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Nepal: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

May 30, 2007

The following item is a Letter of Intent of the government of Nepal, which describes the policies that Nepal intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Nepal, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

May 30, 2007

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. de Rato:

The Government of Nepal held discussions with IMF staff during February 2–15, 2007 on the program supported by the Poverty Reduction and Growth Facility (PRGF). The purpose of this letter and the attached Memorandum of Economic and Financial Policies (MEFP) is to inform you of the progress in implementing the program and set out the policies for the period ahead. In addition, we request waivers for the nonobservance of performance criteria and completion of fourth review under the arrangement.

Despite the difficult political environment, Nepal has maintained macroeconomic stability and all quantitative performance criteria (QPCs) for the fourth review were met. However, some structural reform measures were delayed beyond target dates. In this regard, we request waivers for nonobservance of four structural performance criteria (SPCs) related to: (i) conduct of comprehensive audit of large taxpayers by the Large Taxpayer Office; (ii) establishment of a wide area network (WAN) by the Customs Office for headquarters and (at least) five large customs offices; (iii) divestment by NRB of its shareholding in Non-Life Insurance Division of Rastriya Beema Sansthan and Citizen Investment Trust; and (iv) finalization of NOC's 2005/06 accounts to international standards. Of these, (i) has been completed. Significant progress has been made towards completion of measures related to (ii)–(iv), and we request that the test date for completion of the remaining steps be moved to July 15, 2007.

The government is fully committed to the reform agenda detailed in the 10th Plan/PRSP, which aims to reduce poverty through private-sector led growth and social inclusion. We believe that the policies and measures described in the MEFP are adequate to achieve the objectives of the program, but the government stands ready to take any additional measures that may become appropriate for this purpose. The government will consult with the IMF on the adoption of any such measures, and in advance of revisions to the policies contained in the MEFP in accordance with the IMF's policies on such consultations. It will also provide the IMF with information required to assess progress in implementing the program. The government intends to make this letter, the MEFP, and the staff report on the reviews available to the public and authorize their posting on the IMF website subsequent to Board completion of the reviews.

Sincerely yours,

/s/

Ram Sharan Mahat
Minister of Finance

/s/

Bijaya Nath Bhattarai
Governor, Nepal Rastra Bank

Attachments
Memorandum on Economic and Financial Policies
Technical Memorandum of Understanding

**NEPAL—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES
UNDER THE PRGF ARRANGEMENT**

1. **Nepal is in a defining moment since the people’s movement of April 2006.** On the political front, the Government of Nepal (GON) is making a determined effort to further the peace process and restore participatory democracy. In January 2007, the interim parliament was expanded to include the Communist Party of Nepal (Maoist) to further cement the ceasefire, and an interim constitution was adopted, along the lines agreed in the 12-point Comprehensive Peace Accord signed by the seven party alliance (SPA) and the CPN(M) in November 2006. Also in January 2007, at the request of Prime Minister Koirala and Mr. Prachanda (Chairman, CPN(M)), the United Nations began operations to assist with monitoring human rights and the ceasefire, management of combatants and arms, and fair conduct of constituent assembly elections. The process of combatants and arms management started in February, after which the CPN(M) joined the government on April 1 and paved the way for the formation of representative institutions at the central and local levels. This interim government is charged with the conduct of constituent assembly elections.
2. **On the economic front, expectations for growth and an improvement in living standards are running high.** The GON remains committed to achieving the goals of Nepal’s 10th Plan/Poverty Reduction Strategy Paper (PRSP), which remain appropriate. The PRSP which was finalized in July 2003 lays out Nepal’s objectives and policy agenda for 2002–07 and will continue to guide the policies of the interim government. This agenda has been supported by the Poverty Reduction and Growth Facility (PRGF) arrangement which was approved by the IMF’s Executive Board in November 2003.
3. **The GON remains committed to implementing policy understandings reached under the PRGF arrangement.** This memorandum reviews progress achieved under the PRGF arrangement since the completion of the second and third reviews in November 2006. Progress on the broader objectives of the PRSP for 2005/06 was most recently reviewed in the “Assessment of the Implementation of the Tenth Plan/PRSP” which was finalized in December 2006. Looking forward, this memorandum outlines economic and financial policies for the remainder of 2006/07 in support of which the GON is requesting completion of the fourth review. All quantitative performance criteria (QPCs) and indicative targets (ITs) for review were met, with significant margins. A number of structural performance criteria (SPCs) and structural benchmarks (SBs) have been implemented, albeit with delays. However, finalization of Nepal Oil Corporation (NOC) 2005/06 accounts has not been possible due to delays in the appointment of an auditor. This has now been done and a revised timeframe for completion of the audit has been agreed. For SPCs that were completed with a delay or for which revised understanding have been reached, the GON is requesting waivers from the IMF’s Executive Board.
4. **Going forward, the National Planning Commission (NPC) has begun the preparation of a three-year interim plan.** This plan is focused on rehabilitation, reconstruction, and recovery to provide a medium term focus to economic policies after mid-July 2007. The GON intends to engage all stakeholders and donors in the preparation of the three-year plan, which is expected to be finalized by mid-July 2007. The GON will also formulate the 2007/08 budget by mid-July, on which discussions with the IMF will provide an

