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May 27, 2010

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

We thank staff for a well-focused and concise report, and Mr. Chua and Mr. Thapa for their helpful Buff statement.

It is commendable that the authorities have broadly maintained macroeconomic stability in recent years, mainly aided by robust remittance inflows and remarkable fiscal discipline.

However, the Nepali economy continues to face challenges associated with the global economic downturn, as well as subsequent domestic vulnerabilities, mainly focused on external and financial risks. At this juncture, we agree that use of the Rapid Credit Facility (RCF) would be appropriate to assist in stabilizing the economy by its timely bridging role in addressing the external financing gap, and by its catalytic function in mobilizing donor support. An RCF arrangement should also contribute to boosting Nepal's growth potential in the period ahead. We note staff's assessment that Nepal has adequate capacity to repay the Fund, and its risk of debt distress is moderate. The requested access of 40 percent of quota is also consistent with both the policy regarding access to the shocks window and the authorities' current balance of payment needs.

Going forward, the authorities expressed in the letter of intent their preference for the RCF as a bridge to an Extended Credit Facility (ECF). Given the above-mentioned points and the ECF's expected role in accelerating pending structural reforms aimed at economic growth and poverty reduction, we support the authorities' request for the RCF and look forward to the authorities' continued and close relationship with the Fund in this regard.

Given the unstable political landscape likely to continue for the foreseeable future, the authorities' policy intentions for structural reform are understandably limited, and of an incipient nature. However, the poor business climate, power shortage, inadequate infrastructure, and weak governance are priorities that need to be tackled as soon as the political and security situation have been improved. As staff point out, the authorities should make full use of their eco-geographical advantage of being located between two of the fastest growing economies in the world and find a solution to utilize their vast hydropower potential.

The Fund's policy advice on structural issues, facilitated by its continuing involvement through the RCF and ECF in the period ahead, has the potential to provide significant benefit to the authorities. Moving ahead, we believe that now is the good time to enhance the momentum of structural reform. We look forward to seeing staff's more in-depth analysis on structural reform issues in the next Article IV discussion.

In the short term, the main policy priority for the authorities is to manage external and financial sector risks. We support the broad thrust of policy measures in the letter of intent, and will limit our comments to two items, for emphasis.

- It is clear that the exchange rate peg to the Indian rupee has provided an anchor for macroeconomic stability and that this peg needs to be maintained in the current unstable political and economic climate. However, in the medium term, the authorities need to pay attention to the widening productivity differential with India and the changing trend in the pattern of migration, and preemptively consider the possibility of a change of regime reflecting the changed economic environment. Staff's suggestion of a basket including the Indian rupee and the dollar would be a good one for the authorities' consideration.

- As well set out in box 3, with regulatory gaps and forbearance having contributed to excessive risk-taking, systemic risks in the financial sector are rising and necessitate the authorities' close attention, and well-considered response. In this regard, the recently adopted prudential measures are welcome. We agree with staff that strengthening the crisis preparedness through contingency planning is urgently needed. Among other things, setting up a clear framework for emergency liquidity support, strengthening the bank resolution framework and developing an action plan for crisis management need to be addressed as key elements. We welcome the authorities' TA request to the World Bank in this area.

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