Half-Yearly Review
of
Monetary Policy of the FY 2011/12

Summary

1. The monetary policy for the FY 2011/12 was announced on 21 July 2011. The monetary policy of this fiscal year was formulated against the backdrop of liquidity shortage in the financial system, continuing pressure on balance of payments (BOP), high inflation and low economic growth. The half-yearly review of the monetary policy has been prepared including the development of macroeconomic situations after the announcement of the monetary policy, existing challenges and the policy directions that need to be taken for remaining period of the current fiscal year.

2. Macroeconomic situations have improved remarkably as a result of successful implementation of the monetary policy. The BOP has been in a remarkable surplus and the inflation rate in a declining trend in the current fiscal year.

World Economic Outlook

3. The International Monetary Fund (IMF) has projected that the global economic growth will decelerate. The global economy will only grow by 3.3 percent in 2012. Economic growth in our neighboring countries also seems to be slowing down. Neighboring countries, coming out from the accommodative monetary policy which was adopted after the US financial crisis, have once again begun to move towards the accommodative monetary policy by considering slowdown in economic growth.

4. The inflationary pressure is likely to ease with the deceleration in economic growth. The IMF has projected that inflation rate in advanced countries will fall to 1.6 percent in 2012 from 2.7 percent in 2011. The wholesale price index of food items declined by 4.6 percent in December 2011.

Domestic Economic Situation

Domestic Production

5. The growth rate of agricultural production is likely to remain as expected due to favorable summer and winter monsoon. However, industrial production has not increased due to continuing political transition, yet to be improved peace and security situation, continuous power shortage and low government capital expenditure.

6. The supply of electricity and fuel to the industrial sector has not improved. Under service sector, however, the trade sector is likely to expand as a result of good harvest and inflows of remittances. Expansion of communication under the service sector has also remained satisfactory in the current fiscal year as well. Some contraction in the growth of overall financial sector is likely to occur in the fiscal year 2011/12 because of lack of improvement in capital markets and slow down in real estate transactions.

7. After a sluggish growth in the first six months, the government capital expenditure is expected to get momentum in the remaining period of the fiscal year. In addition, with the effective implementation of recently announced "Immediate Action Plan for Economic Development and Prosperity 2068" and continuation of higher inflows of tourists, growth rate of non-agricultural sector is expected to increase.

Price

8. With the improvement in food prices, inflation rate has been coming down. There is a high pressure on the price of non-food items due to an increase in the fuel price and the depreciation of Nepalese currency with the US dollar. During the five months of 2011/12, the y-o-y inflation based on the consumer price index remained at 7.5 percent compared to 9.6 percent in the same period of the previous year. In the review period, the price index of food and beverage increased by 7.1 percent, compared to an increase of 15.2 percent in the same period of the previous year. The price index of non-food and services increased by 7.8 percent in the review period compared to an increase of 5.0 percent in the previous year.

Government Finance

9. On the government finance front, capital expenditure has remained sluggish in contrast with a substantial increase in current expenditure. As a result, Government of Nepal has incurred a budget surplus on cash flow basis during the review period. During the six months of the current fiscal year, the Government of Nepal has maintained the cash balance of Rs. 35.13 billion because of the budget surplus and domestic debt mobilization.

10. In the review period, the revenue mobilization has increased by 21.6 percent compared to a growth of 14.6 percent in the corresponding period of the previous year. During the six months of 2011/12, government received foreign grants of Rs.21.21 billion and loan assistance of Rs. 2.59 billion.

External Sector

11. External sector has witnessed substantial improvement. During the five months of the current fiscal year, BOP remained in surplus by Rs. 61.19 billion, in contrast to a deficit of Rs. 3.76 billion in the same period of the previous fiscal year. In addition to some improvement in exports, a substantial inflow of remittance and tourist income has contributed to BOP surplus. Compared to the deficit of Rs. 4.58 billion in the previous year, current account also remained in surplus of Rs. 24.89 billion in the review year.

