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May 27, 2010

Statement by Mr. Assimaidou on Nepal
(Preliminary)
Executive Board Meeting 10/54
May 28, 2010

We thank staff for their well-written report, and Mr. Chua and Mr. Thapa for their informative Buff statement.

Following years of modest growth and macroeconomic stability, the Nepal's economy is being impacted by the global financial crisis, which has uncovered its fundamental weaknesses. As exports significantly declined and remittances sharply softened, real GDP is expected to decline to 3 percent in 2009/10, from its 4 ¾ percent growth in the previous fiscal year. Inflation remains at two-digit level and official reserves declined to equivalent of one month of imports. The current account is expected to shift from 4 percent surplus of last year to 2.1 percent deficit this year.

Looking forward, we are pleased to note that the expected global recovery could feed into agriculture, performing services and tourism sectors, and boost growth to 4 percent while improving the current account position by the fiscal year 2010/11. Nevertheless, some downside risks including high imports, capital flight, heightened financial sector vulnerabilities keep the growth prospects low compared to the potential. All these, plus any further delay in global recovery could add stress to the growth prospects. It is also worth noting that the medium-term prospects are challenging, subjected to progress made on political transition and development of the country's vast untapped hydropower resources that could lift growth up to comfortable levels. We encourage the authorities to pursue their structural reforms, notably by reinforcing customs administration, eliminating extra budgetary funds and upgrading the administration of the Nepal Oil Corporation (NOC). Moreover, the weaknesses in the financial sector must be addressed, by tightening monetary policy, strengthening the central bank's supervisory capability and regulatory framework.

Based on the country's track record of policy and reform implementation in previous programs, and its capacity to meet its obligations vis-à-vis the Fund, we support the authorities' request for assistance under the Rapid Credit Facility (RCF) that will help address the impact of the global crisis more effectively.

On the fiscal front, we commend the authorities for their prudent fiscal management which helped preserve macroeconomic stability amid a difficult political environment and the global financial crisis. The adroit management of public finances contributed to the significant reduction of the public debt, placing the debt-to-GDP ratio on a sustainable path at 40 percent. We see merit in the authorities' decision to limit domestic borrowing for the next fiscal year, as it will curb the upward trend of the budget deficit.

On the revenue side, we welcome the reform measures adopted by the authorities, including reforms in custom administration and Inland Revenue Department as well as measures to broaden the tax base and reduce tax evasion, all estimated to have increased revenue collection from 10 ¾ percent of GDP in 2006 to 14 ½ percent in 2009. We concur with the view that, to boost revenue further, other revenue collection areas could benefit from efforts as those made by the Large Taxpayer Office, which with technical assistance from FAD, has yielded significant results. .

Regarding monetary policy and the financial sector, we note that the current regime of exchange rate peg to Indian rupee has broadly served Nepal's economy well. However, the appreciation of the currency over the last 10 years raises some concerns over competitiveness. In light of the financial sector's weaknesses that pose significant challenges to financial stability, notably liquidity shortfalls and imbalances in credit-to-deposit ratios, coupled with the rapid proliferation of financial institutions, we welcome the authorities' resort to rationalize policy instruments in light of the recent mid-term monetary policy review, and the calls for statutory liquidity ratio (SLR), as all comprise market-based open market operations as primary tools for liquidity management and distribution of credit to exports, power, and tourism sectors. We also see merit in the use of penalty interest rates applied to Standing Liquidity Facility (SLF) in view of preventing banks from abusive use of the emergency facility.

As regard structural reforms, we advise the authorities to press ahead with the reform package aimed at strengthening the poverty reduction strategy. To this end, significant efforts in building consensus are required to foster progress in structural areas, notably governance, labor market, physical infrastructure, and the electricity sector. Such progress would contribute greatly to diversify the economy, bolster growth, and reduce poverty while curbing the economy's vulnerabilities to shocks.

With these remarks, we wish the authorities success in their challenging endeavors.