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**Statement by Ms. Lundsager and Ms. Hull on Nepal**
**(Preliminary)**
**Executive Board Meeting 10/54**
**May 28, 2010**

Nepal continues to face a multitude of challenges as it transitions to a democratic, post-conflict state. Weak remittances and exports growth and rising imports have led to a significant deterioration in the current account and a decline in reserves. We have real concerns that at least a portion of the increase in external deficits is a function of the endogenous policy framework, including the exchange rate regime and inadequate financial sector supervision. If external deficits should persist, Nepal will need to consider additional expenditure-switching policies to restore external balance. We note the importance of constructing such polices consistent with Nepal's obligations under Article VIII. We expect the foreign exchange restriction, outlined in the staff supplement, to be removed before any follow-on program is brought to the Board.

**Fiscal Policy**

Fiscal policy has been prudent though spending pressures appear to be rising. The authorities have made significant progress in revenue mobilization, with collections increasing from less than 11 percent of GDP in 2005/06 to over 14 percent in 2008/09. These policies have created some fiscal space for investment in infrastructure and human capital development. However, further efforts to enhance revenues are needed and, until a durable improvement established, we caution against sustained increases in recurrent spending.

**Monetary and Exchange Rate Policies**

The exchange rate appears to be overvalued in an environment of decreasing reserves and mounting political instability. Nepal's current peg to the Indian rupee has served it well as an anchor for sound macroeconomic policies, but the growing overvaluation of the Nepalese currency threatens competitiveness and, thus, medium-term growth and poverty reduction. While this overvaluation might be exaggerated by the recent strength of the Indian rupee, we see a risk that productivity and inflation differentials favoring India could exacerbate the Nepalese rupee's overvaluation and lead to persistent external deficits. While the immediate focus on maintaining the peg seems appropriate, over the medium term, it may serve Nepal better to consider alternative exchange rate regimes, such as a peg to basket of currencies, given the authorities' preference to use the exchange rate as the nominal anchor.

*We welcome the staff's thoughts on the feasibility and timing of such a transition.* That said, in the current environment, we caution the authorities against making statements regarding a possible future devaluation until the situation normalizes and a credible transition path is formulated. We were disappointed that the staff report did not discuss how Nepal plans to use its SDR allocation.

**Financial Sector**

While fiscal policy has been prudent, financial sector regulation and supervision have been lax. Large remittance inflows led to rapid credit growth, fueling asset price bubbles, particularly in real estate. The overall health of the banking sector is precarious, particularly for the two state-controlled banks which are operating with negative capital. In the event of a banking crisis, the peg will limit the NRB's ability to provide liquidity. Therefore, we applaud the steps that the NRB has recently taken to contain credit growth including imposing single borrower and real estate loan exposure limits, and the moratorium of bank license applications. We strongly agree with the staff that the credibility of the NRB needs to be strengthened through enhanced political backing and the strict implementation and enforcement of regulatory measures. The authorities should make concerted progress in restructuring viable banks and continue to move forward with establishing a bank resolution framework, as discussed in Messrs. Chua and Thapa's statement. We encourage the authorities to consider undertaking an FSAP.

The authorities should place great priority on taking prompt and effective action to address the deficiencies in its AML/CFT system identified by the International Co-operation Review Group (ICRG). The deficiencies in Nepal's regime are detrimental to the essential framework and building blocks of an effective AML/CFT system. Corrective action is critical, given Nepal's high level of remittances and vulnerability to money laundering and terrorist financing threats.