

Nepal Rastra Bank
Press Release
on
Monetary Policy for 2009/10
July 24, 2009

Macroeconomic Situation of 2008/09

1. The gross domestic product at producers' prices is estimated to register a growth of 4.7 percent in 2008/09 compared to a growth of 5.3 percent in 2007/08.
2. The agriculture sector is estimated to grow by 2.2 percent in 2008/09 compared to a growth of 4.7 percent in the previous year. The performance of agriculture sector remained sluggish on account of a decline in wheat production by 14.5 percent and pulse production by 5.3 percent, among others. The unfavorable weather condition and flood in eastern part of Nepal contributed to the dismal agro-production in 2008/09.
3. The non-agriculture sector expanded by 4.8 percent in 2008/09 compared to a growth of 5.6 percent in the previous year. The long hours of load shedding, poor labor relations and supply disturbances were the major factors responsible for the sluggish performance of non-agriculture sector in 2008/09.
4. The y-o-y national urban consumer price inflation escalated to double digit figure 12.9 percent in mid-May 2009 compared to 9.2 percent during the corresponding period of the previous year. The annual average consumer price inflation is estimated to soar to 13.0 percent in 2008/09. Such inflation rate was 7.7 percent in 2007/08. The current high level of inflation rate is largely emerging from the supply side.
5. Although the trade deficit widened, the overall balance of payments (BOP) posted a surplus of Rs. 43.1 billion in the first ten months of 2008/09 compared to a surplus of Rs. 19.9 billion in the previous year.
6. The export sector exhibited a satisfactory performance in the first ten months of 2008/09 even in the face of global economic crisis. Total export grew by 19.8 percent in the first ten months of 2008/09 as against a decline of 2.4 percent in the

previous year. The depreciation of the Nepali rupee vis-à-vis the US dollar contributed to the surge in export in 2008/09.

7. Total imports increased by 25.4 percent in 2008/09 compared to a growth of 16.8 percent in the previous year.
8. Workers' remittances increased significantly by 55.5 percent to Rs. 169.2 billion in the first ten months of 2008/09 compared to a growth of 35.5 percent in the previous year.
9. The accumulation of gross foreign exchange reserves reached Rs. 283.4 billion in the first ten months of 2008/09. This level of reserves is sufficient to cover merchandise imports of 12.4 months and merchandise and services imports of 10.1 months.
10. Government revenue increased by 32.1 percent to Rs. 142.2 billion in 2008/09 compared to a growth of 22.7 percent in the previous year.
11. Government expenditure increased by 32.4 percent to Rs.213.6 billion in 2008/09 compared to a growth of 20.8 percent in the previous year. Of the total expenditure, recurrent expenditure grew by 33.5 percent to Rs. 122.1 billion while capital expenditure increased by 37.0 percent to Rs. 73.3 billion.
12. The government budget deficit expanded to Rs. 36.8 billion in 2008/09 from Rs. 33.4 billion in the previous year. In 2008/09, while the gross domestic financing of the budget deficit amounted to Rs. 18.4 billion, the external borrowing reached Rs. 10.4 billion.

Monetary Policy and Programs for 2009/10

13. The monetary policy stance of 2009/10 has been taken to be cautious and tight. The following analysis underpins the stance of monetary policy:
 - a. Nepal is facing a high inflationary pressure from the third quarter of 2007/08. Though the pressure is largely from the supply side, there is a need to be cautious to avert the fuelling of inflation from the monetary expansion. This entails a cautious and tight monetary policy stance.
 - b. Though prices for the tradable are influenced by the international prices, prices for non-tradable are determined through domestic demand and supply. So, there exists the potential to generate inflationary pressure for

non-tradable through excessive growth in money supply. Hence, there is a need for monetary policy stance to be cautious in the present inflationary situation.

- c. The excessive growth in money supply has also the potential to influence asset prices at least in the short run. The monetary policy for 2009/10 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 a 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 2009/10.
 - e. In the face of deteriorating investment environment and the elevated level of remittances, there could be an increase in exposure of commercial banks and financial institutions to the real sector. This increase may lead to a surge of 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 2009/10 has taken this development in the real estate market driven by substantial flow of bank credit to this sector.
 - f. The negative real interest rate for a long period of time partly on account of a rise in inflation has also been a concern of monetary policy. Due to negative real interest rate, the allocation of financial resources has not been efficient. This development also underpins the stance of monetary policy for 2009/10.
14. Inflation rate at the global level is plummeting to single-digit level, while Nepal still faces the inflation at double-digit level, largely due to supply disturbances. Inflation is estimated to ease to a single-digit level with expected improvement in food and vegetable prices. Subject to no further adjustment in the petroleum prices and improvement in distributional channel, the annual

average consumer price inflation is projected to moderate at 7.0 percent in 2009/10.

