# Monetary Policy for Fiscal Year 2004/05

**Nepal Rastra Bank**
**Central Office**
**Baluwatar, Kathmandu**
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# Monetary Policy
## for
# Fiscal Year 2004/05

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**Nepal Rastra Bank**
Central Office
Baluwatar, Kathmandu
Nepal

Website: www.nrb.org.np

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## Acronyms

| | |
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| ADB/N | Agricultural Development Bank of Nepal |
| AMC | Assets Management Company |
| BIMST-EC | Bay of Bengal Initiative for Multi-Sector Technical and Economic Cooperation. |
| BIS | Bank for International Settlement |
| BOP | Balance of Payments |
| CAD | Cash Against Document |
| CAR | Capital Adequacy Ratio |
| CIB | Credit Information Bureau |
| CIF | Cost, Insurance and Freight |
| CIT | Citizen Investment Trust |
| CPI | Consumer Price Index |
| CRR | Cash Reserve Ratio |
| DFID | Department for International Development |
| DRT | Debt Recovery Tribunal |
| EPF | Employees' Provident Fund |
| ERRDB | Eastern Regional Rural Development Bank |
| EWI | Early Warning Indicators |
| FOB | Free on Board |
| FWRRDB | Far Western Regional Rural Development Bank |
| FY | Fiscal Year |
| GDP | Gross Domestic Product |
| HMG | His Majesty's Government |
| IC | Indian Currency |
| IMF | International Monetary Fund |
| L/C | Letter of Credit |
| LMFF | Liquidity Monitoring and Forecasting Framework |
| $M_1$ | Narrow Money |
| $M_2$ | Broad Money |
| $M_3$ | $M_2$ with Foreign Currency Deposits |
| MFA | Multi-Fiber Agreement |
| NBL | Nepal Bank Limited |
| NDA | Net Domestic Assets |

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|---|---|
| NFA | Net Foreign Assets |
| NGO | Non Governmental Organization |
| NIDC | Nepal Industrial Development Corporation |
| NPA | Non Performing Assets |
| NRB | Nepal Rastra Bank |
| OMO | Open Market Operations |
| PRGF | Poverty Reduction and Growth Facility |
| PRSP | Poverty Reduction Strategy Paper |
| RBB | Rastriya Banijya Bank |
| RDB | Rural Development Bank |
| RER | Real Exchange Rate |
| RM | Reserve Money |
| RRDB | Regional Rural Development Bank |
| Rs. | Rupees |
| RSRF | Rural Self-Reliance Fund |
| RWA | Risk-Weighted Assets |
| SAFTA | South Asian Free Trade Area |
| SFDB | Small Farmers Development Bank |
| SFDC | Small Farmers Development Cooperation |
| SLF | Standing Liquidity Facility |
| TT | Telegraphic Transfer |
| VRS | Voluntary Retirement Scheme |
| WRRDB | Western Regional Rural Development Bank |
| WTO | World Trade Organization |
| SAARC | South Asian Association for Regional Cooperation |

# Monetary Policy for FY 2004/05

## Background

1. The economic liberalization process ushered during the nineties enhanced the private sector initiatives in the development of the financial sector in addition to contributing to the structural reform as well as the qualitative and quantitative growth of this sector. However, due to the non-economic incidents that occurred both domestically and internationally in the recent years, the expansion of the private sector slowed, resulting in an adverse impact on the real sector as GDP at producers' prices contracted by 0.6 percent in FY 2001/02. With the recovery in the global economy, the global output is expected to grow by 4.6 percent in 2004. Of the neighbouring economies, while the growth of Indian economy is estimated at 8.2 percent, the Chinese economy is estimated to grow by 8.5 percent in 2004. As against this, due to the adverse internal security problem the Nepalese economy is expected to register a modest growth of 3.7 percent in FY 2003/04 albeit an improvement over 3.1 percent growth in FY 2002/03. Despite the adverse situation, the Nepal Rastra Bank (NRB) is effortful for creating an environment for sustainable economic development through price stability, strengthened balance of payments (BOP), secured, healthier and efficient payments system and reform and promotion of the banking and financial system.

2. In the context of the favorable macroeconomic indicators and based on the concept of competitive financial system, the NRB has been implementing the policy of monetary easing so as to provide dynamism to the economy. In the light of the global experience that a strong, well-managed, and efficient financial system would contribute positively to the sustainable development

of the economy, the NRB has set its priority in devising and implementing appropriate legal, regulatory, managerial, and supervisory policies and provisions aimed at building a sound and stable financial sector. In addition, the process of modernization and structural reform of the NRB has been continuing so as to make it a modern, dynamic, and effective central bank, whereby it would discharge its responsibility of maintaining overall economic stability through the strong and effective monetary, foreign exchange and financial policies.

3. The NRB, as an authority of the financial sector, has fully embraced the existing challenge for further liberalizing the economy and strengthening its regulatory and supervisory roles in the context of Nepal's entry into the World Trade Organization (WTO) on April 23, 2004. Given the process of financial liberalization and upcoming challenges for the economy in developing efficiency in financial institutions from both the capital and regulatory perspectives, the NRB will further intensify its current activities. The Nepalese entrepreneurs will face tough challenges after the expiry of the Multi-Fiber Agreement (MFA) or quota system effective January 1, 2005. Under the compulsory circumstances of further opening up and strengthening of the financial sector, bank and financial institutions also need to become competitive in the open environment by enhancing their capacities. In this context, NRB is strongly moving ahead in initiating reforms in the financial institutions, emphasizing on appropriate regulatory and supervisory measures and providing operational and managerial autonomy. Adequate time will be provided to correct some serious malpractices, if observed in these institutions. In order to protect the interest of common depositors and investors, the NRB will even resort to serious actions to any extent against those who do not initiate the corrective measures.

4. The task of the monetary management has become more challenging following Nepal's entry into the WTO, SAFTA, BIMST-EC framework and acceptance of the PRSP and PRGF agreements with the World Bank and the International Monetary Fund (IMF), respectively. Since the banks and financial institutions are the transmission channels of monetary policy, it is important for the effective monetary policy management to ensure

that their financial health is sound and overall financial sector is stable.

5. Almost two years have passed since the management of the two commercial banks, the Rastriya Banjiya Bank (RBB) and the Nepal Bank Limited (NBL) which, taken together, occupy a significant portion of the Nepalese financial sector, was handed over to the foreign management teams in order to improve these banks' financial health. Taking into consideration the deposits of the general public with these banks and their contribution to the banking transactions, there still remains a challenge to attain the desired result from the reform work of these banks. In the context of speedily moving ahead the implementation of the financial sector reform programme initiated by HMG, the NRB is conscious and committed to the reform of these banks and there is no question of backtracking on reform. On this occasion, the NRB would like to express its view that there should be a proper utilization of resources received in terms of loans and grants. The challenges and problems in the Nepalese financial sector are grave and there is a need for the committed and continuous effort to address them appropriately. NRB, therefore, is of the view that the management contract of these banks with the majority of Nepalese experts and involvement of foreign experts should be continued for some more years. In this connection, a decision has been made to continue the management contract of NBL for one more year with a significant reduction in the expenditure.

6. In recent years, deposits with the commercial banks have increased significantly due to remarkable inflow of private sector remittances; however, the demand for bank credit has not increased proportionately. Since the development expenditure could not increase to the desired extent compared to the rise in the inflows of foreign aid resulting in the cash deposit of HGM/N with the NRB and the slower growth in the private sector credit leading to a significant deceleration in total domestic credit of the banking sector, the task of liquidity management and utilization of foreign exchange reserves has become challenging. In this context, there is a need to improve the monetary policy implementation strategy in order to maintain monetary balance and to make the monetary transmission network effective.

7. This Policy has been prepared as per the clause 94 of the NRB Act, 2002, and consists of four parts, Background, Monetary Policy for FY 2004/05, External and Financial Sector Reform Programmes for FY 2004/05, and Conclusion (Economic and Monetary Situation of FY 2003/04 and Review of Monetary Policy for FY 2003/04 are given in Appendix 1 and Appendix 2, respectively).

## Monetary Policy for FY 2004/05

8. While formulating the monetary policy for FY 2004/05, its objective has been clearly specified together with its strategy, instruments and implementation strategy to achieve the said objective. The monetary policy has been formulated in consistent with the Public Statement on HMG's Income and Expenditure for FY 2004/05.

### Objective of Monetary Policy

9. The primary objective of monetary policy for FY 2004/05 is to maintain price stability and to consolidate the BOP. The inflation is targeted at 4.0 percent while the BOP surplus is projected at Rs. 5.5 billion. With the inflation rate at 4.0 percent, there will be no unnecessary pressure on current exchange rate of the rupee and the real effective exchange rate will remain at the neutral level. As a result, the competitiveness of the Nepalese goods and services exports will remain favorable. Similarly, if the BOP surplus is maintained at the level mentioned above, the foreign exchange reserves of the NRB will be able to finance merchandise imports of 6.5 months. The target of monetary policy is to maintain the aforesaid objectives at a desired level in order to facilitate the economic growth of at least 4.5 percent in FY 2004/05. In this regard, special emphasis will be given to the implementation strategy of monetary policy to maintain overall economic stability.

