Major Highlights of Monetary Policy

for

2006/07

Delivered by

Governor Mr. Bijaya Nath Bhattarai

on July 23, 2006

Nepal Rastra Bank
Central Office
Baluwatar, Kathmandu
Nepal

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1. NRB has been making public its annual monetary policy statement each year since fiscal year 2002/03. This policy statement focuses on broader macroeconomic objectives of attaining price stability, maintaining adequate level of international reserves and ensuring financial sector stability and thereby facilitating high and sustainable economic growth.

2. The detailed monetary policy statement consisting of the implementation status of monetary policy of 2005/06 and comprehensive analysis of this year's monetary policy is published. This is the summary of the main document of monetary policy.

Status of Economic Goals of Monetary Policy of 2005/06

3. The Nepalese economy continued to suffer from a decade long internal conflict, political stalemate, adverse weather conditions and elevated levels of oil prices in 2005/06. As a result, incremental fixed capital formation remained low, economic activities remained sluggish and inflationary pressures continued to persist.

4. The political situation has improved following the successful conclusion of historic people's movement that lasted for 19 days in April 2006.

5. The actual economic growth happened to be lower than 4–4.5 percent, targeted for 2005/06.

6. Real GDP at factor cost is estimated at 2.3 percent for 2005/06. GDP at producers' price is estimated at 1.9 percent for 2005/06. While agricultural GDP is estimated at 1.7 percent, non-agricultural GDP is expected to grow by 2.8 percent.

7. The revised estimates of annual average CPI inflation stands at 8 percent, higher than initially projected for 2005/06. Upward adjustments in domestic oil prices in August 2005 and February 2006 due to the elevated level of global oil prices, a significant increase in transport fares by 25–28 percent in early 2006

and persistence of food inflation throughout the year fueled the overall prices in 2005/06.

8. In the first 10 months of 2005/06, the country's overall BOP stood at a surplus of Rs. 20 billion. The current level of BOP surplus is expected to remain till the end of 2005/06. A significant growth in private sector remittances contributed to the increased level of surplus in the current account and overall BOP of the country.

9. Since the last few years, consolidation of the financial sector stability has been one of the important objectives of this bank. To achieve this objective, various financial sector reform programs have been implemented. In this context, programs such as strengthening inspection and supervisory capacity of this bank, adopting prudential norms as per international standards, establishing and operationalising the Debt Recovery Tribunal (DRT), strengthening the Credit Information Centre, refining the provisions regarding the black listing procedures of willful defaulters as per the suggestion of Shankar Sharma Study Committee, forming a Grievance Hearing Cell (GHC) and handing over the management of two problem banks, namely Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) to the foreign management teams, are under implementation.

10. Non-performing loans (NPL) of commercial banks declined from 30.4 percent in mid-July 2002 to 18 percent in mid-April 2006. Various financial sector reform programs implemented over the past few years contributed to some improvement in financial health of problem banks. NBL and RBB, which were incurring losses in the past, have started generating operating profit since 2003/04.

11. However, the financial sector is still at risk. It is challenging to maintain the financial sector stability in the face of the current level of NPL at 18 percent. In terms of absolute amount, the level of NPL stood at Rs. 29 billion as at mid-April 2006. NRB has taken a serious note of high level of NPL of some private sector banks, besides RBB and NBL.

12. The NPL level of RBB and NBL could not improve significantly due to the recalcitrancy on the part of some big borrowers in repaying their debt. One

argument cited by willful defaulters for their inability to repay debt is unsatisfactory performance of the economy. Following the revision in black listing procedure, those borrowers have brought forth the concept of limited liability, the sole purpose of which is to obstruct the process of loan repayment. NRB is of the view that willful defaulters must be isolated. There is a need for big borrowers to make their business transactions transparent and encourage them to disclose their property publicly. It is also important to initiate harsh punishment against those who make false disclosure of their property. These types of loans require one time settlement and curative measures. On this issue, NRB solicits the active supports from all concerned, including the government of Nepal.

A Brief Review of Intermediate Targets of Monetary Policy of 2005/06

13. The fixed exchange rate regime is the nominal anchor of monetary policy in Nepal. In this context, NRB has been monitoring a real effective exchange rate (REER) of NC. REER of NC has marginally appreciated due to relatively higher level of domestic inflation. However, this level of currency appreciation alone is unlikely to adversely affect the competitiveness of Nepalese goods and services.

14. Broad money growth is estimated at 16.3 percent. Increased private sector remittances contributed to monetary growth.

