Part III

Macroeconomy

Monetary Policy

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Structure of the Nepalese Economy and the Role of Monetary Policy

Evolution of monetary policy of Nepal took place at a time when monetary deepening was very low, when there were only a few financial institutions, and when the degree of monetizations was very low. The economy was mostly of subsistence nature with agriculture contributing more than 90 per cent of the economic activities. Till mid 1960s, narrow money to Gross Domestic Product (GDP) ratio was 8 per cent only and broad money to GDP ratio was less than 10 per cent compared with 20 per cent in India and 23 per cent in Sri Lanka. Financialization of assets was very low even till the end of 1960s. Agricultural Credit Survey done in 1969/70 revealed financial assets of the households comprising not more than 4 per cent with land building and livestock comprising more than 90 per cent of the household assets (NRB, 1972). In 1969/70, only 38 per cent of the households were borrower of one kind or the other. Of the borrowers, more than 42 per cent borrowed in kind. Of the total borrowing amount, 24 per cent was in kind. Nearly 78 per cent of the household expenditure used to go on food consumption; another 6 per cent was spent on clothing and footwear; thus leaving only 16 per cent of the expenditure on other consumption. The share of institutional credit in total borrowing was 18 per cent only of which the share of formal financial institutions was one third (6 per cent).

There was a small change in the structure of the economy till 1980s. The Multipurpose Household Survey of Nepal Rastra Bank (NRB, 1989) showed 58 per cent of the household income in kind, 57 per cent of the rural consumption on home produced goods and services, 84 per cent of the consumption expenditure was on domestic goods and services in 1984/85. The monetary deepening was still low with broad money supply/GDP ratio remaining at 28 per cent. The comparable figures for India and Sri Lanka at that time were 43 per cent and 31 per cent respectively. However, the process of monetization speeded up in the 1980s by virtue of aggressive bank branch expansion and massive injection of money through the fiscal deficit. The outward orientation of the economy also played a key role in this process.

Stage of monetization has a significant bearing on the conduct of monetary policy. First, income elasticity of money demand tends to be high in an economy which is monetizing; hence, monetary targeting without due consideration to this process can suppress economic activities. Second, the scope of monetary policy is defined by the stage of monetization and success of the objectives of monetary policy to attain higher output and employment, if any, is contingent upon this. Third, monetary policy itself has a role to speed up monetization and financialization of savings so that allocative efficiency of limited resources could be

maximized through the process of formal financial intermediation. As the process of monetization speeded up in the 1980s and 1990s along with deepening of the financial system, a wider room for monetary policy operation could be created by that time.

External trade, foreign exchange openness, and exchange rate regime also shape the course of monetary policy. Nepal started looking outwards in terms of economic relations right since the 1950s, and evolution of external trade and foreign exchange regimes began in the 1960s. However, trade-GDP ratio was less than 15 percent till 1970. Both trade and foreign remained controlled till early 1990 and exchange rate remained fixed until mid 1980s when a more flexible currency basket system of exchange rate determination was introduced. But Nepal could never evolve to a fully flexible exchange rate regime from fixed exchange rate system against Indian rupee. Neither there was much room for divergence in macroeconomic policies the country could adopt from those of India. Open border, trade concentration, fixed exchange rate regime, and free and unlimited convertibility of currency still continue to shape the course of Nepal's macroeconomic policies; and this also limits the exercise of independent monetary policy even today.

There have been noteworthy structural shifts in the Nepalese economy—composition of GDP has changed from more than 90 per cent share of agriculture in 1960s to less than 40 per cent now, trade-GDP ratio has exceeded 40 per cent, foreign exchange regime has been liberalized, and much monetary and financial deepening have taken place with broad money-GDP ratio at more than 56 per cent in 2004. But some fundamentals in the exercise of monetary policy have not yet changed from the establishment of NRB in 1956 to date. Nor have the relationships between macroeconomic variables like prices, interest rate and exchange rate diverged significantly. So long as Nepal continues to have current trade, payments, and foreign exchange regime with India, there is not much maneuverability in the country's monetary policy as well. Structural changes in the economy seem to demand shift in macroeconomic policies as well; but, as the following sections will reveal, the room for such policy shift remains fairly limited.

Evolution of Nepal's Monetary and Credit Policies

Nepal Rastra Bank began exercising monetary policy since mid 1960 with instruments like credit control regulations, interest rate administration, margin rates, refinance rate, and cash reserve ratio. In the 1970s, liquidity requirements, credit limits / ceilings and directed credit programmes were introduced. Open market operations evolved only in the 1990s with policy shift from direct to indirect monetary control. Effective exercise of cash reserve requirement and bank rate as active monetary policy tools evolved even later—since late 1990s. The basic objectives of monetary and credit policies have been fostering growth, generating employment, addressing poverty, containing prices, promoting external trade and attaining healthy balance of payments of the country. As so many objectives had been assigned to monetary and credit policies, it was hard to attain all of them, many of them conflicting to each other. Also the distinction between monetary and credit policies remained blurred and assessment of the impact of monetary policy became difficult. Recent shift of the monetary policy objectives from growth focus to stability has to some extent enhanced its credibility. But still the hangover of setting multiplicity of objectives is there in the policy-making institutions.

Monetary and Credit Policies: a Distinction

Often monetary and credit policies are interpreted in the same way. Nepal Rastra Bank has also been exercising monetary and credit policies through the same banner. But monetary and credit policies are not exactly the same. Monetary policy is defined as a policy affecting changes in the quantity of money while credit policy is defined as a policy affecting the cost, availability, and the allocation of credit. Money differs from credit because (i) money is the liability of the banking system whereas credit is an asset, (ii) money refers to banking system only whereas credit has a wider coverage; it consists of lending of all the banks and non-banking institutions, and (iii) money is the most liquid form of assets whereas credit is not. But money is created in the process of credit creation and therefore they are two facets of the same coin.

The authorities have to make a choice between monetary and credit policies. One reason why monetary policy is preferred over credit policy as a macroeconomic policy variable is the underlying

theoretical developments. There is no specific theory of credit demand as the theory of demand for money. The theory of demand for money regards real income or output, interest rate and inflation as the major factors affecting the demand for money. These may be taken also the factors affecting demand for credit, but with a point of caution. Demand for money is for transaction and asset purpose whereas demand for credit is for investment or consumption purpose. However, as the determinants of demand for money seem to closely affect demand for credit as well, we may regard business expectation or desired output growth, interest rate, and inflation rate as the factors affecting demand for credit. This in fact works as a monetary reaction function where not only money supply determines inflation, but prices also affect the demand for working capital and thus determine the supply of money through the process of credit (and demand deposit) creation. When prices are rising, there is a higher need for working capital; as an entrepreneur has to make a higher payment for raw materials, labour, and machinery.

Recent researchers have identified credit as an additional channel of transmission for monetary policy with two implications that are of particular relevance for policymakers. First, it is argued that if one considers the impact of monetary policy on the ability of the banking system to lend, credit succeeds as an intermediate variable where monetary aggregates fail, specifically, when demand for money is unstable. In a transforming economy, policymakers may get a clearer picture of inflation or longer-term economic growth by observing credit rather than monetary aggregates. Second, identifying the credit channel of monetary transmission has permitted a greater understanding of the nature and characteristics of business cycles. It is argued that shocks to bank credit itself may have a considerable impact on economic activity. As such, the credit channel is observed to amplify a mechanism whereby difficulties in the real sector lead to tightness in credit markets, thus shrinking the credit available for investment, which in turn exacerbates the real sector's downturn (see Khan, 2003).

However, in a situation where there is no strong linkage between credit demand and interest rate, it is difficult to take credit as a policy variable. As an instrument of monetary policy, interest rate can be used for encouraging or discouraging credit flows of the banking system and hence money supply. When control of money or credit supply is the need, interest rate structure may be revised upward. If the central bank has no direct control over the interest rate structure of the commercial banks, the same can be done indirectly through open market operations and changes in the bank rate. But control of money supply or credit through interest rate is possible only if market interest rate is sensitive to bank rate and if market borrowing is also sensitive to bank lending rates.

The situation in Nepal is something different; it has past instances of higher credit growth accompanied by high interest rate structure. This has happened owing to the administered interest rate structure for quite a long time coupled with underdeveloped bond market and substitution of money to physical assets rather than to bonds taking place. The latter is quite common in an inflationary situation when the real value of financial instruments depreciates and the value of physical assets appreciates. Besides, empirical studies on the relationship between private sector borrowing from the commercial banks and the lending rates of the banks reveal no significant negative relationship between the two. As the real cost of capital seems to be higher than the lending rates of the commercial banks (as is reflected in the higher interest rate structure in the informal market), availability of bank credit is observed to be more significant than the cost to determine the flow of bank credit to the private sector of the economy.

In essence, although credit seems to be a plausible variable that the central bank can exercise to affect the real economy, a stable money demand function followed by strong association between money and balance of payments and to some extent a positive link between money supply growth and the rate of inflation indicate that Nepal Rastra Bank is better placed to choose money over credit as a tool to stabilize the economy and ensure adequate liquidity to promote economic growth.

Interest Rate as a Monetary Policy Variable

Interest is paid for the sacrifice made by the income holder by deferring consumption for the time being and imparting with liquidity, and to reward the income holder for making saving. There exists a wide array of interest rates in the economy. This is either because of wider verities of securities having

different liquidity, term structure, and degree of risk or market imperfection. The main monetary policy variables at the disposal of the monetary authority for achieving policy goals like growth and stability are the quantity of money, bank credit, and interest rates. Keynesian economists prefer interest rate as the proper monetary policy variable whereas Monetarists opt for money supply as the appropriate policy variable. Many others, from neo Keynesians and Radcliffe economists to open economy monetarists, advocate for credit as the appropriate policy variable. Although the supply of money and interest rate are interlinked, the central bank cannot determine both of them and hence has to choose one of them as a monetary policy variable.

In the Nepalese context, money supply is supposed to be the superior policy variable than interest rate on several counts. First, various empirical studies have shown that money supply is closely related with policy goals like money income, prices, and balance of payments than interest rate is. Second, though money supply is an endogenous variable, affected by policy autonomous factors also, the effects of policy induced factors on it are more dominating and thus more prone to manipulation than interest rate. In the recent years, interest rates are liberalized and the Nepal Rastra Bank has no direct control over them. And, indirect policy tools such as bank rate or discount rate or refinance rate cannot effectively work as a tool for attaining the desired level of market interest rate. This is because financial market is still narrow, shallow and fragmented; and inter-financial institutional flow of fund is very limited.

Interest rate is one of the monetary policy variables along with money supply and credit. But unlike money supply, it is difficult to adopt it as a policy variable for a number of reasons. First, there is a wide range of interest rates, and it is difficult to select 'the interest rate' which can work as a policy variable. Second, it is hard to establish an effective relationship between interest rate and monetary policy objectives in a financially underdeveloped economy. And third, central bank often loses command over interest rate if it is deregulated in a liberal monetary policy framework.

In a process to liberalize the financial system, initiatives to deregulate interest rate structure in Nepal were taken since mid 1980's. The complete liberalization of interest rate structure, however, took place in 1989 only whereby the commercial banks were set free to determine the deposit and lending rates. However, the existing number of commercial banks and the level of competitiveness in the financial market have not allowed interest rate structure to evolve through a perfect market mechanism. Further, there is a great deal of difference in the level of interest rates on loans between the formal and informal markets. Informal market rates for borrowing are much higher than the formal market rates which signal that availability rather than cost of credit is the major determinant of credit supply in the economy.

One noteworthy situation of the Nepalese financial system has been the poor sensitivity of commercial banks to changes in bank rate by the Nepal Rastra Bank. The direct channel of the effect of changes in bank rate on market interest rate is the increased cost of borrowing (from the central bank) of the commercial banks which compels the banks to increase their lending rates as well. But in a situation when banks are themselves over liquid and do not resort to central bank borrowing for financing their lending activities, revision of bank rate by the Nepal Rastra Bank makes no difference and commercial bank lending rates do not necessarily change. This is the reason why bank rate has not yet evolved as a potent tool of credit control or monetary management in Nepal.

To achieve a higher economic growth, there has to be an increased investment both from the public and the private sector. Increased investment can take place only when savings are mobilized sufficiently. Savings, especially financial can be increased if real deposit rates are positive. In this respect, Nepal Rastra Bank had adopted interest rate policy for the (i) mobilization of higher level of savings in the form of bank deposits, (ii) prevention of capital flight to India, (iii) allocation of resources to productive sectors of the economy, and (iv) promotion of economic activities particularly industry and trade. For those purposes, interest rates were regulated since 1967 to 1989. In the past, when interest rates were controlled, Nepal Rastra Bank (NRB) attempted to keep real deposit rates positive by making frequent upward revisions in nominal rates whenever inflation rates were changing. But it was not possible to do so all the time for the NRB. As a result, there could be lags and delays in the policy changes. Moreover, it was not possible for the NRB to determine the

desired nominal interest rates. In this regard, market force was considered as the best judge.

Interest rate spreads indicate the level of financial intermediation cost. The higher the interest rate spread, the higher is the financial intermediation cost. Persistent higher intermediation cost causes financial disintermediation. Obviously, if financial disintermediation starts as a result of higher interest rate spread, it inhibits the financial development. Therefore, the liberalisation of the whole interest rate structure was directed at fostering competition among the financial institutions. Consequently, it was thought that competition would bring down the interest rate spread. However, as there was no such achievement, the spread had to be administered in the later 1990s, initially at 6 per cent and later on at 5 per cent. Then the financial system had to wait for many years before some visible achievement in the reduction of interest rate spread could be observed. Observing the positive trend, the maximum spread limit was withdrawn in 2003. But a number of factors still hold the spread at a higher level. They include (i) segmentation of financial markets, (ii) high non-performing loans and lenders' temptation for high risk premium (iii) inefficiency of the large commercial banks and development banks under state equity capital. Concerns of the central bank over high interest spread needs to be addressed through market related instruments and financial policies. There is not much scope for exercising interest rate as an independent monetary policy tool at this stage of the financial reform.

Role of Autonomy in the Conduct of Monetary Policy

Central bank is the apex financial institution assigned the task of designing and operating monetary policy, regulating / supervising the financial system, and ensuring a healthy growth of the payments system in the country. Among the variables of goal function of monetary policy, the policy focus has changed over time. It is a well-known fact that monetary policy can be used to raise real GDP temporarily above potential level in the short run. Generally, the expansionary monetary policy may not generate inflation in the short run but helps reduce unemployment. However, in the long run, monetary policy determines the rate of inflation. Inflation affects productivity and the growth of potential GDP adversely in the long run. Henceforth, the focus of monetary policy has been shifted to the maintenance of the domestic value of money. The successful operation and conduct of monetary policy by the central bank in terms of achievements of its policy objective is, however, closely associated with the degree of independence the central bank obtains from the government.

Generally, the following arguments are put forward for the central bank independence. First, Central bank independence is needed to prevent time inconsistency in the conduct of monetary policy. Second, time inconsistency in monetary policy gives rise to the problem of credibility. Once the public perceives that central banks' monetary policy actions are not credible, whatsoever good intentioned monetary policy may be, it becomes less effective. Third, the problem of credibility of central bank's policy arises when the central bank is not independent and is forced to meet government's request for unlimited funds. Fourth, coordination of monetary policy with other policies especially exchange rate policy is also needed to make monetary policy effective. And fifth, monetary policies conducted without fixing accountability will not be effective. Central banks can be held accountable for their actions and policy mistakes only when they are granted independence (Khatiwada, 2000).

We normally talk of three dimensions of central bank independence, (i) political independence (ii) macroeconomic independence and (iii) microeconomic independence. Political independence relates to having a clear objective of monetary policy. Now, the focus is towards having a single objective i.e. achieving domestic price stability. Macroeconomic independence relates to freedom to formulate monetary and exchange rate policy. Microeconomic independence relates to financial independence. This is meant for achieving financial stability. The existence of a sound banking financial institutions is possible only when proper prudential norms are put in place and the central bank has the power to seek the effective compliance of such norms.

When NRB came into existence in 1956, the preamble of NRB Act, 1955 stated the objectives of its establishment as (i) to insure proper management for the issue and circulation of Nepalese currency throughout the kingdom, (ii) to stabilize the exchange rates of Nepalese currency in order to

ensure convenience and economic interests of the general public, (iii) to mobilize capital for development and encourage trade and industry in the kingdom and (iv) to develop the banking system in Nepal. The NRB Act, 1995 stated that NRB will have to advance loans repayable within eight months in case His Majesty's Government so needs on terms mutually agreed upon by His Majesty government and the Bank. The Act did not set the limit on government borrowings from the NRB. Of late, a 'Gentlemen Agreement' was done not to borrow in excess of certain amount. However, the government seldom adhered to this limit. NRB's policies on exchange rate were also often guided by the government directives. Lack of independent of NRB from the government in this respect also impinged upon NRB's maneuverability in the conduct of monetary policy.

The new Nepal Rastra Bank Act, 2002 has been instrumental to ensure autonomy and correct the anomalies inherent in the NRB Act. There are now statutory limits to central bank borrowing, freedom for the fixation and management of exchange rate and managing the financial system. But one single statutory objective for monetary policy could not be fixed in the legislation for obvious reasons. Nepal is a small open economy with open border with India. Empirical studies have shown that Indian prices have greater influences on Nepalese prices. This implies that the central bank could not be assigned domestic price stability as the sole objective. An exchange rate regime of the present type in a capital controlled regime did not fully support exchange rate targeting. And, achieving a higher economic growth rate could not also be the objective of monetary policy because of weak relationship of monetary variables with real GDP. As the economy evolves and makes structural shift, the central bank has to gradually move towards single monetary policy objective—price or external sector stability depending on what money can better affect.

Transmission Mechanism of Monetary Policy

Monetary policy objectives have traditionally included promoting growth, achieving full employment, smoothing the business cycle, preventing financial crises, and stabilizing long-term interest rates and the real exchange rate. Although some objectives are consistent with each other, others are not; for example, the objective of price stability often conflicts with the objectives of interest rate stability and high short-run employment. Countries may assign these objectives equal weights or, as many countries have done in recent years, place greater emphasis on the objective of low inflation. This recent shift has been triggered by strong empirical evidence that high inflation (and its associated high variability) distorts the decision-making of private agents with regards to investment, savings, and production, and ultimately leads to slower economic growth. The liberalization of exchange rate regime, capital account liberalization, and growing trade openness have made many countries to shift monetary policy objectives from domestic to external sector stability while some others have opted for inflation targeting as a single most objective.

Monetary Policy Goals for Nepal

Price and external sector stability (exchange rate/ balance of payments) are probably the most important goals of monetary policy in Nepal. Excess money supply causes an upward pressure in the level of prices by increasing aggregate demand in the economy in the wake of inelastic supply of output. So monetary policy purports to contain prices by not allowing money to increase in excess of the desired demand for it. However, the control of money over inflation would be contingent upon the share of non-tradable goods and services in the consumer basket and the degree of demand side pressure on prices. As about one-third of the items under consumers' price index in Nepal are non tradable, and as excess demand is often a cause for price rise, targeting inflation as monetary policy objective is not irrelevant. Regarding balance of payments stabilization, it is observed that in an open economy, excessive monetary liquidity leads to higher aggregate demand and if the demand cannot be met by domestic supply of goods and services, imports from abroad would increase. This would cause deterioration in the balance of payments of the country. Proper monetary planning prevents the economy from such a situation. Price stability can also be instrumental for a healthy balance of payments because stable prices not only help maintaining export competitiveness of the country but also encourage foreign capital inflow in the country, both of which contribute to healthy balance of payments position. With the liberalization of the

external sector and introduction of a more flexible exchange rate system, the objective of monetary policy is also to ensure a stable exchange rate of the domestic currency.

Monetary Policy Variable(s) and Instruments

The main monetary policy variables at the disposal of the monetary authority for achieving ultimate targets are the quantity of money, bank credit, and interest rates. Broadly, two schools of thought prevail on the choice of appropriate policy variable. Keynesian economists prefer interest rate as the proper monetary policy variable whereas quantity theorists opt for money as the appropriate policy variable. Many others from neo Keynesians and Radcliff economists to open economy monetarists advocate for credit as the proper policy variable; although the definition of credit and the objective assigned to this variable are different. In the Nepalese context, money supply is supposed to be the superior policy variable than interest rate on several counts. First, various empirical studies have shown that money supply is closely related with policy goals like money income, prices, and balance of payments than interest rate is. Second, though money supply is an endogenous variable, affected by policy autonomous factors also, the effects of policy induced factors on it are more dominating and thus more prone to manipulation than interest rate. In the recent years, interest rates are liberalized and the NRB has no direct control over them; and, indirect policy tools such as bank rate or discount rate cannot work as the signal for a desired level of market interest rate in the wake of underdeveloped financial markets, particularly when financial layering ratio is very low or nonexistent.

An alternative to quantity of money as a policy variable is bank credit. It is argued that in an open economy with a fixed exchange rate regime, balance of payments becomes an additional source of money supply. Under such situation, the monetary authority can control only the domestic component of the money stock (net domestic credit). Given this, money supply cannot be characterized as an independent policy variable and domestic credit, which is independent of policy goals, should be regarded as the policy variable. However, as discussed earlier, there is no well-developed theory of the supply of credit effect on economic activities, particularly on income and price, as the theory of the effect of money supply is. Thus money is to be preferred over credit as the policy variable. But whether M_1 or M_2 should be the policy variable is an empirical issue. The following sections will explore whether M_1 or M_2 is an appropriate variable to affect the objective of monetary policy.

Monetary policy instruments in general can be listed as bank rate (BR), open market operation (OMO), cash reserve requirement (CRR), statutory liquidity requirement (SLR), administered interest rate, credit ceiling, margin rate, and moral suasions. In a liberal financial system, only the indirect means of monetary control like OMO, CRR and BR are exercised. That is what Nepal has been doing for the last one decade and a half. In advanced economies, bank rate can be used as an indicator of short term (money market) interest rate. If the central bank desires for a tighter monetary situation, it raises the bank (discount) rate, which discourages commercial banks' borrowing from the central bank and thus retards credit expansion activities of commercial banks. Open market operation, which means the sale and purchase of securities to and from the open market, is also used for attaining desired level of the quantity of money in the economy. In Nepal, the indirect policy tools are evolving but their effectiveness in controlling monetary aggregates for economic stability has been mixed; as in many years of the 1990s, actual money supply exceeded the desired level (see Khatiwada, 1999). Nepal has had a long transition of full evolution from direct to indirect monetary policy tools, with painful instances of disfunctioning monetary policy at times.

The Transmission Mechanism

One of the highly debated issues in monetary theory is the role of monetary policy in the economy. Recent theoretical as well as empirical evidence has led to a widespread understanding that changes in the quantity of money affect income, output, prices, interest rates, and the balance of payments. But the controversy still persisting is: what are the channels through which monetary impulses are transmitted to the real sector? Keynesians and Monetarists both acknowledge that changes in money stock have some permanent effect on output or on prices or on interest rate or on a combination of these. However, Keynesians emphasize the effect on interest rate and/ or on output, whereas Monetarists emphasize the effect on the level of prices. Open-Economy-

Monetarists, however, give an emphasis on the balance of payment or exchange rate (depending on whether a country's currency is under a peg or float) implication of the monetary expansion. Keynesians view interest as equilibrating the demand for and supply of money, while Monetarists envision price level as equilibrating them. The Rational Expectation Monetarists, however, argue that money does not exert any effect on output even in the short run if the increase in money is already anticipated. In their view, only un-anticipated monetary expansion will have any effect on real output even in the short run.

To recapitulate, the channels of monetary transmission mechanism, although somewhat concealed in the theoretical discussion, are identified as: (i) cost of capital (interest rate) channel, (ii) wealth effect channel, (iii) credit availability channel, and (iv) quantity of money channel. The first three channels are very close to the Keynesian thought whereas the last channel is the favourite of the Monetarists. Exchange rate is now considered as one of the new channels of monetary policy to affect prices and output in the economy (Khan 2003). Application of either of these channels in an economy hinges on the structure of the economy and the stage of financial development.

Relating quantity theory approach to the Nepalese economy, it can be argued that real income in Nepal is mainly supply determined independently of demand conditions and changes in the quantity of money in such a situation is supposed to impinge on the level of prices and the balance of payments. Since the characteristics of the Nepalese economy indicate that the economy is neither a completely closed nor a completely open one, the effect of monetary changes is supposed to be distributed between price and balance of payments changes in the long run with little or no effect on real output. The reasons why real income is supposed to be mainly supply determined can be mentioned as follows.

(i) The economy is dominated by activities in the agricultural sector mostly governed by weather conditions, and agricultural production which constitutes about two fifth of the GDP is less elastic with respect to prices, as it is in many less developed countries.

(ii) Though there are a few consumer goods industries, we cannot expect an automatic transfer of unskilled excess labour from agriculture (which suffers from disguised unemployment) to industrial sector which generally requires semi skilled or skilled labour force.

(iii) Even if surplus labour from agriculture is made available to industrial sector, the basic problem of industries that is the scarcity of capital remains unsolved and hence additional demand generated from the monetary sector will not be translated into increased output and employment. When supply of output is insensitive to its demand (or the prices), the additional demand generated by the monetary expansion is likely to impinge upon prices for non tradable goods and services and upon the balance of payments through higher level of imports.

Considering the interest rate channel in the Nepalese context, it is to be noted that interest rates in the organized financial market often fail to reflect the true cost or availability of capital in the economy; there is no proper term structure of interest rates consistent with liquidity and maturity of financial instruments; and, bonds market is at a primitive stage with bonds issued at face values and earning fixed interest income. Linkage between short term and long-term interest rates is either weak or lag in the linkage is very long. Portfolio substitution mostly takes place not between money and bonds but between money and physical assets. In such a situation, we can neither establish a positive association between money supply and bond prices and hence negative association between money supply and interest rate nor choose an interest rate that reflects the true opportunity cost of capital. As interest rates can not be pegged by indirect monetary policy measures, and as so called market determined rates are often far away from the realistic level that market forces should determine, the effect of changes in money supply on the level of investment through reduction in the rate of interest and then on real income can not be empirically analyzed. In a capital constrained economy like that of Nepal, where informal market rates of interest are substantially higher than those in the formal sector and where formal financial sector can fulfill only a small portion of the overall credit demand, availability rather than cost of capital is the determinant of investment demand. As such only 15 per cent of the borrowing households in Nepal have resorted to bank loan; the rest still opt for informal sources. Transaction and other hidden costs in formal sector borrowing

undermine interest cost. So, interest rate revision of even a fairly large degree is not likely to pose any remarkable change in investment decisions. The latter is likely to be more affected by business environment - mainly the market prospect and government economic policies - and improvement in the financial service delivery of the banks.

Neo Keynesians have emphasized the role of net private wealth along with income as a factor affecting real flows of expenditure. If consumers are assumed to hold bonds as well as other assets in their wealth portfolio, changes in the value of bonds brought about by changes in the monetary sector will affect the net worth of the consumers. But, whether it is only the rate of interest or also other monetary variables that have wealth effect is highly debated. This is connected with the treatment of financial assets (including money) as a part of net worth of the public. Anyway, increase in private wealth due to changes in the prices of financial assets may stimulate consumption along with strengthening the impact on economic activity of portfolio adjustment.

In Nepal, financial assets, the values of which change due to monetary development, constitute a negligible portion of the net worth of the private sector. Whatever financial savings are held, they are mainly in the form of currency, bank deposits and contractual savings. Not only is the holding of equities, shares and bonds as a part of net worth negligible but also the market values of these securities do not change considerably owing to the absence of secondary market of these securities. Interest income on bank deposits does not constitute as a sizable part of aggregate private sector income, which is evident from the small share of interest earning deposits on the GDP. Besides, return on financial assets including that from renting out properties comprise only 4 per cent of the household income, as revealed in the recent living standard survey (CBS, 2004). This indicates that wealth effect working through changes in interest rate is not very instrumental in affecting aggregate expenditure.

The credit availability channel is likely to be the most direct and powerful channel of transmission, in the Keynesian setting, of monetary impulses to the real sector in a less developed country like Nepal. This is because there exists an almost insatiable demand for credit at the prevailing interest rates in the formal financial sector, and financial institutions are forced to ration the available supply of credit by various non price terms. The rationing of credit on non price terms, such as default risk or credit rating of the customers, causes a reduction in the expenditure of small and risky firms or individuals (as large and established firms are supposed to be less susceptible to such credit restraint); and such rationing occurs in the wake of growing demand for credit even though the rate of interest is unchanged. If trade credit is not available and other financial markets are absent, a limited availability or rationing of loan would directly be transmitted to the real sector in the form of reduced expenditure by business firms and individuals. One manifestation of the credit flow suppression of the banks at present is excess liquidity existing in the commercial banking system amidst demand for credit from the non-bank financial institutions and informal sector at a much higher interest rate. In essence, interest rate in formal financial sector in Nepal is yet to evolve as a flexible, market representative, and true instrument reflecting the cost of capital.

Inflation Targeting — is the Condition Ripe?

Implementation of an inflation-targeting regime requires enabling macroeconomic, institutional and operational conditions. First, the authorities should be fully committed to price stability as the primary goal of monetary policy, ruling out the possibility of targeting any other variable like nominal exchange rate or interest rate or output. However, it is argued that exchange rate arrangements with limited flexibility could coexist with inflation targeting as long as the latter has priority. Besides, in a flexible exchange rate regime, central bank intervention in support of the exchange rate has to be limited to smoothen the effects of temporary shocks on inflation. This is particularly important in small open economies where the pass-through from exchange rate to inflation might be high and with short lags. Further in a strict inflation targeting regime, monetary policy instrument may respond to the output gap, but only to the extent that it affects the inflation forecast, and not because it enters in the central bank's loss function (Khan 2003). A strict inflation targeting is difficult in Nepal at this stage when Nepalese economy is fully open towards India with Nepalese rupee (NRe) pegged to Indian Rupee (IRe) and chances of capital flow across the border remaining high. In a situation when the peg has to be defended at a certain level,

interventions in the foreign exchange market becomes a regular phenomenon to correct cross rate differences in the NRe- IRe and US dollar exchange rates. This undermines the control of monetary aggregates to attain desired inflation target.

Inflation targeting requires an operational framework to guide the central bank authorities in conducting monetary policy. This framework consists of a reasonably well-established channel between policy instruments like money supply and inflation, relative effectiveness of different monetary instruments and the lags involved in the effectiveness, a methodology to produce inflation forecasts using different approaches, and a forward-looking operating procedure that derives an optimal policy rule—the central bank's reaction function—by which changes in the instrument depend on deviations of the inflation forecast (the intermediate target) from the inflation target (Khan, 2003). In a country like Nepal where supply side is prominent in determining inflation and where currency substitution has been taking place in a faster way, observed monetary instruments are less likely to affect inflation.

It is argued that inflation-targeting approach appears to be very promising for developing countries. It is opined that it compels policymakers to deepen reforms, enhance transparency, improve the fiscal stance, and eventually converge to international level of inflation. As the experience of inflation targeting in several countries indicates, central banks must keep the public informed about their policies and performance in order to attain these objectives.

Nepal's monetary policy objectives as defined in the NRB Act, 2002 include more than inflation control. Special tie with the Indian economy tends to synchronize many macroeconomic variables between the two countries. The exchange rate peg is serving the country well in terms of containing inflation and attaining external sector stability. Empirical estimation of the determinants of inflation reveals very weak relationship between money and prices. If inflation targeting is exercised in such a situation, choice of an appropriate alternative monetary variable has to be worked out. This is because money supply is less likely to help contain inflation directly.

The following equation is estimated to see how much of the variation of inflation is explained by money supply alone:

$$gpa = b_o + b_1\, gma_1 \text{ or } gma_2$$

Where gpa = annual inflation rate, gma_1 = annual growth of narrow money and gma_2 = annual growth of broad money. Estimations are done based on annual data series for 1966 to 2004 which are taken from IMF Financial Statistics CD ROM, showing the following results:

$$gpa = \underset{(1.4)}{4.52} + \underset{(1.5)}{0.522}\, gma_1$$

$$R^2 = 0.07,\ F=1.3,\ \rho = 0.19$$

Figures in the parentheses are t-ratios. r is autocorrelation coefficient of the first order.

