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Monetary Policy Response to Covid-19 Pandemic: Short-term and Structural Reforms

POLICY BRIEF

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Summary

The monetary policy is one of the major policy instruments used by central banks around the world to keep a check on the health of the economy. As Covid-19 continues to affect the key sectors of the economy, the central bank of Nepal that also works as the country's Monetary authority – Nepal Rastra Bank (NRB) – has introduced several measures to keep the country's economy running amid the ongoing crisis. This policy brief takes into consideration evolving issues from the pandemic and provides some feasible recommendations to the central bank and the government to frame policies to better address the crisis.

Background

The fiscal policy for FY2078/79 has set a target of 6.5 percent economic growth and kept the inflation rate at 6.5 percent. The main objective of Monetary Policy is to maintain price stability and to maximize employment, all while maintaining financial and exchange rate stability along with an adequate buffer of foreign exchange reserves. Policy interest rate, mobilization of various instruments for liquidity management, credit policy, exchange rate and foreign exchange management, regulation of banks and financial institutions, management of government debt are integral parts of the Monetary Policy.

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Monetary Policy for Covid-19 Affected Economy

Several measures were introduced by NRB at the onset of the pandemic in March 2020 to contain the adverse impact of the covid-19 pandemic on the financial sector and the broader economy. They include lower interest rate on loans, rebate in interest on credit, concessional loans, refinancing facility, easing liquidity conditions and credit, loose cash and capital reserve requirements and lenient loan recovery provisions, among others. These measures have been effective in limiting the adverse impact of the pandemic on the financial sector to a large extent.

However, a loose monetary policy over an extended period will generally have spillover effects on the broader economy through misallocation of resources, as was observed in the form of skyrocketing stock prices and an increase in land prices. While a large number of small new investors risk losing their hard-earned savings by investing in the stock market at the wrong time, so would a general rise in price level make the economy less competitive. Similarly, the pent-up demand seen in the economy with life coming back to normal, in addition to supply chain disruptions and commodity super cycle unfolding in the global markets, have posed a significant risk to the economy through exorbitant import bills and thereby resulting in a large balance of payment deficit. The central bank should closely monitor these developments both in the domestic economy and the global market to minimize the negative spillovers. For this purpose, apart from the short-term measures to dampen the negative impact of the pandemic, the central bank should initiate a series of structural reforms to manage medium and long-term risks to create an environment that is conducive for achieving major monetary policy goals such as price stability, higher economic growth, low unemployment rate, financial stability, and foreign exchange stability. Here are some key aspects of the Monetary Policy:

Relief to the affected sectors

Those most affected by the Covid-19 pandemic is the services sector, particularly those that require 'high contact' such as hospitality, transportation and education including manufacturing along with vulnerable groups such micro and small enterprises (MSEs), informal sector workers and daily wage laborers who cannot mobilize additional resources to cushion the blow of the pandemic (CBS GDP 2021). Similarly, the poor and disadvantaged groups are amongst the most affected people. Coordinated responses from both the government and the central bank through fiscal policy and monetary policy would be effective in alleviating the plight of the affected sectors and groups. Extraordinary measures are required to address this unprecedented crisis. Measures taken by NRB have been effective in providing relief to the affected sectors, areas, and groups during the pandemic and the economic activities have recovered to 74.7 percent of the pre-pandemic level by October 2021 (NRB 2021a). As the situation starts to normalize, the NRB should realign its response by pursuing targeted measures in favor of the most affected sectors and vulnerable groups to stem the negative spillovers of the existing loose monetary policy.

Relevance of policy rate

The policy rate is the most important and effective monetary tool used by central banks to achieve its objective of price stability and economic growth. The rate is used to provide overall guidance to the market interest rate to influence and manage the level of demand in the economy. The rate of inflation in the economy influences the policy rate. In Nepal, the overnight repo rate acts as a policy rate. Overnight repo rate is the interest rate in which the BFIs borrow money from NRB for maintaining their mandatory reserves with the NRB. Since 2016/17, NRB introduced an interest rate corridor (IRC) to maintain the short-term interest rate near the policy rate by keeping the fluctuations within the band of lower limit and upper limit corresponding to the floor rate (deposit collection) and the ceiling rate (standing liquidity facility) respectively. However, the policy rate has not been able to provide any guidance to the movement of short-term interest rates in the banking sector. It is probably for this reason that NRB neither proactively uses its policy rate to target inflation nor reacts to the level of inflation by changing the policy rate.

