

The IMF has had a Long and Cherished Relationship with the NRB
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First of all, I would like to offer my congratulations to the Board, Management and staff of the Nepal Rastra Bank (NRB) on the auspicious occasion of the 50th anniversary of the Bank. This is indeed an important milestone and the Bank can be proud of its service to the nation and to the financial system. In fact we are almost peers, the IMF recently having celebrated the sixtieth anniversary of the Bretton Woods Conference.

The IMF has had a long and cherished relationship with the NRB ever since Nepal's membership of the Fund in 1961. We have had an office in the NRB since 1977, this being the sixth oldest IMF office anywhere in the world. I have had the privilege of being among the twelve resident representatives that have served in Nepal.

My two and a half years in Nepal have been eventful indeed. Only three days after my arrival the government was dismissed. A few months later, in January 2003, a ceasefire was announced and we all hoped that we would see a permanent return to peace. Unfortunately this was not to be and Government's changed again in June 2003 and after the Nepal Development Forum in mid 2004. A month later Prime Minister Deuba was reappointed. Things seemed to have come full circle in by February of this year when Mr. Deuba's government changed once again. Although this has translated into four different Finance Ministers, things at the central bank have been more stable. I was warmly welcomed by Governor Rawal and Deputy Governor's Pant and Bhattarai. And it was good to see Governor Bhattarai's distinguished service to the Bank being recognized in his appointment as the new Governor a few months ago. In fact I and my colleagues from IMF headquarters have been extremely well treated by all the senior staff of the NRB for which we are deeply grateful. For instance, my office here at Baluwatar may not be the largest in Kathmandu but it sits in a beautiful Palace with a splendid view and is the envy of many donor colleagues.

I cannot write on my experiences in Nepal without also mentioning the many other friends and colleagues at the NRB. Throughout my time here, I have had an excellent collaboration with departments throughout the bank. Although the Research Department has a special relationship with the Fund, the IMF has worked closely with many other departments, from Banking Regulation to Internal Audit, and in the course of this we have learned a great deal. Even though much remains to be done to modernize the institution, I have often been

¹ The views expressed in this paper are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its management.

impressed by the talented and dedicated individuals that are to be found across the bank, which I hope bodes well for the years ahead.

I would also like to take this opportunity to thank the NRB for providing a succession of highly dedicated and professional staff to the IMF's resident office. Although I am not familiar with all those who have contributed to building the strong bonds between our institutions, I would draw attention to Deepa Bhattarai who has served since 1988 and Alok Pokharel who returned to the Research Department last year after almost a decade with the resident office.

The last two years have also been notable in deepening the reform relationship between the IMF and Nepal. After over a decade since the last reform program was agreed, an arrangement under the Poverty Reduction and Growth Facility (PRGF) was approved by the IMF Board in November 2003. This supports HMGN's implementation of its 10th Plan/PRSP which provides a comprehensive effort to address the country's low growth, inadequate social sector investment, and limited income opportunities for the poor. HMGN's program with the Fund aims at improving the conditions for sustained growth and poverty reduction, based on sound macroeconomic policies, better prioritization and enhanced efficiency in government expenditure, structural reforms in major sectors of the economy, and improved governance. Reform implementation under the program has been mixed so far mainly due to the political instability that the country has faced over the past two years.

Let me now say a little about the challenges that face the financial sector in Nepal and its custodian, the Nepal Rastra Bank. There is a daunting agenda before us that has to be addressed if the financial sector is to support sustained growth. Excessive government ownership, high non-performing assets, weak regulation and supervision, inadequately developed financial markets, weak corporate governance, lack of a competitive environment resulting from fragmentation of the system, a poor banking culture, a dearth of reliable financial information and transparency, and of course ineffective banking services for the rural sector are some of problems that require urgent redress. This is made all the more urgent by the competition in financial services that will come from Nepal's membership of the WTO. Moreover, it is being implemented at a very difficult time for the country where the insurgency is imposing an enormous toll on economic activity, which of course has affected banking performance. But a crisis also offers opportunities and I am encouraged by some of the financial sector reforms that are underway in Nepal. Moreover, as we move into this millennium the NRB is fortunate to find itself operating under a new central bank act which provides it with the legal authority and autonomy to achieve its objectives.

