

BUFF/ED/10/80

May 25, 2010

**Statement by Mr. Chua and Mr. Thapa on Nepal
Executive Board Meeting 10/54
May 28, 2010**

1. Since the last Article IV consultation in March 2008, significant political developments have taken place within Nepal and a severe economic crisis has unfolded at the global level. The interim government formed after the end of the decade-long civil conflict successfully conducted the constituent assembly (CA) elections in April 2008. The first meeting of the CA ended the more than two-century old monarchy. The two-year term for CA is almost complete and the writing of the new constitution is underway. Political parties are holding dialogues on key issues. The authorities are confident that differences on major constitutional issues will be resolved and the drafting of the constitution will be completed soon.

Macroeconomic situation and outlook

2. Notwithstanding the decade-long civil conflict and political transition, Nepal has so far maintained macroeconomic stability. Prudent macroeconomic policies implemented under the recent PRGF-supported Fund program, the final review of which was successfully concluded in November 2007, played a significant role in underpinning macroeconomic stability. Economic growth, albeit modest, was maintained. Inflation remained largely stable. Backed by strong remittances, the accumulation of international reserves was at a comfortable level, which ensured overall macroeconomic and external stability.

3. The adverse global economic environment has now affected the Nepali economy, raising risks for macroeconomic stability. Economic growth is expected to decelerate from 4.7 percent in 2008/09 to less than 4 percent in 2009/10 on account of poor agricultural performance. Average inflation is projected to hover around 10.7 percent, reflecting the global price developments especially price movements in India. The overall balance of payments position has slipped into a deficit on account of a widening current account deficit, putting pressure on international reserves. The delayed impact of the global economic crisis has resulted in a significant decline in merchandise exports and slowdown in remittances. A deficit in the balance of payments has also caused liquidity shortages, posing risks to the financial sector stability. The authorities are facing the challenges of ensuring external sector

stability and strengthening financial sector stability amid fluid political transition.

Request for a disbursement under the RCF

4. Against this backdrop, the authorities are requesting a disbursement under the Rapid Credit Facility (RCF) in an amount equivalent to SDR 28.52 million (40 percent of quota). The authorities hope that the proposed arrangement with the Fund will help bridge the external financing gap and will also play a catalytic role in mobilizing donor support for meeting Nepal's development needs. The authorities expect that the arrangement with the Fund will help safeguard the financial sector stability and stabilize the overall macroeconomic situation. The RCF is considered as a bridge to an ECF under which the authorities plan to initiate structural reforms aimed at accelerating economic growth and alleviating poverty.

Monetary and exchange rate policy

5. The authorities are focused on keeping monetary policy tight and modulating liquidity, aiming to contain inflation and the balance of payments deficit. The authorities also view the currency peg with the Indian rupee as fundamental to economic stability and take it as an overall anchor for the conduct of monetary policy in Nepal. Notwithstanding the current level of the peg remaining unchanged since 1993 and the Nepali rupee in real terms appearing slightly overvalued on account of some price and productivity differential with India, the authorities have no intention to change the level of the peg in the current macroeconomic and political situation.

6. To achieve these objectives and smoothen the credit crunch situation, the authorities have rationalized policy instruments in the recent mid-term monetary policy review. Market-based open market operations continue to be the primary tools for the short term liquidity management. The authorities have extended the term of repo transaction from 28 days to 45 days and have allowed commercial banks' call deposits to be counted for statutory liquidity ratio (SLR). With a view to ensure credit availability to productive sectors amid tight liquidity conditions, the refinancing facility window has been introduced. This will help avail credit to the export, power, and tourism sectors. The new refinancing provision has helped boost confidence in the financial market. As the refinancing facility has been limited for a maximum period of six months, it is likely to ease the liquidity squeeze in the short term and prevent banks from using it on a long-term basis. Penal interest rates are applied on the standing liquidity facility (SLF) to prevent banks from using the emergency liquidity facility excessively. The authorities consider the current tighter liquidity situation as temporary, on account of the slowdown in remittances and a higher rate of credit growth than deposit growth. Once the growth in remittances recovers and credit growth is reined in, the authorities expect the pressure on liquidity to ease.

Financial sector reforms

7. The authorities are aware of both opportunities and challenges arising from the rapid growth of the banking sector. Aided by a rapid growth in remittances, the recent development of the banking sector has deepened the financial system in Nepal. Excluding the two state controlled banks, namely Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB), capital adequacy ratio for private banks has remained above 12 percent; non-performing loans have come down to 3.4 percent and the profitability of banks as reflected by return to asset ratio is relatively high.