Since 2016/17, NRB introduced an interest rate corridor (IRC) to maintain the short-term interest rate near the policy rate by keeping the fluctuations within the band of lower limit and upper limit corresponding to the floor rate (deposit collection) and the ceiling rate (standing liquidity facility) respectively.

In our case, the interest rate is essentially guided by the demand and supply of loanable funds in the banking sector. For instance, when the NRB increased the paid-up capital of BFIs four to 25 times forcing BFIs to seek

mergers, the demand for deposits increased significantly in line with the increased credit flow capacity. This led to a significant rise in the base rate of banks by more than four percent within two years from 6.1 percent in June 2016 to 10.47 percent in July 2018. Left to its own, the interest rate would have shot up much higher. It was only because of the coordinated intervention of NRB and the Ministry of Finance that the further rise of the interest rate was prevented. NRB had to intervene again in mid-October to stop the steep hike in the interest rates announced by a few banks amidst tightening liquidity conditions. In a banking sector that has more than five dozen BFIs and is as big as the size of the economy, it is quite revealing to find how an interest rate decision of a single bank can affect the entire banking sector.

Inflation

Price stability is the main policy goal of central banks. Analysis of the last four decades of time series data shows a very high correlation between inflation and credit growth that is statistically significant. Over the past four decades, when credit expanded at an average annual rate of 21 percent, GDP grew by an average rate of 4.6 percent per annum, and inflation by 8.4 percent.

The credit expansion has also fanned land prices as bank loans that are disbursed under different headings for different purposes are used to purchase land. High prices have eroded the ability to use land in the productive sector, making it counterproductive for the economy. This has led to a significant rise in the general price level making the economy less competitive and alarmingly import dependent.

High inflation erodes the purchasing power, hitting the poor, vulnerable groups and the working-class the hardest. This has led many countries to adopt a monetary framework that allows the central bank to pursue a single objective of price stability and grants it autonomy to achieve this goal. Though such a framework is inconceivable now for a variety of reasons, price stability should be the primary objective of NRB, and monetary policy should be formulated with this objective in mind.

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Economic growth and level of employment

The second important goal of monetary policy is to achieve higher economic growth. NRB in its monetary policy, embraces the economic growth rate announced by the government and pledges its commitment and support towards achieving that goal. At times, there is a tradeoff between the objectives of price stability and higher economic growth given that higher economic growth can lead to higher inflation.

Empirical analysis shows no correlation between credit growth and economic growth in Nepal. Despite an average annual credit growth of 21 percent over the past four decades, average annual economic growth has been paltry 4.6 percent. It is indicative of the fact that the credit has not flowed into the productive sectors of the economy. Though a very high rate of credit growth sustained over the last several decades has fueled economic activities, it has not yielded commensurate growth in economic output and employment. This shows a missing link between the allocation of resources from the banking sector and economic growth.

Central banks of a few advanced economies are mandated to include objectives relating to the attainment of the desired level of employment in the formulation of monetary policy. For this purpose, timely availability of reliable data on the level of employment is crucial, which is, however, not possible in a developing country like Nepal. For instance, Nepal Labor Force Survey is conducted every 10 years and the rate of unemployment according to the latest survey of 2017/18 is 11.4 percent. In advanced economies, monetary policy is reviewed and calibrated in accordance with the monthly unemployment data.

