Current Macroeconomic Situation

(*Based on Data of the First Eight Months of FY 2004/05*)

Nepal Rastra Bank

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Summary

1. Real economic growth, based on real domestic product (GDP) at producers' price, is projected to be 3.6 percent for FY 2004/05. The projected growth is marginally higher than a growth of 3.5 percent in FY 2003/04. However, the growth of GDP is lower than the initial projection for FY 2004/05. Increased private sector construction, mining and quarrying, and real estate activities are contributory factors to such a projected growth. From demand side, despite weak external demand, increased transfer receipts and bank credit are the fueling factors for the projected growth.

2. The broad money (M_2) growth has remained subdued. So has been the growth of time deposits. Lower growth of net foreign assets (NFA) due to absolute drop in foreign loans and slowdown in remittances has been the factor behind the subdued expansion in M_2. The bank credit to the private sector has accelerated due mainly to the expansion in consumer loans. Hence, short-term interest rates have increased in recent months owing to decline in excess liquidity in the banking system.

3. On a point-to-point basis, consumer price index (CPI) based inflation has increased. The hike in prices of petroleum products has contributed to the rise in prices in recent months. However, average inflation has remained lower than that of last year.

4. The budget deficit has fallen significantly. Notwithstanding a slight slowdown in growth rate of revenue relative to last year, the pace of increase in resource mobilization relative to government expenditure has contributed to the fall in budget deficit. Foreign cash loans have fallen significantly. Foreign cash grants have however, increased significantly. The government has maintained cash balances with Nepal Rastra Bank (NRB). The net domestic borrowing of the government is negative.

5. The surplus in the balance of payment (BOP) is lower than that of last year. Exports have expanded marginally while imports and services have declined. Remittances have increased marginally. However, pension transfers have increased. The share of India in Nepal's total trade continues to rise.

6. Total international reserves continue to rise. The reserve level is sufficient to cover merchandise imports of more than one year. Although the pressure on Indian currency (IC) reserve exists, it is easing gradually.

Real GDP Growth

1. Based on available macroeconomic data upto the first eight months of FY 2004/05, real GDP is projected to grow by 3.6 percent this year. Lower estimates of development spending and weak external demand for domestic goods and services provide bases for lowering the projection of real GDP growth for this year.

2. Agricultural GDP is estimated to grow at a slightly lower rate of 3.4 percent compared to a growth of 3.9 percent last year. The decline in paddy production due to unfavorable weather condition is attributed to a lower growth of agricultural GDP this year.

3. The non-agricultural GDP is projected to grow by 3.7 percent this year. This growth surpasses the last year's growth of 3.1 percent.

4. The driving force behind this year's projected growth of 3.6 percent, which is marginally higher than that of last year's 3.5 percent, is clearly non-agricultural sector. The fueling factors of the growth of non-agricultural sector, especially of private sector construction, mining and quarrying as well as real estate, are private sector's increased transfer receipts and bank credit.

Monetary Situation

5. **Monetary Aggregates:** During the first eight months of FY 2004/05, M_2 expanded (5.9 percent) at a rate which is lower than that of the previous year (6.7 percent). Although the rate of growth of NFA of the monetary sector decelerated, acceleration in net domestic assets (NDA) contributed to an expansion in $M_{2.}$ Consequently, the contribution of NFA to changes in M_2 went down to 26.6 percent in mid-March 2005 from 66.4 percent a year ago. Conversely, the share of NDA in M_2 growth increased to 73.4 percent in mid-March 2005 from 33.6 percent, a year ago. Of the two components of M_2, narrow money (M_1) increased at a rate of 5.4 percent to Rs. 99.0 billion. This rate is more than double the growth rate observed last year (2.3 percent). Time deposits increased at a lower rate of 6.2 percent to Rs. 194.7 billion this year compared to a rise of 9.0 percent last year. Low inflow of remittance at the beginning of the current fiscal year contributed to the deceleration in time deposits during the review period.

Factors Affecting Monetary Aggregates

6. **Reserve Money:** During the review year, reserve money (RM), in contrast to a growth of 6.9 percent last year, declined by 3.4 percent to stand at Rs. 91.2 billion as at mid-March 2005. This decline is a reflection of the decline in commercial banks' deposits with NRB. On the other side, NFA of NRB (after adjustment of exchange valuation gain/loss) increased marginally by 0.6 percent this year compared to a much faster growth of 16.6 percent last year. Such a deceleration in NRB's NFA also contributed to the decline in RM.