The result shows that the explanatory power of money to inflation is very low over the sample period. The coefficient is statistically insignificant. Alternative estimation based on broad money as the explanatory variable gives similar result:

$$gpa = \underset{(1.2)}{4.56} + \underset{(1.4)}{0.444}\, gma_2$$

$$R^2= 0.05,\ F=0.93,\ \rho = 0.18$$

This result also shows that the explanatory power of broad money to inflation is further low. The coefficient is statistically insignificant. When money price relationship is very weak, and when a credible alternative policy instrument does not exist, the room for inflation targeting becomes irrelevant. Even though we take core inflation for targeting purpose, the empirical relationship does not strongly support the view. By adopting core inflation as the target and achieving this, the central bank can technically perform its responsibility, but it will be severely challenged by the public when it fails to control headline inflation.

Empirical analysis shows that inflation in Nepal is explained by a number of variables like Indian prices, real gross domestic output, exchange rate and so on. Specification of this type of equation along with monetary variable can better explain inflation. The following estimating equation and the estimated result substantiates this:

$$gpa = co + c_1 gma_1 + c_2 ggdpa + c_3 gwpia + c_4 gexratea$$

where ggdpa= annual growth of real gross domestic product, gwpia = annual growth of Indian wholesale price index, and gexratea = annual changes of nominal exchange rate of the Nepalese currency against US dollar (a positive growth is depreciation). All the variables are annual averages and the period covered is 1966 through 2004.

The empirical estimation of the above equation has produced the following result:

$$gpa = 1.50 + 0.415\ gma_1(-1) - 0.110\ ggdpa$$
$$(0.5)\quad (1.13)\qquad\qquad (-0.43)$$
$$+ 0.517\ gwpia + 0.089\ gexratea$$
$$(3.6)^*\qquad\qquad (0.88)$$
$$R^2 = 0.353\quad F = 3.4\quad DW = 2.1$$

Monetary variable was lagged by one period in the estimation as the current money supply variable had even weaker relationship with inflation.

The following section will explore the actual lag in the effectiveness of money to contain prices. All the explanatory variables together explain little over one-third of inflation in Nepal. Among the explanatory variables, only Indian inflation is statistically significant to explain inflation in Nepal.

There has been a shift in the money-price relationship over time. Estimation of the above equation in two sub sample periods shows significant differences in some of the relationships. The estimated equations for 1966 to 1985 and 1986 to 2004 give the following result:

Period: 1966 to 1985

$$gpa = 1.54 + 0.89\ gma_1(-1) + 0.14\ ggdpa$$
$$(0.5)\quad (1.5)\qquad\qquad (0.4)$$
$$+ 0.295\ gwpia - 0.267\ gexratea$$
$$(1.8)^{**}\qquad\qquad (-1.5)$$
$$R^2 = 0.42\quad F = 2.6\quad DW = 1.92$$

Period: 1986 to 2004

$$gpa = 21.6 - 2.19\ gma_1(-1) - 0.007\ ggdpa$$
$$(2.8)\quad (-2.5)^*\qquad\qquad (-0.2)$$
$$+ 0.299\ gwpia + 0.325\ gexratea$$
$$(1.2)\qquad\qquad (3.2)$$
$$R^2 = 0.717\quad F = 8.1\quad DW = 1.8$$

A few distinctly different relationships have been observed in the result of these two periods. First, the role of money in explaining inflation seems to be significantly reduced in the second period compared to the first one. As such one period lagged money is exerting negative impact on inflation, contrary to theoretical expectation. Second, the role exchange rate seems to be crucial in determining inflation in the second period compared to the first one. This is obvious for a number of reasons like more frequent devaluation / depreciation of the Nepalese rupee since mid 1980s and rapidly growing share imported goods in GDP during this period. Third when exchange rate change is active, the direct impact of Indian wholesale price on Nepalese inflation is blurred.

One noteworthy question whether Indian WPI or CPI affects Nepalese inflation more has also to be addressed. The following equation explains this:

$$gpa = d_o + d_1 gwpia \text{ or } gcpiia$$

where gcpiia is annual average of Indian CPI. The estimated result taking Indian CPI as explanatory variable is mentioned as follows:

$$gpa = 3.29 + 0.589\ gcpiia$$
$$(2.6)^*\quad (4.5)^*$$
$$R^2 = 0.377\quad F = 10.6\quad DW = 1.54$$
$$\rho = 0.03\quad \text{Period: 1967 to 2004}$$

This result means that Indian CPI alone can explain more than one-third of Nepalese inflation. The coefficient on Indian CPI or gcpiia implies that each one-percentage point increase in CPI in India would cause a 0.59 percentage point increase in consumer prices in Nepal. The estimated equation using Indian WPI as the explanatory variable shows the following result:

$$gpa = 4.66 + 0.427\ gwpia$$
$$(3.3)^*\quad (2.9)^*$$
$$R^2 = 0.210\quad F = 4.67\quad DW = 1.61\quad \rho = 0.08$$

The explanatory power of this equation is less than that of the former implying that Indian CPI can better explain inflation in Nepal. However so far as the lagged effect is concerned, one period lagged Indian WPI explains more of the inflation in Nepal than one period lagged CPI of India. This is obvious because pass-on of WPI inflation of India to Nepal takes more time than the CPI inflation due a time gap involved between wholesaling and retailing of trading items.

Lags in Monetary Policy

Lags in monetary policy are long, and the future effects of policy actions are uncertain. Therefore the central banks must anticipate the effects of its policy actions well into the future. Behavioral changes in money demand, money illusion, imperfection of the market, and long time involved in the transaction of goods services and money affect this lag. Three types of lags are identified in the implementation of monetary policy: (i) recognition lag, (ii) implementation lag and (iii) effectiveness lag. When data and information flow in a time lag, the identification of the problem or recognition of the action to be taken is delayed. The execution lag takes place when policy makers and board directors of the central bank cannot meet frequently to make real time decisions. The effectiveness lag occurs on account of the structure and stage of financial development of the economy.

Globally it is recognized that there is a substantial lag in the effectiveness of monetary policy. It is observed that it takes a year before monetary policy actions have their peak effect on inflation (Batini and Neslon, 2002).

Empirical analysis of the money-price lagged relationship is estimated with the following equation:

$$gcpi = a_0 + a_1 \, PDL \, (gm_1, \alpha, \gamma)$$

where gcpi = monthly inflation rate, gm1 = monthly narrow money growth rate, α is lag operator and γ is constraints imposed on the lag. The data are taken from IMF Financial Statistics CD ROM.

The estimation of the above equation with α = 8 and α = 2 shows the following result:

$$\begin{aligned} gcpi = & -0.04 - 0.024\, gm_1 + 0.023\, gm_1(-1) \\ & \quad (-0.3) \quad (-1.2) \qquad (1.7) \\ & + 0.059\, gm_1(-2) + 0.083\, gm_1(-3) + 0.095\, gm_1(-4) \\ & \quad (5.7)^* \qquad (8.3)^* \qquad (9.3)^* \\ & + 0.096\, gm_1(-5) + 0.086\, gm_1(-6) \\ & \quad (9.6)^* \qquad (8.4)^* \\ & + 0.064\, gm_1(-7) + 0.031\, gm_1(-8) \\ & \quad (4.9)^* \qquad (1.6) \end{aligned}$$

Sum of coefficients of the lagged values of gm_1 = 0.514, R2=0.164 F= 30.8

Time period: 1964:10 to 2004:07, 478 observations after adjusting end points.

Figures in the parentheses are t-ratios and * means significant at 5 per cent level.

The result reveals that the effect of money on prices begins right from the second month of monetary expansion, the effect is maximum in five to six month's time and the effect starts dissipating there after. The effect becomes insignificant after 8 months.

Choosing monthly broad money supply growth (gm2) as the monetary variable, similar result has been observed. The estimated result is as follows:

$$\begin{aligned} gcpi = & -0.46 + 0.016gm_2 + 0.068gm_2(-1) \\ & \quad (-2.2)^* \quad (0.5) \qquad (3.2)^* \\ & + 0.105gm_2(-2) + 0.129gm_2(-3) + 0.137gm_2(-4) \\ & \quad (6.4)^* \qquad (7.8)^* \qquad (8.1)^* \\ & + 0.132\, gm_2(-5) + 0.112\, gm_2(-6) \\ & \quad (8.0)^* \qquad (6.8)^* \\ & + 0.078\, gm_2(-7) + 0.029\, gm_2(-8) \\ & \quad (3.7)^* \qquad (0.9) \end{aligned}$$

Sum of coefficients of the lagged values of gm_2 = 0.810, R^2=0.122 F= 22.0

This result also shows that the effect of broad money on prices begins right from the second month of monetary expansion, the effect is maximum in five to six month's time and the effect starts declining there after. The effect becomes very insignificant after 8 months.

As the explanatory power of estimating equation with narrow money has higher R^2, it corroborates the findings that narrow money is still better policy variable than broad money.

The "Impossible Trinity" and Dilemma of Nepal's Monetary Policy

The impossible trinity is achieving three things at the same time: exchange rate stability, free flow of international capital and an autonomous monetary policy (which means the ability to target inflation and/ or interest rates). It is not possible for straightforward reasons: if capital is free to move in and out, and the exchange rate is fixed, then money can swing in and out in huge quantities and play havoc with domestic inflation and interest rates — which then rules out an autonomous monetary policy. Similarly if interest rate is targeted, monetary aggregates might move beyond desired level (depending upon interest elasticity of money or credit demand) having its implication for external sector balances. In a perfectly open economy case, excess or deficient money supply would then change the course of capital flows, ultimately thwarting the target of interest rate level.

In developing countries, monetary policy has become increasingly important in recent years, even though capital accounts have been progressively liberalized. The reason is that the large movements in global capital during the late 1990s forced many of these countries to abandon fixed or closely managed exchange rate regimes. Such recent developments have put a new face on an older, deeper lesson: namely that freely mobile capital, independent monetary policy, and fixed exchange rates form an impossible trinity. It is opined that it is possible to have any two of these policies, but not all three.

There is a view that real interest rate has to be positive in order to encourage financial savings mobilization. So there is a temptation to control interest rate along with targeting monetary aggregates. Targeting an inflation of less than 5 per cent and attempting to maintain interest rate at a level close to that in India means that both interest rates and money supply have to be at the disposal of the authorities. In a market related monetary and financial structure, this cannot be attained through direct interventions.

Take the exchange rate case next. The central bank has traditionally tried to defend the peg with Indian currency. That policy still holds, which means that the central bank wants one of the legs of the trinity: stable exchange rates. At a time of high capital flows, more frequent interventions have to be made to defend the current peg. Non-sterilized interventions in the foreign exchange market then have serious implications for monetary aggregates which impinge upon prices and balance of payments.

Talking about the third aspect of the impossible trinity that is free flow of capital, Nepal has so far loosely maintained capital control. But institutional capital flows mainly through the banking system and from the private sector individuals towards India remains unregulated. Thus, if the domestic rupee is ruling stronger than what the central bank would like, and if there is cross border difference in interest rates even in fixed exchange rate regime, there is a possibility of strong capital flows from/to the country which would affect directly the exchange rate or would indirectly affect the same through the balance of payments.

In an economy with shallow domestic financial system and high potential for capital flows, monetary targeting for inflation control and exchange rate targeting to defend the peg would be a difficult task for the central bank. In the similar vain, defending a peg would imply a loss of autonomy in monetary operation. This means that NRB has perhaps some times in future to make a hard choice between breaking the peg and loosing monetary autonomy.

Monetary and Financial Policies and Poverty Reduction: Is There any Relevance?

Monetary Policy—Its Rationale for Poverty Reduction

The basic objective of monetary policy is economic stability – both internal and external. Economic stability implies containing inflation, stabilizing the interest rate and the exchange rate which would promote investment for economic growth. Along with stability, monetary policy can help economic growth by ensuring adequate liquidity in the economy to generate demand for goods and services, and a broad based high economic growth is a must for poverty reduction. Besides, targeted credit program would help credit allocation to the poor and desired sectors of the economy, thereby directly promoting their income earning and employment opportunities. Control of inflation would also have a direct support on the efforts to reduce poverty.

Monetary policy has a re-distributive role along with the promotion of growth. As rising inequality, for a given level of income, leads to greater poverty, the distribution of income is also a central concern. Given the importance of macroeconomic policies, and the influence of monetary policy in particular, it is natural to ask if monetary policy can be used as a tool to help the poor through both the income generation and redistribution effects.

Empirical studies (Romer and Romer, 1998; Romer, 1998) suggest that there are indeed important links between monetary policy and the well-being of the poor in both the short run and the long run, but that the short-run and long-run relationships go in opposite directions. Expansionary monetary policy aimed at rapid output growth is associated with improved conditions for the poor in the short run, but prudent monetary policy aimed at low inflation and steady output growth is associated with enhanced well-being of the poor in the long run. Monetary policy can affect output, unemployment, and inflation in the short run. As a result, if poverty and inequality respond to these variables, monetary policy can affect the well-being of the poor. Furthermore, because unanticipated inflation can redistribute wealth from creditors to debtors, monetary policy can also affect income distribution through this channel.

There are views that in the short term, expansionary monetary policy can generate a temporary boom, and hence a temporary reduction in poverty. But, as unemployment returns to the natural rate, poverty rises again. Furthermore, the expansionary policy generates inflation. If a monetary contraction is used to reduce inflation, the adverse effects on poverty offset even the temporary reduction in poverty during the earlier boom. In the long run, monetary policy most directly affects average inflation and the variability of aggregate demand. Therefore, the important question from the perspective of monetary policymakers concerned with the condition of the poor is whether there is a link between these variables and poverty and inequality. Notwithstanding this, monetary policy that aims to restrain inflation and minimize output fluctuations is the most likely to permanently improve conditions for the poor.

The short-run effects of monetary policy can influence the well-being of the poor through three channels. First, and most important, the rise in average income in a cyclical expansion directly reduces poverty. Since expansionary monetary policy raises average income in the short run, this is a powerful mechanism through which monetary policy can immediately benefit the poor. Second, there may be cyclical changes in the distribution of income. The declines in unemployment and increases in labor force participation and in real wages in an expansion are likely to be concentrated disproportionately among low-skilled workers. Thus the income distribution may narrow. Third, the inflation created by expansionary monetary policy has distributional effects. Inflation can harm the poor by reducing the real value of wages and transfers.

For economists sidelining with regulated financial system, monetary policy has its direct role to play like providing subsided food credit for assisting in moderating prices of coarse cereals and pulses, concessional lending to agriculture, particularly the small farmer for increasing food production, subsidized micro credit for the generation of self-employment, etc. China is one example where state led financial services created massive non-farm employment in the rural sector in china during the 1980s and 1990s. All activities in relation to enhancing agricultural growth, non-farm employment, micro enterprises and so on, were supported by appropriate policies, including subsidized credit. As a result, poverty was reduced to 6 per cent of the population by the end of the two decades. There are other country cases also where directed credit has had significant impact on employment creation. Empirically it is observed that high inflation and macroeconomic instability are correlated with less rapid growth of average income and lower income equality (Romar and Romar, 1998). An "anticipated" increase in inflation of one percentage point is associated with a decline in poverty of 0.2 percent. However, the contraction needed to reduce the inflation rate is larger than the expansion that increased it, so the boom-bust cycle raises average poverty.

In a comparison of 66 countries[2], it is found the average income of the poor tends to be lower in countries where monetary policy has produced higher average inflation and greater macroeconomic volatility. And ignoring countries with high rates of inflation — more than 25 percent annually – it is found that a one- percentage point rise in average inflation is associated with a reduction in the poor's average income of about 9 percent. Thus, on average, the poor are much better off in countries where monetary policy has kept inflation low and aggregate demand growth stable[3].

There are a number of empirical studies done in Nepal on the effect of monetary policy on inflation (see Sharma, 1987; Khatiwada, 1994, etc). But there are no studies to empirically link inflation with poverty. This section evaluates the relationship between money supply and inflation in Nepal and inferring the experience of other countries which have established an inverse relationship between inflation and poverty, observes that monetary policy has so far limited role in poverty reduction. But for creating a conducive environment for investment and growth, monetary policy has definitely helped maintain macroeconomic stability.

The relationship between money supply and inflation is weak in Nepal. This reveals that money supply has very limited role in determining inflation in Nepal. There are other domestic and external variables like domestic supply side costs, imported prices and exchange rate which influence the inflation rate. From the low money supply-inflation association, it can be inferred that monetary policy has little to affect poverty through inflation.

Monetary Policy, Credit Availability and Outreach of the Poor

One of the channels of monetary policy to affect the real economy is credit availability. An expansionary monetary policy would widen this channel and thus help output growth using credit as a factor of production. But there is not an automatic and strong linkage between credit flow of the banks and economic growth. Credit should flow in the productive area for it to promote growth. What type of growth is promoted by such credit and how the credit is distributed among economic agents has a bearing on poverty.

There has been a rapid expansion of the financial institutions along with financial liberalization. Subsequently, commercial banks' credit flow rose from 16 percent of GDP in 1985 to 26 percent in 1995 and further to 46 per cent in 2004, one percentage point each year. Of the total credit flow, share of the private sector improved from 52 per cent in 1985 to 79 percent in 2000 and remained at

74 per cent in 2004. This is encouraging, as government has not been a factor to crowd out resources available for the private sector in the recent years.

Distribution of private sector credit of the banks shows growing share of the industrial share in total bank credit. This is encouraging from the perspective of industries creating employment and thus helping poverty reduction. However, industry has so far not been able to absorb large labour force. Agriculture, which absorbs more than two-thirds of the labour force, is mostly out of the reach of formal financial services. Of the total credit extended by commercial banks, only 4 percent went to agriculture in 2004. Agriculture Development Bank, which is a major supplier of rural credit, has somehow been extending credit, but access of the poor households to such credit is also limited. A taxing lending rate of the latter has further adversely affected the agricultural borrowers.

There has been more than three fold increase in per capita credit of the commercial banks in less than a decade. There has been an expansion of credit from other financial institutions, financial cooperatives, and financial NGOs as well. But the available statistics is not very encouraging, indicating that the level of intervention has been rather small.

The living standard surveys done in 1995/96 and in 2003/04 show that borrowing households (from both the formal and informal financial system) have increased from 61 per cent in 1996 to 69 per cent in 2004. Of the borrowing households, only 15 per cent borrowed from the banking system in 2004 compared with 16 per cent in 1996 (see Table). This implies that households having access to bank credit have very marginally gone up from less than 10 per cent in 1996 to 10.4 percent in 2004. Moneylenders and relatives account for more than 80 percent of the borrowing. The poor have to resort more to such source. Only 8.3 per cent of the poorest consumption quintile had access to bank credit in 2004, almost the same as in 1996; whereas 26.8 per cent of the richest consumption quintile has access to such credit in 2004 compared with 21.8 per cent in 1996.

The collateral based lending practice of the banks has been a factor denying access of the poor inn bank credit. In 2004, 28 per cent of the bank loan went free of collateral compared with less than 12 per cent in 1996, a remarkable transformation in eight years. But that is yet to encompass most of the poor. Beside, the lower the consumption group of households, the higher has been the proportion of borrowing for consumption. In 2004, 58 per cent of the borrowing of the poorest consumption quintile went on consumption compared with 62 per cent in 1996. This implies that these households have to meet their basic consumption needs by incurring debt. This raises a fundamental question as to whether the improvement in consumption financed by indebtedness sustains the well-being of the poor households or not. As such, rural indebtedness has been one of the reasons for growing landlessness, migration and even emigration in search of work abroad.

On the whole, liberal monetary policy — working through interest rate liberalization, deregulation of portfolio restrictions, removal of credit ceilings, and withdrawal of other regulations – has been able to have easy credit expansion to trade and industry. But bank financing was confined to limited urban-based business activities and credit expansion concentrated in a few business houses. There was a large misuse of the easy credit, as evidenced by the non-performing assets of the two large banks rising to 60 per cent level in 2004. Such credit was not able to

Household Borrowing and Access to Bank Credit

Description	1995/96	2003/04
Households with Borrowings (%)	**61.3**	**68.8**
Borrowing from Banks (%)	16.1	15.1
Borrowing from Relatives (%)	40.8	54.5
Borrowing from Money Lenders (%)	39.7	26.0
Proportion of Poorest Quintile having access to Bank Borrowing	8.2	8.3
Proportion of Richest Quintile having access to Bank Borrowing	21.8	26.8

Source: NLSSI and NLSS II, CBS (1997, 2004).

promote growth by enhancing the productivity of investment, nor was it supportive to income generation and creation of jobs for the poor. The liberalization of interest rates in 1989 left no room for subsidized credit to targeted sectors or groups of people. The priority sector credit programme, which included agriculture, cottage and small industries and basic service sectors, continued to be in place as the mandated lending requirements of the banks. But the requirement that at least 12 per cent of bank credit should flow towards these priority sectors was often not met. Banks took it as an imposed programme and after a lot of opposition, it is now being phased out. This is likely to deprive the rural households from the bank credit in the absence of alternative formal institutions. While bank financing is still confined to a few business houses, the vast majority of the households remain deprived of any type of formal institutional credit (UNDP, 2004). Besides, the lending practice remains highly collateral based, thus undermining the access of the poor in bank credit.

Conclusion

There have been noteworthy structural shifts in the Nepalese economy in the recent decades. The composition of GDP has changed with services sector emerging as nearly the largest sector, trade-GDP ratio has increased, foreign exchange regime has been liberalized, and much monetary and financial deepening has taken place. But some fundamentals for the exercise of monetary policy have not yet changed. Nor the relationships between macroeconomic variables of Nepal and India like prices, interest rate and exchange rate have diverged significantly. So long as Nepal continues to have current trade, payments, and foreign exchange regime with India, there is not much maneuverability in the country's monetary policy as well. Structural changes in the economy seem to demand shift in macroeconomic policies as well; but the room for such a policy shift in the near future remains fairly limited.

Special characteristics of the Nepalese economy imply that monetary policy continues to have more than one objective to meet. They are attaining price and external sector stability. These objectives are so far mutually consistent, exchange rate changes affecting more inflation than trade and money supply growth affecting balance of payments more than inflation, a typical case of an open and small economy. However, as economic sophistication deepens further with opening of the economy and financial deepening, macroeconomic relationships are bound to shift. A structural shift in the economy would allow the central bank to move from multiple objectives of monetary policy to a single one. But whether it will be inflation or exchange rate depends on the nature of the shift it might take. A move away from monetary aggregates to new instruments of monetary policy will also depend on the changes of basic macroeconomic relationships.

Endnotes

[1] This article is a part of the ongoing research on monetary policy of Nepal Rastra Bank (draft).

[2] Christina D. Romer and David H. Romer (University of California, Berkeley), "Monetary Policy and the Well-Being of the Poor," Economic Review, First Quarter 1999, Federal Reserve Bank of Kansas City.

[3] Ibid

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Economic Research

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Introduction

Nepal Rastra Bank (NRB), the central bank of Nepal, furnishes information on monetary, financial and capital market of the country. It has been designated as the economic adviser of the government by the Act governing it. In that capacity, the central bank needs to be competent enough to comprehend the entire economic activities, besides the aspects directly related to its core functions. For discharging its duties both in the capacity as the monetary authority and the economic adviser to the government, the NRB requires up-to-date information on relevant fields for undertaking comprehensive analysis. The normal ways to have access on information are to conduct studies, research works and surveys and bring them out for public use. The NRB, since its inception, has been performing statutory obligations of submitting annual reports to the government on financial and economic activities. Similarly, to keep abreast with the economic, financial and capital movement in the country, the NRB occasionally has been conducting surveys on such aspects as household budget and credit needs in the economy. Occasional papers on contemporary issues also are brought out to supplement the theoretical exercises in order to facilitate the bank in discharging its statutory as well as other normal duties.

The organization of the paper is as follows. The relevance and significance of the statutory and non-statutory obligations of the bank with regard to its publications will be presented in the subsequent section. The third section deals with the detailed enumeration of each type of materials produced, for example, the statutory and non-statutory works. The fourth section elaborates on the coverage of the publications hitherto continued by the NRB. The fifth section suggests measures to fine tune the existing works and upgrade them. The final section presents the conclusion.

Relevance and Significance

Statutorily, the NRB is bound to submit a report on its activities and financial position. Section 93 of the Nepal Rastra Bank Act, 2002 has the provision of submitting the audit report, reports on economic and financial position and its activities to the government within four months of completing the fiscal year. The balance sheet of the bank is also to be made public within four months of completing the fiscal year. Similarly, section 94 of the Act has made it compulsory to make public the monetary policy of the bank at the beginning of the fiscal year. The content of the report should include the review of the monetary policy adopted in the previous year and analysis with justification for the proposed policy.

As per Section 12 of the Act, the NRB has to disseminate the information on macro economy, development in financial market, money supply, price

stability, balance of payments, extension of credit and foreign exchange etc to the public. Most of this information is generated within the bank, while some are based on the banking and financial systems emanating from the instructions of the central bank. The information on money supply, in fact, depends on the reporting of the commercial banks. Note chests have been set up in 71 locations of the country in order to meet the contingencies of the funds to conduct government transactions. Of the total locations 8 are operated by NRB offices, 43 by the Rastriya Banijya Bank (RBB) and 20 by the Nepal Bank Limited (NBL). The provision of note chest covers 68 districts including remote districts such as Darchula and Dolpa where infrastructures such as telephone and electricity are absent. The means of communications, wherever available, is not regular and in most cases not available at all. In these circumstances, the information contained with regard to the bank's activity such as money supply is largely constrained by the inadequate data available from field offices of the commercial banks. Despite efforts by the commercial banks (where note chests have been set up) to dispatch the information, the NRB either receive the information on the use of such funds late or do not receive any information at all. Paucity of data occasionally hampers in meeting the deadline of publishing and/or making public the information by the NRB.

Foreign exchange regulations and balance of payments (BoP) compilations are exclusively within the jurisdiction of the NRB. Part of the functions of the central bank in respect of the transactions of foreign exchange has been delegated to commercial and development banks and money changing agencies. They need to make timely and correct reporting to the NRB. To plan for the better use of rare foreign currency, it is important to understand the supply and demand sides of it which again depends on the commercial banks and other financial entities transacting foreign currency. The regular supply of accurate information on foreign exchange transactions by agents dealing on it largely depends upon the analysis and reporting of the NRB to the public in general.

Similarly, for compiling the BoP data the central bank again has to rely on the information supplied by various national and international agencies. For current account transactions of the BoP, the staff of the NRBhas to go to different custom points to gather trade data. On the services account, information is collected from various agencies such as tourism (for domestic and international airlines, for instance, it is necessary to disaggregate the account of passengers into residents and non-residents). Hotels, travel agencies, transportation agencies are required to supply data for incorporation into the BoP statistics. On the transfer account, the commercial banks and agencies responsible for remittances play crucial role in reporting the position. Commercial banks often take the reporting exercise as a ritual one and anticipate reminders from the NRB. The information contained in the capital account of the BoP is collected from the reporting of the banking system as well as the government agencies, especially for government drawings and loan repayments. The compilation of the BoP statistics is an exercise vested on the central bank but accomplishment of which depends on the timely reporting of the information by the concerned agencies. Collecting information through diverse sources make it difficult for the publications to come out on schedule.

The NRB publishes statistics on trade, consumer price index and wholesale price index regularly. Besides these, the macro economic indicators are also brought into notice of the public in general as part of the responsibility of the central bank entrusted by the Act. Section 69(4) of the Act makes the bank mandatory to submit a pre-budget review report to the government each year on economic and financial matters. The report thus submitted assists the government to comprehend the prevailing economic and financial system and adopt appropriate policy through budget presentation.

The information thus collected and compiled in a standard format by the NRB together with its interpretations and analysis forms part of the materials to be used by policy makers and planners. The NRB, thus, has been discharging the duty of publishing relevant materials entrusted by the Act as well as other information, which normally are handled by agencies other than the central bank in other countries. Supplying price information by a central bank does look awkward because information on money supply comes from the NRB. It seems strange that the monetary authority is dealing with price statistics. Compilation of trade statistics normally is the task of the Central Bureau of

Statistics, but in Nepal's case it has been taken care of by the NRB since long. The justifications given for the task of compiling price and trade statistics by the NRB are monitoring whether or not interest rate is positive in real terms and gauging the foreign currency liability arising due to imports in the economy respectively. At first sight, the reasons seem relevant; however, the tasks to be borne in respect of price and trade statistics lie on agencies other than the central bank. Nevertheless, the surveys and special studies do assist in identifying the problems and suggest ways to address them.

Publications of the NRB

The materials brought out by NRB can broadly be classified into three categories; (i) items under statutory obligations, (ii) surveys, studies and research works, and (iii) statistical publications. Each of the above categories has significance of its own.

Items under Statutory Obligations

The time frame and contents to be included are specified by the Act. The economic and financial report which has to be submitted to the government under section 93 of the NRB Act 2002 should cover areas such as agricultural and industrial output, banking development, government finance, debt position, money supply, interest rate movements, price, trade and BoP in detail with their impacts on the economy. Along with the economic and financial report, the Act calls for submission of the audit report as well as the accounts of the activities of the bank. Besides these annual publications, the bank publishes its monthly balance sheet within fifteen days of completion of the month.

The economic report deals at length with the overall macro economic aspects of the country and the annual report contains the administrative functions of the NRB. Both reports need to be submitted within four months of the completion of the fiscal year. These reports used to be published separately; but with the introduction of NRB Act 2002, all aspects under section 91 and 93 subsection (a), (b) and (c) are published in one volume from the FY 2002/03 onwards. The new Act has also made it mandatory to announce and publish the monetary policy to be adopted for the fiscal year for the use of general public.

To assist in identifying the problems inherent in the economy, the bank under the provision of section 69(4) of the NRB Act 2002, submits to the government a pre-budget review report which contains a comprehensive analysis of the economy including recent trends and suggests policies to be adopted by the government. In its capacity as an economic adviser to the government such recommendations are made by the NRB; however, there is no binding rule that the government should follow the suggestions.

Surveys, Studies and Research Works

The NRB, in pursuit of investigation of problems associated in the credit and banking development, occasionally has been conducting surveys, undertaken studies in various fields and conducted research on different aspects.

Surveys

The major surveys conducted by the NRB are the Agricultural Credit Survey (ACS) and Household Budget Survey (HBS). While the former intended to find out the drawbacks that remained in the agricultural finance, the latter aimed at gauging the expenditure pattern of Nepalese family in order to develop the price indices.

The ACS was initiated to conduct a comprehensive survey on agricultural credit on November 15, 1968. An Agricultural Credit Survey Board was constituted under the chairmanship of Chief Economic Adviser, Research Department with other five members representing various agencies including the Central Bureau of Statistics, Agriculture Development Bank and Ministry of Food and Agriculture of the government. The Board was entrusted to direct the organization and supervision of the ACS, interpret its results and make necessary recommendations on the basis of the findings. The Board set the following objectives of the survey: a) to find out the credit needs of different types of farmers based on existing pattern of farming and indebtedness of farmers, b) to assess the possibility of increasing productivity and extension of market and c) to explore the ways through which the NRB could contribute in the field of agricultural finance.

For the survey purpose, of the 75 districts 32 were selected as accessible (from the transportation point of view) districts, 20 from Terai and 12 from Hills. These districts covered 2006 Village Panchayats out of more than 4000. The districts and Village Panchayats actually selected for the survey were 22

(15 from Terai and 7 from Hills) and 52 (35 and 17 from Terai and Hills respectively) respectively. Thus, the survey covered 59.38 percent of the cultivated area, 42.91 percent of the population and 42.89 percent of the Village Panchayats. Altogether 3,195 households (2,149 from Terai and 1,046 from Hills) were selected for the study and interviewed on matters related to farming practices, credit use and credit needs in future.

The survey revealed that under the existing farming technology different strata of farmers needed Rs. 58.23 million in total in the surveyed districts. The credit need for the large, medium and small farmers worked out to be Rs. 8.44 million, Rs. 10.64 million and Rs. 39.15 million respectively. If the farms were to use improved technology—chemical fertilizer, pesticide, and tractors—the credit need would be quite different. The survey estimated that the need under improved technology as Rs. 743.60 million ranging from Rs. 163.45 million for large farmers, Rs. 215.59 million for medium farmers and Rs. 364.56 million for small farmers, respectively.

The survey showed that of the total reporting farm families, 48.53 percent had borrowed from money lenders at the interest rate ranging between 10 to 50 percent per annum. Similarly, of the total farm families, 42.08 percent acquired loans from ward/village committees. Of the reporting 3,025 farm families, 84.26 percent expressed satisfaction over the work of the village/ward committees. Even then the contribution of international sector to provide credit to farmers was very low. Of the total borrowing by the farm households, 20.87 percent reported that they had borrowed from the institutional sector like co-operatives, Ward/Village Committee, Agricultural Development Bank (ADB), Land Reform Saving Corporation and commercial banks whereas the remaining 79.13 percent borrowed from private agencies including friends, relatives and landlords, etc.