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Paradox of low income and high price level

Nepalese households are facing a double whammy of a low income and a high price level. After Afghanistan ($507), Nepal has the lowest per capita income in South Asia ($ 1,071). But Nepal is also a South Asian country with a very high price level. For example, the price of goods and services in Nepal is much higher than in India, although our per capita income is only half of that of India. A host of structural issues such as excessive dependence on import, low value addition in the value chain, high profit margins in trades, multiple middlemen in the supply chain, lack of infrastructure, capacity and professionalism and high minimum wage have contributed to a very high price level in the economy. Despite having one of the lowest per capita income, Nepal has the highest minimum wage in South Asia. The minimum wage in Nepal is USD 119 (NPR 13,450) per month compared to

Minimum wage per month

Country	Minimum wage
Nepal	USD 119
Pakistan	USD 117
Srilanka	USD 70
India	USD 65
Bangladesh	USD 18

USD 18 in Bangladesh, USD 65 in India, USD 117 in Pakistan, and USD 70 in Sri Lanka. It is strange to find that the minimum wage (USD 1,428) is higher than the per capita income in Nepal. Hence, the country has not been able to reap the benefits of cost competitiveness of a low-income country through low wages.

Unusual size of the Banking Sector

Nepal has the largest banking sector in proportion to the economy among the South Asian countries. As per the World Bank statistics of 2019, the private sector Credit-to-GDP ratio is 56 percent in India, 57 percent in Sri Lanka, 43 percent in Bangladesh, 25 percent in Pakistan, 27 percent in Kenya and 14 percent in Uganda, whereas it is 84 percent in Nepal (WB 2019).

In 2020/21, the size of the banking sector in terms of deposits has become larger than the size of the economy of Nepal (NRB 2021b). In general, the size of the banking sector grows as the economy develops and the per capita income rises. For instance, the private credit to GDP ratio of low-income, lower middle-income, middle-income, upper middle-income and high-income economies are 13 percent, 45 percent, 107.4 percent, 123.7 percent and 147.8 percent respectively in 2019. Based on income levels, this ratio should have been around 45 percent in Nepal that recently graduated to a lower middle-income country. However, size of the Nepal's banking sector is like that of rich nations such as France with 107 percent, Qatar with 101 percent and the Netherlands with 100 percent.

If the current rate of credit growth is continued, the size of the banking sector measured by private sector credit will be double the size of the economy which is currently 97 percent by the next 10 years. Only a few high-income economies such as Hong Kong (236 percent), USA (191 percent), Japan (176 percent), Switzerland (175 percent) have their banking sector close to two times larger than their economy. As the banking sector grows exponentially in comparison to the economy, any disruption in the financial sector will have a massive impact on the economy at large. This is also likely to make every financial institution a systemically important institution with a disproportionate concentration of risk in the individual institutions.

Remittance, Credit, Imports, Consumption and Revenue

Empirical evidence shows a high level of correlation among remittance inflows, bank credit, imports, consumption and government revenue. Remittance inflow and banking credit have boosted consumption and imports instead of domestic production. Remittances have grown at an average annual rate of 19.7 percent over the past two decades, while private credit from the banking sector, imports and government revenues have grown at an average annual rate of 21 percent, 17 percent and 16.8 percent respectively over the past four decades. Due to high domestic consumption, gross domestic saving has averaged at around 9 percent of GDP over the past 10 years.

Before the Covid-19 pandemic, import of goods reached 36.8 percent of GDP while the export declined to 2.5 percent of GDP, reflecting an economy that has become increasingly import dependent. In an economy with very little domestic production, the exponential expansion of the banking sector precipitates imports, consumption and investment in unproductive sectors such as real estate, and the share market. Such an economic system promotes a rent-seeking behavior, multiple middlemen in the supply chain, economic activities with no or meager value addition, and a low level of employment generation, altogether dissuading people to become entrepreneurs and producers.

According to the IMF Global Debt Database, the household credit in Nepal is 33 percent of

- GDP which is the highest in the South Asia, compared to 12.7 percent in Sri Lanka, 12 percent in India, 8 percent in Bangladesh and 3.7 percent in Pakistan (IMF 2019). This calls for measures such as credit guidance to reallocate bank credit to the productive sectors of the economy. The policy taken by NRB in this regard has helped in gradually channeling credit to the sectors such as agriculture, energy, MSMEs, tourism and other priority sectors. However, it is important to determine the extent of value addition and contribution in the output growth induced by such measures.

