

Mid-term Review of Monetary Policy for 2005/06

Executive Summary

Overview

1. Ever since the enactment of Nepal Rastra Bank (NRB) Act 2002, the bank is following the practice of making the annual monetary policy public at the beginning of the fiscal year i.e. around mid July. In accordance with this practice, monetary policy for 2005/06 was made public on July 22, 2005.
2. With a view to increase transparency in the conduct of monetary policy, a mid-term review of monetary policy is also prepared and made public. In line with this tradition, a mid-term review of monetary policy for 2005/06 has been prepared and is ready for the distribution to the general public.
3. The review has major five sections:
 - i. Economic analysis
 - ii. Monetary analysis and monetary management
 - iii. Half yearly review of financial sector and external sector reform measures
 - iv. Economic and monetary outlook
 - v. Monetary policy stance

Output and Prices

4. The real output growth has been modest and below the potential level over the last couple of years mainly because of decade long insurgency. Food grains production is estimated to decline marginally in 2005/06 owing to unsatisfactory weather conditions both in summer and winter seasons. Hence, agricultural output growth is likely to be lower this year. Likewise, the manufacturing production index increased at a lower rate of 2.4 percent in the first quarter of 2005/06 compared to a growth of 4.0 percent in 2004/05. The analysis of both

agricultural output growth and manufacturing output growth shows that economic growth is likely to be modest in 2005/06.

5. Consumer inflation showed a pressure during the first five months of 2005/06. Unexpected rise in food prices largely accounted for a pick up in overall inflation in the first five months of 2005/06. The rise in prices of petroleum products and the hike in indirect taxes also contributed to the increase in general price level. However, pressure on consumer prices eased slightly in the first six months of 2005/06 due to improvement in food prices. Inflationary pressure still exists due to the elevated level of international oil prices and upward adjustment in domestic oil prices.

External Sector

6. Imports relative to exports have gone up in the first six months of 2005/06. This has widened the trade deficit.
7. Increased workers' remittances have offset the trade deficit resulting a higher level of surplus in balance of payments relative to the level of the preceding year.
8. Workers' remittances have contributed to the external sector stability. International reserve is at comfortable position and is sufficient to finance merchandise imports of 10.4 months and goods and services imports of 8.8 months.

Budgetary Position

9. Internal insurgency has continued to exert strain on the government budgetary position. Despite this, budget deficit has remained under control, contributing to overall macroeconomic stability. However, keeping fiscal deficit under control continues to be a fiscal challenge.

Liquidity, Money and Interest Rates

10. Remittance led growth of net foreign assets (NFA) has contributed to monetary expansion relative to that of last year. Domestic source of monetary growth has remained subdued on account of muted growth in bank loans to the private sector.

11. Despite sluggish economic activities and increased liquidity emanating from remittances, interest rates are stabilized through appropriate level of intervention in open market operations.

Output and Inflation outlook

12. Despite risk to growth from inflation, multilateral institutions have projected the global output growth at 4.3 percent in 2005/06. Nepal's neighbouring countries India and China are showing a sustained pick up in economic growth. The Nepalese economy, however, continues to suffer from decade long insurgency and has been the victim of bad weather. Economic growth is expected to remain modest and less than the target initially set.
13. At the global level, risk to inflation continues to exist from the elevated level of international oil prices. In response to this, many central banks have increased their policy (interest) rates.
14. In the first six months of 2005/06, pressure on Nepalese price level eased slightly. However, higher level of international oil prices and recent adjustment in domestic oil prices are likely to generate inflationary expectations in Nepal. Therefore, risk to inflation continues to exist and consumer inflation is likely to exceed the initial annual target of 5 percent and subsequent revision of 7.0 percent. However, the downward revision in customs duties announced in the recent half yearly budget ordinance will have dampening impact on import prices, thereby on overall prices. The result of such dampening effect will be seen in the forthcoming months.

Monetary Policy Response

15. As monetary policy response to the risk to inflation, the bank rate, which is being used to indicate policy stance has been revised up by 25 basis points to 6.25 percent from the level of 6.0 percent. The supply shock especially oil price shock has generated pressure on overall price level. Aggregate demand, for that matter, monetary factors have little role in it. However, the supply-induced spurt in prices

has generated inflationary expectation. Therefore, the hike in the bank rate is precisely indented to anchor inflationary expectations.

16. In consonance with the hike in the bank rate, the NRB is determined to further mop up liquidity from the market through open market operations. The bank will off-load the stock of treasury bills from its holdings to suck in liquidity. If the offloading of the stock of treasury bills from its holdings and the hike in bank rate did not suffice to modulate liquidity and help achieve monetary policy objective, the NRB will not hesitate to make use of additional monetary policy measures.
17. The NRB would like to thank the stakeholders of monetary policy and multinational institutions for their continued support in the conduct of monetary policy and policy reforms. The NRB also appreciates the interest shown by the press in the formulation and implementation of monetary policy.

Thank You