The survey projected annual production credit need based on improved technology to the tune of Rs. 1 billion. The Survey Committee recommended various administrative reforms including merger of Land Reform Savings Corporation and the ADB. Tasks were given to the government as well as the NRB to raise capital of the institutions having interest on agricultural credit. The refinance schemes and lending by commercial banks to farmers were also suggested. Close coordination among agriculture related agencies were advocated so that the resource crunch of the agricultural sector would be addressed satisfactorily.

Development in the field of agricultural credit, especially after the survey was over, was distinct as ADB and the Land Reform Savings Corporation were merged in 1973 to make a single credit agency at the district level. The NRB earmarked a sizeable amount to refinance the ADB on medium and long-term basis. It purchased shares of different agencies to facilitate agricultural credit. In FY 1978/79 the NRB purchased Rs. 20 million worth of debenture issued by the ADB. An Agriculture Credit Department was set up within the NRB to oversee agriculture financing specifically.

The review survey was conducted during FY 1976/77 with objectives of studying the contemporary state of agriculture, especially the productivity of farm resources. The objectives of the survey were also to estimate the credit needs for agriculture and agro business together with the agencies supplying credit to the farmer. In order to assess credit worthiness of the farmers, the movable and immovable assets held by the different farm families along with their financial investment and capital expenditure were to be examined.

The number of accessible districts was found out to be 39 as against 32 in the previous survey. These districts were the sampling frame of the survey which covered 62 percent of the cultivated area, 66 percent of the farm households, and 66 percent of the total population of Nepal. Of the 39 accessible districts, 35.0 percent (14) were selected from which 7 percent from each village panchayat and farm house were drawn. On that basis, 14 districts, 45 village panchayats and 2655 farm households were selected under the basis of random sampling technique.

The survey revealed that the total annual average gross family income of large and medium size farmers were Rs. 12,805 and Rs. 7,477 respectively while that of small and marginal size farmers were Rs. 5,225 and Rs. 2,821 respectively. The estimated short, medium and long-term credit needs for all the accessible districts for a period of five years (1980/81 to 1984/85) were Rs. 16.32 million, Rs. 363 million and Rs. 118 million respectively. A total amount of Rs. 2,303 million including Rs. 190 million for miscellaneous purposes that was needed for a

period of 5 years was to be taken care of by different financial institutions including the commercial banks. During the survey year, 51.26 percent farm families borrowed from different sources. The proportion of borrowing by farm families was higher in Terai (54.87 percent) as compared to the Hills (42.37 percent). The average borrowing per farm family was Rs. 586, while the large farmers borrowed Rs. 1434 as against Rs. 255 borrowed by the marginal farmers. The average debt per farm family was Rs. 907. The average debt of the large farm family was Rs. 2,367 as compared to Rs. 348 for the marginal family.

The proportion of farm families borrowing from private credit agencies was 75.98 percent in comparison to just 24.02 percent from the institutional agencies. The village moneylenders were the single most popular source for credit constituting 33.87 percent followed by friends and relatives with 24.24 percent. The beneficiary of the institutional source again was the large farmer as opposed to the small and marginal farmers. Interest rates charged by the different credit agencies varied specially among the private sources ranging from 10 to 150 percent. But the institutional source recorded a low and consistent rate of interest ranging from 8 to 18 percent per annum. The requirements of security differed among agencies. According to the survey findings, the institutional sector required 100 percent pledging while land, gold and silver were the objects of pledging in the private sector.

Based on the findings of the survey, a series of recommendations including those on institutional charges were made. The Sajha institutions, the grass root level credit agencies, were recommended to be governed by the ADB. It was advised to distribute loan to all size of farmers for short, medium and long term for production and agro-business purposes. Commercial banks were asked to follow project and area approach in agriculture credit. The NRB was recommended to formulate credit plan and undertake study works on loan delinquencies, lending polices and procedures besides earmarking significant amount for refinancing. Similarly, relevant measures were suggested to the government, especially to bring administrative changes in the rural credit and agriculture financing.

As the access to credit by small and marginal farmers in the institutional sector was limited, a third 'Nepal Rural Credit Review Study 1991-92' was conducted under the technical assistance of the Asian Development Bank. The main objectives were to undertake a review study to formulate recommendations and action plan to make the rural credit system efficient, effective and responsive to the needs of the rural clientele and strengthen the institutional and analytical capabilities of the NRB to conduct such studies. In the survey 7,336 rural households, both borrowers and non-borrowers, from 32 districts were covered. Institutional credit agencies like ADB, NBL and RBB were covered under the case studies. Besides the line agencies at the district level, officials of the government, the Planning Commission and NRB were consulted.

The survey estimated that the average annual household income in rural Nepal was Rs. 26,000 ranging from Rs. 17,000 in the case of landless households to Rs. 71,000 in the case of large farmers. The contribution of agriculture to the above income was 54 percent. During the survey undertaken in FY 1991/92 the proportion of borrowing by farm families from formal sources was 8 percent only. Those borrowing households from the private sources accounted for 34 percent and 49 percent respectively. The responsible factor for the higher percent of informal sector credit was that 81 percent of the credit need of the rural people was for social and/or consumption purposes which was being catered to by the informal sector. Among the formal sources, the ADB dominated the scene by accounting for 85 percent of the rural credit supplied by it. Another reason for its prominence was the Small Farmers' Development Project which covered small and marginal farmers on project basis. The two commercial banks—the NBL and the RBB—invested 10 percent of the total credit under Priority Sector Lending Program (PSLP).

The survey recommended the setting up of a Rural Formal Markets Development Fund where the Asian Development Bank would extend soft loan assistance of $20 million along with contributions from the government and financial organizations including the Nepal Rastra Bank. In order to improve the financial health of the institutions, the need for monitoring and review of the overdue payments at regular basis was suggested. The capacity building up of the manpower was emphasized in the recommendation by coordination among training

agencies of the banking sector, for instance, Agricultural Training and Research Institute (ATRI) of the ADB, Bankers' Training Centre (BTC) of the NRB and the Nepal Administrative Staff College (NASC). An action plan for the implementation of recommendations was also incorporated in the survey report according to which areas of focus and specialization were indicated including the implementing agencies and the time frame.

Since the survey was completed, an agency to promote micro-credit, Rural Micro-Credit Development Centre (RMDC) has been set up to oversee and enhance the credit access among the resourceless farmers and entrepreneurs. The NRB, in line with restructuring and strengthening the financial sector, has planned to phase out the priority sector lending which may directly affect the micro-credit and its delivery mechanism.

Household Budget Survey

With a view to obtaining a correct weight factor in the expenditure pattern of the consumers for constructing reliable consumer price indices, the NRB carried out a household budget survey in eighteen selected market centers in the country during the period 1973-75. The survey results disclosed the social and economic conditions of the residents living in the survey areas through their income and expenditure patterns. The survey areas were selected both from geographical point of view and their locations representing Terai and Hills. Ten main market centers from Terai including Mahendranagar and eight market centers from Hills including Ilam and Okhaldhunga were included the survey. This survey was conducted in two phases. Reports were presented separately for each market center. On that basis, the results of the survey were disseminated separately.

The survey findings of Kathmandu center which was one of the eighteen centers surveyed revealed that on an average each household consisting of 5.7 persons consumed Rs. 645 worth of goods and services during the survey year. Of the total expenses, 57.4 percent was spent on food while 43 percent was for non-food items. Housing claimed 11.4 percent of the total expenditure while clothes constituted 8.9 percent of the household expenses. The sources for meeting these expenses were the following: 47.5 percent from wages and salaries, 31.2 percent from business profits and 9.5 percent from income in kinds. Of all household members ten years of age and older representing 77 percent of the total population, 44 percent were found in the labor force and the rest were economically inactive. About 22 percent of the male and 42 percent of female were engaged in agricultural activities. Similar results were found in the other market centers also.

As a follow up, the survey fieldwork was started in mid-March 1984 and ended in mid-February 1985. A slight delay occurred in releasing the survey results that took place in mid-August 1987. The purpose of the survey again was to find out the changed situation over time occurring due to changes in income and expenditure patterns of the consumers for national accounting purposes. Even then the objective set by the survey was to find out the population falling below the poverty live.

In the sampling framework, five inaccessible mountain districts namely Manang, Mustang, Dolpa, Mugu and Humla were excluded. Out of 70 districts and 29 town panchayats, 23 districts and 12 town panchayats were selected for the study.

The average size of household for the country as a whole was estimated at 6.11 persons comprising 6.16 persons for the rural areas and 5.49 persons for the urban areas. The male female ratio was 50.1:49.9 for the total population. The survey found 95.5 percent of the head of the household having some type of occupation. The literacy rate for the country was 39.6 percent while that for the rural and urban areas stood at 38 percent and 62 percent respectively. Those having dwelling units in the urban areas accounted for 75.7 percent as against 96 percent in the rural areas.

The national average monthly household income was estimated at Rs. 1,233 while for rural and urban Nepal it worked out to be Rs. 1,192 and Rs. 1,785 respectively. At the national level, agriculture income was highest (Rs. 697) comprising 56.2 percent of the total income. The next important source of income was wages, salaries and non-agricultural income. The consumption expenditure data showed that the national average monthly expenditure was Rs. 1,180 of which 95.4 percent was spent on consumables and the remaining for non-consumables. The disaggregated figures for urban and rural household expenditures were estimated at Rs. 1,618 and Rs. 1,147 respectively.

Based on the estimates given by the National Planning Commission for the level of income

required to maintain minimum basic needs, the per capita monthly income for the survey year (FY 1983/84) was estimated at Rs. 160.80 for Hills/Mountains and Rs. 125.64 for the Terai. The households falling below the above income level were considered to be below the poverty line. In the Hills and Mountains, 47 percent and 36 percent of the households were found to be falling below the poverty line. In rural Nepal, 40.7 percent of the households stood below the poverty line. In urban Hills, 12.6 percent household were found to be below the poverty line while this figure for urban Terai was placed at 20.2 percent.

The above survey was in fact comprehensive and covered more areas than the previous survey. Due to change in pattern of living, changes occurred in expenditure and income norms, also. Owing to this, the household budget survey is undertaken normally in the interval of 10 years. During FY 1995/96 the 'Household Budget Survey—Urban Nepal' was conducted with the view that necessary inputs would be available to update the existing weightage used in the consumer price indices. The survey covered 21 urban centers out of 33 municipalities of Nepal. Out of the 29,080 households, 0.8 percent (2,500) was selected for the sample.

The survey findings revealed that the average family size in urban Nepal was 5.2 persons. The Terai had the largest household size of 5.6 persons followed by 5.1 persons in Kathmandu valley. In a household, the sex ratio was 50.8 percent for male and 49.2 percent for female. Of the total urban population above the age of six, 71.8 percent were literate. By sex, the literacy rate of male and female was 83.3 percent and 59.8 percent respectively. Those households owning a house were 70.1 percent as opposed to 24.2 percent living on rented houses in urban Nepal.

The majority of the urban population (above 10 years old) or 51.4 percent were found economically active. In the valley such population was 49.6 percent while in the Hills and Terai, it was 53.4 percent and 51.4 percent, respectively. In terms of income, the Kathmandu valley showed the highest with Rs 10,377 monthly average income which was fairly above Rs 7,386 of the average urban Nepal. The Hills revealed the monthly average income per household of Rs 6,240 as against Rs. 6,211 for the Terai. Of the total expenditure of Rs. 8,137 in urban Nepal, 92.0 percent was spent on consumption and the remaining 8 percent on non-consumable items. The corresponding figures for Kathmandu valley were 92.6 percent and 7.4 percent, for the Hills 90.4 percent and 9.6 percent and for the Terai 92.4 percent and 7.6 percent respectively.

The three household budget surveys provided enough grounds to incorporate novel items to prepare proper weightage for constructing consumer price indices. Besides, the socio-economic aspects of the households of urban as well as rural areas were also revealed. The incidence of poverty was also examined in one of the surveys in order to facilitate the design of a suitable plan by the policy makers to confront poverty.

Other Studies and Statistical Collections

As the Sajha institutions were the dominant grass root level financial institutions specially catering to rural credit needs, the government emphasized on expanding the network. But there were doubts among policy makers especially when such Sajhas came into existence after conversion of village committees. It was thus decided to conduct a survey called 'Sajha Institutions of Nepal, A Benchmark Survey, 1983-84.' The objective of the study was to provide basic information about multipurpose cooperatives to the policymakers, planners, concerned agencies and researchers for further study. The administrative, financial and marketing aspects of the Sajha institutions were to be explored through the survey.

The study covered 2804 villages (1286 in the Hills and 1518 in Terai). One Sajha covered 4 village panchayats on average. The average membership per Sajha was found to be 1883. Those institutions extending credit were 85 percent while those dealing with the marketing and selling of chemical fertilizers accounted 94 percent. The disbursed amount per Sajha recorded Rs. 124,000 and the proportion of overdue to outstanding loans was 75 percent. The overdue loan amounted to Rs 249,000 per Sajha of which 78 percent was above one year maturity. Of the total number of Sajhas, 69 percent had overdue loans. Interestingly, the Sajhas made a profit of Rs. 9,000 on average as interest receivables were taken into account. The administrative cost of Sajha was estimated at 34 percent of the loan disbursement, 13 percent of the loan outstanding and 10 percent of the volume of transaction.

The study revealed weaker position of the Sajha institutions particularly from the point view of over dues and administrative costs involved in the operation of Sajhas. Institutions undertaking marketing as well as loan transactions showed survival symptoms while those hanging around outstanding loans counting income from interest receivables recorded a bleak hope.

Small Farmers Development Project (SFDP), a much appreciated project-oriented poverty alleviating program that was started in 1975, was evaluated by the NRB through a study in FY 1980/81. The objective of the study was to analyze the agricultural and non-agricultural activities undertaken by the small farmers. The asset structure and investment made by small farmers were also to be examined. The credit position of the small farmers by sources was also to be examined. Similarly, the social benefits that the farmers obtained in course of the project were also incorporated into the study.

In assessing the benefits, the project group (members of the SFDP) were compared with the controlled group (the non-members). The findings were that the group members were far better off than those remaining outside the project. The group members were able to receive loans almost double the amount of the controlled group. The average borrowing of the members was Rs. 1,850 in comparison to Rs. 972 of the nonmembers. Institutional credit was made available to 62 percent of the SFDP members while the corresponding figure of the non-members was 13 percent only. The area of cultivated land (including irrigated land) was higher with the members compared to non-members. It indicated the potentiality of expansion of the project in the area. The average family expenditure was higher with the members compared to non-members incurring less expenses in food for both the group. Under the social services front such as education and health, the SFDP group benefited more than the non-members. The members were able to get training such as veterinary, health, education and farming as opposed to non-members primarily belonging to organized groups.

The evaluation clearly indicated the benefits of the project revealed through the advantages available to SFDP members in comparison to non-members. The members wanted to continue their involvement with the project while the controlled group aspired to become members of the SFDP. The latter wanted the project operated in their areas, too, in view of the financial and socio-economic gains made possible by the project. The study suggested replicating the program in other parts of the country in order to address the pervasiveness of poverty in rural areas.

Statistical Compilations

The *Quarterly Economic Bulletin* is the oldest publication of the Nepal Rastra Bank consisting of monetary, banking and exchange rate related statistics that is published regularly. It includes the information on transactions of commercial and development banks. Also included are the information on trade and balance of payments.

The *Main Economic Indicators* is published monthly incorporating the macro-economic statistics with interpretation and stylized analysis. *Commercial Banking Statistics* is another publication in which detailed information about the transactions of the commercial banks are given. In line with the publication of the *Commercial Banking Statistics*, endeavors were made to bring out statistics on non-bank financial institutions. However, only two issues were out as the department overseeing the non-bank financial institution was merged with the then Banking Regulation Department.

Looking at the importance of agriculture in Nepal, the Agricultural Credit Division, under Banking Development Department used to publish a book *Some Important Agricultural Statistics* collecting data from different sources. It ceased to come out with the closure of the Agricultural Credit Division. Later on, the areas overseen by the Agricultural Credit Division were entrusted to the Micro-Credit Department, which seems to put emphasis on project oriented micro-credit programs.

Research and Occasional Papers

The role of economic adviser to the government can hardly be fulfilled if research works on contemporary economic issues are not taken up. Nepal Rastra Bank through its various publications accommodates research articles of the academicians outside from the bank as well the experts from different departments of the Bank.

One the occasion of the silver jubilee of the establishment of the Bank, a publication entitled *Twenty Five Years of the Bank* was brought out covering different activities. Similarly, on the occasion of the

fortieth year of the establishment of the Bank, *Forty Years of Nepal Rastra Bank* was published incorporating major policy decisions and activities during the period.

The Research Department of the bank has been bringing out occasional paper under the name of *Economic Review* with research articles related to economic, banking and financial aspects. The priority for the contributions of articles has been given to the staff of the Bank, yet authors from outside the Bank are also honored duly. There has been the practice of publishing the occasional paper on the auspicious occasion of the anniversary of the bank. The golden jubilee issue of the occasional paper numbered seventeenth.

On the occasion of 49th anniversary of the Bank, Nepal Rastra Bank brought out 'Nepal Rastra Bank Working Paper' which was placed in the website for comments and discussion for the interested groups. Subjects covered in the paper are the issues related to activities of the Bank and economic development issues of the country. Also released by the Bank during the occasion was the book entitled *Asian Development Bank and Nepal* highlighting the relationship of the country with the regional financial institution that has relevance with development of the country.

Special publications highlighting the relationship with international organizations such as International Monetary Fund and World Trade Organization are issued by the bank. Two publications, namely, *The International Monetary Fund and Nepal* and *WTO and Nepal* were published by the Research Department.

Miscellaneous Publications

Each department has a specific role and performs its functions accordingly. Temptation always remains to bring into light the activities of a department. Therefore, quite a few departments have endeavored to bring out publications covering exclusively the subject matters related to the concerned department.

The Bankers' Club is the part and parcel of the Bank. Each month the Club publishes a literary book comprising poems, stories, drama and so on. But a tradition has been set to bring out an issue of *Mirmire* exclusively with articles related to economics and business.

The Public Relations Division of the Bank publishes *Nepal Rastra Bank Samachar* with articles contributed both by insiders as well as the outsiders from the Bank. In the majority of the instances, the publication incorporates the narration of activities done by the Bank during the fiscal year as well as articles of interest concerning economic and financial developments. The same division also releases an issue of *Nepal Rastra Bank Samachar* in vernacular with a view to communicate the events to the staff in general. Relatively thin in size, the monthly administrative news item is of immense interest to the staff.

The Bankers' Training Centre (BTC) brings out *Prasikchhen* covering the programs as well as reporting of the training programs to the interested persons. Research articles of interest also are published in the publication.

The Banking and Financial Institutions Regulation Department publishes *Banking Prabardhan* on a bi-annual basis year accommodating articles mainly concerned with banking promotion, financial development and other economic activities.

The compilation of circulars, regulations, Acts and bye-laws are published by the Bank regularly in most cases with a 'label' 'for official use only' attached on them. To highlight the departmental activities, the departments bring out publications which are quite irregular in nature. Though purely for individual purpose, the Nepal Rastra Bank's library compiles the list of new books, magazines and periodicals under the name of 'Library Awareness' which helps the readers to pick up the articles of interest. Similar publications, though not regular, are brought out by the Public Debt Management Department, Financial Management Department and Banking Supervision Department. Such publications give a broad outline of the activities of a particular department which may benefit the general readers.

Evaluating the Publications

Statutory obligations to produce annual reports on economy and activities are submitted within the time frame stipulated in the Act. But publishing for the use of general public takes a longer time. By the time the material is available, the content of the report almost becomes obsolete. Information available on time serves better to address the problems, if any, in the system. Almost all the publications of the Bank are free of cost and they are distributed to those intending to possess the publications irrespective of the level of understanding of the subject matter.

The publications that are distributed without any cost follows the status oriented norm. Within the Bank, the normal practice is that all sorts of materials

including surveys and reports are made available to staff up to first class level. It is not necessary that everyone within that level is interested in every publication of the Bank. The optimal use of the publication is possible only when the need is identified and the interested person is ready to pay for it. To bring out materials involves cost. If the time taken for the preparation of the material as well as distribution to the public is also considered, the real cost is much higher than the material cost reflected in pricing. Therefore, to ensure that the genuine users find easy access and materials are properly utilized, the dissemination system should be altered to suit the contemporary available technology.

The materials should be made available not only in printed form but also through the electronic information system. The genuine users by now are capable to use the materials, howsoever the bulk that may be, if those are placed into website. It may involve some cost at the initial stage, but in the long run this becomes cost effective in terms of resource use. Relying on electronic device to disseminate information of the Bank helps in saving the printing cost of materials which normally is done in two languages, vernacular and English. The interested persons can obtain the materials required for them at all the time using the website.

The printed materials are often criticized on the basis of print quality, use of substandard materials and poor binding. This occurs normally for the publications given for print on contract basis. The quality of materials printed at the NRB's own press is well maintained.

The editing of publications matters when quality is to be ensured both from cost incurred as well as meeting the expectation of the readers. In the publications usually brought out during the anniversary, for example, *Nepal Rastra Bank Samachar* and *Mirmire*, it seems that no serious attempt is made in selecting articles for publishing. The articles received for publication are rarely dishonored. Incorporation of all types of articles could have an adverse impact on the quality of the publication.

The distribution system of printed materials is not based on objectivity. On the basis of the position one holds, the mailing list is prepared and publications dispatched at the Bank's cost. Neither response is anticipated nor is the pain of updating the roster taken. The materials that are unable to be distributed are returned to the sender's address; even then, no revision is done to update the mailing list. Therefore, there is a need to look into the upgrading of the publications of the NRB in terms of editing, printing and distribution qualities.

It is found that NRB conducts surveys and studies but in some cases the reports are confined to the draft stage only. By reasons not specified, those reports fail to be disseminated. The study on 'Remittances in Nepal' conducted by the Head Office and the study on 'Informal Trade' undertaken by the Birgunj Office of the NRB serve best illustrations.

The studies financed by the NRB are also not published in full form except for the synopsis. The outsourcing of research work and dissemination of such reports also could add to the vast knowledge of national economy.

In publishing the materials, the publishers (in this case the departments) seem to be free so long as the basic norms of the Bank is not violated. Unbridled situation like this will raise the printing cost while achievements may be limited. No specific time frame to bring out a publication from a particular department is drawn. A circumstance of this nature has put the scenario of Bank's publication into disarray. To make it predictable, a systematized publication policy is needed.

Suggested Measures

The publications of the NRB claim huge financial resources, but it is difficult to establish the degree of benefit brought about by the free distribution system. First, the Bank should decide which way the publications should go; electronic or printing method. Considering the cost involved in printing, distributing and handling, switching to electronic media is worthwhile. No problem arises for distribution. Interested persons may obtain the material easily through the electronic device. It is crucial to prioritize what type of publication should go into website and what should be printed.

Until the publications are placed in the website completely, the printed materials also will have to be circulated. The practice of distributing for free should gradually be stopped and a reasonable price needs to be charged. Quoting the price is not intended for making a profit nor is to cover the cost; but applying the price means the publications reach the genuine users. This ensures utilization of resources and the cost is recovered partially. Disarray in the publication

of materials from different departments has created problems such as diversity in printing work and lack of systematic and organized endeavor to bring out the publication on time. There is no control over the quality in printing and costs involved. It is therefore necessary to handle the printing and publication of the important materials from one window. This will help in reducing the costs and homogenize the quality of printing through one channel within the Bank. If possible, distribution also should be centralized.

The time schedule should be maintained in bringing out the publication. Coordination among departments could help to consolidate the publications, and reduce the numbers accordingly. The paper and print quality should be of high standard so that the importance of the publication is reflected. Due attention should be given to the contents of the publication.

Coordination among different departments in publishing statistics may also contribute to enhance the quality, promptness and address the need of the users. By avoiding duplication, the resources involved in printing may also be saved. Materials contained in the *Quarterly Economic Bulletin* and *Commercial Banking Statistics* are of the same nature in the majority of cases. The latter presents slightly detailed information which could be accommodated into the *Quarterly Economic Bulletin*. Planned and coordinated work assist to enrich the quality of content as well as the lay-out of the publication.

Conclusion

Through its publications, the NRB reports to the government about the economy and its activities. Submission of the annual report, auditing report, report on the Bank's activities and the report on economic and financial position of the Bank within four months of the completion of the fiscal year is a statutory obligation. Because of this, no lapses remain in this exercise unlike in other publications particularly in maintaining the publishing schedule.

There is an absence of policy regarding publication as a result of which the departments bring out publications simply with a memo approved by the higher authority. Exercises of this nature breeds competition among departments leading to inferior quality of the publications. Expenses increase but use of the materials draw the least attention. As a result, there is a waste of resources and time ensuring complacency in compromising inferior products, too. To discourage this trend, the policy decision about the nature, time and quality of publication should be made in advance and the schedule should be maintained accordingly to ensure quality control.

Use of electronic devices needs be speeded up so that modern technology remains in place saving space to store the publications. It assists to clean up the library complex as well as the inventory of the bank. Electronic media is found to be user friendly and cost saving specially in transmission of the materials to overseas countries.

A provision of introducing a nominal price to the publications could be made for ensuring proper use of the publications. Only the needy persons will hold the required NRB publication—paying the price which is not intended to cover the cost but to make sure the use of material in proper perspective. Hence, the complementary distribution policy needs to be reviewed.

Surveys and research studies conducted by the NRB sometimes take a longer time than originally scheduled. Information thus received may lose value because of the time factor which would otherwise have been used for policy decision. Reports brought out late do not serve the purpose originally planned for. In some instances, it has been observed that some studies do not get published despite heavy involvement of human and financial resources of the bank. To discourage this trend, a well-planned time schedule should be maintained regularly so that the inputs received from the studies fully serve the purpose.

The NRB is striving to focus on 'core functions' of the central bank. In this pursuit, many ancillary works have to be abandoned and such services need to be obtained from service providers. Because of the fact that the Nepalese market is not ready to provide all sort of services according to the aspiration of the clients who normally expect publications of high quality, gradual outsourcing could be the norm. In these circumstances, no compromise in quality of products and materials should be made. Even the distribution mechanism may be outsourced.

A huge amount of financial resources is involved in bringing out the publication of the NRB, but the achievement does not seem satisfactory. No measuring rod is available to examine the degree of services provided by the NRB through free distribution of its publications; however, it is a matter

of satisfaction that the information contained in the NRB's publications are received warmly and treated as authentic by many public and private bodies including foreign agencies. There still remains a room to improve the quality and standard of the materials both with respect to content and layout. The resource use could be optimized through switching the publication media into the electronic system. The printed items should also be priced also so that genuine users obtain the materials. As the value received by the users of the NRB publications is growing, the bank should make changes through policy decisions ensuring quality and timely publication.

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Foreign Exchange

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Introduction

The external sector policy is designed considering domestic stability and external competitiveness. However, the external sector policy of a country cannot be fully independent of the overall macroeconomic policy. Because of inward looking approach of the country till the 1980s, foreign exchange policy of Nepal was restrictive as in the case of many of other developing countries, particularly the least developed ones. In the controlled regime, the exchange rates of foreign currencies vis-à-vis Nepalese rupee used to be determined officially and kept unchanged for a long period. All the foreign exchange earnings had to be surrendered to the banks at the official exchange rate, in which the rate for foreign currency is generally kept low. In such a regime, the national currency normally tends to be overvalued, thus encouraging imports and discouraging exports.

The foreign exchange system was controlled as well and one had to get permission from the authority for obtaining even a small amount of foreign currency other than the Indian rupee. There was the system of issuing import license for importing goods from countries other than India. Normally, such practice tended to be favorable for influential people as it was easy for them to obtain the license. There was the practice of selling such license with premium, substantial in some cases, thus contributing to the license holder to make easy money even without undertaking import business.

The foreign exchange system of a country depends on overall economic policy being pursued by it. In the pre-liberalization era, the foreign exchange system was restrictive; as soon as the country started to follow the path of economic liberalization, the foreign exchange policy has been geared towards the same direction. In fact, after entering into liberalization after the mid-1980s, the reform initiated in the foreign exchange front has been more pronounced than in other sectors of the economy. There have been substantial changes over the years. The major reforms during the period include the following: a) determination of the exchange rate by the market forces for all currencies other than the Indian rupee; b) adoption of open general license system for imports; and c) substantial relaxations in foreign exchange regulations.

Evolution of Foreign Exchange System

The foreign exchange system of Nepal can be analyzed on the basis of three broad time frames: a) the period prior to the establishment of the Nepal Rastra Bank (NRB) in 1956, b) the period from 1956 to the pre-liberalization period; and c) the period after liberalization.

The Period Prior to the Establishment of the NRB

There was widespread circulation of the Indian currency (IC) during this period. The IC was not only performing as a medium of exchange but was also accepted as a store of value by the people based on geographical, economic and social proximity between the two countries. Due to lack of transportation facilities, many parts of the country were not as integrated as compared to today. Before the construction of Mahendra Highway, it was almost impossible to travel between East and West Nepal. On top of that, given the then education level and other attributes, many people may not have had knowledge about the Nepalese Currency (NC). In such a situation it was natural for the people's preference of IC over the NC, as many people, particularly residents of the border areas, did not have much confidence on the NC. Besides, there was also the absence of legal provisions regarding currency circulation.

The exchange rate of NC vis-à-vis the IC used to be determined by the Sharaf, a business community involved in money changing business. Anyone could enter into such a business as neither there was any restriction to purchase and sale IC nor any license required for entering into such business. Even though the government used to intervene in the foreign exchange market by fixing the NC/IC exchange rate from time to time, considering the trends in the fluctuations of the exchange rate, the rate fixed by government could not be reflective to capture the market rate. The IC/NC exchange rate was fully at the mercy of the limited number of Sharafs that used to determine the rate through consultation with one another. They fixed the rate on the basis of demand for and supply of IC in the market. As a result the exchange rate used to change frequently. It used to be so volatile that often one could see a noticeable change in the rate even within a day (Table 1).

The Reserve Bank of India (RBI) was the custodian of Nepal's convertible currency holdings. All the convertible currencies of the country used to be deposited with the banks in India. Consequently, there used to be no separate convertible currency reserves of Nepal. Nepal had to get the permission from the RBI in order to use its own foreign currency. This practice continued till the execution of the first Trade and Transit Treaty between Nepal and India

Table 1

Exchange Rate of Nepali Rupee vis-à-vis Indian Rupee at Kathmandu Market (Average rate per 100 IC)

	First Quarter	Second Quarter	Third Quarter	Forth Quarter	Total	Annual Average
1942	102	92	94	97	385	96
1943	93	89	92	90	364	91
1944	87	83	83	80	333	83
1945	67	67	75	75	284	71
1946	75	81	89	92	337	84
1947	99	99	109	105	412	103
1948	100	103	109	107	419	105
1949	103	103	110	106	422	106
1950	104	106	111	114	435	109
1951	117	131	137	139	524	131
1952	149	155	156	158	618	155
1953	160	161	170	167	658	165
1954	173	183	179	173	708	177
1955	154	156	150	148	608	152
1956	136	135	136	145	552	138
1957	155	153	161	169	638	160
1958	165	163	165	166	659	165
1959	155.5	164.5	163.5	148.5	632	158

Source: Nepal Rastra Bank (1971).

on November 12, 1960. It was only after that Treaty that the convertible currency earnings of Nepal started to be deposited at the NRB's account.

After NRB´s Establishment in 1956 to the Pre-liberalization Period

After its establishment in 1956, the NRB took the initiative to address the above-mentioned weaknesses that persisted in the foreign exchange system. In this connection, the Bank had to a) eliminate dual currency system, b) bring stability in the exchange rate, c) regulate the foreign currency transactions, and d) manage the foreign exchange reserves of the country. These issues are examined below.

Elimination of Dual Currency System

The top priority accorded by the NRB in the initial period of its establishment was to do away with the dual currency system by inculcating confidence in the NC. The NRB acknowledged the fact that without abolishing the dual currency system, effective foreign exchange management and the implementation of independent monetary policy would not be possible.

Realizing the need of sufficient legal authority for attaining the above objectives, the following acts were promulgated one after another: a) the Increase in the Circulation of the Nepalese Currency Act, 1957, b) the Control of the Foreign Exchange Transaction Act, 1960, and c) the Foreign Exchange (Regulation) Act, 1962.