12. The total exports increased by 11.2 percent during the six months of FY 2011/12 compared to a growth of 9.0 percent during the same period of the previous year. On the other hand, in contrast to a decline by 0.1 percent last year, imports have increased by a higher rate of 16.8 percent during the review period. Despite improvement in growth of exports, trade deficit has increased further in the review period. Trade deficit has increased by 17.9 percent in the review period, in contrast to a decline of 1.3 percent in the same period last year.

Financial Sector

13. As of mid-Oct 2011, the total number of branches of banks and financial institutions reached 2111 comprising 1142 branches of commercial banks, 630 branches of development banks and 339 branches of finance companies. Eight branches of banks and financial institutions came into operation utilizing the loan facility at zero interest rate provided by the Nepal Rastra Bank with an objective of encouraging banks and financial institutions to open their branches in unbanked areas.

14. During the six months of the current fiscal year, the financial system observed substantial increase in liquidity. Amidst low credit flow, a higher interest rate on deposits and elevated level of remittance inflows contributed to the increase in liquidity in the financial system.

15. The liquid fund of the banks and financial institution has been increasing. During the review period, such assets have increased by 24 percent (Rs. 33.77 billion) in contrast to a decrease of 15.3 percent in the same period of the previous year. Because of this, the liquidity-deposit ratio in mid-Dec 2011 reached 33.1 percent from 30.6 percent in mid-July 2011. The liquidity-deposit ratio of commercial banks, development banks and financial companies remained at 37.6 percent, 34.4 percent and 28.2 percent respectively. As a result of the surge in liquidity in the financial system, short-term interest rates have decreased. For example, the weighted average 91- day treasury bills rate and the weighted average inter-bank rate came down to 0.70 percent and 0.90 percent respectively as at mid-Jan 2012.

16. Due to the higher supply relative to the demand for shares in the stock market, share prices have not improved as expected.

17. Compilation and dissemination of broad monetary survey, as mentioned in the monetary policy of 2011/12, has been begun since the fourth month of current FY2011/12. Broad monetary survey includes development banks and finance companies along with commercial banks. During the review period, broad money (M_2) grew by 8.8 percent compared to a growth of 1.7 percent in the same period of the previous year.

18. Credit flow of banks and financial institutions has been lower than the deposit mobilization in the review period of the current fiscal year. Credit flow has grown by Rs. 36.54 billion, while deposit mobilization has grown by Rs. 73.77 billion. Despite the increased remittance inflows, credit flow has remained at a lower level as banks and financial institutions have not moved towards new areas of market and no expansion in traditional areas.

Financial and External Sector Performance

Micro finance and access to finance

19. As mentioned in the monetary policy statement of the FY 2011/12, drafts of necessary acts to establish Micro-Finance Authority and to convert Rural Self Reliance Fund into National Micro Finance Fund have been finalized.

20. Survey is underway to study the access to financial services in hilly areas of Far Western and Mid Western regions.

21. Under the provision of providing interest free loan up to Rs. 5 million and Rs. 10 million to open branch in district headquarter and outside district headquarter of 30 remote districts respectively, five commercial banks and three development banks have utilized Rs 70 million until 29 January 2012.

22. Existing provision of covering deposit guarantee of up to Rs 200 thousand in savings and fixed deposits of natural person has been extended to commercial banks.

23. Rural Credit Survey, initiated in 2010/11, has moved forward in the FY 2011/12.

Financial Sector Reform, Regulation and Supervision

24. Since the Financial Sector Reform Program ended on 31 December 2011, additional reform programs are under discussion with World Bank and IMF.

25. Supervisory departments have been restructured and strengthened further for effective implementation of inspection and supervision.

26. Final draft of amendment of existing Inspection and Supervision Bylaw 2002 has been prepared in order to move towards risk based supervision.

