Report on Monetary Policy
for
FY 2003/04

Background

1. In Nepal, competitive practices were introduced in the banking and financial sector only in the early 1980s. Prior to that, a system of controlled regime prevailed wherein the number of financial institutions, their area of operations, and their transactions were limited. Although there was an expansion in the number of financial institutions and a concomitant increase in the regulatory and supervisory responsibilities of the Nepal Rastra Bank (NRB), the expected outcome relating to the expansion and strengthening of the financial sector was not achieved due to the prevailing problems and weaknesses in implementation. However, clear signs of improvements have been noticed recently. As Nepal is undertaking various efforts in the light of its accession to the World Trade Organization (WTO), it is necessary to continue with the financial sector liberalization policy and accord priority to both the quantitative and qualitative developments of financial institutions. In this perspective, the NRB has taken the initiative in implementing as well as enforcing the compliance of the prudential regulations based on international standards. Corresponding supervisory arrangements are under implementation to strengthen the country's financial sector. Although it could be a little difficult for the financial institutions to comply with the regulatory arrangements in the context of economic slowdown, these provisions are *sine qua non* to make these institutions efficient players in the growing competitive environment in the days to come.

2. The Monetary Policy and Programme for FY 2002/03, with objectives of securing both domestic price and the balance of payments (BOP) stability for the sustainable economic growth and maintaining financial sector stability, soundness and credibility, was made public on July 16, 2002 as per the provision made in clause 94 of the NRB Act, 2002. The Report on Monetary Policy for FY 2003/04 is being made public in consonance and close coordination with the fiscal policy of His Majesty's Government (HMG). The objectives and strategies of this policy are designed with due consideration of the overall economic indicators and for creating a favorable impact on economic stability. The accommodative monetary policy, which was followed in an attempt to lower the cost of funds for encouraging economic activities and investment projects in the background of the overall stable economic conditions prevailing in the previous years, will be

continued in the current fiscal year as the policy has become supportive in arresting the economic slowdown and extending resources towards sick industries and the export sector. This report, including the background, is divided into eight parts comprising overall economic situation, review of monetary policy and financial sector reform programme implemented in FY 2002/03, existing problems of monetary policy, monetary policy framework and programme for FY 2003/04, financial sector and foreign exchange reforms, challenges of monetary policy for FY 2003/04 and projections of monetary aggregates and the conclusion.

Overall Economic Situation

3. Some improvement in economic activities took place in FY 2002/03 over FY 2001/02. In the external sector, a surplus in the BOP leading to an expansion in foreign exchange reserves was achieved. While the average annual inflation rates during FY 1999/00, 2000/01, and 2001/02 were 3.5 percent, 2.4 percent, and 2.9 percent, respectively, there was some pressure in prices in FY 2002/03. On the government finance front, although regular expenditure increased, budget deficit was under control due to a decline in development expenditure. Because of significant increase in the BOP surplus, liquidity expanded. Consequently, the interest rate structure, especially short-term interest rates, declined.

4. In FY 2001/02, the agricultural sector grew by 2.2 percent and the non-agriculture sector declined by 2.1 percent, resulting in the overall decline of GDP by 0.5 percent. In FY 2002/03, GDP is estimated to have increased by 2.3 percent at producers' price (2.4 percent at factor cost), the growth rates of the agricultural and non-agricultural sector estimated at only 2.1 percent and 2.5 percent, respectively. The agricultural sector could not grow as expected because of the late monsoon in some areas and the flood and landslides in some other areas. The persistence of economic recession in the global economy, especially in the advanced economies, has had an adverse impact on Nepal's export and tourism. The spread of SARS disease in the Asian countries is also estimated to have had some negative impact on Nepal's tourism. A ceasefire that took place between HMG and the rebel group in January 2003 and the initiation of the second round of talks brought about some positive impact on the economy; still, because of uncertainty in peace and security condition, investment-friendly climate could not be ensured and the targeted 4.0 percent economic growth rate for FY 2002/03 could not be attained.

5. In FY 2002/03, there was some pressure on prices and the average inflation rate is estimated at 4.8 percent. In FY 2001/02, the average inflation rate was 2.9 percent. The rise in the prices of food-related items emanating from the drought situation and the upsurge in prices of petroleum products including edible oil at

the international level, among others, which brought about a corresponding increase in their prices in Nepal, put pressure in the overall price level. Although there has been some increase in prices compared to the targeted inflation rate of 4.0 percent due to the significant rise in the prices of the above-mentioned items, the price situation is still under control.

6. Among the monetary aggregates, broad money (M_2), that had increased by only 4.4 percent in FY 2001/02, increased by 10.8 percent in FY 2002/03. Because of the increase in the net foreign assets (NFA) due to a surplus in the BOP and the upsurge in the bank credit to the private sector, M_2 expanded at a higher rate. The rate of growth of M_2 was lower than the estimated growth rate of 12.0 percent owing to the increase in the net non-monetary liabilities of the banking sector compared to its projected growth rate. Narrow money (M_1) increased by 7.4 percent in FY 2002/03 compared to the growth rate of 9.3 percent in FY 2001/02 and the projected growth rate of 11.8 percent for FY 2002/03. The growth of M_1 was estimated lower than that in the previous year due to the higher growth rates of the net non-monetary liabilities and the time deposits. Since short-term government securities amounting to Rs. 8.5 billion were sold via the secondary market auction system to mop up liquidity in FY 2002/03, reserve money expanded at a lower rate compared to that in FY 2001/02.