The legal constraints were resolved to a large extent after the promulgation of these acts. For example, the provisions enshrined in the Increase in the Circulation of the Nepalese Currency Act, 1957 could be considered enough for abolishing the dual currency system by making the Nepalese rupee one and only legal tender. The Act, among others, included the following provisions: a) one should accept the Nepalese currency for all the transactions including the ones determined in terms of foreign currency using the exchange rate of the NRB; b) the settlement of borrowing/ lending in the foreign currency should be made in Nepalese rupee using the existing exchange rate of the NRB prevailing on the day of the transactions; and c) the violation of the above provision would result in a penalty extending from Rs. 100 to Rs. 1000.

The name of the Act ´Increase in the Circulation of Nepalese Currency´ itself implies its objectives. It was enacted in order to establish the Nepalese rupee as the only one legal tender. Yet, many practical aspects, including the provisions regarding foreign exchange transactions, necessary for its effective implementation, were missing in the Act. Therefore, notwithstanding the above provisions, it was not that easy to abolish the dual currency system by merely declaring the Nepalese rupee the one and the only one legal tender, unless some pragmatic measures acceptable to general people were adopted, given the practice of widespread use of IC. Thus, there was the enactment of the Control of the Foreign Exchange Transaction Act, 1960. The Act had come up with many provisions regarding foreign exchange transactions. The Act made it mandatory to get the NRB's permission to deal in foreign exchange. The Act also restricted an individual for accepting or providing any foreign exchange from/to any individual other than a license holder. Besides, the exchange rates to be used for foreign exchange transactions were not allowed to be different from those prescribed by the NRB.

The legal provision alone was not sufficient to change the deep-rooted practice being used by the people. Such a practice demanded a practical approach acceptable to the people. Hence, the authority initiated the following measures: a) fixation of NC/IC exchange rate at Nepalese Rupees (NRs.) 160 per 100 Indian Rupees (IRs.) effective from April 13, 1960; b) commitment of the NRB to buy and sale any amount of IC at the exchange rate fixed by it, thus introducing the system of unlimited convertibility of IC; and c) establishment of a large number of exchange counters throughout the kingdom in order to make the exchange facility for Indian rupees easier and convenient with the arrangements of conducting these counters from early in the morning to late in the evening.

The promulgation of the two acts together with the adoption of above measures helped contain the circulation of IC to some degree. Although some of the basic legal requirements needed for foreign currency transactions were met by the Control of the Foreign Exchange Transaction Act, 1960, there existed no provisions that were adequate for effectively regulating foreign exchange. Therefore, another Act, namely the Foreign Exchange Regulation

Act 1962 came into force on August 17, 1963, repealing the Control of the Foreign Exchange Transaction Act 1960. The new Act is in force till date with two amendments—first amendment on October 18, 1987 and the second on August 7, 2002.

The promulgation of the Acts together with the initiation of the above measures proved successful in reducing the circulation of IC in the country to some extent. However, instances of IC circulation persisted to a large extent in the Terai areas till 1966, when India devalued its currency. This was because even in those trading centers where the Foreign Exchange Regulation Act was in operation, holding of the IC was legally allowed and this prevails till date. When the IC holding is not illegal and could be used easily, it was natural for the people in the Terai region to hold the IC in the context of the long open border, free movement of people from/to India, social, cultural, religious proximity etc. Moreover, the people were of the firm belief that IC would emerge stronger than NC and there would be a devaluation of NC against the IC and not vice versa. This expectation might have also prompted them to hold IC. Therefore, when people have plenty of IC, which used to be easily acceptable for making any kind of payment, it is understandable that legal restrictions alone were not sufficient to do away with IC circulation.

Nepal did not devalue its currency even in the face of substantial devaluation of the Indian rupee by India on June 6, 1966. Consequently, the exchange rate of the Nepalese rupee vis-à-vis the Indian rupee appreciated remarkably. Accordingly, the exchange rate moved to NRs. 101 per IRs. 100 from the existing rate of NRs. 160 per IRs. 100, with the IC holders incurring huge unexpected exchange losses. This development not only contributed to the surrendering of the IC holding of general public to the banking system, but also made them reluctant to hold the IC unnecessarily. Subsequently, the circulation of IC came virtually to an end.

Stability in the Exchange Rate System

With respect to foreign exchange, the Nepal Rastra Bank Act 1955 had stated the following:

(a) The Bank shall have the right to deal in transactions between Nepalese currency and foreign currencies at the exchange rate fixed by it from time to time on the basis of the par value fixed by His Majesty's Government (HMG). It may authorize commercial banks and financial institutions also to engage in foreign exchange transactions. HMG shall consult the Bank while fixing such par value (Clause 21 Sub-clause 1) and, b) HMG may frame regulations or issue orders relating to foreign currency control in consultation with the Bank (Clause 21 Sub-clause 2).

Looking at the above one may argue that since all of the power regarding foreign exchange rests on the government, the status of Bank is confined to be simply an implementer of the policy being formed by HMG. Similar inference can be drawn from the Foreign Exchange Regulation Act, 1962 as well. The clause 15 of the Act states "In case it is so deemed necessary for implementing the purposes of this Act, HMG may from time to time issue general or special instructions to the Bank, and the Bank shall comply with such instructions in relation to matters or actions under this Act."

However, as a specialized entity in this field, the Bank could influence HMG sufficiently in determining the exchange rate as well as framing regulations regarding foreign exchange transactions. Though, as in the case of many other countries in the world, the power to fix the par value and frame regulation or issue orders relating to foreign currency control were kept with HMG, it was bound even legally to consult the NRB in doing so. This shows that though the *de jure* power was still with HMG, the Act had made the NRB the *de facto* authority on matters relating to the fixation of the exchange rate and framing necessary rules and regulations regarding foreign exchange. Therefore, it was the responsibility of the NRB to make necessary arrangements in this connection including the exchange rates of the Nepalese rupee *vis-à-vis* foreign currency.

On the one hand, the Nepal Rastra Bank Act 1955 itself had made the Bank *de facto* authority in matters relating to foreign exchange including exchange rate determination and, on the other hand, the exchange rate of IC determined by the Sharaf used to be quite volatile as elaborated above. Furthermore, since all the convertible currency holdings of Nepal used to be deposited with the banks in India until the execution of the first Nepal India Trade and Transit Treaty on November 12, 1960, neither the private sector was involved in dealing with those currencies nor HMG had felt the necessity for determining the exchange rates for such currencies. Therefore, the

Nepalese foreign exchange markets composed of only the Indian currency during that period.

As stated above, the major transactions of IC used to be conducted on the basis of exchange rate determined by the private sector. HMG also used to fix the rate but that was applicable only for the purpose of importing certain specified goods. In this context on March 17, 1956, that is, before the establishment of the NRB, HMG had fixed the exchange rate of Nepalese rupee at NRs. 175.50 per IRs. 100 and authorized the Nepal Bank Limited, the only Bank operating in the country, to make available the required Indian rupees for trade purpose only. For all other purposes it was required to procure IC at the free market exchange rate, which used to change frequently, as elaborated above. Therefore, addressing the exchange rate issue was one of the important concerns for the NRB. Thus, within the time frame of less than two months of the Bank establishment, that is, on July 1, 1956, the authorization of conducting Indian currency business was transferred to the NRB with the fixation of the Indian rupee's exchange rate at NRs. 150 per IRs. 100.

It is well known that Nepal has been following two sets of policies regarding the exchange rate—one for Indian rupee and another for convertible currencies.

(a) Policy Regarding the Indian Rupee: Certainly, the absence of exchange rate of the Nepalese rupees vis-à-vis other foreign currencies was not a pleasant situation for the central bank of a country; the primary concern, however, was to make the IC/NC exchange rate stable which was imperative even for eliminating the dual currency system as elaborated above. At the time of the establishment of the NRB, HMG had fixed the exchange rate of the Indian rupee at NRs. 154.50 per IRs. 100, but that rate was not applicable for all transactions. It was only for the purpose of importing certain specified goods. For all other purposes, people had to resort to free market rates determined on the basis of demand and supply.[1]

Against this background, the elimination of the multiple exchange rates was a precondition even for instilling confidence of the general people, particularly those residing in the Terai, in the Nepalese rupees. A necessary condition required the abolishment of the dual currency system and also for ensuring the people about the easy availability of IC for making the payments to India. While abolition of the dual currency system and elimination of multiple exchange rates of Indian rupee was the first concern, Nepal not only fixed the exchange rate of Indian rupee at NRs. 160 per IRs. 100 and made it applicable for all purposes, but also introduced the system of free and unlimited convertibility of Indian rupee effective from April 13, 1960. Subsequently, the banks in Nepal started to make Indian rupees available as per demand emanating from various quarters at the fixed exchange rate. As a result, the multiple exchange rate system was done away with.[2]

The introduction of the system of fixing the exchange rate of IC at NRs 160 per IRs 100 emerged successful. Primarily due to favorable trade balance with India, the IC holdings of the country kept on increasing through 1965 except for a marginal drop in 1963. Meanwhile, India devalued its currency by as high as 36.5 percent on June 6, 1966. Because of the comfortable level of the IC holdings and also with a view to immunize the Nepalese economy from the likely inflationary effects of the IC devaluation, Nepal did not devalue its currency despite a huge devaluation of IC. This resulted in appreciation of the Nepalese rupee by about 37 percent against the Indian rupee. The new exchange rate was, thus, fixed at NRs 101 per IRs 100.

The decision not to devalue Nepalese rupee contributed a lot in eliminating the problem of dual currency, as the overnight loss in the value of IC not only resulted in a significant loss to the IC holders, but confidence about the Indian rupee also shattered. As a result, people started to exchange the Indian rupee with the local currency thus contributing in the authorities´ effort in increasing NC circulation all over the country.

As expected, Nepal could not sustain such an appreciated value for a long time as shown by subsequent deterioration in the trade balance with India, resulting in a substantial fall in IC reserve. While the decline in the IC reserves was exerting pressure to HMG, the devaluation of Sterling Pound on November 19, 1967 by 10 percent put further pressure. It is to be noted that although a substantial proportion of Nepal's trade used to be conducted with India, Nepal had been pursuing the policy of expanding its trade with overseas countries and the policy was gradually gaining momentum. In such a situation, the appreciated currency was certain to hurt

the economy. Therefore with a view to maintaining the competitiveness of its goods in the world markets including India, Nepal devalued its currency by 24.8 percent on December 8, 1967, thus setting the new parity at Rs. 135 per IRs 100. From this period to November 30, 1985, when the rate for Indian currency was set maximum at NRs 170 per IRs 100, the exchange rate of Nepalese rupee against Indian rupee went through three revisions (Table 2).

Until November 1985, the NRB used to fix the buying and the selling rates on the basis of parity fixed by the government. The policy of parity fixing by HMG underwent a major change on May 31, 1986. It was decided to include all the currencies, including the IC in the basket and the NRB started to quote its buying and selling rate of IC on a daily basis. Theoretically, the inclusion of the IC in the basket implied that its exchange rate could also change on the daily basis. In practice, however, it has not undergone changes on that basis for a single time. Its exchange rate has changed (revaluation or devaluation) only through the discretionary decision.

(b) Convertible Currencies: Nepal has been adopting a significantly different methodology in case of exchange rates of convertible currencies. The NRB started to buy and sell the convertible currencies from 1960, four years after its establishment. Initially, HMG used to fix their exchange rates in Indian rupee term on the basis of exchange rates prevailing in India. The official rates and the market rates of IC in Nepal used to be different as stated above. Since it was not practicable to fix the rates in terms of Nepalese rupees in a situation of multiple exchange rate system, HMG used to fix the rate in Indian rupees. When the multiple exchange rates system came to an end after Nepal initiated a move to provide free and unlimited convertibility of the Indian rupee by fixing the exchange rate at NRs. 1.60 / IRs. effective from April 13, 1960, Nepal started to quote the exchange rates of convertible currencies

Table 2

Discretionary Change in the Exchange Rate of the Nepalese Rupee vis-à-vis Indian

Date	Exchange Rate of Rupee/Unit of IC	Remarks
Apr 13,1960	1.60	Fixation of the new rate after the establishment of NRB with the introduction of free and unlimited convertibility of IC
Jun 6,1966	1.01	A marked appreciation of about 37 percent of Rupee due to the decision of the government not to follow the Indian path of sharp devaluation of its currency.
Nov 8,1967	1.35	Devaluation of the rupee as explained in the text.
Dec 22,1971	1.39	Following the realignment of currency on Dec, 17 1971, the exchange rate of NC/IC was also revised along with Pound Sterling, Deutsche Mark and Japanese Yen effective from Dec 22, 1971.
Mar 22,1978	1.45	-
Nov 30,1985	1.70	14.7 percent devaluation of Nepalese rupee against the foreign currencies.
May 31,1986	1.68	It was decided to also include IC in the currency basket system effective from June 1, 1983. The previous practice of setting the buying and the selling rate of IC on the basis of parity fixed by the government were done away with. NRB started to quote the buying and the selling rate of IC also on a daily basis as in the case of other currencies.
Jul 1,1991	1.65	-
Feb 12,1993	1.60	Adjustment due to change in India.

Source: NRB (1996) and *Quarterly Economic Bulletin*.

in terms of Nepalese rupee itself effective from May 14, 1960, as it was no longer necessary to fix the rates in Indian rupee terms. At first, the exchange rates of only three currencies, that is, US dollar, Pound Sterling and Swiss Franc used to be quoted by the NRB. The Japanese Yen was included in the list from August 1961. It is to be noted that some of other non-convertible currencies, besides Indian rupee, namely Burmese Kyat, Malaysian Ringgit and Pakistani rupee also used to be quoted. The list kept on increasing and reached 17.[3]

Though Nepal had to adopt a different exchange rate system in case of Indian rupee due to the attributes mentioned above, the system with rest of the currencies has been, by and large, in line with the international practice. Along with other countries in the world, Nepal was following the system of fixed parity prior to the collapse of Breton Woods System. The system was brought to end in accordance with the Smithsonian agreement. Subsequent to this, all the important currencies were realigned under a floating system. Nepal also opted for the system, but it could not be effective because of the pegging of the Nepalese rupee to the US dollar. The exchange rate of the Nepalese rupee vis-à-vis the US dollar did not witness any change until and unless it was devalued or revalued by HMG. The exchange rates of other currencies, however, used to change because of the practice of calculating such rates on the basis of the exchange rates of these currencies in the international market.

At the beginning of 1980s, the global economy was going through significant ups and downs, accompanied by wide changes in the exchange rates. Meanwhile, India de-linked its currency from the fixed parity with Sterling Pound and floated its currency. As a result, the IC exchange rate in terms of the US dollar started to change almost on a daily basis. As the Nepalese rupee was having fixed parity with both the US dollar and the Indian rupee, the broken cross rate started to emerge between the US dollar/IRs. and the Nepalese rupee. Sometimes, the magnitude of the broken cross rate used to be too large. In order to rectify this, there was no alternative other than taking discretionary measures of devaluation or revaluation of the US dollar exchange rate. However; the decision of this nature by HMG normally took its own time. So it was felt that this sort of procedure was not adequate to meet the challenge of the day and it was decided to leave the matter of exchange rate to the NRB through the adoption of a system known as the currency basket system. Accordingly, effective from June 1, 1983, the Nepal Rastra Bank introduced the trade-weighted basket of currency system.[4]

With the introduction of the currency basket system, the NRB was authorized to change the parity of the rupee/ US dollar exchange rate, and if required the exchange rate of the rupee vis-à-vis the US dollar was allowed to change on a daily basis. The US dollar started to float. Though the name of the countries and weight of the respective currencies assigned in the basket were not disclosed, the principal trading partners including India may have been included. In view of the higher share of the country's trade with India, the Indian rupee might have been given higher weight. Theoretically, inclusion of the Indian rupee and US dollar in the basket means allowing these currencies' exchange rate to change on a daily basis and there were instances of such changes in case of the US dollar. The case was different in case of the Indian rupee since due to the importance of maintaining the fixed parity with this currency, the frequent revision in its exchange rate was almost ruled out. Furthermore, because of the status of intervention currency given to the US dollar, the exchange rates of all other convertible currencies, as usual, continued to be determined on the basis of international cross rates with the US dollar.

As mentioned above, the value of the US dollar used to change, but the frequency and the magnitude did not capture the pace as in the case of the movements of the exchange rate of the Indian rupee vis-à-vis the US dollar. From the introduction of this system on June 1, 1983 to its formal burial on March 4, 1992 through the adoption of partial convertibility of the Nepalese rupee, the exchange rate of the US dollar moved to Rs 43.10 from Rs 14.20—an increase Rs 28.90 per US dollar. But not all the increase did take place under the grab of the basket system. Nepal had devalued its currency thrice within the period. This shows that of the total change, Rs 10.40 was through the government's devaluation decision and Rs 28.80 was through the gradual adjustment under the system (Table 3).

The Indian economy was passing through a period of serious crisis towards the beginning of the 1990s. Its foreign exchange reserves had fallen to a rock bottom level. The Indian rupee thus went

Table 3

Exchange Rate of Nepalese Rupees/ US Dollar (Mid-Rate)

Mid –Month	Mid-Rate
1965 July	7.64
1966 July	7.64
1967 July	7.64
1968 July	10.15
1969 July	10.15
1970 July	10.15
1971 July	10.15
1972 July	10.15
1973 July	10.55
1974 July	10.55
1975 July	10.55
1976 July	12.50
1977 July	12.50
1978 July	12.00
1979 July	12.00
1980July	12.00
1981 July	12.00
1982 July	13.20
1983 July	14.50
1984 July	16.40
1985 July	17.70
1986 July	21.20
1987 July	21.90
1988 July	23.60
1989 July	27.50
1990 July	29.20
1991 July	42.80
1992 July	42.70
1993 July	49.24
1994 July	49.35
1995 July	50.70
1996 July	56.53
1997 July	57.03
1998 July	67.93
1999 July	68.48
2000 July	70.75
2001 July	75.03
2002 July	78.30
2003 July	75.05
2004 July	74.45

Source: Calculated from the data published in *Quarterly Economic Bulletin.*

through two devaluations in two days. As the Nepalese economy was not facing the similar crises, it was neither justifiable nor sustainable for Nepal not to follow the Indian measures without adjusting the NC/IC parity in the context of the free and unlimited convertibility of Indian rupee. Further, it was also not justifiable for Nepal to revalue the Nepalese rupee vis-à-vis the Indian rupee given the persistent trade gap and consequent pressure on Indian rupee balance in the banking sector. Thus, Nepal decided to follow the Indian path of devaluation. However, considering the likely inflationary pressure, Nepal opted to take a two-way prescription: a) the parity for Indian rupee was brought down to Rs 165 from Rs 168, and (b) the US dollar exchange rate moved up to Rs 42.70 from Rs 38.00.[5]

Regulations for Providing Foreign Exchange

Nepal's foreign exchange system was strictly controlled as in the case of many of other developing countries in the world until the beginning of the 1990s when the country embarked upon the liberalization era. Generally, the foreign exchange policy of a country trails behind the overall economic policies. A country cannot pursue a completely liberal foreign exchange policy if the overall economic policy is a restrictive one. Encouraging exports, protecting import substitution industries and discouraging imports were the main thrust of the external sector policy of the country before it entered into liberalization. The import-substitution industries used to be protected providing several facilities including lower customs, tax concessions and rebates. Furthermore, they were enjoying foreign exchange facilities as they were provided foreign exchange at a favorable or special rate. They were benefited with respect to the exchange rate too, as in an officially determined exchange rate system, the value of domestic currency tends to be generally higher than the actual value.

The country has been adopting the trade diversification policy, with special emphasis on export promotion to countries other than India. Given the over concentration of trade with India, it was appropriate to adopt such policy. In addition, efforts have been made to earn more and more of convertible foreign exchange and enhancing the reserve of such currencies. In this connection Nepal adopted the following measures in the foreign exchange front.

(a) Bonus System : The first measure for the purpose was the adoption of "Exporters Exchange Entitlement Scheme," popularly known as the Bonus System. Under this system, those earning convertible

foreign currencies through the export of goods to third countries were issued a bonus certificate. Only those having a bonus certificate were eligible for importing from third countries. The bonus premium rates used to be governed mainly by the demand of goods to be imported from third countries in India. The bonus system contributed significantly to trade diversification. However, because of some of the inherent weakness such as frequent change in the bonus premium rates, instances of over invoicing of exports etc. it was decided to replace the system by the one known as dual exchange rate system with effect from March 30, 1978.

(b) Dual Exchange Rate System : The dual exchange rate system was introduced with a view to providing effective incentives to Nepalese exports. Two types of exchange rates for the US dollar were fixed. Initially, the buying and the selling rates of the first category, which was known as the basic rate, were fixed at Rs.11.90 and 12.10 respectively and the buying and selling rate for the other category (the second rate) were fixed at Rs. 15.90 and 16.10 respectively. The basic exchange rate remained the same throughout the period of the existence of this system (from March 30, 1978 to September 19, 1981). However, the second rates were adjusted downward by Rs. 2 on February, 20, 1980, thus setting the buying and the selling rates at Rs. 13.90 and Rs. 14.10 respectively.

Under this system, the basic rate was prescribed for the transactions falling under the government and service sector, while the second rate was prescribed for all the convertible foreign exchange earnings through export. In case of import from third countries, the basic exchange rate was prescribed for a list of some specified goods only; for the rest of the imports one had to pay the second rate.

Besides contributing to open import trade to some extent as the import license for all the commodities, excepting for the banned items and those commodities under quantitative restriction, started to be provided automatically, Nepal's export to third countries also recorded a significant rise. This was the main motive behind this scheme. Viewed from this angle only, the scheme could be rated as fully successful. However, there emerged some adverse effects. The first one was the shift of import trade towards India. This shift was not a pleasant one for the authorities given the trade diversification policy of the country. The second was the detection of some instances of over invoicing of export and under invoicing of import due to the second higher rate. Consequently, the dual exchange rate system was scrapped from September 19, 1981 by devaluing the Nepali rupee vis-à-vis the US dollar by 9.1 percent. After that, the new buying and the selling rate of 1 US dollar were set at Rs 13.10 and 13.30 respectively, lower by Rs. 0.80 in comparison to the second rate.

(c) Auction System : Although Nepal could achieve some degree of success with regard to trade diversification, the policy adopted was not that effective and efficient for the overall economic development. The foreign trade policy was characterized by the requirement of import license, quantitative restrictions, imposition of widely dispersed import tariffs in the name of protecting domestic industries etc. Besides, the officially determined exchange rate used to be favorable for importers as the value of domestic currency was generally kept appreciated under such system. This was substantiated by the existence of substantial premium of the US dollar in the black market. All these led to the proliferation of trading firms rather than the industries. Certainly, there was the development of import substituting industries and persons involved in establishing such industries might have reaped the benefits. But, in view of the little domestic value addition, establishment of such industries was in no way that significant from the perspective of overall economic development of the country.

Over the years, the authorities were also becoming convinced with the weaknesses of the controlled system and were contemplating towards adopting an open, liberal and market friendly economic approach in line with the other developing countries of the world.

The import license auction system was introduced in July 1986, as a first move towards this direction. The goods were classified into different groups and sub-groups. Initially, 88 commodities were included in the list, which were classified into three groups. While Group A included essential raw materials, Group B and Group C comprised basic consumer goods and luxury goods, respectively. Later on, in May 1990, Groups D and E were added. Of the additional groups, Group D was meant for goods which were highly liable to deflate to India, and

Group E included only the consumer goods to be largely handled by small traders. The maximum allocation of licenses was determined on the basis of estimated demand of the goods to be imported.

There used to be a large participation of business community, including the small traders. This contributed to eliminate the monopoly of limited houses in overseas business. The system was so designed that there was the least chance for one to influence the decision as the premium, the main basis for the licensing decision, used to be fixed by a committee set up for the purpose. This system contributed a lot to increase transparency, reduce administrative impediments in this area and facilitated new entrants, aside from generating considerable amount of revenue for HMG.

Meanwhile, Nepal embarked into economic liberalization policy through the introduction of partial convertibility of the Nepali rupee in March 1992. Notwithstanding the ultimate aim of going for a full-fledged open general license (OGL) system, it was not practically feasible to introduce the system in one go. It was decided to gradually reduce the list of goods under the auction system. The list of the goods was reduced to 43 immediately after the introduction of partial convertibility. Later on, the number was reduced to 12 keeping only 6 items under the auction system. Finally, from July 15, 1993, the six items were also brought under the OGL. Since then all the items except for certain specified items like gold, silver, precious stone, armaments and narcotic drugs are under the OGL and any registered company or firm can import any amount of goods through letter of credit.[6]

The Post-Liberalization Period

Earlier, one had to pass through several stringent processes to obtain even a small amount of convertible currency prior to liberalization. It was not possible to get even 1 dollar without the NRB's permission. The trade regime was restrictive, too. One had to obtain import license that used to be issued by HMG. Obviously, the issuance of license could not be fair always. The license-issuing authority had some discretionary power, which could be abused off and on. In such a situation procuring an import license was very difficult for a common man, while the case would be different for the ones who could exert influence of some type, thus contributing to concentrate the foreign trade on such influential persons, mainly the big business houses.

The major features of the foreign exchange system of the then controlled regime were as follows: a) no role was given to the market forces in determining the exchange rates of foreign currency; and b) very complicated procedures were adopted for providing all other currencies excepting Indian rupee.

The adoption of such restrictive measures in the foreign exchange front could not be termed as unnatural given the existence of inward looking policy of HMG in the other sectors of the economy. Nepal initiated major changes in the foreign exchange sector when HMG embarked on the economic liberalization policy. All the facilities including providing cash incentives to the exporters were eliminated. With the introduction of the OGL system, the requirement of obtaining import license by paying premium was also done away with. The provision of requirement of recommendation for importing industrial raw material was eliminated. There have been structural changes in the overall economic policy of the country.

The restrictive provisions of the foreign exchange policy have been gradually relaxed and made transparent. The major reforms initiated in the external sector policy are discussed below.

Legal Reforms

Though the NRB was entrusted to deal with the matters pertaining to foreign exchange and used to be consulted by HMG to effect any changes in this regard, it was not independent till the enactment of the Nepal Rastra Bank Act 2002, and subsequent second amendment in the Foreign Exchange Regulation Act 1962. Certainly, the NRB was given the authority by the Nepal Rastra Bank Act, 1955 also. It was given authority for dealing in transactions between Nepalese currency and foreign currencies at the exchange rate fixed by it from time to time on the basis of the par value of the foreign currencies fixed by HMG and the Bank was also given power to authorize commercial banks and other financial institutions to engage in foreign exchange transactions (Clause 21(1)). NRB, however, was not entrusted to frame the rules and regulations. There was the provision of framing such rules and regulations by HMG in consultation with the NRB (Clause 21(2)).

HMG, being the supreme authority of a country having ultimate power, could influence the working of any of the organization, including the central bank. However, in the context of liberalization, keeping

such power with HMG was thought to be inappropriate. Meanwhile, the world climate was turning in favor of the central bank's independency. Thus, the Nepalese authority also decided to make the NRB independent and promulgated the Nepal Rastra Bank Act 2002 replacing the earlier one. The Act, besides giving more power to the NRB in other areas of its operations also made the Bank fairly independent in the foreign exchange front. With this Act the Bank has been the sole authority to formulate, implement and cause to implement foreign exchange policy of Nepal (Clause 62). The Act has given full authority to the NRB in matters relating to: a) issuing license under this Act or other prevailing laws to the person willing to deal in foreign exchange transactions; b) framing rules and bylaws and issuing necessary order, directives, or circulars in order to regulate dealings in the foreign exchange transactions by the foreign exchange dealer; c) inspecting, supervising and monitoring the foreign exchange dealer; d) setting base, limitations and terms and conditions for the transactions of the foreign exchange dealer; and e) prescribing the system of determining the foreign exchange rates of the Nepalese currency.

More importantly, the Act has also empowered the NRB to formulate the bylaws. In addition to this, the Act has come up with most of the provisions required for the formulation and the implementation of the effective foreign exchange policy in the changed context.

Subsequent to the enactment of the Nepal Rastra Bank Act, 2002 there has been a second amendment in the Foreign Exchange Regulations Act 1962 effective from August 7, 2002. Apart from removing the irrelevant provisions, the amendments have incorporated all of the provisions required for implementing foreign exchange policy in line with the spirit of liberalization and globalization.

Exchange Rate Reform

As discussed earlier, the exchange rate used to be determined officially. The exchange rate so determined may not represent the market as there would be no necessary adjustments in the rate for a long time. There was no self-adjusting mechanism in such a system. The tendencies of the authority would be to keep the domestic currency at a higher value. When the value of domestic currency is kept at an artificially appreciated level, there would be every chance of fostering black market for foreign exchange. In such a situation it is natural for foreign exchange earners either not to bring the earning into the country or sell at the black market rather than surrendering to the banking system at a lower rate, thus adversely affecting the official foreign exchange reserve position of the country and compelling the authority to impose further stringent measures.

After the introduction of the partial convertibility of the Nepalese rupee in March 1992 and subsequent full convertibility in February 1993, there has been substantial change in the exchange rate system of Nepal. Except for the Indian rupee, the exchange rates of convertible currencies started to be determined on the basis of demand and supply in the market. The role of the NRB has changed from a rate maker to a rate taker. The exchange rate of convertible currencies started to be determined by the authorized dealers, though the NRB also published the exchange rates of foreign currencies for its own use. However, the rates published by the NRB are only indicative. Each of the commercial banks is free to determine its own buying and the selling rate for convertible currencies and other near money instruments. The commercial banks are themselves responsible to fulfill their foreign exchange obligations. They have been made free to manage their foreign exchange reserves in the international market.

As the central bank of the country, the NRB cannot be indifferent in such an important matter relating to exchange rates, however. In this connection, though commercial banks are authorized to determine the buying and the selling rate of the foreign currency, the NRB has been successful to make them agree, through moral suasion, in keeping the difference between the buying and the selling rate within one percent. It means that if a commercial bank fixes the buying rate lower, accordingly its selling rate needs to be lower, too. For example, if Bank A sets the buying rate at Rs. 70 per unit of US dollar, its selling rate should not be more than Rs 70.70 (one percent of the buying rate). Likewise, if Bank B's buying rate is Rs. 71, its selling rate cannot cross Rs. 71.71.

When banks are allowed to determine the exchange rate, the rates may be different for different banks. In such a situation, the question may arise with respect to the exchange rate being published by

the NRB. Normally, the commercial banks in Nepal use similar exchange rates, though there have been some instances of different rates being used by different banks. The commercial banks have established an association called the Foreign Exchange Dealers Association (FEDAN) with a view to sharing knowledge and avoiding unhealthy competition in foreign exchange transactions. Its membership consists of all the 17 banks of the country. One of the primary tasks of FEDAN is to work as a bridge between its members and the NRB in matters relating to foreign exchange. Each commercial bank is required to send its exchange rate to the FEDAN on a daily basis. The FEDAN collects such exchange rates and then sends to the NRB. After receiving the exchange rates of all commercial banks via the FEDAN, the NRB calculates the average exchange rate for the US dollar; and this average rate is the exchange rate for US dollar to be published for the next day. After computing the exchange rate of the US dollar, the exchange rates for other convertible currencies are calculated on the basis of their cross rates with the US dollar in the international market.

Even in the context of giving freedom to the market forces in the determination of the exchange rate, the central bank is fully responsible for every issue in the foreign exchange front. No one can claim of market-determined exchange rate to be always realistic; sometimes, it may change without any justifications, causing adverse impact on the economy. There are several instances of adverse consequences experienced by the countries adopting such an exchange rate system.