### Strategies of Monetary Policy

10. Of the monetary aggregates, broad money ($M_2$) has been projected to increase by 12.5 percent for FY 2004/05 as compared to the increment of 13.5 percent in FY 2003/04 (Appendix 3). The money demand arising from the projected 4.5 percent economic growth in FY 2004/05 as compared to 3.7 percent economic

growth in FY 2003/04 will be met from the liquidity overhang of FY 2003/04 to some extent. In this context, $M_2$ growth projection at 12.5 percent for FY 2004/05 as compared to the 13.5 percent growth in FY 2003/04 has been expected to keep inflation in check.

11. For FY 2004/05, growth rate of narrow money ($M_1$) has been projected at 10.5 percent compared to the 9.5 percent of FY 2003/04. To achieve the projected economic growth of 4.5 percent, the 10.5 percent growth rate of $M_1$ has been considered to be necessary and sufficient.

12. Among the factors affecting money supply, monetary sector's net foreign assets (NFA after adjusting foreign exchange valuation) has been projected to increase by Rs. 5.5 billion (5.2 percent) in FY 2004/05 while it increased by Rs. 14.5 billion (15.9 percent) in FY 2003/04. Although the private sector's remittances have been projected to continue to increase, the growth of NFA has been projected to be lower than that of FY 2003/04 owing to the likely expansion in imports in FY 2004/05.

13. The monetary sector's net claims on government has been projected to increase by Rs. 7.0 billion (11.2 percent) in FY 2004/05, though it remained negative in FY 2003/04. Similarly, the monetary sector's claims on private sector has been projected to rise by 15.0 percent in FY 2004/05 as compared to the 10.5 percent growth in FY 2003/04. Based on the assumption that monetary sector's claims both on the government and the private sector will increase, domestic credit is projected to go up by 13.3 percent in FY 2004/05 as compared to the rise of 7.8 percent in FY 2003/04.

14. The excess liquidity of commercial banks will be taken as the operating target of monetary policy for FY 2004/05. In order to monitor and forecast short-term liquidity position, the liquidity monitoring and forecasting framework-LMFF-(Appendix 4) has been made operational with effect from July 15, 2004. To facilitate the same task, an inter-departmental liquidity monitoring working group has already been formed. A high-level monetary management committee has also been constituted to provide

policy guidelines in different aspects of monetary management including the operations of the LMFF.

**Reforms in Monetary Policy Instruments and Implementation Strategy**

15. The existing provision of taking the bank rate as an indication of monetary policy stance will continue until the completion of financial sector reform programme and full-fledged development of secondary open market operations. The bank rate has been kept unchanged at 5.5 percent in the context that some central banks have raised their bank rates, the price situation has not been fully brought under control, and there exists a challenge of managing the liquidity in the economy for the medium term.

16. The refinance rate for rural development banks and export credit in domestic currency including agricultural credit has been revised downwards to 3.0 percent from 4.5 percent. The refinance rate for export credit in foreign currency is kept unchanged at 2.0 percent, with a provision that the commercial banks charge not more than 4.0 percent to the borrowers of this facility.

17. Among the various monetary policy instruments, the cash reserve ratio (CRR) is being used as a prime and effective instrument to inject liquidity to and absorb liquidity from the economy. The CRR, which has been used particularly for last few years to reduce the cost of resources of commercial banks and to manage necessary liquidity in the economy, has been gradually lowered in the neighboring countries as well as the majority of the countries in the world in complement to the prevalent use of indirect monetary instruments and prudential regulatory measures. In this context, the CRR has been reduced from 6.0 percent to 5.0 percent for FY 2004/05. This policy change will release additional resources of Rs. 2.0 billion which will help reduce the financial intermediation cost to some extent. As soon as the existing adverse situation in the country improves, the possible increment in aggregate demand is expected to be supplemented by this provision.

18. In order to monitor and analyze the monetary situation, a third monetary aggregate will be compiled by incorporating foreign currency deposits. This third monetary aggregate will be termed as

$M_3$ ($M_2$ with foreign currency deposits) as depicted in Appendix 5. $M_3$ will be taken as a measure of broad monetary liquidity.

19. For the last one decade, open market operations (OMO) are being used as the flexible short-term monetary instruments. The auction of treasury bills in primary as well as secondary market and repo transactions are being undertaken under the OMO. Based on the yield curve, the quantity of sale and purchase in secondary market is currently determined by the market. Likewise, the repo rate is fixed by adding 0.5 percentage point to the market-determined simple average of weighted average rate of 91-day treasury bills in the latest four auctions. Under the existing provision, the NRB fixes rates based on the market that ultimately determines the quantity in secondary market transactions. The NRB mops up liquidity through outright sale in the secondary market if commercial banks bid below the rate as shown by the yield curve, whereas it injects liquidity through outright purchase after adding some percentage points (currently 2.0 percentage points) to the yield curve rate. In addition, the NRB has been absorbing liquidity through the tap sale. All these existing OMO provisions have been abolished. The NRB, from now on, will fix the quantities for outright purchase auction, sale auction and repo auction based on LMFF and depending upon the trends of monetary targets. The secondary market interest rate will be determined by the market, based on the quantities fixed for such transactions. Earlier, the commercial banks used to take initiative for open market transactions. From now onwards, the NRB will take initiative on the basis of liquidity position in the economy. This new provision will help make the process that was initiated in September 1989 more market-determined.

20. Treasury bills with different maturities (28-day, 91-day, 182-day and 364-day) will be opened for outright purchase and sale in the secondary market. However, priority will be given to the issue of short-term treasury bills so as to influence the overnight inter-bank rate and make the secondary OMO more effective. In the secondary market outright sale and purchase, the time framework for repayment does not arise because of the changes in ownership but the maturity period of repo under the secondary market

auction transaction has been kept unchanged from the existing 1 to 7 days.

21. Secondary market sales auction will be used to mop up the excess liquidity from the commercial banks and secondary market purchase auction and repo auction will be used to provide liquidity to the commercial banks.

22. The standing liquidity facility (SLF) provided by the NRB to the commercial banks for 1 to 7 days to meet their short-term liquidity requirement through repo has been abolished. Instead, a separate SLF has been arranged. Currently, the quantity of the SLF will be determined on the basis of the total securities of HMG under the ownership of commercial banks. The quota of total SLF will be set for each of the commercial banks on the basis of the above-mentioned criterion. The SLF will be provided to the commercial banks at their initiative.

23. Loan under the SLF will be automatically made available and it will be fully collateralized. The collateral for this type of loan will be treasury bills and development bonds of HMG. Under this provision, the loan will be provided up to 90 percent of the face value of the collateral. As the SLF is the alternative to the secondary market sale of treasury bills and inter-bank (money) market borrowing, the rate on such facility will be a penal rate. Therefore, with a view to check the misuse of the facility and prevent adverse effect on secondary market and inter-bank transactions, the open market operations committee will fix the rate on such facility by adding certain percentage point on the last auction rate of 91-day treasury bills. The maturity period of SLF will be 1 to 5 days.

24. As per the new provision, the auction rate of secondary market outright sale will act as a floor rate in short-term money market, whereas the rate determined under the SLF will act as the ceiling rate. These two rates would act as a tunnel under which the inter-bank transaction rate is especially expected to hover around.

25. As stated in the Public Statement on HMG's Income and Expenditure for FY 2003/04, the NRB made public the issue calendar for the mobilization of domestic borrowing by HMG so as to make appropriate management of monetary liquidity.

However, some difficulties arose in monetary liquidity management since the domestic loan could not be collected as specified in the issue calendar as the amount of domestic loan as budgeted was not required by HMG. Various distortions could emerge in the economy if monetary liquidity is not managed properly. Therefore, the NRB will request HMG to mobilize its total domestic borrowing for FY 2004/05 as per the issue calendar of the NRB.

26. As per the provision in the NRB Act, 2002, except for monetary management purposes, the government securities under the ownership of the NRB should not exceed 10 percent of the net revenue of the preceding year. While the NRB is required to sell the government securities in excess of the amount as prescribed in the Act on the one hand, non-marketable securities of Rs. 864.0 million comprising special bond 2004 'Ga' amounting to Rs. 123.8 million, special bond 2004 amounting to Rs. 555.2 million, and special bond 2004 ‘ka’ amounting to Rs. 185.0 million are under the ownership of the NRB on the other. The NRB will further request HMG for permission to convert such non-marketable government securities into marketable ones so as to keep government securities under the statutory limit and to facilitate the task of mopping up of the excess liquidity of the commercial banks.