15. Bank credit off-take has been lower than expected. Lower level of investors' confidence and cautious approach adopted by banks in their lending resulted in a lower than expected growth of credit off-take.

16. Excess reserves of commercial banks have been chosen as an operating target of monetary policy for the last two years. Liquidity monitoring and forecasting framework (LMFF) is put in place to monitor excess liquidity of commercial banks. In this context, excess liquidity of commercial banks amounting to Rs. 13.5 billion was mopped up through sale auction in 2005/06. Likewise, on short-term basis, liquidity amounting to Rs. 6.5 billion was mopped up through reverse repo auction.

World Economic Outlook

17. According to IMF, world output is projected to grow by 4.9 percent in 2006. The engines of global output growth are USA, China, India and Russia. The African Continent and its sub Saharan region is registering a growth rate of more than 5 percent. Latin America is witnessing a growth of about 4 percent. It is a matter of concern for us that Nepal could not benefit from high and broad based world economic growth.

18. For 2006, inflation in developed countries is projected at 2.3 percent, emerging Asian countries at 3.8 percent and neighboring countries, India and China at 4.8 percent and 2 percent respectively. Owing to the adoption of tight stance of monetary policy at the global level, world inflation has remained in check.

19. Due to long standing internal conflict and political stalemate, Nepal could not benefit in terms of economic growth. The higher level of global output growth has, however, generated an increased demand for Nepalese labourers in regional labour market. The result has been the significant growth of remittances. Consequently, despite the internal conflict, Nepal's external sector has remained stable.

20. Second time after 1997, India has constituted a committee to look into the prospect of capital account convertibility. NRB is closely watching the policy changes that India is likely to take on capital account convertibility. Prerequisites for opening up of capital account do not exist in Nepal at the moment. However, a need for a gradual relaxation of capital account controls is undeniable.

Domestic Economic Outlook

21. Following the successful conclusion of recent historic peoples' movement, there is a prospect of a rebound in economic growth.

22. The country is in transition. Foreign and local investment in the economy hinges on how quickly the current transitional period improves. However, a level of monetary liquidity warranted in support of intended rate of economic growth exists in ample.

23. Inflation outlook in Nepal depends on the behaviour of world oil prices and the modus of settlement of the Nepal Oil Corporation (NOC) cumulative loss of Rs. 11 billion. The spare capacity of global economy is in state of decline. Inflationary pressure is likely to be on the boil. In response to this, most of central banks have tightened their monetary policy stance. As a result, global inflation is expected to remain under control. The NRB expects a corresponding impact on Nepalese inflation.

24. External sector of Nepal is expected to remain stable in 2006/07 as well. The growth of private sector remittances and level of foreign assistance are likely to underpin the external sector stability of Nepal.

Monetary Policy Framework for 2006/07

25. The monetary policy framework for 2006/07 has been prepared on the basis of likely developments of economic goals of monetary policy, liquidity situation and experience gained in the conduct of monetary policy in the preceding years. The monetary policy framework is also forward looking as it is formulated on the basis of economic outlook of near future. Global economic situation and the direction of monetary policy stance of world central banks are also taken into consideration.

Monetary Policy Stance

26. A cautious but a tight monetary policy stance has been adopted for 2006/07. As stated above Nepal's economic growth rate has been low in recent years. Despite an adequate level of liquidity, economic growth remained low due to non-economic factors. Interest rates are low due to excess liquidity. However, international short-term interest rates are moving up. There is pressure on inflation. Addressing these conflicting issues would be the focus of monetary policy for 2006/07.

Economic Goals of Monetary Policy

27. The budget speech of 2006/07 has targeted economic growth at 5 percent. Without jeopardizing the primary goal of monetary policy, i.e. inflation, an adequate level of liquidity aimed at facilitating the targeted economic growth will be ensured.

28. Annual average CPI inflation is projected at 6 percent for 2006/07. Low food inflation due to the prospect of good weather conditions and low level of global inflation owing to tight monetary policy stance by the global central banks are the underlying factors for inflation projection at 6 percent. However, it is not easy to make accurate projection of inflation due to the elevated and volatile global oil prices. Domestic oil price adjustment to the extent of compensating operating loss plus one-third of cumulative loss of NOC is estimated to drive inflation up by 3 percentage points.

29. The BOP surplus is projected at Rs 16 billion on the back of expected increased remittances and foreign assistance.

Intermediate Targets of Monetary Policy

30. The overall monetary management in 2006/07 will be in keeping with the fixed exchange rate regime and target of economic goals as stated above. To guide the monetary management, broad money is projected at 16.1 percent for 2006/07. The underlying factors of monetary projections are economic growth at 5 percent, inflation at 6 percent and a reasonable level of surplus in BOP.

