Current Macroeconomic Situation

(Based on the First Quarter of 2006/07)

Monetary Situation

1. In the first quarter of FY 2006/07, broad money (M_2) increased by 3.9 percent compared to a growth of 2.8 percent in the corresponding period last year. A higher increase in net domestic assets (NDA) in sources side and time deposit in uses side contributed for the higher growth in M_2 in the review period.

Table 1: Growth of Monetary Aggregate (in percent)

	FY 2005/06	FY 2006/07
Broad Money	**2.8**	**3.9**
Narrow Money	2.0	1.7
Time Deposits	3.2	5.0

2. Of the components of M_2, narrow money (M_1) grew by 1.7 percent in the review period compared to a growth of 2.0 percent last year. Time deposits, the other component of M_2, went up by 5 percent compared to a growth of 3.2 percent in the previous year. The continuous rise in remittances and the shift of currency to deposit on account of improvement in banking habit of the public contributed to the higher growth in time deposits in the review period.
3. Net foreign assets (NFA), the principle source of monetary expansion, after adjusting foreign exchange valuation gain/loss, increased by 0.7 percent (Rs 1.3 billion) in the review period compared to a rise of 3.3 percent (Rs 3.6 billion) last year. A negative growth of export and an increase in payment by Nepal Oil Corporation (NOC) to Indian Oil Corporation (IOC) lowered the growth of NFA in the review period. In addition, the monetary gold amounting to Rs. 410.0 million (revalued) maintained as a reserve for the issuance of note has been reclassified in other assets. This rearrangement of balance sheet items also depressed the growth of NFA in the review period.
4. Domestic credit registered a growth of 2.4 percent in the review period compared to a rise of 2.3 percent last year. Despite an increase in short term loans to other financial and non-financial institutions by the commercial banks, a slowdown in the claims on the private sector at 2.7 percent on account of loan write off by Nepal Bank Limited (NBL) in the review period compared to a growth of 4.2 percent last year resulted in the growth of domestic credit at the level of the previous year. NBL wrote off credit amounting to Rs. 2.8 billion consisting principal of Rs. 821.7 million and interest of Rs. 2 billion between mid-August 2006 and mid-October 2006. This contributed to the deceleration in credit growth to private sector in the review period.
5. Nepal Food Corporation, Janakpur Cigarette Factory Ltd, National Trading Ltd. and Nepal Telecom availed more credit from the commercial banks in the review period. Likewise, short-term lending to development banks and finance companies by the commercial banks also increased in the review period. Through this process, credit to small borrowers expanded in the review period.

6. The net non-monetary liabilities witnessed a negative growth of 4.1 percent in the review period compared to a growth of 1.8 percent last year. A decline in loan loss provisioning and interest suspense account on account of loan write off by NBL, and reclassification of monetary gold in others assets contributed to the negative growth of net non-monetary liabilities in the review period.

Monetary Liquidity

7. As mentioned above, the growth of M_2, which measures the monetary liquidity in the economy, remained higher in the review period compared to that of the previous year. M_2 as a percentage of GDP increased to 61.7 percent as at mid-October 2006 from 58 percent a year ago.

8. Likewise, liquid funds of the commercial banks stood at Rs. 65.4 billion as at mid-October 2006 compared to Rs. 49.0 billion as at mid-October 2005. As a result, liquid funds to deposit ratio increased to 21.6 percent at mid-October 2006 from 19.3 percent a year ago. Of the total liquid funds with the commercial banks, the proportion of funds in foreign currency was 49.3 percent (Rs. 32.3 billion) and the rest was in local currency.

9. On the sources of liquidity, the net injection of liquidity by way of intervention in foreign exchange market amounted to Rs. 16.8 billion in the review period compared to Rs. 7.2 billion in the comparable period last year. Because of the foreign exchange inflows due to continuous rise in workers' remittances, on the one hand, and nominal appreciation of Nepali currency (NC) against the US dollar on the other, the commercial banks opted to sell their foreign exchange to Nepal Rastra Bank (NRB) rather than placing abroad on short-term basis. NRB also decided to purchase foreign exchange from the commercial banks to prevent the further nominal appreciation of NC against the US dollar.

Table 2: Net Injection of Liquidity through

Foreign Exchange Interventions

(Rs in billion)

	FY 2005/06	FY 2006/07
August	1.2	6.5
September	2.2	4.7
October	3.8	5.6
Total	7.2	16.8

10. To some extent, liquidity injected by way of the intervention in foreign exchange market was sterilized through open market operations (OMOs). In the review period, net liquidity of Rs 8.9 billion was mopped up through secondary market. Outright sale auction and reverse repo auction mopped up Rs 3.3 billion and Rs 5.6 billion respectively in the review period compared to Rs 3.4 billion absorbed through sale auction in the comparable period last year.