The stability, both internal and external, has been the primary concern of each and every country and such stability cannot be achieved in the face of exchange rate volatility. Thus a central bank, having the responsibility of foreign exchange management, should always focus on maintaining exchange rate stability by intervening in the market. Certainly, no central bank can dictate the market in a liberalized exchange rate system. However, it can and should influence the market by adopting the indirect means. In this context, the NRB can intervene and has been intervening in the exchange rate market through two means. One, moral suasion itself can be and has been an effective tool. For example, because of the moral suasion of the NRB, the spread between the buying and selling rate could have been maintained within one percent limit. Two, the NRB can signal

Table 4
Transactions with Commercial Banks Under Intervention (Millions of US Dollar)

	Purchase from Commercial Banks		Sales to Commercial Banks		Difference (Purchase-Sale)
	Nos.	Amount	Nos.	Amount	Amount
1991/92	1	8.7	-	0.0	8.7
1992/93	8	110.5	-	0.0	110.5
1993/94	5	69.6	4	22.1	47.5
1994/95	-	0.0	10	163.6	-163.6
1995/96	7	41.8	8	164.8	-123.0
1996/97	7	44.7	5	35.1	9.6
1997/98	8	65.6	6	59.6	6.0
1998/99	15	161.0	-	0.0	161.0
1999/00	7	70.3	4	28.2	42.1
2000/01	5	94.8	15	162.1	-67.3
2001/02	9	107.5	7	102.4	5.1
2002/03	24	323.1	2	7.8	315.3
2003/04	30	408.7	3	27.6	381.1
2004/05	36	472.5	4	50.1	422.4
Total	**162**	**1978.6**	**68**	**823.4**	**1155.2**

Source: Compilation from Individual Interventions by the Foreign Exchange Management Dept. of NRB.

its view on the prevailing rates to market from the exchange rate it fixes while buying/selling the foreign exchange with the commercial banks through intervention.

Table 4 shows that NRB has been buying/selling the foreign exchange with the commercial banks through intervention at their request since Nepal embarked into the liberalization phase. This is necessary in a liberalized exchange rate system; otherwise, the objective of stable exchange rate may not be achieved. If the central bank does not buy/sell the foreign exchange, the foreign exchange dealers, that is, the commercial banks may raise/reduce the exchange rate frequently to a greater extent, thus creating uncertainty in the exchange rate, which is bound to have a detrimental impact on the overall stability of the economy. Considering the likely adverse effect of exchange rate fluctuations on the economy, as done by other central banks in the world, the NRB is effortful to make the exchange rate stable. In the context of freedom in determining the exchange rate, the NRB cannot impose on the commercial banks to fix the rate as prescribed by it. However, to some extent it can influence the market as stated above. To this effect, the NRB, has been buying and selling foreign exchange through intervention in order to maintain the exchange rate stability.

As exchange rate stability is the primary concern, the NRB normally does not change (increase/decrease) the intervention rate; it uses the middle rate of the prevailing published rate while purchasing the foreign exchange from the commercial banks or selling it to them. However, it can (and has sometimes) used different rates, if it believes that the prevailing exchange rate is unduly overvalued or undervalued.

Though the NRB does purchase/sell foreign exchange through intervention, it does not want get involved in such activity; rather it intends to meet the requirement of the concerned bank through inter-bank transactions. This implies that if a commercial bank requires foreign exchange, it should first try satisfying its need from another commercial bank. It may approach the NRB, through FEDAN, only when the requirement is not fulfilled through the inter-bank. As an association of the foreign exchange dealers, the FEDAN keeps the information of the foreign exchange position of all of its members. If the NRB entertains requests of individual banks, there may be a possibility of commercial banks to approach the NRB without making any attempt to get the required funds through the inter-bank. Such arrangement has been made so as to develop the inter-bank transactions and discourage the individual bank to immediately approach the NRB.

Institution Building

Money Changers

Foreign exchange transactions used to be carried out only through the banking system prior to the first half of the 1990s. Though some of the entities such as hotel, travel agencies etc. were also issued licenses; these were only for specific purposes with the objective of serving their clients only. Confining the foreign exchange transactions to a limited sector was not desirable in the liberalized context as one (foreigner) in need of converting the foreign currency into Nepali rupee would either had to resort to the hotel or to go to a bank. None of the options was preferable as exchanging the currency in a hotel implied not obtaining the actual price for his/her foreign exchange and proceeding to a bank was even more problematic for a new person. Therefore, in order to resolve these difficulties, the NRB started to issue license to the private sector from 1995. In order to regulate these entities, the Bank brought a directive in 1995 by the name of 'Money Changers Directives 1995' into implementation. Money changers have been operating throughout the country since then and the number of money changers as at mid-June 2005 stood at 219.

The NRB issues two categories of licenses—one for Indian currency and another for convertible currencies. Both categories require the fulfillment of the necessary procedures stipulated by the NRB. Over and above the general procedures set forth by the Bank, the money changers are required to deposit Rs. 100,000 as guarantee in case of license for Indian rupees and Rs. 600,000 for convertible currencies to the NRB. Of the amount, at least 10 percent must be in cash and the remaining 90 percent can be in the form of bank guarantee. It is to be noted that a license holder of convertible currency is not allowed to sell the foreign currencies; only buying is permitted. Such a money changer needs to surrender the foreign currency to the bank, in which it had opened an account as per stipulation of the NRB. With respect to the Indian currency, the moneychanger can both buy and sell the Indian rupee.

Money Remitting Firms or Companies

It is well known that the tendency of the Nepalese going abroad for employment has been taking an increasing trend in recent years. Initially, most of them used to send their earnings to Nepal through the unofficial channel owing to several factors including the lack of knowledge about the banking practices. They used to send their earning mainly through the 'hundi' system. Some of the workers used to send their savings with their friends and relatives that were returning to Nepal. Some, on the other hand, used to carry the money while returning back.

Under such circumstances, there is every possibility that the fund would not reach the specified person in whose favor it was sent. Apart from this, it was difficult to estimate the inflows as such remittances are not recorded in the statistics. Therefore, the NRB initiated efforts to channel such inflows through the official channel and started issuing license to the private sector. Currently, private sector money transfer units are becoming more and more active and encouraging Nepalese workers to remit money through the official channel. By mid-June 2005, the number of such units has reached to 23. One money-remitting company has been even carrying out such business by opening an office abroad. In this connection the NRB has prescribed fairly easy license issuing procedures. A firm or company willing to undertake money remitting business as an agent of a company abroad would need to keep only Rs. 600,000 as in the case of money changers. However, a bank guarantee equivalent to Rs. 5 million is required for opening an office abroad.

Because of the diversification of institutions, the remittances through the official channel have been increasing remarkably as shown by the data published by the NRB.

Other Reforms

After moving into the market determined exchange rate system, the policy of providing the foreign exchange facilities has been changed accordingly. There have been substantial relaxations in the policy pertaining to the provision of foreign exchange. In the context of a liberal exchange rate system, the imposition of stringent measures as carried out during the fixed exchange rate regime is not necessary.

Import

Prior to the adoption of present open and liberal policy through the adoption of open general license (OGL) system, Nepal's import trade was too much restrictive. Subsequent to the introduction of OGL system, import of all the commodities except gold, silver, precious stones, intoxicated drugs and armaments, has been made open. The earlier restrictions imposed on import from countries other than India has been lifted. Now, everyone can import unspecified quantity/amount of goods by opening letter of credit (L/C). In the case of small imports, opening of L/C is not even required. They can be imported through drafts/TTs. In this connection, immediately following the introduction of OGL system, import of up to US $ 3000 could be made through drafts/TTs. The amount has been raised to US $ 30,000 now. The foreign exchange required for such import is made available easily through the commercial banks.

Regarding the import from India, although the normal mode of payment is in Indian rupee, which is freely convertible, some of the products can also be imported on payments of convertible currencies. This system was introduced since 1993 in order to facilitate the easy access to industrial raw materials. Presently, there are 66 items that can be imported under this system. Only the registered industries are eligible for importing goods by opening L/C and imports would be permitted only from the concerned manufacturing firm/company of India.

Foreign Currency Account

Export and tourism have been the traditional sources of foreign exchange for Nepal. Of late, there has been an increasing tendency for Nepalese to seek overseas employment and hence remittances from the workers have been emerging as one of the principal sources of the convertible currencies for the country. Prior to the adoption of liberalization policy, the foreign exchange earners were required to surrender their earnings to a bank at the then prevailing exchange rate, which was not reflective of the market. The commercial banks were required to buy the foreign currency using the exchange rate fixed by the NRB. Under such an exchange rate system, the value of national currency appeared to be generally at an appreciated level. This tendency, aside from discouraging exports, also made the foreign exchange earners feel that they were not

obtaining the actual price of their earnings. This contributed to increase the tendency of either not bringing in the foreign exchange to the country or exchanging them in the black market. The prevalence of huge black market premium in those days would be enough to substantiate this.

The foreign exchange earners may have felt deprived of the actual price of their earnings even under the present market determined exchange rate system as several complaints are often lodged from the business community about cartelling by the commercial banks while fixing the exchange rate. Besides, the foreign exchange earners would incur loss if they sold the foreign exchange at buying rate and bought it at the selling rate.

Though everyone was familiar with these issues in the earlier days also, but due to the prevailing economic policy and restrictions in the legal system, there was no provision to open foreign currencies until the first amendment of the Foreign Exchange Regulation Act 1962 in 1987. Only then the foreign exchange earners were permitted to open foreign exchange account in a bank in Nepal. In the beginning, accounts could be opened only in the US dollar and the Sterling Pound. Subsequently, the list of currencies has been increased. Now, the foreign exchange account can be opened in all the currencies for which the buying and the selling rate are being fixed by the NRB. Initially, such account could be opened only up to 30 percent of the earnings. The proportion has been gradually increased and now the foreign exchange earners are allowed to keep all of their earnings by opening foreign currency account in a bank. Moreover, while only the foreign nationals and institutions were eligible to open such account initially, now the Nepalese nationals and institutions are also allowed to open such account.

Under the arrangement, four types of accounts (current, saving, call, and fixed) are allowed to be opened in any of the commercial banks in Nepal upon presentation of relevant documents specifying the sources of foreign exchange earnings. Eligible individuals, firms, entities or commercial banks need no permission from the NRB to open such accounts.

The existing foreign exchange account can broadly be divided into two categories: a) foreign nationals and institutions and Nepalese nationals having the source of foreign exchange earning, and b) exporters, hotels and travel/trekking agencies etc. Of the two categories, encouraging the first category to bring in the foreign exchange earnings into Nepal is not easy without convincing them of easy withdrawal as well as the spending facilities. Moreover, there is a practical difficulty to compel them to bring in their foreign exchange earnings. Thus the criterion for withdrawal and spending from such account has been made fairly wide and easy. In case of the second category, however, the criterion has been made relatively narrow because of the legal binding for them to bring the foreign exchange. Notwithstanding the relatively narrower criteria, they have benefited much from the system.

Foreign Exchange Facility

During the controlled regime no one was permitted to obtain foreign exchange without the approval of concerned authority. The situation has changed remarkably in the recent years and this is going to be relaxed more in the years to come. Now, the requirements of foreign exchange for any purpose can be obtained directly from the commercial banks. The present arrangements in this regard can be broadly divided into following:

a) Exchange facilities not requiring permission for unspecified amount of foreign exchange,
b) Exchange facilities not requiring permission for up to a certain specified limit, and
c) Exchange facilities that can be acquired only after the permission.

(a) Exchange facilities not requiring permission for unspecified amount of foreign exchange: Such unlimited foreign exchange facility is to be made available directly through commercial banks for the payment of import through letter of credit by any firm, company or industry registered under the existing rules and regulations. Lately, the foreign exchange required for the payment to educational institutions abroad also does not require permission from the NRB. The concerned commercial bank can provide such facilities provided the applicant has approached the bank with the documents from the institutions as well as recommendation from the Education and Sports Ministry.

(b) Exchange facilities not requiring permission for up to a certain specified limit: Commercial banks are allowed to provide the foreign exchange facilities for certain purposes directly. But the maximum limit of such facility is fixed by the

NRB and it can be changed from time to time. Currently, no permission is required for providing the foreign exchange of up to US$ 1,000 for any purpose (except for capital account), if that amount is for the payment to an institution abroad. Similarly, since the requirement of opening of letter of credit is not made compulsory for importing goods of up to US $ 30,000 and can be imported under drafts/ TTs also, such payments can be made directly from the commercial banks. Moreover, Nepalese citizens visiting countries other than India are allowed exchange facilities not exceeding US$ 2,000 directly from the commercial banks against their passports once in a fiscal year. However, this restriction of receiving this facility once in a fiscal year may not apply to the government officials or officials from public corporations.

(c) Exchange facilities that can be acquired only after the permission from the NRB: Permission of foreign exchange facilities for almost all current transactions is granted if the applicants furnish relevant documents. The permission for the purpose of living expenses for the students pursuing education abroad, medical expenses, conventions, meeting etc. abroad is to be granted by the NRB on the basis of documentary evidence. In other words, anyone requiring foreign exchange for the above purpose and applies at the NRB with the invoice from the concerned institutions will get the permission if the demand is substantiated by the valid documents.

The NRB also readily issues exchange permission for some items of capital nature such as payment for principal and interest of loans, dividend, technical service fee, management fee and royalty, as per the existing legal system.

Issues Relating to Foreign Exchange System

After the liberalization of exchange rate system and subsequent relaxations in rules and regulations in this regard, substantial improvements can be seen in the foreign exchange front, thus falsifying the apprehension of adverse consequences of the liberalization policy. The primary objective of the foreign exchange policy is to maintain stability, particularly external sector stability. The stability of the exchange rate movement and build up of the international reserves over the years illustrate that the current foreign exchange policy of Nepal is rightly shaped.

A comparative study of the yearly movements of exchange rates and international reserve of two periods i.e. from 1960 to 1992 (the year when Nepalese rupee was made partially convertible in the current account) and from 1992 to 2004 shows that in the close regime the balance of payment used to be deteriorated frequently as shown by movements in the international reserves of the country, forcing the authority to adjust (generally devalue the national currency) the exchange rate of domestic currency, sometimes in a huge magnitude.

Such a situation would not emerge in the liberalized system; the market would automatically adjust the exchange rate. In this context, there is marked improvement in the standard deviation of 6.8 during the second period (in the liberalized era even in the context of small sample, that is, where the number of observations is 13) as opposed to 11.5 in the first period, having fairly large number of sample, that is, 33; the marked improvement in the standard deviation in the liberalized era would support the hypothesis that exchange rate is the main factor for the weakness of the overall foreign exchange system. While the exchange rate was less volatile during the second period, the rise in the convertible currencies' reserve also supports the preference of liberal exchange rate system over the controlled one.

Despite these achievements, there are several issues that need to be taken into consideration.

The Exchange Rate System

The exchange rate of the Nepalese rupee has been pegged with the Indian rupee, the exchange rate for which is officially determined. On the other hand, India is under the managed floating rate system. The value of Indian rupee is increasing in the recent years. Its exchange rate vis-à-vis the US dollar has appreciated even remarkably because of the fall in the US dollar rate driven by a dramatic rise in its trade deficit. The Indian economy is performing well over the years and the prospect is expected to be better in the years to come, signaling even further appreciation of the Indian rupee.

On the other hand, the situation of Nepal is just the reverse owing to the deterioration in the law and order situation of the country caused by the internal insurgency. The economy has been growing by less than 3 percent. The conventional sources of foreign exchange earning, that is, tourism is drying up and

earning from exports is not likely to increase unless the law and order situation is improved. Furthermore, foreign capital, including foreign aid, is also not expected to increase in the immediate future at least until the law and order situation in the country is restored. All of this would lead to exert pressure in the balance of payments position, which in turn would result in the depreciation of the rupee.

However, given the exchange rate system, it is necessary for Nepal to adjust its exchange rate with US dollar in line with the movement of IC/Dollar rate in order to control the gap of the broken cross rate. The NRB has been successful to maintain the broken cross rate within limit, thanks to its practice of prompt response to commercial banks' request for intervention.

The exchange rate of Nepalese rupee vis-à-vis the Indian rupee has been fixed at Rs 1.60 per Indian rupee. The parity was fixed on February 12, 1993, by revaluing the national currency by 3 percent (from NRs. 1.68 to NRs 1.60 per unit of IR) against the Indian currency as the Indian economy was passing through a difficult phase during that period, reducing its foreign exchange reserve position to its lowest level of about US$ 1 billion. Over the years, the Indian economy has undergone drastic changes, especially with respect to the foreign exchange reserve position that has crossed US$ 140 billion. Even under such a situation Nepal has been able to keep the NC/IC exchange rate constant for over 12 years at the same time not allowing cross rate differentials of more than 2 percent. This has been possible due to the continuous improvements in the balance of payments and subsequent rise in the foreign exchange reserve position of the country. Even the Indian currency reserve was increasing up to 2002. Thereafter, the IC reserve of the country started to take a downward trend and Nepal has now reached a position of purchasing the Indian rupee by spending convertible currencies. Though this situation has been brought about principally by the payment of POL products by the Nepal Oil Corporation in Indian currency as opposed to the dollar payment earlier, the sharp drop in the Indian currency reserves can also be ascribed to the implicit rise in the value of the Nepalese rupee vis-à-vis the Indian rupee.

Given the open border together with the cultural and economic proximity, it is not advisable to float the Indian currency. However, it is crucial to undertake constant monitoring of the exchange rate movement as well as periodic revision in the parity. This is essential not only from the economic perspective, but also from the viewpoint of maintaining confidence by the Nepalese in the national currency. It is to be noted that the dual currency system was abolished after 1966 when the Nepalese currency was kept unchanged for a while even after substantial devaluation of IC by India. Now, the circulation of IC seems to be increasing again. Therefore, rather than keeping the exchange rate unchanged for a long period of time and taking a pronounced devaluation or revaluation decision, it would be desirable to adjust the rate by applying due caution to curb the likely speculative tendencies. Even in the present context, one cannot rule out the possibility of speculative motives. The timely revision in NC/IC rate is advisable even for maintaining the Nepalese rupee competitive in terms of convertible currencies.

Capital Account Convertibility

This has been a widely debated issue in recent times and also seems relevant in the present context. It is being contended that the external sector would perform even better if the capital account opened up. The example cited is the improved performance observed after the opening of the current account. This can be taken as a valid argument. However, given the open border with India, liberalization of the Indian economy, and the country's current fluid situation, one needs to think twice before making a suggestion for opening the capital account across the board. It is true that Nepal's balance of payments position has been constantly in surplus for the last several years. But, one should not forget the declining trend observed more recently. Even India, whose position is remarkably favorable, has not made its currency fully convertible, but is cautiously moving towards this direction.

Besides, the balance of payments position has been in surplus mainly due to the emergence of a relatively new source of foreign exchange, that is, remittances from the workers employed abroad. A look at the balance of payments table published in the NRB's *Quarterly Economic Bulletin* shows that the surplus has been largely driven by the remittances. Inflows from other sources have not been that substantial. The remittance cannot be considered as a sustainable source of foreign exchange as it depends solely at the mercy of a country providing

employment to the foreign workers. A country can change the policy relating to employment of foreign workers, thus affecting the inflows. No international forum, including the World Trade Organization, is likely to interfere in this matter. For example if Malaysia, one of the major countries providing employment to Nepalese, changes the policy and adopted a stand of not employing Nepalese worker, the remittance inflow would be severally affected.

Thus, opening the capital account without analyzing all the relevant issues may push the economy into jeopardy. Every country can take lessons from the East Asian crisis. Had the crisis-affected countries adopted a fixed exchange rate policy or put certain regulations for foreign investment, particularly in the inflow of hot money, they would not have to face the crisis of that magnitude. Countries adopting a cautious stand, such as China and India, were insulated from the crisis. Hence, prescribing the opening up of capital account across the board at one go is not advisable, at least until the restoration of normalcy in the country.

The foregoing issues have been deliberated not with the intention of sticking with the present policy. Eventually, Nepal should also go for opening up of the capital account. For the time being however, the country should adopt a gradual approach. Initially, specifying a certain limit can open some of the transactions of capital nature.

Other

Though there have been substantial relaxations in the trade regime as well as in the provision relating to foreign exchange, there are still many regulations that can be relaxed soon. These include provisions such as providing passport facilities only once in a year, requirement of NRB permission even to take loans from abroad, requirement of NRB permission for repatriation etc.

Conclusions

Even after more than a decade of the reform process, Nepal's foreign exchange system cannot be termed as a well-managed and fully liberal one. While capital account has not been fully liberalized yet, certain current account transactions still require NRB´s permission. More importantly, even the exchange rate system, the backbone of foreign exchange system, requires improvement prior to the opening of the capital account. It is not pertinent to prescribe the opening up of capital account under the present two distinct exchange rate systems for IC and convertible currencies.

Though there has not been complete liberalization and there exist certain weaknesses which call for due consideration, viewed from the present state of liberalization in this sector—from the exchange rate determination system to relaxation in rules and regulation for providing foreign exchange facilities—it can be said that reform initiated in this sector, particularly after the introduction of convertibility of Nepalese rupee in 1992, has been far ahead of other sectors of the economy. While the shift from an officially determined exchange rate regime to a market determined one is the landmark development in this direction, equally significant is the introduction of the open general license system. Besides, incessant relaxations in rules and regulations regarding foreign exchange transactions including the exchange facilities to be provided to general public, foreigners as well as to the foreign investors have contributed much.

Capital account has not been opened yet and may take some more years. There is still the requirement of permission from the NRB for obtaining exchange facilities even for some of the current transactions. However, in view of the constant efforts of the NRB to undertake reforms, it can be fairly said that the foreign exchange system of Nepal would be more open and liberal in the years to come.

Endnotes

[1] Details are given in NRB (1996), p. 95

[2] *Ibid*, p. 96

[3] The currencies included US $, Pound Sterling, Swiss Franc, German Mark (DM), Japanese Yen, Canadian $, French Franc, Swedish Kroner, Netherland Guilder, Austrian Schilling, Italian Lira, Australian $, Pakistani Rupee, Belgian Franc, Burmese Kyatt, Malaysian Ringgit, and Indian Rupee Later, the Malaysian Ringgit was removed from the list.

[4] NRB (1996), p. 98.

[5] See *Ibid* and Table 3 for details.

[6] For detail, see NRB (1996), pp. 107-112.

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Inflation

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Introduction

Inflation is "a process of continuously rising prices or equivalently of a continuously falling value of money" (Laidler and Parkin,1975). The definition implies that a rise in the price of individual commodities is not inflationary if offset by falls in other prices. A sustained rise in the general price level means that a given sum of money will buy a smaller quantity of goods: hence the alternative characterisation of inflation as a continuous decline in the purchasing power of money. The value of durable goods producers or consumers' - however, remains roughly constant as the prices of goods rise along with general price index. If these goods also serve as alternative assets to money, an increase in the expected rate of inflation would cause a shift out of money and bonds into consumer durables. A number of studies based on country-specific as well as cross-country data provide evidence to support this. These studies in general show that variations in the expected inflation rate, explain the variations in the proportions of a country's assets held in liquid form (Laidler,1985). Many economists would also regard the expected rate of inflation as an important determinant of the opportunity cost of holding money. While theoretically one might expect its influence to be reflected in the nominal rates of interests usually included in the demand for money functions, the evidence does suggest that expected inflation rates affect the demand for money directly in a manner over and above their indirect influence via nominal interest rates.

In the recent years, many economists and central bankers have been advocating and adopting price stability as the sole objective of monetary policy in order to promote economic stability and economic growth. With the objective of price stability, inflation targeting has been considered as one of the best monetary frameworks in conducting monetary policy. In fact, this policy framework is based on the classical concept of direct relationship between money and price. Among other objectives, price stability has been considered as the most achievable objective of monetary policy. Hence, the level and dynamics of price become unavoidable pre-requisites for any economic analysis. The behaviour of the economy in real term can be judged only on the basis of the movements of prices and without actually getting a feel of the level of the price it becomes hard to judge the performance of economy in real terms. Since the price stability is a main objective of monetary policy, observations of price movement and identification of determinants of inflation are vital for both monetary policy formulation and its implementation. It is widely accepted that economies perform better in terms of growth, employment and living standard in a low inflation environment. The low inflation helps maintain macroeconomic

stability and supports proper allocation of resources in the economy. It also keeps the purchasing power of money stable ultimately helping in containing the spreading of poverty in the economy.

If price implies the purchasing power of money on the one hand, it also indicates value of goods and services on the other. People have to pay the price of goods and services at the time of consumption. In fact, nothing is free in life. Price is practically measured and expressed in monetary term. In the market economy, the interaction between demand for and supply of any commodity determines the price of that commodity. There are various sorts of goods and services with different prices and these prices change in the economy. Because of this situation, there exists a practice of constructing price index to measure the general price level in the economy. Some examples of price indexes are: GDP deflator, Consumer Price Index (CPI), Wholesale Price Index (WPI), etc.[11]

The GDP deflator is the ratio of nominal GDP in a given year to real GDP of that year. The deflator measures the change in prices that has occurred between the base year and the current year. Since the GDP deflator is based on a calculation involving all the goods produced in the economy, it is a widely based price index that is frequently used to measure inflation.

The consumer price index (CPI) measures the cost of buying a fixed basket of goods and services representative of the purchases of urban consumers. The CPI differs from the GDP deflator in the following main ways:

(i) The deflator measures the prices of a much wider group of goods than the CPI does.

(ii) The CPI measures the cost of a given basket of goods, which is the same from year to year. While the basket of goods included in the GDP deflator, however differs from year to year, depending what is produced in the economy in each year.

Any change in price affects different sectors of the economy. Inflation, i.e., increase in price level, is considered as an economic evil because it not only distorts prices but also erodes savings, discourages investment, stimulates capital flight, inhibits growth, makes economic planning a nightmare and in its extreme form, evokes social and political unrest (Debelle et al, 1998). Such is the reason why price stability is desired by many in the economy.

It is to be noted that the two main indexes used to compute inflation, the GDP deflator and the CPI, accordingly differ in behaviour from time to time. For example at times when the price of imported oil rises rapidly, the CPI is likely to rise faster than the deflator. In Nepal, CPI is mostly used to analyse the inflationary situation in the economy.

This essay is organized as below. Section two covers the history of price collection in Nepal. Data and methodology in the analysis of inflation is given in section three followed by the presentation of price movement in Nepal on decade basis in section four. Section five explains the composition and structure of CPI in Nepal, while review of various theories of inflation is done in section six. Section seven covers the econometric analysis of the determinants of inflation in Nepal, whereas section eight discusses stationarity and co-integration test. The second last section deals with inflation controlling measures in Nepal and finally, the last section concludes the essay.

History of Price Collection

The history of price collection in Nepal can be traced back to 1902 when "Gorkhapatra" had begun to collect and publish retail prices of a few commodities (NRB, 1981). Since 1956, the Kathmandu Municipality Office started publishing retail prices of consumers' goods in its monthly magazine "Jana Chetana". However, these attempts could not last for a long period, as such in 1962, His Majesty's Government, the Central Bureau of Statistics (CBS) began collecting prices of selected consumers' goods in the Kathmandu Valley.

Realizing the importance of price statistics, Nepal Rastra Bank (NRB) began collecting prices of essential consumers' goods in a systematic way since its establishment in BS 2013 (1956). Initially, NRB collected prices of 15 consumer goods in a fortnightly basis. The number of consumer goods were gradually increased to 31 in 1960 and then to 46 in 1965. In 1957, NRB started to construct the un-weighted price index for Kathmandu and published it on a regular basis. Later in 1962, NRB brought forth the un-weighted price index for the Terai region and a year later in 1963, it was extended to the Hilly region as well. In the mean time, since 1962/63 CBS had started to construct and publish the weighted consumer price index for Kathmandu; however this process could continue only till 1969/70.

Ultimately to arrive at the weighted price index at the national level, Nepal Rastra Bank had no choice but to launch a nation wide household budget survey (HBS) and then determine the weighting factors. The first of such surveys was launched in the year 1972/73 and thereafter the second and the third surveys followed in approximately a gap of ten years in 1983/84 and 1995/96 respectively. The second survey of 1983/84 was a multi-purpose household budget survey designed also to obtain the key macroeconomic indicators of the country. The fourth of such surveys is on the pipeline, scheduled to be conducted starting the next fiscal year 2005/06.

After the launching of the first HBS, there has been a continuous flow of data on consumer price index, the weights of which are constantly being updated and the consumption basket being revised with the help of household budget surveys. The current weights of the consumer price index is based on the third HBS conducted in 1995/96.

In addition to Consumer Price Index, NRB has also begun to publish the Wholesale Price Index (WPI) since 2000/01. This has indeed added new dimension in looking at the price movement in Nepal, thereby broadening the horizon and the scope in analysing the movement of the price in the country.

Data and Methodology

Although the time series data on price in Nepal does not cover a long period, the observations of price movements show rather a unique feature. Prior to 1972/73, as the weighted consumer price index was not available at the national level, the available information on price has been used as a proxy to analyse its movement for the period 1956/57 to 1971/72.

For the period 1956/57 to 1961/92, un- weighted price index for Kathmandu computed by NRB has been used whereas, data series on weighted consumer price index for Kathmandu computed by the CBS for the period 1962/63 to1971/72 has been used as a proxy for the national level and for the period after that, the availability of the time series on weighted urban national consumer price index produced by NRB has made it imperative for its use.

Price movement has been observed based on the available statistics with some important explanation for substantial movement of price. However, empirical study has been carried to identify the determinants that are statistically significant in influencing the price level in Nepal. As far as the empirical study is concerned, the sample has been taken for the period 1972/73 to 2003/04 because of the availability of the weighted national consumer price index for that period only. It has been observed that the Price level in Nepal has been significantly influenced by money supply, Indian price, exchange rate, and supply situation of food grains.

Price Movements in Nepal

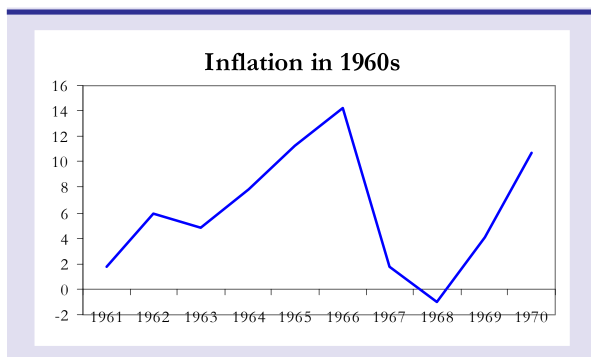
It is a universal fact that a higher rate of inflation brings about volatility and ultimately paves the way for distortions in the optimum allocation of resources in the economy. It is likely to induce inflationary expectations thereby encouraging distortion in the savings and investment. As such is the case, inflation in Nepal has remained the central concern of all the issues pertinent to economic management. All the efforts made by the Government in the past could simply not materialise to the desired level. In the span of the last 33 years after NRB started producing National weighted urban CPI, the annual rate of inflation averaged at 8.9 percent. It reached to a record level of 21.1 percent in 1991/1992 reflecting as one of the major hurdles in the pursuit of stable and self-sustained economic growth of the nation.

To give an overall glimpse over the past fifty years, the analysis of the price movement in Nepal has been carried out on a decade basis. Obviously, during the fifties, price movements were not found to be uniform. The available statistics indicated that the change in price was extremely severe in 1958/59 with the average inflation reaching a double digit at 11.0 percent due mainly to the volatility in the exchange rate of Nepalese rupees vis-a-vis Indian rupees. In 1960, there was the unification of the currency thereby making the Nepalese rupees the sole medium of exchange. The Nepal Rastra Bank during this time was also successful in fixing the exchange rate of Nepalese rupees vis-a-vis the Indian rupees. As a result of this, the changes in the price in 1960/61 was marginal.

In 1960s

An analysis of the price movements during the sixties[2] shows that the annual rate of price rise measured in terms of the Consumer Price Index (CPI) averaged at 6.2 percent. It is interesting to note that during this period, three of the fiscal years viz., 1964/65, 1965/66 and 1969/70 witnessed double

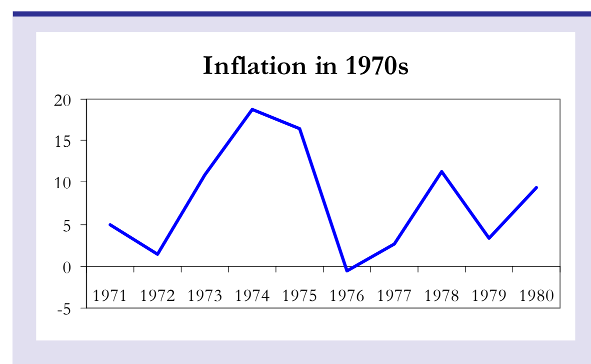
digits inflation at 11.2 percent, 14.2 percent and 10.7 percent respectively. The price dynamics during the mid sixties and also towards the end depicts an alarming trend. The prices of food articles for all Nepal showed a substantial upward movement and recorded the highest change in 1964/65. This unprecedented rise in the price particularly of the food articles was attributable to the adverse weather situation causing a drastic fall in the production of food grains in the kingdom. The situation was also not favourable in India either: as such, the supply shortage due to the poor performance of the agriculture sector in the country in conjunction with the rise in the import price induced the CPI to move up during 1964/65 to 1965/66. In addition to this, monetary expansion had also contributed to such a rise in price during these years. However, the succeeding year viz. FY 1966/67 witnessed only a marginal rise in the price level and a year later in 1967/68 the price poised a negative growth. The contributory factor for the fall in the prices was the appreciation of Nepalese currency vis-à-vis Indian currency in May 1966. Thereafter in December 1967, the Nepalese currency was devalued vis-a-vis the Indian currency by 24.78 percent thereby leading the prices of most commodities, including that of the food articles to go up. During this time, both the custom and excise duties were increased heavily and as a result of excessive credit disbursed to the public sector and a rise in the net foreign asset, money supply had gone up. In addition to all these, the prices of non food items in India had also gone up. All these factors cumulated to exhibit an upward thrust in the prices to register at double digit (10.7 percent) in the last year of the sixties.



