slightly higher than the ratio of 3.8 percent in FY 2005/06. For the current FY 2007/08, the projection for the deficit is 4.7 percent, still lower than the general benchmark of 5 percent for the developing countries.

Foreign Borrowings: The foreign borrowings amounted to Rs. 4.5 billion in FY 2002/03, Rs. 7.6 billion in FY 2003/04, Rs. 9.3 billion in FY 2004/05, and Rs. 8.2 billion in FY 2005/06. The revised estimate for FY 2006/07 was Rs. 10.3 billion. For the current FY 2007/08, the target for the foreign borrowing is Rs. 15.8 billion. Foreign borrowings had financed an average of 12 percent of the total expenditure during FY 1999/2000 compared to its ratio of 8.2 percent during FY 2003/04-2006/07. Thus, the government borrowing was significantly contained during the PRGF period.

Domestic Borrowings: The domestic borrowings amounted to Rs. 8.9 billion in FY 2002/03, Rs. 5.6 billion in FY 2003/04, Rs. 8.9 billion in FY 2004/05, and Rs. 11.8 billion in FY 2005/06. The revised estimate for FY 2006/07 was Rs. 17.9 billion. For the current FY 2007/08, the target for the domestic borrowing is Rs. 20.5 billion. Domestic borrowings had financed an average of 9.4 percent of the total expenditure during FY 1999/2000 compared to such ratio of 9.8 percent during FY 2003/04-2006/07.

Outstanding Debt Liability: The outstanding debt liability of the government was Rs. 303.9 billion (domestic Rs. 80.5 billion and foreign Rs. 223.4 billion) in mid-July 2003. This increased at a nominal rate of 1 percent to reach Rs. 315.9 billion (domestic Rs. 99.3 billion and foreign Rs. 216.6 billion) in mid-July 2007. The domestic debt stock recorded an annual rise of 5.4 percent while the foreign debt stock declined at an annual rate of 0.8 percent during the period. The outstanding debt/GDP ratio fell from 61.7 percent (domestic 16.3 percent and foreign 45.4 percent) in mid-July 2003 to 43.9 percent (domestic 13.8 percent and foreign 30.1 percent) in mid-July 2007. The debt stock, especially the foreign debt portion, has fallen quite substantially. This is expected to reduce the debt-related risks and vulnerabilities in the economy. The progress made in the mobilization of resources through revenue and foreign grants and the control in the growth of the fiscal expansion and the debt liability could be regarded as a welcome step on the public finance front.

6. Budget for FY 2007/08: Poverty Reduction and Social Sector Development

The budget for FY 2007/08 has given special focus on the targeted programs and activities aimed at reducing the poverty level in the country. Intensive program of poverty reduction covering the development of socio-economic infrastructure at the local level and enhancement of the skills, capacity and opportunities for the marginalized people is being run in the 40 districts including those in the Karnali zone that are lagging in the human development index besides covering all the southernmost village development committees (VDCs) of the Terai. Specific programs covering vegetables, livestock, fishery and herbs development are envisaged for raising the income level of the deprived through the agriculture. The day-meal program has been continued and scholarships provided so as to enhance the ratio of school enrollments among the marginalized target groups. "One family, one employment" program initiated in FY 2006/07 has been continued. Agriculture, land reform, local infrastructure development, expansion of alternative energy, forestry development, environmental conservation, etc., have been the other programs directly associated with the poverty reduction objective.

The budget for FY 2007/08 has incorporated strong packages for the purpose of human and social development. Compared to the allocation for FY 2006/07, the allocation for education has been increased by Rs. 5.4 billion to aggregate Rs. 28.4 billion, arranging additional number of teachers, training them and improving their capacity utilization, physical infrastructure development of the schools, conduct of the literacy programs, etc. Health sector has been allocated Rs. 12.2 billion, Rs. 2.9 billion more than that allocated in FY 2006/07. The health sector has targeted expansion in the primary health services, control of the population growth, reduction in the child and maternal mortality rates, improvement in the physical condition of the hospitals, and raising the average life expectancy of the people. Distribution of the potable drinking water among an additional two million people through development of a number of drinking water projects has been the target for FY 2007/08. Accordingly, drinking water has been allocated Rs. 5.3 billion. Senior citizen health program would be initiated in all the districts. A sum of Rs. 950 million has been allocated for the senior citizens. A law would be enacted to develop a reliable contributory pension system for the old-age security of the government employees, other workers and also the self-employed.