Table 3: Liquidity Absorption Through Open Market Operations

(Rs in billion)

	FY 2005/06			FY 2006/07		
	Sale Auction	Reverse Repo Auction	Total	Sale Auction	Reverse Repo Auction	Total
August	1.4	-	1.4	1.0	2.6	3.6
September	-	-	-	1.3	1.5	2.8
October	2.0	-	2.0	1.0	1.5	2.5
Total	3.4	-	3.4	3.3	5.6	8.9

11. In the review period, the commercial banks availed the standing liquidity facility (SLF) amounting to Rs. 1.95 billion compared to Rs 1.17 billion availed in the previous year.

12. The interbank transactions under the call money market systems meant for facilitating the banks and the financial institutions to borrow from each other, if need arises, amounted to Rs. 48.1 billion during the review period as compared to the higher transactions of Rs.57.3 billion during the first quarter of FY 2005/06. The increased use of SLF and the decline in inter-bank transaction despite excess liquidity in the market cannot be taken as positive development. Such a tendency on the part of commercial banks makes the task of liquidity management daunting.

Table 4: Inter bank Transactions

(Rs. in billion)

	FY 2005/06	FY 2006/07
August	20.6	13.4
September	24.7	18.8
October	12.0	15.9
Total	57.3	48.1

13. The weighted average 91-day Treasury bill rate remained lower relative to that of the previous year on account of excess liquidity with the commercial banks in the review period. Compared to the level of 3.10 percent in the previous year, the weighted average 91-day Treasury bill rate stood at 2.54 percent at the end of the review period. Likewise, the weighted average inter-bank rate stood at 1.20 percent as at mid-October, 2006 compared to 2.36 percent a year ago.

Table 5: Short-term Interest Rates

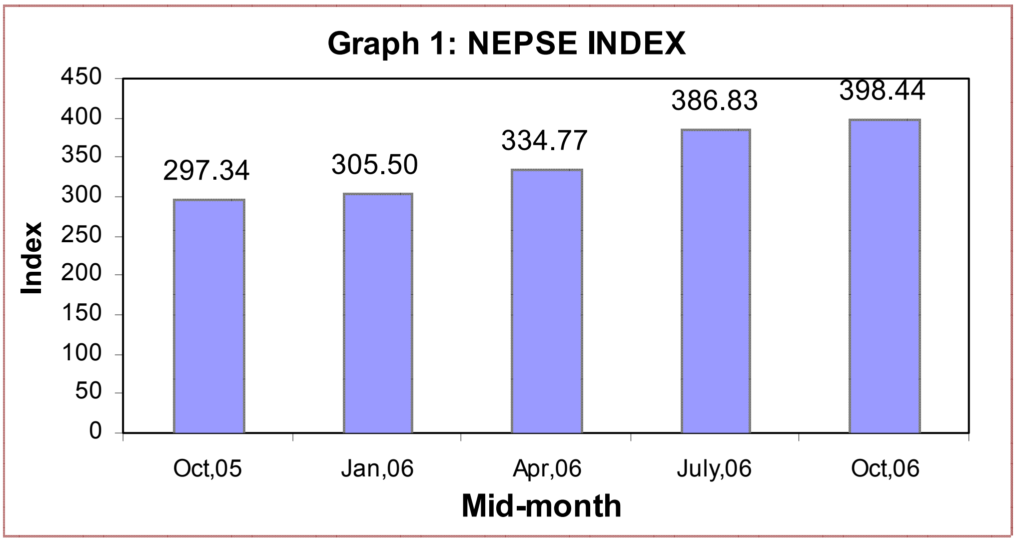
(In percent)

	FY 2005/06		FY 2006/07	
	91-day TB rate	Interbank rate	91-day TB rate	Interbank rate
August	2.259	2.468	2.989	2.074
September	3.385	3.868	2.783	1.832
October	3.102	3.177	2.537	2.111

Securities Market Situation

14. On the primary issue front, Nepal Securities Board granted permission to issue securities amounting to Rs. 95.0 million consisting ordinary shares of Rs. 15 million for two financial institutions and right shares of Rs. 80 million for three financial institutions in the first quarter of FY 2006/07.

