Current Macroeconomic Situation

(Based on the data of first six months of 2006/07)

Monetary Aggregates

1. In the first six months of 2006/07, broad money (M_2) registered a lower growth of 6.1 percent compared to a growth of 6.2 percent in the same period of the previous year. A lower growth of net foreign assets (NFA) contributed for the slowdown in M_2 growth.
2. Of the components of M_2, while the narrow money (M_1) recorded a higher growth of 4.7 percent in the review period compared to a growth of 3.0 percent last year, the growth rate of time deposits, another component of M_2, remained lower at 6.8 percent compared to a growth of 7.8 percent in the previous year. A slowdown in the growth of workers' remittance and growing attraction of depositors towards other financial institutions due to lower interest rates of commercial banks relative to the other financial institutions decelerated the growth rate of time deposits of commercial banks in the review period.
3. NFA, an expansionary factor of money supply, after adjusting exchange valuation gains/loss, increased by 3.9 percent (Rs. 5.40 billion) in the review period compared to a growth of 9.8 percent (Rs. 10.54 billion) last year. A deceleration in the growth of workers' remittance and a decline in exports contributed to lower the growth of NFA in the review period.
4. Domestic credit, which had grown by 4.3 percent last year, increased by 0.1 percent in the review period. Though a decline in claims on government also contributed for the sharp deceleration in domestic credit in the review period, the credit write off of Rs 16.02 billion by Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) has been the main factor for the slowdown. If the written off credit is adjusted, total domestic credit would increase by 5.1 percent, marginally higher than that of the last year.
5. Of the total domestic credit, net claims on government declined further by 10.2 percent in the review period compared to a decline of 4.3 percent in the previous year. A higher rise in government resources in comparison to expenditure resulted in cash balance of Rs. 8.45 billion with NRB, which contributed to lower the net claims on government of the monetary sector in the review period.
6. Claims on government non-financial enterprises increased by 9.7 percent in the review period as against a decline of 15.7 percent in the previous year, due mainly to borrowing from commercial banks by some of the enterprises such as Janakpur Cigarette Factory, Nepal Food Corporation, Nepal Oil Corporation and Janak Educational Material Centre.

7. Against a decline of 3.5 percent in the previous year, claims on financial institutions increased by 16.9 percent in the review period. The increase has been mainly due to the upsurge (34.1 percent) in banks' claims on non-government financial institutions. An increase in short-term placements by commercial banks on development banks and finance companies contributed to increase the claims on non-government financial institutions in the review period. This can be taken as favorable development for the economy as it can increase the credit flows to small borrowers.

8. Credit flows to private sector, a major component of domestic credit, increased by 2.7 percent in the review period compared to a growth of 8.3 percent in the previous year. The huge amount (Rs 16.02 billion) of credit written off by NBL and RBB in the review period contributed for the slowdown. If the written off credit is adjusted and only fresh flows are considered, growth rate of credit to private sector would come out to be 9.2 percent, which is marginally higher than that of the previous year. In spite of somewhat higher growth, the private sector credit off take has not been as expected due mainly to conflict in industrial relation, general strikes and *bandha*.

9. A growth of net non-monetary liabilities remained negative in the review period. Such liabilities, which had increased by 4.6 percent last year, declined by 13.2 percent in the review period. This was due to decline in loan loss provision and interest suspense account following the credit written off by NBL and RBB in the review period. However, net non-monetary liabilities grew by 0.8 percent if credit written off is adjusted.

Money Market

10. The NRB injected net liquidity of Rs 34.32 billion through foreign exchange intervention in the review period compared to Rs 22.5 billion last year. In the review period, the NRB made only purchase interventions of the US dollar in the foreign exchange market. Nepalese currency (NC) vis-à-vis the US dollar appreciated in the review period due to the continued inflow of worker's remittances and appreciation of Indian currency (IC) vis-à-vis the US dollar. Therefore, the NRB made the purchase interventions of the US dollar in order to prevent further appreciation of NC vis-à-vis the US dollar.

