

SUR/10/54

June 14, 2010

**The Acting Chair's Summing Up
Nepal—2010 Article IV Consultation and Request for
Disbursement Under the Rapid Credit Facility
Executive Board Meeting 10/54
May 28, 2010**

Directors agreed with the thrust of the staff appraisal. They observed that, after years of macroeconomic stability, Nepal's economy is experiencing a substantial, albeit somewhat delayed, impact of the global crisis, which is exposing the country's structural weaknesses. External and financial sector risks have risen as evidenced by the significant deterioration of the current account, the reserve decline, wavering confidence, and banking sector liquidity stress.

Against this background, Directors welcomed the authorities' commitment and efforts to safeguard external and financial stability. They viewed maintaining the exchange rate peg as a key short-term objective to shore up confidence, observing that it has served Nepal well so far by providing macroeconomic stability. In the medium term, a number of Directors recommended a reconsideration of the type of peg as well as alternative options for a nominal anchor. Directors stressed the need for monetary policy to support the peg by maintaining short-term interest rates above those of India, and suggested that liquidity management be strengthened to avoid abrupt fluctuations in interest rates. They also stressed that emergency liquidity support needs to be consistent with the peg. Directors encouraged the authorities to phase out the import and foreign exchange restrictions.

Directors took note of significant credit and liquidity risks in the financial sector. They welcomed the recent macroprudential measures adopted by the Nepal Rastra Bank to limit banks' liquidity risk and exposure to the real estate sector, but stressed that enforcement will be crucial for their effectiveness. Directors encouraged the authorities to strengthen the bank resolution framework, including through the passage of the amended Banks and Financial Institutions Act, enhance contingency planning, and expand regulatory oversight over savings and credit cooperatives.

Directors noted that bank licensing policy needs to be tightened and financial sector consolidation facilitated. They observed that the rapid proliferation of financial institutions has stretched the authorities' supervisory capacity, and welcomed the recent licensing

moratorium. Directors also encouraged the authorities to proceed with the restructuring of the two state-controlled banks.

Directors commended the authorities' fiscal prudence, and supported its continuation. They noted that, although improved debt dynamics have created room for higher spending, a tight fiscal stance remains justified in the short term to support the exchange rate peg. They encouraged further efforts to curb tax evasion and broaden the tax base.

Directors reiterated that tackling long-standing structural problems remains essential to achieve high growth over the medium term. Key areas for improvement are the business climate, governance, infrastructure and labor relations.

Directors viewed the arrangement under the Rapid Credit Facility (RCF) as helpful in cushioning the shock from the global crisis and boosting confidence. They hoped that the RCF would serve as a bridge to a program addressing Nepal's structural challenges that could be supported by an arrangement under the Extended Credit Facility.

The next Article IV consultation with Nepal is expected to be held on the standard 12-month cycle.