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May 27, 2010

**Statement by Mr. He and Ms. Liu Naji on Nepal
(Preliminary)
Executive Board Meeting 10/54
May 28, 2010**

We thank staff for their informative reports and Mr. Chua and Mr. Thapa for their insightful Buff statement.

Under political transition and as the global crisis is having a substantial impact on the economy, Nepal's outlook is challenging. The authorities are facing challenges of liquidity management, external and financial sector stabilization, and long-standing structural problems. To help address the impact of the global crisis, mainly to tackle the country's deterioration in the current account balance and the decline in international reserves, we support the authorities' request for a disbursement of the indicated amount under the RCF, especially since Nepal has a successful record of PRGF-supported program implementation and adequate capacity to repay the Fund.

We could agree with the general thrust of staff's appraisal and would like to limit our comments to the following.

On monetary policy, we share staff's view that although it needs to support the peg, liquidity management should be strengthened and abrupt fluctuations in the interest rate should be avoided. However, under the current situation, as weak remittances, trade deficit, and capital flight have squeezed Nepal's liquidity, we caution against tightening. In this case, responding to commercial banks' loan disbursements reduction, deposit and lending rates increase, plummeted real estate transactions, and falling stock market dominated by financial institutions, we welcome the authorities' move to rationalize policy instruments and strengthen open market operations. In particular, we find their efforts to extend the repo transaction term, introduce a refinancing facility window, and inject liquidity as the interbank market rates rose as appropriate. Under the current circumstances, we deem it important to extend the necessary credit to key sectors. As for the Nepalese rupee, we concur with staff that the peg should remain as one of the key near-term policy objectives as remittances growth is expected to recover and import growth to moderate. More importantly, the peg is needed to underpin macroeconomic and financial stability. Over the medium term, we agree with staff that a basket could be considered.

The authorities' achievement and continued commitment to maintain fiscal discipline despite the political situation is commendable. On the revenue side, revenue growth resulting from import-related taxes and duties is helpful. We look forward to further administrative reforms to broaden the tax base and reduce tax evasion. On the expenditure side, in the face of a relatively lower economic growth, we see merit in adopting more active fiscal stimulus and urge effective capital project implementation if assistance from donors is available.

It is encouraging to see the rapid growth of the financial sector in Nepal. At the same time, as recognized by both staff and the authorities, the proliferation also heightens vulnerabilities as supervision and regulatory enforcement is overstretched. We commend the NRB's recent prudential measures to contain credit and liquidity risks in the banking sector and find staff's suggestions to safeguard financial stability are appropriate. Since the improvement of supervision and regulation would not be accomplished overnight, it would be very useful to maintain adequate central bank reserves and, at the same time, a strong international reserve position so as to anchor confidence in the financial system.

We agree with staff that political stability and improved security are necessary to tackle Nepal's long-standing structural problems, namely the business climate, external competitiveness, and economy diversification. To this end, we reiterate our support to Nepal's RCF request, which could lead to an upper credit tranche arrangement that would support necessary reforms, both in this critical phase and in a longer-term agenda.

With all these remarks, we wish the authorities success in their efforts.