7. The budget deficit on cash basis stood at Rs. 11.0 billion as of mid-July 2003. The budget deficit was Rs. 18.3 billion at the end of FY 2001/02. Government revenue, which had increased by 3.8 percent in FY 2001/02, went up by 11.2 percent in FY 2002/03 and reached Rs. 56.1 billion. Regular expenditure went up by 11.8 percent in FY 2002/03 compared to an increase of 13.5 percent in FY 2001/02. Against a decline of 13.8 percent in FY 2001/02, development expenditure fell by 26.5 percent in FY 2002/03, leading to a lower decline of budget deficit by 40.3 percent in FY 2002/03. Of the budgeted domestic borrowing of Rs. 12.0 billion, Rs. 9.0 billion was mobilized as of mid-July 2003, and the cash deposits with the NRB amounted to Rs. 2.1 billion. As HMG repaid the matured national savings certificate, some treasury bills and special bonds amounting to Rs. 4.2 billion, the net domestic borrowing stood at Rs. 2.7 billion.

8. Changes were also observed in the interest rate structure in FY 2002/03. Most of the interest rates came down from the level compared to that of FY 2001/02. The weighted average rate of 91-day treasury bills declined from 4.71 percent in FY 2001/02 to 3.48 percent in FY 2002/03. The savings deposit rate of commercial banks dropped from an average of 4.77 percent in mid-July 2002 to 4.53 percent in mid-May 2003. Similarly, the three-month, six-month and one-year average deposit rates decreased from 4.19 percent, 4.7 percent and 5.92 percent, respectively, in mid-July 2002 to 4.03 percent, 4.63 percent and 5.63 percent,

respectively, in mid-May 2003. Likewise, some decline in the lending rates was also noticed. The fall in interest rate was attributed to the accommodative stance of monetary policy.

9. The NEPSE index fell by 22.7 points (10.0 percent) to 204.9 in mid-July 2003 from 227.5 in mid-July 2002. While share price-related transactions declined, other indicators such as market capitalization and volume of share transactions increased. Although the NEPSE index somewhat declined, the other indicators revealed a mixed outcome as the result of the directive issued by the NRB to financial institutions to increase the total paid-up capital, the listing of new development banks and finance companies and the increase in paid-up capital of listed finance companies.

10. In the external sector, total exports increased by 4.2 percent during the first eleven months of FY 2002/03. In the corresponding period of FY 2001/02, total exports had decelerated by 14.1 percent. While exports to India fell by 5.3 percent during this period of FY 2002/03, exports to third countries rose by 18.5 percent. Against a decline of 7.4 percent in total imports during the same period of FY 2001/02, total imports increased significantly by 17.3 percent during this period of FY 2002/03. Of the total imports, imports from India and third countries rose by 26.7 percent and 10.8 percent, respectively. As imports increased at a higher rate compared to the increase in exports, the trade deficit widened. A surplus of Rs. 5.1 billion was recorded in the BOP resulting from the increase in remittances during the first 11 months of FY 2002/03.

11. Foreign exchange reserves rose from Rs. 105.9 billion in mid-July 2002 to Rs. 112.3 billion in mid-June 2003 due to the surplus in the BOP. Of the total foreign exchange reserves, convertible reserves went up significantly and amounted to Rs. 98.4 billion in mid-June 2003 while inconvertible reserves dropped substantially to Rs. 13.9 billion. Convertible reserves increased as a result of the rise in the number of Nepalese working overseas and efforts at the policy and institutional level in routing the remittances through the banking channel. The decline in exports to India resulted in the fall in inconvertible reserves during this period. The available foreign exchange reserves was sufficient to finance 11 months' merchandise imports and 9.5 months' imports of goods and services.

12. The nominal exchange rate of the Nepalese rupee with the India rupee was stable but appreciated vis-à-vis the US dollar by 4.4 percent, from Rs. 78 per US dollar (buying rate) in mid-July 2002 to Rs. 74.75 per US dollar on July 16, 2003. The Nepalese rupee appreciated vis-à-vis the US dollar due to the weakening of the US dollar in the international market and the increase in convertible foreign currency reserves in Nepal.

Review of Monetary Policy and Financial Sector Reform Programme Implemented in FY 2002/03

13. While formulating the Monetary Policy for FY 2002/03, the GDP growth scenario was unfavorable: GDP growth had been negative for the first time since FY 1982/83 due to slowdown in economic activities resulting from external and internal factors. Tourism and manufacturing industries were in dire condition. The country's BOP was in deficit. In the financial sector, two large banks were passing through a very difficult financial phase. The operation and management of some of the private sector commercial banks was not satisfactory. As a result, the financial sector's stability was at stake. Against the backdrop of these economic and financial indicators and the low level of inflation as well as the adequate foreign exchange reserves position in terms of imports coverage despite the deficit in the BOP, the monetary policy's stance for FY 2002/03 was aimed at providing additional liquidity and lowering the lending rates without creating an adverse impact on economic stability.

14. Because of the accommodative stance of monetary policy, the impact on the intermediate targets (money supply and domestic credit) has been as expected. As indicated above, M_2 expanded by 10.8 percent in FY 2002/03 compared to a growth of 4.4 percent in FY 2001/02. Due to the increase in the availability of liquidity and the overall fall in the lending rate, the bank credit to the private sector expanded satisfactorily in FY 2002/03. As compared to the increase of 5.2 percent in FY 2001/02, the bank credit to the private sector increased by 13.2 percent in FY 2002/03. Owing to the slightly higher rate of inflation and the decline in nominal interest rates in FY 2002/03, the overall real lending rates have come down significantly.

15. In the situation when the development expenditure could not increase, it was due to accommodative monetary policy that bank credit to the private sector promoted investment and prevented the decline in overall investment. This increase in private investment also played a supportive role for the attainment of 2.3 percent economic growth rate in FY 2002/03.

16. Against the monetary policy target to attain a surplus of Rs. 3.5-4.0 billion in the BOP, a surplus of Rs. 5.1 billion was recorded during the first eleven months of FY 2002/03. The same level of surplus in the BOP is estimated for the end of FY 2002/03.