27. In the process of enhancing supervisory capability of NRB, effective implementation of necessary recommendations obtained from the international consultant has been started.

28. As per the program of preparing contingency plan in accordance with the suggestions of bank supervision consultant in order to address the emergence of crisis suddenly in the financial system, action plan from the consultant has been received.

29. In order to figure out the potential impact on the financial health of banks, necessary guidelines have been issued to banks to conduct stress tests on their own based on the feedback received from the sample stress test.

30. Selective licensing policy has been adopted to establish financial institutions in the rural areas with inadequate access to financial services.

31. Necessary study is being carried out in order to make a timely revision in existing licensing policy so as to create an environment of promoting banks and financial institutions by genuine investors.

32. In order to increase strategic involvement rather than quantitative presence of the promoters, a study is being conducted to improve the fit and proper test of promoters for newly established banks and financial institutions.

33. In the context of policy of maintaining financial stability by encouraging merger of banks and financial institutions including corporate governance, healthy competition and financial consolidation, one separate merger unit has been established in the concerned department. Nepal Rastra Bank had issued the Merger Bylaws in May 2011

to facilitate the process of merger. In line with the bylaws, six pairs of bank and financial institution are in the process of merging.

34. Necessary directives have been given to update the self-declaration of records of loans taken from various banks and financial institution by directors or their family members as well as firms/companies under the ownership or control of their own or their family and such activities are being monitored.

35. To minimize the credit risk arising from multiple banking transactions, a provision has been introduced to exchange credit information of borrowers among the D class Micro Credit Development Banks, Cooperatives and Non-Government Organizations licensed for limited banking transactions in the case of lending of more than 30 thousands to any person, group member or groups.

36. Provision of providing refinance facility at 6.5 percent interest rate has been introduced to increase the credit flows to agriculture and hydropower by revising the existing refinancing facility.

37. Additional time has been given to bring home and real estate loans within the prescribed ceiling and the limit of residential home loans has been increased to Rs. 10 million.

38. Policy provision has been made to allow the renewal of margin lending if the loan is active. B and C class financial institutions have been allowed to maintain call account at banks and financial institutions until mid-July 2012.

39. A provision has been introduced to lend a minimum of 10 percent of the total loans and advances by A class commercial banks in agriculture and energy sectors. According to this provision, if such investments are less than 10 percent of total loans, bank should increase its loan by 2 percent point at minimum annually from the level of mid-July 2011 to reach 10 percent by mid-July 2014.

Foreign Exchange Management

40. A provision has been made allowing bank and financial institutions to extend credit in foreign currency to hydropower related project and also to invest in different foreign currency denominated instruments with the approval from Nepal Rastra Bank.

41. A provision has been made for non-resident Nepalese (NRN) to open up bank account in convertible foreign currency. Necessary provisions have been made so that individuals, firms, companies and organizations can open bank account abroad.

42. Nepalese citizens are allowed to exchange cash up to USD 1,000 or equivalent other foreign currencies from the institutions licensed by NRB upon declaration of sources of income with their identity card. A provision has been introduced to allow the settlement of card transactions between Nepal and Bhutan in Indian currency.

Economic and Monetary Outlook

43. The economic growth rate of the current fiscal year is expected to be as targeted by the budget of this fiscal year. Because of the favorable monsoon, agriculture sector is

estimated to grow by 4.75 percent and because of the expansion of service sector, non-agriculture sector is estimated to grow by 4.25 percent. As a result, the gross domestic product (GDP) is estimated to grow by 4.5 percent at basic prices and 5 percent at producers' prices.

44. As per the revised estimates, annual inflation is expected to remain at 8.0 percent in the fiscal year 2011/12.

45. The remittance inflow may slowdown in the remaining period of the current fiscal year and imports may go up further because of expected increase in government's capital expenditure. The balance of payments is estimated to be in surplus of Rs. 40 billion by the end of this fiscal year.