Despite the strained budgetary outlook hard pressed for earmarking large sums to meet the security challenge in an environment of rising social conflict and other disturbances that obstruct the process of change, it is encouraging to note that the investments in the social and economic sectors as percent of the total estimates have not fallen but risen compared to the previous year. As percent of the total expenditure estimate for FY 2007/08, social sector expenditure (education, health, drinking water, local development, and other social services) represented 37.6 percent. The revised estimate of such ratio in FY 2006/07 was 37.2 percent. The economic sector (agriculture, irrigation, land reform, forestry, transport, electricity, and other economic services) has been allocated 22.4 percent of the total budget in FY 2007/08 as compared to the revised estimate of 21.2 percent in FY 2006/07.

A total of Rs. 51.2 billion (30.3 percent) has been earmarked for programs like the rural infrastructure, capacity and income enhancement, assistance for the local bodies, people's participation-based programs, social security, etc., that have the potential to contribute directly to the objective of poverty reduction. The allocation for the gender-responsive budget amounts to Rs. 19.1 billion, 11.3 percent of the total budget. The share of the first priority expenditure in the social sector as percent of the total budget amount (Rs. 169 billion) was 89.4 percent compared to that of 84.8 percent in FY 2006/07. Expenditure as per the strategic focus of the budget for FY 2007/08 is projected at Rs. 31 billion, representing 18.3 percent of the total budget, with the expenditure on employment-oriented, poor-focused and broader economic growth sharing Rs. 15.51 billion and the expenditure on inclusive development and targeted programs sharing Rs. 15.46 billion.

7. Objectives of the Multilateral Financial Institutions (MFIs)

It would be relevant to note the objectives of the MFIs like the IMF, World Bank and the ADB so as to look at the specific roles and responsibilities that these institutions would be undertaking. The Fund and the World Bank as the twin Bretton-Woods institutions share the same goal of raising the living standards in their member countries. Their approaches to this goal are complementary, with the Fund focusing on ensuring the stability of the international financial system. The Fund was established to promote international monetary cooperation, exchange rate stability and orderly exchange arrangements. It provides policy advice and technical assistance to the member countries, makes loans and helps countries devise policy programs to solve the BOP problems. IMF loans are relatively short-term and funded mainly by the pool of quota contributions that its members provide. The World Bank, which has a motto of *Working for a World Free of Poverty*, promotes long-term economic development and poverty reduction by providing technical and financial support to help countries reform particular sectors or implement specific projects. The World Bank assistance is generally long-term and is funded both by member countries' contributions and through bond issuance. The Fund staff are primarily economists with wide experience in macroeconomic and financial policies while the World Bank staff are often the specialists in particular issues, sectors, or techniques. The IDA, as the part of the World Bank, helps the world's poorest countries. It aims to reduce poverty by providing interest-free credits and grants for programs that boost economic growth, reduce inequalities, and improve people's living conditions. The IDA is one of the largest sources of assistance for the world's 80 poorest countries. It is the single largest source of donor funds for basic social services in the poorest countries. IDA credits have no interest charge and repayments are stretched over 35 to 40 years, including a 10-year grace period. The IDA also provides grants to countries at risk of debt distress.

The vision of the ADB is *An Asia and Pacific Free of Poverty.* It is dedicated to poverty reduction in Asia and the Pacific. It contributes low-interest loans, guarantees, grants, private sector investments, and knowledge and advice to help build infrastructure and improve essential services such as health and education to boost the quality of life, particularly for the 1.9 billion people in the region still living on $2 or less a day. The focus of the ADB is on encouraging economic growth, social development and good governance, while promoting regional cooperation and integration. With the growing realization that too much development was bypassing too many people in he region, the ADB in 1999 adopted elimination of poverty as its principal mission. The assistance at present is guided by the medium-term strategy (2006-08) which has these five priorities: catalyzing investment from the private sector, strengthening inclusiveness, promoting regional cooperation and integration, encouraging effective environmental management, and improving governance and preventing corruption.

