International Monetary Fund

Nepal and the IMF

Press Release:
IMF Executive Board Approves US$ 42.05 Million Disbursement Under Rapid Credit Facility for Nepal
May 28, 2010

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Nepal: Letter of Intent

May 13, 2010

NEPAL: LETTER OF INTENT

Kathmandu, May 13, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Strauss-Kahn:

1. **Nepal is in the midst of a major political transition.** Following the comprehensive peace accord which ended the 10-year armed conflict in 2006 and Constituent Assembly elections in April 2008, the political parties remain focused on completing the peace process and the promulgation of the new constitution, after which general elections will be held. Despite the progress of the past several years, the political situation remains fragile and the government's ability to implement comprehensive structural reform is currently limited.

2. **The global crisis is having a delayed and substantial impact on our economy:**

- **Remittance deceleration.** Nepal is heavily dependent on remittances—constituting over 20 percent of GDP. Owing to the global crisis the outflow of Nepali workers abroad decreased by 12 percent during 2009. As a result of fewer Nepalis leaving to work abroad, the growth of remittances halved to 17 percent year-on-year in the first half of 2009/10 from an average of 34 percent in 2005–08.

- **Trade balance deterioration.** Exports have declined by 14 percent so far this fiscal year due to falling demand.[1] While exports to India have dropped by 6 percent, exports to other countries are down by 26 percent, reflecting the appreciation of the Indian rupee. At the same time, as imports continued to soar (by 46 percent) on the assumption that remittances growth would continue in line with previous years, the trade deficit has risen by 67 percent in the first half of 2009/10, reaching 28 percent of GDP. In sum, the 2009/10 current account is set to record a sizeable deficit of 2 percent of GDP, the first deficit since 1997/98.

- **Reserve drain.** These developments, combined with net capital outflows, have in just a few months reduced international reserves by US$ 400 million (13 percent) from their July 2009 peak to US$ 2.5 billion in March 2010. Reserves now cover only 5 months of imports compared to 6 months as recently as October 2009.

[1] Nepal's fiscal year begins in mid-July.

3. **The impact of these shocks on Nepal's economy has been significant.**

- **Liquidity and financial sector.** The slowdown in remittance growth contributed to a financial sector liquidity squeeze, which drove up interest rates and exposed financial sector weaknesses. As reserves fell, some banks experienced liquidity stress as banks' credit-to-deposit ratios are high. The Nepal Rastra Bank's (NRB) liquidity injections have since lowered interbank interest rates and banks are reported to have reduced new loan disbursements. But, asset quality is likely to deteriorate in the coming months as roll-over and liquidity risks increase.

- **Economic activity.** Decelerating remittance growth, tightening liquidity conditions, and a poor monsoon suggest activity is weakening: real GDP in 2009/10 is projected to fall to less than 4 percent compared to 4¾ percent in 2008/09. This slowdown will make the government's efforts to accelerate economic growth and reduce poverty on a sustainable basis more difficult.

4. **The government of Nepal recognizes that the deteriorating external position and the financial sector require immediate attention.** The speed with which reserves have declined over the past months is worrisome. While we have capital controls in place, our open border and extensive trade links with India present challenges in enforcing these regulations. Against this background and financial sector vulnerabilities, we view a relatively high reserve coverage as essential. To address these challenges, we are committed to strong macroeconomic policies to safeguard external and financial sector stability.

Policies to Address Shocks

5. **The NRB has recently introduced measures to improve the provision of liquidity:**

- The terms for repo transactions were lengthened from 28 to 45 days—similar to measures taken in many other countries during the crisis;

- Commercial banks' call deposits can count towards meeting the statutory liquidity ratio; and

- A new refinancing facility to channel credit to the export, power and tourism sectors has been introduced.

We expect these measures to contribute to an easing of liquidity conditions in the coming months and promote credit provision to priority sectors, while overall liquidity conditions remain consistent with the peg.

6. **The NRB has taken measures to safeguard financial sector stability.** The rapid credit growth in recent years—fueled partly by remittance inflows—has created asset price

bubbles, particularly in the real estate and housing markets. To strengthen the health of the financial sector and financial stability, we have recently taken several prudential measures.

- **Licensing policy.** The NRB imposed a moratorium in December 2009 on new bank licenses while the policy is being reviewed. However, to promote the provision of financial services in rural areas, the moratorium has been lifted for microfinance institutions (class D) and eased for development banks (class B).

- **Lower single borrower limits**. Single borrowing limits will be lowered to 25 percent of capital by July 2010, with exceptions for some infrastructure projects such as hydropower, cable cars, and the planned fast track road linking Kathmandu with the Terai region.

- **Real estate limits.** Banks are required to lower exposure to real estate loans (and housing) to 25 (40) percent of total loans by end-2009/10. Both limits will be further lowered by 10 percentage points by end 2010/11 and by an additional 5 percentage points by end 2011/12. Loans above the limit will be penalized by provisioning requirements on the basis of a risk weight of 150 percent.