But we still have a long way to go. The political leadership of Nepal must really believe in reforms and accelerate them or a poorly functioning financial system will be a major drag on growth and prosperity. The IMF will continue to help Nepal with technical advice and financial resources but Nepal must above all be ready to help itself. Let me highlight three key challenges facing the NRB as it enters its six decade.

First and above all the NRB must modernize itself quickly. The aim must be to engineer a central bank that can develop and implement sound monetary and supervisory policies, and command the complete confidence of the banking system. This respect cannot be ordered or demanded by its power, but must be earned by its capability. Its staff must be highly professional and competent officials familiar with modern banking practices, led by management who have a clear vision of how to develop the financial sector as an engine of growth. The bank must be a transparent, independent but accountable, institution that applies its mandate in an even handed way. And it should concentrate on core central banking functions. For an effective partnership to develop, the central bank must listen carefully to, and learn from, the banking community. At the same time, Nepal's banks should facilitate healthy competition and ensure the timely provision of information required for the NRB to do its job.

A critical area must be the development of a professional staff. After all, the NRB is only what its staff make it. Its reputation depends on the performance of its officials. In this regard, when I came to the NRB over two years ago I found it heavily overstaffed with inadequate delegation of responsibilities and weak incentives for strong performance among the bank's officers. Two years on, staffing levels have come down, but much remains to be done to instill a merit based performance, recruitment and training system that builds the capacity of the NRB to function effectively in a globalised economy where financial transactions are becoming more sophisticated. Specialized career streams in critical areas such as bank supervision, auditing and accounting need to be established. I'm pleased that this issue is being given serious attention by the NRB's management.

A second crucial issue in front of the NRB is to deal with non-performing assets and privatization of public banks. NPAs of at least 7-8 percent of GDP or \$450 million – the same as the country's entire development spending - are clearly unsustainable and present a major risk to the banking system and to the budget. Most of course are with the public banks - RBB and Nepal Bank Limited (NBL) – which have been raided by unscrupulous elements and are technically insolvent. But the problem extends to other banks in the system which poses a threat to banking stability even beyond restructuring of the big two. While the management teams in RBB and NBL have been able to improve the situation, further support from the government and judicial system is required otherwise the general public of this country will pay the price for the excesses and corruption of a minority and scarce resources will be diverted. The NRB should also oversee the quick privatization of these public banks where this is feasible to "fit and proper" owners. Improvement in these banks' performance should not be seen as reason to delay the process, but to accelerate it.

Third, we need to improve the regulatory system and bank supervision to avoid these problems arising in the future. The onus here falls squarely on the NRB. The central bank must prioritize the further strengthening of new banking legislation that embodies the Basle Core Principles and ensure compliance with these principles. In this regard, the NRB has to move expeditiously to improve the quality of its on and off site supervision, the timeliness of its feedback and be determined to act where there are violations of the regulations. As per the Basle principles, the NRB must urgently step up its evaluation of banks' lending and

investment policies, practices and procedures and those on the management of the loan and investment portfolios. It can only do this if it has a cohort of trained, experienced supervisors and regulators who have incentives to perform to high standards and adequate resources are devoted to this core central banking function.

There are of course other important issues facing the NRB such as preparing Nepal for greater competition arising from its commitments in the financial services to the WTO, and improving access to banking services for the rural poor. An important consideration going forward is that the Bank should not overextend itself into areas which are beyond its mandate or where it does not have competence. Careful consideration needs to be given to the gradual phasing out of non core central bank functions such as development finance and the management of development funds. And the NRB should continue to pay attention to the outsourcing of a range of administrative functions and non core activities which can bring further efficiency gains.

Going forward, the NRB faces a radically different domestic and global environment than it has over most of its history. Given its apex role, it has no alternative but to adapt rapidly to the conditions it faces. This is no different for the IMF or any institution. While the NRB still has work to do if it is to become an effective central bank in a modern market-based financial system, it now finds itself more independent and autonomous than ever before. This provides enormous opportunities for it to modernize itself and to meet its core objectives. But autonomy also brings with it the need for accountability and transparency. The NRB must be able to show that its increased powers are being used responsibly and are producing better performance. This will enhance its public credibility and ensure the Bank serves the nation effectively over the next fifty years. You can be assured that the IMF will continue to stand by the Nepal Rastra Bank as a friend and advisor in the years ahead. Happy Golden Jubilee Nepal Rastra Bank.