7. **Money Multiplier:** Money multipliers of both M_1 and M_2 showed an upward trend this year. M_1 multiplier went up to 1.085 this year from 0.989 last year. Similarly, M_2 multiplier rose to 3.219 from 3.031 last year. The reduction in the cash reserve ratio (CRR) as well as a fall in excess reserves of commercial banks contributed to a rise in both money multipliers

8. **Net Foreign Assets :**. Based on monetary survey, of the expansionary factors of money supply, the NFA of the monetary sector (adjusting the foreign exchange valuation) increased by 4.0 percent to Rs. 109.61 billion compared to a much larger magnitude of increase (12.0 percent) last year. The decline in inflow of foreign loans this year was responsible for such a slow down in the growth of NFA.

9. **Claims on Government:** The cash balance maintained by the government with NRB lowered monetary sector's net claims on government by 3.3 percent to Rs. 60.25 billion. Such a claim had declined by 11.2 percent last year.

10. **Claims on Government Enterprises:** In contrast to a 0.3 percent decline last year, monetary sectors claims on non-financial institutions increased significantly by 50.8 percent to Rs. 4.40 billion this year, due mainly to the upsurge in credit flow to the Royal Nepal Airlines Corporation (RNAC) and Nepal Oil Corporation (NOC) from the commercial banks. However, monetary sector's claim on financial institutions declined by 1.2 percent to Rs. 13.2 billion in contrast to an increase of 10.9 percent last year, due mainly to the repayment of refinance to NRB by rural development banks and development banks.

11. **Claims on Private Sector:** Monetary sector's claims on private sector increased by 12.3 percent to Rs. 193.7 billion compared to a slightly slower increase of 9.2 percent last year. Such an upsurge in credit flows to private sector was attributed to a competitive expansion of consumer credit by the commercial banks. During the review period, mainly Nepal Arab Bank Limited, Himalayan Bank Limited, Nepal Investment Bank Limited, Everest Bank Limited increased the credit flows to the private sector. However, the contribution of Nepal Bank Limited (NBL) and Rastraiya Banijya Bank (RBB) has been marginal.

12. **Domestic Credit:** As a result of factors outlined in 9 through 11 above, domestic credit of the monetary sector increased by 8.1 percent to Rs. 271.5 billion compared to a much narrower growth of 3.5 percent last year. The share of the government in total domestic credit this year decreased by 1.4 percentage points to 22.2 percent.

13. **Net Non-Monetary Liabilities and Net Domestic Assets:** Net non-monetary liabilities (adjusting the foreign exchange valuation) increased by 10.2 percent to Rs. 87.5 billion this year compared to a lower growth of 3.4 percent last year due mainly to an increase in loan loss provisioning and rise of paid-up capital of the commercial banks. The NDA (adjusting the foreign exchange valuation) increased by 7.1 percent to Rs. 184.1 billion compared to an increase of 3.6 percent last year. The expansion in domestic credit accounted for a relatively higher growth of NDA this year compared to that of the preceding year.

Implementation of Monetary Policy Instruments

14. NRB mopped up Rs. 10.5 billion liquidity by means of sale auction and injected Rs. 1.3 billion by way of purchase auction this year. NRB released liquidity of Rs.5.8 billion through repo auction and mopped up liquidity amounting to Rs. 4.1 billion by way of reverse repo. Thus, liquidity amounting to Rs. 14.6 billion was mopped up and liquidity amounting to Rs. 7.1 billion was released resulting in a net withdrawal of liquidity amounting to Rs. 7.5 billion through money market operations. NRB also provided standing liquidity facility amounting to Rs. 40.2 billion in cumulative terms to the commercial banks.

15. NRB intervened in the foreign exchange market to purchase US$ equivalent of Rs. 23 billion and sell Rs. 2.8 billion, injecting net liquidity of Rs. 20.2 billion this year.

16. However, expansion in bank credit to private sector brought down the excess reserves of commercial banks. As a result, 91 days weighted average treasury bills rate increased to 2.94 percent in mid March 2005 from 0.62 percent in mid August 2004.

