Report on Monetary Policy for FY 2003/04 Delivered by Dr. Tilak Rawal, Governor, Nepal Rastra Bank

(Major Points)

Review of Economic Situation

1. During FY 2000/01, the growth rate of narrow money was 15.7 percent and that of broad money 15.2 percent. GDP grew by 4.7 percent during the year. Inflation was contained at 2.4 percent. BOP surplus was Rs. 5.2 billion and gross foreign exchange reserve level was Rs. 105.2 billion.

2. During FY 2001/02, the growth rate of narrow money was 9.3 percent while broad money grew by 4.4 percent. Economic growth witnessed a negative rate at 0.5 percent. Inflation averaged 2.9 percent. BOP recorded a deficit of Rs. 3.3 billion, the first such deficit after FY 1995/96 when BOP had recorded a deficit of Rs. 1.1 billion. Gross foreign exchange reserve amounted to Rs. 105.9 billion.

3. In an environment of low level of inflation and the comfortable foreign exchange level in terms of import capacity, the report on monetary policy for FY 2002/03 came out with flexible monetary policy measures with a view to addressing the slump in the economic activities, the industrial slowdown, and the rural finance requirements to the extent permitted by the macroeconomic fundamentals.

4. Though there was a BOP deficit of Rs. 1.1 billion up to the first five months of FY 2002/03, BOP situation witnessed improvements in the following consecutive months, with the BOP surplus estimated at Rs. 5.1 billion during the first 11 months. The gross foreign exchange reserve level in mid-June 2003 reached Rs. 112.3 billion, equivalent to 11 months' merchandise imports.

5. During the first 11 months of FY 2002/03, narrow money rose by 5.7 percent and broad money by 9.7 percent. GDP growth is estimated at 2.3 percent. Inflation, which remained stable up to the first 8 months, rose, on point to point basis, to 8.1 percent in mid-April 2003, 7.7 percent in mid-May 2003, and 6.6 percent in mid-June 2003, with the average inflation rate for FY 2002/03 estimated at 4.8 percent. The inflation is, therefore, at a somewhat higher level than what was projected, i.e. 4 percent with the GDP growth also projected at 4 percent.

Projection of Monetary Aggregates

6. It is in the above background that the report on monetary policy for FY 2003/04 has been brought out. The basic objective of this year's monetary policy is to attain price stability, improved structure of the BOP and foreign exchange stability. For FY 2003/04, GDP projection is 4.7 percent with the projections of inflation rate at 4.3 percent and BOP surplus at Rs. 2 billion.

The growth rate of narrow money is projected at 9.2 percent and that of broad money at 11.2 percent.

Monetary Policy Stance and Framework for FY 2003/04

7. The monetary policy for the fiscal year 2003/04 is directed at keeping inflation within the control and avoiding the unnecessary depletion of the nation's international reserves. Along with this, the primary goal of monetary policy has been achieving and strengthening economic as well as financial sector stability. The monetary policy also aims at managing the adequate level of liquidity through enhanced level and efficiency of financial intermediation and keeping lending rates at an appropriate level

8. The current pegged exchange rate system with Indian currency will be maintained. The peg has been taken as nominal anchor of monetary policy, ensuring domestic price stability as well as facilitating economic growth. The objective of monetary policy in conjunction with the pegged exchange rate system is to maintain the real effective exchange rate at the constant level preventing it from undue appreciation or depreciation.

9. Monetary and credit aggregates will be taken as intermediate targets of monetary policy. To keep a track of monetary aggregates, monetary programming will be initiated. As a step to this direction, an inter-departmental Liquidity Monitoring and Projection Working Group has already been constituted.

10. Net domestic assets (NDA) of the NRB, a factor affecting reserve money, will be taken as the operating target in order to attain the intermediate target of monetary policy.

11. To keep NRB's net domestic assets within the desired level, open market operations and short-term interest rates will be used as instruments of monetary policy. The secondary open market operations will be strengthened to manage the short-term liquidity of the system. The repo facility will be continued as a standing liquidity facility for commercial banks.

12. The bank rate will be used as an indication of monetary policy stance as the open market interest rates including the repos are determined by the market forces. The bank rate, however, will be maintained at 5.5 percent. The policy of not making changes in the bank rate for the time being is taken in view of the higher rate of inflation in FY 2002/03 compared to that of FY 2001/02.

13. Currently, commercial banks are required to maintain 7 percent balance of their domestic current and saving deposits and 4.5 percent balance of their domestic fixed deposits with the NRB as well as 2 percent vault compulsory ratio of total domestic deposit. The existing system has been changed into a single and uniform compulsory ratio of 6 percent. The two percent vault compulsory ratio has been done away with.

14. The auction for shorter-term treasury bills in addition to the existing 91-day and 364-day treasury bills will be introduced. This is expected to facilitate in arriving at the benchmark yield curve.

