Mid-Term Review

of the

Monetary Policy 2008-09*

1. Nepal Rastra Bank, on 29 Sep 2008, had publicly announced the monetary policy of 2008-09. This Policy is forward looking as it was designed based on the prevailing global and domestic economic outlook, along with cognizance of the macroeconomic possibilities that would likely evolve in the future. After the announcement of the policy, the world witnessed a dramatic and sharp change in the global economic activities. The fallout from sub-prime mortgage crisis, which had germinated from the United States of America, gradually spread to both developed and developing countries and is resulting in a decline of global output and employment. To avert this crisis, coordinated efforts have been made at an international level by multilateral organization and G-20 countries, along with stimulus packages' of crisis-struck countries. Despite these efforts, there is no indication that the crisis will be abated. While Nepal has escaped the immediate impact of the global financial crisis, the effects of this crisis have recently emerged and are reflected in some sectors of the Nepalese economy as well.

2. During the announcement of the 2008-09 monetary policy, a major concern for overall macroeconomic management was the higher and rising level of prices. Further, the Bank was aware of the possible risks in the financial sector emanating from financial crisis such as: excessive exposure of banks and financial institutions in real estate; the rising share and asset prices; and loss of value of bank deposits resulting from negative real interest rates. Given these circumstances and an underlying liquidity overhang in the economy due to elevated inflows of remittances in later period of 2007-08, the Bank thus adopted a cautious and tighter monetary policy stance in 2008-09 in order to control the monetary impacts on prices and anchor inflationary expectations for achieving macroeconomic stability.

3. In the sequence of announcing the mid-term review of the monetary policy of 2008-09, I would like to highlight the first six month's performance in some key macroeconomic fronts.

4. In the agriculture front, the Government of Nepal (GON), Ministry of Agriculture and Cooperatives, has estimated that paddy, the major food crop will grow by 5.2 percent of the previous year amounting to 4.5 million metric ton. Other food crops such as maize and millets have been estimated to grow by 2.8 and 0.5 percent respectively. However, other food crops like wheat, vegetables and fruits are estimated to grow by a lower rate than that of the previous year on account of a long winter drought. The regular roadblocks and strikes have also badly affected the flow of agriculture and livestock products to the market causing a loss to the farmer and therefore, to the economy as a whole.

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* A statement given by Deependra Bahadur Kshetry, the Governor of Nepal Rastra Bank

5. In the non-agriculture front, a disruption in road connection with the eastern part of Nepal on account of Koshi flood, load shedding, security threats, road blockage, strikes and problematic industrial relations have deteriorated to domestic industrial activity and production. A growing external dependency in the face of declining industrial production for meeting internal demand, has posed a serious challenge to maintain macroeconomic equilibrium.

6. The year-on-year (y-o-y) inflation in mid-January 2009, which is based on national urban consumer price index, increased by 14.4 percent. The food and beverages group, which is a major component of the consumer price index, soared up by 18.3 percent while the portion of the price index of relating to the non-food group grew by 10.3 percent.

7. In the fiscal front, the total expenditure of the GON increased by 12.3 percent during the first six months of 2008-09 in comparison of 30.2 percent growth in the same period of the previous year. In the review period, the current expenditure increased by 13.1 percent compared to an increase of 21.8 percent in the previous year. The capital expenditure, however, declined by 23.4 percent amounting to Rs. 7.9 billion as against an increase of 66.3 percent a year ago. Likewise, the revenue mobilization by GON, increased by 25.5 percent amounting to Rs 59.5 billion; this compared favorably with a growth of 25.4 percent in the previous year.

8. In the first six months of 2008-09, the budget of the GON on cash basis remained in surplus by Rs 7.4 billion. The budget was in deficit by Rs 3 billion during the same period in the previous year. A higher revenue mobilization relative to the expenditure, a higher receipt of foreign assistance compared to the previous year and internal borrowing of Rs 8.7 billion in the review period, contributed to increase the government deposits, to Rs 18.7 billion with the NRB. Such a higher level of deposits of the GON cannot be regarded appropriate for capital mobilization.