17. Although the target of monetary policy was to contain the average inflation rate at 4.0 percent, the average inflation rate of 4.8 percent for FY 2002/03 could not be considered a significant deviation from the target. As stated in the Monetary Policy and Programme for FY 2002/03 that the cash reserve ratio (CRR) would

be cut in two phases, the cash balances to be maintained by the commercial banks in their own vault was reduced from 3 percent of total domestic deposit liabilities to 2 percent, effective July 22, 2003. With a view to keeping inflation at the desirable level, the slated second phase reduction in the CRR was not undertaken. The lower expansion of reserve money due to the mopping-up of the liquidity through the secondary market transactions also helped contain the inflation rate at 4.8 percent.

18. After the abolishment of the average weighted interest rate spread of 5 percent through the Monetary Policy and Programme for FY 2002/03, the interest rate structure of commercial banks has become more competitive. The spread has not increased either.

19. As per the provision in the NRB Act, 2002 and the Monetary Policy and Programme for FY 2002/03 of gradually off-loading the excess government securities under the NRB's ownership to banks and the non-bank sector, the government overdraft of FY 2002/03 amounting to Rs. 5.9 billion was converted into marketable treasury bills and placed for sale in the secondary market. As a result, the share of government securities under the NRB's holding dropped. At the request of the NRB, HMG repaid the matured special bonds, with 9 percent rate of interest, amounting to Rs. 559 million and treasury bills amounting to Rs. 1.4 billion; this assisted in reducing the share of government securities under the NRB's ownership. While the total government securities under the NRB ownership was Rs. 19.4 billion in mid-January 2003 or 40.5 percent of the government revenue of FY 2001/02, continuous efforts from HMG and the NRB resulted in the sale through the secondary market and the repayment by HMG which brought down the balance as of mid-July 2003 to Rs. 5.3 billion, excluding Rs. 10.8 billion allocated for secondary market transactions for the objective of liquidity management. The outstanding government securities under the NRB's ownership as of mid-July 2003 was 10.9 percent of the revenue of FY 2001/02 and was close to the legal limit.

20. As per the Monetary Policy and Programme for FY 2002/03, out of Rs. 1.5 billion earmarked for refinancing to sick industries with 55 percent allocated to the industry and 45 percent to the hotel business, Rs. 505 million was disbursed by 9 commercial banks to 41 industrial firms and hotels. Although there was considerable demand from the industries for the refinancing facility, this facility could not be utilized as per the target since the industries could not fulfill the criteria laid down for this purpose.

21. As HMG's excessive use of overdraft facility disturbs monetary stability and makes it hard to attain monetary objectives, a provision made in the NRB Act, 2002 does not allow HMG to utilize the overdraft exceeding more than 5 percent of the net revenue of the previous year. Still, HMG had used the overdraft (Rs. 5.9 billion) exceeding the limit (Rs. 2.32 billion) for FY 2001/02 that had affected the monetary policy's target of BOP stability. As the cash deposits of HMG with the NRB was Rs. 2.1 billion as of mid-July 2003, HMG did not have to utilize any overdraft facility from the NRB in FY 2002/03.

22. With a view to promoting professionalism in the operation of banks and financial institutions and avoiding conflict of interest in the pursuit of making inspection and supervision effective for the financial sector stability, the representatives of the NRB in the commercial banks and development banks were called back as per the commitment in the Monetary Policy and Programme for FY 2002/03. HMG has also withdrawn its directors from commercial banks, excluding from those which it fully or partly owns.

23. The management contract of the two large banks (Nepal Bank Limited [NBL] and Rastriya Banijya Bank [RBB]), with government ownership, is moving forward under the assistance of the World Bank (WB). The management group of ICC Consulting Firm of Bank of Scotland (Ireland) Ltd. has taken over the management of the NBL since July 20, 2002. With regard to the RBB, the management team including foreign consultants has been operating since January 16, 2003. The management plan relating to the NBL's reform measures submitted by the management team of the NBL has been approved by the NRB and the WB. Likewise, the management team for the RBB has already submitted its management plan and budget plan to the NRB. The NRB, in the process of the approval, has forwarded the plan to the WB for its concurrence. Necessary arrangements have been made to monitor and supervise the functions and progress of the management teams in both of these banks.

24. As a special Act is required for the establishment of the Assets Management Company (AMC) so as to reduce the increasing non-performing loans (NPL) of the banking system, a draft ordinance relating to the AMC has been prepared and sent to HMG, Ministry of Finance. In addition, HMG, the NRB and the commercial banks have agreed to invest 40 percent, 10 percent and 50 percent, respectively, to meet the capital requirements of the proposed AMC.

25. With an objective of strengthening and carrying forward the financial sector reform programmes on a priority basis, the draft of Banks and Financial Institutions Ordinance, which aims at maintaining legal consistency in all deposit-taking banks and financial institutions, has been sent to HMG, Ministry of

Finance. Similarly, the draft ordinances relating to Anti-Money Laundering, Secured Transactions and Insolvency have been sent to HMG.

26. As per the provision made in the Bank and Financial Institutions Debt Recovery Act, 2002, HMG has formed the Debt Recovery Tribunal on June 19, 2003 so as to bring into implementation the provisions of the Act. The proportion of NPL of commercial banks is expected to decline after the Tribunal started functioning from July 17, 2003 onwards.

27. Credit Information Regulations, 2003 has already been issued in order to strengthen the credit information system from the legal perspective. The preparation of Credit Information Directives, as stated in clause 7 of this Regulation, is in its final stage.

28. Inspection and Supervision Regulations, 2003 and On-site Supervision Directives, 2003 have already come into effect since mid-March 2003. In the process of strengthening the inspection and supervision task of the banks and financial institutions, inspection and supervision works of NRB-licensed small farmers cooperative institutions have been arranged through the Small Farmers Development Bank.