opportunity to update the medium-term macroeconomic framework and the Medium-Term Expenditure Framework.

A. Macroeconomic Developments and Policies

5. **Macroeconomic stability has been maintained and policies remained appropriate in the first half of 2006/07.** Notwithstanding political uncertainties and poor weather conditions, real GDP growth is on an upward trajectory. Underlying CPI inflation was 6 percent, broadly in line with price developments in India. International reserves rose from US\$1¾ billion at end-2005/06 to over US\$2 billion in mid-January 2007, supported by robust private remittances and foreign aid inflows. The overall and domestically financed deficits were lower than programmed. Revenues have grown strongly, aided by a strong tax administration effort, higher customs duty rates on selected imports, a broadening of the excise tax base. With development spending still constrained by implementation capacity at the local level, the budget made a net repayment to the domestic banking system of Nrs. 6 billion (1 percent of GDP). Monetary and exchange rate policies of the Nepal Rastra Bank (NRB) remained firmly geared to maintaining the exchange rate peg to the Indian rupee.

B. Structural Reforms

6. **The GON and NRB have completed implementation reform actions agreed for the fourth review (except finalization of audit of NOC 2005/06 accounts).**

Fiscal Reforms

- **Tax administration:** With the introduction of performance indicators and performance-based incentive schemes in the Large Taxpayer Office (LTO) and the model customs office, tax administration and revenue collection has improved. The LTO has conducted comprehensive audit of tax return of 30 large taxpayers. In addition, to assess the extent of excise leakages, the LTO has conducted audits of excise returns of large taxpayers for mid-October 2006. Based on its study of VAT nonfilers, the Internal Revenue Department (IRD) has reduced the proportion of nonfilers to lower than 15 percent through deregistration of dormant VAT taxpayers. As regards income tax, the IRD made compulsory electronic tax deduction at source (ETDS) for all large taxpayers after January 15, 2007, and introduced the fiscal printer to improve recordkeeping and reduce tax evasion. In addition, the IRD will make mandatory the installation of excise sticker machines in all cigarette and beer factories by April 15, 2007. The new sticker regime will be fully operational by July 15, 2007. The Customs Department is implementing its three-year reform program. As part of this action plan, and in line with IMF recommendations, the department has made significant progress in establishing a wide-area network (WAN) between the headquarters in Kathmandu and the five largest customs offices to improve information sharing among the offices. This WAN will facilitate greater ASYCUDA functionality, with AsDB and UNCTAD assistance. To improve customs administration, the cabinet has approved a new Customs Act, which has been submitted to parliament.

