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May 27, 2010

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

We thank staff for well-written reports, and Mr. Chua and Mr. Thapa for their helpful statement.

1. Despite an extended and challenging political transition, the Nepali authorities have succeeded in maintaining broad macroeconomic stability. High remittance inflows, accounting for 21 percent of GDP, have played a major role in financing large trade deficits and building up reserves. However, delayed impact of the global financial crisis has reduced remittance growth and led to a decline in exports in the first half of 2009/10. This, along with sharply increased imports, put pressure on reserves and liquidity. Weak remittances and exports, with poor harvest due to deficient monsoon, would adversely affect growth in 2009/10. In this context, maintaining political and economic stability and addressing growing financial sector vulnerabilities will be crucial in the period ahead. We broadly agree with the staff assessment and, in view of the authorities' commitment to sound policies, as stated in their LOI and reiterated by Mr. Chua and Mr. Thapa, we support their request for a disbursement under the Rapid Credit Facility.

2. The authorities' prudent fiscal policy in a challenging environment is commendable, supported by significantly increased import taxes, grants, and lower-than-budgeted capital spending. Nepal's risk of debt distress remains moderate, and its public debt below the average of comparators. A debt-to-GDP target ratio at the current level of 40 percent would be an appropriate fiscal policy anchor, and would allow for an increase in the overall deficit over the medium term to 3.5 percent of GDP, and in the domestically financed deficit to 2.5 percent of GDP. The available fiscal space should be used to invest in infrastructure and human capital, with a view to improving execution capacity and ensuring spending quality. However, we agree that public domestic borrowing should be contained close to current level in the short-run to support the peg and also to leave some room for private sector credit and help ease interest rates. We welcome the authorities' progress on revenue mobilization by reforming customs administration and Inland Revenue Department, as well as recent measures to broaden the tax base and reduce tax evasion. Strengthening the National Oil Corporation's financial position requires an automatic fuel pricing mechanism, while

designing an appropriate electricity tariff adjustment mechanism would help address power outage problems and prevent further losses by the Nepal Electricity Authority.

3. We concur that the exchange rate peg to the Indian rupee serves the economy well, anchoring inflation expectations and macroeconomic stability. We also note the indications of a modest overvaluation and some loss of competitiveness. Maintaining appropriate level of short-term interest rates (relative to those of India) and a more active liquidity management could help support the peg and liquidity, as indicated by staff. We welcome the central bank's measures to address the tight liquidity conditions. We note that the authorities intend to take additional measures to prevent capital flight and contain import growth in case of continued pressures on reserves.

4. Addressing financial sector vulnerabilities is critical, given the banks' high exposure to liquidity and credit risks. This is all the more urgent in view of the rapid growth in the financial sector, which has put pressures on limited supervisory capacity, as underscored by Mr. Chua and Mr. Thapa. After having declined significantly, non-performing loans could increase following a likely significant decline in real estate prices or credit growth, and the largest borrower's default would bring banks' capital adequacy ratios below the minimum. In this context, maintaining adequate reserves will be essential for strengthening public confidence. We welcome the recent bank restructuring measures, as well as the tightening of bank licensing and prudential regulations, including reducing limits on single borrower, real estate exposure, loan-to-value, and credit-to-deposit ratio. Further, we encourage the authorities to strengthen enforcement of these measures including by improving the central bank's supervisory capacity.

5. While structural reforms remain instrumental for putting the economy on a sustainable higher growth path, the authorities' ability to implement such reforms during the political transition is understandably constrained. Therefore, timely and strong political consensus remains a prerequisite for the success of major reforms aimed at improving the business climate, external competitiveness, and economic diversification. As indicated by staff, improved infrastructure and labor relations and further development of Nepal's vast hydropower potential could put the economy on a higher growth path. We welcome the recent improvements in health and education indicators and the significant reduction in poverty.

We wish the authorities success in their endeavors.