29. Under the provision made in sub-clause (1) of clause 86 of the NRB Act, 2002, the NRB has taken control over the management of the NBL since March 14, 2002. The operation of this Bank is proceeding through the management committee established under sub-clause (2) of the same clause. As this measure led toward the improvement of the Bank's financial condition, the control over the Bank has been extended for the next two years under the same committee. Likewise, under the provision made in sub-clause (1) of clause 86 of the NRB Act, 2002, the management of the Lumbini Bank Limited has been taken under the control of the NRB since March 20, 2002. The operation of this Bank is under the management committee established as per sub-clause (2) of the same clause. The financial position of the Bank is improving after this arrangement. The control over the Bank has been extended for a maximum period of one year for the accounts to be audited and passed by the Annual General Meeting (AGM) and for the sale and distribution of shares allotted to the public in order for the Board of Directors, including the representatives from the ordinary shareholders, to function.

30. As stated in the Monetary Policy and Programme for FY 2002/03, the special study relating to the enhancement of the operational capability of the Agricultural Development Bank (ADB/N) and the Nepal Industrial Development Corporation (NIDC) is underway.

31. With a view to enhancing competition among banks and financial institutions and providing more financial services to the public, the Monetary Policy and Programme for FY 2002/03 had allowed the development banks to operate savings account transactions not exceeding 20 percent of their total financial resources. Consequently, they have mobilized savings deposits amounting to Rs. 247 million as of mid-April 2003.

32. As per the ongoing five-year structural reform programme in Rural Development Banks under which a policy has been set for the privatization of the profitable Rural Development Banks, a decision was made on June 10, 2003 relating to the privatization of Western Rural Development Bank in which 51 percentage points out of NRB's 61 percent share would be transferred to the private sector. In addition to this, under the structural reform programme, the selection process of executive directors for these banks through open competition is in progress.

33. As announced in the Monetary Policy and Programme for FY 2002/03, a sum amounting to Rs. 100.0 million from NRB's profit of FY 2001/02 has been allocated to the Rural Self-help Fund, especially in order to meet the long-term capital requirement for specified priority sectors such as tea, cardamom, cold storages, etc. In this connection, Rural Self-help Fund Credit Directives, 2000 has been timely amended and made effective since April 28, 2003.

34. A provision has been made to include under the category of deprived sector credit the commercial banks' loan up to Rs. 100,000 per head for the individuals going abroad for foreign employment. In this regard, the Employment Promotion Board has issued the credit directives, and the Bank of Kathmandu has been selected as a lead bank for this purpose.

35. With a view to encouraging the transfer of convertible foreign exchange earnings from foreign employment more through the banking system, the NRB had arranged, as per its Monetary Policy and Programme for FY 2002/03, to provide 15 paisa per US dollar as commission to licensed private firms in addition to the prevailing buying rate. There has been a positive impact of this provision on the accumulation of convertible foreign exchange reserves. Currently, 19 firms, excluding the commercial banks, are undertaking money transfer businesses as agents and one firm is conducting the business directly. In addition to this, in order to make money transfer business more competitive, letters of intent have been granted to 17 other firms to conduct the money transfer business directly as well as acting as agents.

36. As in other countries, a separate worker passport for the identity of workers travelling to foreign countries needs to be issued. This arrangement supports the objective of promoting foreign employment opportunities and routing the

remittances thus generated through the formal channels and also enhancing reliability of the BOP statistics. Until the permanent worker passport is issued, the NRB has requested HMG to use a special stamp with 'workers' to be embossed on the general passport.

37. For implementing the agreement reached between the NRB and People's Bank of China on June 17, 2002, the following arrangements have been made: (i) the commercial banks and other licensed bodies could purchase Yuan from the Chinese tourists coming to Nepal at the prevailing exchange rate; (ii) commercial banks could open the bank account in Yuan at the Jhangmu (Khasha) branch of Bank of China; (iii) the Yuan purchased by the commercial banks could be deposited at this branch; (iv) commercial banks could sell the convertible foreign currencies to purchase Yuan and could deposit it at the Jhangmu branch; (v) commercial banks could deposit at this branch Yuan received by Nepalese exporters from Chinese importers; and (vi) the Yuan at the branch could be used to settle payments for the imports from China.

38. As per the Monetary Policy and Programme for FY 2002/03, the foreign investors can now repatriate the dividend from their investments directly through commercial banks. However, for the purpose of statistical records, these investors need to apply once in the beginning at the NRB in its specified format. After receiving the application as per the specified format, the NRB would grant the specified commercial bank the permanent exchange licence. On the basis of this licence, the commercial banks can provide the exchange facility equivalent to the foreign investors' dividends.

39. Necessary steps for enhancing the capability and efficacy of the NRB, expediting the Bank's organizational reform and re-engineering measures, revising existing policy on human resource development, speeding up the Bank's mechanization system and modernizing the existing payment systems are taking place. These measures have been taken primarily to discharge efficiently the responsibilities as laid down by the NRB Act, 2002 and attain the objectives. To develop it as an efficient, modern and robust central bank, the NRB has been initiating timely reforms to make its organizational structure relevant, practical and effective. In addition, a total of 154 posts ranging from officer first class to non-officer first class have been frozen, effective from April 14, 2003.

40. For strengthening the organizational set-up, the NRB announced the voluntary retirement scheme (VRS) in April 2003 taking into account the prospects of socio-economic security of the employees. After the implementation of this scheme, the established posts at the Bank have been lowered by 370. In order to bring about expected reforms in the Bank's operation and functioning by enhancing professional expertise and specialization, persons with outstanding

academic qualifications have been recruited in the service of the Bank as per its needs. Besides, the NRB has continued to increase the benefits to the employees and the opportunities for their career development in the process of fulfilling the objectives of human resource management.

Existing Problems of Monetary Policy

41. The Monetary Policy and Programme for FY 2002/03 had projected a growth of 12.0 percent in M_2 and 11.8 percent in M_1 in order to facilitate attaining 4.0 percent economic growth without creating an adverse effect on the price level and the BOP position. The BOP position improved, but the price level remained at a slightly higher level as compared to the projected one, while the economic growth rate achieved was just 2.3 percent. In the background of lower economic growth attributed to various reasons, a challenge of containing the inflation rate at the desired level and attaining the targeted economic growth still persists for the successful implementation of the Monetary Policy for FY 2003/04.