15. With respect to the secondary market transactions, the year on year (y-o-y) NEPSE index remained buoyant showing an increase of 34 percent to 398.44 points at mid-October 2006. Stock market activities witnessed an expansion because of the rise in remittances, lack of alternative investment opportunities, increase in margin lending by commercial banks against the collateral of shares and a boost in investors' confidence on account of the gradual improvement of peace and security situation in the country.



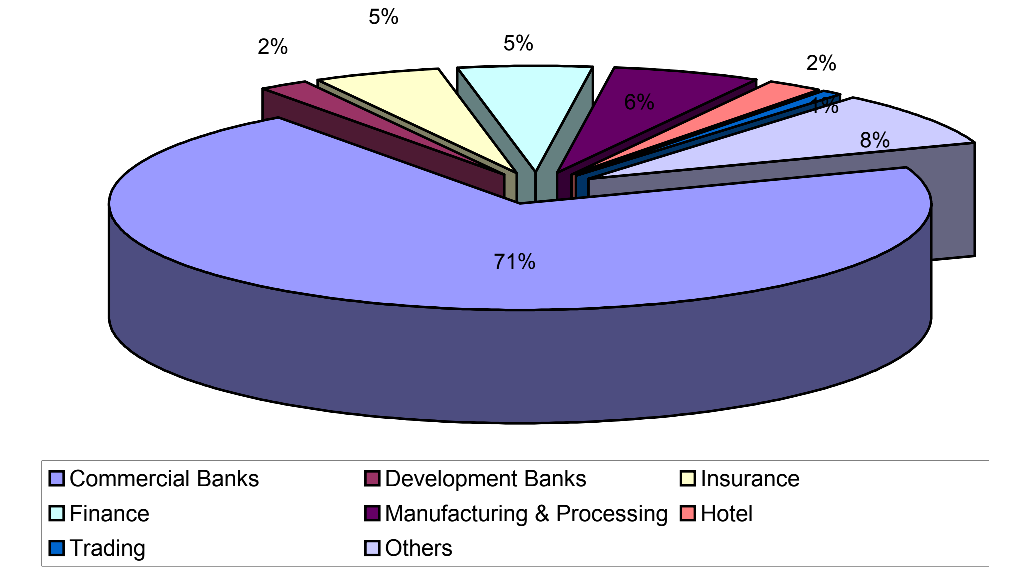
16. Group-wise, the share price index of commercial banks remained highest at 448.1 as at Mid-October, 2006, while that of the trading group the lowest at 149.7 (Table 6).

Table 6: Group wise NEPSE Index

	Mid-October 2006
NEPSE Index	**398.4**
Commercial banks group	448.1
Insurance group	394.6
Development Banks group	321.5
Production and processing group	319.8
Finance companies group	274.3
Hotels group	179.0
Trading group	149.7
Others	429.3

17. The y-o-y market capitalization increased by 47.9 percent to Rs. 100.6 billion at mid-October 2006. Reflecting an expansion in the size of the stock market, market capitalization to GDP ratio increased to 17.3 percent as at mid-October 2006 from 11.7 percent a year ago. Of the total transactions, bank and financial institutions accounted for 82.8 percent; production and processing companies 5.6 percent, hotels 2.3 percent, business entities 0.8 percent, and other groups accounted for 8.3 percent.

Graph 2: Sectoral Market Capitalization



18. The number of companies listed in the Nepal Stock Exchange Ltd reached 139 by mid-October 2006. This number was 125 a year ago. Out of the total listed companies, bank and financial institutions were 92, followed by production and processing industries 29; hotels 4, business entities 8 and other groups 6.

19. Total paid up capital of the listed companies reached Rs. 20.4 billion by mid-October 2006, showing an increase of 16.7 percent over the period of one year. This increase was due to the additional listing of companies in the Nepal Stock Exchange Ltd, and the issuance of ordinary and right shares by some of the financial institutions.

20. The turnover ratio, which measures the liquidity of the stock market, reached 0.24 as at mid-October compared to that of 0.16 a year ago reflecting an expansion in the stock market activities.

21. The twelve-month rolling standard deviation as at mid-October 2006 was 38, compared to that of 24.7 a year ago. This reflected an increased volatility in the stock market.

