Current Macroeconomic Situation

(Based on the Data of the First Eight Months of 2006/07)

Money, Credit, Liquidity and Interest Rates

Money Supply

1. In the first eight months of 2006/07, broad money (M_2) grew by a higher rate than that of the previous year. The higher growth of net domestic assets contributed to the expansion of M_2 by 11. 4 percent in the review period compared to a rise of 8.4 percent last year.

2. Narrow money (M_1) registered a growth of 5.8 percent in the review period compared to a growth of 6.3 percent last year. Time deposits, another component of M_2, increased by a higher rate of 14.1 percent compared to a growth of 9.5 percent a year ago. The significant increase in the deposit collection due to the overbidding in primary issuance of shares by Gurkha Development Bank resulted in a higher level of increase in the time deposits of commercial banks in the review period.

3. Net foreign assets (NFA), an expansionary source of money supply, after adjusting exchange valuation gains/loss, increased by 8.7 percent (Rs.12.19 billion) in the review period compared to a growth of 12.7 percent (Rs.13.65 billion) in the previous year. The lower level of growth in NFA relative to that of the previous year was on account of slowdown in inflow of workers' remittances and the decline in exports in the review period.

Domestic Credit

4. Domestic credit of monetary sector expanded by 8.7 percent in the review period compared to a growth of 5.8 percent in the previous year. The increase in short-term placement by commercial banks in finance companies and development banks boosted domestic credit in the review period.

5. Of the credit aggregates, monetary sector's net claims on the government declined by 11.6 percent in the review period compared to a decrease of 3.0 percent last year. A substantial increase in government's cash balance with Nepal Rastra Bank (NRB) on account of a lower expenditure relative to revenue mobilization resulted in the decline in net claims on government in the review period.

6. Contrary to a decline by 5.0 percent last year, claims on government non-financial enterprises increased by 2.1 percent in the review period due mainly to additional bank loans utilization by some of the government non-financial enterprises such as Nepal Oil Corporation, Nepal Food Corporation, Gorkhapatra Corporation and Janakpur Cigarette Company Ltd in the review period.

7. Claims on financial institutions substantially increased in the review period in contrast to a decline by 1.2 percent last year. A rise in short-term placement by commercial banks in development banks and finance companies due to higher deposits collection on account of collection of excess amount from the primary issue of shares of Gurkha Development Bank contributed to the increase in claims on financial institutions, particularly non-governmental financial institutions in the review period.

8. Credit flow to private sector, a major component of domestic credit, grew at a marginally higher rate of 10.7 percent in the review period compared to 9.5 percent last year. On the backdrop of decline in exports, slowdown in growth of imports and sluggish industrial activities, credit to private sector did not pick up as expected. If credit write-off of Rs 16.02 billion by Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) in the review period were to be adjusted, the growth of the private sector credit would be as low as 4.1 percent.

9. Net non-monetary liabilities recorded a growth of 0.5 percent in the review period compared to a growth of 5.2 percent last year. Net non-monetary liabilities increased marginally due to the decline in loan loss provisioning for non-performing loans and interest suspense account following the credit write-off by NBL and RBB in the review period.

Liquidity Injection

10. Net liquidity of Rs 44.43 billion was injected on cumulative basis through the purchase intervention of the US dollar equivalent to Rs 44.94 billion and the sale intervention of Rs 0.51 billion in the review period. There was net injection of Rs 30.70 billion in the comparable period last year. The higher level of liquidity injection through foreign exchange intervention in the foreign exchange market was on account of higher level of workers' remittances, though decelerating, and fall of import growth in the review period.

Table 1: Liquidity Injection through Foreign Exchange Intervention

Rs in billion

Mid-Months	2005/06			2006/07		
	Purchase	Sale	Net Injection	Purchase	Sale	Net Injection
August	1.70	0.52	1.18	6.55	-	6.55
September	2.16	-	2.16	4.75	-	4.75
October	3.78	-	3.78	5.59	-	5.59
November	6.20	-	6.20	5.13	-	5.13
December	4.83	-	4.83	6.88	-	6.88
January	4.49	0.13	4.36	5.42	-	5.42
February	2.93	-	2.93	3.36	0.51	2.85
March	5.26	-	5.26	7.26	-	7.26
Total	31.35	0.65	30.70	44.94	0.51	44.43

Liquidity Absorption

11. A higher level of liquidity of Rs 21.95 billion was absorbed on turnover basis in the review period compared to Rs 8.76 billion last year. Compared to Rs 10.04 billion liquidity absorption comprising of Rs 5.04 billion from sale auction and Rs 5.0 billion from reverse repo auction in the previous year, a total liquidity of Rs 21.95 billion was absorbed through sale auctions (Rs 7.89 billion) and reverse repo auction (Rs 14.06 billion) in the review period. In the previous year, a total liquidity of Rs 1.28 billion was injected through purchase auction of Rs 830 million and repo auction of Rs 450 million.