- **Loan-to-value limits**. Commercial banks loans cannot exceed 60 percent of fair market value of collateral or project.

- **Credit-to-deposit ratio limits**. Commercial banks credit-to-deposit ratios should not exceed 95 percent by end-2009/10, 85 percent by end-2010/11, and 80 percent by end-2011/12.

- **Facilitating bank restructuring**. The NRB has begun liquidation of Nepal Development Bank (NDB) and also completed the restructuring of the Nepal Bangladesh Bank.

- **Risk management.** The NRB has drafted risk management guidelines that will be issued to commercial banks by July 2010.

We recognize that some of these new prudential measures will be challenging for the commercial banks to meet. In this context, we reaffirm our commitment to enforcing existing regulations and developing bank-by-bank time bound actions plans if necessary.

7. **We remain fully committed to maintaining financial stability and support the current peg.** The peg to the Indian rupee has been and continues to be a key anchor for Nepal's economic stability. We have taken strong measures to stem the balance of payments deficit. The NRB recently raised margin requirements on gold and silver imports and introduced quantitative limits on gold and silver imports. The government has also raised tariffs on gold imports, and is considering measures to curb imports of consumption goods to safeguard foreign exchange resources for growth-enhancing imports of capital goods. In the

mid-term review of monetary policy, to protect the balance of payments position, the NRB also limited the availability of the passport foreign facility to twice a year and $2,000 per transaction. The NRB and the Government of Nepal will take additional measures as necessary. We are aware that maintaining quantitative limits on the availability of foreign exchange for leisure travel may give rise to an exchange restriction under Article VIII of the IMF's Articles. In this context, we commit to removing any restrictions that may arise from these measures by March 2011 as the balance of payments situation is expected to improve. Remittance growth is expected to recover in 2010 as the host countries of our workers recover and import growth should moderate over the coming year in response to recent measures and tighter liquidity conditions. However, we do not anticipate that remittances growth will recover to the levels prevailing before the crisis, and generating strong export growth in the near term will remain difficult. In a longer-term perspective, the widening productivity differential with India presents challenges but we anticipate that continued labor mobility to offset competitiveness losses. Once the peace process is concluded, we expect to advance structural reform to address the productivity gap.

8. **While the measures outlined above are important in the short term to support the balance of payments position, we are cognizant that liquidity provision needs to be consistent with the peg.** Against the background of a challenging external situation, monetary policy needs to remain tight and interest rates above those of India. While NRB liquidity provision through blanket repos has succeeded in normalizing interbank rates during the recent liquidity squeeze, going forward, individual banks' liquidity needs will be met through the Supplementary Liquidity Facility at penalty rates. For solvent banks without adequate collateral, the bank rate window will be used under heightened NRB oversight and conditionality. The modalities for accessing the bank rate window will be further clarified by July 2010 in our continuing effort to improve communication with banks and the public. The NRB remains committed to intervening insolvent banks, as demonstrated in the case of the Nepal Bangladesh Bank and the Nepal Development Bank.

9. **We are committed to strengthening financial sector supervision further to safeguard financial stability and enhance the NRB's capacity and credibility.** Before end-July 2010, the NRB will begin a thorough assessment of the health of the financial sector, including solvency and liquidity risks, through stress testing and special on-site inspections. In this area, we welcome the possibility of a Fund resident technical assistance advisor. To the extent shortcomings are identified, corrective action will be taken promptly and regulatory forbearance eschewed. Beginning in 2010/11, the NRB will also introduce penalties for pledging of promoters' shares by deducting them from bank capital, in line with international practice. We will also strive to improve the timeliness and accuracy of data compilation, in particular in the financial sector.

10. **Contingency planning will be enhanced.** With technical assistance from the World Bank, the NRB will develop a contingency plan in case financial sector stress breaks into a crisis. We will seek to expedite passage by the Constituent Assembly of the amended Bank

and Financial Institutions Act (BAFIA), which would strengthen the bank resolution framework.

11. **The bank licensing policy will remain restrictive and financial sector consolidation will be encouraged.** The NRB's supervisory capacity has not been developed in line with the rapid growth of the financial sector. Against this background, further licensing of commercial banks will remain very restrictive and the supervisory capacity of the NRB will be strengthened commensurate with the expansion of the financial sector. To ensure access to financial services in rural areas, the NRB will work with commercial banks and microfinance institutions to encourage provision of services through mobile banking and agent banking, without additional banks entering the financial system. We will also promote banking sector consolidation by facilitating the public trading of promoters' shares by July 2010.

12. **We remain committed to reforming two state-owned banks.** Although progress has been made in strengthening the management of Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB), a comprehensive strategy is needed to bring the banks back to solvency. To build on the reforms to date, we will begin recapitalizing NBL in 2010/11 and continue our efforts to strengthen the management of both banks.

