

Current Macroeconomic Situation

(Based on the Data of the First Ten Months of 2006/07)

Monetary Situation

Money Supply

1. In the first ten months of 2006/07, broad money (M_2) grew by 10.0 percent compared to a growth of 10.8 percent in the same period of the previous year. Despite the elevated level of expansion in net domestic assets, a substantially lower growth of net foreign assets (NFA) contributed to a slow down in the growth of M_2 in the review period.
2. Narrow money (M_1) expanded by 6.4 percent in the review period compared to the expansion of 9.9 percent last year. Time deposits, another component of M_2 , increased by 11.8 percent in the review period, which is marginally higher than the growth of 11.2 percent a year ago. A higher level of remittance inflows, although at decreasing rate, and continued expansion in services sector contributed to maintain marginally higher growth of time deposits in the review period.
3. Compared to a 19.0 percent (Rs 20.5 billion) growth last year, NFA, after adjusting foreign exchange valuation gain/loss, increased by a lower rate of 4.9 percent (Rs.6.9 billion) in the review period. A fall in export and deceleration in workers' remittances contributed to such a lower growth of NFA in the review period.

Total Domestic Credit

4. Domestic credit of monetary sector registered an expansion of 11.2 percent in the review period. Such credit had expanded by 9.1 percent in the previous year. Such a high growth of domestic credit in the review period was due to increase in credit flow to non-financial government enterprises and short-term placement in non-government financial institutions along with the improvement in credit flow to private sector.
5. Of the credit aggregates, monetary sector's net claims on government fell significantly in the review period. Compared to a fall of 1.5 percent in the previous year, such credit declined by 13.4 percent in the review period. The government maintained a cash balance of Rs 15.72 billion with Nepal Rastra Bank (NRB) on account of a higher revenue mobilization relative to the expenditure of the government. As a result, net claims on government registered a sharp decline in the review period.
6. Claims on non-financial government enterprises increased by 54.2 percent in the review period against a decline of 8.0 percent in the previous year. Additional bank credit availed to non-financial government enterprises such as Nepal Oil Corporation, National Trading Ltd, Nepal Food Corporation, Janak Education Material Center Ltd and Janakpur Cigarette Factory contributed to increase in claims on non-financial government enterprises in the review period.
7. Commercial banks have increased short-term placement in financial institutions, particularly, in finance companies in the review period. Therefore, claims on non-government financial institutions increased by 135.2 percent in the review period compared to a growth of 63.3 percent in the previous year.
8. The credit flow to private sector, a major component of domestic credit increased by 16.7 percent in the review period, compared to a growth 13.8 percent last year. Low interest rates and diversification of loan portfolio by private sector commercial banks boosted the private sector credit flow in the review period. The growth of private

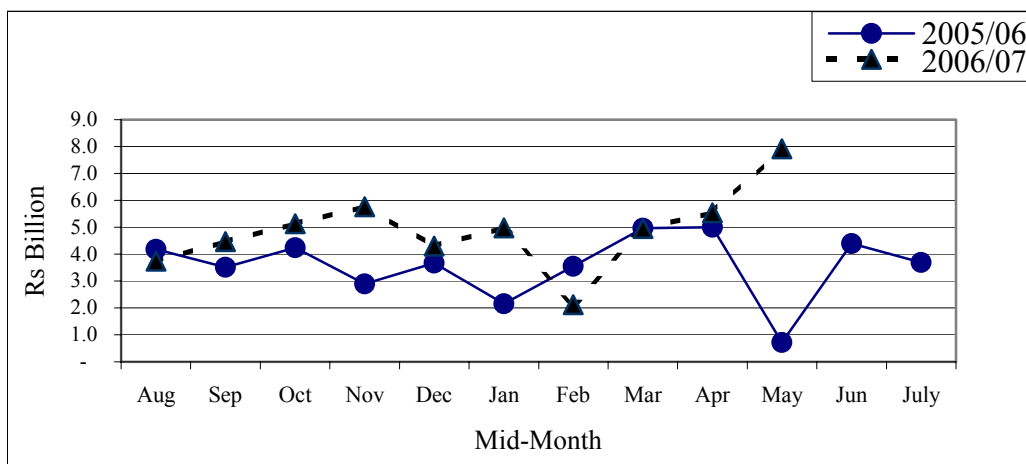
sector credit would be 10.2 percent if the credit write-off (Rs. 16.02 billion) by Nepal Bank Ltd (NLB) and Rastriya Banijaya Bank (RBB) were adjusted.

