

The contents of this document are preliminary and subject to change.
--

GRAY/10/1949

May 27, 2010

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

We thank the staff for their informative report. We also thank Mr. Chua and Mr. Thapa for their candid statement. We support the proposed decisions. As we generally agree with the staff's appraisal, we will limit our comments on the following issues:

Fiscal Policy

Although we commend the authorities for keeping appropriate fiscal policy conduct, we agree with the staff that the authorities need to further improve their fiscal prudence. The economic slowdown, as well as the tough circumstances in the financial sector, may bring pressure to the nation's fiscal situation. Therefore, we would like to encourage the authorities to make every effort, including the implementation of the fiscal reform, to assure a policy maneuver against downside risks.

Financial Sector

As stated in the staff report, amidst severe circumstances in the financial sector, containing liquidity and credit risks is of the biggest challenges in Nepal's financial sector. Regarding the liquidity risks, after lax monetary policy conduct in the past years, it is commendable that the authorities have started to tighten its monetary policy. In a theoretical sense, the recent slowdown in bank lending, followed by the decrease in the broad money growth, can be regarded as part of the outcomes of monetary tightening. Nonetheless, the underdevelopment of liquidity risk management in the banking sector might complicate the transmission mechanism of monetary tightening and cause an exaggerated credit crunch. Against this background, the authorities should encourage the banks to enhance liquidity risk management, so as to facilitate a smooth functioning of monetary tightening.

Regarding the increasing credit risk, we note that the stress test indicates high vulnerabilities

in bank credits. In particular, amid the decreasing trends in real estate prices, we are concerned about further deterioration in real estate-related credits. Therefore, we would like to encourage the authorities to make a contingency plan, including public fund injection, for the case that Non-performing loans further increase.

Balance of Payment Pressure

While the staff report suggests that the authorities, facing a large deficit in current account balance, intend to take measures to contain imports, we wonder if such measures are really desirable, especially from the viewpoints of their negative influence on resource allocation and the effectiveness of any import control. First, if the authorities try to decrease imports through macro-policy tools, a substantial slowdown in domestic demand and recession will be needed. Second, if the authorities try to discourage imports through regulatory tools, they will cause inefficient resource allocation and will lead to an increase in illegal activities. Third, if the recent increase in imports stems has been caused by lax bank lending activities, the desirable measures would be to strengthen the monitoring of credit risks in bank lending as a whole, instead of focusing specifically on import-related loans. *We would welcome the staff's comments, if any.*

With these comments, we wish the authorities every success in their endeavors.