11. Liquidity injected in the economy through foreign exchange interventions was managed through the open market operations (OMO). Net liquidity of Rs 19.45 billion was mopped up in the review period, compared to Rs 7.74 billion last year. In the review period, Rs 5.89 billion was absorbed through sale auctions and Rs 13.56 billion through reverse repo auctions. In the same period last year, absorption through these instruments amounted to Rs 4.57 billion and Rs 4 billion respectively. Last year, liquidity injection through purchase auctions had amounted to Rs 830 million. In the review period, there has not been any injection of liquidity through OMO.

Table 1: Open Market Operations

(First Six Months)

Rs. in billion

	Instruments	2005/06	2006/07
A	**Total Liquidity Absorbed**	**8.57**	**19.45**
1	Sale auctions	4.57	5.89
2	Reverse Repo auctions	4.00	13.56
B	**Total Liquidity Injection**	**0.83**	**0.0**
1	Purchase auctions	0.83	0.0
2	Repo auctions	0.0	0.0
C	**Net liquidity Absorbed**	**7.74**	**19.45**

12. The use of standing liquidity facility (SLF) has increased in the review period compared to last year. Compared to Rs 1.92 billion last year, commercial banks used Rs 8.19 billion SLF in the review period. Shortage of funds in some of the commercial banks increased the use of SLF in the review period. Inter bank transactions also increased, marginally however. Compared to Rs 94.40 billion last year, inter bank transactions stood at Rs 94.54 billion in the review period.

Table 2: Standing Liquidity Facility and Inter Bank Transactions

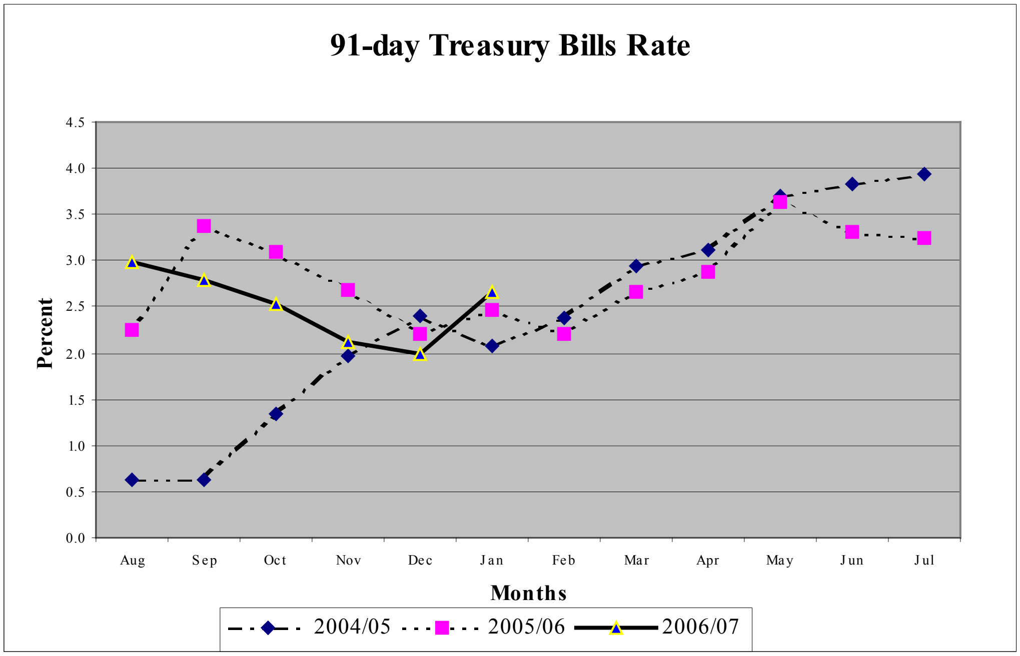
(First Six Months)

Rs. in billion

	2005/06	2006/07
Standing Liquidity Facility	1.92	8.19
Inter Bank Transaction	94.40	94.54

Short-term Interest Rate

13. Notwithstanding the excess liquidity with commercial banks, the prudent liquidity management increased the short-term interest rate in the review period compared to last year. The weighted average interest rate of 91-day Treasury bill stood at 2.67 percent as at mid-January 2007 compared to 2.46 percent a year ago. Likewise, the weighted average inter bank rate rose to 3.03 percent as at mid-January 2007 compared to 1.22 percent a year ago.