Table 7: Stock Market Related Indicators

(Rs. in million)

Group	No.	Paid up capital	Percent	Market capitalization	Percent	Turn-over	Percent
Commercial Banks	15	8687.7	42.64	70998.1	70.60	193.59	78.74
Development Banks	10	846.9	4.16	1775.5	1.77	7.99	3.25
Finance Companies	52	2738.1	13.44	5376.8	5.35	8.24	3.35
Insurance Companies	15	1256.7	6.17	5125.3	5.10	6.54	2.66
Production/Processing Organizations	29	2757.0	13.53	5810.9	5.78	0.17	0.07
Hotels	4	1552.9	7.62	2321.7	2.31	0.09	0.04
Business Entities	8	76.6	0.38	772.4	0.77	0.19	0.08
Others	6	2460.9	12.08	8385.3	8.34	29.05	11.82
Total	**139**	**20376.8**	**100.00**	**100566**	**100.00**	245.86	**100**

Inflation

Consumer Inflation

22. The y-o-y consumer inflation remained at 7.5 percent at mid October 2006 compared to 7.8 percent a year ago. Although the prices of cereal products remained at a lower level, the rise in prices of pulses, vegetables and fruits exerted pressure on inflation (Table 8).

Table 8: The List of Some Group of Commodities with Double Digit Growth in Prices

(y-o-y)

(In percent)

	Weight (Percent)	FY 2005/06	FY 2006/07
Wheat and Flour	1.79	7.8	26.6
Pulses	2.73	6.0	24.2
Vegetables and Fruits	7.89	0.9	16.3
Spices	1.85	-1.4	22.4
Household goods and services	14.87	13.7	10.2
Transportation and Communications	4.03	16.5	17.4

23. Despite the elimination of the base effect of the hike in prices of oil in August 2005, the y-o-y consumer inflation remained at 7.5 percent at mid-October 2006 on account of the lagged effect of the increase in oil prices in March 2006 and a significant increase in the prices of pulses (24.2 percent), vegetables and fruits (16.3 percent) and spices (22.4 percent).

24. Region wise, consumer inflation remained higher in the Hills and Terai at 7.8 percent each and relatively low in the Kathmandu Valley at 6.7 percent. The respective inflation rates were 8.5 percent, 8.6 percent and 6.4 percent a year ago.

Table 9: Comparative Inflation in Kathmandu Valley, Terai and Hills

(y-o-y)

(In percent)

	FY 2005/06	FY 2006/07
Overall Consumer Inflation	**7.8**	**7.5**
Kathmandu valley	6.4	6.7
Terai	8.6	7.8
Hills	8.5	7.8

25. At mid-October 2006, the y-o-y core inflation edged up to 6.2 percent from 4.4 percent a year ago. Inflationary expectation backed by the rise in oil prices earlier accounted for the pick up in core inflation in the review period.

Wholesale Price Inflation

26. At mid-October 2006, the y-o-y wholesale price inflation surged up 10.4 percent from 9.4 percent a year ago. A significant price rise of cereals, cash crops, pulses and spices together with the lagged effect of the hike in prices of petroleum products in March 2006 accounted for such a surge in wholesale price inflation. Group wise, the prices of agricultural commodities showed an increase of 14.6 percent, manufactured goods 6.7 percent and the imported commodities of 6.1 percent.

National Salary and Wage Rate

27. The y-o-y Salary and Wage Rate Index rose by 8.0 percent at mid-October 2006. The growth of such index was 2.2 percent a year ago (Table 10). The surge in wage rate on account of shortage of laborers owing to the Nepalese workers seeking foreign jobs and the 10 percent increment in the allowances of civil service contributed to the rise in the national salary and wage rate index in the review period. In the same period a year ago, wage rate and the salary indices had increased by 8.4 percent and 6.6 percent respectively.

Table 10: National Salary and Wage Rate Index

(y-o-y)

(In percent)

	Weights (Percent)	FY 2005/06	FY 2006/07
Overall index	100	2.2	8.0
Salary index	27	0.0	6.6
Wage rate index	73	3.0	8.4

Fiscal Situation

Government Expenditure

28. On the fiscal front, total government expenditure rose by 17.7 percent to Rs 19.5 billion in the first quarter of FY 2006/07. In the same period last year, the government spending had increased by 12.4 percent. The increase in recurrent expenditure on account of 10 percent increase in allowances of the civil servants and a rise in administrative expenses exerted pressure on total expenditure in the review period. The capital expenditure of the government, however, remained sluggish.

Government Revenue

29. The government revenue picked up a significant growth of 26.7 percent to Rs 16.2 billion in the first quarter of FY 2006/07. Revenue had increased marginally by 0.6 percent in the corresponding period last year. An improvement in consumers' confidence on the strength of the rise in workers' remittance and an increase in customs revenue on account of the adjustment in tariff rates as well as income tax contributed to the growth of revenue in the review period (Table 11).

