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May 27, 2010

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

1. We thank staff for their informative report and Messrs. Chua and Thapa for their instructive Buff statement.
2. Nepal has begun to experience the spillover effects of the global crisis, as exports are on the decline and growth on remittances is slowing down. Before the crisis, Nepal had experienced a rapid expansion of domestic credit, fuelled by remittances that increased domestic demand and, consequently, imports. The growth in imports has impacted the level of international reserves significantly and deteriorated the current account. Even though economic growth has weakened, it is still projected to remain in positive territory in 2009/2010. However, the remainder of 2009/2010 will be challenging, given weaker foreign currency inflows, financial sector vulnerabilities, and the fragile political situation.
3. We welcome the significant progress Nepal has made in reducing its debt to a more sustainable level, thus creating room to implement stimulus policies. The authorities made important progress in increasing revenue, which can be attributed in part to the benign environment observed before the crisis. However, the prevailing high inflation, the deteriorating balances of payment, the exchange rate peg, and constrained liquidity conditions—apart from the fact that the country is categorized as being in moderate risk of debt distress—are overwhelming reasons why the authorities should preserve fiscal prudence. We concur with staff that, in the short term, external borrowing should be undertaken on concessional terms or through grant financing.
4. Although spending has increased, it has been attributable in part to improving health care and education as well as securing the peace process. Going forward, attention must be paid to improving the infrastructure necessary for boosting growth and

reducing poverty. The authorities will thus need to arrive to a comfortable balance between spending for growth and development and meeting the requirements of fiscal prudence. In this context, we view the ongoing measures for improving revenue administration and enhancing tax receipts as crucial facets of the reform agenda.

5. According to the staff's assessment, the exchange rate is modestly overvalued but can remain at the current level, given the outlook of a pick-up in remittances and a deceleration in the growth of imports. In any event, careful monitoring of external accounts is essential in this transitional period, including by making necessary adjustments to the domestic demand policy in order to avoid further deterioration of the current account and reserves position.
6. Given the strong expansion of domestic credit observed in the precrisis period, we welcome the authorities' efforts to improve the supervisory and regulatory capacity of the Nepal Rastra Bank to better safeguard financial sector stability. The prudential measures recently introduced—such as the lowering of the single borrowing limits, reducing exposure to real estate lending, placing limits on credit to deposit ratio, the restructuring of banks, and the pending introduction of risk management guidelines—are steps in the right direction. However, close monitoring of the institutions to ensure compliance is important.
7. We note that the difficult political environment has hindered structural reforms critical to improving the business climate, fostering growth, reducing poverty, and diversifying the economy. We encourage the authorities to accelerate these reforms as the political climate improves.
8. In light of the authorities' commitment to prudent macroeconomic management, we agree to the request for financial support under the Rapid Credit Facility.
9. With these comments we wish the authorities of Nepal success.