Securities Market Situation

14. On the primary issue front, Nepal Securities Board granted permission to ten financial institutions to issue ordinary shares amounting to Rs. 111 million and right shares amounting to Rs. 525 million in the first six months of 2006/07.

15. With respect to the secondary market transactions, the year on year (y-o-y) NEPSE index witnessed buoyancy with an increase of 75.81 percent to 537.09 points in mid-January 2007. This index was 305.50 a year ago. Increase in the investors' confidence on account of the improved peace and security situation resulting from the settlement of the political conflict and the release of the financial statements of the banks and financial institutions along with dividend declaration contributed to the share market resilience. Additionally, continuous rise in remittance inflows, lack of alternative investment opportunities, and low interest rate have also contributed for the expansion of share market.

16. The y-o-y market capitalization increased by 96.2 percent to Rs137.30 billion in mid-January 2007. Market capitalization to GDP ratio reached 21.3 percent in mid-January 2007 from 12 percent a year ago. Of the total transactions, bank and financial institutions, manufacturing and processing companies, hotels, business entities, and other groups accounted for 83.5 percent, 4.3 percent, 1.8 percent, 0.6 percent, and 9.9 percent respectively.

17. The number of companies listed in the Nepal Stock Exchange Ltd reached 141 by mid-January 2007. This number was 127 a year ago. Of the total listed companies, 94 are banks and financial institutions. Production and processing industries, hotels, business entities, and other groups consist of 29, 4, 8 and 6 respectively.

18. Total paid up capital of the listed companies stood at Rs. 20.85 billion in mid-January 2007, showing an increase of 18.8 percent over the period of one year. This increase was due to the additional listing of the companies in the Nepal Stock Exchange Ltd, and the issuance of ordinary and right shares by some of the financial institutions.

19. Monthly turnover to market capitalization ratio increased to 0.79 percent in mid-January 2007 compared to 0.26 percent a year ago.

20. The twelve-month rolling standard deviation in mid-January 2006 climbed up to 66.8 compared to 13.8 a year ago.

Sensitive Share Price Index

21. Nepal Stock Exchange Limited has started to make Sensitive Share Price Index public from January 1, 2007. Currently, the Index is developed comprising 56 companies, which are listed in "A" category by the NEPSE. There are certain criteria fixed by the NEPSE to include a company in "A" category. These include: paid up capital of at least Rs. 20 million, number of shareholders at least 1000, book value of share not less than paid up value, shares offered publicly, profit recorded for the last three years, and the disclosure of the financial statements made in the stipulated time. The sensitive index that the NEPSE has been calculating taking July 16, 2006 as the base, recorded 135.14 on January 14, 2007.

Inflation and Wages

Consumer Price Inflation

22. The year on year (y-o-y) consumer price inflation increased to 7.6 percent in mid-January 2007. Such was 7.0 percent in mid-January 2006. A significant increase in the prices of pulses (16.6 percent), vegetables and fruits (13.7 percent) and spices (26.9 percent) as well as the continuation of the pass-through effect of March 2006 increase in petroleum prices accounted for the higher inflation of 7.6 percent in the review period.

23. Group-wise, the indices of food and beverages and non-food and services groups increased by 8.0 percent and 7.1 percent, respectively. Region wise, highest inflation of 8.5 percent was recorded in Terai followed by Kathmandu Valley (7.2 percent) and Hills (6.5 percent). The respective inflation rates were 7.1 percent, 8.0 percent and 6.2 percent a year ago.