15. The auction system will also be introduced for the government-dated securities. The objective is to determine the market interest rates of sufficiently wide maturity spectrum of government debt instruments.

16. In order to give investors the opportunity to plan their investments, an issue calendar for all dated securities will be issued and made available in NRB website.

17. With a view to making public debt management efficient and effective, a requisite infrastructure will be created for the issuance of scripless government securities.

18. NRB will make a provision of additional refinancing facility of Rs 1.5 billion for the sick industry loans in the current fiscal year also. The refinancing rate will be lowered from the current 3 percent to 2 percent. To avail this facility, the commercial banks will have to lower the current interest rate of such loans at 6.5 percent to 5.5 percent.

Financial Sector and Foreign Exchange Reform Measures

19. On the basis of the study report of the consultants, the re-engineering and restructuring of NRB will be undertaken in the current FY 2003/04.

20. With a view to reducing the mounting non-performing assets of the banking sector, the necessary work is underway for setting up the Assets Management Company. The budget 2003/04 has earmarked Rs 150 million for the establishment of the Company.

21. A new Credit Information Centre (CIC) with legal entity in the form of public limited company will be established to cater the credit information needs of all the commercial banks and financial institutions. This Centre will be responsible for procuring and exchanging the credit information of banks and financial institutions, updating the details of the default and insincere borrowers, blacklisting or taking necessary action against those borrowers and reporting to the NRB.

22. Although initiative for the establishment of a Credit Rating Agency was taken in the previous years, necessary legal, procedural and investment related arrangements could not be made public. These tasks will be completed this fiscal year and arrangement will be made for the establishment of a Credit Rating Agency.

23. The risk weighted capital adequacy ratio has been fixed at 11 percent, of which 5 percent has to be the core capital for the current fiscal year. For FY 2004/05, the capital adequacy ratio has been fixed at 12 percent, comprising 6 percent core capital.

24. The policy of rescheduling and restructuring the loans on the basis of the mutual consent of the bank and the client will be continued. This is based on flexible policy taken for loan rescheduling and restructuring. Though the policy requires presenting a written work plan regarding the loan rescheduling and restructuring and the collection of 25 percent of the earned interest by the date of such rescheduling and restructuring, this has not been made compulsory. However, a loan loss provision for such rescheduled and restructured loan should be made as per the classification based on the existing overdue period.

25. As in the past, the credit supplied to micro-finance institutions by commercial banks will be categorized as the deprived sector credit. This practice will encourage the functioning of micro credit institutions in the rural areas and these institutions will not be in short of financial resources.

26. An international audit company is carrying out a study under the assistance of the Asian Development Bank. Necessary decisions for ADB and NIDC will be taken on the basis of the study report as well as the NRB onsite supervision report.

27. The share of foreign equity participation ceiling in the joint venture commercial banks is currently 67 percent. In keeping with the ongoing financial liberalization and Nepal's likely accession to WTO, such ceiling will be increased as per the requirement.

28. With an objective of according priority and accelerating the financial sector reform program, the draft legislations relating to the depository corporations, anti-money laundering, secured transactions, insolvency and AMC have already been submitted to HMG. Through the FY 2003/04 budget, HMG has expressed its commitment for the enactment of these bills.

29. To upgrade the inspection and supervision according to international standards, a study relating to the effectiveness of New Capital Accord (Basel II), developed by the Basel Committee on Banking Supervision, in the Nepalese context will be undertaken.

30. Necessary enforcement measures will be introduced to speed up the statistics and information reporting system to the NRB. Although timely reporting of statistics and information from banking and financial institutions is very essential for the NRB in formulating the monetary and financial policies, for the overall macroeconomic management and for conducting research and analysis in economic fields, some financial institutions have not been submitting the statistics within the stipulated period for which enforcement will be strengthened.

31. The provision of making exports through the Cash Against Document (CAD) mechanism in the absence of the letter of credit or prepayments is made further easier. Under the new provision, exporters are allowed to make their exports up to US$ 100,000 through the CAD mechanism by maintaining 10

percent bank guarantee. Prior to this, exports through the CAD mechanism was up to US$ 50,000 and the required bank guarantee was 25 percent.

32. Against the provision of importing from third countries only through the letter of credit, imports up to US$ 3,000 was also allowed through Draft/TT a few years ago. This limit of imports through Draft/TT has been raised to US$ 30,000.

33. The facility of opening usance letter of credit is extended for commercial imports in addition to that for the industrial exporters. However, the maximum period of such usance letter of credit will be one year.

Conclusion

34. It is believed that these monetary and financial policy measures will help raise the efficiency of financial intermediation, strengthen the financial sector, ensure overall economic stability and thereby help promote sustained economic growth. NRB expects that HMG, the financial sector and other concerned quarters will continue to support NRB for the successful implementation of these measures.