27. Currently, HMG does not provide government enterprises guarantee for bank loans. However, some loans used by the government enterprises under government guarantee in the past are yet to be repaid. The interest rate charged on such loans being higher than the current market interest rates has led to the successive increase in the interest obligation of such enterprises over the years. If the total loan including principal and interest under such guarantee is converted into short-term securities and is made marketable, the future loan obligation of the government will be reduced due to the existing low short-term interest rates. The financial position of the banks will also improve when they receive these amounts. The NRB will have extra securities in open market for liquidity and monetary management. Therefore, the NRB will request HMG to issue ad-hoc treasury bills equivalent to the said loan amount. A provision will be made to cancel the

proposed securities from the date the government enterprises repay the principal and interest of the loan.

28. From FY 2004/05 onwards, development bonds of HMG will be issued in the primary market by the auction and the secondary market transactions will be opened through Nepal Stock Exchange Limited. These development bonds will be issued as coupon bonds and an arrangement will be made to issue these bonds on a uniform price through price auction. As these bonds will be opened through the Stock Exchange in the secondary market, the NRB will not provide liquidity directly against such bonds. However, an arrangement will be made to accept these bonds as a collateral for repo transaction and to provide standing liquidity facility to the commercial banks (clause Nos. 21 and 23).

29. The policy arrangement of allocating 5 percent of the profit of the NRB to the Rural Self-Reliance Fund (RSRF) will be continued in order to provide institutional credit in rural sector and to facilitate the national priority sectors in raising the long-term capital. HMG, through its Public Statement on Income and Expenditure for FY 2004/05, has already made an arrangement to provide an additional fund of Rs. 20.0 million to the RSRF.

30. The positive efforts and contributions of the NRB alone will not be sufficient to overcome the problems relating to structural, institutional and comparative benefits of industrial sector. However, taking into consideration the slackness of the industrial sector, the arrangement of providing refinance for sick industries is continued in order to support and facilitate the rehabilitation of the industries. Since FY 2001/02, an arrangement of the refinance amounting to Rs. 2.25 billion was made for commercial banks and development banks for the rehabilitation of sick industries. Of this refinance amount, Rs. 635.1 million was sanctioned for industries, including those in the industrial districts in FY 2003/04, as of mid-July 2004. Through this provision, 114 hotels and 32 industries have benefited in the form of interest subsidy of Rs. 62.1 million during the past three years. In this context, for the current FY 2004/05, refinance facility of Rs 1.0 billion is arranged following the same criteria and procedures. The refinance rate for this facility has been revised downwards to 1.5 percent from the existing 2 percent. When the commercial banks utilize such

refinancing facility, the interest rate for the borrower would have to be maintained at 4.5 percent. The progress relating to the implementation of this arrangement will be monitored every three months.

## Financial and External Sector Reform Programmes for FY 2004/05

31. With a view to expanding financial intermediation and enhancing financial sector stability, health and efficiency, thereby ensuring the effectiveness of monetary policy, the following programmes will be implemented during FY 2004/05. The objective of these programmes is the gradual liberalization of the financial sector and the external sector as well as the proper utilization of the foreign exchange reserves for the economic development of the country.

### Reforms in Financial Sector

32. Under the financial sector reform programme, the process of restructuring the NBL and the RBB, the reengineering of the NRB and the overall capacity building in the financial system need to be further enhanced and made effective. Taking into consideration the fact that the time-frame for bringing these problem commercial banks back into normal position by completing the task of their restructuring could range up to 4 to 5 years, the policy of utilizing in a cost effective way the financial assistance of the World Bank and the DFID will be initiated.

33. Under the NRB's reengineering, work relating to making the organizational structure scientific, right-sizing the human resource component and enhancing the productivity of the NRB is ongoing. In order to reduce the operating cost all the NRB committees, except those constituted as per the statutory requirement, are now made allowance-free. The overtime allowances have been cut down. Garden maintenance and cleaning activities have been outsourced. Provision is made for employees to use economy-class concessional fare air-tickets while traveling abroad. The execution of such cost effective measures is expected to save an annual sum of Rs 250.0 million. On the contrary, commercial banks and financial institutions have been observed to have not done the needful to reduce their operating costs. The NRB,

therefore, is of the view that they also need to take necessary measures to reduce their operating costs.

34. As per the NRB's directives, commercial banks and financial institutions are required to sell their equity investments in other banks and financial institutions by mid-July 2004. In this context, for FY 2004/05, commercial banks are directed to maintain cent percent provision for any unsold equity investment except those investments that are prohibited to be sold under the prevailing law.

35. To catalyze the private sector initiative for investment on socio-economic infrastructural development projects related to water resources, education and health on the basis of economic feasibility, policy will be formulated for encouraging the commercial banks to invest in such projects.

36. In the context of the issuance of the Banks and Financial Institutions Ordinance, 2004, regulations and directives that were issued separately for banks and financial institutions will be revised and issued in an integrated way.

37. In order to manage the credit information system of banks and financial institutions, to extend necessary information to the concerned parties, to prepare and update the black-list of credit misusers and to broaden the scope of credit information, the existing Credit Information Bureau (CIB) will be replaced by a new CIB in the firm of a company in the current fiscal year.

38. For making the legal structure pertaining to banks and financial institutions up-dated, strong and convenient for the purpose of making bank and financial sector transactions healthy, secured and sound, the draft ordinances relating to Assets Management Corporation (AMC), anti-money laundering, secured transactions, and insolvency have been prepared and submitted to HMG. HMG has also expressed its commitment through the Public Statement on HMG's Income and Expenditure for FY 2004/05 to formulate and implement the legal provisions relating to the secured transactions, insolvency and anti-money laundering during this fiscal year.

39. Taking into consideration the prevailing adverse situation, capital adequacy ratio (CAR) to be maintained by the banks and financial

institutions on the basis of risk-weighted assets (RWA) will be continued at 11.0 percent, with core capital at 5.5 percent, for FY 2004/05 in place of the previously fixed ratio of 12.0 percent. Banks and financial institutions would be required to maintain such ratio at 12.0 percent, with effect from FY 2005/06.

40. Arrangement has been made for the regulation, inspection and supervision of the small farmers cooperatives, previously under the supervisory purview of the NRB, through the Small Farmers Development Bank (SFDB). For the remaining cooperatives and non-bank financial institutions licensed, and presently inspected and supervised, by the NRB, an arrangement will be made to establish a separate, second-tier institution responsible for the supervision of these institutions. For the cooperatives established and operated under the Cooperative Act, 1991 a provision has been made in the Public Statement on HMG's Income and Expenditure for FY 2004/05 to make an institutional arrangement for their regulation, inspection and supervision. By this arrangement, it is believed that the task of regulation, inspection and supervision of such cooperatives will be institutionalized and consolidated.

41. The RSRF, presently operating under the management of the NRB, will be converted into a financial institution providing wholesale micro credit under the inspection and supervision of the NRB.

42. The demand for financial services in the rural area is increasing. However, the availability of banking and financial services in the rural area has been inadequate due to the deteriorating law and order situation. Under these circumstances, the expansion of micro-finance services seems to be a more reliable and accessible means so as to increase the access of the deprived people to the institutional credit. A National Micro-finance Policy will be formulated in FY 2004/05 since the Financial Intermediation Act, 1992, seems to be insufficient. Similarly, as there is an utmost need of alternative energy in the rural area, priority will be given to the establishment of rural micro-finance institutions and arrangements will be made to invest in alternative energy through these institutions.

43. In order to maintain financial discipline and make the tasks of inspection and supervision at par with the international standards, the procedures, policy and arrangement adopted for identifying, and minimizing, the risks of commercial banks and financial institutions will be reviewed. The international forum for inspection and supervision, Basel Committee on Banking Supervision, has made a provision for minimum capital fund (Basel II), effective from 2007. For the effective execution of the New Capital Accord (Basel II) in the context of Nepal, the concept paper prepared by the New Capital Accord Implementation Preparatory Core Committee will be continuously improved in accordance with the revisions made by the Bank for International Settlements (BIS).

44. In the context of significant expansion in the number and the growth of size, structure and transactions of the banks and financial institutions, it is felt that the supervisory capacity of the NRB should be made further sound, consolidated, simple, result-oriented, regular, transparent and effective. The existing task of inspection and supervision needs to be decentralized. Accordingly, from the beginning of FY 2004/05, a supervision office will be opened at Bharatpur in Chitawan district so as to begin the inspection and supervision for the banks and financial institutions situated in the districts under the Narayani, Lumbini, Gandaki and Dhaulagiri zones.

45. In order to refine the existing supervisory process, an evaluation of the effectiveness in the context of Nepal of the core principles prepared by the Basel Committee on Banking Supervision will be made in FY 2004/05. On the basis of the results obtained from such evaluation, the existing supervisory mechanism will be made sound and effective on a continuous basis.

46. In the process of revising the existing supervisory system of the NRB, the Supervision By-laws, 2003 have been formulated and implemented. As per the By-laws, the off-site supervision and on-site inspection of all the banks and financial institutions licensed by the NRB will be regularly conducted and arrangements will be made for their effective compliance.

47. The existing accounting system of the NRB will be amended also in consonance with the international criteria and the internationally recognized accounting system will be implemented so as to enhance the transparency of the financial position and operating condition of the NRB.

