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May 27, 2010

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

We thank staff for the informative and well-written set of papers. We are also grateful to Mr. Chua and Mr. Thapa for their informative Buff statement. Notwithstanding the civil conflict, Nepal maintained macroeconomic stability until 2008, in part thanks to the policies implemented under the PRGF concluded at the end of 2007. Starting in 2009, the global crisis has impacted Nepal's economy, leading to substantial external unbalances. Indeed, exports and remittances fell, imports increased, and reserves declined. The situation has been exacerbated by high financial sector vulnerabilities and political instability. In this context, we share the staff's and authorities' assessment on the suitability of the peg between the Nepalese rupee and the Indian rupee. Notwithstanding the difference of productivity between Nepal and India, the peg is much needed in the near term in order to avoid a capital flight that would undermine the financial stability.

Against this background, we can support the disbursement under the Rapid Credit Facility (RCF) in an amount equivalent to SDR 28.52 million (40 percent of quota) in order to offset the external financing gap, boost the confidence in the financial system, and ease banks' liquidity problems. At the same time, we urge the political parties to reach an agreement on the constitution and ensure political stability, which is necessary for sustained growth.

Despite our support for the proposed decision, we believe that a program would have been more appropriate to address Nepal's structural problems. In this regard, we note that the RCF is regarded by the authorities as a bridge to a program under the Extended Credit Facility (ECF); we look forward to discussing further this possibility. However, the authorities should start acting immediately to cope with the structural problems which threaten financial and external sustainability by promoting sound macroeconomic policies. Import restrictions as well as foreign exchange restrictions which are inconsistent with the Fund's Articles must be avoided.

The first priority for Nepal is to maintain the stability of the financial sector. The fast growth in this sector has increased credit and liquidity risks. Many banks and other financial institutions are exposed to these risks and, in case of a systemic banking crisis, the NRB's capacity to provide liquidity could be limited by the peg. Accordingly, while we welcome the measures taken by the authorities to stabilize the financial sector, further action must be taken, including an assessment of the solvency and liquidity risks, a strengthening of the NRB's supervisory capacity, and a contingency plan for emergency liquidity support.

In the fiscal area, we share the staff's view of maintaining strict fiscal discipline in the near term with the aim of supporting the peg with the Indian rupee. In addition, the potential cost of the financial sector restructuring requires prudent fiscal policy management. In the medium term, the fiscal space must be used to increase capital expenditure in order to improve productivity and achieve higher growth. In this regard, we regret the recent increases in current expenditure, which will be difficult to reverse in the future.