15. Like in the past, 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 2009/10 as well. In order to meet this target, a BOP surplus of Rs. 18.0 billion is projected for 2009/10.
16. The existing liquidity overhang in the economy is sufficient enough to facilitate the economic growth of 5.5 percent as mentioned in the budget speech for 2009/10. The growth rate of broad money is projected at 17.0 percent for 2009/10. It is estimated to grow by 21.0 percent in 2008/09. With a view to containing inflation at 7.0 percent, the growth in M2 is projected at a lower rate than that of the previous year.
17. The gross domestic credit of banking sector is projected to expand by 19.3 percent in 2009/10. Of the total domestic credit of banking sector, the credit to the private sector is projected to increase by 20.7 percent in 2009/10 compared to a growth of 24.2 percent in the previous year.
18. The NRB has a plan to prepare broad monetary survey by including development banks and finance companies into the coverage of monetary statistics framework. Likewise, the bank is planning to prepare monthly export-import price index (XMPI) within this year, which is believed to further assist trade related and macroeconomic analysis.

Monetary and Credit Measures

19. The range of counterparties (commercial banks, development banks and finance companies) for the conduct of monetary policy has been kept unchanged. The existing practice of undertaking the monetary operations only with counterparties will be continued and the short-term Standing Liquidity Facility (SLF) is entitled only to counterparties. In order to obtain these facilities, the counterparties should regularly submit their financial statements in formats stipulated in the NRB consolidated directives on a regular basis.

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 kept unchanged at 5.5 percent. Likewise, the bank rate is kept unchanged at 6.5 percent.
22. Refinance rates have been kept unchanged as follows:
 - (a) 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 2009/10.
 - (b) The provision of refinance rate to the Rural Development Bank at 3.5 percent has been continued.
 - (c) Export credit refinance facility in domestic currency has been kept unchanged at 2.0 percent. Commercial banks are allowed not to charge more than 5.0 percent to the concerned borrower on such facility.
 - (d) Export credit refinance facility in foreign currency has been kept unchanged effective with extra surcharge of 25 basis points at the prevailing 6-month LIBOR rate.
 - (e) 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.
 - (f) 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 2.0 percent from 1.5 percent and for finance companies to 1.5 percent from 1.0 percent.
23. The penal rate for SLF has been kept unchanged at 3 percent along with the existing cap of 90 percent and maturity period of 5 days.
24. The commercial banks, development banks and finance companies are now required to invest in government securities at a ratio of 6.0 percent, 2.0 percent and 1.0 percent of their total domestic deposit mobilization respectively by second quarter of 2009/10. Such ratio should be maintained at a ratio of 8.0 percent, 3.0 percent and 2.0 percent respectively by the end of the fourth quarter of 2009/10.

Financial Sector Reform, Regulation and Supervision

25. The limit of minimum level of paid up capital has been kept unchanged. Now onwards, the base for increasing capital of licensed banks and financial institutions by the NRB will be their capital fund.
26. After the placement of the external management teams, there has been improvement in the financial health of Nepal Bank Limited and Rastriya Banijya Bank. They have started generating operational profit. However, there has not been a satisfactory recovery of non-performing loans of these banks as expected. Net worth in these banks is still negative. Therefore, the programs of upgrading the capital of these two banks to a stipulated level will be effectively implemented.
27. In order to extend the mobilization of financial resources, concepts on financial assets rescheduling and securitization will be prepared and, accordingly the draft of the Act will be submitted to the Government of Nepal (GON) in 2009/10. Likewise, a draft of the Act pertaining to terrorist financing will be submitted to the GON.
28. The ongoing actions against the willful defaulters will be strongly implemented for maintaining the financial sector stability.
29. Private sector will be encouraged to establish a credit rating agency and additional effective measures will be implemented so as to strengthen the credit information bureau.
30. As per the budget speech of 2009/010, a policy as well as institutional provision will be made in order to guarantee the deposits of small depositors up to Rs. 200,000.
31. In order to avert the excessive concentration of credit in a single sector, single obligor limit has been currently set at 50.0 percent, including 25.0 percent from fund based and remaining from non-fund based. This limit has been slashed to 25.0 percent of core capital including that of non-fund based effective from July 17, 2010.

32. In the context of the possibility of the establishment of foreign bank branches and offices in Nepal beginning 2010, the memorandum of understanding will be prepared for home-host supervisory relation within this year
33. The implementation of Early Warning Signal (EWS) to banks and financial institutions will be further strengthened so as to enhance the efficiency of off-site supervision. In the process, "Stress Testing" of commercial banks will be carried out.
34. Viewing the inadequacy of compliance-based supervision in the event of growing competition, evolving new instruments and products in the financial sector, a risk-based supervision will be implemented in a planned way in addition to compliance-based supervision.
35. 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 and external sector and secured internal payments system, thereby creating a conducive economic environment necessary for high level of economic growth.
36. The NRB believes that the Government of Nepal, financial community, civil society and donor agencies will continue to assist it, as before, for the implementation of the monetary policy of 2009/10.
37. The bank wishes to thank all stakeholders for their cooperation in implementing the monetary policy of 2008/09.
38. The full text of the monetary policy of 2009/10 including the annual matrix of policies and programs, annexes and statistical tables are available at the NRB website: www.nrb.org.np.

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