46. The growth of broad money supply has been revised to stand at 15.0 percent in the current fiscal year of 2011/12. The private sector credit is estimated to grow by 14.0 percent as mentioned in the monetary policy of this fiscal year.

Monetary Policy Stance and Management

47. Channelizing the existing liquidity of the financial systems towards productive sectors is challenging.

48. Although inflation is in a declining trend in the fiscal year 2011/12, it is still high and there is an upside risk of inflation due to the possibility of rise in administered prices.

49. It is necessary to determine the monetary policy stance and carry out monetary management by monitoring the government transactions. Nepal Rastra Bank will make monetary management through outright sales of government securities owned by it if the need arises.

50. Monetary and credit policy would maintain cautious stance to increase credit flows to productive sectors through the macro-prudential measures.

51. Because of high investment of bank and financial institutions directly and indirectly in real estate, there is a high risk of adverse impact on their balance sheet. Monetary policy will be targeted towards the avoidance of pressure on the monetary expansion due to increase in liquidity in the financial sector.

52. The interest rate spread in the financial system of Nepal has remained high. The effort of monetary management will be to maintain interest rate at a desired level by monitoring regularly the interest rate spread.

53. In the context of changed financial scenario, the operating strategy of monetary policy framework will be changed from the next fiscal year.

54. The operational mechanism of monetary policy will be gradually oriented towards interest rate corridor.

55. Institutional provision will be made to carry out the coordination among the monetary policy, financial regulation, supervision and macro prudential policies.

56. In accordance with the "Immediate Action Plan for Economic Development and Prosperity 2068" issued by the Government of Nepal in January 2012, general loan, refinancing and loans rescheduling provisions will be reviewed to increase credit flows to agricultural and energy sector and to solve the problem of housing loans under the real estate sector loans.

57. Practical difficulties in providing refinance facility to export industries from the NRB will be resolved in order to ensure the adequate level of credit flows towards these industries from banks and financial institutions.

58. To encourage the credit expansion from the banks and financial institutions to the development of Small and Medium Enterprises (SMEs), a provision of establishing SME desk by the banks and financial institutions will be effectively implemented.

59. Through credit policy measures, resource flows will be ensured towards the areas identified by the Investment Year programs for investment promotion.

Lastly

60. Last two years witnessed a pressure on balance of payments, high inflation, liquidity shortage and low economic growth. Macroeconomic situations have, however, improved remarkably as a result of successful implementation of monetary policy. There is a balance of payments surplus and a declining trend of inflation in the current fiscal year.

61. In the remaining period of the current fiscal year, likely pressure in the balance of payments cannot be denied if imports increase and the remittance inflows slowdown. Similarly, despite a fall in food prices, there is a risk of inflationary pressure due to the increase in the prices of non-food and services. On the other hand, in spite of improvement in liquidity situation during the review period of the current fiscal year, credit flows have remained sluggish because interest rates on loans have not declined. Contraction of private sector credit flows may impact the economic growth negatively.

62. Considering these facts, the stance of monetary policy for the remaining period of the fiscal year has been to maintain financial stability and promote economic growth without having pressure on balance of payments and inflation.

63. The stance of monetary policy is expected to help maintain macroeconomic stability and financial stability. In the situation of prolonged political transition, regular energy crisis and lose of investors' confidence, maintaining economic growth with macroeconomic stability and financial stability is very challenging. However, the objectives of monetary policy are expected to be attained if banks and financial institutions, entrepreneurs and other stakeholders provide cooperation and act rationally.

64. The full document of the half-yearly review of monetary policy of the fiscal year 2011/12, summary of which has been presented here, is posted in the NRB's website (www.nrb.org.np). As usual, Nepal Rastra Bank would like to thank all the stakeholders for their cooperation in implementation of the monetary policy of the current fiscal year 2011/12 and kindly requests for further cooperation in coming days.