24. In mid-January 2007, y-o-y core inflation increased to 6.5 percent from 4.5 percent a year ago. The higher rise in core inflation in the review period is mainly attributed to the price

rise of wheat and wheat flour, spices, education, reading and recreation & other grains and cereal products.

25. Notwithstanding the favorable atmosphere created by the improvement in the internal security situation for easing inflationary pressure by mitigating supply bottlenecks, the period observed higher rate of inflation due to unfavorable weather condition and price hike of commodities such as spices, cereals etc. imported from India.

Wholesale Price Inflation

26. In mid-January 2007, the y-o-y wholesale price inflation remained higher at 10.4 percent compared to 8.2 percent a year ago. A significant rise in the prices of food grains, livestock, pulses, construction materials and spices together with the pass through effect of the hike in prices of petroleum products in March 2006 accounted for the higher rise in wholesale price inflation. Group-wise, the indices of agricultural commodities registered the highest increase of 13.1 percent, followed by domestic manufactured commodities (9.7 percent) and the imported commodities (7.2 percent).

National salary and Wage Rate

27. The y-o-y Salary and Wage Rate Index rose by 9.7 percent in mid-January 2007. The Index had increased by 4.3 percent a year ago. The surge in wage rate on account of shortage of labors owing to the Nepalese workers seeking foreign jobs and the 10 percent increment in the allowances of civil service contributed to the rise in the Index in the review period. Wage Rate and the Salary group Indices increased by 10.9 percent and 6.2 percent, respectively.

Fiscal Situation

Government Expenditure

28. In the first six months of 2006/07, total spending of the Government of Nepal (GON) showed an increase of 11.9 percent to Rs 44.77 billion compared to a growth of 17.7 percent in the corresponding period of the previous year. Sluggishness in the development activities at local level due to the absence of people's representatives in Local Bodies and resulting deceleration in capital expenditure as well as the low growth of recurrent expenditure accounted for such a deceleration in government expenditure.

Government Revenue

29. In the review period, government revenue recorded an increment of 19.7 percent to Rs 37.80 billion compared to a lower growth of 5.9 percent in the corresponding period last year. The adjustment in tariff rates, improvement in customs valuation, increased tax compliance, increased consumers' confidence as well as an increase in non-tax revenue resulting mainly from dividend contributed to such a higher growth of the revenue in the review period.

30. In the review period foreign cash-grants receipts to the GON increased remarkably by 56.7 percent to Rs 7.9 billion compared to a lower growth of 38.2 percent in the same period last year. Inflows of grants from Japan, India, the U.S. and European countries for the health sector, local level small projects and budgetary support contributed to such an increase in the foreign cash grants in the review period. Foreign cash loans, however, registered a decline of 10.0 percent in the review period as opposed to a sharp rise of 94.9 percent last year. The amount of foreign cash loans stood at Rs 1.90 billion in mid January 2007.

Budget Deficit/Surplus

31. As a result of a higher growth of government resources compared to the growth of expenditure, the GON budget recorded a cash surplus of Rs 2.65 billion in the first six months of 2006/07 in contrast to a deficit of Rs 2.50 billion in the same period last year.

Foreign Trade

32. In the first six months of 2006/07, total exports declined by 3.5 percent in contrast to an increase of 15.1 percent in 2005/06. Of the total exports, export to India declined by 3.8 percent in 2006/07 as against a significant growth of 27.1 percent in the same period of 2005/06. Similarly, exports to other countries declined by 2.7 percent in comparison to a decline of 5.1 percent last year. The decline in exports is attributed to the slowdown in external demand for Nepalese goods, frequent dispute between labor union and entrepreneurs and long hours of load shedding.

33. The decline in exports to India was attributed to the decline in the exports of polyester yarn, plastic utensils, cattle-feed, copper wire & rod, jute goods, noodles, G.I pipe and pashmina (Table 3). Likewise, the decline in exports to other countries was due to the decline in the export of readymade garments, woolen carpets and handicrafts.