31. Net bank credit to the government of Nepal is projected at Rs 8.3 billion.

32. Bank credit to the private sector is projected to grow by 18 percent in 2006/07. The objective is to increase the credit flow to the private sector.

33. Time deposits with the commercial banks is projected to grow by 16.5 percent in 2006/07.

Operating Target of Monetary Policy

34. The excess reserves of commercial banks will continue to remain as the operating target of monetary policy. Open market operations will be conducted to keep the operating target within the desirable level. LMFF will guide the open market operations.

35. Commercial banks will be counterparties in the conduct of monetary policy. This is in consonance with excess reserves of commercial banks, chosen as operating target of monetary policy.

Monetary Policy Instruments and Implementation Procedure

36. Export refinancing rate in local currency is maintained at the prevailing rate of 3.5 percent. Refinancing rate for sick industry loans also remains unchanged at 1.5 percent.

37. Refinancing for small and cottage industries will be made available at 3.5 percent

38. Refinancing amounting to Rs. 2 billion has been earmarked for sick industries for 2006/07. Refinancing amounting to Rs. 500 million has been sanctioned for loans provided to indigenous, ethnic, oppressed people (as defined by the government) and Nepalese women workers going to foreign countries for employment. Refinancing rate for this category will be 1.5 percent.

39. Given the current inflationary pressure, CRR is maintained at 5 percent. However, the medium-term policy is to slash it down to 3 percent.

40. To absorb/inject liquidity, open market instruments such as sale auction, purchase auction, repo auction and reverse repo auction will be continued.

41. In case, treasury bills holding of this bank are found inadequate to suck in excess liquidity and as a result, distortions are created in the economy, the NRB stands ready to issue its own bills.

42. The maximum maturity period of SLF borrowing has been extended from prevailing 3 days to 5 days. The existing procedures of the collateral related conditions attached to standing liquidity facility (SLF) to commercial banks remain unchanged. SLF is put in place to ensure a secure, healthy and efficient domestic payments system.

Micro Finance

43. After the enactment of National Micro Finance Policy as proposed in the budget speech of 2006/07, NRB will bring out and implement short-term, medium-term and long-term programms relating to rural micro finance.

44. Currently, NRB itself is operating the Rural Self-Reliance Fund (RSRF). The government of Nepal had provided a cumulative total of Rs. 40 million as seed money for RSRF in the past. Between 2002/03 and 2004/05, NRB appropriated a sum total of Rs 253.4 million to this Fund. The budget speech of 2006/07 has

also earmarked Rs 100 million for this Fund. Thus altogether, a sum of Rs. 393.4 million is available for the operation of this Fund. Besides this, all the assets and liabilities of various microfinancing projects which are already completed, will be transferred to RSRF.

45. RSRF will be converted into an autonomous microfinance and cooperative institution in 2006/07.

46. Efforts will be made to transfer the shares owned by this bank in all the rural development banks to the government of Nepal. The objective is to transform the role of NRB into a competent and accountable regulatory authority.

47. With a view to help extend rural microfinance programmes to the hills of the country, microfinance development banks will be allowed to operate in additional 5 hilly districts with the same level of minimum capital of Rs. 20 million.

48. NRB will encourage the private sector to establish a separate investment trust with a purpose of making share investment in microfinancing institutions in rural areas. The NRB is of the view that this is one of the approaches of strengthening microfinancing institutions operating in rural areas. Interested domestic and foreign agencies will be encouraged to deposit money in this trust. The amount deposited by commercial banks will be treated as loans to the deprived sector. Foreign agencies investing in this trust will be allowed to repatriate profits earned from such investment.

Financial Sector Reforms

49. As stated in the budget speech of 2006/07, willful defaulters have been allowed to schedule their loans within September 16, 2006. The NRB in close coordination with the government will initiate a process of taking strict action against those willful defaulters who do not settle or reschedule their debts within the stipulated time frame.

50. With a view to discourage possible banking fraud and criminal activities, it is stated in the budget speech of 2006/07 that Banking Fraud and Punishment Act and Anti-Money Laundering Bill will be enacted. The NRB has already submitted the draft bill to the government. In addition, NRB will also take

initiative to draft a bill relating to merger and acquisition of banks and financial institutions.