Share Market Transactions

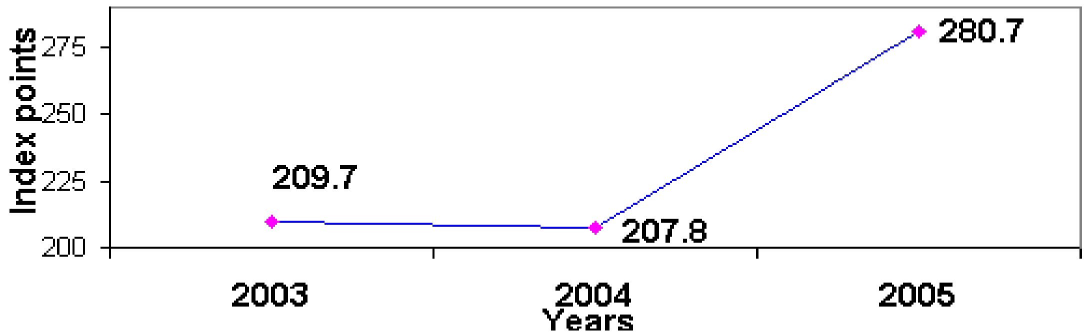
17. Nepal Stock Exchange (NEPSE) Index increased by 72.9 index points (35.1 percent) to 280.7 as at mid-March 2005 compared to the same point of time last year. Such a rise in NEPSE was attributed to an increase in the number of listed companies and market

capitalization during the review period. The total amount of listed shares increased by 25.5 percent to Rs 16.3 billion due to new listing and issue of bonus shares by some banks, finance companies and insurance companies. Similarly, the market capitalization of the listed companies rose by 53.4 percent to Rs 59.0 billion compared to that of last year. Moreover, the number of companies listed increased to 123 as at mid-March 2005 from 113 a year ago. Similarly, the number of companies traded increased to 75 from 63 last year.

Chart : 1

NEPSE Index

(Mid-March)



Price Situation

18. The National Urban Consumer Price Index (CPI), on point-to-point basis, increased by 5.7 percent in mid-March 2005 compared to an increase of 4.4 percent last year. The higher growth in the price index was mainly attributable to the rise in the prices of housing goods and services, transport and communication, and restaurant meals resulting from the upward revision in the prices of petroleum products together with the sharp rise in the price of sugar and related products this year. The overall price index, increased to 161.9 in mid-March 2005 from 153.1 a year ago. The average growth rate of price index for the first eight months of this year, however, slowed down to 3.7 percent compared to a rise of 5.1 percent last year.

19. The slow growth of prices prior to the hike in the prices of petroleum products during the first half of the current fiscal year accounted for a lower level of average rate of inflation this year compared to that of last year.

20. On a point-to-point basis, the prices of food and beverages group moved up by 4.7 percent compared to an increase of 3.1 percent last year. The index of sugar and related products shot up by 25.5 percent. Products that recorded an increase in indices are meat, fish and eggs (9.1 percent), restaurant meals (7.4 percent), grains and cereal products (5.8 percent), vegetables and fruits (4.0 percent), pulses (3.6 percent), and beverages (3.2 percent). However, the indices that declined were those of oil and ghee (7.5 percent), and spices (4.9 percent).

21. The price index of non-food and services group increased at a slightly higher pace of 6.8 percent compared to an increase of 5.7 percent last year. The indices that increased were those of transport and communication (14.1 percent), housing goods and services (12.3 percent), education, reading and recreation (4.6 percent), tobacco and related products (2.5 percent), cloth, clothing and sewing services (2.5 percent), footwear (1.3 percent) and medical and personal care (1.1 percent).

22. Region-wise, the prices in the Kathmandu Valley, Terai and Hills increased by 6.1 percent, 5.2 percent and 6.6 percent respectively. Such indices had increased by 7.0 percent, 3.2 percent and 3.4 percent respectively last year. Thus, the rate of inflation in

the Kathmandu valley increased by 0.9 percentage points. It has decelerated by two percentage points in Terai and by a higher magnitude of 3.2 percentage points in the Hills. The prices of food and beverages group rose in the Kathmandu Valley, Terai and Hills by 5.4 percent, 3.8 percent and 5.9 percent respectively. Similarly, the prices of non-food and services group increased in the Kathmandu Valley, Terai and Hills by 6.9 percent, 6.6 percent and 7.3 percent respectively.