Liquidity Management

The banking sector has been facing challenges relating to the management of liquidity. The pattern shows that the problems have become more seasonal in recent years. The main reasons for the frequent liquidity constraints in the banking sector are the government's inability to smooth spending throughout the year, high credit growth compared to deposit growth, very high imports compared to growth in remittance leading to a negative balance of payments and replacement of Credit Capital Deposit (CCD) ratio by Credit Deposit (CD) ratio as means of measuring the the availability of credit, among others. The NRB quarterly report shows the government cash reserve of NPR 239 billion is lying unspent with the NRB at the end of the first quarter of the current financial year. The total credit in the first three months of the current financial year shows a growth of NRB 323 billion (7.8 pecent) compared to a deposit growth of NPR 56 billion (1.2 percent) leading to a massive mismatch in the asset and liability of the banking sector. The growth in credit and deposit in the corresponding period in the previous year was NPR 137 billion (4.2 percent) and NPR 188 billion (4.9 percent) respectively. The balance of payment has declined by NPR 76 billion amid rise in trade deficit by 59.4 percent and decline in the inward remittance by 7.6 percent in the first quarter of the current financial year. The excessive credit that fuels trade deficit drains the resources out of the country's banking sector. Similarly, the substitution of CCD ratio by CD ratio as a measure of the loanable fund from the beginning of the current financial year has further shrunk the availability of the total credit in the system. All these factors have led to the tightening of liquidity condition in the banking sector and a steep jump in the interbank lending rate to 4.75 percent in mid-October from 0.11 percent a year earlier. To address this situation, NRB has pumped massive liquidity in the system using various instruments especially statutory liquidity facility (SLF) and repo auction. However, these measures alone are not sufficient in mitigating these inherent structural issues relating to the supply of financial resources for facilitating credit growth in the banking system.

Sovereign Debt

Prior to the Covid-19 pandemic, Nepal had one of the lowest sovereign debts in South Asia along with Afghanistan and Bangladesh. However, after the onset of the pandemic, sovereign debt has increased significantly in the last two financial years, reaching over 40 percent of GDP, amidst negative economic growth and lower revenue generation. As the government revenue is merely sufficient to finance recurrent expenditure and service public debt, additional public debt must be raised to finance capital expenditure for infrastructure development and investing in public sector enterprises. Although the public sentiment is against public debt, it contributes to the nation's economic development if used judiciously in enhancing the productivity and competitiveness of the economy. The low level of sovereign debt of less than 27 percent of GDP in the last one-decade is also an indication of a low level of capital expenditure that has adversely affected the level of infrastructure development in the country. As Nepal is in the process of graduating into a lower middle-income country,

it is important to expedite infrastructure development by mobilizing grants and external concessional financing that a least developed country is eligible for before it is forced to rely on markets for moblizing resources on commercial terms.

A low level of domestic sovereign debt of around 10.4 percent of GDP in the decade before the Covid-19 pandemic had led to an inadequate supply of government securities necessary for maintaining statutory liquidity requirement in the banking sector. As a result, the interest rate on short term government securities were much lower than the policy rate and the inflation rate. This has enabled the government to borrow short-term debt at a negative real interest rate while the private sector had to bear the differential interest rate by paying higher interest on its debts. The domestic sovereign debt has now risen to 18.8 percent of GDP - the highest so far in the last four decades. As the interest rate on government treasury bills has also increased in recent weeks amid higher demand for debts from the government and tightening liquidity conditions, the BFIs will be able to generate reasonable revenues from investment in short-term government securities.