In 1970s

As a result of the world oil crises, major parts of the globe had experienced a high inflationary pressure in the early years of the of seventies.[3] Nepal had also been hit heavily with inflation at double digit during the period 1972/73 to 1974/75 due mainly to the rise in the prices of petroleum products. Monetary expansion during these years had also contributed to the upward thrust in the inflation of the Kingdom. The price rise was as high as 11.0 percent to 18.8 percent during these years. To curb with the situation, His Majesty's Government had introduced a 10 points inflation control measure to contain the inflation, which had then rocketed during 1972/73 to 1974/75.

However, a good harvest as well as the price control measure taken in India following the declaration of emergency in conjunction with the increase in the production of food grain together with monetary tightening back at home had eased the pressure on the price front ultimately leading to the negative growth of 0.6 percent in the inflation rate in FY 1975/76. The price index of food and beverage group during this period registered a decline of 3.9 percent.



The movements in the prices in the individual years during the review period were not uniform. The changes in the prices of food and beverages were observed to be more erratic that that of non- food and services implying a direct relationship of food grains production in the country and their import prices from India. Although some pressure had started to build up in the prices both in the country and neighbouring India, after the Emergency in India was lifted, a good harvest of the cereal and other food grains helped contain inflation at a lower single digit of 2.6 percent in 1976/77.

The production of food grains in 1977/78 had recorded a decline. In April 1977, the Nepalese rupees was devalued with the Indian currency by 4.3 percent and re-valued with the US dollar in order to diversify

imports from India to third countries. The impact was then felt by a sudden unprecedented jump in the price level by 11.4 percent in 1977/78. It was also observed that the year 1976/77 saw a substantial increase of 27.6 percent in the money supply as well as a significant increase in the indirect taxes by HMG. Also, the central excise duty in India was increased in 1978. All these factors have made a significant contribution in exerting an upward pressure in the price in 1977/78.

In order to combat the increasing level of price in the country, HMG had revised custom and excise duty thereby containing the inflation at a single digit in 1978/79; however the shortfall in the production of food grains and an upward revision in the prices of petroleum products in 1979/80 contributed to an upsurge in the price level again registering the inflation at double digit of 11.0 percent in the FY 1979/80.

The average national inflation in the seventies is recorded at 7.9 percent compared to 6.2 percent in the sixties.

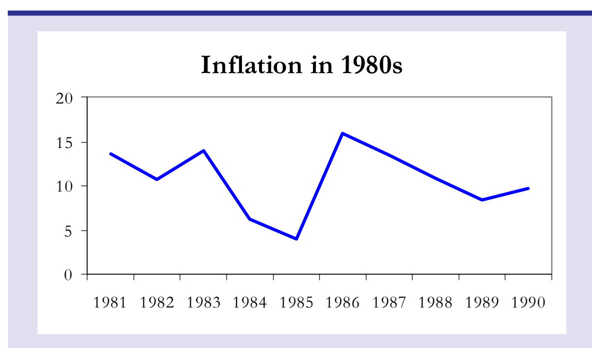
In 1980s

The 1980s witnessed an average inflation rate of 10.7 percent (Table 1), which was higher than in the previous decades. The analysis of the annual price movements in this decade revealed some unprecedented rise in inflation in the fiscal years 1980/81 (13.6 percent), 1981/82 (10.6 percent), 1982/83 (14.0 percent), 1985/86 (15.9 percent), 1986/87 (13.4 percent), and 1987/ 88 (10.9 percent). This reflects that the country was facing double digit inflation for more than half the period between 1980-1990. Various factors contributed to the upsurge in the price movement on Nepal. The higher rate of inflation recorded during these periods may be attributed among other things to the rise in prices of food and beverages group, higher inflation rates in India, the lagged impact of the rise in the price of petroleum in Nepal in 1979/80, increase in the cost of production due to the rise in the fertilizer prices and expansionary fiscal policy of the government which registered a growth of about 30 percent in government expenditure in 1981/82 and 1982/83 each[4]. The production of food grains had declined by 12 to 16 percent between 1979/80 and 1982/83 owing to a severe drought experienced both in Nepal and the bordering areas of India. Hence, the real GDP had witnessed a decline of 2.3 percent in 1979/80 and 3.0 percent in 1982/83. On the other hand, monetary expansion, due to a higher level of deficit financing, was steady which had an adverse implication on the prices as well as on the balance of payments in the beginning of 1980s. In September19, 1981 and December 17, 1982, Nepalese rupee was devalued by 9.1 percent and 7.7 percent respectively vis-à-vis US dollar in order to gain control of the BOP crisis. Such successive devaluation had also obviously contributed significantly in flaring up of the inflation.

A number of anti-inflationary policy measures with regard to monetary management were taken during this period. The two large state owned commercial banks were allowed to open branches so as to mobilize savings and also mop up the excess liquidity in the economy. The commercial banks were directed to maintain 25 percent of total deposit liabilities in liquid assets while a compulsory cash reserve ratio of 4 percent of the total deposits in their safe vaults and 5 percent of total deposits with the Nepal Rastra Bank effective July16, 1981. The central bank also instructed the commercial banks to maintain a 3:1 ratio between borrowings and capital fund effective from the fiscal year 1981/82. A number of consecutive changes in the interest rate structure were effected on June 15,1982 and August 17, 1982 to control the domestic price level, correct the ever widening trade deficit and maintain an appropriate level of liquidity. The commercial banks were also directed to provide loans against the government's Development Bonds for a maximum period of one year at a rate of 1.5 percent higher than the rate specified in the Bonds.

To foster healthy competition among banks, commercial banks were granted autonomy to offer 1.5 percent (savings deposits) and 1.0 percent (time deposits) above the prevailing rates of interest effective November 16, 1983. In addition, measures were also adopted to enable commercial banks to maintain a credit-deposit ratio of 75 percent by mid-July 1985 (Mathema, 1995)

As a result of the improvement in the domestic agricultural production (28 percent), as well as price situation both in Nepal and India and in pursuance with the above-mentioned anti-inflationary measures, inflation dropped to single a digit at 6.3 percent in 1983/84 and 4.0 percent in 1984/85.



However, the price situation could not remain comfortable for a very long period. The inflationary pressure was again felt tremendously high during the first three years of the second half of the eighties. The fiscal years 1985/86, 1986/87 and 1987/88 witnessed a double-digit inflation at 15.9 percent, 13.4 percent and 10.9 percent respectively with FY 1985/86 facing the highest inflationary impact in the decade. In spite of the increase in food grains production and improvement in the price situation in India, the devaluation of Nepalese rupee vis–a-vis the US dollar by 14.7 percent on November 30, 1985 was the main contributing factor to this higher rate of inflation. Following the devaluation, electricity tariff was raised by 22 percent and fertilizer prices were raised ranging between 20 to 33.5 percent. These factors had a negative effect both on the cost of production of the domestic goods as well as on the prices of the imported goods.

The above factors are seen to have had a subsequent lag effects in the later two years of the decade. Although inflationary pressure moderated to some extent during the last two years, it remained at a level higher than 8 percent. The last two years of 1980s were also badly hit by the trade and transit impasse with India beginning on March 23, 1989. Although this impasse terminated in June 1990, it had a wide-ranging impact in Nepal's economic development, affecting adversely on the overall growth rate, creating supply constraints due to heavy rationing of petroleum products and pushing up the prices of imported goods. A relatively better performance of the agricultural production could not fully nullify the negative impact created by the trade and transit deadlock with India, although it helped in bringing down the inflation level to a single digit.

In order to redress the situation, the government embarked on an economic stabilization programme in 1985/86, which was supported by a stand-by arrangement with the International Monetary Fund. The programme brought significant stabilisation gains in the field of external current account deficit and the overall balance of payments, but not in the price sector. In pursuit of redressing structural constraints to growth and maintaining inflation rate at a desirable level and strengthening the external current account position over the medium term, the country embarked on a three–year Structural Adjustment Programme (1987/88-1989/90). The introduction of programme budgeting, enhancing of the private sector participation in industrialization, implementation of liberal export promotion policy and the financial policy with the intention to keep bank credit expansion within desirable limit were some of the strategies adopted under the SAP

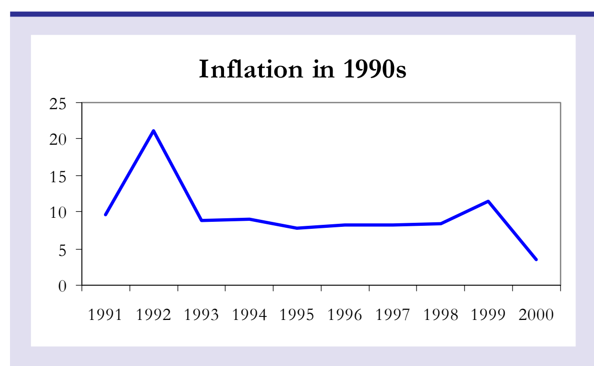
In 1990s

The nineties observed the speeding up of the economic liberalisation process. This decade also experienced a higher-level inflation due mainly to the structural changes in the economy. Average inflation stood at 9.6 percent during the 1990s (Table 1). Although the amicable resolution of the 15 month long trade and transit dispute with India towards the end of 1989/90 eased the supply situation, the outbreak of the gulf war in August 1990, slowing down of the agricultural production (6.7 percent in 1990/91) combined with a relatively higher growth of the aggregate WPI of India induced an upward pressure on CPI to remain at 9.7 percent in 1990/91.

Although the average change in the National Urban Consumer Price Index remained at a level below 10 percent in most of the years in 1990s, the FY 1991/92 witnessed an inflation of 21.1 percent, the highest ever recorded in the Nepalese context. While looking at the regional distribution of inflation rate in the review year, it is seen that Terai experienced the highest rate at 21.5 percent, followed by Kathmandu at 20.8 percent and the Hills at 19.7 percent. Commodity wise, the inflationary thrust lied on the food and beverages group rather than in the non-food and services. The index for the food and beverages shot up by a whopping 24. 4 percent, while that for the non food and services group went up only by 15 percent. The higher rise in food and beverages index was mainly due to the steep rise in the index of rice, the staple food of the Nepalese

people and spices which were ultimately imported from India.

Many other factors were also responsible for such an unprecedented rate of inflation in 1991/92. One of the important factors was the devaluation of Nepalese rupees vis-à-vis US dollar and other convertible currencies by 20.9 percent towards the end of the FY 1990/91, following the policy of the convertibility in the current account, which pushed up the import prices of raw materials, fuels, fertilizers, construction materials, daily consumer goods, etc. Along with the devaluation, the government also adjusted upwards the administered prices of goods and services like milk, petroleum products, education fees, telephone and electricity charges (IDS, 1994), in line with the market based liberalisation policy. The higher rate of inflation in India (13.5 percent measured by WPI) due to the balance of payments crisis and the resultant devaluation of the Indian currency also assisted in raising the prices of the imported goods from India. Moreover, shortages in the supply of essential food grains were also experienced because of the shortfall in production during the year in Nepal. In addition, the perpetually long expansionary fiscal policy of the government in the past continued to put pressure on the monetary liquidity that fanned the inflationary fire from the demand side. Increase in money supply also fuelled the inflation from the demand side as well. During the year, narrow money (M1) went up by 19.5 percent compared to an increase of 14.5 percent in the preceding year.



This period was crucial for the Nepalese economy from various points of view. Along with the restoration of democracy in 1990 and the assumption of the political power by the popularly elected government in 1991, Nepal entered into the era where difficult challenges in rebuilding the economy lay ahead. Many reform measures were enhanced in order to maintain macroeconomic stability together with bringing out the structural changes in the economy. Among others, containment of the monetary expansion within the manageable limit, thus making it consistent with the real sector growth and inflation was one of them. Open market operation was introduced as an indirect tool to control monetary aggregates within the desirable limit. Major steps were also initiated in the financial sector policy reforms. Liberal policies were also adopted in sectors like the public enterprises, industry, foreign investment and technology as well as trade and foreign exchange. Prudential fiscal policy was adopted to contain the growing budget deficit by strengthening the revenue administration, and prioritizing and restraining government expenditure.

Inflation was relatively stable, at around 8 percent between 1992/93 and 1997/98. The economic liberalization policies taken up by the government in the various macroeconomic sectors since 1990 has been instrumental in containing the rate of inflation within a single digit in this period. Entering into ESAF (Enhanced Structural Adjustment Facility) in 1992/93 further assisted in achieving significant progress in macroeconomic situation including the containment of inflation (Mathema, 1995). Moreover, considerable improvement in agriculture and non-agriculture production, reduction in tariff rates, control in deficit financing, and relative stability in exchange rates also contributed in maintaining the inflation at that level. However after six years of gaining stability, inflation soared to 11.4 percent in 1998/99 due mainly to the surge in prices of food and beverage group as a result of a shortfall in the supply of cereals, vegetables, pulses and spices. Monetary expansion (M1) of 17.4 percent in 1997/98 also contributed in fuelling up the price in the following year. However, inflation came down to 3.5 percent in the 1999/00 owing mainly to the rapid deceleration in the price index of food and beverage group attributing to the good harvest of cereal production as a result of favourable weather condition.

2000 Onwards

From the very beginning of the twenty-first century, inflation has been contained at the desirable level. Many countries around the Globe also experienced low level of inflation in most parts of

the 1990s and the beginning of 2000s. Inflation in Nepal stood at 2.4 percent in 2000/01, 2.9 percent in 2001/02, 4.8 percent in 2002/03 and 4.0 percent in 2003/04. A good supply situation and a favourable price situation in India in conjunction with a good harvest both in Nepal and neighbouring India as a result of a favourable weather condition for both the cereal and cash crops as well as vegetables and fruits is mainly attributed in containing inflation at a level lower than 5 percent during the first four years of the 2000's. However, the hike in the prices of petroleum products by an average of 35.7 and an upward revision in the VAT rate by 3 percent during the first half of the FY 2004/05, is expected to exert an upward thrust on the consumption basket raising the inflationary pressure slightly above the projected level of 4.3 percent in 2004/05.

Table 1
Price Dynamics (Percentage Change)

Period	Food and Beverage Group	Non-food & Services Group	Overall
1960s	4.8*	NA	6.2
1970s	8.0	7.7	7.9
1980s	11.0	10.2	10.7
1990s	9.9	9.1	9.6
2000 onward**	2.3	5.0	3.5

* It is an average of last five years (1965/66 to 1969/70).
** First four years only.

Composition and Structure of the CPI in Nepal

The National Urban Consumer Price Index is constructed and published on a monthly basis. For food items, prices are collected every week; while in a number of other cases, as with household materials, health services, personal cares, etc., data are collected less frequently, either on a monthly, quarterly, half yearly or yearly basis. The number of items in the consumption basket varies according to different regions. The CPI basket for Kathmandu Valley consists of 301 items, while it includes 282 and 262 items in the case of the Hills and the Terai respectively. The CPI component indices are publicly available at two basic subgroup levels:
(i) Food and Beverages group
(ii) Non-food and Services group.

There are 10 different subgroups in the Food and Beverages Group and 7 different subgroups in the Non-food and Services group

The current weighting factors have been derived from the Third Household Budget Survey (HBS) conducted in 1995/96 (Appendix 1). It has been noticed that the weights have been gradually shifting with time since the first survey conducted in 1973/74, gradually gearing towards non-food and services groups reflecting the changing nature of the consumption pattern being drifted away from the food items. However, the food and beverages group still occupies 53.2 percent of the weight.

Table 2
Structure and Performance of CPI During 1973/74 to 2003/04

	Mean in Percent	Standard Deviation
Overall CPI	**9.0**	**5.1**
Food & Beverage	**9.0**	**7.0**
Grains and Cereal products	8.0	10.5
Rice and Rice Products	8.1	11.0
Pulses	10.3	11.7
Vegetables and Fruits	10.2	10.0
Spices	11.4	16.3
Meat, Fish and Eggs	10.1	5.5
Milk and Milk Products	9.5	5.6
Oil and Ghee	10.0	15.5
Sugar and Related products	7.3	14.2
Beverage	8.7	7.0
Restaurant Meals	11.1	8.5
Non-Food & Services	**8.9**	**3.3**
Cloth, clothing & Sewing Services	7.3	3.7
Cloths	6.4	4.6
Clothing	7.8	4.0
Footwear	6.9	4.5
Housing	8.6	4.4
Fuel, Light and Water	11.8	7.4
Transport and Communication	9.1	5.7
Medical and Personal Care	7.8	4.0
Education, Reading and Recreation	9.4	5.5
Tobacco and Related Products	7.5	5.3

During 1973/74 to 2003/04, food and beverage groups remained highly volatile compared to non-food and service groups. The standard deviation of the former group stood at 7.0 while that of latter group stood at 3.3 (Table 2). Within the food and beverage group, prices of grains and cereal products, pulses, vegetables and fruits, spices, oil and ghee, as well as sugar and sugar related products remained highly volatile during the review period owing mainly to the supply side fluctuation. Moreover, fuel, light

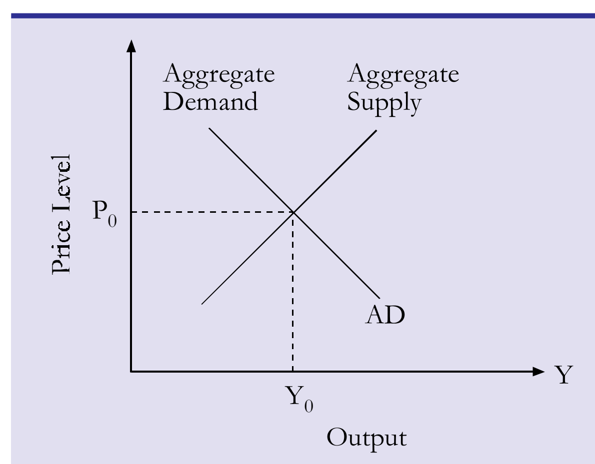
and water witnessed a high volatility within the non-food and services group with a standard deviation of 7.4 percent due to mainly to the unplanned and abrupt upward revision of the prices of government controlled goods.

In this way, during the period 1973 to 2004, inflation in Nepal averaged at 9.0 percent, with a standard deviation of 5.0 percent. Out of the 33 years under study, 12 years witnessed double digits inflation. Only in one year the growth in the rate of inflation was negative. Cumulative inflation has been more than 288 percent between 1973 and 2004. Historical inflationary experience in Nepal has reflected that factors like money supply, government expenditure, real GDP, Wholesale Price of India (WPI), exchange rate can mainly be attributed to the growth in the inflationary pressure felt by the Nepalese economy.

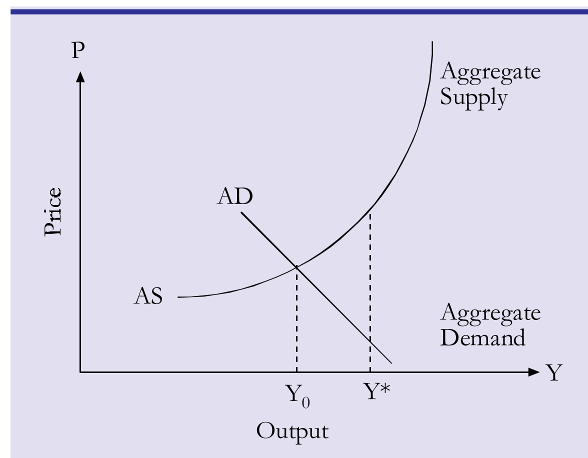
Review of Theories of Inflation

The key concept in analysing output, inflation, growth, and the role of policy are aggregate demand and supply. The level of output and the price level are determined by the interaction of aggregate demand and aggregate supply.

Aggregate demand is the relationship between spending on goods and services and the level of price whereas the aggregate supply curve specifies the relationship between the amount of output firms produce and the price level. Supply shocks can reduce output and raise prices.



The basic tools for analysing output, the price level, inflation and growth are the aggregate supply and demand curves. Shifts in either aggregate supply or aggregate demand will cause the level of output to change - thus affecting growth - and will also change the price level - thus affecting inflation.



However, it is to be noted that one of the crucial points about macroeconomics adjustment is that the aggregate supply curve is not a straight line. The above figure shows that at low levels of output, below potential output Y*, the aggregate supply curve is quite flat. When output is below potential, there is very little tendency for prices of goods and factors (wages) to fall. Conversely, for output above potential, the aggregate supply curve is steep and prices tend to rise when demand increases. The aggregate demand curve can be shifted by monetary and fiscal policy measures..

Literature in economics however indulges in the following four basic theories in explaining the inflationary process. They are: excess demand theory, cost-push theory, Phillips curve theory and the structural theory (Khatiwada, 1994).

Excess Demand Theory

Excess demand theory argues that prices rise because aggregate demand generated by money supply (monetarist perspectives) or government expenditure (Keynesian perspective) exceeds the level of output in the economy. The upward movement of the aggregate demand curve, given the aggregate supply curve, raises the price in the economy. Obviously, money supply higher than the desired level creates the situation of "too much money chasing too few goods", and this generates an inflationary pressure in the economy. Without the support of money supply, inflation cannot last for a long period. Moreover, the government expenditure, particularly deficit financing by overdrawing from the central bank also creates the same effect as in the case of increase in the money supply.

The monetarist version of excess demand theory of inflation states that if the country has no excess productive capacity, excess supply of money over demand is reflected by the rising prices. Given that there is full employment or productive capacity has been exhausted, increase in money supply exerts a proportional increase in prices. Although Nepalese economy is well below the full employment level, there is inelastic supply of production due to structural rigidities. As such, money supply can affect prices in Nepal substantially. Between 1959/60 to 2003/04, narrow money increased by 15.6 percent on an average and considering the real GDP growth rate of about 4.0 percent during 1972/73 to 2003/04, on an average, the growth of money seems to be in excess of the demand for it.

If the supply side of the economy is responsive, excess demand generated by the monetary sector may not be reflected on prices, it may then be reflected on the level of output. Because of subsistence level of farming, structural bottleneck and easy access to Indian market for the smooth supply of goods and services, the above case does not prevail in the Nepalese pretext. The growth in real GDP of 4.0 percent on an average directs towards the insufficiency of domestic supply situation to meet the demand generated by the rapidly growing population accentuated by expansive monetary and fiscal policies.

Increase in government expenditure can also exert inflationary pressure over the economy, particularly through deficit financing. However, as the impact of budget deficit on prices can be captured by the money supply variable, it is imperative to include aggregate expenditure as a factor for inflation. Government expenditure has a monetary implication through foreign aid or deficit financing or through crowding out effect on economic resources. However, expansionary aggregate demand policies tend to produce inflation unless they occur when the economy is at high levels of unemployment. In case of depression, expansionary policies may not produce inflation.

Cost-Push Theory

However, the cost-push theory emphasizes on the supply side and asserts that prices rise because of increased cost of production. The left upward movement of aggregate supply curve also pushes the price level up in the economy. Rise in wages, interest rates, and cost of raw materials can increase the cost of production generating price rise in the economy. Structural rigidities in the developing countries also raises the cost of production or creates a situation of supply irresponsive to market demand, pushing the price level up.

From the external front, depreciation or devaluation of the domestic currency has the similar effect as increase in cost. The change in the exchange rate not only affects prices of imported goods but also affects prices of domestic goods produced using imported raw materials and capital goods.

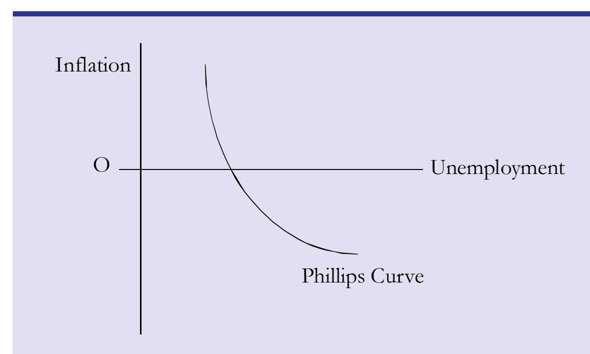
Phillips Curve Theory

The Phillips curve model shows trade-off between unemployment and money wages (prices): the lower the unemployment, the higher will be the wage. Since labour cost plays a significant role in cost of production, wage rise reflects a higher level of price. According to this theory, inflation is due to the declining level of unemployment.

The following figure presents a typical down ward sloping Phillips Curve showing that high rates of unemployment are accompanied by low rates of inflation and vice versa. The curve suggests that less unemployment can always be attained by incurring more inflation and that the inflation rate can always be reduced by incurring the costs of more unemployment. Hence there seems to be a trade off between inflation and unemployment.

However, the modern view suggests that in the long run the Phillips curve is almost vertical having no trade-off between unemployment and inflation, as such unemployment ultimately runs down to the national rate.

However this is hardly the situation in developing countries like Nepal where unemployment and underemployment are an ever lasting problem. Due to downward wage rigidity, the developing countries



like Nepal can have higher unemployment and higher inflation simultaneously. In other words, the developing countries generally face situation of stagflation.

Structural Theory

The structural theory of inflation suggests that structural bottlenecks or such characteristics existing in the economy are mainly responsible for inflation. This approach to the inflation argues that the nature of the inflation in the developing countries cannot adequately be determined with reference to the level of aggregate demand only.

This theory is especially relevant in the case of developing country like ours because there are many structural issues or rigidities in the economy such as lack of transportation, black marketing, artificial shortages of consumer items, subsistence level of production, existence of saving-investment gap and government regulation of prices. As a result, the economy continuously faces price rises due to the scarcity in supply.

Determinants of Inflation in Nepal

Economists in explaining the causes of inflation have come up with various theories and of them the demand side source of inflation has generated the theory of excess demand, (persistent excess in demand over supply) while the supply side source of inflation has given birth to the cost-push theory and the Phillips curve.

The excess demand theory as discussed above postulates that prices are prone to escalate when there is monetary expansion in excess of growth in real output. Based on the excess demand theory, inflation is viewed as the result of increase in aggregate demand either by monetary expansion or increase in government spending through deficit financing. Classical economists always argued that inflation is a monetary phenomenon, on the assumption of small government and full-employment level of output in the economy.

This argument is represented by the famous Quantity Theory of Money, according to which the relationship between money supply and prices can be established as:

$$MV = PY$$

Where ,

M = Quantity of money supply

P = Level of price

V= Income velocity

Y= Volume of real income

This theory asserts that the changes in money stock will cause changes in prices under the assumption that the volume of real income is determined independent of money stock. The income velocity and the volume of real income are assumed as constant in the short run. In other words V is stable, Y is at full employment level, hence P is directly proportional to quantity of money supply.

Based on this theory, a bivariate regression between price and money gives the following results.

$$dln(cpi) = 0.003 + 0.55\, dln(AM1) \quad \dots (1)$$
$$(0.11) \quad (2.59)^*$$

Adj R^2 = 0.16, DW = 1.56, F =6.7,
AIC =-3.40, SC =-3.31

$$dln(cpi) = 0.007 + 0.46\, dln(AM2) \quad \dots (2)$$
$$(0.17) \quad (2.06)^{**}$$

Adj R^2 = 0.098, DW = 1.60, F =4.3,
AIC =-3.33, SC =-3.24

t-statistics in parenthesis

* significant at 1 percent significant level

** significant at 5 percent significant level

where,

CPI = Consumer Price Index

AM1 = Average Narrow Money Supply

AM2 = Average Broad Money Supply

d = difference

ln = natural log

Equation (1) reveals that the coefficient of money supply is significant. The regression results indicate that among the two monetary aggregates, narrow money affects the inflation level more than broad money. One percent increase in narrow money may result in 0 .55 percent increase in the inflation level whereas one percent increase in broad money increases the level of inflation by 0.46 percent only. However, the explanatory of power of above equations is very low. The first equation explains only 16 percent variation in inflation while the second equation explains only 0.09 percent. Although this results may not be generalised, it at least indicates that in Nepal narrow money influences the level of inflation more than the broad money. The above specification of the price equation is in closed monetarist framework.

Aggregate demand may also be influenced by the increase in government expenditure too. As such, inclusion of total government expenditure as an

explanatory variable in the above model gives the following results.

$$dln(cpi) = -0.008 + 0.51\ dln\ (AM1) + 0.12\ dln\ (GEXP) \ldots (3)$$
$$(-0.23) \quad (2.35)^{**} \quad (0.98)$$

Adj R^2 = 0.16, DW = 1.72, F =3.8, AIC =-3.37, SC =-3.23

t-statistics in parenthesis

* significant at 1 percent significant level

** significant at 5 percent significant level

where,

CPI = Consumer Price Index

AM1 = Average Narrow Money Supply

GEXP = Total Government expenditure

d = Difference

ln = Natural log

Inclusion of government expenditure in the model has not changed the explanatory power of the model. Further, the coefficient of government expenditure is statistically insignificant.

Moreover, if the supply side of the economy is responsive to the aggregate demand, then the chance of price rise will be meagre. This however implies that excess demand generated by the monetary sector will not be reflected on the prices but it may be reflected on the level of output. In order to capture the supply side situation, change in price has been regressed with the growth of real GDP. The empirical result is shown as:

$$dln(cpi) = 0.084 + 0.01\ dln(RGDP) \quad \ldots (4)$$
$$(5.43) \quad (0.033)$$

Adj R^2 = 0.03 DW = 1.41, F = 0.00

t-statistics in parenthesis

* significant at 1 percent significant level

** significant at 5 percent significant level

where,

CPI = Consumer Price Index

RGDP = Real GDP growth

d = Difference

ln = Natural log

The above model shows a very poor fit

The very insignificant coefficient on real income shows that the domestic output has not been able to exert any pressure on prices. This reflects that in Nepal because of several factors such as subsistence level of farming with no price responsiveness, structural bottlenecks on the expansion of production in the short run and easy access to Indian market for the supply of goods and services, the real GDP has not been successful in meeting the demand generated in the economy. Any over production can be exported to India and any shortage of supply is fulfilled by importing from India.

Inflation in Nepal can be looked upon from both the demand and supply side simultaneously as inflation here is generally observed as the outcome of the interaction of several factors. Hence putting together all of the above mentioned explanatory variables in a single model and running a regression, we get the following results.

$$dln(cpi) = -0.007 + 0.51\ dln\ (AM1)$$
$$(-0.19) \quad (2.30)^{**}$$
$$+0.12\ dln\ (GEXP) - 0.02\ dln\ (RGDP) \ldots (5)$$
$$(0.95) \quad (-0.068)$$

Adj R^2 = 0.13, DW = 1.72, F =2.48, AIC =-3.30, SC =-3.12

t-statistics in parenthesis

* significant at 1 percent significant level

** significant at 5 percent significant level

where,

CPI = Consumer Price Index

AM1 = Average Narrow Money Supply

GEXP = Total Government expenditure

RGDP = Real GDP

d = Difference

ln = Natural log

The explanatory power of the model has not changed significantly even after combining the variables together. Except, for money supply, coefficients of all the other variables have been found statistically insignificant though they have the theoretically expected sign.

The above models are however a 'closed economy monetarist' type od model in which only indigenous variables are responsible for inflation.

The foregoing analysis has indicated that indigenous factors of inflation have not been able to fully explain the behaviour of prices in Nepal. Given the pegged nature of the exchange rate with Indian currency since 1960, external prices and the exchange rate together can generate both the demand-pull and cost-push types of inflation. Since Nepal has to import industrial raw materials and capital goods, inflation in Nepal can highly be influenced by the external shocks, particularly by the Indian prices. Although the initial effect of external prices falls on the traded goods, it may also be transmitted to the non-traded goods later on.

As such, inclusion of Indian prices may be more relevant in analyzing the behaviour of prices in Nepal.

Indian prices exert an impact on the Nepalese prices in two ways. First, change in prices in India leads to a change in the import prices of both consumer goods and capital goods as well as industrial raw materials. Second, when prices in India are high, Nepalese goods get their ways to India creating supply shortages and eventually raising the prices in Nepal (IDS, 1994). Actually, "law of one price" tends to exist between Nepal and India because of open border and close as well as big trading partner.