42. Despite the provision made in the NRB Act, 2002 that the government securities owned by the NRB should not be more than 10 percent of the previous year's government revenue, this ratio has surpassed the prescribed limit because of the previous budget imbalances. When the NRB-owned securities are sold to the financial market in excess of its capacity, imbalances in the financial sector could occur. Therefore, the structural challenge is that HMG should introduce significant reforms in managing its budget deficit so as to reduce the adverse effect on monetary management emanating from the huge budget deficit as that happened in the past.

43. The proportion of NPL of banks and financial institutions is increasing due to the non-recovery of loans within the stipulated period. Despite the NRB's emphasis on regulation, inspection, supervision and monitoring of the banking and financial sector for enhancing credibility and strengthening of this sector, the proportion of NPL still appears to be on the higher level. Such situation has led to risk and uncertainty problems in the financial and monetary sector as well as in the government finance and overall macro-economic situation.

44. Despite the significant growth and development of banks and financial institutions in recent years, the informal financial sector is still prevalent in the country. The informal financial sector prevails primarily due to the inadequate supply of the required financial services from the formal sector. As a large portion of the remittances earned by Nepalese abroad is estimated to have come to the country through the informal channel, informal transactions seem to exist also in the external sector. Thus, the inadequate supply of formal financial services in

relation to the demand for such services is another major structural difficulty of the monetary and financial sector.

45. Even after fourteen years of interest rate deregulation and the establishment of large number of banks and financial institutions in the country, a question has been raised against the efficiency of financial intermediation owing to the higher spread between deposit and lending rates. In order to enhance the efficacy and attractiveness of formal financial sector through maximum deposit mobilization and anticipated credit flow, the other existing problem is to further narrow down the difference between deposit and lending rates.

46. Until now an efficient executive body responsible for regulations, inspection and supervision of a large number of cooperative institutions does not exist. As a result, a problem has emerged in restoring credibility by way of streamlining the use of funds of these institutions.

47. A number of problems have been noticed in Nepal's external transactions, too. Although the trade deficit and current account deficit are high, the foreign exchange reserve position in terms of import coverage has not weakened due to a surplus in the BOP basically contributed by increasing remittances. The existing exchange rate system that has been implemented for achieving macroeconomic stability is relevant on the one hand; but, on the other, a difficult situation prevails regarding the successful implementation of monetary and foreign exchange policy in strengthening the national economy through the sustainable increase in gross national savings, price stability and enhanced export by minimizing the external transactions risk.

48. The current overall situation of banking and financial sector's corporate responsibility is also problematic. In the process of discharging the responsibility of ensuring stability and competitiveness of the financial system through financial and monetary policy reforms, the NRB has given priority for implementing the international standards and necessary provisions relating to regulation, inspection and supervision of the financial institutions to their full extent. The NRB often faces problems during the implementation of these guidelines and measures aimed at fully meeting the commitment to ensure the maximum benefits to all the stakeholders of the financial system.

Monetary Policy Framework and Programme for FY 2003/04

49. The framework for monetary policy for FY 2003/04 has been directed at keeping inflation within control and avoiding the unnecessary depletion of the nation's international reserves. The primary objective of monetary policy is to strengthen the economic and financial sector stability as well as to maintain the macroeconomic indicators at the favorable level. In addition to this, the monetary

policy aims at managing the adequate level of financial resources required for a developing country like Nepal through enhanced level and efficiency of financial intermediation and keeping the lending rates at the desired level.

50. The pegged exchange rate system with the Indian currency will be maintained. The peg is aimed at ensuring the monetary policy's major objective of overall economic stability as well as maintaining domestic price stability for promoting economic growth. The objective of Monetary Policy and Programme for FY 2003/04 in conjunction with the pegged exchange rate system is to maintain the real effective exchange rate at the constant level, thereby preventing it from undue appreciation or depreciation.

51. Monetary and credit aggregates (money supply and domestic credit) will be taken as intermediate targets in between ultimate targets (price stability and strengthening of the BOP) and monetary policy instruments. Monetary programming will be initiated to ensure that the intermediate targets are consistent with the ultimate goals of monetary policy. To expedite this work, an inter-departmental Liquidity Monitoring and Forecasting Working Group has already been constituted.

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

53. To achieve the ultimate targets of monetary policy, open market operations and short-term interest rates will be used as the main monetary instruments to maintain the NRB's NDA within the desired level. Open market instruments will be used more effectively for short-term liquidity management. The secondary market transactions of treasury bills will be made more effective. The repo facility will be continued as a standing liquidity facility for commercial banks.

54. Currently, commercial banks are required to maintain compulsory reserve at 7 percent of their current and saving deposits and 4.5 percent balance of their fixed deposits with the NRB as well as vault compulsory ratio at 2 percent of total domestic deposits. In the light of the undergoing management reforms in the RBB and the NBL as well as the increasing efficiency of the commercial banks to manage their financial resources themselves, the provision of maintaining 2 percent balance in commercial banks' vault as a part compulsory reserve has been withdrawn. Effective from FY 2003/04, commercial banks are required to maintain 6 percent of their total domestic deposit liabilities at the NRB as compulsory reserve. A single, uniform compulsory ratio has been introduced so as to bring about uniformity and simplicity in the previously differentiated compulsory rates with respect to the different domestic deposit liabilities.

55. The bank rate will be used as an indication of monetary policy stance as the open market interest rates including the repos are determined by the market. The bank rate will, however, be maintained at 5.5 percent. The policy of keeping the bank rate unchanged is taken in view of the higher rate of inflation in FY 2002/03 compared to that of FY 2001/02.

56. Currently, the monetary survey is prepared on the basis of balance sheet information of the NRB and the commercial banks only. In the light of the presently rapid expansion of non-bank financial institutions, there is an urgent need to prepare a banking survey encompassing the transactions of non-bank financial institutions into the monetary aggregates. As a fundamental requirement for preparing the banking survey, the collection and processing of data from such institutions will be accorded top priority.