Merger and acquisition

NRB adopted a policy of promoting merger and acquisition to reduce the number of BFIs in the country after nearly two decades of licensing spree during the nineties and 2000s. At its peak in 2011, there were 32 commercial banks and 88 development banks in 2012 and 79 finance companies. Moratorium on issuing a new license was imposed in December 2009. Currently, there are 27 commercial banks, 18 development banks and 17 finance companies. If the proposed voluntary merger between Himalayan Bank and Nepal Investment Bank both of which were incorporated as a joint venture bank is successful, it is going to make a significant contribution towards the consolidation of the country's banking sector. However, as a corollary of a merger between big banks, each merged entity will become a systemically important institution in terms of both size and risk. This is going to pose a new set of challenges to the stability of the financial sector in view of a very large concentration of the risks in a few institutions. This is particularly critical in the light of a banking sector which is going to be twice the size of the country's economy within the next ten years if the current rate of very high credit growth and low economic growth is continued.

The existence and diversification of financial institutions is necessary for the stability and development of the financial sector, management of risks and ensuring greater access to financial services.

In pursuit of promoting mergers among commercial banks, it is also equally important to safeguard the existence of smaller financial institutions such as development banks and finance companies. The existence and diversification of financial institutions is necessary for the stability and development of

the financial sector, management of risks and ensuring greater access to financial services. The development banks have particularly played an instrumental role in making financial services accessible to the rural population and forcing the commercial banks to open branches outside the capital and urban areas. While there has been greater clarity on the part of the NRB about the importance of preserving the existence of different financial institutions, the key challenge would be to prevent them from acquisition by the big commercial banks. It is therefore important to introduce a slew of incentives to continue operating as development banks and finance companies.

Implication of multifold capital increment

NRB increased the capital of BFIs from four to 25 times through its monetary policy of 2015/16, which was to be completed within two years of its announcement. The overarching goal of this unexpected and very stringent measure was to force the BFIs into mergers and acquisitions to reduce their number significantly. The measure raised the minimum capital requirement of Nepal's commercial banks equivalent to its counterparts in India which is about a hundred times bigger in terms of the size of the economy. While no study has so far been conducted to evaluate the major implications of the decision, hasty conclusions have been drawn to label it a successful decision based purely on the reduced number of development banks and finance companies. The policy, however, had failed to influence mergers and acquisitions among commercial banks.

The policy had a profound impact on the broader economy through different channels. While at glance, it looked as if the BFIs were equipped with much better capital buffers necessary to safeguard against various risks. The policy had direct implications on the reallocation of resources into the banking sector, massive credit growth, rising imports, steep rise in interest rates, soaring asset valuation and share market, excessive risk taking for higher returns and issues of corporate governance among others. It is therefore important to undertake a comprehensive study of the effects of the policy decision relating to the capital hike on the financial sector and economy. The outcome of such study will be important in drawing lessons in the future policy making. For instance, NRB's policy to allow upgrading of BFIs based on paid-up equity capital prompted serious mismanagement across many BFIs during late 2000s pushing them to the brink of liquidation.

Ownership Structure of BFIs

In Nepal, it has become increasingly difficult to delineate between the promoters of the banks and the owners of the corporate houses given that most of the large business houses in the country have a major stake in the BFIs and other financial institutions such as insurance companies and merchant banks as well as rating agencies. Some emerging major business groups are also considering making a foray into the financial sector. Such poor delineation between the promoters of BFIs, other financial institutions and the owners of the business houses is likely to promote unprofessional and unethical banking and financial practices due to issues relating the conflict of interests. For instance, it might promote intergroups lending under quid pro quo arrangements making SMEs and a general public difficult to access financial services from the banks. In the past, there had been instances of extracting insured sum from an insurance company by its own promoters through wrongful means.

In the late 2000s, NRB pursued a policy of diluting the stake of promoters in BFIs and allow greater representation of public shareholders including a provision of professional director in the board to instill good governance in the BFIs. In this regard,

the promoters' stake was reduced from 70 percent to 51 percent in the BFIs with the exception of the fully owned government banks. NRB should reintroduce this policy to implement the second phase of diluting the stakes of the promoters from the BFIs. As this policy will also lead to an increased supply of shares of BFIs in the market, the manipulation and volatility of share prices seen in certain scripts of development banks and finance companies in recent days can be addressed to a large extent.