48. With regard to the restructuring of the Agricultural Development Bank (ADB/N) and the Nepal Industrial Development Corporation (NIDC) under the financial sector reform programme, the restructuring tasks under the Restructuring Plan submitted by the consultant for the improvement of the ADB/N will gradually be implemented. Similarly, in the case of the NIDC, necessary actions will be put in place in line with the decision made by HMG in this regard.

49. Structural reform process of the rural development banks that had started since 2002 will be continued. In this context, out of NRB's 66.75 percent share in the share capital of the Eastern Regional Rural Development Bank (ERRDB), Biratnagar, the privatization process of which has just started, a component of 56.75 percentage points will be transferred to the group members as well as the employees of the ERRDB and the general public. In this way, the privatization process of the ERRDB will be completed within FY 2004/05. Moreover, an alternative arrangement for strengthening the financially distressed Far-Western Regional Rural Development Bank (FWRRDB) will be made by evaluating the special voluntary retirement scheme (VRS) launched by the FWRRDB.

50. Timely reforms in the payments system in the banking offices of the NRB will be carried out in the context of the gradual modernization of the payments system. In this regard, a detailed study on clearing house management and improvement in the reconciliation process will be initiated.

51. In place of the present NRB practice of directly receiving from the public the soiled notes and exchanging them, this function will henceforth be handed over to the private sector. This new arrangement will involve the private sector in the note exchange function in addition to facilitating this function even in places where NRB offices are not located. Individuals or entities willing

to take up this work need to obtain NRB approval and the note exchange work will be carried out only through the approved individuals or entities.

**Reforms in External Sector**

52. Currently, there is an arrangement of providing exchange facility up to US$ 500 through commercial banks to individuals and institutions for different purposes. This arrangement helps smoothen the payments system in small amounts and facilitate the general public at large. To make this arrangement easier and more convenient, such limit will be revised upwards up to US$ 1,000 from the existing limit of US$ 500 from FY 2004/05.

53. Currently, there is an arrangement of providing the repatriation of air ticket relating to the Nepalese nationals visiting abroad (except India) for one time only within a fiscal year. To monitor the implementation of such arrangement, there is a provision of endorsing the passport of the Nepalese national and submitting the copy of such endorsement to the NRB. The volume of paper-work these days is rapidly increasing due to the increase in the number of the Nepalese nationals visiting abroad. As the current monitoring process regarding the repatriation of air tickets seems cumbersome, an arrangement for automatic payment of such repatriation will come into force effective from FY 2004/05. All the Nepalese visiting abroad as well as the concerned travel agencies and the airlines are expected to benefit from this arrangement.

54. The existing provision allows only specified Nepalese officials visiting abroad to purchase business class air tickets, and repatriation is made for such tickets. In the background of the evolving liberal stance of the foreign exchange management policy, the current restriction on the business class air ticket for the travel abroad by the Nepalese nationals has been eliminated. As a result, the concerned individuals will be free to choose the type of air ticket.

55. While opening letter of credit (L/C) and paying convertible foreign currency for the import from abroad (except India), if the cheques issued to the concerned customs office as the margin at 10 percent of the foreign currency amount had to be cancelled, it

could only be done on the approval of the NRB as per the existing provision. This arrangement has been substituted by a new arrangement whereby the commercial banks could themselves cancel such cheques by following the prescribed procedures. Import business is expected to benefit from this procedural refinement.

56. There is an arrangement of exporting abroad (except India) on the basis of advance payment certificate issued by the concerned commercial bank. In case the exporter is not able to export during the six-month maturity period of such certificate, NRB approval is presently required for extending the time period. From now onwards, arrangement will be made for the concerned commercial bank itself to extend the maturity period if the period does not exceed three years from the date of the issue of the certificate. Export based on the advance payment certificate would be benefited from this procedural refinement.

57. If any amount collected in the foreign agency account of the commercial banks could not be paid for some reason, the remitting bank would demand refund of such amount. Under the existing arrangement, NRB approval is required for remitting the sum if it amounts to US$ 2,000 or more. From now onwards, arrangement will be made to remove such limit and to remit such sums by the concerned commercial banks themselves.

58. When an agency based in Nepal purchases goods and services, payment for such purchase is made to the seller in foreign currency, as per the existing rules. According to the existing arrangement, permission of the NRB is necessary to issue bank guarantee (bid bond, performance bond, etc.) in convertible foreign currency by the seller in the name of the buyer. Effective FY 2004/05, such bank guarantee may be issued by the commercial banks themselves.

59. Foreign exchange sector has been more liberalized since 1991. In this context, effective FY 2004/05, arrangement has been made whereby the exchange facility required by the various government institutions, councils and other bodies would be provided directly by the commercial banks after completing the procedures

specified by the NRB. This arrangement is expected to be beneficial to the different bodies that require foreign exchange.

60. As per the existing provision, individuals or institutions having convertible foreign currency deposit accounts in commercial banks are not eligible to make payment in foreign currency in Nepal. From now onwards, this restriction will not be applicable if the recipient is a government body.

61. The provision of making exports through cash against document (CAD) has been undergoing timely revisions. Prior to now, exporters were allowed to make exports up to US$ 100,000 through the CAD mechanism by maintaining 10 percent of export value as bank guarantee. From now onwards, the guarantee ratio is revised downwards to 5 percent, which is expected to reduce the cost for the exporters.

62. The internet-based E-commerce and E-payment systems, under which payments are made through the credit cards, are increasingly getting popular these days. However, due to the lack of a cyber law, the Nepalese commercial banks are facing practical difficulties in such payments. In this context, arrangement has been made whereby the commercial banks are allowed to make the E-payments by means other than the credit cards. Individuals requiring E-payment facility under the existing arrangement would be benefited from this step.

63. Under the existing arrangement, the maximum period that the commercial banks could invest convertible foreign exchange received under the foreign currency deposit accounts of individuals and institutions is one year. From now onwards, this limit is removed. Through this arrangement, commercial banks would obtain more flexibility in mobilizing their foreign currency reserves.

64. Of the cash US dollars submitted by the commercial banks to the NRB, 98 percent, after deducting 2 percent, has been deposited in the US dollar account as maintained in the NRB by the respective commercial banks. Effective from this fiscal year, the following arrangements will be implemented in the case of convertible currencies other than the US dollar:

(a) The amount of rupee will be counted at the existing buying rate.

(b) After deducting 2 percent, 98 percent of such rupee amount will be deposited in the US dollar account of the commercial banks.

(c) For this purpose, the buying rate of the US dollar will be used.

(d) As there will be no need for the commercial banks to maintain foreign currency accounts other than the US dollar account, all such other accounts will be closed.

65. If an individual has obtained foreign currency credit card under the existing provision, such individual from now onwards could utilize the foreign currency available, under the allowable exchange facility, in the form of credit card/debit card in addition to the cash or the travelers' cheque. Besides, on the conditions of foreign currency reconciliation later on, if the commercial banks so wish, a policy provision of issuing credit card/debit card with an expenditure limit of US$ 5,000 will be made. This arrangement will be beneficial to individuals traveling abroad with credit card/debit card.

66. As there has been no separate exchange facility available for transportation, imports from abroad (except India) have been made only on the basis of CIF. Also taking into consideration the operationalization of the dry port in Birgunj from this fiscal year, separate exchange facility will be available for importers on FOB basis. In view of this arrangement, various options in the area of freight management will be available to the importers for making imports on competitive basis.

67. If a Nepal-based licensed agent/representative of any money transfer company situated abroad needs bank guarantee for the purpose of receiving advance payment from the principal company, a policy provision of making such facility available, within the specified limits, directly from the commercial banks will be initiated in FY 2004/05. This provision is expected to facilitate the licensed agents in making immediate payments of the remittance to the concerned parties.

68. The number of groups of the commodities that can be imported from India through the payment of the convertible foreign currency has reached 39 since this provision was operationalized in FY 1992/93. This policy, by reducing the cost for the importers, has also contributed to the industrialization process. Similarly, there has been a positive impact on the import-based export industries on account of the comparatively lower price of the raw materials used by such industries and the increase in their competitive capacity. Moreover, consumers have benefited as the price of the domestically-consumed goods has been lowered to some extent. In view of these considerations and taking into account the foreign exchange reserves, the currency mix, etc., the number of the commodities that could be imported from India through the payment of the convertible currency will be expanded in FY 2004/05 as such a provision does not seem to have had an adverse impact on the economy.

69. As in other central banks, some portion of the gross foreign exchange reserves of the NRB is in the form of the gold, some portion of which is held at banks abroad and some within the country. In conjunction with the development of financial markets, NRB has been earning interest over the years through gold deposits abroad like other international reserves. Within the past 12 years, the NRB has earned US$ 4.0 million from such investment. In this context, a policy provision of investing the gold stock lying idle with NRB and earning interest from it will be made in this fiscal year. To invest in the international market, the purity and size of the gold should be that of the international standard. However, most part of such gold stock in Nepal is not as per the international standard. So, the NRB is studying different alternatives of investing the gold and earning interest from it. Necessary steps will be taken on the basis of the findings of this study.