13. **The fiscal stance will remain prudent.** While the fiscal consolidation over the past years has created some fiscal space, the current external situation calls for a continued cautious fiscal stance to support the peg and maintain macroeconomic stability. We will keep domestic financing to around 2 percent of GDP in 2010/11 and increase it moderately to around 2½ percent in 2011/12 provided the external situation improves. In addition,

- On revenue administration, we will continue to build on the recent improvements to increase the revenue-to-GDP ratio. We have developed a comprehensive reform strategy for the customs department, measures to curb tax evasion, broaden the tax base, and improving the audit function of the large tax payer office, with the help of Fund technical assistance.

- We are committed to easing capacity constrains in capital spending. Recurrent spending will be restrained, while health, education and security expenditure will be safeguarded.

- We also intend to improve the coverage of the financial information, the accounting system, monitoring expenditure, and systems to coordinate donor activity.

- We will ensure that the financial health of the Nepal Oil Corporation (NOC) is safeguarded and we will continue our strategy of incremental price adjustments as needed to avoid losses of the NOC.

Request for Access under the Rapid Credit Facility

14. **Despite these measures, the pressure on the NRB's international reserves and the financial sector is expected to continue in the near term.** Against this background, the Government of Nepal requests access of 40 percent of quota (SDR 28.52 million) through the Rapid Credit Facility based on the urgent balance of payment needs and the strength of our macroeconomic adjustment polices. Access at this level is motivated based on the need to safeguard reserve adequacy and maintain confidence in the face of significant external and financial sector risks. In addition to our commitments above, to benchmark our progress, we are committed to meeting a set of Indicative Targets for end-2009/10, including the NRB's net international reserves and net domestic assets, and the government's net domestic financing (Table 1). We also expect that Fund financial support will serve as a bridge to an Extended Credit Facility, which we hope to start negotiating later this year.

15. **The RCF will also provide policy support for our poverty reduction strategy.** Our current Plan/Poverty Reduction Strategy Paper objectives include macroeconomic stability, institution building and structural reforms to raise growth and reduce poverty. We expect Fund financial support and our policy commitments under the RCF to have a catalytic effect on confidence, helping to catalyze international donor support and strengthen macroeconomic stability. An interim poverty reduction plan covering the period mid-2007 to mid-2010 is currently in place. Moving forward, a three-year plan covering mid-2010 to mid-2013 with special focus on employment and equity is being formulated in consultation with stakeholders.

16. **We are committed to completing a safeguards assessment.** In this context, we are liaising with Fund staff to conduct an external audit for the NRB in accordance with international standards, and authorize Fund staff to have access to the external audit reports and hold discussion with the auditors.

17. **The Government of Nepal and the NRB agree to publish this letter.**

Sincerely yours,

/s/	/s/
Surendra Pandey	Yuba Raj Khatiwada
Minister of Finance	Governor, Nepal Rastra Bank

Nepal: Indicative Targets

		Jul-09	Mar-10	Jul-10
		Actual	Actual	Indicative targets
I.	Floor on net international reserves of the NRB (in millions of US dollars) 1/	2792	2581	2,400
II.	Ceiling on net domestic assets of the NRB (in millions of Nrs.) 2/	-23,179	14,517	15,500
III.	Net dometic financing of the budget deficit (ceiling on cumulative flow from beginning of FY, in million Nrs) 3/	23,174	-9,194	23,500
IV.	Ceiling on contracting or guaranteeing of new nonconcessional external debt(in millions of US dollars) 4/	0	0	0
V.	Ceiling on accumulation of external payments arrears (in millions of US dollars) 5/	0	0	0

1/ Net international reserves of the Nepal Rastra Bank (NRB) will be calculated as gross international reserves including holdings of nonconvertible currencies less international reserve liabilities. Holdings of Indian rupees will be converted into U.S. dollars at the program exchange rate of 45 Indian rupees per U.S. dollar; holdings of other nonconvertible currencies will be converted into U.S. dollars at market exchange rates. Assets denominated in SDRs will be converted at the program exchange rate of 1.57 U.S. dollars per SDR. Gross international reserves consist of monetary gold holdings of the NRB, holdings of SDRs, Nepal's reserve position in the IMF, cash in foreign currencies, and foreign currency assets held abroad that are under the direct and effective control of the NRB and readily available. International reserve liabilities consist of all outstanding liabilities of Nepal to the IMF and any convertible currency liabilities to nonresidents with an original maturity of up to one year.

2/ Net domestic assets of the NRB will be calculated as the difference between domestic assets and liabilities of the NRB. Domestic assets consist of claims by the NRB on the government, state-owned enterprises, financial institutions, banks, the private sector and other assets as reported in the NRB's balance sheet. Domestic liabilities consist of government deposits, capital accounts, and other liabilities as reported in the NRB's balance sheet.

3/ Net domestic financing of the budget deficit is defined as the sum of net credit to government by the banking system (NRB and deposit money banks), net changes in holdings of treasury bills and other government securities by nonbanks, and privatization receipts by the government.

4/ The definition of debt, for the purposes of the program, is set out in Executive Board Decision N. 12274, Point 9, as revised on August 24, 2000.

5/ The indicative target on nonaccumulation of external arrears is continuous.