Table 11: Revenue Collection

In the first quarter of FY

	Rs in million				% Change		
	2003/04	2004/05	2005/06^P	2006/07	2004/05	2005/06	2006/07^P
Tax Revenue	**8,973.2**	**11,007.9**	**11,380.2**	**14,031.1**	**22.7**	**3.4**	**23.3**
Indirect Tax	7,089.4	8,496.5	9,332.9	11,467.1	19.8	9.8	22.9
Customs	3,062.2	3,477.6	3,305.5	3,869.5	13.6	-4.9	17.1
VAT	2,726.4	3,607.7	4,708.3	5,862.0	32.3	30.5	24.5
Excise	1,300.8	1,411.2	1,319.1	1,735.6	8.5	-6.5	31.6
Direct Tax	1,883.8	2,511.4	2,047.4	2,563.9	33.3	-18.5	25.2
Income Tax	1,344.9	1,868.4	1,354.4	1,828.3	38.9	-27.5	35.0
Registration tax	261.0	328.8	350.4	543.3	26.0	6.6	55.1
Vehicle Tax	277.9	314.2	342.6	192.3	13.1	9.0	-43.8
Non Tax Revenue	**1,938.0**	**1,705.6**	**1,414.4**	**2,178.8**	**-12.0**	**-17.1**	**54.0**
Total Tax	**10,911.2**	**12,713.5**	**12,794.7**	**16,209.9**	**16.5**	**0.6**	**26.7**

P: Preliminary estimates

30. In the first quarter of FY 2006/07, foreign cash grants of the government increased by 52.5 percent in contrast to a decline of 8.5 percent in the corresponding period last year. Total foreign cash loan, however, decreased by 42.5 percent in the review period, as opposed to an increase of 40.7 percent last year.

Budget Deficit / Surplus

31. As a result of a growth of revenue and foreign cash grants in the first quarter of FY 2006/07, government's budgetary surplus expanded to Rs 133.7 million in contrast to a deficit of 2.0 billion last year.

Foreign Trade

32. On the external sector front, total exports declined by 1.9 percent in the first quarter of FY 2006/07, as against an increase of 15.1 percent in the corresponding period last year. Of the total exports, export to India declined by 4.9 percent in comparison to a significant growth of 32.2 percent in the same period last year. The continuation of the additional duty of 4 percent imposed since August 2006 by India on a number of products of Nepal was one of the crucial factors responsible for the decline in exports to India. Exports to other countries, on the other hand, rose by 4.5 percent in contrast to a decline of 9.1 percent in the corresponding period of the previous year.

33. In terms of commodities, the decline in the growth rate of exports to India was attributed to the fall in the exports of polyester yarn, plastic utensils, G.I pipe, jute goods, cattle-feed and zinc sheet (Table 12). Likewise, the increase in the exports to other countries was due to the increase in the export of pulses, paper & paper products, tanned skin, woolen carpet, and tea.

Table 12: Decline in Exports of Selected Commodities to India

First quarter

(Rs. in million)

	$2005/06^P$	$2006/07^P$	Decline
Polyester Yarn	828.0	384.2	-443.8
Plastic Utensils	376.5	74.9	-301.6
G.I. pipe	199.7	2.7	-197.0
Jute Goods	724.0	575.7	-148.3
Cattle feed	141.9	1.9	-140.0
Zinc sheet	602.4	480.2	-122.2
Wire	500.9	397.8	-103.1
Chemicals	344.6	245.2	-99.4
Copper Wire Rod	109.3	13.4	-95.9
Pashmina	104.5	12.4	-92.1
Readymade garment	290.8	206.2	-84.6
Noodles	123.1	50.1	-73.0
Total	**4345.7**	**2444.7**	**-1901.0**

34. Total imports decelerated to 9.4 percent in the first quarter of FY 2006/07 compared to a growth of 19.3 percent in the same period of the previous year.

While imports from India decelerated to 10.9 percent in the review period in comparison to a higher growth of 30.8 percent in the corresponding period of FY 2005/06, imports from other countries rose by 6.9 percent in comparison to a growth of 4.3 percent last year.

35. A rise in the import of petroleum products, vehicles & parts, medicine, other machinery & parts, hot rolled sheet in coil and cement from India and crude palm oil, medicine, textiles, copper wire & rod, computer parts and aircraft spare-parts from other countries led to the rise in total imports in the first quarter of FY 2006/07.

