

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

GRAY/10/1977

May 27, 2010

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

We thank staff for a clear set of papers and Mr. Chua and Mr. Thapa for their informative Buff statement. It is clear that Nepal faces a range of political and economic challenges as the impacts of the financial crisis begin to be felt. We also note the mixed record on economic management with prudent fiscal management set against more passive monetary policy and relaxed financial sector supervision. We recognise that the latter may have exacerbated the impacts of the recent economic crisis on the economy as remittances and the trade balance deteriorate. We support the findings of the Article IV consultation and encourage its publication. We also agree to the proposed disbursement under the rapid credit facility. We note that an ECF may also be under consideration. *Can staff elaborate on their thoughts concerning the choice between these instruments in Nepal's case?*

We commend the authorities for their success in maintaining fiscal discipline through the political transition. Debt reduction has helped create fiscal space. But we agree with staff that carefully managing the deficit and domestic borrowing is paramount if the currency peg is to be supported in the near term. We also encourage the authorities to build on progress in revenue mobilization and to follow through on identified measures, including curbing tax evasion and reforming the customs department.

We agree that the exchange rate peg to the Indian Rupee has provided an anchor for macroeconomic stability. But we also note that the Nepali rupee appears to be moderately overvalued even when remittances are taken into account. We welcome further discussions between the authorities and staff on the role and type of peg in the medium term as well as alternative options for a nominal anchor. We also stress the importance of measures to enhance competitiveness and growing productivity divergence with India especially as the prospects for a full recovery in remittances remain uncertain. Finally, we ask the authorities to comply with the obligations under Art.VIII and therefore to reconsider the exchange restrictions outlined in the Supplementary Information Note from staff.

Weaknesses in the financial sector do give cause for concern. The rapid expansion in the number and exposure of Banks has left the system vulnerable to the slowdown in remittances and restricted the room for policy. We commend the authorities for the measures to contain credit and liquidity risks in the banking sector. We encourage quick implementation of these measures as well as the preparation of contingency plans and the passing of the Banks and Financial Institutions Act to strengthen the bank resolution framework.

Finally, we encourage the authorities to work towards strengthening their AML/CFT systems by addressing the deficiencies identified by the International Cooperation Review Group.