Entry of small investors in the stock market

During the pandemic, a very large number of individuals have become active in the share market through the online share trading platform TMS (Trade Management System). This online platform has opened opportunities for a very large number of small investors to invest in financial assets and benefit from the wealth creation when the share market fares better. However, most of these small investors have very little knowledge about the share market and do not know how to read and analyze the financials of the companies. This poses greater risk to these small investors who might end up losing their hard-earned savings by investing in wrong stocks.

Many institutional players such as merchant banks have raised considerably large funds to invest in public shares to reap the benefits of the booming stock market. Besides, a few large individual players have also become very active during the pandemic amidst lower interest rates and availability of funds for trading from the banking sector. The daily trade volume of transactions in terms of amount reached a record high. A closer analysis of the price movement in the stock market shows a great deal of manipulation in the share prices of companies with a relatively small number of public shares. Such manipulation is not seen in the share prices of commercial banks which have a relatively large number of public shares and the probability of concentration of their public shares in the hands of a few is slim.

The loan against shares, known as margin loan, has increased by more than 110 percent in the last financial year 2020/21. Though the margin loan accounts for only 2.5 percent of the total credit, the pace with which it has grown in the last one year has forced NRB to introduce a ceiling on margin loan with effect from the current financial year to contain risk that is building up in the system.

Easing Know Your Customer (KYC) requirements for marginalized and rural population

KYC requirements to open a bank account at BFIs are extremely cumbersome, lengthy and user unfriendly. This is particularly true for the poor, disadvantaged and rural population as the information and documents

required to fulfill KYC requirements are taxing to provide. Such a policy, therefore, makes it difficult to ensure financial access to the poor and those living in rural areas. There are 460 rural municipalities out of 753 local governments in the country. Various policy measures taken by the central bank aimed at enhancing the financial access of the rural population has engendered the commercial banks to open their branches in 750 municipalities by the end of last financial year 2020/21. While it is important to comply with KYC guidelines to ensure the safety and security of financial services and various risks associated with the identity of users, the extent and relevance of requirements can be contextualized to make it more practical and effective. To prevent possible misuse arising out of the simplified arrangements, real time monitoring of unusual and suspicious transactions should be instituted using advanced information technology.

Informal trade and remittance outflow to India

Nepal suffers a very high twin deficits with India in terms of trade – both formal and informal – and remittance. No official record is available on remittance outflows from Nepal given that it takes place through informal channel. The World Bank's bilateral remittance matrix is the only official source in which the remittance outflows from Nepal to India is estimated. Similarly, the informal trade between Nepal and India along more than 1700 kilometer of open border could be significant, obviously to the benefit of India. No studies have been done to determine the volume of informal trade and remittance and how those transactions are financed. The outcome of such study would have been instrumental in understanding the gravity of situation and formulating policies to address the situation in the interest of both countries. There are various sectors of the economy that are dominated by Indian communities and monopolized by Indian migrant workers such as construction, industries and repairs and maintenance.

A very high deficit in informal trade and remittance with India implies that the demand for the Indian rupee to facilitate these transactions is met through informal channels. The indifference of the authorities to tackle these critical issues has led to the draining of the country's financial resources and reinforcement of the informal economy that is detrimental to the country's economic development.

Credibility of the Central Bank

For the monetary policy to be effective, the credibility of the central bank is probably the most important factor. To ensure this, the independence of the central bank and strict enforcement of the policies and directives of the central bank is pivotal. Likewise, the monetary tools used by the central bank to meet specific objectives should be relevant and effective. The credibility of the NRB has often come under question due to the lack of control over inflation, recurrent liquidity concerns and frequent changes and withdrawal of policies and directives due to political pressures, among others. The lack of enforcement of punitive measures has encouraged a few BFIs to become a habitual offender and defy NRB directives and reap disproportionate benefits from noncompliance, as compared to those who have strictly adhered to the directives. The NRB must enforce its credibility to ensure the effectiveness of monetary policy to achieve monetary policy goals of price stability, economic growth, financial stability, and exchange rate stability.