8. However, the authorities are cognizant that the proliferation of banks has overstretched the supervisory capacity of the central bank. The authorities are also aware of risks to financial stability from high credit-to-deposit ratios and significant exposure to real estate loans. The authorities have taken a serious note of the recent stress test results showing high vulnerability to credit and liquidity risks. The authorities will continue to assess the health of the financial sector through stress tests.

9. In response to these emerging risks, the authorities have recently adopted a number of prudential measures aimed at stabilizing the financial sector. The authorities have imposed a moratorium on license applications while they review the licensing policy. The authorities have eased, however, the moratorium with respect to micro finance banks and development banks with a view to expanding banking services to the rural areas. To further improve the health of the financial sector, the authorities have also recently adopted a number of macro-prudential measures. To address the excessive leverage built up in recent times, the authorities have directed banks to gradually lower the credit-deposit ratio to 80 percent over the medium term. To prevent asset prices from building further and to rein in the credit expansion to real estate, the loan-to-value limit has been fixed at 60 percent of the fair market value of collateral. Likewise, the authorities also plan to lower the single borrower limit from 50 percent to 25 percent of capital with effect from January 2011. Regarding sectoral exposure of credit to real estate and housing loans, a limit has been fixed at 40 percent of total loans in real estate and housing loans.

10. While the two large government controlled commercial banks have been put under the outside management with the financial assistance of the World Bank, the central bank has also started restructuring some private sector banks. Nepal Development Bank has been liquidated, and the central bank has completed the process of restructuring Nepal Bangladesh Bank. To put in place a bank resolution framework, the authorities have readied the amended Banks and Financial Institutions Act (BAFIA) for parliamentary approval. The authorities are seeking technical assistance from the World Bank on contingency planning for the financial sector.

11. The authorities consider that a strong international reserve position is key to financial sector stability. Hence, the authorities have taken strong measures to strengthen the balance of payments position. In an effort to safeguard foreign exchange resources, the authorities

have raised margin requirements as well as quantitative limits on gold and silver imports. With a view to preventing capital flight, the authorities have temporarily limited the availability of the passport foreign facility for leisure travel to twice a year and \$2000 per transaction. The authorities are committed to relaxing such restriction by March 2011 when the balance of payments situation is expected to turn around.

Fiscal policy

12. Despite the difficult political situation, the authorities are committed to maintaining fiscal discipline. Notwithstanding pressures on peace-related expenditures and wages, the overall public expenditure has been contained. Although capital spending has remained lower than expected, the authorities have maintained social spending resulting in relatively improved social indicators.

13. In the face of a relatively lower level of economic growth, revenue collection has been accelerated from 10.7 percent in 2005/06 to 14.5 percent of GDP in 2008/09. A significant rise in imports fueled by substantial growth in remittances has boosted revenue. A number of revenue administration reforms aimed at broadening the tax base and reducing tax evasion have also contributed to the growth in revenue. The authorities also appreciate the technical assistance they have received from the Fund on public financial management.

14. As a result of these developments, domestic financing of budget deficit is projected to remain at 1.6 percent and overall budget deficit to hover around 2 percent of GDP. The prudent management of public finances in Nepal has led to a gradual reduction in debt level from 64 percent in 2002/03 to 40 percent of GDP in 2008/09. This not only has reduced debt risks and made the public debt sustainable but has also created fiscal space for social and physical capital spending going forward.

Structural reforms

15. Nepal has a track record of structural reforms relating to government finance, public enterprises and financial sector during the earlier Fund programs. Given the national focus on drafting a new constitution and taking forward the peace process to its logical conclusion, it has been difficult to initiate structural reforms further at this point. The authorities consider structural reforms pertaining to public enterprises especially the Nepal Oil Corporation (NOC) are key to streamlining public resources for accelerating economic growth and reducing poverty. The authorities look forward to implementing a medium term Fund program as the political situation stabilizes with the completion of the peace process and the promulgation of a new constitution.

Conclusion

16. The authorities express their commitment to adopting prudent macroeconomic policies and seek the support of Board members for their request for a disbursement under the

RCF. The authorities broadly share the staff analysis and accept the policy advice as presented in the Article IV report. We wish to thank the mission team for the constructive dialogue in Kathmandu during February 24- March 8, 2010.

17. The authorities consent to the publication of the staff report and the letter of intent.