

Nepal Rastra Bank
Press Release
on
Monetary Policy for 2008/09
September 29, 2008

Macroeconomic Situation of 2007/08

1. The gross domestic product at basic prices registered a growth of 5.6 percent in 2007/08 compared to a growth of 2.6 percent in 2006/07.
2. The agriculture sector grew by 5.7 percent in 2007/08 compared to a growth of 0.9 percent in the previous year. The agriculture sector showed a satisfactory performance on account of solid (16.8 percent) increase in the paddy production underpinned by the favorable weather condition.
3. The non-agriculture sector expanded by 5.6 percent in 2007/08 compared to a growth of 4.1 percent in the previous year.
4. The annual average consumer price inflation rose to 7.7 percent in 2007/08 from 6.4 percent a year ago. The year-on-year (y-o-y) consumer inflation surged to 12.1 percent in mid-July 2008 from 5.1 percent a year ago. The y-o-y consumer inflation surged further to 13.1 percent in mid-August 2008 from 6.3 percent a year ago.
5. Although the trade deficit widened, the overall balance of payments (BOP) posted a surplus of Rs. 29.67 billion in 2007/08 compared to a surplus of Rs. 5.90 billion in the previous year.
6. Total exports grew by 2.4 percent in 2007/08 as against a decline of 1.4 percent in the previous year.
7. Total imports increased by 16.1 percent in 2007/08 compared to a growth of 12 percent in the previous year.
8. The workers' remittances increased significantly by 42.5 percent to Rs. 142.68 billion in 2007/08 compared to a marginal growth of 2.5 percent in the previous year.

9. The accumulation of gross foreign exchange reserves reached Rs. 212.62 billion in 2007/08. This level of reserves is sufficient to cover imports of 11.3 months and merchandise and services imports of 9.1 months.
10. The government revenue increased by 22.6 percent to Rs. 107.55 billion in 2007/08 compared to a growth of 21.3 percent in the previous year.
11. The government expenditure increased by 22.2 percent to Rs.163.31 billion in 2007/08 compared to a growth of 20.5 percent in the previous year. Of the total expenditure, the recurrent expenditure grew by 18.5 percent to Rs. 91.41 billion while the capital expenditure increased by 39.7 percent to Rs. 55.52 billion.
12. The government budget deficit expanded to Rs. 33.03 billion in 2007/08 from Rs. 30.09 billion in the previous year. In 2007/08, while the gross domestic financing of budget deficit amounted to Rs. 20.50, the external borrowing reached Rs. 11.33 billion.

Monetary Policy and Programs for 2008/09

13. The monetary policy stance of 2008/09 has rather been cautious and tight. The following analysis underpins the stance of monetary policy:
 - a. Inflation has reemerged as a major challenge for monetary policy. There is a need to be cautious that monetary growth is not the source of inflation.
 - b. An excessive growth in money supply has the potential to generate inflationary pressure for non-tradables. Hence, there is a need for monetary policy stance to be cautious in the present inflationary situation.
 - c. In a small and open economy with fixed exchange rate regime like that of Nepal, domestic prices tend to be influenced by international prices. However, the excessive growth in money supply has the potential to influence prices of shares, real estates and money as an asset at least in the short run. The monetary policy of 2008/09 has taken a note of this.
 - d. The wider volatility in equity prices adversely affects the banking sector in particular and the economy as a whole in general. Excessive exposure of banks and financial institutions to the share market leads to bubble. When the bubble busts, the non-performing loans (NPLs) rises, leading to a

stress in the banking sector. This fact has also been taken into account in choosing the stance of monetary policy for 2008/09.

- e. The increased exposure of commercial banks and financial institutions, and the elevated level of remittances have contributed to the surge in real estate prices. As the banks and financial institutions provide loans to real estate based on the market value of land and houses as collateral, a bubble in the real estate market directly affects the banking sector. Monetary policy stance for 2008/09 has taken this development in the real estate market driven by substantial flow of bank credit to this sector into account.
 - f. The real interest rate has remained negative for a long period of time partly on account of rise in inflation. Due to this, the allocation of financial resources has not been efficient. Ample public deposits with financial institutions have also depressed interest rates. This development also underpins the stance of monetary policy for 2008/09.
14. The first-round effect of petroleum price adjustment of June 9, 2008 is likely to last until the first ten months of 2008/09. The second-round effect of the hike in prices of petroleum products has already been reflected into the increase in the fare of public transportation. However, inflation is estimated to ease to a single-digit level with expected improvement in food prices after the harvest of summer crops. Assuming no further adjustment in the petroleum prices takes place, the annual average consumer inflation is projected to moderate at 7.5 percent in 2008/09.
 15. The international reserves sufficient to cover the merchandise and service imports for at least 6 months has been taken as the second primary objective of monetary policy of 2008/09. In order to meet this target, the BOP surplus of Rs. 12 billion is projected for 2008/09.
 16. The monetary liquidity sufficient enough to facilitate the economic growth of 7 percent as mentioned in the budget speech for 2008/09 will be made available.
 17. The growth rate of broad money is projected at 18.5 percent for 2008/09. It grew by 25.2 percent in 2007/08. With a view to reining in inflation at 7.5

percent, the growth in M2 is projected at a lower rate than that of the previous year.

18. The gross domestic credit of banking sector is projected to expand by 23.3 percent in 2008/09. Of the total domestic credit of banking sector, the credit to the private sector is projected to increase by 25.0 percent in 2008/09 compared to a growth of 24.3 percent in the previous year.