The focus of the IDA (World Bank) and the ADB is, therefore, on poverty reduction, building infrastructure, and improving the sectoral dimensions of socio-economic development. On the other hand, the focus of the IMF is on strengthening the financial and macroeconomic management to promote economic stability on a sustainable basis. Economic growth, employment and international trade could flourish in an environment where the macroeconomic management is sound and the confidence as to the overall economic stability is high. Accordingly, the IMF lends to the central bank of the country for the BOP purpose while the IDA and the ADB lend to the government to support it in its mission of economic development through cooperation in the various sectoral areas and dimensions. Given the macroeconomic stability that the economy of Nepal has been enjoying over the years, it could be presumed that the objective of the IMF with respect to its operation in Nepal has been attained to a satisfactory degree. Looking at Nepal's very high poverty level, inadequate infrastructure, and quite modest socio-economic development indicators, it seems that the IDA and the ADB need to aggressively embark on their operations before they could satisfy themselves about the progress of their mandated mission in Nepal.

Witnessing the persistence of a host of development problems and challenges which could be attributed to the deep and widespread social and political conflicts raging in Nepal for quite a long time now, these multilateral financial institutions at the present are quite generously expanding their activities in order to support Nepal in expediting her socio-economic development endeavors. For example, the World Bank approved on December 7, 2007 its largest-ever support package worth US$ 253 million (Rs. 15.9 billion) in grants, which Nepal and the World Bank signed on January 31, 2008, for projects like the Poverty Alleviation Fund, Education for All, Irrigation and Water Resources, and Road Sector Development. In January 2008, the Asian Development Bank (ADB) approved US$ 10 million (Rs. 6.3 billion) grants, the highest-ever single component so far provided by the ADB. The four-year project, which begins in 2008, is centered on remote 20 districts focusing on poverty reduction, inclusive development, governance and decentralization, rural infrastructure, growth in economic and employment opportunities, rural transport, and other supplementary infrastructure. While Nepal will deserve more such assistance in the coming days, the Nepalese implementation capacity also needs to be improved substantially so as to benefit the economy and people from the opportunities generously offered by the donor community. So, these institutions' increased support for the capacity enhancement especially in the field of project management, covering dimensions like the coordination, policy, operation and evaluation, would become highly relevant and useful for the country.

8. PRSP/PRSC: Some Comments

There are mixed observations regarding the effectiveness of the PRSP/PRSC in tackling the urgent and deep problems that Nepal's development process has been encountering. A recent study published by the ActionAid Nepal and the Institute for Policy Research and Development (Khanal and others, 2008) entitled Role and Effectiveness of Foreign Aid under PRSP in Nepal points out important areas and limitations of the PRSP/PRSC. According to the study, the PRSC aimed to support Nepal's reform programs with special focus on reviving economic growth, improving infrastructure and social sector development with better access to the excluded groups, fulfilling part of the financing gap through emphasis on the priority programs, improving governance through strengthening the civil service as well as improvement in the financial management and procurement practices of the government, and maintaining a sound fiscal balance and macroeconomic stability. The study mentions that the PRSC was supposed to contribute to pro-poor growth by creating fiscal incentive for, and improving the effectiveness of, growth-enhancing public investments and improving the investment climate. An assessment of the performance against the thrust or priority areas of reforms under the PRSC showed no satisfactory performance in many areas, according to the study. The study identifies that limits in the budgetary deficit, or maintenance of the fiscal balance, and success in raising the VAT rate were some areas showing satisfactory performance as per the conditions laid down in the PRSC. There were some successes in the devolution of the management responsibility of the primary schools and basic health services to the local management bodies. The report observes that the activities of the Poverty Alleviation Fund (PAF) were generally consistent with the goal of improving the social inclusion, with many projects being implemented in a growing number of the VDCs in different districts, focusing on the

Dalits and other disadvantaged groups. If the overhead costs were kept within limits and programs implemented in coordination with the local bodies, this program would be effective in addressing the livelihood problems of the poor. The study finds that the economic growth rate declined during the PRSC period and also that no attempts at broadening the base of economic growth were undertaken. The study notes that there was no satisfactory improvement in the areas of governance and legal system. The study observes that the governance further weakened, with no institution-related reforms strengthened for improving the delivery system which was at the heart of the PRSP. The study mentions that the foreign aid played a catalyst role in fulfilling foreign exchange requirement, meeting trade deficit, supporting saving-investment gap, and funding the fiscal gap of the government budgets.