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

58. In order to meet their short-term liquidity requirements for a week or less, commercial banks avail the repo facility in the secondary market operated by the NRB. The repo rate in such a borrowing has been fixed at 0.5 percentage point in excess of the existing weighted average treasury bill rate. This upward adjustment in this rate is made with an objective of promoting inter-bank money market transactions and encouraging the commercial banks to resort to borrowing from the NRB only in cases where they fail to satisfy their liquidity requirement through interbank transactions. Unless the necessary adjustments made in the repo rate are compatible with the changes in treasury bill rate, the rationale of using the repo system would not be effective. Hence, in order to achieve the monetary policy goals, necessary adjustments will be made in the repo rate in line with the overall liquidity situation.

59. With a view to providing additional financial instruments with wide maturity spectrum for the investors willing to invest in government securities, the auction system will also be introduced for other short-term treasury bills in addition to the existing 91-day and 364-day treasury bills. This would facilitate in developing benchmark yield curves based on market-determined interest rates.

60. Currently, the auction system is used only for treasury bills. With a view to issuing the government debt instruments with wide maturity spectrum on the

basis of market-determined interest rates, the auction system will be introduced for the long-term government securities also.

61. The issue calendar pertaining to government securities will be made public with an objective of strengthening public debt management by increasing the attraction of investors to the government securities. All information relating to this will also be made available at the NRB web-site. The existing secondary market system will be strengthened by making government securities transactions simpler and more transparent. With a view to developing a secondary market, the government securities will be gradually converted into marketable ones. The government debt stock held by the NRB will be sold gradually through the secondary market in order to maintain the stock under the desired level in accordance with clause 75 of the NRB Act, 2002.

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

63. As per the policy of revitalizing the sick industries, refinance facility of Rs. 505 million at an annual interest rate of 3 per cent was provided to the commercial banks for sick industries out of the total allocated amount of Rs. 1.5 billion for FY 2002/03. With an objective of revitalizing the sick industries by providing them additional relief, the NRB will make Rs. 1.5 billion refinance facility available to the commercial banks to provide loans to sick industries (including for the industries in the industrial districts) for FY 2003/04. The refinance rate for this facility has been revised downward to 2 percent from the existing 3 percent. Because of this reduction in the NRB refinance rate, arrangements have been made for the commercial banks to reduce their lending rate for sick industries to 5.5 percent from the existing 6.5 percent. Commercial banks, while applying for the refinance facility, are also required to fulfill the standards set by the Sick Industries Revitalization Main Committee. The NRB has arranged such refinance facility at the reduced interest rate for the third consecutive time in order to provide relief to the entrepreneurs facing difficulties.

64. A penalty on shortfall up to 25 percent of the priority and deprived sector lending requirement as per the NRB's directive has been waived for FY 2002/03 also.

Financial Sector and Foreign Exchange Reform

65. The NRB re-engineering work will be implemented on the basis of the study that is being undertaken by the consultants under the WB assistance. This study intends to identify the long-term requirements of the qualified and efficient human resource and to implement all mechanisms required for human resource development in the Bank. These arrangements will be put in place in view of the

need to develop a strong, efficient and well-managed central bank in order to attain the soundness, effectiveness and stability in the financial sector; design a secure, healthy and efficient payments system; and achieve the other objectives enshrined in the NRB Act, 2002.

66. With a view to reducing the mounting NPL of the banking sector, the necessary work is underway for setting up an AMC. In this regard, HMG, in its public statement of income and expenditure for FY 2003/04, has mentioned about issuing an ordinance relating to this company by the first six months of the current fiscal year and has also earmarked Rs. 150 million for setting up this company. These commitments have paved the way for the establishment of this company in the near future which, in turn, is expected to help lower the NPL of commercial banks and other financial institutions.

67. A need to establish a separate credit information center has arisen since the existing Credit Information Center (CIC) provides its service only to the commercial banks and national level development banks. In this context, a new CIC with legal entity, in the form of public limited company, will be established by liquidating the assets and liabilities of the existing CIC and transferring them to the new CIC during FY 2003/04 to cater the credit information needs of all the commercial banks and financial institutions. This Center will be responsible for procuring and exchanging the credit information of banks and financial institutions, updating the details of the defaulting and insincere borrowers, blacklisting or taking necessary action against those borrowers, acquiring information in case a bank finances over and above the prudential limit and reporting to the NRB by conducting inspection, supervision and monitoring the implementation of directives by the commercial banks and other financial institutions.

68. Although initiative for the establishment of a Credit Rating Company was taken in the previous years, necessary legal, procedural and equity-related arrangements could not be made. These tasks will be completed and arrangements will be made for the establishment of a Credit Rating Company during this fiscal year.

69. The risk-weighted capital adequacy ratio, to be maintained by commercial banks, has been readjusted for the current fiscal year. Although these banks were required to maintain a minimum risk-weighted capital adequacy ratio of 12 percent, of which 6 percent had to be the core capital for FY 2002/03, because of the prevailing difficult situation, the minimum risk-weighted capital adequacy ratio for FY 2003/04 has been readjusted at 11 percent, with the core capital at 5.5 percent. Commercial banks will have to maintain a minimum of 12 percent risk-weighted capital adequacy ratio, comprising 6 percent core capital, from FY

2004/05 and onwards. This change in the capital adequacy requirement is expected to provide some relief to the commercial banks.

70. As per the present system, commercial banks are allowed to reschedule and restructure the loans by themselves after the repayment of the minimum 25 percent interest accrued along with the fulfillment of other necessary procedures and loan loss provision of 12.5 percent of such loans. While keeping this system intact, commercial banks are also allowed to reschedule and restructure loans even if the above-mentioned minimum 25 percent of interest accrued is not repaid. However, a loan loss provision for such rescheduled and restructured loans, as per the existing requirements, should be made in accordance with the classification based on the existing overdue period.