23. The point-to-point National Wholesale Price Index increased by 8.5 percent compared to an increase of 3.6 percent last year. In spite of the decline in the prices of spices and pulses, the growth in the prices was mainly attributable to the rise in the prices of chemical fertilizer and chemical goods, food grains and cash crops together with the sharp rise in the price of petroleum products,. The prices of imported commodities, agricultural commodities and domestic manufactured commodities increased by 12.4 percent, 7.7 percent and 4.3 percent respectively. The average National Wholesale Price Index for the first eight months of this year increased at a relatively higher rate of 6.3 percent compared to a rise of 4.5 percent last year.

Government Budgetary Operation

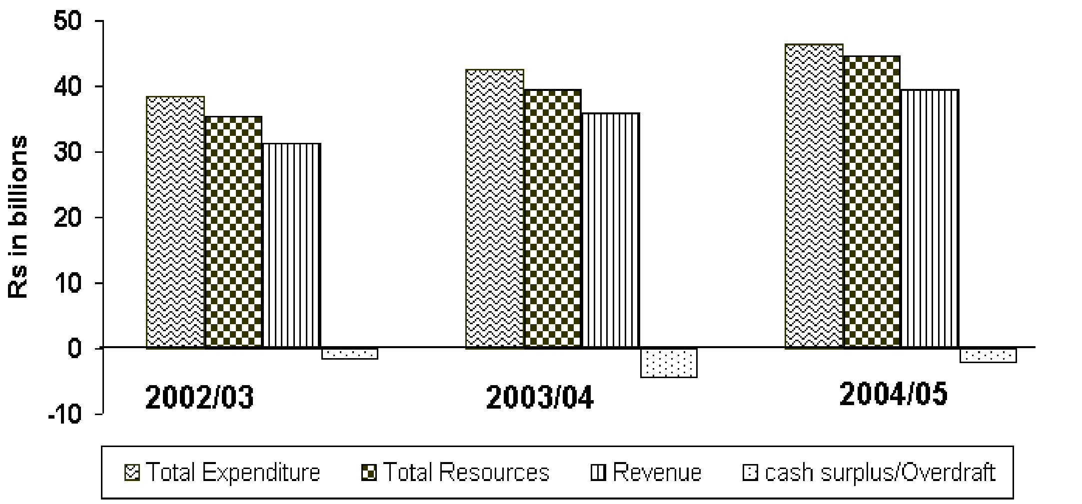
24. In the absence of previous fiscal year's data according to the new expenditure classification into recurrent, capital and principal repayment, only the current year's data have been presented. Based on the cash flow data, the total expenditure of the government increased by 8.7 percent to Rs. 46.3 billion compared to a rise of 10.9 percent last year. Of the total expenditure, recurrent expenditure stood at Rs. 33.2 billion (71.6 percent), capital expenditure at Rs. 5.7 billion (12.4 percent) and principal repayment at Rs. 6.0 billion (13.0 percent). Expenditure under freeze account recorded a fall of 12.2 percent to Rs. 1.4 billion.

25. Total non-debt resources (revenue, non-budgetary receipts and others, and foreign grants) increased by 13.0 percent to Rs. 44.6 billion compared to a rise of 11.5 percent last year. Revenue, the major source (88.4 percent) of the government resources, grew by 10.1 percent to Rs. 39.4 billion compared to a rise of 14.6 percent last year. Foreign grants increased to Rs. 4.0 billion compared to Rs. 2.5 billion received last year.

Chart. : 2

Government Expenditure, Resources and Budget Balance

(First Eight Months)



26. Due to the higher growth in non-debt resources compared to that of total government expenditure, the budget deficit declined by 45.7 percent to Rs. 1.7 billion. HMG mobilized Rs. 1.4 billion through foreign cash loans and internal borrowing amounted