The study also finds apparently weak relationship between the foreign aid and GDP growth, with the deceleration in the growth rate amidst rising aid corroborating this phenomenon. Though there was a sharp reduction in the poverty ratio during 1996 through 2004, the report, based on the trends, observes that the role of foreign aid in poverty reduction was meager. The NLSS II, the study notes, evidently proves that the contribution of the remittance income alone was more than 7 percentage points out of the reduction of the poverty by 11 percentage points during the period of 1996-2004. According to the study, foreign aid measurably failed to enhance the productive capacity of the Nepalese economy which otherwise would have helped unleash resources for sustained growth, thereby lessening the external dependency itself over time. The study remarks that the low priority on sectors contributing to the broad-based growth as well as the adoption of the narrowly-focused big bang liberalization guided by deregulation principles as per the conditions of the donors led to such aggravated situation. For the sake of fiscal balance, as the study notes, development programs were curtailed, more so in sectors like the agriculture, thereby constraining enhancement of the productive capacity of the economy and impacting negatively on the process of sustaining the broad-based economic growth. The study suggests for following a more accommodative approach by avoiding the imposition of stringent conditions harmful for both the democratization and peace-building processes, as Nepal now is passing through a political transition needing generous support from the donors for the purpose of progressive socio-economic transformation of the Nepalese society. According to the study, the so-called macroeconomic framework designed to link conditions on policy matters must be replaced by a framework that is compatible with the MDGs. The study opines that the tightening of fiscal and monetary policies without considering the composition of the proposed expenditures would become unfounded. For reducing the gap between the haves and the have-nots and addressing the problem of social contradictions and unrest, the study advises the donor community to adopt the aid programs so that they fully finance strategies for achieving the MDGs, also including the shelter, health, education, food security, and employment generation as the basic components of the aid strategy.

9. World Bank's Views on the PRSC

The Simplified Implementation Completion Report on the PRSC-I (Credit No. 3830-NEP) prepared by the World Bank has assessed the progress concerning the activities and reform initiatives under the PRSC. According to the report, the broad themes of the PRSC have been categorized as growth, service delivery, governance, and social inclusion under economic policy sector of the poverty reduction and economic management department. On the whole, the program has been ranked as satisfactory from the viewpoints of its outcome as well as the Bank and the borrower performances. The institutional development impact of the program has been rated as the *modest* and its sustainability assessed as the *likely*. According to the report's assessment, prudent fiscal and monetary policies resulted in macroeconomic stability, with contained inflation and maintenance of a comfortable level of foreign exchange reserves in line with the PRGF program with the Fund. The economic growth rate was not at par with the five percent average recorded during the 1990s. The demand for the Nepalese exports also weakened in the overseas markets. Large inflows under the current transfers, especially the remittances, resulted in a higher reserve level. Significant progress was made in streamlining tax policies and improving tax administration. Reforms to improve public expenditure management have been deepening. Building on the process of prioritizing development expenditure, the government is reorienting public spending priorities toward pro-poor activities. A move toward program-based budgeting is being facilitated through the implementation of sector-wide approaches in education and health. The medium-term expenditure framework (MTEF) has been extended to the recurrent side of the budget. The MTEF has also helped in warding off the unreasonable demands on the public expenditure. Besides, a coherent medium-term strategy on aid harmonization has been in place.

Financial sector reform has been progressing satisfactorily on several fronts though recovering dues from the large defaulters is proving difficulties. The PRSC I prior action included the appointment of foreign management teams with the responsibility for restructuring two of the largest state-owned, loss-making commercial banks. Progress in the areas of financial operations, accounting process, staff restructuring including the VRS, computerization, branch rationalization, etc. has been noticeable. Concurrent to these measures, the Banking and Financial Institutions Ordinance initially promulgated in February 2004 unified five separate banking laws under a single umbrella Act besides contributing to strengthen the regulatory and oversight functions of the NRB. In September 2004, Article 86 of the NRB Act was amended to further strengthen the central bank's ability to deal with the troubled banks. Blacklisting directives strengthened in September 2003 to penalize willful defaulters were modified in June 2004 to make the provisions of these directives consistent with the limited liability clauses of the Company Law. The pursuit of large defaulters, however, has been difficult despite the setting up of a Debt Recovery Tribunal as they could capitalize on loopholes in the legal system.