Financial Sector

- **NRB “re-engineering:”** To address the qualified opinion on 2003/04 and 2004/05 NRB account by international accounting firms, make further progress towards meetings IFRS standards, and spur improvements in the Internal Audit and Financial Management Departments, the Auditor General appointed an international accounting firm for NRB’s 2005/06 accounts in January 2007. Also, to focus the NRB on its core functions and to address noncompliance with IFRS standards, the NRB has divested its shareholding in the Citizen Investment Trust, the Eastern Rural Development Bank, and a portion of its shareholding in the Non-Life Insurance Division of Rastriya Beema Sansthan. To strengthen NRB supervisory capacity and to ensure that the central bank is well placed to meet the challenges of financial sector liberalization as part of WTO commitment in 2010, the NRB conducted a self-assessment of its compliance with Basle Core Principles for Effective Banking Supervision, with IMF technical assistance. With this self-assessment, the NRB supervision department has prepared a time-bound action plan to address the identified gaps in its supervisory framework. To enhance off-site supervision, the NRB has developed a manual for analyzing data submission by development banks and finance companies. Also, the supervision department is developing an early warning system based on off-site data for effective communication of risks to senior management.
- **Legal framework.** A draft Anti-Money Laundering Bill to strengthen the integrity of the financial system is to be presented to Parliament in 2007. In addition, the NRB is drafting guidelines to clarify the procedure for mergers and acquisitions to facilitate consolidation among financial sector institutions, along with a revised BAFIA. To strengthen the basis for repo operations, the NRB Board has approved a Master Repo Agreement for the NRB and commercial banks.
- **Loan recovery:** The GON has taken action against a number of large, willful defaulters and annulled their passports, frozen their bank accounts, and placed restrictions on their asset sales.
- **Restructuring of commercial and development banks:** The commercial banks under external managers (Nepal Bank Limited and Rastriya Banijya Bank; NBL and RBB, respectively), made operating profits in the first half of 2006/07, reduced their NPLs, improved lending practices, and made substantial progress in computerization of their branches. Restructuring of Nepal Industrial Development Corporation (NIDC) is progressing with efforts underway to divest its shares in a commercial bank. Earlier in late 2006, the NRB intervened to stem a bank run on a troubled private sector bank. The NRB took over management of the bank, the board was dissolved, and management dismissed. The takeover restored confidence in the bank as deposit withdrawals ceased immediately. Moreover, NRB management subsequently was able to partially restore the deposit base and recover a significant amount of nonperforming and connected loans.

Public Sector Reforms

The decline in international oil prices, and price increases on some petroleum products have provided a much needed respite to the loss-making NOC which is operating broadly at break-even levels. However, the accumulated suppliers' credits to Indian Oil Corporation, NOC's sole supplier continue to constrain supplies. To address these credits, the NOC has discussed options with IOC to schedule and settle the accumulated credits. Meanwhile, the draft Petroleum Sale and Distribution Act to liberalize the oil sector and further increase private sector participation was submitted to Parliament in November 2006.

II. MACROECONOMIC OBJECTIVES AND POLICIES

A. Macroeconomic Objectives

7. **Economic activity is expected to recover somewhat in 2006/07.** Real GDP growth is expected to increase to 3–4 percent. While agriculture output growth is likely to remain dampened due to erratic weather conditions and manufacturing may still take some time to recover from unsettled labor market conditions, tourism and construction appear to be making a strong rebound. Underlying CPI inflation is projected to remain around 5–6 percent, in line with price developments in India. The current account is projected to remain in surplus with continued strong remittance inflows.

B. Fiscal Policies

8. **The 2006/07 budget aimed to raise and improve the quality of public spending, raise the revenue-to-GDP ratio, and limit domestic borrowing.** On the revenue side, a rebound in activity and reduced supply disruptions are expected to help revive revenue performance, and the targeted increase to 13 $\frac{1}{3}$ percent of GDP is expected to be met. The budget makes provisions for a significant scaling up of social sector and public investment programs on health, education, and rural infrastructure, prioritized along the lines of the Medium-Term Expenditure Framework. The allocation for security-related spending was reduced by $\frac{1}{2}$ percent of GDP to 2 $\frac{3}{4}$ percent. Implementation capacity for increased local level investment remains weak but is expected to be overcome partially by scaled-up grants for village development committees, where past experience with community and user groups' participation in project implementation has been favorable. With the rise in spending to meet development needs, the overall deficit (after grants) is expected to rise to 5 $\frac{1}{2}$ percent of GDP. External aid is projected to increase from 3 $\frac{3}{4}$ percent of GDP in 2005/06 to 6 $\frac{1}{4}$ percent, and the gross domestically financed deficit would be limited to Nrs. 18 billion (2 $\frac{3}{4}$ percent of GDP).

9. **Since the adoption of the budget in mid-July 2007, the peace process has moved forward quickly, requiring adjustments in the budget.** The additional spending needs for peace-related activities, including the upkeep of Maoist cantonments, security arrangements and preparations for constituent assembly elections, and other rehabilitation needs for internally displaced persons are high. Nevertheless, to maintain fiscal balance, the GON will aim to meet these needs with only a limited increase in domestic financing through a reallocation from capital spending (where projects are unlikely to take off in this fiscal year

due to technical problems) or low priority spending to peace-related spending and will aim to achieve a modest increase in the revenue target. The GON has also set up a Peace Fund for which is hopes to attract donor and other financing. Expenditures from the Fund will be undertaken in a transparent manner, and supporting regulations have been finalized.