Balance of Payments

36. The overall BOP registered a surplus of Rs. 1.03 billion in the first quarter of FY 2006/07 compared to a surplus of Rs. 3.57 billion in the corresponding last year. Despite the increase in workers' remittances, the surplus in the BOP was lower than the previous year on account of the decline in exports of merchandise goods, net services income and net income, the reclassification of monetary gold in other assets and some increases in the payments of NOC to IOC.

37. Under the current account, while receipts from travel increased by 23.7 percent to Rs. 2.0 billion, remittances registered a rise of 28.5 percent to Rs. 23.8 billion in the first quarter of FY 2006/07. In the corresponding period of the previous year, while income from travel had declined by 37.3 percent, remittances had gone up by 17.9 percent.

Table 13: Foreign Exchange Receipts From Nepalese Nationals

(Rs. in million)

	Annual	First quarter	
	FY 2005/06	FY 2005/06	FY 2006/07
1. Compensation of Employees	6467.6	1422.5	883.0
2. Workers' remittances	97536.2	18489.3	23762.0
3. Pension	12007.3	2332.4	2662.6
From India	6293.1	1007.3	1045.5
From other countries	5714.2	1325.1	1617.1
4. Total	116011.1	22244.2	27307.6

38. Under the financial account, the government received Rs. 1.24 billion as foreign loan and repaid Rs. 1.14 billion in amortization.

39. Although the BOP position with other countries remained at a surplus, there was a deficit with respect to India. The BOP position with India resulted in a deficit on account of a significant deficit in the current account. In the process of managing the balance of payments with respect to India, the number of commodities imported from India on the basis of payment of convertible currency has been gradually raised to 91. In this process, in the first quarter of FY 2006/07, commodities equivalent to Rs. 3.0 billion were imported from India on the basis of payment of convertible currency. This formed 10.5 percent of total imports from India. (Table 14).

Table 14: Import from India on Payment of US Dollar
First quarter

(Rs. in million)

	2005/06	2006/07
Total Import from India	26066.8	28896.9
Import on Payment of US Dollar	2865.5	3031.2
Share of Import on Payment of US Dollar (in percent)	11.0	10.5

40. As the Indian currency reserves were not adequate to meet the trade deficit with India despite the foregoing measure, the NRB purchased IRs. 8.3 billion by selling US$ 180 million in the first quarter of FY 2006/07. In the corresponding period of the previous year, IRs Rs. 7.5 billion was purchased by selling US$ 160 million.

Table 15: Purchase of Indian Currency Through Sale of US Dollar
First quarter

(In million)

Month Ending Mid	FY 2005/06		FY 2006/07	
	Sale of US dollar	Purchase of I.C.	Sale of US dollar	Purchase of I.C.
August	60	2611.3	50	2334.6
September	50	2191.9	60	2786.5
October	50	2652.1	70	3205.3
Total	**160.0**	**7455.3**	**180.0**	**8326.4**

Foreign Exchange Reserves

41. In comparison to mid-July 2006, gross foreign exchange reserves fell slightly by 0.2 percent to Rs. 164.8 billion as at mid-October 2006. Such reserves had risen by 3.3 percent in the corresponding period of the preceding year. The foreign exchange reserves in Nepalese rupee terms declined on account of the appreciation of NC against US dollar between mid-July 2006 and mid-October 2006. On the basis of US dollar, gross foreign exchange reserves went up by 1.9 percent to US$ 2.3 billion at mid-October 2006 from US$ 2.2 billion at mid-July 2006. The share of convertible reserves in the total reserves remained at 94.1 percent at mid-October 2006 compared to 94.4 percent a year ago. The current level of reserves is adequate for financing merchandise imports of 10.8 months, and merchandise and service imports of 8.8 months.

Price of Oil and Gold in the International Market and Exchange Rate Movement

42. The price of oil (Crude Oil Brent) in the international market rose slightly by 0.4 percent to US$ 58.50 per barrel on October 15, 2006 from US$ 58.24 per barrel at mid-October 2005. The price of gold, on the other hand, rose by 27.7 percent to US$ 595.10 per ounce on October 15, 2006 from US$ 466.00 a year earlier.

43. In comparison to mid-July 2006, the Nepalese currency vis-à-vis the US dollar appreciated by 2.08 percent at mid-October 2006. It had depreciated by 1.81 percent in the corresponding period of the previous year. The exchange rate of one US dollar stood at Rs. 72.59 at mid-October 2006 compared to Rs. 71.65 a year ago.