The establishment of the Roads Board as an autonomous entity to fund road maintenance was also a prior action of the PRSC I. The performance of the Board primarily depends on strengthening coordination with the body responsible for local and district road maintenance as well as receiving performance reports on the activities conducted by all road agencies so as to be able to release them the funds. Opening up the petroleum sector away from the monopoly of the State-owned Nepal Oil Corporation has also remained an important but still unfinished agenda. For improving the trade facilitation as a key for Nepal to remain competitive in the post multi-fiber arrangement (MFA), the Birgunj Inland Container Depot (ICD) became operational with the signing of a Memorandum of Understanding (MOU) between Nepal and India. The administrative reforms in customs such as the improved classification and harmonization, introduction of a customs calendar, and extension of the ASYCUDA to additional customs points should also provide a significant boost to Nepal's trade facilitation efforts. The need to make the labor laws flexible has also been understood by the stakeholders. Various reform initiatives have occurred toward improving the access to the social services through devolving implementation responsibilities to the community groups and providing the necessary financial and technical support. The devolution of the primary schools to the school management committees has been gaining momentum and the initial indicators of these devolved schools point out better performance. Similarly, the devolution of the health posts and hospitals to the local management groups is also progressing satisfactorily. Necessary activities are going on for increasing the coverage of safe drinking water services and the sanitation facilities.

A prior condition of the PRSC I in improving the inclusion was the establishment of the Poverty Alleviation Fund (PAF) as an independent body to channel resources to the poor communities. The PAF has been fully operational and expanding its mandated services over the years. Reforms to improve inclusion are integrated into ongoing overall sectoral reforms. For instance, the revised Civil Service Act incorporates affirmative actions in the civil service. In education, scholarships for the Dalit and children from other marginalized groups are in place and mechanisms for the social audit of these schemes are operationalized. There are reserved seats for Dalits and women in the health management committees.

Substantial progress has been made in carrying forward the governance reforms as an integral component for enhancing the internal capacity of the public sector so as to deliver services and generate pro-poor growth. The government has accorded high priority for strengthening institutions that tackle corruption at the level of both enforcement and prevention. The Commission for Investigation of Abuse of Authority remains the only constitutionally independent anti-corruption agency in South Asia and is increasingly being seen as the bulwark against corruption. The government has also taken several steps to improve the efficiency and accountability of the civil service. Some progress has been made in rationalizing the process of transfers, tenures and promotions, thereby allowing greater stability of tenures and policy coherence. This process has been underpinned by the development of a comprehensive Personnel Information System which has been linked to payroll information, and enables greater accuracy in civil service records and allows for the management of postings and transfers. The push toward increasing transparency is also reflected in progress on improving accounting and auditing practices. A number of new accounting and auditing standards have been published by the independent Accounting Standards Board and the Auditing Standards Board. Reforms have been made in the government accounting and financial management as well. Work on reconciliation of the overdue revenue and other unsettled accounts following the reports of the constitutional bodies like the Auditor General has been progressing. A new Procurement Act has been promulgated, codifying a more transparent and competitive public procurement and tendering process for the procurement of goods, civil works and services based on the UNICTRAL model law. The Nepal Administrative Staff College is building its capacity in delivering the procurement-related training.

The sustainability of reforms supported by the PRSC program hinges critically upon the ability to communicate the economic rationale behind such reforms. The government needs to hold consultations with relevant stakeholders, including people within the government, to not only inform the public at large about the pros and cons of reforms but also to solicit alternative strategies that could potentially maximize social welfare. Simple analytical work in a few crucial reform areas could help strengthen the resolve for reforms which needs to be supplemented by an appropriate communications strategy. Making environment supportive for reforms, developing realistic and relevant conditions at the time of program design, focusing attention on the implementation of reforms, and linking the assistance to up-front actions and not on promises would comprise the reasonable hedge against the risk of slow implementation of the envisaged program and activities.

10. Conclusion

While the economic growth squeezed due to the abnormal situation prevailing in the economy and the improvement in the poverty situation is attributed to the remittance flows besides the growth in the farm wage and the non-farm income, the PRGF/PRSC contributed toward fostering the macroeconomic stability and implementing important reform initiatives even in the ongoing period of political transition. The role of the PRGF/PRSP in mobilizing both the domestic and foreign resources has been quite evident. The mobilization of greater level of resources through the foreign grants has been a direct outcome of the programs. Directing more resources toward social, infrastructural and poverty-focused areas is also supported by these programs. Due to the various quantitative indicators and structural performance requirements, the macroeconomic situation remains prudent and the structural bottlenecks impeding the process of efficient resource allocation are significantly reduced. Investments could be catalyzed in a sound investment climate supported by strong macroeconomic fundamentals. So, the role of these programs in refocusing the stance and structure of the economic policies, mobilizing more resources, allocating the available resources efficiently including for the targeted poverty programs, ensuring macroeconomic soundness as the pre-requisite for increased investments and economic growth, and providing confidence and stable environment for carrying out the economic activities has been extremely important.