Table 3: Decline in Exports of Selected Commodities to India
(First Six Months)

(Rs. in million)

	2005/06^{P}	2006/07^{P}	Decline
Polyster yarn	1899.8	1118.7	-781.1
Plastic utensils	489.4	217.9	-271.5
Cattle-feed	315.4	54.2	-261.2
Copper wire & rod	186.9	29.9	-157.0
Jute Goods	1486.2	1330.2	-156.0
Noodles	263.1	124.0	-139.1
G.I. Pipe	205.5	92.7	-112.8
Pashmina	129.5	17.9	-111.6
Total	**4975.8**	**2985.5**	**-1990.3**

34. Total imports growth decelerated to 6.4 percent in the first six months of 2006/07 compared to the growth of 22.5 percent in the same period last year. While imports from India increased by 7.6 percent in the review period compared to a higher growth of 31.4 percent in the corresponding period last year, imports from other countries, too, recorded a lower growth of 4.3 percent in comparison to a growth of 10.4 percent last earlier.

35. A rise in the import of petroleum products, vehicles & parts, thread, hot rolled sheet in coil and other machinery & parts from India and crude palm oil, computer parts, chemical fertilizer, copper wire & rod, medicine and textiles from other countries led to the rise in total imports in the first six months of 2006/07.

Balance of Payments

36. In the review period the overall BOP registered a surplus of Rs. 5.4 billion as compared to higher surplus of Rs. 10.5 billion in the corresponding periods of 2005/06. The lower BOP surplus in the review period is attributed to the increase in trade deficit, deceleration in the growth rate of remittance inflows and rise in deficits under net services.

37. During the review period current account registered a surplus of Rs.0. 98 billion as compared to Rs. 3.74 billion in the corresponding period of the previous year. Increase in goods and services deficits together with deceleration in the growth rate of workers' remittances contributed for the shrinkage in current account deficit. The decline in demand for Nepalese workers from Qatar after the completion of the Asian Games and declining attraction of Nepalese workers going to Malaysia due to low wage rate led to the deceleration in the growth rate of remittance inflow in the review period.

38. Under the financial account, the government received Rs. 2.89 billion as foreign loan and repaid Rs. 3.78 billion in amortization.

Foreign Exchange Reserves

39. In comparison to mid-July 2006, gross foreign exchange reserves rose by 2.5 percent to Rs. 169.24 billion in mid-January 2007. Such reserves had gone up by 9.8 percent in the corresponding period last year. On the basis of US dollar, gross foreign exchange reserves went up by 6.8 percent to US$ 2.38 billion in mid-January 2007. In the same period last year, such reserves had increased by 8.8 percent. The share of convertible reserves in the total reserves rose marginally to 95.0 percent as at mid-January 2007 from 94.9 percent in mid-January 2006, resulting in a corresponding decline in the share of the non-convertible reserves to 5.0 percent from 5.1 percent. Based on the first six months of imports of goods and services, the current level of reserves are adequate for financing merchandise imports of 10.9 months and merchandise and service imports of 9.0 months.

Price of Oil and Gold in the International Market and Exchange Rate Movement

40. The price of oil (Crude Oil Brent) in the international market declined by 17.4 percent to US$ 51.62 per barrel at mid-January 2007 from US$ 62.48 per barrel in mid-January 2006. The price of gold, on the other hand, rose by 11.6 percent to US$ 627 per ounce at mid-January 2007 from US$ 561.75 a year earlier.

41. In comparison to mid-July 2006, the Nepalese currency vis-à-vis the US dollar appreciated by 4.2 percent in mid-January 2007. It had depreciated by 0.9 percent in the corresponding period of the previous year. The exchange rate of one US dollar stood at Rs. 71.10 in mid-January 2007 compared to Rs. 71.00 in mid-January 2006.