10. **Beyond 2006/07, the GON intends to remain focused on its medium-term objectives of raising resources to finance infrastructure and needed structural reforms while lowering the public debt-to-GDP ratio.** A further increase in the revenue-to-GDP ratio should be possible from tighter administration and base broadening, including elimination of VAT exemptions and reducing customs and excise leakages. As implementation capacity improves, it would be possible to raise spending on much needed social sector and infrastructure projects, mainly through higher external aid while further reducing security-related spending to lower levels as the peace is firmly reestablished. The overall deficit (after grants) and domestic financing would be limited. This would leave room to meet the costs of further reforms in the financial and public enterprise sectors. Discussion with the IMF in the context of the 2007/08 budget would provide an opportunity to specify the medium-term fiscal framework, taking into account the evolving needs for rehabilitation, reconstruction, and recovery.

C. Monetary and Exchange Rate Policies

11. **The NRB's monetary and exchange rate policy will remain geared toward maintaining the peg to the Indian rupee.** The peg has served Nepal well given close ties with India. In addition, the level of the exchange rate peg is appropriate. Consistent with this objective, broad money growth is projected at around 16 percent in 2006/07, assuming real GDP growth of 3–4 percent and a small decline in velocity. This would accommodate the projected domestic financing needs of the budget while allowing real private sector credit growth of 8–9 percent. Reserve money growth is projected around 15 percent, with a targeted increase in the NRB's net foreign assets (NFA) of US\$110 million.

12. **The NRB will take steps to further improve monetary operations and its internal processes.** To address excess liquidity in the financial system, the NRB has expanded the list of imports from India eligible for payment in convertible currencies, and will explore options to further extend the range of transactions with India suppliers in convertible currencies, including those conducted by the NOC. The MOF has also agreed to issue a stock of T-bills (which could be placed in a separate government account at the NRB) to assist with liquidity management.

D. Structural Reforms

13. **The GON and NRB are determined to press ahead with structural reforms in three macrocritical areas in the context of the PRGF arrangement.** More broadly, the GON is committed to improving service delivery to the public and to improve governance, consistent with the overall objectives of Nepal's PRSP. To this end, the GON intends to maintain a continuous dialogue with all stakeholders to ensure that these objectives are met.

Fiscal Reforms

- **Tax administration:** The GON will make a strong effort to further reforms to raise revenue collection, reduce leakages, enhance audit, and improve taxpayer services in the Inland Revenue and Customs Departments. To help improve revenue administration, the MOF has requested further IMF and donor assistance. To make the audit of large taxpayers more effective, starting 2007/08, the responsibility to audit tax deduction at source (TDS) will be shifted to the LTO. The IRD will make compulsory ETDS for Kathmandu-based government offices after July 15, 2007, design a strategy for ETDS implementation, and extend computerization significantly at the large taxpayer and retail levels to reduce underinvoicing. In addition, the IRD will make a strong effort to ascertain whether VAT taxpayers with suspended PANs are still trading with a view to prosecuting tax evaders and recover tax arrears. The Customs Department will streamline clearance procedures at the largest customs point in Birgunj. Steps will be taken to gain parliamentary passage of an amended Customs Act in time for inclusion in the 2007/08 budget.
- **Fiscal transparency.** The GON is committed to significantly improving transparency as envisaged in fiscal ROSC that it conducted with IMF collaboration.

E. Financial Sector

14. Steps will be taken to improve the banking framework and loan recovery, further NRB re-engineering, and help restructure troubled commercial and development banks.

- **Legal framework:** To improve the legal framework for financial sector activity, a revised Banking and Financial Institutions Act (BFIA) will be finalized. Cabinet approval for the act will be sought by August 31, 2007. In view of the proliferation of financial institutions relative to market size, the NRB has raised the minimum capital requirements for commercial banks, and tightened licensing criteria.
- **NRB “re-engineering:”** In the remainder of 2006/07, the NRB intends to address gaps in the supervisory framework identified in the self-assessment against the Basle Core Principles.
- **Commercial banks:** With restructuring of NBL and RBB by external managers in its third year under the Financial Sector Reform Program with assistance from the World Bank, the GON is now looking ahead to the next phase.