The following equation regressed with only money supply and Indian wholesale price as the explanatory variable, gives the estimation as:

dln(cpi)) = -0.015 + 0.43dln(am1) + 0.45dln(WPI)... (6)
(-0.52) (2.39)** (3.76)*

Adj. R2 = 0.39, DW = 1.80, F =10.35*,
AIC = -3.79, SC =-3.65

t-statistics in parenthesis
* significant 1 percent significant level
** significant 5 percent significant level

Inclusion of Indian wholesale price as an explanatory variable has improved the explanatory power of the model from 16 percent to 39 percent. AIC and SC, with the lowest value so far seems also to have favoured this model.

Another external factor that may have an impact on the domestic prices is changes in the exchange rate of the domestic currency vis- a- vis the currencies of the trading partners. In fact depreciation of the domestic currency exerts a similar shock on the domestic price as the increase in the foreign price in foreign country

Nepal has devalued the Nepalese rupees time and again. Since Nepal's manufacturing goods are based on imported raw materials and capital goods, the depreciation or devaluation of the Nepalese rupees is likely to affect prices through cost-push factor. As such it becomes imperative that exchange rate be also included as one of the explanatory variable in the estimating equation.

The following equations (7) and (8) have been estimated including exchange rate of Nepalese rupee with Indian currency and that with the US dollar respectively as explanatory variable. The results are as follows:

dln(cpi)) = -0.009 + 0.37dln (am1)
(-0.36) (2.13)**
+ 0.49dln (WPI) + 0.47dln (XIC) ... (7)
(4.25)* (2.17)**

Adj. R2 = 0.47, DW = 1.64, F =9.41*,
AIC = -3.88, SC =-3.70

t-statistics in parenthesis
* significant 1 percent significant level
** significant 5 percent significant level

dln(cpi)) = -0.014 + 0.44dln(am1)
(-0.49) (2.36)**
+ 0.46dln(WPI) - 0.01dln(XUS $) ... (8)
(3.68)* (-0.20)

Adj. R2 = 0.36, DW = 1.75, F =6.66*,
AIC = -3.72, SC =-3.54

t-statistics in parenthesis
* significant 1 percent significant level
** significant 5 percent significant level

The coefficient of exchange rate with the Indian currency (equation 7) possess the expected sign and is statistically significant whereas that with the US dollar (equation 8) is statistically not significant and is with theoretically wrong sign thereby reflecting the importance of the Nepalese exchange rate with Indian currency. Thus, this supports the argument for the pegged exchange rate with the Indian currency. Any change in NC-IC exchange rate among others, affects the price in Nepal significantly.

Further to the above analysis, a general model of the following type including wholesale price Index of India and exchange rate with the Indian rupees as the explanatory variable has been estimated

$dln(cpi) = a_0 + a1 dln(am1) + a2 dln(GEXP) + a3 dln(RGDP) + a4 dln(WPI) + a5 dln(XIC)$

Here: a1>0, a2>0, a3<0, a4>0, a5>0

where,

CPI = Consumer Price Index
AM1 = Average Narrow money supply
GEXP = Government expenditure
RGDP = Real Gross Domestic Product
WPI = Wholesale Price Index lagged of six month
XIC = Exchange rate NRs/IC
ln = natural log
d = difference

The estimating equation gives the following results

dln(cpi)) = -0.003 +0.37dln(am1) -0.003dln(GEXP)
(-0.085) (2.09)** (-0.027)
-0.21dln(RGDP) +0.50dln(WPI) +0.47dln(XIC) ..(9)
(-0.91) (4.12)* (2.16)**

Adj. R^2 = 0.44, DW = 1.55, F = 5.56*,
AIC = -3.79, SC =-3.51

t-statistics in parenthesis
* significant 1 percent significant level
** significant 5 percent significant level

The explanatory power of the above equation is 44 percent.

Except for the coefficient of government expenditure, all the other coefficients have the expected signs. The coefficients of average money supply, wholesale price of India and exchange rate with Indian currency have been found to be statistically significant indicating that these are the most important determinants of inflation in Nepal. Although government expenditure does not seem to be influencing the price level directly, its indirect effects through the monetary expansion cannot be ruled out.

The insignificant coefficient on real income on the other hand shows that the domestic output has not been successful in exerting significant effect on prices. The coefficient on money supply indicates that each ten percent change in money supply causes 3.7 percent change in the rate of inflation in Nepal.

The above equation is estimated also including one year lag value of narrow money and we get the following results

dln(CPI)= 0.07 + 0.44dln(am1)– 0.16dln(am1(-1))
(0.22) (2.13)** (-0.66)
–0.01dln(GEXP)–0.19dln(RGDP)+0.55dln(WPI)
(-0.10) (-0.80) (3.82)*
+0.44 dln (XIC) ... (10)
(1.90)**

Adj. R^2 = 0.43, DW = 1.63, F = 5.56*,
AIC = -3.74, SC =-3.41

* Significant at 1 percent level
** Significant at 5 percent level
*** Significant at 10 percent level

Including the lag of narrow money has not improved the explanatory power of the model at all and the coefficient of lag value of average money supply is also observed to be insignificant. Furthermore, including the inflationary expectation in the model and excluding the insignificant variables from the above model, we get the following results.

dln(CPI) = -0.014+ 0.35dlag(am1)+0.46 dlag(WPI)
(-0.50) (2.00)*** (3.60)*
+0.51 lag(XIC)+0.098 lag (CPI(-1)) ... (11)
(2.23)** (0.64)

Adj. R^2 = 0.43, DW = 1.63, F = 5.56*,
AIC = -3.74, SC =-3.41

* Significant at 1 percent level
** Significant at 5 percent level
*** Significant at 10 percent level

In this equation also, the coefficient on money supply and Indian WPI are found to be significant, but the coefficient on inflationary expectation is not statistically significant. Hence, expectation of price rise does not bear any statistical significance on the current level of price. It also reflects lack of dynamism in the economy (equation 11)

Finally, dropping the insignificant variables like government expenditure, real GDP, inflationary expectation, and lag value of money supply from the above model and estimating the equation we get the following results.

dln(cpi)) = -0.009 + 0.37dln(am1) + 0.50dln(WPI)
(-0.362) (2.13)** (4.25)*
+ 0.46dln(XIC) ... (12)
(2.16)**

Adj. R^2 = 0.47, DW = 1.64, F = 9.41*,
AIC = -3.89, SC =-3.70

t-statistics in parenthesis
* significant 1 percent significant level
** significant 5 percent significant level

The explanatory power of the model has increased to 47 percent. All coefficients are significant and have the expected sign (equation 12). The model however suggests that 53 percent of the change in inflation level still remains to be explained.

This suggests that besides the quantitative factors, there are several qualitative factors that affect the prices in Nepal. The effects of administered prices, supply bottleneck due to market imperfection, underdeveloped transportation and communication network as well as artificial shortage are some of them. Moreover, the country has fragmented markets and pocket economics, because of which the surplus supply pocket may be exporting essential supplies to India and the deficit pockets may be importing the same from India at higher prices, thereby inviting inflation into the economy.

In addition, excessive government intervention in economic activities, now and then, and regulation of the economy in the past have also contributed to the distortion of price in the market. Controlled trade and dual foreign exchange rate regime in the past had often created monopoly in the imports of goods and services. As a result, the determination of market prices relied on the discretion of the monopolists. The inefficiency of a large number of public enterprises, involved in acquiring and distributing essential commodities in the country, is also highly

responsible for aggravating the inflationary pressure in Nepal. In addition, frequent upward revision of administered prices has also been equally contributing to the price rise in Nepal.

Stationarity, Co-integration Test, and Error Correction Model

Stationarity Test (Unit Root Test)

The practice of exploiting information contained in the current deviation from an equilibrium relationship, in explaining the path of a variable, has benefited from the concept of co-integration propounded by Granger,1986 and Engle and Granger,1987.

A series that is tending to grow over time cannot be stationary (although it may possibly be stationary around some deterministic trend), but the changes in that series might be stationary. In the long run, two or more series can move closely together and the difference between them can be constant even when the series themselves are trended. A series is said to be integrated of order d, denoted as I (d), if it has to be differenced d times before it becomes stationary (Engle and Granger, 1987). A stationary time series has a time independent mean i.e. a constant mean and is homoscedastic. It is observed that most economic variables are non-stationary and they follow a random walk (Granger, 1986). A non-stationary series within the framework of ordinary least square (OLS) estimation violates its basic assumption and as such one cannot get the best unbiased linear estimates (BLUE). According to Phillips (1986), the asymptotic theory within a non-stationary process is completely different from that with a stationary process. However, even if there exists a spurious correlation between non-stationary variables, the basic statistical test may still be significant, though it still violates the BLUE property (Grange and Newbold, 1974). There are no limiting distribution for t-ratios for regressions between I (1) variables, R^2 has a non-degenerate limiting distribution and the Durbin Watson statistic tends to converge towards zero. To establish the existence or non-existence of a long run equilibrium relationship between two economic time series x and y, we must first test whether 'x' and 'y' variables are integrated to the same order. Stationarity test of these variables reveals the order of integration following the Augmented Dickey Fuller test (Dickey & Fuller, 1981). If both variables are I(1), then the test for co-integration can be performed by using residuals of OLS estimates (Graph 1).

In other terms, time series data need to be tested for stationary, because if the estimating equation is having non- stationary variables then it may give rise to spurious relationship and lead to incorrect statistical inferences.

The graph of the variables (level) in the model reflect non-stationarity situation (graph.1.) indicating that the variables must have a unit root. Therefore, unit root test with a view to identifying the order of integration of the selected time series is performed. The selected method for the unit root test is the Augmented Dickey Fuller (ADF) test.

The results of the ADF is presented in Table 2.

Table 2
Unit Root Test

Variables	ADF Text	Mackinnon Critical Value		
		1%	5%	10%
Log(CPI)	-0.92	-3.67	-2.96	-2.62
dlog(CPI)	-4.24*	-3.68	-2.97	-2.62
log(AM1)	-0.58	-3.67	-2.96	-2.62
dlog(AM1)	-3.57*	-3.68	-2.97	-2.62
log(RGDP)	0.44	-3.67	-2.96	-2.62
dlog(RGDP)	-5.31	-3.68	-2.97	-2.62
log(GEXP)	-2.89***	-3.67	-2.96	-2.62
dlog(GEXP)	-3.01**	-3.68	-2.97	-2.62
log(WPI)	-0.27	-3.68	-2.97	-2.62
dlog(WPI)	-4.37*	-3.69	-2.97	-2.62
log(XIC)	-1.66	-3.67	-2.97	-2.66
dlog(XIC)	-3.68*	-3.68	-2.97	-2.62

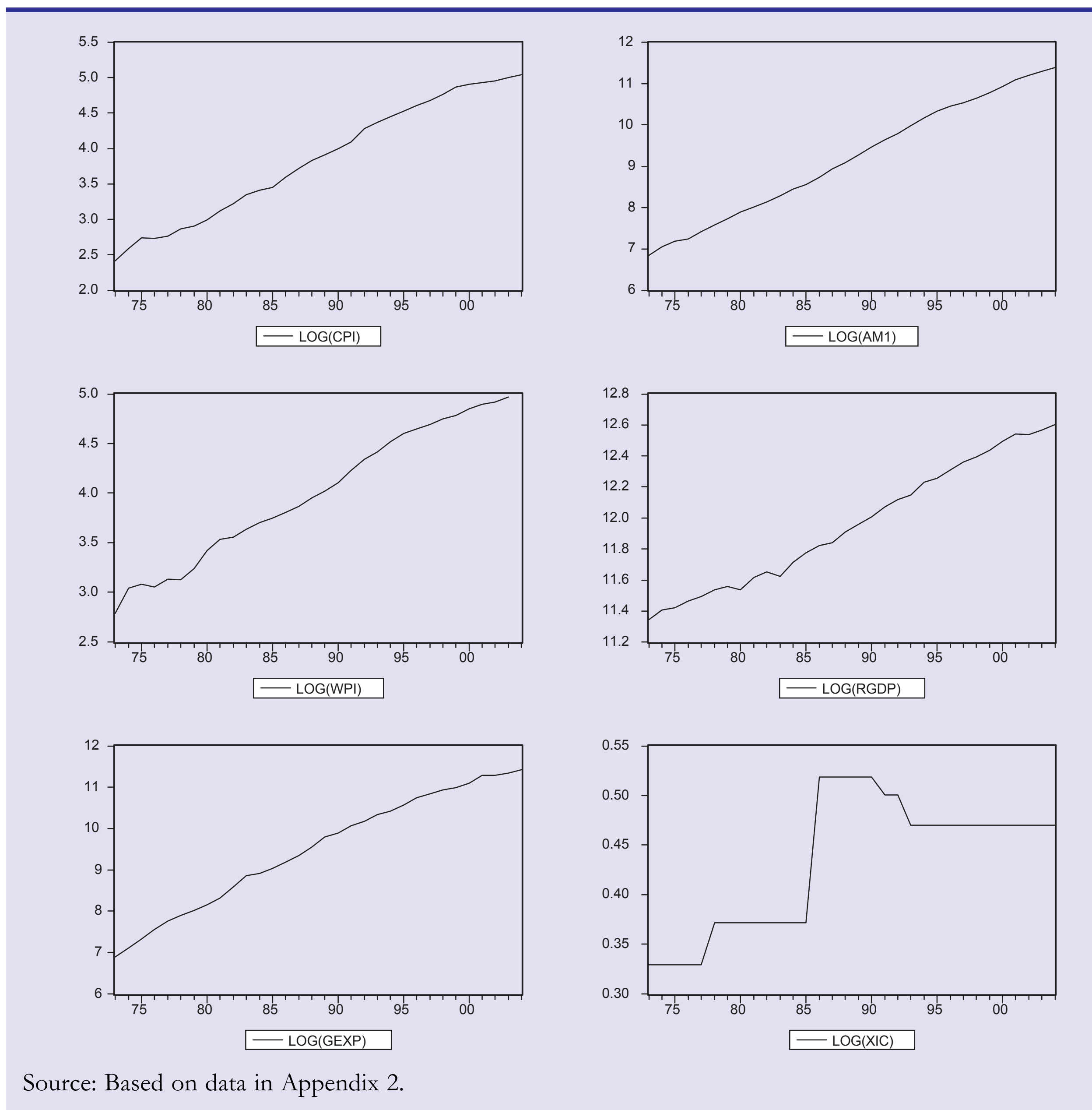
* = significance at 1 percent level
** = significance at 5 percent level
*** = significance at 10 percent level

The results of ADF test show that time series data (level) are not stationary but the first difference of the series are however found to be stationary. As such, the above OLS estimates have been done in first difference of the time series. The ADF test also reveals that the time series data are integrated of order I(1), as such, hence, we can move towards performing the co-integration test. Although the data in level are non-stationary, they can have co-integrating relation.

Co-integration Test

Cointegration test shows the long run relationship between the variables under consideration. Two time series are said to be co-integrated of order d,b denoted I(d b) if they both are integrated of order d but there exists some linear combination of them that is integrated of order b<d (Engle and Granger, 1987).

Graph 1
Data in Level



Source: Based on data in Appendix 2.

As seen in table 2, the variables under consideration are stationary only in the first difference. As such, we can perform the co-integration test among these variables (level). If the variables are co-integrated, the residual of the following model should be stationary.

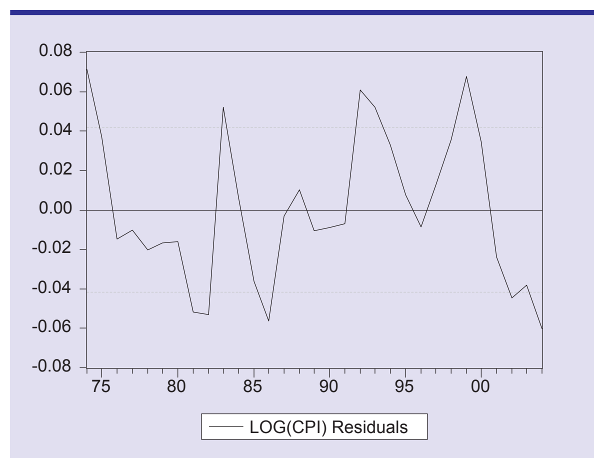
$$\ln(cpi)) = a_0 + a1\ln(am1)+a2\ln(GEXP) +a3\ \ln(RGDP) +a4\ln(WPI) +a5\ln(XIC)+ e \quad \ldots(13)$$

Empirical results of equation (10) is as follows.

$$\ln(CPI) = -4.5 + 0.1\ \ln(am1)-0.02\ \ln(GEXP)$$
$$(-1.57) \quad (1.25) \quad (-0.22)$$
$$+0.34\ \ln(RGDP)+0.64\ \ln(WPI)+0.63\ \ln(XIC) \quad \ldots(14)$$
$$(1.14) \quad (3.67) \quad (2.63)$$

Adj R^2 = -0.99 dw = 0.87

Graph 2
Movement of Residuals



The graph 2 of residual and the following ADF test of residual confirm that residual of the model shown in equation (10) is stationary at 5 percent level of significance. Hence, It can now be inferred that variables under consideration are co-integrated to each other. As such, inflation in Nepal is seen to have a long run relationship with money, Indian price, government expenditure, domestic production and change in the exchange rate with Indian currency.

Table 3
ADF Test on Residuals

ADF Test Statistic	-3.550009	1% Critical Value*	-3.6752
		5% Critical Value	-2.9665
		10% Critical Value	-2.6220

* MacKinnon critical values for rejection of hypothesis of a unit root.

Error Correction Model (ECM)

In economics controlled experiments are not possible. Variables are stochastic and much of the data consists of non-stationary time series as found above, as such we can't rely on the standard regression procedure (OLS). As the variables are non-stationary, the OLS estimators have sampling distribution with properties very different from what we know so far. OLS estimation in non-stationary variables produces spurious result while estimation in first difference looses the long run relationship among the variables. Hence, ECM is a modelling technique that captures both long run relationship and short run dynamics. A major advantage of error-correction model is that they result in equation with first differenced and hence stationary dependent variable but avoid the problem of losing long run information on data. ECM reveals both short-term relationship and the adjustment toward the long run equilibrium. Hence, the ECM model is formulated as follows.

$$Dln(CPI) = b_o+b_1 fDln(X)+b_3e_{t-1}+d_t \quad \dots (15)$$

where X is a set of explanatory variables

More specifically, the following ECM model is estimated.

$$Dln(CPI) = b_o+b_1Dln(am1)+b_2Dln(GEXP)+b_3Dln(RGDP) +b_4Dln(WPI)+b_5Dln(XIC)+b_6e_{t-1}+d_t \dots (15a)$$

Empirical results of above ECM model is shown in equation (16)

$$\begin{aligned} Dln(CPI) = &\ 0.02 + 0.43Dln(am1) - 0.03Dln(GEXP) \\ &(-0.70) \quad (2.64)^* \quad (-0.37) \\ &-0.005+Dln(RGDP)+0.59Dln(WPI) \\ &(-0.02) \quad (5.07)^* \\ &+0.71Dln(XIC)-0.45e_{t-1} \quad \dots (16) \\ &(-2.47)^* \quad (1.58) \end{aligned}$$

$AdjR^2 = 54$, DW = 1.45, F = 6.63*

The coefficient of error term is found to be statistically significant and the value of coefficient implies that 0.45 percent of disequilibrium in CPI in any one year is made up within the next year.

Inflation Controlling Measures

Inflation, like unemployment, is a major macroeconomic concern. However, the costs of inflation are much less obvious than those of unemployment. But consumers dislike inflation because it is often associated with disturbances, such as the oil price shock that reduce their real income. It is also argued that inflation upsets familiar price relationships and reduces the efficiency of the price system.

Although some economists argue that a mild inflation is desirable for economic growth, inflationary situation is not preferred in general. It actually creates macroeconomic instability and distorts resources allocation in the economy. More importantly, inflation aggravates the poverty by increasing inequality and lowering the purchasing power of money. It also brings uncertainty in the economy distorting both savings and investment decisions. Hence, price stability has been the major concern of monetary policy in Nepal. Price stability implies the low and stable level of inflation in the economy.

The determinants of inflation identified above set the direction in finding the measures to contain inflation in the economy. It has been found that inflation in Nepal is influenced by both the demand

and supply side factors. Hence, there should be a policy mix to combat inflationary situation in Nepal.

The econometric study revealed that money supply is a significant factor in determining the inflation in the Nepalese economy. As such, to avoid an inflationary situation in the economy, money supply should be regulated according to its demand. However, without the support of the monetary policy, inflation cannot last long; hence, monetary policy should be geared toward achieving price stability in the economy.

Another measure could be the fiscal consolidation for containing inflation. The government should control the monetization of budget deficit. It has been a well-established fact that increasing the government expenditure could crowd out the private sector investment thereby increasing the inflationary pressure in the economy. Moreover, deficit financing through overdraft from the central bank is highly inflationary. In Nepal, however, Nepal Rastra Bank Act 2058 has imposed a limit on the overdraft amount that the government can utilise at a time.

Given the pegged nature of exchange rate system with the Indian currency, inflation in Nepal is directly influenced by the Indian prices. In the recent years, the Indian economy, while growing at a higher rate, is also maintaining price stability. As such, inflation in Nepal has been comfortable benefiting from such a situation in India. In fact, the pegged exchange rate system with the Indian currency has been contributing in maintaining price stability in Nepal so far. However, with more financial sector liberalisation in days to come, especially after capital account is made fully convertible, the Nepalese exchange rate system with Indian currency needs to be more flexible. This calls for a proactive monetary policy in Nepal.

Besides the main determinants, inflation in Nepal has also been found to be affected by qualitative factors like the effects of administered prices, supply bottleneck due to market imperfection, underdeveloped transportation and communication network as well as artificial shortages. Going through the history of inflationary situation in the country, as it has been observed, increment of the domestic prices has, in one way or the other, been associated with structural bottlenecks (Mathema, 1994). As such, concrete policy must be pursued to ensure an effective management of the supply of essential goods in the economy.

Concluding Remark

A review of price movement during the period 1973 to 2004 revealed that inflation in Nepal stood at an average of 9.0 percent with a standard deviation of 5.0 percent. Out of a period of 33 years under review, 12 years witnessed the double digits inflation. Only in one-year (1995/76), inflation was found to be negative. Cumulative inflation has been more than 288 percent between 1973 and 2004.

An econometric analysis in identifying the causes of inflation in Nepal revealed that domestic prices are influenced by both the monetary and structural factors. Empirical results confirm that Indian prices, money supply and exchange rate changes are the most significant determinants of inflation in Nepal. Moreover, inflation in Nepal has long run relationship with money supply, Indian WPI, government expenditure, real GDP, and exchange rate. Further, the significant coefficient of error correction term establishes the fact that the long run effects are being felt after the period of one year and about 45 percent of any disequilibrium in CPI in any one year is being made up within the next year.

It has been noted that the conventional measures of price by consumer price index (CPI) cannot however, isolate the supply shock effect on the price movement with which monetary policy has negligible relationship. For the accountability and credibility of the monetary policy with regard to price stability objective, there should be a measurement of core inflation, eliminating distortionary effects of supply shocks (Shrestha, 2002). With the further liberalization of the economy and the adoption of capital account convertibility, Nepal needs to adopt a flexible exchange rate regime. Hence, monetary policy needs to set a single goal of price stability, adopting inflation targeting regime.

So long as the controlling the inflation is concerned, it becomes imperative to devise both demand and supply management policies in Nepal. The growth of money supply should be managed properly. Since money supply in Nepal is highly influenced by the net foreign assets (NFA), sterilization through effective open market operation is very vital in managing money supply in Nepal. To further mitigate the possible spill over impacts from the change in Indian price, it would be a wise idea to have an effective supply management system such as maintaining buffer stocks and monitoring the price of non-tradable goods.

Endnotes

[1] The GDP deflator is the ratio of nominal GDP in a given year to real GDP of that year. The deflator measures the change in prices that has occurred between the base year and the current year. Since the GDP deflator is based on a calculation involving all the goods produced in the economy, it is a widely based price index that is frequently used to measure inflation.

The consumer price index (CPI) measures the cost of buying a fixed basket of goods and services representative of the purchases of urban consumers. The CPI differs from the GDP deflator in the following main ways:

(i) The deflator measures the prices of a much wider group of goods than the CPI does.
(ii) The CPI measures the cost of a given basket of goods, which is the same from year to year. While the basket of goods included in the GDP deflator, however differs from year to year, depending what is produced in the economy in each year.
(iii) The CPI directly includes prices of imports, whereas the deflator includes only prices of goods produced in the country.

[2] Inflation data for the first two years of 1960s were un-weighted price index for Kathmandu and for the remaining period, it was weighted price index for Kathmandu complied by CBS.

[3] *As said earlier, weighted national urban price index is available since 1972/73. Obviously, it is more reliable than the previous un-weighted price index and weighted price index for Kathmandu.*

[4] The overall budget deficit (before grants) increased from an average of 5.9 percent of GDP during 1976/77-1980/81 to 10.3 percent during 1981/82-1985/86.

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Currency Management

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Background

The beginning of the monetary system in Nepal may be traced to the issue of the "manank" coins minted during the Lichhivi period, although those coins did not have a definite shape, weight and size. It was only from the reign of King Mahendra Malla that minting of copper coins with definite shape, size and weight started. The first silver coins in Nepal, known as "daam", came into circulation during the reign of King Sadashivadeva. In the Malla period, the expansion of Nepal's external trade with Tibet promoted the circulation of the Nepalese coins both in Nepal and the Tibet. Standardization of coins started from the reign of His Majesty Prithivi Narayan Shah. Thereafter, the golden "asarfi" came into circulation during the reign of King Rana Bahadur Shah.

Paper money came into circulation in India from 1861 onwards. As a consequence of this and the development of railways in the Indo-Nepal border areas, trade with India started growing. Inability of the Nepali metal currency to cater the growing demand for money arising from increased commercial transactions between Nepal and India forced public to use Indian currency as the medium of transactions in Nepal. An effort was made to increase the supply of Nepali coins by establishing a mint at Sundhara in 1930. But Nepal's monetary system took a quantum jump only after the Sadar Mulukikhana Adda (Government Treasury) started issuing Nepali currency notes in 1945. In short, it may be said that, the development of metal currency in Nepal started with the growth in Nepal-Tibet trade, and that of paper currency with the progressive expansion in Indo-Nepal trade.

Prior to the establishment of the NRB in 1956, the task of issuing and management of the Nepalese currency was performed by the Sadar Mulukikhana, albeit, on a small scale. Sadar Mulukikhana had issued a total of Rs. 54.9 million from September 17, 1945 onwards of which, notes of Rs. 39.7 million were in circulation as of mid- July 15, 1957. Those days, dual currency system existed in the country. The circulation of Nepalese currency was limited to the Kathmandu Valley and some hilly areas. Most of the government transactions including revenue and expenditures were carried out and the bank accounts maintained in Indian currency. Due to dominance of Indian currency the demand for the Nepalese currency was relatively low. The exchange rate of the Nepalese currency vis-à-vis the Indian currency was highly unstable. Banking activities were also confined to a few cities. These factors placed Rastra Bank in a difficult position to formulate and implement independent monetary policy effectively.

There was a need to promote circulation of the Nepalese currency in place of the Indian currency in

accordance with the demand of the economy on the one hand and to monetize the non-monetized sector on the other. It was indeed very difficult to establish the Nepalese currency as the national currency unless the confidence of the general public was build up on it. The limited distribution system of the Nepalese currency and easy availability of the Indian currency made the task of adequate supply of the Nepalese currency more challenging. Against this environment, the Nepal Rastra Bank was established on April 26, 1956 as the country's central bank with the sole authority to make necessary arrangements for managing the issue and circulation of the Nepalese currency.

Nepal Rastra Bank, right from its inception, concentrated all its efforts on establishing the Nepalese rupee as the only legally acceptable currency by gradually dislodging the Indian rupee all over the Kingdom. Rastra Bank took initiative to make necessary arrangements for exchanging Nepalese and Indian currencies, collecting governmental revenue in Nepalese currency and for minimizing minting of coins. With a view to support these initiatives the Nepalese Currency Circulation Act, 1958 and the Foreign Exchange Regulation Act, 1963 were enacted.

In order to ease the supply of the Nepalese currency and provide the exchange facility for Indian currency to the public, Rastra Bank opened exchange counters, mobile counters and depots in addition to branches and sub-branches. With this infrastructure in place, the exchange rate for 100 Indian Rupees was pegged for the first time at Rs. 160 with effect from April 13, 1960 for maintaining stability between the Nepalese and Indian currencies.

Confidence of the Nepalese people on Nepalese currency was building up gradually and therefore, the Nepalese currency was made the only legal currency all over the Kingdom by 1967. Rastra Bank had to make a Herculean effort for nearly one decade of its establishment to accomplish this success.

In most of the remote hills and rural areas of the kingdom, it was not possible to promote the circulation of the Nepalese currency just through a few branches of the Nepal Rastra Bank and Nepal Bank Limited at desired level. Therefore, in 1966, the Rastriya Banijya Bank was established as the second commercial bank under state ownership with major responsibility of conducting governmental transactions. The expansion of Rastriya Banijya Bank's branch network greatly helped in cultivating banking habit among the general public, enhancing the circulation of the Nepalese currency and monetizing the economy. Besides, the Currency Chests were established in all the districts of the Kingdom that helped simplifying and expediting the process of revenue collection and payment. Even to date, these Currency Chests have been serving as the major channels for supplying the Nepalese currency.

Over the time, management of currency notes by the Rastra Bank has been more systematic and a continuous effort is being made on modernization and mechanization of currency management. Initially, the notes in plain paper with a watermark as the only security feature were printed in Nasik (India). Those notes have gradually been replaced by notes printed from naturally produced cotton rag / combers and polymer substrate (plastic) that contained the world's ultra-modern security features. Similarly, the destruction and fund transfer of currency notes have gone through immense modernization and the counting, sorting and verification of notes have been mechanized.

The currency management function of the Nepal Rastra Bank has centred on assisting the implementation of the monetary policy, fostering financial deepening, monetization, and simplification of the payment system.

The currency management is not only important but also complex. It is not merely printing and issue of notes. Apart from being an extremely sensitive issue, it has extensive perimeters. In general terms, currency management implies printing, issue, supply, and destruction of notes. However, in broad terms, it embodies numerous tasks including: correct assessment of the demand and supply situation of notes in the economy; arrangements for designing, printing, verification and reserve / security, and issue and distribution of notes; operation of the Currency Chest; counting and sorting of notes; fund transfer; exchange and reimbursement; and destruction of notes. These tasks can be grouped into three categories: policy, technical and procedural. The policy aspect encompasses tasks like assessment of demands for notes of different denominations; determination of the quantity of notes to be printed; increasing/ decreasing the denominations of notes; making arrangements for security/reserves, whereas the

technical aspect includes designing of notes; quality of paper; security features and other specifications. The tasks that begin from issue of notes to their destructions fall under the procedural aspect.

Legal Provisions Relating to Nepalese Currency Management: Nepal Rastra Bank Act, 2002

Section 2. Definition

(i) **"Currency note"** means the bank note in circulation in the form of cash and the word also includes coins.

(k**) "Nepalese currency"** means the currency of Nepalese rupee denominations .

Section 5. Functions, Duties and Powers of Bank

(a) To issue bank notes and coins.

Section 8. Privileges and Facilities to Bank

(d) There would be no tax, fee, charge, duty on the export and import of bank notes, coins, gold, silver and the paper, metal, chemicals, and other materials to be used for printing bank notes and minting coins.

Section 29. Functions, Duties and Powers of Board

(b) To take necessary decisions with regard to the denominations of bank notes and coins, the figures, size, metal, materials for printing notes, and other materials; and to frame appropriate policies with regard to their issue.

Section 51. Monetary Unit

(1) The **Rupee** shall be the monetary unit of the Kingdom of Nepal and such Rupee shall be divided in one hundred **Paisa.**

(2) The Rupee referred to in sub-section (1) shall be a legal tender within the Kingdom of Nepal and His Majesty's Government shall provide guarantee for such Rupee.

Section 52. Power to issue Bank Notes and Coins

(1) The Bank shall have monopoly over the issue of bank notes and coins in the Kingdom of Nepal. Such notes and coins shall be legal tenders in the Kingdom of Nepal.