71. The structural reform of the rural development banks will be continued. In this regard, the Eastern Rural Development Bank, Biratnagar, which is generating profit following the initiation of the reform measures, will be privatized adopting the procedures applied to the Western Rural Development Bank, Butwal. As in the past, the credit extended to micro-finance institutions by commercial banks will be counted as the deprived sector credit. This practice will encourage the functioning of micro-credit institutions in the rural areas as these institutions will be able to meet some of their financial resources.

72. The NRB will allocate 5 percent of its profit in FY 2003/04 to the Rural Self-Help Fund to meet the long-term capital requirement of the specified priority sectors such as tea, cardamom, cold storages, etc.

73. A special study on ADB/N and NIDC is being carried out through an international auditing institution under the assistance of the Asian Development Bank (ADB). Necessary decisions for these two institutions will be taken on the basis of this study report as well as the NRB on-site supervision report.

74. Since Nepal is in the process of obtaining the membership of the WTO, the competition in the banking and financial sector will further increase globally along with her entry into this organization. In this respect, the NRB will further strengthen its regulatory and supervisory functions in addition to intensifying other reform initiatives carried out for the development, stability and efficacy of the financial sector. These steps will enhance the competitiveness of the Nepalese financial sector.

75. In the past few years, while there has been a halt in the entry of new joint-venture commercial banks on the one hand, some foreign investment has also been withdrawn on the other. Given this, and against the background of Nepal's likely accession to the WTO in the near future, the financial liberalization policy adopted by the country and the need for more competition, technologies, services

and instruments in the banking sector, the maximum ceiling for foreign equity in joint venture banks for foreign investors will be increased from the existing 67 percent in view of the need and request of reputed foreign banks.

76. As per the request of the NRB, HMG has committed, through its public statement of income and expenditure for FY 2003/04, to enact the legislations relating to the banks and financial institutions, AMC, anti-money laundering, secured transactions and insolvency. This will accelerate the process of legal reform in financial sector and will further contribute to the regulatory as well as the institutional development of this sector.

77. Considering the expansion of the banking sector, application of new technologies by commercial banks and the evolving increased competition in the financial market, the supervisory role of the NRB will be further strengthened. In this regard, the Off-site Supervision Directives will be introduced by the second quarter of FY 2003/04. For the effectiveness of the off-site supervision, arrangement will be made for receiving the statistical information from commercial banks electronically. The CAMELS (Capital, Assets, Management, Earnings, Liquidity, and Sensitivity) rating of commercial banks as per the international standard will be continued for the internal use of the NRB. And, priority will be accorded to carrying out the overall inspection of banks exhibiting a weaker position in this rating.

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

79. In view of making the NRB surveillance over banks and financial institutions strong, simple, result-oriented and regular and following the policy of establishing a separate supervision office in the area where the density of financial institutions is high, a bank and financial institutions supervision unit of the NRB will be established in Chitwan district in FY 2003/04. A study in this regard has already been completed. This unit will be primarily responsible for assisting the concerned departments of the NRB by conducting regular inspection and supervision of banks and financial institutions of that area.

80. The ratio of NPL of the government and semi-government financial institution is high. Emphasis will be laid on the effective implementation of the regulatory provisions to bring down the ratio of such loans. The NRB, being motivated by positive thinking and attitude rather than shying away from its duties and responsibilities, will be fully committed to implement all the measures necessary for loan recovery and will support all actions taken for reducing the ratio of NPL.

81. The exchange facility up to US$ 2,000 and US$ 1,000 for the purpose of visa, based on the categories of the countries, is being provided to all the Nepalese nationals visiting abroad (except India) for their personal or formal visit. Now onwards, this facility up to US$ 2,000 will be provided even if the visit is for the countries currently under the category of up to US$ 1,000. Most of the Nepalese nationals visiting abroad will obtain the adequate amount of foreign exchange because of this facility and will be an additional step in the policy direction of further convertibility of the Nepalese currency. In case the transactions do not fall under the current account and commercial banks are unable to provide the necessary exchange facility, the NRB will provide the facility.

82. Additional items will be included in the list that can be imported from India through the payment of convertible currency. The inclusion of additional items will be made on the basis of the structure of foreign currency reserves of the country, advantages to the industries, effect on value addition and competitiveness of the industries, and the prospect of export promotion. This arrangement is expected to contribute positively to the Nepalese economy with the lower cost of production in industries importing these items. The provision of importing certain items from India through the payment of convertible currency has been continuing since FY 1992/93. Currently, this list consists of 33 items including the changes made in the subsequent years.

83. The provision of making exports through the Cash Against Document (CAD) mechanism, even in the absence of the letter of credit or prepayments, is made further easier. Under the new provision, exporters are allowed to make exports up to US$ 100,000 through the CAD mechanism by maintaining only 10 percent bank guarantee. This flexible adjustment is made in view of the successful implementation of the existing provisions under which exporters are benefiting on the one hand and export payments are also timely settled on the other. Prior to this, exports through the CAD mechanism was allowed up to US$ 50,000 and the required bank guarantee ratio was 25 percent. The new provision is expected to enhance the export competitiveness by lowering the cost of exporters.

84. The system of importing from third countries only through the letter of credit was amended and imports up to US$ 3,000 was also allowed through Draft/TT a few years ago. This limit of imports through Draft/TT has been raised to US$ 30,000. Such an arrangement has been made in view of the reluctance of foreign exporters to make transactions of small amounts through the letter of credit on the one hand and the maximum charge being levied by the correspondent banks on the other. This provision is expected to lower the charges payable by the Nepalese importers.

85. Since the facility of making necessary provisions against the foreign exchange risk is already provided to all importers, the facility of opening usance letter of credit will be extended to other importers in addition to the industrial ones. The maximum period of one year of such usance letter of credit will be continued and the documents relating to this type of letter of credit can be discounted under the prevailing provisions provided the Nepalese commercial banks are willing.