Table2: Open Market Operations

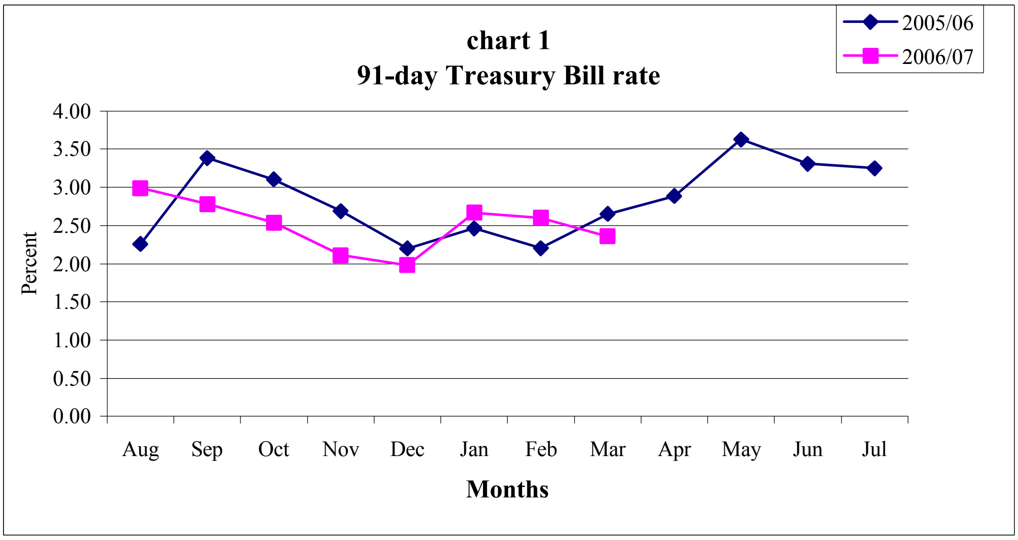
Rs in billion

	2005/06	2006/07
Purchase Auction	0.83	-
Sale Auction	5.04	7.89
Repo Auction	0.45	-
Reverse Repo Auction	5.00	14.06

12. The use of standing liquidity facility (SLF) increased in the review period compared to that of the preceding year. Commercial banks used Rs 8.49 billion loans under SLF in the review period compared to Rs 2.28 billion last year. The higher level of SLF borrowing was on account of liquidity shortage in some of the commercial banks in the review period. However, the inter bank transaction was lowered at Rs 111.21 billion in the review period compared to Rs 129.02 billion last year.

Short-term Interest Rates

13. Short-term interest rates remained marginally lower in the review period compared to that of the previous year. A 91-day weighted average Treasury Bill rate stood at 2.36 percent in the review period compared to 2.65 percent last year. Likewise, weighted average inter bank rate stood at 1.39 percent compared to 2.84 percent last year.



Securities Market

14. Nepal Securities Board (SEBON) granted permission to issue ordinary shares of Rs. 222.25 million to nine financial institutions and right shares of Rs. 531.25 million to eight financial institutions during the first eight months of 2006/07.

15. The year on year (y-o-y) NEPSE index increased by 46.85 percent to 498.98 points in mid-March 2007. This index was 339.79 a year ago.

16. The y-o-y market capitalization increased by 61.4 percent to Rs 130.18 billion in mid-March 2007. Market capitalization to GDP ratio increased to 20.2 percent from 13.8 percent a year ago. Of the total transactions, bank and financial institutions, manufacturing and processing companies, hotels, business entities, and other groups accounted for 82.7 percent, 4.7 percent, 2.3 percent, 0.6 percent, and 9.6 percent respectively.

17. Total paid up capital of the listed companies stood Rs. 21.01 billion in mid-March 2007, an increase of 12.7 percent over the period of one year. This increase was due to the additional listing of companies in Nepal Stock Exchange Ltd, and the issuance of ordinary and right shares by some of the financial institutions.

18. Monthly turnover to market capitalization ratio increased to 0.55 percent in mid-March 2007 compared to 0.41 percent a year ago.