9. Net non-monetary liabilities increased by 7.0 percent in the review period compared to an increase of 15.7 percent last year. Net non-monetary liabilities increased at a lower rate due to the decline in loan loss provisioning for non-performing loans and interest suspense account following the credit write-off by NBL and RBB in the review period.

Purchase and Sale of Foreign Exchange and Liquidity Management

10. A substantially higher amount of the US dollar has been purchased from commercial banks in the review period compared to that in the previous year. Compared to a liquidity injection of Rs 39.64 billion through the purchase of 548.8 million US dollar a year ago, total liquidity of Rs 52.46 billion has been injected through the net purchase of the US dollar 731.7 million in the review period through foreign exchange interventions. Such a higher level of purchase of the US dollar in the review period was due to the elevated level of remittances and decline in the growth rate of imports. With regard to managing Indian currency reserves, the US dollar 690 million has been sold in the Indian money market to purchase Indian currency equivalent to Rs 48.89 billion in the review period. In the previous year, Indian currency equivalent to Rs 34.88 billion was purchased through the sale of the US dollar 490 million.

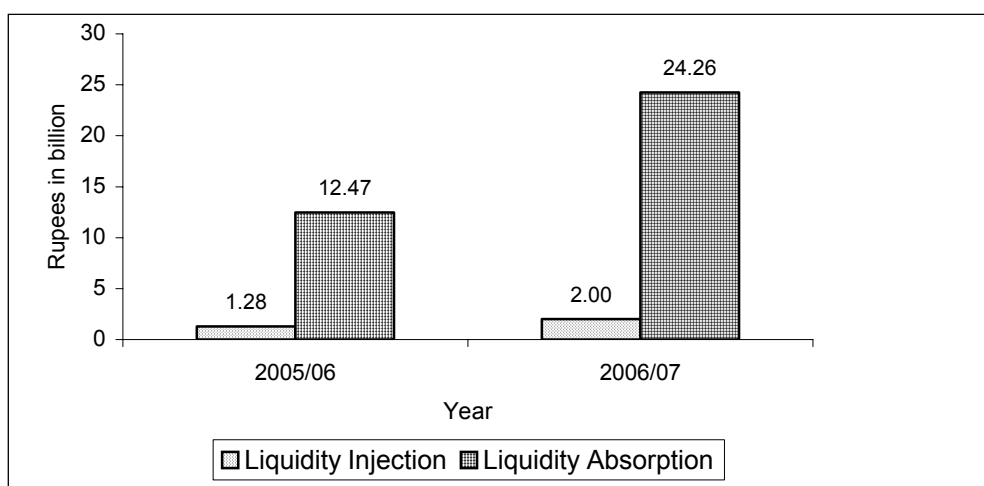
Chart 1: Purchase of Indian Currency by selling the US dollar



Open Market Operations

11. Besides the management of liquidity through the foreign exchange interventions and IC purchase from Indian money market, open market operations in domestic bills were also conducted to modulate liquidity. In the review period, sale auction and reverse repo auction, on turnover basis, absorbed Rs. 10.20 billion and Rs. 14.06 billion respectively, resulting in total liquidity absorption of Rs. 24.26 billion. Adjusting liquidity injected through the repo auction of Rs 2 billion, net liquidity absorption in the review period stood at Rs 22.26 billion. In the same period last year, net liquidity of Rs 11.19 billion was mopped up. In the previous year sale auction and reverse repo auction had absorbed Rs 5.97 billion and Rs.6.50 billion respectively while the purchase and repo auctions had injected Rs 830 million and Rs 450 million respectively.

Chart 2: Open Market Operations (In the first ten months)



Standing Liquidity Facility (SLF)

12. Commercial banks availed Rs 30.04 billion under SLF in the review period compared to Rs 8.03 billion last year. The higher level of SLF borrowing was on account of liquidity shortage in some of the commercial banks in the review period.

Short-term Interest Rates

13. Short-term interest rates did not observe large fluctuation in the review period on account of modulation of liquidity. The weighted average 91-day Treasury Bill rate remained between 1.85 percent and 2.29 percent in the review period.