70. The bilateral cooperation and assistance agreement made between NRB and People's Bank of China two years ago aimed at facilitating the trade transactions between Nepal and People's Republic of China and not necessitating the Chinese nationals visiting Nepal to carry convertible foreign currencies, by providing limited convertibility to the Chinese Yuan. The renewal

process of such agreement for two more years is under way as both countries are benefiting from the transactions under the agreement. Taking into consideration the remarkable number of the Chinese tourists in the world tourism, the agreement is expected to attract the Chinese tourists towards Nepal.

71. There is no policy provision for Nepalese entities to invest and establish offices abroad because of the comparatively controlled foreign exchange management regime. In the light of the globalization and, especially, as Nepal has become a member of the WTO, in addition to opening the Nepalese market to the foreigners, it is also high time for opening the foreign markets to the Nepalese entrepreneurs. In this context, a policy provision about the alternative arrangements for the Nepalese entities to set up offices/representative offices abroad as well as to invest abroad will be formulated.

72. The facility of inter-bank buying/selling transaction in Indian currency (IC) was provided to the commercial banks in FY 2003/04 itself. In this context, a policy arrangement will be made in FY 2004/05 for the inter-bank lending/borrowing in IC.

73. Freedom of determining buying and selling rates of the convertible foreign currency has been provided to the commercial banks in the past. In this context, necessary arrangement will be made with respect to the corrections required on the basis of the study on the effects of the spread between the buying and selling rates as maintained by the commercial banks.

74. The foreign exchange reserve level of the NRB is gradually increasing owing to the country's favorable BOP over the years. As foreign exchange reserve is an important component of the national economy, it is important to make maximum use of this resource through its appropriate management. From this viewpoint, necessary steps will be taken following further study in this area.

## Conclusion

75. Despite the adverse law and order situation prevailing in the country, the macroeconomic indicators have remained satisfactory. However, the microeconomic indicators have not remained so. In

the light of this overall economic situation, the monetary policy for FY 2004/05 has been formulated with a central focus on the challenges of maintaining monetary balance and financial sector stability. In the current background of the rapid expansion of the banks and financial institutions network along with the financial sector liberalization, the implementation of this monetary policy will enhance the effectiveness of the NRB to undertake appropriate regulation, supervision and monitoring responsibilities for the qualitative development of the financial sector. As monetary policy implementation strategy becomes strong and transparent, it assists in bringing about economic and financial stability in a dynamic context. The various programmes of external sector reforms adopted for the purpose of accelerating the utilization of foreign exchange reserves will enhance the effective utilization of national resources. This policy is expected to facilitate the mobilization of resources and their utilization in the productive investments so as to expedite economic development by bringing about stability and credibility in the policies pertaining to monetary, foreign exchange and financial sectors. For the successful implementation of this policy, NRB looks forward to the continuous cooperation from HMG, donor community, banks and financial institutions, and the general public as usual.

Thank you.

**Appendix 1**

# Economic and Monetary Situation of FY 2003/04

1. During FY 2003/04, the overall indicators of macroeconomic stability had remained satisfactory and the economy was improving despite the low economic growth rate. While the inflation was under control, foreign exchange reserves of the country reached a high level due to significant surplus in the BOP. However, the microeconomic indicators were not satisfactory. Due to the sluggish external demand for goods and services, domestic production, tourism, banking sector and employment had been adversely affected. Although the budget deficit was under control, there was no improvement in the expansion of the development expenditure as desired. Despite some monetary expansion while compared to the previous years, the monetary situation remained under control.

2. Some improvement in output was noted in FY 2003/04 as GDP at producers' price increased by 3.7 percent compared to the 3.1 percent increase in FY 2002/03. The increase in GDP in FY 2003/04 was primarily due to the favorable weather condition and some improvement in the services sector. Of the total GDP, the primary sector registered an increase of 3.7 percent in FY 2003/04 compared to the 2.5 percent increase in FY 2002/03. In contrast, the secondary sector decelerated by 1.8 percent in FY 2003/04 compared to an increase of 2.3 percent in FY 2002/03. The tertiary sector posted an increase of 4.2 percent in FY 2003/04 as compared to the rise of 3.3 percent a year earlier.

3. While analyzing the GDP from the demand side, total domestic demand at current prices grew by 9.0 percent in FY 2003/04 compared to a growth of 9.8 percent in FY 2002/03. Of the total domestic demand, the private sector consumption expanded at a rate similar to that in FY 2002/03 whereas investment by the private sector plummeted considerably. Although the total

government expenditure expanded, the share of the development expenditure in the total expenditure was low, leading to an insignificant role of the development expenditure in enhancing the productive capacity of the economy. The deceleration in investment of the private sector was also not a good indication for future economic growth. While there was no anticipated improvement in the private sector and government's capital expenditures, the external demand for the Nepalese goods and services was also decreasing. For instance, net exports of goods and services declined by 10.6 percent in FY 2003/04 compared to a decline of 27.2 percent in FY 2002/03. The continuous decline in the net exports of goods and services has adversely affected not only the GDP, employment and the banking sectors but also the associated foreign currency earnings.

4. Private sector remittances played an instrumental role in the external sector stability of the economy. Despite the adverse internal peace and security condition and less than satisfactory improvement in the internal economic activities, the private sector's remittances increased significantly due to the rising trend of the Nepalese going abroad for foreign employment during the last few years. While Nepal received remittances equivalent to Rs. 36.8 billion in FY 1999/2000, the remittances showed an increasing trend in the subsequent years and reached Rs. 54.2 billion in FY 2002/03. Remittances showed an upward trend in FY 2003/04 also. While the services sector had been playing a prominent role in meeting the significant portion of the trade deficit till the past few years, the role of the private sector's remittances has become paramount in the recent years. Although arrangements were made for the establishment of money transfer agencies as well as the provision of other facilities so that the private sector's remittances are routed through the official channel, a significant portion of such income is estimated to have come through the unofficial channel. If more remittances were to come through the official channel, this would contribute more to the national economy.

5. The average inflation rate, based on the consumer price index (CPI), was estimated at 4.0 percent for FY 2003/04. The average inflation rate was 4.8 percent in FY 2002/03. The average

inflation rate for FY 2003/04 was lower than the projected rate of 4.3 percent primarily due to the favorable weather conditions, which prevented the rise in the prices of food products, and the decline in the prices of imports, especially imports of food items from India owing to favorable weather conditions in India. With regard to asset prices, the NEPSE index, which was 204.86 in mid-July 2003, increased to 226.61 in mid-July 2004. The real estate price index has not yet been prepared. However, the rise in the inflow of private remittances, increasing migration from the rural areas to the urban areas following the adverse law and order situation as well as the lack of adequate investment opportunities created an upward pressure on the price of the real estate in the urban areas.

6. On the external sector front, the export of the goods during the first eleven months of FY 2003/04 increased by 5.5 percent compared to the corresponding period of FY 2002/03. The import of goods increased by a higher rate of 10.3 percent, though lower compared to the 15.7 percent growth in FY 2002/03. Of the total exports, exports to India increased by 17.4 percent while exports to other countries declined by 8.1 percent Accordingly, imports from India and other countries went up by 12.0 percent and 8.1 percent respectively. Total trade deficit increased by 13.6 percent as compared to the 23.9 percent rise during the same period in FY 2002/03. Primarily owing to the upsurge in remittances and the loan assistance received from the World Bank under the PRSP, the surplus in the BOP stood at Rs. 14.8 billion during the first eleven months of FY 2003/04. Consequently, the gross foreign exchange reserve accumulated to Rs. 126.5 billion as at mid-June 2004, which is sufficient to finance 11.2 months' goods import and 9.3 months' goods and services import.

7. With regard to the exchange rate, it stood at Rs. 74.14 per US dollar in mid-July 2004 compared to Rs. 74.75 at the same date in the previous year, resulting in the 0.8 percent appreciation over the year.

8. Budget deficit, on cash basis, amounted to Rs 8.7 billion in FY 2003/04 compared to Rs.12.6 billion in FY 2002/03. Due to the higher growth in non-debt resources in relation to the total government expenditure, budget deficit in FY 2003/04 decreased

by 30.7 percent. Revenue increased by 10.1 percent and aggregated to Rs. 61.9 billion in FY2003/04. Similarly, the total expenditure reached Rs. 77.8 billion, reflecting a growth of 5.5 percent. The rate of increase of development expenditure was 12.2 percent and regular expenditure 3.1 percent. Total revenue and total expenditure in FY 2002/03 had risen by 11.5 percent and 2.0 percent respectively.