F. Nepal Oil Corporation

15. To address NOC losses, the GON will gradually adjust upwards prices of oil products with the objective of introducing an automatic pricing mechanism for oil products at that time. In the meantime, suitable measures to finance flow losses have been devised.

III. PROGRAM MONITORING

16. **The program will be monitored using the definitions, data sources, and frequency of monitoring set out in the attached Technical Memorandum of Understanding (TMU).**

The government will make available to Fund staff all core data, appropriately reconciled and on a timely basis, as specified in the TMU.

17. **Performance criteria.** Table 1 shows quantitative performance criteria and benchmarks until mid-July 2007. In addition, the nonaccumulation of external payment arrears will constitute a continuous performance criterion, as will the standard injunctions against overdue financial obligations to the IMF, imposition or intensification of restrictions on current payments, introducing or modifying multiple currency practices, conclusion of bilateral payments agreements inconsistent with Article VIII, and imposition or intensification of import restrictions for balance of payments purposes. Structural performance criteria and benchmarks for the fifth review are identified in Table 2.

18. **Program review.** The fifth and final review of the program under the PRGF arrangement is expected to be completed by mid-October 2007. This review will focus on: (i) the implementation of administration reforms at the Inland Revenue and Customs Departments; (ii) financial sector reform; (iii) safeguards issues; and (iv) progress in oil sector and SOE reform.

19. **The NRB and GON are committed to accurate data reporting under the PRGF-supported program.** In this context, the NRB intends to follow through fully with IMF recommendations to improve its financial accounts, internal audit, and financial management made in the context of the Safeguards Assessment.

Table 1. Nepal: Quantitative Performance Criteria and Indicative Targets
(In billions of Nepalese rupees, unless otherwise stated)

	Jul. 17, 2006 Actual	Oct. 17, 2006 Actual	Jan. 14, 2007 (PC)	Apr. 13, 2007 (IT)	Jul. 15, 2007 (PC)
Performance criteria (PC) and indicative targets (IT) 1/					
I. Floor on net foreign assets of the NRB (in millions of U.S. dollars) 2/ 3/	1,842.7	1,852.7	1,882.7	1,912.7	1,952.7
II. Ceiling on net domestic assets of the NRB 2/ 4/	-28.1	-26.1	-23.8	-25.7	-18.8
III. Ceiling on change in net domestic financing of central government budget 4/ 5/ Cumulative from July 17, 2006	...	2.0	4.7	7.4	11.7
IV. Ceiling on contracting or guaranteeing of new nonconcessional medium- and long-term external debt by the central government and NRB Cumulative from July 17, 2006 (in millions of U.S. dollars) 6/	...	0.0	0.0	0.0	0.0
V. Ceiling on short-term external debt contracted or guaranteed by the central government and NRB (in millions of U.S. dollars) 6/	0.0	0.0	0.0	0.0	0.0
VI. Accumulation of external payments arrears Continuous performance criterion during the program period (In millions of U.S. dollars)	0.0	0.0	0.0	0.0	0.0
Indicative targets (IT)					
I. Ceiling on reserve money	110.1	112.9	117.4	117.8	127.7
II. Floor on central government revenue 7/ Cumulative from July 17, 2006	...	14.7	36.9	57.4	85.3

1/ Mid-January 2007 and mid-July 2007 are performance criteria test dates. Figures for mid-April 2007 are indicative targets.

2/ Valued at the program exchange rates. Monetary gold valued at program prices (US\$600 per oz.).

3/ Adjusted upward/downward by excess/shortfall of foreign program financing. Details specified in the Technical Memorandum of Understanding (TMU).

4/ Adjusted upward/downward by shortfall/excess of rupee equivalent of foreign financing. Details specified in the TMU.

5/ Adjusted upward/downward by shortfall/excess of privatization receipts. Details specified in the TMU.

6/ External debt as in the TMU.

7/ Adjusted upward/downward by excess/shortfall of privatization receipts. Details specified in the TMU.