Table 1: Average weighted 91-day Treasury Bill Rate (in percent)

Mid Month	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul
2005/06	2.26	3.38	3.10	2.69	2.20	2.46	2.20	2.65	2.89	3.63	3.31	3.25
2006/07	2.99	2.78	2.54	2.11	1.98	2.67	2.60	2.36	1.85	2.43		

Securities Market

14. In the aftermath of the political change and resulting improvement in the peace and security situation, Nepalese share market has been witnessing the bullish trend for the last one year. The year on year (y-o-y) NEPSE index increased by 33.1 percent to 513.45 points in mid-May 2007. This index was 385.89 a year ago.
15. The NEPSE Sensitive Index, calculated taking 16 July 2006 as the base period, stood at 128.59 in mid-May 2007. This index was 122.69 a month ago.
16. The y-o-y market capitalization increased by 47.3 percent to Rs 138.48 billion in mid-May 2007. Market capitalization to GDP ratio increased to 19.2 percent from 14.5 percent a year ago. Of the total market capitalization, bank and financial institutions, manufacturing and processing companies, hotels, business entities, and other groups accounted for 83.2 percent, 4.2 percent, 2.2 percent, 0.6 percent, and 9.8 percent respectively.
17. Total paid up capital of the listed companies stood Rs. 21.35 billion in mid-May 2007, an increase of 12.2 percent over the period of one year. This increase was due to the additional listing of securities.
18. Monthly turnover to market capitalization ratio remained at 0.36 percent in mid-May 2007 compared to 0.41 percent a year ago.

19. Total number of companies listed at the NEPSE increased to 131 in mid-May 2007 compared to 129 a year ago. Among the currently listed companies, 96 are bank and financial institutions. Production and processing industries, hotels, business entities, and others companies are 21, 4, 5 and 5 respectively.
20. The twelve-month rolling standard deviation, which indicates fluctuation in share price stood at 64.4 in mid-May 2007 compared to 29.4 a year ago.
21. Nepal Securities Board (SEBON) granted permission to issue ordinary shares of Rs. 237.25 million to ten financial institutions, and right shares of Rs. 867.25 million to twelve financial institutions during the first ten months of 2006/07.

Inflation

Consumer Price Inflation

22. The year on year (y-o-y) inflation was 4.6 percent in mid-May 2007 compared with 9.1 percent corresponding period last year. This was on account of elapse of the base-effect of hike in prices of petroleum products in March 2006 on one hand and the lower rate of price rise in the food and beverage group, as compared to last year, on the other. Besides, the impact of recent appreciation of the Nepalese currency against the US dollar on imported commodities also helped to ease the consumer price inflation in the review period.
23. Group-wise, the index of food and beverages group rose by 6.1 percent in the review period as compared to a rise of 9.1 percent a year ago. Despite a 20.0 percent rise in the price of spices, the decline in the prices of sugar and related products by 16.3 percent as well as the slower rise in the prices of pulses (11.2 percent), grains and cereal products (6.4 percent), vegetables and fruits (6.4 percent) and beverages (2.3 percent) contributed for the lower rate of inflation in this group compared to last year. The index of non-food and services group rose by 3.0 percent compared to a rise of 9.1 percent last year. The moderation in prices of this group is due to the end of the base effect of hike in petroleum prices last year as well as the impact of recent appreciation of the Nepalese currency against the US dollar on imported commodities.
24. Region-wise, the price level in Terai, Kathmandu Valley, and the Hills rose by 5.0 percent, 4.4 percent and 4.0 percent respectively in the review period. Last year, inflationary pressure was high in Hills with a price rise of 9.7 percent followed by Terai with 9.5 percent and Kathmandu Valley with 8.0 percent. The relatively higher inflationary pressure in the Terai region during the review period is attributable to Terai unrest
25. The period average inflation was 6.8 percent in the first ten months of 2006/07 compared to 7.8 percent in the corresponding period last year.
26. In mid-May 2007, the y-o-y core inflation edged up to 5.6 percent compared to 5.1 percent a year ago. This reflects a rise in inflationary expectations in the review period.

Wholesale Price Inflation

27. The y-o-y wholesale price inflation recorded at 6.2 percent in mid-May 2007. Such inflation was higher at 9.3 percent a year ago. Group-wise, the wholesale price of agricultural commodities rose by 7.5 percent compared to a rise of 11.6 percent a year ago. Despite the 19.0 percent rise in the price of fruits and vegetables compare to last year, the prices of major agriculture commodities such as food grains (2.3 percent), cash crops (4.4 percent) and pulses (11.9 percent), recorded a lower rise. The prices of the domestically manufactured commodities, however, recorded a higher growth of 8.4 percent compared to that of 2.6 percent a year ago. In this group, construction

material, food-related products and beverages and tobacco witnessed a higher rise in price by 14.2 percent, 8.9 percent and 5.6 percent respectively. The group of imported commodities witnessed a significant fall in the price level from 10.5 percent last year to 3.0 percent this year. The lower inflationary pressure on imported commodities is mainly attributed to the appreciation of the Nepalese currency against the US dollar.