9. $M_2$ increased by 13.5 percent in FY 2003/04 compared to the rise of 9.8 percent in FY 2002/03. $M_2$ had been projected to grow by 11.2 percent in FY 2003/04; however, owing to the significant rise in NFA, it increased by more than the projected rate. $M_1$ grew by 9.5 percent in FY 2003/04 compared to the projection of 9.2 percent. During 2002/03, $M_1$ had gone up by 8.6 percent. Reserve money (RM), which had increased by 2.5 percent in FY 2002/03, grew by 10.6 percent in FY 2003/04. The higher estimated growth for RM in FY 2003/04 was attributed to the significant increase in NFA of the NRB.

10 The banking sector's credit to the private sector increased by 9.1 percent during the first 11 months of FY 2003/04. This credit had expanded by 11.2 percent during the same period in the previous year. Despite the comfortable level of liquidity in the banking system, the private sector credit growth was not found satisfactory due to the lack of improvement in the external as well as internal demand. Owing to the slower expansion of the bank credit, the utilization of foreign exchange reserves remained low despite the increment in such reserves. Difficulties encountered in the process of development activities as well as the expansion of the private sector resulted in lower level of utilization of international reserves, leading to their increased accumulation.

11. The monetary conditions in FY 2003/04 remained supportive to economic growth due to availability of required level of liquidity emanating from the expansion of NFA, low interest rates and stable financial situation. However, monetary sector's net claims on government (claims on government minus government's repayment of principal minus cash surplus) was negative at Rs. 5.7 billion during the first 11 months of FY 2003/04. During the same period last year, government's net borrowing from the monetary sector was Rs. 4.77 billion. Although the budget

estimate for domestic borrowing for FY 2003/04 was Rs. 11.8 billion, only Rs. 5.6 billion was mobilized. The government repaid the securities amounting to Rs. 6.3 billion that led to a net issue of securities amounting to a negative of Rs. 717.1 million.

12. As of mid-July 2004, altogether 315 financial institutions were in operation. They included 17 commercial banks, 20 development banks (performing micro credit as well as other transactions), 58 finance companies, 32 saving and credit cooperatives that were approved by NRB for undertaking limited banking operations, 44 NGOs that have received license from NRB to undertake financial intermediary transactions, 5 Regional Rural Development Banks (RRDBs), 2 national level development banks involved in providing wholesale credit to the institutions undertaking micro finance transactions, 18 insurance companies, and one each of the Employees Provident Fund (EPF), Citizen Investment Trust (CIT) and Nepal Stock Exchange Limited. Most of these financial institutions have confined their transactions to the urban or semi-urban areas due to the difficult situation for operating their business in rural areas. Although the financial saving mobilization has been facilitated due to the increased remittances, difficulty is experienced in liquidity management because of lack of adequate demand for the resources of the financial institutions. The ratio of the non-performing assets (NPA) of the government-owned RBB and NBL was about 60 percent and that of the commercial banking system as a whole 28.8 percent. The financial position of the ADB/N and the NIDC also remained worrisome.

13. To overcome the above-mentioned problems of the financial system, some preventive and curative measures were implemented. Introduction and implementation of financial infrastructural measures such as prudential regulation, corporate governance and financial legal reform were of the preventive nature while management contract and corporate reform of some banks were of the curative nature.

**Appendix 2**

# Review of Monetary Policy of FY 2003/04

## Ultimate Targets of Monetary Policy

1. The monetary policy framework was formulated with the objective of keeping average inflation rate at 4.3 percent and maintaining the BOP surplus at Rs. 2.0 billion, thereby preventing any depletion of the foreign exchange reserves. The average inflation remained at 4.0 percent due to satisfactory agricultural production both in Nepal and India, controlled money supply growth and appreciating trend of the Nepalese currency. By entering into the IMF's PRGF and the World Bank's PRSP arrangements, Nepal received Rs. 0.77 billion and Rs. 5.5 billion foreign loan under the PRGF and PRSP respectively. This, along with the upsurge in foreign aid, absence of pressure on imports as development expenditure could not expand as desired, and the increasing trend in private sector's remittances led to a considerable rise in the BOP surplus (Rs. 14.5 billion), resulting in a significant increase in international reserves.

2. The aim of monetary policy was to facilitate the economic growth of 4.7 percent with an effective liquidity management while maintaining price and BOP stability. Although the macroeconomic situation remained at a satisfactory level, the microeconomic indicators remained unsatisfactory due to difficult law and order situation facing the country. Similarly, although the development expenditure expanded in comparison to the previous year, it was not up to the desired level. Likewise, investment by the private sector could not go up. Thus, while domestic demand was sluggish, the external demand for the Nepalese goods and services did not improve as expected especially due to the decline in exports to the third countries. Consequently, only 3.7 percent GDP growth was achieved in FY 2003/04, less than the targeted GDP growth (4.7 percent). Despite the macroeconomic stability

and comfortable liquidity position, the targeted economic growth could not be attained due to the non-economic factors that affected the transmission channels of the monetary policy.

## Intermediate Targets of Monetary Policy

3. In the light of the monetary management objective of avoiding unnecessary pressure on the existing exchange rates so as to ensure that monetary balance or inflation did not go out of control, monetary policy for FY 2003/04 was directed at maintaining the real exchange rate (RER) at the constant level. Accordingly, the RER remained unchanged during FY 2003/04. Due to the appreciation of the Nepalese rupee vis-à-vis the US dollar in the recent times and the maintenance of existing fixed exchange rate of the Nepalese rupee with the Indian rupee for a long time, two arguments have been put forward for making adjustment in the exchange rate: (a) declining Indian currency reserves right after the signing of the Nepal-India Trade Treaty in March 2002 and (b) high rate of economic growth in India but not in case of Nepal, owing to adverse peace and security situation, leading to unequal growth rates between the two countries. Although there was a drop in the IC reserves because of increased inflow of convertible foreign exchange through banking channel, utilization of IC for importing petroleum products and the increase in import from India, the overall foreign exchange reserves remained at a high level. Inflation in Nepal remained lower compared to that in India, thereby helping maintain the RER at the comfortable level. This was the basis for maintaining the existing exchange rate between the Nepalese rupee and the Indian rupee. Due to the likely adverse impact on the prices and the possibility of instability in the monetary balance, the current exchange rate of the rupee with the IC has been kept unchanged.

4. To attain the above-mentioned ultimate goals of monetary policy for FY 2003/04, $M_1$ and $M_2$ were projected to grow by 9.2 percent and 11.2 percent, respectively. Based on the available data, $M_1$ is expected to rise by 9.5 percent or close to the target and $M_2$ is estimated to grow by (13.5 percent) higher than that targeted. The higher growth rate of $M_2$ is attributed to the significant rise in the NFA. Out of the banking sector's total domestic credit, the decline in net credit to HMG and the lower rate of growth of credit to the

private sector compared to the projected rate led to the deceleration in domestic credit.

5. In FY 2003/04, $M_1$ was expected to increase as targeted while NRB's net domestic assets (NDA), the operating target that helps in attaining the intermediate target, was expected to remain considerably lower than the target. Such a significant decline in NDA was attributable to the mopping up of excess liquidity of commercial banks through the sale in the secondary open market, of the of government securities under the holdings of NRB in order to keep the holdings within the legal limit.

## Status of Implementation of Monetary Policy Instruments

6. As stated in the Report on Monetary Policy for FY 2003/04, the CRRs with respect to the different types of domestic deposit liabilities were simplified and unified into a single CRR rate of 6.0 percent of the total domestic deposit liabilities of the commercial banks to be maintained with NRB. The provision of maintaining 2.0 percent balance in commercial banks' vault as part of CRR was withdrawn. The policy arrangement made it possible for the commercial banks to invest their fund in the government securities that led to the decline in the share of NRB's holdings of the government securities and thus helped control the expansion of RM.

7. With an objective of making the work of issuing government securities simple and transparent, attracting the investors to the government securities, and making it simpler for the commercial banks in their short-term liquidity management, the issue calendar was for the first time, placed on the web-site on August 20, 2003, as per the target of making public the issue calendar and posting it in the NRB's web-site with all the necessary information. As the development expenditure of HMG as compared especially to the domestic non-debt resources and foreign grants and loans did not go up as expected, there was no need of raising domestic borrowing as targeted in the budget.

8. With a view to providing additional financial instruments to the investors willing to invest in short-term government securities, 28-day and 182-day treasury bills have been introduced through the auction system on a regular basis since September 11, 2004.

Moreover, the 28-day, 91-day, 182-day and 364-day treasury bills auction has helped the interest rates to be determined by the market.

9. The existing provision of adding one percentage point to the rate determined as per the yield curve for outright purchase in the secondary market transaction was revised to two percentage points, effective from December 9, 2003. While fixing the repo rate, taking into consideration the situation of economic indicators instead of the earlier provision of taking the highest accepted rate out of the previous four auctions of the 28-day, 91-day, 182-day and 364-day treasury bills and adding 0.5 percentage points, effective from April 21, 2004, 0.5 percentage points was added to the average weighted discount rate of the latest four auctions of 91-day treasury bills.

10. HMG accepted, in principle, the auctioning of the long-term government securities. Accordingly, for developing the necessary legal framework, a draft on Primary and Secondary Market Transactions of Government Securities Regulation, 2004 was sent to HMG.