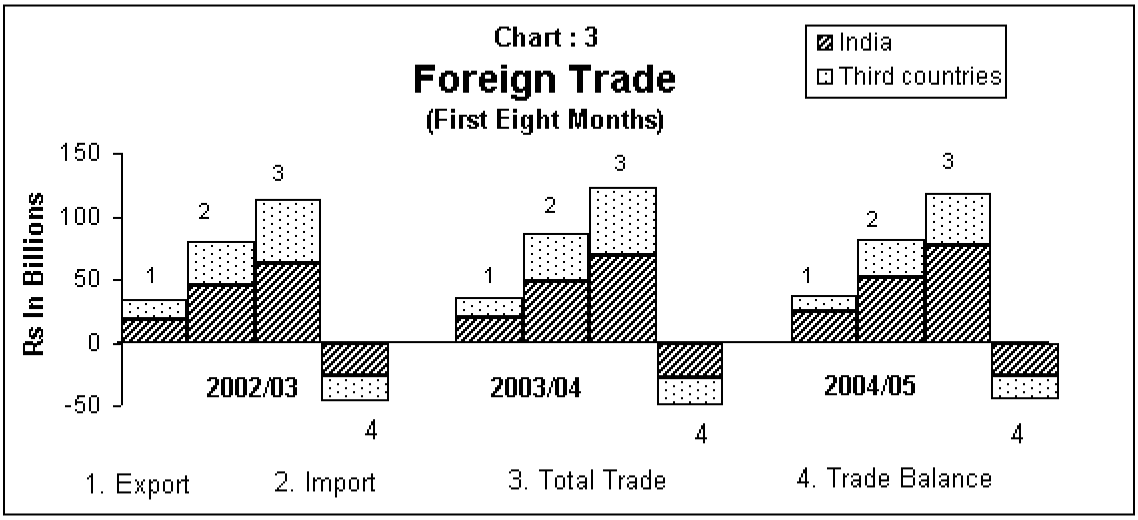
to Rs. 2.3 billion. HMG's cash transactions in mid-March 2005 resulted in a surplus of Rs. 2.0 billion compared to a surplus of Rs. 4.2 billion in mid-March 2004.

27. Due mainly to a higher rise in non-debt resources compared to the total government expenditure, the total net outstanding domestic debt of the government declined to Rs. 83.4 billion in mid-March 2005 from Rs. 85.4 billion in mid-July 2004, as reflected in the surplus Treasury Position of Rs. 2.0 billion in mid-March 2005 compared to the surplus of Rs. 753 million in mid-July 2004.

Foreign Trade

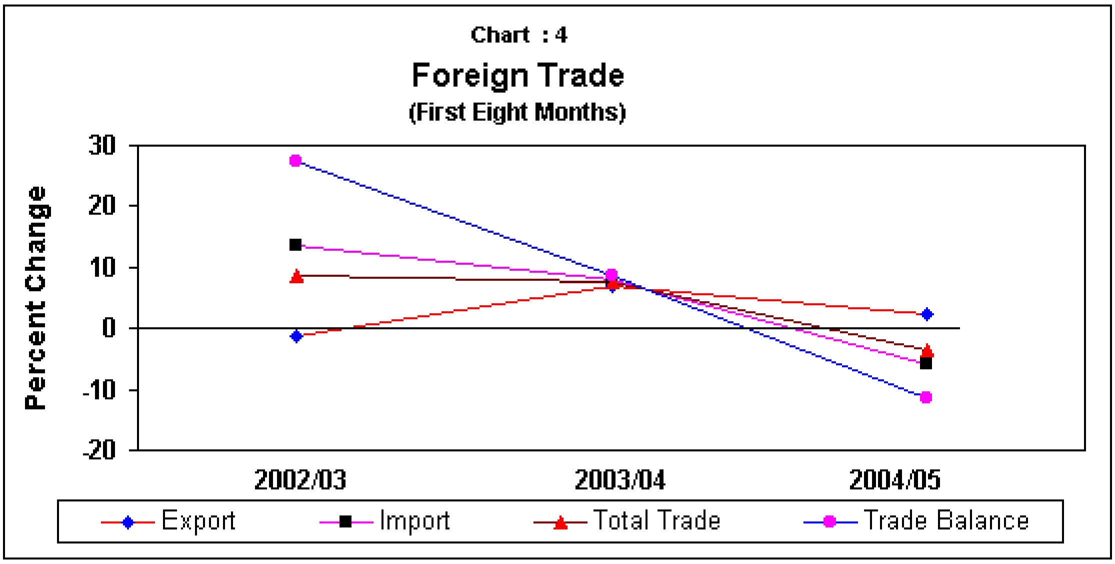
28. Total exports increased marginally by 2.3 percent to Rs. 36.9 billion compared to a higher rise of 6.9 percent last year. Exports to India increased significantly by 20.9 percent to Rs. 24.9 billion compared to a rise of 11.8 percent last year. Exports to other countries fell substantially by 22.4 percent to Rs. 12.0 billion this year in contrast to a marginal increase of 0.9 percent last year. Among the major exportable commodities, the exports to India of cardamom, vegetable ghee, tea, thread, jute goods, aluminum section, copper wire and rod, brass-sheet, chemicals, feed, footwear and textiles increased. The exports of toothpaste, ginger, rice bran oil, G.I. pipe, M.S. pipe, and readymade garments to India declined. The exports of woollen carpets and tanned skin to other countries went up while that of readymade garments, pulses, jewellery and pasmina declined.