9. In the external front, the balance of payments (BOP) has remained in surplus by Rs 28.5 billion in the first six months of 2008/09, as against a deficit of Rs 1.9 billion in the corresponding period of the previous year. The current account has remained in surplus by Rs 16.7 billion in the review period as against a deficit of Rs 10.9 billion in the same period of the previous year. Despite an external sector stability built on an account of elevated inflows of remittances, the widening trade deficit is a matter of critical concern.

10. In the monetary front, broad money (M_2), a measure of overall liquidity, increased by 11.0 percent in the review period compared to an increase of 10.3 percent in the previous year. A significant increase in net foreign assets of the monetary sector contributed to increase M_2 in the review period.

11. Domestic credit expanded by 5.7 percent in the review period compared to an expansion of 10.2 percent in the previous year. A decline in net claims on government by 18.8 percent and a lower rate of growth of private sector credit, owed significantly to slowdown in domestic credit in the review period. Private sector credit expanded by 11.4 percent in the review period compared to a growth of 14.0 percent in the previous year. In the review period, commercial banks expanded the credit to the private sector by 11.5 percent amounting to Rs 375.5 billion, compared to a rise of 16.0 percent in the previous year. The review period witnessed a decline in credit demand by production sector, however, the growth of consumption credit increased.

12. An elevated inflow of remittances and an expansion of bank branches in the remote areas contributed to the increase in the deposit mobilization of commercial banks in the review period. The deposit mobilization of commercial banks increased by 12.9 percent (Rs 54.3

billion) in the review period amounting to Rs 475.8 billion compared to an increase of 11.3 percent (Rs 37.9 billion) in the previous year.

13. With establishment of a development bank, the total number of banks and financial institutions reached 173 as in mid-January 2009. In the first six months period of 2008-09, commercial banks opened a total of 62 new branches, thus making 617 commercial bank branches overall presently operating in Nepal.

14. Under the monetary management, net liquidity of Rs 20.7 billion mopped up on cumulative basis through open market operations during the review period. A net liquidity of Rs 6.81 billion was mopped up in the corresponding period of the previous year, including an injection of Rs 2.0 billion through repo auctions. In order to avert a situation of excess liquidity with the commercial banks, the NRB mopped up a higher amount of liquidity from the market in the review period.

15. The NRB injected net liquidity of Rs 73.2 billion in the market through a net purchase of 963.6 million US dollar from foreign exchange intervention in the review period. The intervention was necessitated by an encouraging inflow of remittances in the review period. For managing IC demand as well as the IC reserves, the NRB purchased IC of 33.9 billion by selling 720.0 million US dollar in the review period. The NRB had purchased IC of 26.3 billion by selling 660.0 million US dollar in the previous year.

16. Under the standing liquidity facility, commercial banks used Rs 38.2 billion in the review period, compared to the use of Rs 46.9 billion in the previous year. The inter-bank transactions stood at Rs 146.8 billion in the review period compared to Rs 168.1 billion in the previous year.

17. As per the provision of export refinancing facility in domestic currency at 2.0 percent and sick industries refinancing facility at 1.5 percent, in the review period a hotel was granted a sick industries refinancing facility of Rs 7.0 million through Western Development Bank.

18. Considering the loss likely to be borne by the Nepalese importers in the face of sharply declining international commodity prices and to abate the cost of global financial crisis, the existing 90 days limit of trust receipt loan has been extended to a maximum of 180 days in the review period.

19. In order to address the issue of financial inclusions and increase the outreach of deprived classes to the institutional credit, the deprived sector credit to be provided by commercial banks, has been kept unchanged at 3 percent of total outstanding credit. The limit of the deprived sector credit for development banks has been increased to 1.5 percent from the existing limit of 1 percent. Finance companies are also now required to provide deprived sector credit totaling 1 percent of total outstanding credit. The development banks have disbursed deprived sector credit of Rs 394.3 million as in mid-January 2009.

20. For the banks and financial institutions failing to maintain a minimum level of capital fund, prompt corrective action (PCA) has been introduced and implemented as a new supervisory instrument since 2008-09. Given the international practice of undertaking corrective actions as per the degree of weaknesses of the banks and financial institutions, the bank has introduced and implemented by-laws relating to the prompt corrective actions.

Economic and Monetary Outlook

21. The ongoing political transition has adversely affected economic activities, which are reflected in sluggish growth of private and public sector investment. Likewise, the

domestic energy crisis has severely affected the growth of non-agriculture production. As the effects of global financial crisis, which has started to appear in the second half of the current fiscal year, the economic growth is likely to come down from its earlier projection.