28. The y-o-y salary and wage rate index rose by 11.9 percent in mid-May 2007, compared to a rise of 4.8 percent a year ago. Such an increase in this index was on account of ten percent increase in the allowances of civil servants in mid-July 2006, rise in the wages of industrial laborers, and labor shortage in the rural areas due mainly to the migration of youths to urban areas and increasing trend of seeking employment abroad. In the review period, both salary and wage rate indices rose by 6.2 percent and 13.8 percent respectively, compared to an increase of 0.4 percent and 6.5 percent respectively last year.

Fiscal Situation

Government Expenditure

29. In the first ten months of 2006/07, total expenditure of the Government of Nepal (GON) on cash basis increased by 12.6 percent to Rs.79.11 billion. Such expenditure had increased by 15.1 percent in the corresponding period of the previous year. Lower than expected growth in capital expenditure and decline in principal repayment accounted for the deceleration of total expenditure in the review period.
30. In the first ten months of 2006/07, total recurrent expenditure went up by 13.6 percent to Rs.53.15 billion compared to a growth of 8.4 percent in the corresponding period of the previous year. Increase in the allowance of government employees, increasing expenditure on Maoist army management, expanded parliament management, reestablishment of the police posts, compensation to the victims of conflicts are mainly responsible for the acceleration of recurrent expenditure in the review period.
31. Capital expenditure went up by 35.0 percent to Rs.15.01 billion in the review period compared to an increase of 35.7 percent in the corresponding period of the previous year. Absence of elected representatives in local bodies, Terai unrest, sluggish implementation of some projects, uncertain power supply accounted for the deceleration in capital expenditure.
32. In the review period, the recurrent, capital, principal repayments and freeze expenditure constituted 67.2 percent, 19.0 percent, 11.2 percent and 2.6 percent respectively. Such composition was 66.6 percent, 15.8 percent, 14.3 percent and 3.3 percent respectively in the same period of the previous year. Though capital expenditure constituted a lower portion of the total expenditure, it has been higher in the review period than during the same period last year. The share of principal repayment declined in the review period due mainly to the appreciation of Nepalese Rupee vis-à-vis US dollar.

Resource Mobilization

33. In the first ten months of 2006/07, total resources of GON increased by 25.8 percent to Rs.81.97 billion compared to an increase of 11.7 percent in the corresponding period of the previous year. A significant increase in revenue and foreign grants contributed to such an acceleration of the total resources.
34. In the first ten months of 2006/07, total revenue of GON rose by 22.5 percent to Rs. 63.71 billion in contrast to a decline of 0.2 percent in the corresponding period of the previous year. The increase in customs revenue, value added tax (VAT) and excise duty as a result of significant increase in the import of high tax yielding vehicles and

spare parts together with remarkable rise in income tax contributed for such a significant growth of revenue.

Table 2 : Revenue Collection (First Ten Months)

	Rs. in Million			Percent Change		Composition	
	2004/05	2005/06	2006/07	2005/06	2006/07	2005/06	2006/07
Value Added Tax	14348.2	17226.3	20554.8	20.1	19.3	33.1	32.3
Customs	12413.7	11749.2	13294.1	-5.4	13.1	22.6	20.9
Income Tax	7580.3	7819.7	10326.1	3.2	32.1	15.0	16.2
Excise	4953.2	4928.1	6716.3	-0.5	36.3	9.5	10.5
Registration tax	1408.0	2103.0	2109.5	49.4	0.3	4.0	3.3
Vehicle Tax	687.8	665.5	674.4	-3.2	1.3	1.3	1.1
Non-Tax Revenue	10753.2	7532.1	10039.0	-30.0	33.3	14.5	15.8
Total Revenue	52144.4	52023.8	63714.2	-0.2	22.5	100.0	100.0

Foreign Cash Grants

35. In the first ten months of 2006/07, foreign cash grants went up by 62.4 percent to Rs. 12.62 billion. It had increased by 81.3 percent last year.