Nepal's track record in furthering reforms, strengthening the macroeconomic structure and restoring macroeconomic stability despite the extremely difficult situation has been appreciated by the donor community. The PRGF fourth review report of the IMF dated May 30, 2007 stated that the government's efforts and achievements—continued macroeconomic stability and further progress in structural reforms under trying circumstances—merited international support.

While completing on November 9, 2007 the fifth and final review of Nepal's economic performance under the PRGF, the Executive Board of the IMF commended Nepal for implementing prudent macroeconomic policies and structural reforms under difficult political circumstances. As the peace process moved forward, achievement of sustained higher economic growth and poverty reduction rested on the resolution of political uncertainties and continued implementation of key structural reforms in the fiscal, financial and public enterprise sectors, observed the Board. Continued macroeconomic stability was contingent on prudent fiscal policies that took into account the changing needs of the country, according to the Board, The Board believed that the 2007/08 budget was appropriately focused on boosting social sector and infrastructure spending, raising the revenue/GDP ratio, and limiting domestic financing. The Board welcomed the government's commitment to enhancing fiscal transparency. The Board also suggested improving efficiency-enhancing structural reforms and infrastructure investments. In the years ahead, effectively addressing the challenge of expediting economic growth and focusing on social sector in an environment of macroeconomic stability constitute the pre-requisite to poverty reduction to a substantial extent and on a sustainable basis. Hence, the PRGF/PRSC should be evaluated on the basis of their intended objectives and not on the basis of the criteria that do not form part of their package. Also, the effects of the other variables and situations that impact the working of the economy should not be interpreted as the effects of these programs. On the whole, the outcomes of these programs in making the macroeconomic framework and operations sound and sustainable, resource generation and utilization process effective, investment climate favorable, and development outcomes strengthened, focused and self-sustaining are worth appreciating.

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Appendix I

IMF Approves In-Principle Three-Year SDR 49.9 Million PRGF Arrangement for Nepal (November 14, 2003)

The Executive Board of the IMF approved in-principle a three-year SDR 49.9 million PRGF arrangement for Nepal to support the country's economic reform program through July 2006. The IMF Board's decision will become effective upon a further decision following the World Bank's Executive Board review of Nepal's Poverty Reduction Strategy Paper, scheduled for November 18, 2003. At that time, Nepal will be able to draw an amount equivalent to SDR 7.13 million under the PRGF arrangement. Following the Executive Board discussion, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, said:

"Nepal's Poverty Reduction Strategy Paper (PRSP) is a comprehensive and participatory effort to address the country's low growth, inadequate social sector investment, and limited income opportunities for the poor. The authorities' Fund-supported reform program aims at improving the conditions for sustained growth and poverty reduction, based on sound macroeconomic policies, better prioritization and enhanced efficiency in government expenditure, structural reforms in major sectors of the economy, and improved governance. The authorities are to be commended for their strong track record of policy implementation in support of their request for Fund assistance."

"To maintain macroeconomic stability, the authorities are firmly committed to putting fiscal policy on a sound and sustainable basis. Determined implementation of tax policy measures and strengthened tax and customs administration will help mobilize additional revenue. At the same time, careful prioritization of all spending will help raise allocations for key sectors and poverty-related spending. This will need to be supported by improved capacity building efforts to enhance the efficiency and effectiveness of development spending."

"Continued implementation of financial sector reforms is critical for achieving the PRSP's objectives. The NRB will be transformed into a modern and efficient central bank, and the authorities are strengthening the commercial banking sector through enhanced debt recovery, including tightened criteria for blacklisting loan defaulters and the establishment of a Debt Recovery Tribunal. It will be important to ensure the effective and timely application of these measures to all defaulters. Progress is also being made in improving the performance of the two largest and financially troubled commercial banks through installation of external managers."

"Implementation of the authorities' structural reform agenda will be key to creating conditions for higher, private sector-led growth. This includes the privatization or liquidation of selected public enterprises, civil service reforms and decentralization measures aimed at improving service delivery. Ongoing efforts to curb corruption, including strengthening of the Commission for Investigation of Abuse of Authority and the Special Corruption Court, are welcome and will need to be sustained over time."