22. The monetary policy for the current fiscal year had made projection of annual average inflation at 7.5 percent. However, the inflation hit 14.4 percent (y-o-y) in the sixth-month of the current fiscal year thereby making the six-month average inflation at 14.0 percent. Notwithstanding the downward trend in global price and the substantial reduction in the prices of food products and metal products since September 2008, Nepal is passing through a high inflationary pressure. This is mainly attributed to supply-driven factors such as energy crisis, *bandhs*, strikes, etc. which have raised the costs of production and distribution. Based on the analysis of past trend and existing scenario along with some positive future outlook, the earlier projection of annual average inflation has been revised upward to remain within 11.0 percent.

23. GON has adopted the policy of adjusting domestic petroleum prices in accordance with the global prices. The NRB believes that such policy will improve the supply management and help reduce the price volatility of petroleum products. Despite the reduction in the prices of petroleum products, it has not been fully reflected in the overall price situation due mainly to weak implementation of petroleum price adjustment with the fare of public transportation.

24. The NRB opines that the supply-driven factors are more responsible for the current inflation in Nepal. However, the Bank is also aware that monetary expansion will have further impact on inflation especially through the prices of non-tradable and real estates. With the view to alleviate further inflationary pressure fueled by monetary expansion, the NRB will continuously mopping up the excess liquidity of the banking sector, through the open market operations based on the liquidity situation as indicated by the liquidity monitoring and forecasting framework as well as deposits mobilization, loan extension and cash flow statements of the banking sector.

25. The overall BOP was projected to register a surplus of Rs. 12.0 billion in 2008-09. In the first six months of 2008/09, this annual target was breached and the BOP registered a surplus of Rs. 28.5 billion. Though there exists the significant possibility of maintaining this surplus to attain the targeted BOP surplus of Rs 12.0 billion, this trend is estimated not to continue in the remaining months; this is due to the reduction in the number of workers going for foreign employment in the sixth and seventh months of the review year, decline in the tourist arrival, the possible retrenching the workers as an effect of global financial crisis and widening trade and service account deficit.

26. The effect of global financial crisis is likely to transmit from the real sector to financial sector of Nepal. The NRB has been continuously monitoring the likely impact of global financial crisis on financial sector. As the financial crisis is likely to have its immediate impact on those banks and financial institutions having weak capital structure and inadequate liquidity situation, the NRB advises banks and financial institutions to continuously monitor their loan portfolio and maintain the asset quality. The banks and financial institutions need to be aware of improving their asset quality following the advancement of the financial sector reform program.

27. There is no remarkable change in the economic and financial situation, which had existed at the issuance of this monetary policy. The inflation rate is still high and there is no positive sign in addressing the negative rate of real interest rate in the market. The

liquidity position is also in comfortable position so that tight and precautionary monetary stance is going to be continued for the remaining period of this fiscal year.

28. If the financial sector is unable to mobilize the necessary liquidity through financial markets, open market operations and standing liquidity facility, NRB will provide to financial institutions necessary facility as the lender of the last resort. The bank rate has been kept unchanged at 6.5 percent. In the review period, there was no use of this facility.

29. Cash reserve ratio has been kept unchanged at 5.5 percent, which is the fraction of the total domestic currency deposit liability required to be maintained by bank and financial institutions with the NRB.

30. Export refinance policy rate in both domestic currency and foreign currency, has been kept unchanged with the aim to promote the export for the forthcoming period of this fiscal year.

Conclusion

31. There has not been any significant progress in economic activities in the first six months of 2008-09. In the period of this mid-term review, the BOP experienced a significant surplus, which had contributed to external sector stability; however the decreasing number of Nepalese in foreign employment will likely reduce both remittance flows and thus the current account surplus. There is also a continuing pressure of high inflation resulting in negative real interest rate. In this situation of high inflation and external sector uncertainty, NRB is alert and is determined to focus on providing a smooth monetary management for the remaining period of this fiscal year.

32. The NRB would like to thank all concerned individuals and institutions for their co-operation in implementing the programs and policies as outlined in the annual monetary policy of 2008-09.

March 22, 2009

Nepal Rastra Bank

Baluwatar