Table 2. Nepal: Proposed Structural Performance Criteria and Benchmarks for Fifth Review of the PRGF Arrangement

Measures	Timing
Structural Performance Criteria	
A. Fiscal Sector Reforms	
1. Large Taxpayer Office (LTO) to conduct comprehensive audit of large taxpayers 1/	July 15, 2007
2. Inland Revenue Department (IRD) to reduce VAT nonfilers to 12.5 percent or less of registered VAT taxpayers 2/	July 15, 2007
3. Customs Department to streamline customs clearance at Birgunj customs office 3/	July 15, 2007
4. Customs Department to establish Wide-Area Network (WAN) for headquarters and at least five large customs offices	July 15, 2007
B. Financial Sector Reforms	
1. Cabinet approval of revised Banking and Financial Institutions Act 4/	August 31, 2007
2. NRB to divest all its shareholding in Non-Life Insurance Division of Rastriya Beema Sansthan	July 15, 2007
3. NRB to divest all its shareholding in at least two rural development banks	July 15, 2007
4. Finalize audit of NRB 2005/06 accounts by an international auditor	July 15, 2007
C. Nepal Oil Corporation	
1. Finalize audit of NOC 2005/06 accounts in accordance with international standards	July 15, 2007
Structural Benchmarks	
1. Submission to Parliament of amendments to Customs Act	April 15, 2007
2. Submission to Parliament of draft Anti-Money Laundering Act	July 15, 2007
3. Submission to Parliament of revised Banking and Financial Institutions Act	September 30, 2007
4. IRD to make compulsory ETDS for Kathmandu-based government offices	July 15, 2007
5. NIDC to implement rationalization and divestment instructions of the MOF	July 15, 2007
6. NRB to draft guidelines for mergers and acquisitions of banks and financial institutions 5/	August 31, 2007

1/ LTO to conduct audit of income tax (including tax deduction at source) and VAT returns, and excise declarations of 2005/06 for a cumulative number of at least 50 large taxpayers. LTO to conduct quarterly audit of excises for large taxpayers (mid-January and mid-April filings).

2/ Averaged over the filing months April/May and May/June 2007.

3/ The department will reduce the number of steps in the clearance process for imports from countries other than India to at most 10 steps.

4/ The revised act is expected to address gaps in the supervisory and regulatory frameworks identified by the assessment against the Basel Core Principles, ensure consistency with provisions of the Company Act, provide for a strengthened framework for mergers and acquisitions, and bring bank insolvency and resolution frameworks under the purview of the BFIA.

5/ The guidelines are expected to specify the regulatory framework, enabling procedures, conditions for approval, and actions in case of contravention.

NEPAL—TECHNICAL MEMORANDUM OF UNDERSTANDING FOR PRGF ARRANGEMENT
May 30, 2007

This memorandum sets out the framework for monitoring the PRGF-supported program for 2006/07. It specifies quantitative performance criteria and indicative targets and the content and frequency of the data to be provided for monitoring the financial program. All foreign currency nondollar denominated quantities under the program will be converted into U.S. dollars at program exchange rates specified in Table 1.

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Net Foreign Assets of Nepal Rastra Bank

1. **Net foreign assets (NFA) of the Nepal Rastra Bank (NRB)** is defined as the difference between the market value of gross foreign assets and liabilities, at program exchange rates. Gross foreign assets of the NRB consist of monetary gold, foreign currency balances at the NRB, foreign exchange balances held outside Nepal, foreign securities (valued at market prices), foreign bills purchased and discounted, IMF reserve position and SDR holdings. Excluded from gross foreign assets will be participation in international financial institutions and holdings of precious metals other than monetary gold. Gross foreign liabilities are all foreign currency denominated liabilities and use of Fund credit.
2. **The NFA floor will be adjusted** downward/upward by the shortfall/excess of the identified foreign program financing as set out in Table 2. Foreign program financing is defined to include adjustment loans from multilateral creditors other than the Fund, budget support from bilateral creditors, loans (if any) from private creditors (including commercial banks) and rescheduling of medium- and long-term public and publicly-guaranteed debt (exceptional financing).

B. Net Domestic Assets of NRB

3. **Net domestic assets (NDA) of the NRB** is defined as the difference between reserve money and rupee value of NFA of the NRB, at program exchange rates. NFA of the NRB is defined in Section A above; reserve money is defined in Section C.
4. **The NDA ceiling** will be adjusted downward/upward by the excess/shortfall of the identified foreign program financing as set out in Table 2. External program financing received for financial and public sector reforms over the amounts identified in Table 2 would not lead to a downward adjustment of the NDA ceiling. The upward adjustment in the ceiling due to a shortfall in external program financing compared to Table 2 would be capped at Nrs. 5 billion (around 1 percent of GDP).

C. Reserve Money of the NRB

5. **Reserve Money (RM) of the NRB** consists of currency in circulation outside the NRB, deposits of commercial banks at the NRB, and other private sector deposits at NRB. As of July 17, 2006, RM stood at Nrs. 110.7 billion.