86. There has been a remarkable increase in the number of the Nepalese people working abroad and the remittance inflows from them have become an important part of the Nepalese BOP. In view of this, manpower agencies, engaged in sending Nepalese nationals to work abroad, will be permitted to open foreign currency account in the Nepalese commercial banks out of the service charge they receive in foreign currency under the prevailing rules. This is expected to generate a positive impact on foreign employment promotion and remittance mobilization.

87. For the simple and smooth transfer of remittances through the banking system from the Nepalese working overseas, banks and financial institutions operating inside the country will be further encouraged to develop their relationship and maintain coordination with the respective countries' banks, financial institutions and recognized agents.

88. From now onwards, commercial banks are allowed to make inter-bank transactions of the Indian Currency (IC) among themselves. At present, such type of transactions is taking place only between the NRB and the commercial banks. Since the inter-bank transactions of the IC did not take place among the commercial banks, one of the organs of inter-bank transactions remained inactive. Similarly, the NRB will not charge the commission on the IC purchase made by commercial banks. This will ultimately facilitate the customers, as the commission charge of the commercial banks will also come down to some extent.

Challenges of Monetary Policy for FY 2003/04

89. Since the monetary policy is operated through financial institutions, especially commercial banks, the sound financial health of these banks is very crucial for the efficient monetary management. The financial health of the two large commercial banks, the NBL and the RBB, covering nearly 40 percent of the total transactions of the banking sector, has not been satisfactory and, because of this reason, the management of these banks has been handed over to the foreign consultants on contract basis. Unless the financial position of these banks improves, the impulses of monetary policy will not be transmitted to the real sector as expected.

90. The bad loans of the commercial banks, including those owned by the private sector, have been increasing particularly because of the slowdown in economic activities and sickness in some of the industries. The mounting bad debts will

pose challenges to the loan recycling process, subsequently discouraging the private sector investment. If the proportion of bad loans of private sector commercial banks also does not come down, the effectiveness of monetary policy will be weakened.

91. The ceiling on the interest spread was abolished through the Monetary Policy and Programme for FY 2002/03. This was aimed at fostering competition among the financial intermediaries so that the spread could be brought down. If this happens, both the depositors and borrowers would benefit and financial intermediation efficiency would also improve. The whole process would have a positive impact on the economy. If the commercial banks increase the spread rate ignoring this spirit, the saving mobilization in the financial sector will be reduced and financial resources in the financial sector will be curtailed, adversely affecting the overall investment. This will pose challenges for attaining the monetary policy objectives.

92. Under the process of financial sector reform, there can not be two opinions on the necessity of legal reforms in the financial sector. If the legislative reforms in the financial sector are delayed and the developed legal fundamentals are not implemented effectively, it will be hard to achieve the expected outcome from the monetary policy.

93. The primary objective of the monetary policy has been to keep inflation low. In case the structural causative factors affecting inflation become unfavorable and the foreign exchange rate changes unexpectedly, the implicit inflation target of monetary policy will not be achieved.

94. The Rural Self-Reliance Fund has been regarded as an important component of the institutional credit delivery mechanism in the rural areas. The NRB-licensed cooperatives and NGOs undertaking limited banking transactions are the users of the Fund. Acquiring funds from the above Fund at the concessional rate, these institutions supply credit for the promotion of productive activities in the rural areas. The NRB had allocated Rs. 100 million to this Fund through the Monetary Policy and Programme for FY 2002/03. With a view to increasing the rural credit through the formal sector, the NRB has given continuity to the policy of allocating 5 percent of its profit to this Fund for the current fiscal year also. Despite these efforts, the implementation of monetary policy will not be effective if the atmosphere for the smooth operation of the financial institutions in the rural areas is not conducive.

Projections of Monetary Aggregates and the Conclusion

95. Signs of improvement in the Nepalese economy have been witnessed since the second half of FY 2002/03 in contrast to the disappointing economic performance

attributed to both the domestic and external economic as well as non-economic factors in FY 2001/02. The NRB is always committed to facilitating a higher economic growth rate by strengthening macroeconomic structure, developing the financial sector and maintaining financial sector stability. In the context of the development of the financial sector as a strong economic sub-sector and the contributions that this sector can make to the expansion and dynamism of the economy through this sector's development and reform, the NRB has accorded high priority to the overall development, expansion and deepening of this sector. Accordingly, a number of monetary and financial reform measures have been implemented. The reform initiatives relating to the organizational restructuring, utilization of modern technologies, development of efficient, talented and well-motivated human resource and managerial strengthening are under implementation in the NRB. These measures are undertaken for making the NRB as an effective central bank capable of overseeing the overall economic management even more efficiently and also addressing the problems in the financial sector on a sustainable basis. The NRB is further committed to discharge its regulatory as well as supervisory responsibilities for the qualitative development of the financial sector. This is particularly important in the context of the rapid quantitative growth of the banking and financial institutions in an environment of financial liberalization.

96. The growth rate of M_2 and M_1 for FY 2003/04 is projected at 11.2 percent and 9.2 percent, respectively. These are in line with the objectives of containing inflation at 4.3 percent, attaining the BOP surplus of Rs. 2 billion and facilitating economic growth of 4.7 percent during this year. The successful implementation of this monetary policy will assist in maintaining long-term stability in both the economic and financial fronts. A continuous monitoring of the implementation of this policy will be carried out. As a result of the implementation of the provisions made in this policy, a solid contribution will be made for sustaining the macroeconomic stability, fostering the qualitative growth of financial sector, increasing efficiency in financial intermediation, improving the availability of credit to the entrepreneurs at the reduced interest rate, providing refinance facility to sick industries, increasing the dynamism of the economy, and bringing about effectiveness of the financial sector reform. The NRB policies so far implemented have proved highly useful for strengthening the overall macroeconomic structure and promoting economic activities, productive investments, productivity, employment and economic growth in an environment of economic stability and strong macroeconomic fundamentals. The NRB expects that HMG, the financial sector and other concerned quarters will continue to support the NRB for the successful implementation of this monetary policy.