11. In order to prepare the basic infrastructure for the issuance of scripless government securities, a concept paper was prepared and submitted to HMG.

12. A penalty charged on shortfall up to 25 percent of the priority and deprived sector lending requirement as per the NRB's directive was waived for FY 2003/04.

13. The provision relating to the ceiling on lending rates of commercial banks not to exceed by 0.50 percentage points from the published rate was eliminated. The provision for commercial banks to maintain a maximum of one percent spread between buying and selling of the convertible currency was abolished as it was observed that the spread was maintained at the desired limit.

14. For the past few years, emphasis has been given on the use of the indirect instruments of monetary management. In this respect, a policy of gradually phasing out the priority sector lending was adopted though the deprived sector lending requirement would remain unchanged. However, with an objective of supplementing

the long-term credit flow to the rural areas, the NRB, as per the policy of depositing up to 5 percent of its profit to the RSRF, deposited to the Fund Rs. 174.8 million (Rs. 74.8 million out of its profit for FY 2002/03 and Rs. 100.0 million out of its profit for FY 2001/02) in the last two years. Moreover, for supplying long-term capital to national priority sectors such as tea cultivation and processing, a line of credit amounting to Rs. 100.0 million was approved for the ADB/N for FY 2003/04.

15. As timely reporting of monetary statistics is necessary for monetary management, it has also been clearly specified in Clause 74 of the Banks and Financial Institutions Ordinance, 2004 that banks and financial institutions that do not make data available on time will be penalized.

## Status of Financial Sector Reforms

### Financial Legal Reforms

16. As a special act is necessary for the establishment of the AMC in order to gradually reduce the bad loans of the banking sector, the draft ordinance pertaining to the AMC was prepared and submitted to HMG.

17. The existing CIB has been providing credit information to the commercial banks and a few national level development banks only. With a view to increase the coverage of the Centre by including the entire banking and financial sector, the process of establishing it as a company was initiated.

18. To manage credit information and regularize the blacklisting of defaulters on a timely basis though maintaining accuracy and appropriateness in the lending of commercial banks and financial institutions, a directive relating to the provision of credit information and blacklisting has been formulated and made effective since September 18, 2003.

19. After the establishment of the Debt Recovery Tribunal (DRT) on June 18, 2003 and its subsequent operation since July 17, 2003, 89 cases have been filed at the Tribunal to recover a sum of Rs. 847.1 million. Of the total, 29 cases amounting to Rs. 185.0 million have already been decided and Rs. 21.7 million recovered, and the

remaining amount has been under the recovery process. The trend of filing the cases with the Tribunal is continuing.

20. The Bank and Financial Institutions Ordinance was enforced since February 4, 2004. In the process of formulating the acts pertaining to the financial sector, the draft ordinances relating to Anti-Money Laundering, Secured Transactions and Insolvency were prepared and submitted to HMG.

**Reforms in Regulations, Inspection and Supervision**

21. For FY 2003/04, commercial banks were directed to maintain, on the basis of RWA, a minimum of 11 percent as capital funds, with the core capital at 5.5 percent. The majority of the commercial banks maintained their capital funds accordingly. Similarly, a directive effective from FY 2003/04 was issued whereby loan restructuring arrangement was kept unchanged and banks were directed to reschedule and restructure the loans themselves in case the minimum 25 percent of the interest accrued was not repaid

22. To make the supervisory role of the NRB more efficient, strong and transparent, the Off-site Supervision Directives was prepared and made effective since January 15, 2004. To make the off-site supervision more effective, data from the commercial banks are being received through on-line software and Early Warning Indicators (EWI) are being received on off-site basis. Banks are now submitting their work plans for the compliance with the directives issued, within 90 days of such issuance, based on the report following the completion of the on-site supervision. NRB has been undertaking the monitoring and inspection work in this connection on a regular basis.

23. Policy-based decision, necessary amendment to ‘Supervision Directives’ and arrangement relating to physical and human resource management were made for the opening up of a Supervision Office at Bharatpur of Chitwan District.

**Reengineering of Nepal Rastra Bank**

24. The organizational structure of the NRB has been changed under its reengineering work. Further, the functional duplication among the departments is eliminated and a new corporate structure has been formulated. Functions relating to human resource

management as well as updating the positions at the various departments based on the workload are in progress. The tasks pertaining to the first phase of reengineering have already been implemented and the second phase of the reengineering is at the stage of commencement. After the implementation of the first phase of the VRS, 102 employees took voluntary retirement under the second phase of the VRS.

25. Downsizing the Ilam office of the NRB was done under the organizational restructuring. The Bhadrapur office was closed while the Kankadvitta Exchange Counter was handed over to the NBL.

**Structural Reform of Regional Rural Development Banks**

26. With regard to the structural reform work of the RRDBs initiated in 2001, executive directors at some RRDBs were appointed through the open competition.

27. Under the ongoing reform of RRDBs as per the policy of handing over the profit-making RRDBs to the private sector, the process of transferring 51 percent of the NRB's share out of its 61 percent share in the WRRDB has begun. Accordingly, 35.18 percent share was sold in the first phase and the remaining 15.82 percent share is planned to be sold in the second phase.

28. As per the structural reform work of RRDBs, with a view to improving the financial position of the FWRRDB by downsizing the excess employees, the VRS scheme was implemented and 25 employees retired in FY 2002/03.

29. As per the ongoing five-year structural reform work of rural development banks, the ERRDB, Biratnagar, that made a profit in FY 2002/03, has been in the process of being privatized under the same modality as that in the WRRDB. Out of 67.75 percent share of NRB in this Bank, the process of transferring 57.75 percent share to the private sector and retaining 10.0 percent share by the NRB has begun.

**Status of External Sector Reforms**

30. In view of the reluctance of foreign exporters to make transactions in small amounts through the L/C on the one hand and the maximum charge being levied by the correspondent banks on the

other, the limit for importing at one time from third countries (excluding India) through Draft/TT was raised from US$ 3,000 to US $30,000. This arrangement was expected to reduce the charges payable by the Nepalese importers and act as an incentive to them.

31. Earlier, opening usance L/C under deferred payment or suppliers' credit was allowed only on imports of industrial capital goods from third countries on payment of convertible currency. Since the last fiscal year, this arrangement has been made applicable to all types of imports. The maximum period of one year of such usance L/C has been continued and the documents relating to this type of L/C could be discounted under the prevailing provisions if the commercial banks so desired.

32. With the intention of facilitating exporters, even in the absence of the L/C or prepayments, the existing limit of US $ 50,000 for exports through CAD mechanism at one time was raised to US$ 100,000 effective from FY 2003/04. The bank guarantee ratio required to be submitted by exporters for this purpose was reduced from 25.0 percent to 10.0 percent. This provision made a positive contribution by enhancing the export competitiveness through reducing the exporters' cost.

33. On the basis of the considerations like the structure of the foreign currency reserves of the country, the effect on value addition and competitiveness of the industries, the prospects for export promotion, etc., six additional groups of commodities were included in the list of the earlier 33 groups that could be imported from India through the payment of the convertible currency. This arrangement, through the lower cost of production for industries importing these commodities, is believed to have contributed positively to the industrialization process of the country.

34. The earlier one-time exchange facility up to US$ 2,000 and US$ 1,000 in a fiscal year on the basis of passport being provided to all the Nepalese nationals visiting abroad (except India) based on the categories of the countries was changed according to which the exchange facility up to US$ 2,000 was being provided for all countries (except India). It is believed that the Nepalese visiting abroad would be able to obtain the adequate amount of foreign

exchange in a simplified manner. Besides, this would be an additional step in the policy direction of further convertibility of the Nepalese currency.

35. Manpower agencies, engaged in sending the Nepalese nationals to work abroad and receiving service charge in foreign currency as per the prevailing rules, were included under the list of individuals or institutions entitled to open foreign currency deposit accounts. This has generated a positive impact on foreign employment promotion and remittance mobilization.

36. Despite the significant increase in the number of Nepalese going abroad for employment, the share of their earnings remitted through the formal banking channel has remained quite low. In this context, NRB has been adopting liberal policy for issuing licenses to the private agencies interested in the work of remittance. In FY 2003/04, the number of the agencies receiving license increased to 29 from 12 and these agencies also expanded their services domestically through sub-agents. In the process of providing such license, an additional 40 agencies received the letters of intent in FY 2003/04. The network of private agencies involved in remitting money has now spread to different countries where Nepalese citizens are working. This arrangement has made it easier and simpler for the Nepalese workers to remit their money. Moreover, the policy arrangement of exchanging at a rate of 15 paisa more per US dollar over the prevailing rate the money collected by these agencies has also been effective. As a consequence, the remittance amount sent by the Nepalese working abroad has increased significantly.

