Monetary Policy 2076/77 Highlights

International Outlook

1. Global economy is expected to contract by 4.9 percent due to reduced economic activity owing to mobility and economic restrictions due to COVID-19 and mitigating measure put in place to contain its spread. This is in stark contrast to the economic growth of 3.6 percent in 2018 and 3.2 percent in 2019. Similarly, Advanced, and Emerging Markets and Developing Economies are projected to contract by 8 percent and 3 respectively, down from growth by 1.7 and 3.7 percent in 2019.
2. China's economy is projected to grow by 1 percent in 2020 down from 6.2 percent in 2019 but still faring well on the back of earlier resolution of major COVID-19 cases while India's economy is projected to shrink by 4.5 percent an 8 point swing from a growth 4.2 percent in 2019.

Implications: Global Economy has slowed down substantially owing to COVID-19 but china's recovery shows signs that economic growth can bounce back once COVID peak is reached and the infection curve starts shifting downwards. However, these are only tentative numbers with the underlying assumption that things will get better and the worse has passed which may not necessarily be the case. The projections thus show an outlook of the year as of the end of June and may change drastically if the issue of the virus is not resolved with possible additional downsides likely if that was the case. The situation will probably need to be monitored for an additional one or two quarters to truly ascertain the overall damage caused.

Review of Economic Status

3. Nepal's economy is expected to grow at just 2.8 percent in Fiscal Year (FY) 76/77 compared to 7 percent in the FY 75/76.
4. Ratio of Gross Domestic Savings to Gross Domestic Products is at 18.1 percent compared to 20.5 percent in the previous Fiscal Year. Similarly, Ratio of Gross National Savings to Gross Domestic Products is at 46 percent compared to 48.9 percent in the previous Fiscal Year.
5. Average Consumer Price Inflation (CPI) is around 6.28 percent in the current FY compared to 4.51 percent last FY.
6. Recurrent Expenditure in FY 76/77 is projected at 786.53 Arba, Capital Expenditure at 191.77 Arba, Financial Management Expenses at 116/4 Arba and Tax Collection at 84.36 Arba. Recurrent expenditure has increased this FY while other expenditures and tax collection has decreased.
7. In the first 11 months of FY 2075/76 Balance of Trade has improved by 16.4 percent to stay at Loss of 1012.81 Arba.

8. In the first 11 months of FY 2075/76 Remittance Inflow has decreased by 3 percent to stay at Rs 774.86 Arba. Balance of Payment is projected to be at a surplus of Rs 179.37 Arba

Implications: COVID-19 has affected all economic activity in the second half of the FY and the results can be seen in Nepal's projected growth numbers. Inflation has increased slightly and so has overall recurrent expenditure while tax collection and capital expenditure have taken a hit as mobility is limited. This can also be observed with a Balance of Payment Surplus due to decreasing imports as consumption has been affected.

Similarly, the tiring state of government finance may be a problem as the government will need to source significant external debt to fund additional capital expenditure projects and drive the development agenda forward. The reduction in credit disbursement in particular can have a significant impact on economic productivity as Nepal has one of the higher Total credit to GDP ratios in the world (i.e. High credit-based consumption). The BOP situation will need to be strictly monitored as a consumption rush during Dashain can drive consumption and consequently imports substantially.

Securities and Stocks

9. NEPSE index has grown to 1362.34 percent from 1259 this FY while Market Capitalization is Rs. 1792.76 Billion up from 1567.50 Billion Last FY.
10. A total of 19 BFIs (17 Commercial Banks and 2 Finance Companies) were permitted by NRB to issue Debentures worth Rs 45.25 Arba in the market this fiscal year.

Implications: Stock Market seemed to have started on a bullish trend at the start of 3rd Quarter last FY but dropped substantially and has recovered slightly after being shut down for few months. This period has also seen an increase in public issues.

Review of Monetary Policy 2076/77

Monetary Management

11. Money Supply has grown by 17.5 percent up to the end of Jestha w.r.t. the limit of 18 percent set for the current fiscal year.
12. Domestic credit growth has been 16.9 percent in reference to the cap of 24 percent set for the fiscal year and Private Sector credit growth has been 13 percent in reference to the cap of 21 percent set for the fiscal year.
13. The weighted average 91-Day treasury Bills rate was 1.27 percent at the end of 2076 Ashad as compared to 4.97 percent in the corresponding period of the previous year whereas weighted average interbank lending rate is 0.35 percent down from 4.53 percent in the corresponding period of the previous year.
14. The average base rate for commercial banks was 8.66 percent at the end of 2076 Ashad as compared to 9.57 percent in the corresponding period of the previous year whereas weighted average lending rate was 10.42 percent down from 12.24 percent in the corresponding period of the previous year.