Monetary and Credit Measures

19. From 2008/09 onwards, the range of counterparties for the conduct of monetary policy has been broadened to development banks and finance companies. Earlier, only commercial banks enjoyed this status. With the enlarged range of counterparties, the monetary operations will take place with the commercial banks, development banks and finance companies. Earlier, the short-term Standing Liquidity Facility (SLF) was provided exclusively to commercial banks. From now onwards, development banks and finance companies will also be entitled to this facility. In order to get these facilities, the counterparties should regularly submit their financial statements in formats stipulated in the NRB consolidated directives on a regular basis. This new provision is expected to enhance the effectiveness of the implementation of monetary policy in the days ahead.
20. As and when required, monetary liquidity will be moderated through outright purchase auction, repo auction, outright sale auction and reverse repo auction as the main instruments of monetary policy.
21. The cash reserve ratio (CRR) has been raised to 5.5 percent from the existing 5 percent of the total domestic deposits effective from October 17, 2008. The system of the calculation of CRR on the basis of two weeks' lagged deposits will be continued.
22. The bank rate will be used to provide the lender of the last resort facility to the banks and financial institutions having accounts with this bank for the maximum period of 6 months in case the liquidity adjustment through inter-bank market, OMOs and SLF remains inadequate. This facility will be provided against the collateral of cash balances held at the NRB for the

purpose of CRR, treasury bills of the GON and good loans. As an indicative of tight monetary policy stance, the existing bank rate of 6.25 percent has been increased to 6.5 percent.

23. With a view to enhancing the competitiveness of the Nepalese exports, the refinance rate on exports in Nepalese currency has been reduced to 2 percent from the existing rate of 2.5 percent. Commercial banks using such facility will not charge more than 5 percent interest rate while extending such loans to their borrowers.
24. The existing provision of refinance facility of Rs. 2 billion to sick industries and the refinance rate at 1.5 percent will be continued for 2008/09.
25. The penal rate for SLF has been increased from existing 2 percent to 3 percent. This is aimed at developing inter bank money market.
26. The cap on SLF facility has been eased from 75 percent to 90 percent.
27. The provision of refinance rate to the Rural Development Bank at 3.5 percent has been continued.
28. The existing provision of refinance facility to commercial banks and development banks against the collateral of credit provided to small and cottage industries at the refinance rate of 2.5 percent has been continued.
29. The deprived sector credit requirement of 3 percent for commercial banks has been continued. The deprived sector credit requirement for development banks has been increased to 1.5 percent from 1.0 percent. The deprived sector credit requirement of 1.0 percent has been introduced for finance companies.

Financial Sector Reform, Regulation and Supervision

30. The financial sector reform program initiated under the financial assistance of the World Bank since 2002/03 will be continued in 2008/09 as well.
31. Since the placement of the external management teams, Nepal Bank Limited and Rastriya Banijya Bank have started generating operational profits. However, due to a lower-than-expected recovery of non-performing loans of these banks, negative net worth has remained at Rs 23.0 billion. Since there is no immediate possibility of reversing negative net worth into capital adequacy

level, the placement of the external management in these banks will be continued in 2008/09.

32. The BASEL II has been introduced for commercial banks from the beginning of 2008/09. The existing provision of capital adequacy ratio for development banks, finance companies and micro finance development banks has been continued.
33. With a view to addressing the regulatory and supervisory challenges arising from the growing number of banks and financial institutions, the NRB has been preparing itself for the introduction of new set of regulatory and supervisory instruments. In this process, Prompt Corrective Actions (PCA) will be strictly implemented from 2008/09 for those banks and financial institutions, which are likely to fail to maintain the minimum capital adequacy ratio as per BASEL II.
34. The current provision of evaluating banks as per the CAMELS rating resultant indicators calculated on the basis of compulsory annual on-site supervision at the corporate level will be continued.
35. The special provision will be made for on-site supervision of the banks and financial institutions having poor financial health.
36. The implementation of Early Warning Signal (EWS) to banks and financial institutions based on CAELS rating of the concerned banks and financial institutions prepared from the analysis of off-site supervision report will be continued.
37. The auditing of big branches of large banks by external auditors will begin from 2008/09. The necessary standards relating to this provision will be fixed by the NRB.
38. The timely revision and refinement in the Long Form Audit Report will be made. This will be also used as one of the supervisory instruments.
39. From 2008/09 onwards, the risk-based supervision method will be implemented in a planned way for each bank and financial institution.
40. The NRB will issue prudential norms of international standards for the regulation and supervision of contractual saving organizations such as

Employees Provident Fund (EPF) and Citizen Investment Trust (CIT). The inspection and supervision of these financial institutions on the basis of these norms will commence within this fiscal year.

41. The bank believes that implementation of the policies and programs envisaged in this monetary policy will contribute to the prudent macroeconomic management, the consolidation of financial as well as external sectors, and secured internal payments system, thereby creating a conducive economic environment necessary for a higher level of economic growth.
42. The NRB believes that the Government of Nepal, financial community, civil society and donor agencies will continue to assist, as before, for the implementation of the monetary policy of 2008/09.
43. The bank wishes to thank all stakeholders for their cooperation in implementing the monetary policy of 2007/08.
44. The full text of the monetary policy of 2007/08 including the annual matrix of policies and programs, annexes and statistical tables are available at the NRB website: www.nrb.org.np.

Thakur Prasad Sharma
Act. Deputy Director
Public Relation Division