19. In the review period, NEPSE delisted 12 companies failing to audit financial statements, convene annual general meetings, and remained closed for a long time. Hence, the number of companies listed in the Nepal Stock Exchange Ltd remained at 131 in mid-March 2007. Out of the total listed companies, 96 were bank and financial institutions.

Production and processing industries, hotels, business entities, and others consisted of 21, 4, 5 and 5 companies respectively.

20. The twelve-month rolling standard deviation remained at 69.2 in mid-March 2007 compared to 16.3 a year ago, indicating an increased volatility in the share prices.

21. The NEPSE Sensitive Index, calculated taking July 16, 2006 as the base period stood at 123.31 in mid-March 2007. This index was 131.02 a month ago.

Inflation

Consumer Inflation

22. The y-o-y consumer price inflation rose by 6.2 percent in mid-March 2007 compared to 7.7 percent in the corresponding month of the preceding year. A significant increase in the prices of pulses (17.9 percent), vegetables and fruits (18.4 percent), spices (26.8 percent), meat, fish and eggs (12 percent), oil and ghee (10.9 percent), and milk and milk products (6.9 percent) contributed to the inflationary pressure on the food and beverage group. The disturbed-supply system due to the weeks long general strike called in the Terai region led to the rise in prices of this group further in the review period. However, the pressure was eased on the non-food and services group as the base effect of the hike in petroleum prices in March 2006 ended in the review period.

23. Group-wise, the indices of food and beverages group increased by 9.2 percent in the review period compared to 6.2 percent last year. On the other hand, the indices of non-food and services group increased by 3.2 percent compared to 9.1 percent last year. Region-wise, Terai experienced the highest inflation of 6.5 percent followed by Kathmandu Valley (6.4 percent) and Hills (5.2 percent). The respective inflation rates were 9.0 percent, 5.5 percent and 7.6 percent a year ago. Higher level of inflationary pressure in the Terai region was on account of intermittent general strike in that region in the review period. As a result, the index of the food and beverage group showed a rise of 9.9 percent in the Terai region in the review period.

24. In mid-March 2007, the y-o-y core inflation edged up at 6.8 percent from 3.7 percent a year ago. This growth was mainly on account of the price rise of wheat and wheat flour (27.7 percent as against the 11.3 percent rise in the last year) and the spices (26.8 percent as against the 2.4 percent of last year).

Wholesale Price Inflation

25. In mid-March 2007, the y-o-y wholesale price inflation remained higher at 12.2 percent. In the corresponding period last year, wholesale price index had increased by 6.2 percent. A rise in the prices of agro-products like pulses (24.0 percent), fruits and vegetables (41.0 percent), spices (27.7 percent), food-grains (15.8 percent), and domestic manufactured commodities like construction materials (16.6 percent) accounted for the inflationary pressure on wholesale price in the review period. The effect of intermittent general strike

called in the Terai region in the review period also contributed to the rise in wholesale price inflation. Group-wise, the indices of agricultural commodities registered the highest increase of 19.9 percent, whereas imported commodities and the domestic manufactured commodities witnessed a relatively low increase of 3.7 percent and 8.7 percent, respectively.