29. Total imports dropped by 5.7 percent to Rs. 81.5 billion as against a rise of 7.9 percent last year. Imports from India rose by 7.4 percent compared to a similar rise (7.6 percent) last year. However, imports from other countries fell by 22.4 percent as against a growth of 8.2 percent last year. Imports from India of pulses, thread, chemicals, petroleum products, medicine, cold-rolled sheet, and plastic granules and that of edible oil, telecommunication equipment and parts, transport vehicles and parts, steel wire and crude coconut oil, from other countries increased. However, the imports of wheat, rice, hot-rolled sheet, M.S. billet and other machineries as well as parts, cement from India and that of thread, raw wool, crude soybean oil, crude palm oil, chemical fertilizers, plastic granule, aircraft equipment, electrical goods, other machineries as well as parts and textiles from other countries declined.



30. The growth of exports and the decline of imports resulted in a drop in the trade deficit by 11.5 percent to Rs. 44.6 billion. The trade deficit had widened by 8.6 percent last year. Trade deficit with India, which had recorded a rise of 4.6 percent last year, fell by 2.6 percent this year. Trade deficit with other countries declined by 22.4 percent in contrast to a rise of 13.9 percent last year**.** Total trade flows, which had increased by 7.6 percent last year, declined by 3.4 percent this year. Owing to the increase of import

from, and export to India, the share of India in total trade shot up to 64.8 percent from 56.2 percent last year. However, the share of other countries in total trade decreased to 35.2 percent from 43.8 percent last year.



31. The overall export/import ratio, which stood at 41.8 percent last year, rose further up to 45.3 percent this year. The export/import ratios for India and other countries stood at 48.0 percent and 40.6 percent respectively compared to the respective ratios of 42.7 percent and 40.6 percent last year.

Balance of Payments

32. According to the BOP statistics pertaining to the first seven months of FY 2004/05, the magnitude of trade deficit shrank by 5.9 percent to Rs. 38.4 billion because of a decline in imports and a rise in exports, albeit marginal. Trade deficit had expanded by 7.6 percent last year. On the services front, receipts from government services increased by 8.7 percent to Rs. 3.6 billion. While travel receipts declined by 27.3 percent to Rs. 6.7 billion, other receipts increased by 1.6 percent to Rs. 4.6 billion. As a result, service receipts declined by 12.6 percent in contrast to a magnificent rise of 25.1 percent last year. Similarly, on the payments side, despite a decline in transportation by 4.4 percent, total expenses rose by 17.5 percent to Rs. 13.8 billion due mainly to the rise in expenses on travel and others by 40.3 percent, and 28.2 percent, respectively.

33. Income receipts (credit) soared by 50.5 percent to Rs. 2.6 billion while the income payments (debit) increased by 16.5 percent to Rs. 3.3 billion. As a result, the total deficit on goods, services and income increased by 3.8 percent to Rs. 38.0 billion compared to a similar rise (3.9 percent) last year.

34. Under transfer receipts, foreign grants slowed down by 8.5 percent to Rs. 12.7 billion compared to a rise of 50.6 percent last year. Workers' remittances increased by 2.0 percent to Rs. 36.1 billion compared to a growth of 4.3 percent last year. Pension receipts increased substantially by 92.3 percent to Rs. 7.3 billion. Similarly, other transfer receipts (Indian excise refund) increased by 11.7 percent to Rs. 1.2 billion. At the same time, the transfer payments increased by 7.6 percent to Rs. 1.9 billion compared to an increase of 2.2 percent last year.

35. Current account surplus stood at Rs. 17.3 billion compared to a surplus of Rs. 13.5 billion last year. Capital transfer stood at Rs. 696.8 million compared to the level of Rs. 1087.2 million last year.