Research Collaboration

It is fair to state that NRB is the most competent and resourceful institution in the country to undertake and promote research in the areas of economy and finance. There is a full-fledge Research Department in NRB headed by an Executive Director and staffed by a team of competent personnel with very sound academic and research background. The monthly data on inflation, trade, balance of payment, forex reserves, credit, government debts, etc. published by NRB is an important source of information for research and policymaking.

Aside from publishing important statistics, it is important for the NRB to undertake research on the key areas of finance and economy for informing policymaking. NRB is well-positioned to promote data driven research in the country by widening the scope of its research work and collaborating with various institutions such as think tanks, research institutions and universities.

Policy Recommendations

1. NRB should realign its policy response by taking targeted measures in favor of the most affected sectors and groups so that negative spillover effects of the protracted loose monetary policy can be contained as the situation improves.

2. NRB must establish the efficacy and relevance of policy interest rate to bring about the desired outcome of the monetary policy. This will also facilitate deregulation of interest rates that was introduced in the late eighties.

3. NRB should calibrate monetary tools to achieve the primary objective of price stability. Given the futility of the policy rate to influence a level of demand in the economy, it has become necessary to use various measures including macroprudential policies to calibrate the level of demand in the economy to ensure price stability.

4. NRB should adopt a policy of incentivizing credit flows to productive sectors and discouraging credit flows to unproductive sectors of the economy given that very high credit growth is not accompanied by commensurate economic growth. Interest rate on productive sector lending can be set at the maximum of two and a half percent above the base rate. This would force the BFIs to raise the interest rate on lending to unproductive sectors to maintain the spread rate allowed by NRB.

5. NRB should tackle the issue of both consumer price inflation and asset price inflation through credit policy given that high credit growth has resulted in an elevated price level thereby making the economy less competitive.

6. NRB should moderate the credit growth to 15 percent in the medium to long run as compared to the annual average of 20 to 21 percent that was seen in the last three decades. This would curb the excessive growth of the banking sector in comparison to the size of the economy and limit the growing risk in the financial sector.

7. NRB should implement policies to promote domestic production to stem excessive imports that can have serious impact on the balance of payment and the financial stability.

8. NRB should take necessary measures to resolve instances of frequent liquidity constraints in the banking sector. In this regard, a mechanism should be instituted to allow the government's cash reserve held at NRB to flow back to the market beyond the former's one-month cash requirement.

9. The government should ensure an adequate supply of government securities for the management of liquidity in the banking sector. This will allow the government to optimize the use of domestic credit available at a very low interest rate by investing in public infrastructure which tends to have a large multiplier effect.

10. NRB should incentivize voluntary mergers among commercial banks to reduce their number and limit unhealthy competition in the banking sector. Given the role of development banks and finance companies in catering to lower segments of the market, NRB should protect these intitutions from takeover from commercial banks to ensure diversification in the banking sector and access to financial services.

11. NRB should undertake a comprehensive independent assessment of the impact of decision relating to capital increment imposed on BFIs in 2072/73. The outcome of the study is expected to provide crucial insights into the impact of the very unusual decision on the financial sector and the

- broader economy and will be useful to draw important lessons in the future.

12. NRB should reintroduce measures to dilute promoters' holdings from 51 percent to 30 percent in BFIs over the period of the next 15 years at the rate of five percent every five years. It can be started with the BFIs that have completed 20 years of its establishment. In the final phase, the promoter's share can be reduced further down to 15 percent. These measures will help end the monopoly of business houses in the ownership and management of the BFIs to ensure good governance and eliminate conflict of interests in the country's banking sector. Similar measures should be extended to other segments of the financial sector such as insurance, merchant banking, etc.

13. NRB should simplify KYC guidelines in favor of the rural population and marginalized and vulnerable groups to facilitate their access to financial services.

14. NRB should undertake a comprehensive study to determine the extent of informal trade and remittance outflow to India and the modalities of financing these activities. The outcome of the study will be instrumental in regulating these activities.

15. NRB should take all the necessary measures to enhance its credibility to ensure the effectiveness of its monetary policy.

16. NRB should collaborate with various institutions to promote research in finance and economy for evidence-based policymaking.

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