Implications: Money Supply and Credit Growth have both been impacted significantly due to COVID-19 and associated lockdown measures. The limits thus set for inflation control have been maintained . Both 90-day Treasury bill rate and interbank lending rates have decreased substantially as have Banks's base rate and lending rates as liquidity has been building up in the banking system as newer credit disbursement has come to almost a standstill. Expect rates to go down further until economic activity begins to take shape again and mobility situation improves drastically.

Loans Related Programs.

15. Owing to the provision of Financial Institutions being able to avail foreign currency loans up to the value of their capital, Commercial Banks have availed loan equivalent to 7 Crore USD against permitted amount of 9 Crore USD. Similarly, three Microfinance institutions have availed loan equivalent to 2.06 Crore USD and 1.1 Crore Japanese Yen.
16. Banks have availed loans of 9.7 percent of total loans for Agriculture, and loans of 11.1 percent of total loans for Energy & Tourism Sectors as opposed to the minimum limit of 10 percent and 15 percent as of 2077 Jestha.
17. Deprived Sector Lending for class "A","B", and "C" FIs has reached 5.9 percent of total credit portfolio .9 percent higher than minimum limit of 5 percent.

Implications: Provision for improving deposit base/loanable funds for banks is doing its work but not many institutions are taking the foreign currency loan route currently. Microfinance

Institutions have not been able to add extra funds this year. Banks are nearing toward meeting the limits on loans to priority sectors but since the limits have increased through this year's policy. further work will be needed.

COVID-19 Impact Mitigation Measures (Pre-Monetary Policy)

18. Mandatory Cash Ratio reduced from 4 to 3 percent and Bank Rate reduction from 6 to 5 percent to ensure higher liquidity and cheaper funds.
19. Repo rate reduced from 4.5 to 3.5 percent.
20. Discount on Interest for Loans in Last quarter of previous FY set at 2 percent for all BFIs with 3 percent for Retail microfinance Institutions.
21. Postponement/Deferral of Countercyclical Buffer provisions for the FY.
22. Deferral of interest payments to end of FY 76/77 and 10 percent discount if Interest payable on Chaitra 2076 was paid in Chaitra itself.
23. Extension of up to 60 days on servicing of short-term working capital loans.
24. Loans to private health facilities for extending coverage and expansion to assist the containment of COVID and facilitate treatment to be considered priority sector lending.
25. Provision to provide subsidized loans to individuals who could not travel to foreign countries despite having necessary approvals to start their own business within 7 days.
26. Elimination of charges for use of RTGS system during lockdown.

Implications: Provided intermediate relief to FIs and customers and was intended to mitigate the effects of COVID-19 and Lockdown.

Monetary Policy 2077/78

Economic and Monetary Goals.

27. Inflation is expected to be limited at around 7 percent compared to target of 6 percent previous fiscal year.
28. Foreign Reserves to cover up to 7 months of imports will be maintained similar to previous fiscal year.
29. Money Supply will be limited to within 18 percent and private sector credit growth will be limited to within 20 percent.

Implications: Monetary Policy does not have a stated economic growth target focusing more on revitalizing the economy. Other targets remain similar to last FY.

Operating Target and Instruments

30. Switch from weighted average Interbank rate of Commercial Banks to that of Class "A","B", and "C" FIs as the operating target of the policy.
31. The existing standing liquidity facility (SLF) rate as the upper bound of the IRC (Interest Rate Corridor) has been maintained at 5 percent, repo rate as the policy rate has been reduced to 3 percent from 3.5 percent and the deposit collection rate as the lower bound has been reduced from 2 percent to 1 percent.
32. Cash Reserve Ratio of 3 percent remains the same.
33. Statutory Liquidity Ratio (SLR) has been kept unchanged at 10 percent for Commercial Banks, 8 percent for Development Banks and 7 percent for Finance Companies.
34. The bank rate applied for the purpose of the lender of the last resort (LOLR) facility is maintained at 5 percent.

Implications: Certain Policy rates have seen a further downwards revision in addition to those executed for intermediate financial relief due to the effect of COVID-19 and subsequent lockdown. Decrease in policy rates are intended to reduce cost of funds and improve liquidity in the market for credit creation purpose. Switch from lending rate between commercial banks to those between FIs shows move towards broader monetary policy considerations.

Securities and Stock Market.