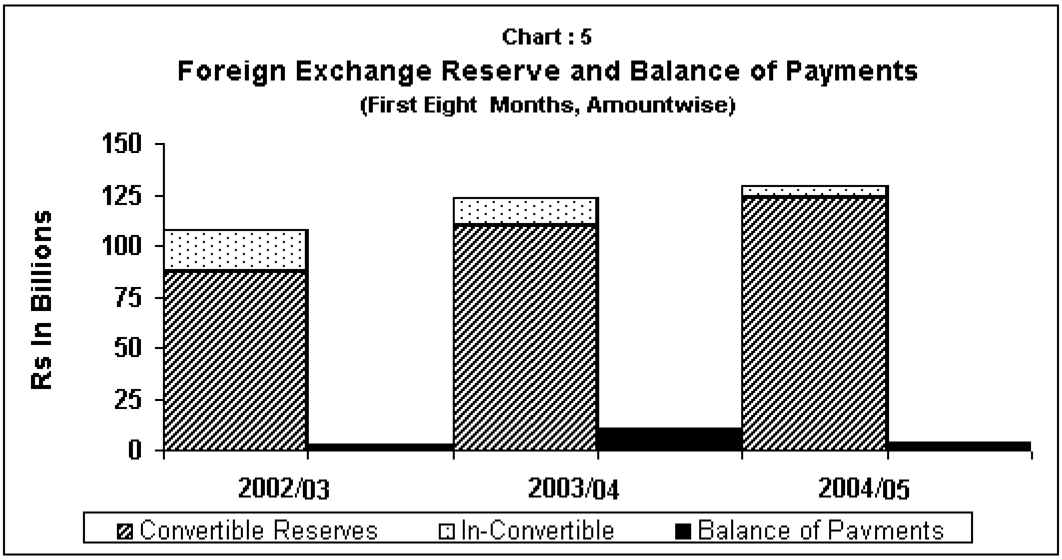
36. Under the financial account, other investment assets stood at Rs. 18.2 billion compared to Rs. 23.5 billion last year. Of this amount, Rs. 1.8 billion was on account of trade credits. Compared to Rs. 16.7 billion last year, other investment liabilities turned into a

negative sum of Rs. 2.5 billion this year. Of this amount, Rs. 179.4 million was on account of trade credits. HMG received Rs. 1.7 billion as loan and repaid Rs. 3.3 billion in amortization. As a result, the net government borrowing stood at a negative of Rs. 1.6 billion. Foreign currency and deposit liabilities dropped by Rs.507.5 million. Consequently, the financial account resulted into a negative sum of Rs. 20.8 billion. Because of the surplus in the current account and the inflow of miscellaneous capital, the overall BOP continued to remain in surplus to the extent of Rs. 2.9 billion compared to a surplus of Rs. 10.8 billion last year.

37. Based on the monetary statistics, Nepal was able to maintain a BOP surplus amounting to Rs. 4.4 billion as at mid-March 2005 compared to a much larger surplus of Rs. 11.0 billion as at mid-March 2004.

Foreign Exchange Reserves

38. The gross foreign exchange reserves rose by 5.0 percent to Rs.129.9 billion as at mid-March 2005 compared to an increase of 14.8 percent last year. The decline in imports from other countries and the rise in remittances through the banking system were the factors responsible for the 12.4 percent growth in the convertible currency reserves. Inconvertible reserves fell by 52.4 percent due to the decline in both remittances and net services income from India. Last year, the convertible reserves had increased by 25.1 percent while the inconvertible reserve had declined by 30.3 percent. The share of convertible reserves in the total reserves rose to 94.9 percent as at mid-March 2005 from 88.6 percent as at mid-March 2004, resulting in the corresponding fall in the share of the non-convertible reserves to 5.1 percent from 11.4 percent. The current reserves level is sufficient to finance merchandise imports of 12.7 months and merchandise and service imports of 10.7 months. Hence, the current reserves position is at a comfortable level.



Price of Gold and Oil in the International Market

39. The price of gold increased by 10.7 percent in the international market to US$ 440.7 per ounce on March 15, 2005 from US$ 398.1 in the corresponding period last year. Similarly, the price of oil (Crude Oil Brent) rose by 55.3 percent to US$ 53.5 per barrel on March 15, 2005 from US$ 34.4 per barrel during the same period last year.

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