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May 27, 2010

**Statement by Mr. Prader and Mr. Ábel on Nepal
(Preliminary)
Executive Board Meeting 10/54
May 28, 2010**

We thank staff for a well written set of papers and Messrs. Chua and Thapa for their informative Buff statement. Nepal's current situation is unique in many respects. The country is located between two of the fastest growing economies in the world, but remains one of the poorest countries in Asia, although social indicators have recently improved. Over the past decade, progress on structural reforms has been held back by fragile political circumstances. Now the political transition is well under way and there are hopes that improved security may enhance the business climate and help structural reforms.

Remittances are a very important for Nepal, although they fluctuate extensively. The number of Nepalese workers leaving to work abroad declined by 12 percent in 2009 and the growth of remittances decelerated sharply to 17 percent in the first half of 2009/10 from 30 percent in the previous year.

We agree with staff that the exchange rate peg to the Indian rupee remains appropriate as remittances are expected to recover and import growth to moderate. The peg is needed to underpin macroeconomic and financial stability. At the same time, monetary policy needs to support the peg by maintaining short term interest rates above those of India and liquidity management should be strengthened to avoid abrupt fluctuations in interest rates. We would be interested in staff's comments on the news that the authorities are considering changes to the peg.

We are concerned that banks overextended themselves and their vulnerabilities were exposed by the recent liquidity squeeze. Stress tests indicate high vulnerability to liquidity and credit risk. We thank staff for the very informative summary of the risks to financial stability in Nepal presented in Box 3.

We agree with staff that although the debt reduction has created fiscal space, in the short run the peg calls for containing domestic borrowing close to current levels.

We commend the authorities for maintaining fiscal discipline during the political transition. This has been a remarkable achievement and must be preserved going forward.

We agree with staff's assessment that Nepal is facing an urgent balance of payments need and stabilizing reserves is imperative to boost confidence both in the currency peg and the financial sector. Therefore, we support the authorities' request for a disbursement under the Rapid Credit Facility (RCF) in the amount of SDR 28.52 million (40 percent of quota).