D. Net Domestic Financing of the Central Government Budget

6. **Net domestic financing (NDF) of the budget is defined as net credit to the central government (NCG) by the banking system (NRB), and deposit money banks (DMBs) and net change in holdings of treasury bills and other government securities by the nonbank sector.** The flow NDF of the budget would be the cumulative change in book value from July 17, 2006 in the sum of the following government debt instruments: (i) treasury bills; (ii) development bonds; (iii) national and citizen savings certificates; (iv) special bonds (including duty drawback bonds); and (iv) loans and advances from the NRB and deposit money banks (DMBs) *minus* government deposits with NRB and DMBs. This stock stood at Nrs. 94.2 billion at July 17, 2006. Central government is defined here to include line ministries, departments and public institutions.

7. **The ceiling on net domestic financing** will be adjusted upward/downward by the shortfall/excess of rupee equivalent of foreign program financing as set out in Table 2. External program financing received for financial and public sector reforms over the amounts identified in Table 2 would not lead to a downward adjustment of the NDF ceiling. The upward adjustment in the ceiling due to a shortfall in external program financing compared to Table 2 would be capped at Nrs. 5 billion (around 1 percent of GDP). The ceiling on net domestic financing will be adjusted upward/downwards by 100 percent of the amount of any shortfall/excess in privatization receipts beyond the programmed amounts (Table 3). The ceiling on net domestic financing will be adjusted upward for onlending operations to cover flow losses of Nepal Oil Corporation. The ceiling on net domestic financing will not be adjusted down for external assistance received directly into the Peace Fund.

E. Central Government Revenue

8. **Central government revenue** is defined as reported in the treasury accounts (economic classification), excluding principal repayments to the budget by corporations and including privatization receipts. The floor on central government revenue is cumulative from the start of the fiscal year. The central government revenue benchmark will be adjusted upward/downward by 100 percent of the excess/shortfall in privatization receipts.

F. Contracting or Guaranteeing of New Nonconcessional External Debt

9. **Contracting or guaranteeing of new medium- and long-term nonconcessional external debt** is defined as contracting or guaranteeing new nonconcessional external debt by the central government and the NRB with an original maturity of more than one year (valued at program exchange rates as defined in Table 1). Nonconcessional debt is defined as borrowing containing a grant element of less than 35 percent on the basis of currency-specific discount rates based on the OECD commercial interest reference rates (CIRR). For maturities of less than 15 years, the grant element would be calculated based on six-month CIRR averages, while for maturities longer than this, the grant element would be based on ten-year CIRR averages. This performance criterion applies not only to debt as defined in point No. 9 of the *Guidelines on Performance Criteria with Respect to Foreign Debt* (Decision No. 12274-(00/85), August 24, 2000) but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are credits extended by the IMF and financing from the World Bank and Asian Development

Bank (AsDB), and government counter guarantees on project loans from both the World Bank and AsDB, as well as changes in indebtedness resulting from rescheduling operations or rollovers. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract is entered into, or guarantee issued.

G. Contracting or Guaranteeing of Short-Term External Debt

10. **Stock of short-term external debt outstanding** is defined as debt with original maturity of up to one year owed or guaranteed by the NRB and central government (valued at program exchange rates as defined in Table 1). The term debt is defined as set forth in point No. 9 of the *Guidelines on Performance Criteria with Respect to Foreign Debt* (Decision No. 12274–(00/85), August 24, 2000), but excludes normal import-related credits.

H. Accumulation of External Payment Arrears

11. **The program's performance criterion on nonaccumulation of external payment arrears is continuous throughout the program period.** External payments arrears are defined as overdue payments (interest and principal payments) on short-term debt in foreign currencies with an original maturity of up to and including one year (spot, money market, letters of credit) and medium- and long-term debt contracted or guaranteed by the central government. As of May 15, 2007, there were no external payment arrears.

II. DATA REPORTING REQUIREMENTS

12. For the purpose of monitoring the performance under the program, data will be provided in the format shown in Tables 4–9. Nepal shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Nepal in achieving the objectives and policies set forth in the letter. All the program monitoring data would be provided by the Ministry of Finance and the NRB. In addition, a written reconciliation of NRB program data (NFA, NDA and Reserve Money) with the accounting records will be prepared for all test dates under the PRGF arrangement. Data on gross foreign assets and gross foreign liabilities would be provided at market prices and program exchange rates. All the data relating to the above programmed targets will be furnished within eight weeks after the end of each test date.