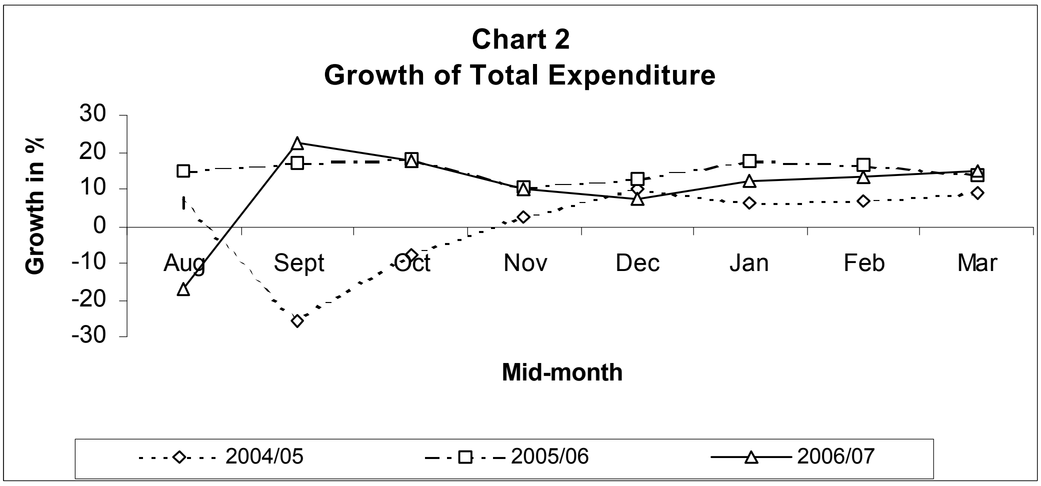
National Salary and Wage Rate Index

26. The y-o-y salary and wage rate index (2004/05=100) rose by 10.1 percent in mid-March 2007. The growth of such index was 4.3 percent a year ago. In the same period, the wage rate and the salary group indices increased by 11.4 percent and 6.2 percent, respectively. The effect of 10.0 percent increment in the allowances of civil service from mid-July 2006, the rise in the wage rates of industrial labors (13.3 percent) due to the pressure created by the trade unions in the recent months, the surge in wage rates of domestic agricultural (10.9 percent) as well as construction (7.5 percent) labors on account of short-supply due to Nepalese workers' tendency to seek foreign jobs, were the major reasons behind the rise in the National Salary and Wage Rate Indexes in the review period.

Fiscal Situation

Government Expenditure

27. In the first eight months of 2006/07, total expenditure of the Government of Nepal (GON), on cash basis, increased by 15.0 percent to Rs 60.65 billion compared to a growth of 13.9 percent in the same period of the preceding year.



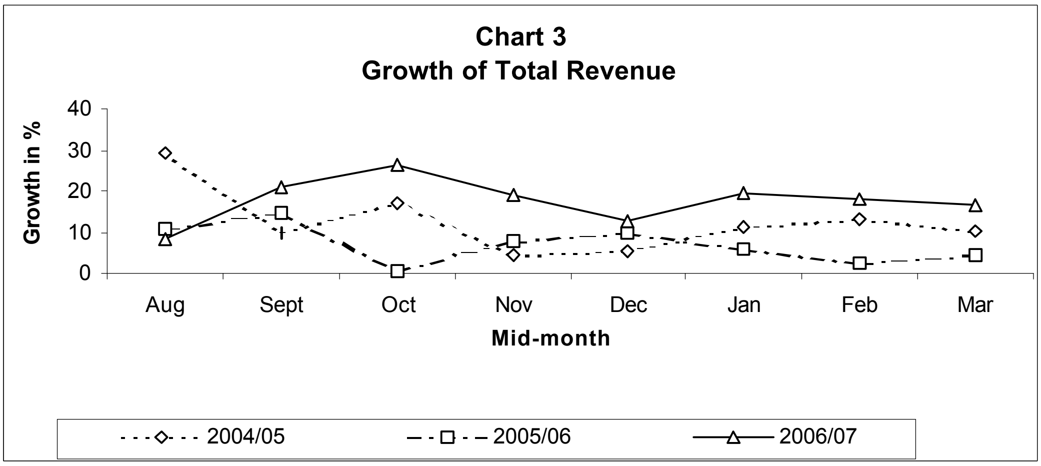
28. Of the total government expenditure, recurrent expenditure increased by 14.6 percent to Rs 42.87 billion compared to an increase of 12.8 percent in the preceding year. As there

is a past trend of higher spending in the last quarter of the fiscal year, the growth of recurrent expenditure should be checked.

29. In the review period, total capital expenditure rose by 12.6 percent to Rs 9.12 billion compared to a higher increase of 41.2 percent in the corresponding period of the previous year. Terai unrest and absence of elected representatives in local bodies accounted for such a deceleration in capital expenditure.

Government Revenue

30. In the first eight months of 2006/07, total revenue grew by 16.4 percent to Rs 48.04 billion compared to a growth of 4.6 percent in the same period of the preceding year. Adjustment in customs and excise rates through this year's budget, improvement in customs valuation, increased tax compliance, a rise in corporate income tax and value added tax as well as an increase in some non-tax revenue contributed to such an acceleration in revenue in the review period.



31. In the first eight months of the 2006/07, non-debt resources of the GON increased by 24.7 percent to Rs 60.59 billion compared to the growth of 8.9 percent in the corresponding period of the preceding year. A significant growth of revenue and cash foreign aid contributed for such a high growth of non-debt resources.

32. The foreign grants received by the GON increased by 76.1 percent to Rs 10.63 billion in the first eight months of 2006/07 compared to a growth of 51.9 percent in the corresponding period last year.