## Appendix 3

# Monetary Survey

Rs. in million

| Monetary Aggregates | 2002 | 2003 | 2004 | 2005 | 2002/03 | | 2003/04 | | 2004/05 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Jul | Jul | July[1] | July[1] | Amount | Per-cent | Amount | Per-cent | Amount | Per-cent |
| 1. Net Foreign Assets | 88419.1 | 91407.0 | 104990.5 | 110490.5 | 4363.5[2] | 4.9 | 14500.0[3] | 15.9 | 5500.0 | 5.2 |
| 1.1. Foreign Assets | 106996.3 | 109306.3 | 124803.4 | 130420.9 | 2310.0 | 2.2 | 15497.1 | 14.2 | 5617.5 | 4.5 |
| 1.2 Foreign Liabilities | 18577.2 | 17899.3 | 19812.9 | 19930.4 | -677.9 | -3.6 | 1913.6 | 10.7 | 117.5 | 0.6 |
| 2. Net Domestic Assets | 135569.1 | 154504.3 | 174146.6 | 203579.2 | 17559.6[2] | 13.0 | 18725.8[3] | 12.1 | 29432.6 | 16.9 |
| 2.1. Domestic Credit | 207322.9 | 228443.8 | 246243.3 | 279064.4 | 21120.9 | 10.2 | 17799.5 | 7.8 | 32821.1 | 13.3 |
| a. Net Claims on Govt. | 59576.5 | 62825.0 | 62395.0 | 69395.0 | 3248.5 | 5.5 | -430.0 | -0.7 | 7000.0 | 11.2 |
| b. Claims on Govt. Enter. | 14431.1 | 14661.9 | 17040.9 | 17840.9 | 230.8 | 1.6 | 2379.0 | 16.2 | 800.0 | 4.7 |
| - Financial | 11355.1 | 11828.7 | 14013.7 | 14313.7 | 473.6 | 4.2 | 2185.0 | 18.5 | 300.0 | 2.1 |
| - Non-Financial | 3076.0 | 2833.2 | 3027.2 | 3527.2 | -242.8 | -7.9 | 194.0 | 6.8 | 500.0 | 16.5 |
| c. Claims on Private Sector | 133315.3 | 150956.9 | 166807.4 | 191828.5 | 17641.6 | 13.2 | 15850.5 | 10.5 | 25021.1 | 15.0 |
| 2.2. Net Non-monetary Liabilities | 71753.8 | 73939.5 | 72096.7 | 75485.2 | 3561.3[2] | 5.0 | -926.3[3] | -1.3 | 3388.5 | 4.7 |
| 3. Broad Money | 223988.2 | 245911.3 | 279137.1 | 314069.7 | 21923.1 | 9.8 | 33225.8 | 13.5 | 34932.6 | 12.5 |
| 3.1. Money Supply | 77156.1 | 83754.1 | 91742.8 | 101377.2 | 6598.0 | 8.6 | 7988.7 | 9.5 | 9634.3 | 10.5 |
| Currency | 55658.3 | 56885.2 | 65137.4 | 69905.5 | 1226.9 | 2.2 | 8252.2 | 14.5 | 4768.1 | 7.3 |
| Demand Deposits | 21497.9 | 26868.9 | 26605.5 | 31471.7 | 5371.0 | 25.0 | -263.4 | -1.0 | 4866.2 | 18.3 |
| 3.2. Time Deposits | 146832.1 | 162157.2 | 187394.3 | 212692.5 | 15325.1 | 10.4 | 25237.1 | 15.6 | 25298.2 | 13.5 |

1 Projection

2 Adjusting the exchange valuation loss of Rs. 1,375.6 million.

3 Adjusting the exchange valuation loss of Rs 917.0 million.

**Appendix 4**

# Liquidity Monitoring and forecasting Framework

1. **NRB Foreign Exchange Transactions**
   a. *Foreign exchange interventions (in hard currencies):*
      Purchases +
      Sales -
   b. *Transactions in IC*
      Purchases +
      Sales -
      Change in IC balance
   c. *Unexplained*
      Net foreign assets of NRB
2. **Change in government overdraft (reduction -)/deposits (reduction +)**
   a. *Current transactions*
      Expenditure (Change) +
         Total expenditure (cumulative)
      Revenue (Change) -
         Total revenue
   b. *Financing transactions*
      Maturing government securities +
      New issue -
   c. *Unexplained*
3. **Changes in Claims on Government**
   Claims on government
   a. *Open market operations*
      Purchases +
      Sales -
   b. *Unexplained*
4. **Changes in Claims on Financial Institutions**
      Claims on financial institutions
5. **Changes in Other Private Sector Claims (net)**
   a. *Changes in claims (increase+)*
      Claims on private sector

*b. Changes in deposit (increase -)*

Other deposits

**6. Changes in Banks' Lending/Refinancing**

*a. Loans*

New loans +

Repayments -

*b. Repos*

New repos +

Maturing reops -

**7. Changes in Currency in Circulation (Reduction +)**

*a. Public*

Public (currency outside NRB)

**8. Changes in Other Items Net**

*a. Other assets (increase +)*

Other assets

*b. Other liabilities (Increase -)*

Other liabilities

**9. SUM 1- 8**

**10. Changes in Banks' Deposits (Increase +)**

Banks' deposits

**11. Changes in Required Reserves**

Required reserves

**12. Changes in Excess Reserves**

Excess reserves

## Appendix 5

# Monetary Survey with $M_3$

Rs. in million

| Monetary Aggregates | 2002 July | 2003 June | 2003 July | 2004 June[1] | Changes During the First Eleven Months of FY 2002/03 Amount | 2002/03 Percent | 2003/04 Amount | 2003/04 Percent |
|---|---|---|---|---|---|---|---|---|
| **1. Net Foreign Assets** | **88419.1** | **91606.1** | **91407.0** | **105244.8** | **2487.3**[2] | **2.8** | **14754.3**[3] | **16.1** |
| 1.1 Foreign Assets | 106996.2 | 111356.7 | 109306.3 | 127676.6 | 4360.5 | 4.1 | 18370.3 | 16.8 |
| 1.2 Foreign Currency Deposits | 17648.5 | 17904.9 | 17388.4 | 19036.4 | 256.4 | 1.5 | 1648.0 | 9.5 |
| 1.3 Other Foreign Liabilities | 928.6 | 1845.7 | 510.9 | 3395.4 | 917.1 | 98.8 | 2884.6 | 564.6 |
| **2. Net Domestic Assets** | **135569.2** | **149039.7** | **154504.3** | **165155.7** | **14170.2**[2] | **10.5** | **9734.9**[3] | **6.3** |
| 2.1 Domestic Credit | 207323.0 | 227257.6 | 228443.8 | 238769.9 | 19934.6 | 9.6 | 10326.1 | 4.5 |
| a. Net Claims on Govt. | 59576.6 | 64342.9 | 62825.0 | 57123.8 | 4766.3 | 8.0 | -5701.2 | -9.1 |
| b. Claims on Non-Financial Govt. Ent. | 3076.0 | 2857.8 | 2833.2 | 3552.6 | -218.2 | -7.1 | 719.4 | 25.4 |
| c. Claims on Financial Institutions | 11355.1 | 11790.0 | 11828.7 | 13361.2 | 434.9 | 3.8 | 1532.5 | 13.0 |
| i. Government | 11323.1 | 11758.0 | 11739.0 | 13220.6 | 434.9 | 3.8 | 1481.6 | 12.6 |
| ii. Non-government | 32.0 | 32.0 | 89.7 | 140.6 | 0.0 | 0.0 | 50.9 | 56.7 |
| d. Claims on Private Sector | 133315.3 | 148266.9 | 150956.9 | 164732.3 | 14951.6 | 11.2 | 13775.4 | 9.1 |
| 2.2 Net Non-monetary Liabilities | 71753.8 | 78217.9 | 73939.6 | 73614.2 | 5764.4[2] | 8.0 | 591.2[3] | 0.8 |
| **3. Broad Money ($M_2$)** | **223988.3** | **240645.7** | **245911.3** | **270400.5** | **16657.5** | **7.4** | **24489.2** | 10.0 |
| 3.1 Money Supply ($M_1$) | 77156.2 | 80696.8 | 83754.1 | 88232.3 | 3540.7 | 4.6 | 4478.2 | 5.3 |
| a. Currency | 55658.3 | 57613.6 | 56885.2 | 62449.3 | 1955.3 | 3.5 | 5564.1 | 9.8 |
| b. Demand Deposits | 21497.9 | 23083.2 | 26868.9 | 25783.0 | 1585.3 | 7.4 | -1085.9 | -4.0 |
| 3.2 Time Deposits | 146832.1 | 159948.9 | 162157.2 | 182168.2 | 13116.8 | 8.9 | 20011.0 | 12.3 |
| **4. Broad Monetary Liquidity ($M_3$)** | **241636.8** | **258550.6** | **263299.7** | **289436.9** | **16913.9** | **7.0** | **26137.2** | 9.9 |

1 Estimated.
2 Adjusting the exchange valuation gain of Rs. 699.7 million.
3 Adjusting the exchange valuation loss of Rs 916.5 million.