Table 4.	Net Foreign Assets of Nepal Rastra Bank
Table 5.	Balance Sheet of Nepal Rastra Bank
Table 6.	Net Domestic Financing of Central Government Budget
Table 7.	Central Government Revenue
Table 8.	Contracting or Guaranteeing of New Medium- and Long-Term Nonconcessional External Debt by the Central Government and NRB
Table 9.	Contracting or Guaranteeing of Short-Term External Debt by the Central Government and NRB

Table 1. Program Exchange Rates and Gold Prices 1/	
Foreign currency	Foreign Currency/U.S. Dollar
Nepalese rupee	75.0
Indian rupee	46.45
SDR	0.68
Japanese yen	117.0
Euro	0.80
Pound sterling	0.55
Gold prices (U.S. dollars per ounce)	600.0
1/ Currencies not shown here will be converted first into U.S. dollars using official exchange rates used by the IMF's Finance Department on July 17, 2006.	

Table 2. Program Foreign Financing, 2006/07 (In millions of U.S. dollars)				
	Oct. 17, 2006 Actual	Jan. 14, 2007 Actual	Apr. 13, 2007	Jul. 15, 2007
Foreign financing (cumulative)	32.9	41.4	45.9	69.2

Table 3. Program Privatization Receipts, 2006/07 (In millions of Nepalese rupees)				
	Oct. 17, 2006 Actual	Jan. 14, 2007 Actual	Apr. 13, 2007	Jul. 15, 2007
Privatization receipts (cumulative)	0.0	0.0	495	1,978

Table 4. Net Foreign Assets of the Nepal Rastra Bank, 2006/07 (In millions of U.S. dollars)				
	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Net foreign assets 1/				
Assets				
Foreign exchange				
Monetary gold				
Reserve position in the Fund				
SDR holding				
Liabilities				
Deposits				
CSI credit accounts				
ESAF/PRGF				
1/ At program exchange rates and prices.				

Table 5. Balance Sheet of the Nepal Rastra Bank, 2006/07 1/ (In billions of Nepalese rupees)				
	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Net foreign assets				
Assets				
Liabilities				
Net domestic assets				
Claims on public sector				
Net credit to government				
Claims on government 2/				
Less: Deposits				
Claims on public enterprises				
Claims on private sector				
Claims on commercial banks				
Other items (net)				
Reserve money				
Currency outside banks				
Currency held by banks				
Bankers' deposits				
Private sector deposits				
1/ For program monitoring purposes. 2/ Excluding IMF promissory notes.				

Table 6. Net domestic financing of the Budget, 2006/07 (In millions of Nepalese rupees)				
	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Net claims on government (stock)				
Banks				
NRB (net)				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				
Loans and advance				
Less: Deposits				
DMBs				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				
Nonbanks				
Claims				
Treasury bills				
Development bonds				
National saving certificates				
Citizen saving certificates				
Special bonds				

Table 7. Central Government Revenue, 2006/07 (In millions of Nepalese rupees)				
	Oct. 17, 2006	Jan. 14, 2007	Apr. 13, 2007	Jul. 15, 2007
Total revenue (GON)				
Less: Principal repayment by corporations				
Total revenue 1/				
Tax revenue				
Taxes on goods and services				
VAT/sales tax				
Excise taxes				
Others				
Taxes on international trade				
Import taxes				
Indian excise refund				
Export taxes				
Agriculture reform fee and other				
Taxes on income and profits				
Taxes on property				
Nontax revenue 1/				
Charges, fees, and fines				
Sales of goods and services				
Dividends				
Royalty and fixed asset sales				
Interest receipts				
Other				
1/ Excluding principal repayments by corporations.				

Table 8. Contracting or Guaranteeing of New Nonconcessional Medium- and Long-Term External Debt by the Central Government and the NRB (In millions of U.S. dollars)									
Date	Creditor	Project	Date of Agreement	Currency	Maturity Period	Grace Period	Interest Rate	Amount	Disbursement

Table 9. Contracting or Guaranteeing of New Short-Term External Debt by the Central Government and the NRB (In millions of U.S. dollars)									
Date	Creditor	Project	Date of Agreement	Currency	Maturity Period	Grace Period	Interest Rate	Amount	Disbursement