"The authorities are to be commended for reaching an agreement on WTO accession. To fully realize the benefits from accession, it will be important to enhance external competitiveness, including through measures that will make the labor market more flexible."

"The authorities have demonstrated their commitment to reforms through strong policy implementation under difficult circumstances, and the broad support for the PRSP strategy represents an encouraging basis for breaking the cycle of low growth, poverty, and insurgency which Nepal has faced. Nevertheless, peace and political stability will be essential to ensure that the strategy's objectives of high economic growth and broad-based poverty reduction are fully achieved, and the authorities are encouraged to make strong efforts to work toward a peaceful resolution of the conflict," Mr. Sugisaki stated.

Recent Economic Developments

Despite decades of development efforts supported by foreign aid, Nepal remains among the poorest countries in the world with almost 40 percent of the population living in poverty. While macroeconomic conditions remained broadly stable in the 1990s, growth was constrained by financial sector weaknesses, weak public sector management, poor governance, and low agricultural productivity. More recently, economic management has been complicated by security problems related to the Maoist insurgency and an uncertain political environment, with real GDP growth in 2001/02 falling as low as 0.1 percent.

However, there have been some modest improvements in 2002/03 made possible by the ceasefire, and GDP growth rate recorded 3.9 percent. The January 2003 ceasefire, however, broke down in August 2003 and peace talks stalled. If peace could be restored and structural reforms implemented, growth would rise further to 5-6 percent over the medium term. Similarly, the economy witnessed price stability, with inflation remaining below 5 percent. The current account deficit is projected to increase, but higher aid, remittances, and other inflows should allow international reserves to be maintained at six months of imports of goods and services.

Appendix II

Chairman's Summing Up

Nepal Poverty Reduction Strategy Paper and Joint IDA-IMF Staff Assessment--Meeting of the Board of Executive Directors of IDA (November 18, 2003)

The Executive Directors discussed Nepal's Poverty Reduction Strategy Paper (PRSP) and the Joint IDA-IMF Staff Assessment of the PRSP. Directors welcomed the PRSP as providing a good vision for accelerating Nepal's reform momentum, improving economic and human development and fighting poverty. However, they noted major challenges and risks from the uncertainties posed by the continuing conflict and political instability.

Directors welcomed the focus on accelerating income and employment growth in rural Nepal and the recognition of social inclusion as a fundamental development challenge facing the country.

They noted the strategy's recognition of the country's constrained fiscal situation and weak implementation capacity, and welcomed proposals for a realistic approach to manage these constraints through a Medium-Term Expenditure Framework and an Immediate Action Plan.

They were also encouraged by the strategy's emphasis on improving delivery of public services through devolution of management to local communities and reducing corruption and corruption practices.

Some Directors felt that the PRSP may have underestimated the impact of civil conflict and the challenges it posed to implementation going forward. They noted that PRSP growth scenarios appeared optimistic and called for deeper analysis of the risks involved. They stressed the need to identify sources of growth and their linkages to poverty reduction. Directors also called for improvements in the costing of public policies as inputs to annual budget processes and further development of the MTEF to deepen prioritization to cover all government spending. They advised further elaboration of pro-poor rural strategies to ensure social inclusion through targeted programs and improvements across all the sectors in public service delivery.

Directors emphasized implementation of a coherent monitoring and evaluation strategy, including building capacity for poverty monitoring and developing an institutional framework for its implementation. They stressed the need for broadening and deepening the participatory process underlying the PRSP in order to enhance and secure ownership and accountability. In this regard, Directors urged that an open and transparent dialogue be institutionalized to share information and seek feedback about the document's implementation, and translate it into languages of the major ethnic groups.

Directors emphasized that the success of the PRSP process is contingent on peace and political stability which, in turn, is key to a sustainable macroeconomic framework to protect pro-poor expenditures, and improving governance and the overall policy environment. The immediate challenges for implementation are strengthening capacity to execute the envisaged programs, improving expenditure planning and control through an improved public expenditure management system, and building an effective monitoring system.

Directors noted the importance of developing output and outcome targets for the PRSP and the need to institutionalize effective monitoring and evaluation. In this regard, they supported greater stakeholder participation in assessing progress in the implementation of the PRSP. They strongly encouraged the government to undertake poverty and social impact assessments of key reforms envisaged in the PRSP. Finally, Directors concurred with staff that the PRSP provides a sound basis for IDA's concessional assistance to Nepal.