Budgetary Stance

33. In the review period, the government incurred a cash budget deficit of Rs 61.0 million compared to the higher deficit of Rs 4.14 billion in the corresponding period last year. A

significant growth of non-debt resources relative to the expenditure accounted for a low level of cash budget deficit in the review period.

34. In the review period, the GON mobilised Rs 11.48 billion through borrowing – including Rs 9.30 billion from domestic borrowing and Rs 2.18 billion from external borrowing. As capital expenditure did not increase as expected, the government recorded a cash surplus of Rs 11.70 billion with the NRB in the review period. As a result of higher cash surplus in the NRB and domestic debt repayment of Rs 2.7 billion, the net domestic financing of the government budget stood at a negative Rs 4.02 billion in the review period.

35. As a result, total outstanding debt stock of the government declined to Rs 90.18 billion in mid-March 2007 from the level of Rs 94.20 billion in mid July 2006.

Foreign Trade, Balance of Payment and Foreign Exchange Reserves

36. In the first eight months of 2006/07, total exports plummeted by 6.6 percent in contrast to an increase of 13.3 percent in the corresponding period of 2005/06. Of the total exports, export to India declined by 6.4 percent in 2006/07 as against a significant increase of 20.5 percent in the same period of 2005/06. Likewise, exports to other countries fell by 7.0 percent in comparison to a decline of 0.1 percent in the preceding year. The responsible factors for the poor performance of the export sector were the lack of industrial security, long hours of load shedding and the Terai bandh, among others.

37. The decline in exports to India was ascribed to the decline in the exports of polyester yarn, cattle-feed, plastic utensils, G.I. pipe and readymade garments. Likewise, the decline in exports to other countries was due to the decline in the export of readymade garments, pashmina, woolen carpets, handicrafts and tanned skin.

38. Total imports fell by 1.1 percent in the first eight months of 2006/07 in contrast to a significant growth of 26.3 percent in the same period last year. While imports from India increased by 2.3 percent in the review period compared to a higher growth of 31.7 percent in the corresponding period last year, imports from other countries posted a decline of 6.4 percent in contrast to a growth of 18.7 percent a year earlier.

39. Although the import of vehicles & parts, electrical equipment, hot rolled sheet in coil, cold rolled sheet in coil, and agricultural equipment & parts from India showed a slight rise, the import of palm oil, readymade garments, polythene granules, other machinery and parts and electrical goods from other countries posted a significant decline, resulting in a decline in total imports in the first eight months of 2006/07.

Current Account and BOP

40. In the review period, current account recorded a surplus of Rs. 11.76 billion in comparison to Rs. 5.56 billion in the corresponding period of the previous year. An increase in net transfers (including remittances) was responsible for the increase in current account surplus.

41. Under the financial account, the government received Rs.5.16 billion as foreign loan and repaid Rs. 4.32 billion in amortization.

42. Consequently, the overall BOP registered a surplus of Rs. 12.19 billion in the review period compared to a surplus of Rs. 13.65 billion in the corresponding period of 2005/06

Forex Reserves

43. In comparison to mid-July 2006, gross foreign exchange reserves rose by 7.2 percent to Rs. 177.08 billion in mid-March 2007. Such reserves had gone up 11.3 percent in the corresponding period of the previous year**.** In terms of US dollar, gross foreign exchange reserves went up by 12.7 percent to US$ 2.51 billion in mid-March 2007. In the same period last year, such reserves had increased by 9.6 percent. The share of convertible reserves in the total reserves rose to 95.4 percent as at mid-March 2007 from 94.0 percent in mid-March 2006, resulting in a corresponding decline in the share of the non-convertible reserves to 4.6 percent from 6.0 percent. On the basis of the first eight months of imports of goods and services, the current level of reserves is adequate for financing merchandise imports of 12.4 months and merchandise and service imports of 10.1 months.

Oil and Gold Prices

44. The price of oil (Crude Oil Brent) in the international market declined by 3.3 percent to US$ 61.02 per barrel in mid-March 2007 from US$ 63.08 per barrel in mid-March 2006. The price of gold, on the other hand, rose by 15.6 percent to US$ 643.25 per ounce in mid-March 2007 from US$ 556.50 a year earlier.

Exchange Rate

45. In comparison to mid-July 2006, the Nepalese currency vis-à-vis the US dollar appreciated by 5.11 percent in mid-March 2007. It had depreciated by 1.47 percent in the corresponding period of the previous year.