35. Limits on Margin Lending has been extended from 65 percent to 70 percent.
36. Weighted Average Price of last 120 days will be used instead of last 180 days for capital gain tax calculation.

Implications: Larger limit means margin trading volume can improve and the 120 days method means that relatively more accurate capital gain can be established.

Credit and Source Management.

37. Develop Agriculture Development Bank as "Lead Bank" in agriculture sector, it can issue Agriculture Bonds to ensure long-term availability of resources for agricultural project funding.
38. Expert Banks in Energy Sector can now issue "Energy Bonds" to fund long term energy projects.
39. Commercial banks to extend credit disbursement to agriculture sector to 15 percent of total credit by 2080 Ashad and credit disbursement to energy sector to 10 percent of total credit by 2081 Ashad.
40. Indications that Commercial banks can invest in Agricultural Bonds to fulfill Agricultural Credit Requirements but to be made clearer.
41. Inter-bank Credit swapping of agricultural portfolio to be made simpler.
42. Provisions to provide loans at 1 percent higher than base rate for Hydropower Projects with Reservoirs and removal of provision requiring the approval of NRB to partially capitalize interest of hydropower projects whose production had started but transmission lines have been delayed.
43. Provisions for Banks to maintain a portfolio of loans less than NPR 1 Crore to SMEs at 15 percent of their total loan portfolio.
44. Provisions for Commercial banks to provide at least 500 or on the basis of 10 per branch whichever is higher as subsidized loans and Development banks to provide at least 300 or on the basis of 5 per branch whichever is higher as subsidized loans at 5 percent.
45. Priority Sector Lending in Agriculture, Micro Enterprises and SMEs, Energy and Tourism for Development Banks and Finance Companies to be made 20 percent and 15 percent of total credit portfolio by end of FY 80/81.
46. Refinancing Fund for refinancing of major loans affected by COVID-19.
47. Provision for extension of Interest Payment Terms extension for affected sectors up to 1 year based on severity of effect from Ashad 2078. (6 months for least severe, 9 months for mediumly severe and 1 Year for Highly severe)
48. Banks can restructure loans using alternate methods such as Private Equity, Venture Capital, Debt Equity Conversion, and Special Purpose Vehicles.

Implications: Impetus on Agriculture and Energy sector to promote greater lending and various relief measures and recovery measures for looking. The extension of priority sector lending to development banks and financial institutions as well as increase in requirement for commercial banks show a move towards channelizing the financial system to drive next stage of economic growth. Provision for per branch system will ensure greater access to subsidized loans and provisions for payment deferral will allow affected businesses time to recover.

Nonetheless, there are also several downside risks to allowing capitalization of principal and interest; especially with interest rates looking like they will stay on the lower side for at least one or two additional quarters in the minimum before economic activity and credit expansion returns to normalcy. If not managed properly, this will certainly result in the creation of asset bubbles in the economy, as NPA figures of BFI's might be distorted in the short run allowing for greater credit expansion at cheaper costs. However, since the drop in NPA levels is policy driven, the end of policy protection will lead to higher NPA Levels once again and the newer credit as evidenced time and again in Nepal will probably add to overall consumption than anything else.

Similarly, compulsory priority sector lending has its own problems as seen by mandatory financing in Hydro Power Projects (HPPs). Small HPPs financing in particular has been problematic with gaps being observed on revenue forecasts and actual receipts. Even in case of Agricultural Financing, hurdles persist; smaller land plots and difficulty in land pooling, lack of comprehensive insurance coverage, manpower constraints and market constraints among others form capacity issues in agricultural enterprise which need to be addressed before banks can lend aggressively to this sector. Otherwise there remains a risk of cash flow issues and business sustainability of ventures.

Financial Sector Improvement

49. Banks and FI's that begin combined operations within Ashad 2078 through merger/and or acquisition will be able to avail the following facilities up to Ashad 2079 on top of those already available:
    a. Reduction in cash reserve ratio by 0.5 percentage points and Statutory Liquidity Ratio by 1 percentage point.
    b. Extension of Limit for Collection of Institutional Deposits by 10 percentage points.
    c. Extension of Limit for Collection of Deposits from a single Institution by 5 percentage points.
    d. Cooling Down Period of 6 months for Directors/Top Level Employees for switching to another organization will be suspended.