51. The NRB will encourage banks, finance companies, other financial institutions and private investors to establish infrastructure development bank with the joint share participation. The NRB will make a set of prudential regulations consisting of capital, loans loss provisioning, single borrower limit etc. to facilitate the establishment of this kind of Bank.

52. It is stated in the budget speech of 2006/07 that Industrial Reconstruction Trust will be established with the involvement of the government, central bank, financial institutions and enterprises intending to reconstruct themselves. The NRB will coordinate with the banks and enterprises for the establishment of the proposed Trust.

53. The NRB will continue to encourage financial institutions willing to undertake debt related mutual funds transactions.

54. According to the current provision, a minimum paid up capital of Rs. 1 billion is required for the establishment of a new national level commercial bank. The existing national level commercial banks are required to increase their paid up capital gradually to Rs 1 billion by the end of mid-July 2009. For this purpose, all commercial banks are appropriating some amount from their profit to capital adjustment fund. Some timely changes are made in this provision. Accordingly, commercial banks may maintain Rs 1 billion paid up capital by the end of mid-July 2009 or, make adjustment in above stated fund. Commercial banks are free to decide on any of these options and may go for combinations of these two. However, those banks increasing the paid up capital through capital adjustment fund are required to maintain a minimum paid up capital of Rs. 500 million. Following measures will be initiated for those banks which fail to make provisions of capital requirement as stated above:

(a) distribution of dividend will be banned,

(b) branch expansion will not be allowed,

(c) a limit on deposit mobilization will be imposed,

(d) single obligor limit relating to loans to an individual and a company will be reduced,

(e) any other actions will be initiated.

These measure are expected to encourage banks to go for merger and acquisition in the event they fail to mobilize the required capital.

55. Stringent measure are initiated to discourage the trend of issuing cheque which can not be encashed due to inadequate cash balances or uncashable due to other reasons.

56. Capital adequacy ratio (CAR) is fixed at 11 percent (including for the computation of CAR for 2005/06) till BASEL II is implemented.

External Sector Reform

57. With a view to simplify the settlement of petty transactions, a limit of foreign exchange facilities to be provided by commercial banks to individuals and institutions has been raised up from US$ 1500 to US$ 2500.

58. Commercial banks themselves are allowed to provide foreign exchange facilities upto US$ 5000 for individuals and US$ 10,000 for a family (Nepalese citizens only) migrating with valid visa to developed countries like USA, Canada, Australia, New Zeeland and UK.

59. A provision allowing commercial banks to open usance letter of credit of more than 1 year by themselves to countries other than India has been made.

60. With a view to enhance the competitive edge of Nepalese industries, a provision of allowing the import of raw materials and intermediate products from India against US dollar payment is put in place. The number of items allowed against US dollar payment from India currently stands at 91. The existing practice of gradually increasing the number of items importable against the payment of US dollar from India will be continued.

61. The NRB will initiate and implement policy measures relating to entrepot trade. Nepalese traders will be allowed to sell goods imported through the import letter of credit from exporters of any other countries without entering the Nepal border at prices higher than the import prices to other countries.

62. Currently, Nepalese nationals who want to go on travel to SAARC countries other than India and Tibet, autonomous region of China through surface rout are allowed the exchange facility of USD 300 per visit. This ceiling has been raised to USD 1000.

63. The following provision has been made for the licensed moneychanger firm/company with respect to their convertible exchange acquired through the purchases.

    (a) They can sell to commercial banks,

    (b) they can open foreign currency account in the bank and financial institutions under the existing rules, and

    (c) they can provide foreign exchange passport facility as per the existing rule.

64. In the process of expansion of their businesses, if manpower companies want to legally operate their branches/representative offices/contact offices abroad, NRB will provide the necessary exchange facility to run their offices on the recommendation of the concerned department of the Government of Nepal.

65. The main document of monetary policy with detailed analysis of monetary policy, financial sector and external sector is made public and uplinked in NRB Website (www.nrb.org.np).

Lastly,

66. The NRB started to publicly announce the annual monetary policy since 2002/03 following the enactment of NRB Act in 2002. I am delighted to present this fifth monetary policy statement which focuses on the existing challenges of monetary policy as well as financial and external reform programs.

67. On behalf of NRB, I would like to thank to various agencies of the government of Nepal, banks and financial institutions, business community, institutions, scholars and international institutions for their support in formulating this monetary policy.

68. I expect to receive support from you all in implementing the policies and programs incorporated in this monetary policy. NRB believes that the implementation of the policies and programs of this monetary policy will help ensure the macroeconomic stability, facilitate the targeted economic growth and stabilize the financial sector.

    Thank you.