Budget Deficit /Surplus

36. In the review period, fiscal situation of the Government of Nepal (GON) remained contractionary. High growth rate of resource compared to expenditure contributed to such a budget surplus. In the review period budget remained at a surplus of Rs.2.85 billion. Last year, the budget was at a deficit of Rs.5.08 billion.

Deficit Financing

37. Of the total estimated domestic borrowing of Rs.17.90 billion (in the budget), GON mobilized Rs10.03 billion in the first ten months of 2006/07. However net domestic borrowing of the GON remained at a negative figure of Rs.3.66 billion in the review period.
38. Foreign cash loan declined by 18.4 percent to Rs.2.47 billion in the review period. Last year foreign loan of Rs.3.03 billion was received.
39. In the review period, GON maintained a cash surplus of Rs.15.72 billion with Nepal Rastra Bank.

Foreign Trade and Balance of Payments

40. Nepal's external sector did not perform satisfactorily in the first ten months of 2006/07. Exports fell by 0.3 percent in contrast a growth of 3.3 percent in the corresponding period of the previous year owing to a number of factors such as the deteriorating security condition, frequent bandhs, lack of investment-friendly climate and power shortages. While exports to India rose by just 1.0 percent in the review period in comparison to a higher growth of 8.0 percent in the same period of 2005/06, exports to other countries declined by 3.1 percent in comparison to a decline of 5.6 percent in the preceding year.
41. The rise in the exports of thread, textiles, zinc sheet, M.S. pipe and juice was responsible for the slight increase in the exports to India. On the other hand, the decline in exports to other countries emanated from the fall in the export of readymade garments, pashmina, woolen carpets, handicrafts and tanned skin.
42. In the first ten months of 2006/07, total imports rose by 10.5 percent in comparison to a higher growth of 16.0 percent in the same period last year. Imports from India

increased by 11.4 percent in the review period compared to a higher growth of 20.2 percent in the corresponding period last year. Likewise, imports from other countries rose by 9.0 percent in comparison to a growth of 9.9 percent a year earlier.

43. The rise in total imports in the first ten months of 2006/07 was attributed to the rise in imports of vehicles & spare parts, petroleum products, cold-rolled sheet in coil, electrical equipment and hot-rolled sheet in coil, among others, from India as well the rise in imports of crude palm oil, computer parts, gold, chemical fertilizer and telecommunication equipment & parts, among others, from other countries.
44. The overall BOP recorded a surplus of Rs. 6.87 billion in the first ten months of 2006/07. Of this surplus, the current account surplus was Rs. 4.72 billion and the remaining Rs. 2.15 billion was ascribed to the capital and financial account. In the corresponding period of 2005/06, the BOP and the current account surpluses were Rs. 20.50 billion and 13.41 billion respectively. As in the previous year, the inflow of remittances was largely responsible for the surplus in the current account in the review period.

Foreign Exchange Reserves

45. In comparison to mid-July 2006, gross foreign exchange reserves fell by 0.3 percent to Rs. 164.6 billion in mid-May 2007. Such reserves had gone up by 20.6 percent in the corresponding period of the previous year. In terms of US dollar, gross foreign exchange reserves went up by 12.4 percent to US\$ 2.50 billion in mid-May 2007. In the same period in the previous year, such reserves had gone up by 17.5 percent. The share of convertible reserves in the total reserves rose to 96.1 percent as at mid-May 2007 from 94.1 percent a year ago, resulting in a corresponding decline in the share of the nonconvertible reserves to 3.9 percent from 5.9 percent. Based on the first ten months of imports of goods and services, the current level of reserves is sufficient for financing merchandise imports of 10.7 months and merchandise and service imports of 8.8 months.

Oil and Gold Prices

46. The price of oil (Crude Oil Brent) in the international market went down by 3.5 percent to US\$ 66.51 per barrel in mid-May 2007 from US\$ 68.94 per barrel in mid-May 2006. The price of gold also declined by 2.8 percent to US\$ 668.25 per ounce in mid-May 2007 from US\$ 687.50 a year earlier.

Exchange Rate

47. In comparison to mid-July 2006, the Nepalese currency vis-à-vis the US dollar appreciated by 12.79 percent in mid-May 2007. It had depreciated by 2.55 percent in the corresponding period of the previous year. The exchange rate of one US dollar stood at Rs. 65.70 in mid-May 2007 compared to Rs. 72.19 in mid-May 2006.