    This is much more lucrative compared to the previous FY where the following incentives were provided.

a. Time period for reaching limits for agriculture, energy and tourism sector to be extended to 2078 Ashad.
b. Time period for maintaining interest spread of 4.4 percent to be extended to 2078 Ashad.
c. No need for permission of NRB to extend branches
d. Cooling Period of 6 months for CEO, Acting CEO, or Directors to switch to other banks and FI's to be removed.
e. Time period for issuing debentures worth 25% of paid-up capital to be extended to 2078 Ashad

Implications: This is a more lucrative policy that last year that continues the push for mergers and acquisitions with the impetus still being more voluntary rather than forced. However, merger provisions for banks and FI's with crossholdings have tightened. Incentives for merger feel much more lucrative this time around and should lead to larger mergers to an extent. However, failing this, we can expect the central bank to move more aggressively next FY.

On the other hand, if big mergers do happen, they can create too big to fail institutions (Systemically Important Banks) which will need greater supervisory oversight and control structures as governance issues would lead to impact on a national level. This had been recognized in last years Monetary Policy where there was provision for additional regulation for Systemically Important Banks. Nonetheless, even without mergers certain banks today are big enough to cause problems to the entire economy if assets quality is not measured properly and governance issues arise, Hence, policy action from the central bank seems paramount and should be in the process of materializing soon.

Regulation

50. Extension of CCD Ratio from 80 to 85 percent but previous adjustments have all been cancelled.
51. Provisions to limit cash dividend distribution for all BFIs with focus on greater reserves or capital improvement.
    e. BFI's with a distributable profit lower than 5 percent of their paid-up capital, cannot distribute cash dividend.
    f. BFI's with a distributable profit higher than 5 percent of their paid-up capital will be allowed to distribute up to 30 percent of distributable profits as cash dividend given cash dividend payout rate cannot be higher than bank's weighted average deposit rate.
52. Extension to the provisions of issuing debentures worth 25% of commercials banks capital by 2 years/ up to Ashad 2079.
53. Provisions to enable risk weight determination of credit through credit rating as well.

54. Provisions for Countercyclical Buffer has been postponed and risk wights for operation, market and overall risk have been revised from 5,3, and 5 percent to 3,1,and 3 percent for the purpose of capital adequacy on the back of additional investment in COVID-19 affected sectors.
55. Loans categorized as Pass in Q2 of FY 76/77 can be categorized as Pass up to Q4 of FY 76/77. However, if interest or capital cannot be collected up to FY 76/77 the provisioning must be 5 percent.
56. Basel III to be implemented in National Level development banks from FY 77/78

Implications: Basel III implementation to be extended to National level Development Banks for greater sustainability. Policy measures are mainly intended to shore up liquidity and ensure BFIs should not have to provision highly in case of good loans and reduce their profitability. Dividend policy is intended to strengthen BFIs capital with value mostly coming in terms of bonus stock and or transfer to reserves.

Microfinance Regulation

57. Approval and licensing process and Microfinance Institutions (MFIs) has been stopped.
58. Capping of Maximum Interest Rate for Lending by MFIs at 15 percent and increase on Loan Limits to 1.5 Million from 0.7 Million.
59. Class "A","B","C", and Wholesale Class "D" FIs can only charge up to 0.5% as service charge on deprived sectors lending to MFIs.
60. Microfinance can only establish branch in wards of local levels where another branch is not present.
61. Implementation of NFRS from this FY in MFIs financial statements.

Implications: The Capping of Maximum Interest Rate at 15 percent will affect profitability while additional limits for loans should improve business volume. There is a push towards making MFIs more operationally efficient and the loss in additional income will push them to organize better.

Foreign Exchange

Implications: Improvements on existing facilities on Trade, LC, Advanced Payment and not any substantial new practices to note.

Corporate Governance, Financial Literacy and Client Protection.

62. On account of need for financial prudency on the back of COVI-19, provisions related to remuneration and facilities availed by top Executives of BFIs will be reevaluated.

63. Capping of Service Charge for Credit Disbursement at 0.75,1,1.25, and 1.5 percent for Class "A", "B", "C, and "D" FIs.

Implications: Income for BFIs will decrease as rates have been capped, Salary and Facilities review is intended to maintain goodwill of public institutions during the pandemic situation.

Overall, the monetary policy follows through on many of the previous monetary policy initiatives such as push for mergers, Basel Implementation, and higher regulation of Income practices of BFIs

However, the policy has also addressed major issues pertaining to the financial system in the aftermath of COVID-19, bringing in policy measures that strengthen both BFIs risk profile and liquidity position. Provision for Interest Capitalization and Support for Lower Provisioning allows BFIs to maintain profitability while also providing various banking facilities at discount to customer affected by COVID. Measures to improve stock market are similar to the demands being put forth. Overall, the policy accommodates both previous policy directions and requirements of today market and various stakeholder.