(2) The Bank shall issue notes pursuant to sub-section 1(1), only against the security, and the liability of such issued notes shall be equal to the value of property kept as security. At least fifty percent of the property to be kept as security shall be one or more of gold, silver, foreign currency, foreign securities, and foreign bills of exchange and the remaining percentage shall be one or more of the coins (Mohar Double or coins of higher denomination, the debt bond issued by His Majesty's Government, the promissory note or bills of exchange payable in Nepal within a maximum of eighteen months from the date of repayment by bank.

Provided that in case His Majesty's Government so permits, at least forty percent of the assets to be maintained as backing for the note issue may be in the form of one or more forms among gold, silver, foreign currencies, foreign securities and foreign bills of exchange, and the balance in the form of one or more from among Nepalese coins (Mohar rupee, or coins of higher denominations), Nepalese securities, promissory notes or bills of exchange refinanced by Nepal Rastra Bank which are due to be redeemed inside Nepal within a maximum period of eighteen months.

(3) For the purpose of sub-section (2), the valuation of property shall be made as follows: -

(a) The price of gold at the rate fixed by his Majesty's Government on the recommendation of the Board;

(b) The price of silver at the rate deemed appropriate by the Board;

(c) The foreign currencies at the rate fixed by the bank;

(d) The debt bond issued by His Majesty's Government, the foreign securities and bills of exchange at the rate deemed appropriate by the Board on the basis of market rates;

(e) Coins at the rate of face value.

(4) The Bank shall issue the bank notes of various denominations as may be necessary. While issuing bank notes in this way, the figures appearing in the notes, size and denominations shall be as approved by His Majesty's Government and the figures, internal security arrangements, invisible security features, the materials for printing bank notes and other materials shall be as decided by the Board.

(5) His Majesty's Government may, in consultation with the Board, declare that banknote of any denomination shall cease to be legal tender in any place other than the prescribed place or office having published a notification in the Nepal Gazette.

(6) The Bank shall not reissue the notes, which are torn, defaced or excessively soiled.

(9) The Bank shall be responsible for payment of the bank notes issued by the Bank and the notes

issued by His Majesty's Government prior to the establishment of the Bank.

(10) No liability other then the liability referred to in sub-section (9) shall be borne from the property given as security for issuance of bank notes.

Section 53. Bank-notes and Coins to be all Acceptable

The bank notes and coins issued by the Bank having made them legal tender shall be all acceptable to the extent of the amount of face value for repayment of all types of public or private debts within the Kingdom of Nepal.

Section 55. Issuance of Currency and Security

Matters relating to printing of bank notes and minting coins, providing security to the unissued banknotes and coins, keeping them in appropriate manner and the matter of safe keeping or destroying the old banknotes or coins, plate and dies not in circulation shall be as prescribed.

Section 56. Provisions for Exchange of Currency:

The Bank shall, without any fee or charge, change a bank note or coin with legal tender in the Kingdom of Nepal with the banknotes or coins of same denomination or of different denominations of the equal value.

Section 57. Soiled or Counterfeit Currency

(1) The Bank may withdraw, destroy or replace the soiled currency with other bank note or coin.

(2) Notwithstanding anything contained in sub-section (1), the Bank may deny to replace banknote or coin the design of which has been deleted, or torn, defaced or more then fifty percent of its portion has been destroyed.

(3) The Bank may withdraw or destroy such bank notes or with or without compensation to the owner of the bank notes or coins referred to in sub-section (1).

(4) No owner of the lost or stolen bank notes or coins shall be entitled to a reimbursement from the Bank. The Bank may forfeit without any compensation, the coins or notes the outer appearance of which is changed, or which is counterfeit coin or fake note.

Section 58. Provisions Relating to Currency Inventory and Issuance of Currency

The Bank shall carry out the functions relating currency inventory and issue of currency and to regularly supply the banknotes or coins in order to meet the demand of currency.

Section 59. Account of Issued Currency

The Bank shall maintain account of the entire bank notes and coins in circulation showing them separately as monetary liability. Such liability shall not include the bank notes and coins in stock or not in circulation.

Section 60. Currency Recall

(1) The Bank may recall the bank notes and coins in circulation within the Kingdom of Nepal by issuing in exchange therefor other bank notes and coins in equivalent amount. The Bank shall publish and transmit public notice clearly specifying the period during which the bank notes or coins must be presented for exchange and where they are to be so presented.

(2) Notwithstanding anything contained in section 53, upon expiry of the time prescribed pursuant to sub-section (1), bank notes and coins to be exchanged shall cease to be legal tender.

(3) The Bank may demolish, cut, break, or destroy in any manner whatsoever, the banknotes and coins withdrawn from circulation pursuant to sub-section (1) and the currency with defect, as prescribed.

Section 61. Reproduction and Counterfeiting of Currency

(1) No person shall commit or cause to commit any of the following acts: -

(a) To forge, counterfeit or alter bank notes and coin in circulation as legal tender in the Kingdom of Nepal or any cheques or payment card or to do any other act relating to it or to assist in any of such acts;

(b) To possess, transport or issue any bank note or coin or cheque or payment card with the knowledge that such bank note or coin, cheque or payment card was falsely made, forged, counterfeited or altered or to assist in such acts in any manner; or

(c) To possess, transport any sheet of metal, stone, paper, die or any other material or substance with the knowledge that it was destined to be used in falsely making, forging, counterfeiting or altering any bank note or coin, cheque or payment card or to assist in any of such acts.

(2) Any reproduction of bank notes, coins, checks, securities or payment cards, denominated in Nepalese Rupees, and the creation of any objects that by their design imitate any such bank note,

coin, check, security or payment card, shall require the prior written authorization of the Bank.

(3) The Bank may take appropriate action to prevent the issue of fake note or counterfeit currency or duplicate cheque or payment. The Bank may issue necessary order, directives or notices while taking such actions.

Chronology of Note Issue

The Sadar Mulukikhana issued, for the first time notes of Rs. 5, 10 and 100 denominations on September 17, 1945. These notes had the signature of Treasurer Janak Raj Pandey. The Re.1 denomination notes were issued, for the first time, in 1952 during the tenure of Treasurer Narendra Raj Pandey.

Nepal Rastra Bank on its own started printing and issuing notes from February 19, 1960. It was this day that the Bank had issued notes of the already existing four denominations (Re.1, Rs. 5, 10 and 100) bearing the signature of the first Governor Himalaya Sumsher J.B.R. Over the twelve different Governor's tenures notes of new denominations were issued. Currently notes of eleven denominations are in circulation, including Re.1, Rs. 2, 5, 10, 20, 25, 50, 100, 250, 500 and 1000. Notes issued after the establishment of the Nepal Rastra Bank include Rs. 1000 in 1969 and Rs. 500 in 1971 during the tenure of Yadav Prasad Pant, Rs. 50 in 1977 during the tenure of Kul Shekhar Sharma, Rs. 2 in 1981 and Rs. 20 in 1982 during the tenure of Kalyan Bikram Adhikary, and Rs. 250 and Rs. 25 in 1977 during the tenure of Satyendra Pyara Shrestha. Of these, notes of Rs. 250 denomination are commemorative notes issued on the occasion of the accession to throne by His Majesty King Birendra.

Nepal Rastra Bank for the first time introduced Polymer notes of Rs. 10 denomination on September 30, 2002 during the tenure of Tilak Rawal. This was a shift in terms of raw materials from naturally cultivated cotton to re-cycled polymer substrate.

The Old Print Notes, that is, notes printed by Sadar Mulukikhana contained the Portrait of King Tribhuvan. Similarly, Portrait of King Mahendra was included in the notes printed in 1960 and that of King Birendra in notes of 1974. The Portrait of present King Gyanendra appeared in Nepalese notes for the first time in 2002.

On the occasion of the Golden Jubilee Anniversary Nepal Rastra Bank has decided to print and issue Rs. 50 denomination notes with new and attractive design.

The issue of Nepalese currency notes in chronological order by denomination is presented in table 1 below.

Special Features of Nepalese Notes

Reflection of monarchical institution, religion, language, natural beauty, arts and culture of Nepal and the depiction of a portrait of His Majesty with Shreepech (Crown) and watermarking of the Crown are the chief features of the Nepalese currency notes. Besides, pictures of different temples, gods and goddesses, the flora and fauna and the Himalayas are included in notes of different denominations. From nationalism and cultural identity viewpoint woodcrafts and stone sculptures have been used.

The currency notes of different denominations issued by the Nepal Rastra Bank and those currently in circulation have the following unique features:

Table 1
Stages of Note Issue

Denomination	Date of Issue	Issuing Agency	Governor
5, 10 & 100	Sept. 17,1945	Sadar Mulukikhana	Mr. Janak Raj Pandey*
1	1952	Sadar Mulukikhana	Mr. Narendra Raj Pandey*
1, 5, 10 & 100	Feb. 19, 1960	Nepal Rastra Bank	Mr. Himalaya Samsher J.B.R
1000	Dec. 24, 1969	Nepal Rastra Bank	Dr. Yadav Prasad Pant
500	June 7, 1971	Nepal Rastra Bank	Dr. Yadav Prasad Pant
50	April 26, 1977	Nepal Rastra Bank	Mr. Kul Sheshar Sharma
2	April 26, 1981	Nepal Rastra Bank	Mr. Kalyan B. Adhikari
20	Nov. 8, 1982	Nepal Rastra Bank	Mr. Kalyan B. Adhikari
250	April 10, 1997	Nepal Rastra Bank	Mr. Satyendra Pyara Shrestha
25	April 11, 1997	Nepal Rastra Bank	Mr. Satyendra Pyara Shrestha
10 (Polymer)	Sept.30, 2002	Nepal Rastra Bank	Dr. Tilak Rawal

* Cashier (KHAJANCHI)
Source: Nepal Rastra Bank.

Table 2
Some Features of Nepalese Notes

Denomi-nation	Temple/ Palace	Wildlife	Himalayas	God /Goddess, Colour etc.
1	Pashupatinath	Musk- Deer (in running motion)	Dhaulagiri	–
2	Jay Bageswori	Leopard	–	Black Lentil colour
5	Telaju Bhabani	Yak	–	Kuber*
10	Changu Narayan	Krishnasar (couple)	–	Lord Vishnu #
20	Krishna Mandir	Jaryo@	–	Almond colour
25	Hanuman Dhoka Palace	Cow (with grey hair)	Machhapuchhre ~	–
50	Janaki Mandir	Black- Buck	–	–
100	Nyatpole Dewal	Rhinoceros	Himalayan Range	Goddess Laxmi
250	Hanuman Dhoka Palace	Cow (with grey hair)	Machhapuchhre ~	–
500	Maitidevi	Tiger (male)	Ganesh Himal	Goddess Saraswoti
1000	Soyambhunath	Elephant (adult)	Gaurishankar	Goddess Dakshinkali

@ a kind of Deer. **~** shape like tail of a Fish. ***** a rich person symbolizing the wealth. **#** mounted on the Eagle (Garuda).
Source: Nepal Rastra Bank.

In addition to visible features mentioned above Nepalese currency notes in circulation have various technical features called *technical specification*. Such features by their nature are difficult for the general public to understand. A few of them are listed below:

Size**:** All notes have the same width of 70 mm. The length, however, varies from 110 mm in Re.1 notes to 172 mm in Rs.1000 denomination. Cutting edge tolerance level is +/- 1.5 to 2.0 mm.

Printing Type: 1-3 Lithographic, 1-2 Letterpress, Single or Multi-colour Intaglio.

Paper Quality: 100 percent Cotton rag (small denomination) and combers (higher denomination) with 3 dimensional mould made watermark of His Majesty's Portrait and 1.2 to 4.0 mm. wide polyester based or de-metallised windowed security thread reading reversed-out 'NRB'… 'NRB'. The polymer notes are made of Polymer Guardian Substrate (plastic paper).

The **weight** of the paper is 85.0 gsm (grammes per square metre) in the case of paper notes and 80.5 gsm in the case of Rs.10 polymer notes with tolerance limit of +/- 5.0 to 5.5 gsm.

Folding Endurance: The notes will show no sign of delamination or surface fracture even after 5000 (in the case of polymer notes 10000) mean double folds under 1 kg tension using an Folding Endurance Tester.

Security Features

Different types of security features have been included in the notes of different denominations issued by the Nepal Rastra Bank. On the basis of these security features, the Bank determines whether a note is counterfeit or not by examining with the available technology and equipments. The security arrangements in the Nepalese currency notes can be broadly divided into two categories: conventional type and modern type.

Conventional type consists of:

- Paper of the note,
- Admixture of colours used in the note,
- Size and type of note,
- Portrait of His Majesty with Crown,
- Watermark of the Crown,
- Suki impression,
- Logo of the Rastra Bank,
- Impression of His Majesty's regalia,
- Ordinary type security thread (except in Re. 1 notes),
- Note numbers, including prefix number,
- Signature of the Governor.

Modern type security features include:

- Micro-lettering (except in Re.1 and Rs.2),
- Intaglio printing (in notes of above Rs.10 denomination),
- Demetallic Clear-text Windowed Security Thread,
- Machine readable features,
- Fluorescence ink (mainly in numbers and Governor's signature),
- Blink feature,
- PEAK (Printed and Embossed Anti-copy Key) feature,
- Anti-photocopy line structure,
- See Through Register,

- FIT Medal,
- STEP (Summary Twin Effect Protection) feature,
- Iridescent colouring etc.

Of the above-mentioned security features, the conventional (visible) ones and some of the modern type features like Intaglio, See Through, PEAK are easily identified even by the naked eyes in the day-light with little bit of human consciousness. Most of the modern types also known as Intrinsic / Inherent security features can be detected only with the help of advanced technical machines like magnifying lens, STEP watcher, ultra violet light etc. Two of the security features - watermark and security thread are printed in the process of manufacturing the paper itself. Other features are printed or embossed afterwards during several stages (normally six) of printing. The signature of the Governor and the note numbers including prefix numbers, however, are printed at the end.

Effort was made to incorporate different security features in the last two decades. However, during the tenure of two Governor's Satyandra Pyara Shrestha and Tilak Rawal several security features that are difficult to counterfeit have been incorporated using latest available technology. The prominent features are presented below:

The notes received by the Rastra Bank if declared counterfeit after detail examinations are forfeited without any compensation to the owner. However, no legal provision exist authorizing the Rastra Bank to take action against a person who carries or makes counterfeit notes. The only action the Bank can initiate is to inform the Police authority to file the case with appropriate court.

The counterfeit notes so far found in the country are of bigger denominations (Rs. 500 and Rs. 1000) and the technology used for making such notes is colour photocopying and computer scanning. As the

Governor	Security Features
Ganesh Bdr. Thapa	- Crown Watermark - Security Thread
Hari S. Tripathi	- Crown Watermark - 1.2 mm wide Clear-text Windowed Security Thread
Satyandra P. Shrestha	**First Series** - Crown Watermark - 1.2 mm wide Clear-text Windowed Security Thread - Fluorescence on both sides of note number, signature of the Governor and both sides of Coin Emblem - Machine readable '1000' **Last Series** - Portrait Watermark - Size of the Portrait of His Majesty's the King is big - 2.5 mm wide Clear-text Windowed Security Thread - Fluorescence on both sides of note number, signature of the Governor and Coin Emblem only - Machine readable '1000' - PEAK feature - See Through Register - Anti-copy Line Structure - Portrait of the new King
Tilak Rawal	- Portrait Watermark - 4 mm wide Clear-text Windowed Security Thread - Fluorescence on both sides of note number, signature of the Governor and the Crown Plumb - Machine readable '1000' - PEAK feature - See Through Register - Anti-copy Line Structure - STEP feature - FIT Medal - Iridescent coating

Source: Nepal Rastra Bank

task of producing or manufacturing counterfeit currencies is extremely complex, expensive and risky venture, only notes of bigger denominations have been found to be forged.

Nepalese Currency Notes

As per Section 2, Sub-section (1) of the Nepal Rastra Bank Act, 2002, 'Currency note' is defined as the bank note in circulation in the form of cash including coins and 'Nepalese Currency' as the currency of Nepalese rupee denominations (Part 'k'). The Rupee is the monetary unit divided in one hundred Paisa (Section 51, Sub- section '1').

Note is a legally acceptable currency within the Kingdom of Nepal. The notes issued by the Nepal Rastra Bank have, on the one hand, guarantee of His Majesty's Government (Section 51, Sub-section '2') for the final payment and on the other hand, are issued only after depositing hundred percent security in accordance with the theoretical concept of proportional reserve system. Due to government guarantee for payment and a hundred percent security provision, the general public accepts currency notes as money and uses them as a medium of exchange for daily transactions and unit of saved reserve.

Although the Rastra Bank has monopoly over the issue of bank notes and coins it can do so only against the security simply because note issue implies increase in Rastra Bank's monetary liability. With every increase in the quantity of notes issued, the Bank has to make provision of 100 percent security. Section 52, Sub-section (2) of the Nepal Rastra Bank Act 2002, has made clear legal provision for the Bank to maintain security deposit while issuing notes. The Act also requires that prior to issuing notes for circulation the Bank has to deposit hundred percent assets as security. Security deposit has to be at least fifty percent in the form of gold, silver, foreign currency, foreign securities, and foreign bills of exchange and the remaining percentage in Nepalese coins (Mohar, Double or coins of higher denominations), debt bond issued by His Majesty's Government, the promissory note or bills of exchange due to be redeemed within eighteen months in Nepal from the date of repayment by the bank.

However, with prior approval from His Majesty's Government the Bank may issue notes by depositing a maximum of forty percent back-up by the first category assets and the balance by the second category assets.

The price of the gold deposited as security is determined by His Majesty's Government on the recommendation of the Bank's Board and that of the price of silver at a rate deemed appropriate by the Board. The price of foreign currencies has to be in accordance with the exchange rate fixed by the Bank. Currently, the price of gold has been fixed at Rs. 175 per gram and that of silver at Rs. 3,300 per kg. This price was last revised in 1986. In 1957, the price of gold and silver deposited as security against issued notes was valued at Rs. 150 and Rs. 2 per tola (11.66 gm) respectively.

From the very first year of its establishment the Nepal Rastra Bank continuously followed the practice of preparing and publishing separate Balance Sheet of the Issue Department. The purpose of separate balance sheet is to inform public about the authenticity, composition and adequacy of assets deposited as security against the notes in circulation. The Bank, however, has recently decided to stop this practice of publishing two separate Balance Sheets for the Banking and the Issue Departments from the Fiscal Year ended on 2004.

Prior approval of the His Majesty's Government is required for changing the figures, size and denominations of the notes, whereas the Board of the Bank can make changes in invisible security features, internal security arrangements and the material for printing bank notes.

The Note Exchange Regulations, 1991 classified Nepalese currency notes into two categories: registered and non-registered notes. 'Registered notes' were defined as notes above the denomination of Rs.100 and the `non-registered notes' as notes other than the registered ones. Before 1991, Rs.100 denomination note was also classified as registered note. The process of destruction, claim reimbursement and payment of the first category notes was different to that of the second category of notes.

Over the time, volume of registered notes increased significantly. As a result heavy pressure was build up to the Currency Management Department in managing and handling of such notes. The new Note Exchange Regulations, 2003 and the Note Destruction Regulations, 2003 do not have provision of categorizing notes into registered and unregistered. Enactment of these regulations automatically led to cancellation of Rs. 500 and Rs. 1000 denomination as registered notes.

Determination of the volume of notes to print or to issue is primarily based on factors, such as, level of monetization, budgetary situation, inflation, foreign currency reserves, growth in industry and commerce, trend of banking sector savings and investments, volume of development expenditure, notes in the stock and quantity of notes to be destroyed that have direct impact on the demand for currency notes in the economy. In addition, the past four or five years supply trend is also given due consideration

Release of notes for circulation is commonly termed as 'note issue'. In the event of new note issue, the common public is informed through notification in the major national news media with description of the prominent features including change in the artwork, size, paper and denominations. However, no public notice is required for reprinted notes. The note issue function is performed by the Currency Management Department, district offices of the Rastra Bank, and branches of the commercial banks that are authorized to operate the Currency Chest.

Currency in Circulation

By Type

With the increase in circulation of Nepalese currency, a substantial decrease in the proportion of coins and increase in the share of notes is observed. Proportion of coin which was 43.8 percent in mid-July 1960 decreased to 6.5 percent in mid- July 1980 and to less than 1.0 percent in mid- July 2003 (Table 3). Experiencing high printing and management costs and shorter life-span of smaller denomination notes, Rastra Bank has adopted the policy of stopping printing of notes of Re. 1, Rs. 2 and Rs. 5 denominations and replacing them with the coins. It is envisaged that this policy would, to some extent, increase the proportion of coins in circulation in the years to come (Table 3).

By Denomination

While analyzing composition of different denominations notes in circulation over the years, an increasing trend of bigger denominations is observed. The proportion of higher denomination notes (Rs. 500 and Rs. 1000) which was 73.2 percent of the total currency in circulation in mid-July 1993 increased to 83.9 percent in mid-July 2000 and 86.5 percent in mid-July 2003 (Table 4). Increases in the proportion of higher denominations was due to public preference, mainly because such notes facilitated higher value transaction and savings with ease of transportation. The Bank, too, has been relieved of the big cost incurred on printing smaller denominations notes in huge quantities and also in terms of management and handling (Table 4).

By Nature of Account Keeping

The Nepal Rastra Bank has issued notes equivalent to Rs. 165,787.0 million from the stock till the end of mid-July 2003. Of this, Rs. 77,192.4 million (46.6

Table 3

Currency in Circulation : by Type*

(Rs. in million)

	Notes (1)		Coins (2)		Current in circulation (3) = (1)+(2)	
	Amount	Percent	Amount	Percent	Amount	Percent
1960	67.6	56.2	52.7	43.8	120.3	100.0
1965	276.5	87.6	39.1	12.4	315.6	100.0
1970	522.7	91.9	46.0	8.1	568.7	100.0
1975	906.4	93.3	64.8	6.7	971.2	100.0
1980	1,784.4	93.5	124.3	6.5	1,908.7	100.0
1985	3,865.5	95.8	170.1	4.2	4,035.6	100.0
1990	10,270.8	97.6	255.6	2.4	10,526.4	100.0
1995	24,253.5	98.9	278.0	1.1	24,531.5	100.0
2000	45,258.8	99.1	391.1	0.9	45,650.0	100.0
2003	61,092.0	99.2	516.5	0.8	61,608.5	100.0

* Excluding notes and coins held by Nepal Rastra Bank

Source: Nepal Rastra Bank, Quarterly Economic Bulletin, Mid-October - Mid-January 2004 issue.

Table 4

Notes in Circulation : By Denomination* (Mid-July)
(Rs. in million)

	1993		1996		2000		2003	
Denomination	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
1	91.2	0.5	109.8	0.4	153.1	0.3	175.8	0.3
2	102.6	0.6	100.2	0.4	168.5	0.4	213.5	0.3
5	223.0	1.3	269.7	1.0	391.0	0.9	457.9	0.7
10	463.0	2.6	491.4	1.8	579.8	1.3	847.4	1.4
20	334.0	1.9	546.4	2.0	570.5	1.2	764.9	1.2
25	-	-	-	-	320.2	0.7	308.6	0.5
50	765.0	4.3	1,012.7	3.7	1,184.2	2.6	1,299.6	2.1
100	2,780.0	15.6	3,252.6	11.8	4,015.1	8.7	4,232.1	6.8
250	-	-	-	-	33.9	0.1	91.8	0.2
500	3,900.0	22.0	6,387.9	23.3	10,876.1	23.7	16,162.5	26.1
1000	9,100.0	51.2	15,280.8	55.7	27,641.8	60.2	37,420.1	60.4
Total	**17,758.8**	**100.0**	**27,451.5**	**100.00**	**45,934.2**	**100.0**	**61,974.3**	**100.0**

* Excluding Old Print Notes.
Source: Nepal Rastra Bank, Annual Report, different issues.

percent) have been destroyed and notes equivalent to Rs. 61,974.3 million (37.4 percent) are currently in circulation. An amount equivalent to Rs. 26,620.3 million (16.0 percent) remains in the Currency Chest held by Rastra Bank and the two commercial banks (Table 5).

Table 5

Notes in Circulation* (Mid-July 2003)
(Rs. in million)

1.	Notes Issued from the Stock (Cumulative)	165,787.0
2.	Notes in Currency Chest {(a)+(b)}	26,620.3
	(a) With Nepal Rastra Bank	25,488.0
	(b) With Commercial Banks	1,132.3
3.	Notes Destroyed (Cumulative)	77,192.4
4.	Notes in Circulation [(1)-{(2)+(3)}]	61,974.3

* Excluding Old Print Notes.
Source: Nepal Rastra Bank

The maximum number of notes issued from the stock till mid- July 2003 was of Re.1 denomination (648.5 million pieces). Similarly, the lowest quantity of notes issued was that of Rs. 250 denomination (only 0.5 million pieces). Initially, Rs. 250 denomination note was issued along with artistic folder as commemorative note. But since a large quantity of such notes were lying idle in Bank's vault it was decided in 2000 to put those notes in circulation like other notes. Data presented in Table 6 reveals relatively high consumption of notes of smaller denominations. However, between mid-July 2000 and mid-July 2003, the number of Rs. 500 and Rs. 1000 denomination notes issued from the stock increased significantly by 71.3 and 60.5 percent respectively (Table 6).

Security Against Note Issue

Gold worth Rs. 831.7 million, silver worth Rs. 459.3 million, His Majesty's Government Bonds worth Rs. 4,172.0 million and the remaining in foreign currency and foreign securities were deposited as security against the notes issued till mid-July 2003. An analysis of the composition of the assets deposited as security of the notes issued over 1993-2003 period shows proportion of gold, silver, and foreign currency and securities higher than 84 percent. There is no change in the amount of gold and silver deposited as security since 1993 (Table7).

Per Capita Notes in Circulation

After the Rastra Bank started issuing notes and made arrangements for the Currency Chests, the per capita notes in circulation increased from Rs. 4.3 million in 1957 to Rs.138.8 million in 1981 and Rs. 2473.4 million in 2003. Such an increase in the per capita notes in circulation has helped to transform the subsistence Nepalese economy into a market

Table 6

Note Issued from the Stock (Cumulative): by Denomination*

(In number)

Denomination	Mid-July 2000	Mid-July 2003	Change (%)
1	601,479,612	648,580,594	7.8
2	263,664,156	312,165,156	18.4
5	424,155,516	494,256,529	16.5
10	432,538,033	519,038,865	20.0
20	143,308,766	187,909,742	31.1
25	25,149,804	39,999,786	59.0
50	123,573,650	156,825,591	26.9
100	177,308,716	227,297,941	28.2
250	249,820	499,820	100.1
500	48,366,628	82,865,171	71.3
1000	49,818,029	79,965,620	60.5
Total Value (in Rs.)	109,043,238,354	165,787,005,841	52.0

* New Print Notes.

Source: Nepal Rastra Bank

Table 7

Security Against Note Issue

(Rs. in million)

	Gold	Silver	Foreign Currency and Securities	Total	Coins	HMG Bonds	Security of Note Issued*	Percentage of Foreign Exchange and Gold and Silver in Total Security
	(1)	(2)	(3)	(4)=(1)+(2)+(3)	(5)	(6)	(7)	(8)=(4)/(7)x100
1993	831.7	459.3	13,682.1	14,973.1	22.6	2,670.0	17,665.7	84.8
1995	831.7	459.3	23,248.1	24,539.1	22.6	-	24,561.7	99.9
1997	831.7	459.3	26,116.0	27,407.0	22.6	2,620.4	30,050.0	91.2
1999	831.7	459.3	34,606.0	35,897.0	22.6	2,620.4	38,540.0	93.1
2001	831.7	459.3	51,536.4	52,827.4	22.6	-	52,850.0	99.9
2003	831.7	459.3	56,517.0	57,808.0	-	4,172.0	61,980.0	93.6

* Including notes equivalent to Rs.5.8 million issued by Sadar Mulukikhana (Old Print Notes).

Source: Nepal Rastra Bank, Annual Report, different issues.

economy and to enhance the level of monetization. Details of per capita notes in circulation are presented in table 8 below.

Average Printing Cost

Per unit printing costs incurred by denomination incurred in 2000 and 2004 are presented in table 9. The printing cost of higher denomination notes in 2004 has increased by more than 130.0 percent mainly due to the addition of more costly security features like STEP feature, FIT Medal and Iridescent coating during latter half of the tenure of Governor Tilak Rawal. The high cost of Rs. 10 denomination reflects the cost of printing newly introduced Polymer notes. Another reason for such a big increase in the cost structure is the inclusion of the cost of clearing and forwarding of notes from the Kolkata Port to Kathmandu and travel and other direct expenses incurred, whereas the cost in the year 2000 included only the C.I.F. Kolkata price of note printing (Table 9).

Table 8

Per Capita Notes in Circulation*
(Rs. in million)

Mid-July	Population (in millon)	Notes in Circulation*	Per Capita Notes
1957	9.3	39.7	4.3
1961	9.4	107.8	11.5
1971	11.6	563.2	48.6
1981	15.0	2,082.2	138.8
1991	18.5	12,348.7	667.5
2001	23.2	51,980.6	2,241.0
2003	24.7	61,092.0	2,473.4

* Excludes notes held by Nepal Rastra Bank.
Source: Nepal Rastra Bank.

Table 9

Average Printing Cost of Notes: By Denomination*
(In Rs.)

	Per Unit Cost		
	2000	2004	Change (%)
1	0.76	-	-
2	1.06	-	-
5	1.10	1.73	57.3
10	1.26	3.28	160.3
20	1.58	2.34	48.1
50	1.94	3.16	62.9
100	2.12	5.13	142.0
500	3.10	7.18	131.6
1000	3.39	7.82	130.7

* Estimate.

Source: Nepal Rastra Bank.

Though the unit cost of printing smaller denominations notes looks lower in comparison to that of notes of bigger denominations, they are in fact more expensive due to lower durability and higher management expenditure. The age of notes of Re. 1, Rs. 2 and Rs. 5 denominations is less than six months as against three years of Rs. 500 and Rs. 1000 denominations notes. This ageing, however, is estimated only on the basis of experience and not on systematic evaluation. In view of the fact that the notes of smaller denominations are more expensive from the cost viewpoint, Rastra Bank has adopted the policy of stopping their printing and gradually replacing them with coins.

Note Design

The primary stage in the manufacturing process of notes is "designing of notes". Note designing basically implies the task of preparing framework of the notes to be printed. During the preparation of the specimen note special attention is paid to the denomination, colour, shape, type, size, etc of the note. Similarly, artwork, artistic design and figures that provide Nepalese identity in terms of royal institution, religion, art, culture, natural resources, wildlife are selected.

Apart from different colour and size of notes, pictures, animals, temples and mountain are so chosen that even the illiterate public will also find no difficulty in identifying notes of different denominations.

Of the notes currently in circulation, the green-coloured Rs. 100 note, the highest denomination note until 1969, has the picture of one-horned rhinoceros, found in the Char Koshe (thick terai) jungles. Such a unique picture has enabled even the illiterate public to conduct economic transactions with Rs. 100 denomination notes without any difficulty.

After 1969, the highest denomination note in circulation is of Rs. 1000. The logic behind the selection of an elephant for this note was that it carries a value equivalent to donation of one of the biggest animal, an elephant. Similarly, a Rs. 50 denomination note carries a black- buck. Other notes carry picture of viharas, temples, stupas and idols built in different regions of Nepal.

A Note Design Committee with Governor as chair pursuant to Section 10 of the Nepal Rastra Bank Note and Coins Regulations, 2003 is in place. Other members of the Committee are two Deputy Governors, some senior officials of the Nepal Rastra Bank, prominent personalities such as linguist, archeologist, historian, wildlife expert, etc. This Committee prepares detail design of the notes of different denominations to be printed and submits the blue print along with its recommendation to the Board. Such design after endorsement by the Board is presented to His Majesty's Government for approval.

Printing

After the design of the note is approved by the government, printing phase begins. In the absence of high quality security press in the country notes are being printed by reputed security printers selected through global tender from among pre-qualified companies.

For the purpose of preparing pre-qualification list of security printers, Bank invites global tender

through advertisement in major national and international newspapers. Bank then prepares pre-qualification list of selected companies on the basis of credibility, size of transactions, experience, technology, security features and reputation in the global market. The current pre-qualification list, which was prepared in 2002 includes the following ten Security Printers :

- Giesecke & Devrient GMBH, Germany
- De La Rue Currency, U. K.
- Real Case De La Moneda, Spain
- Oebs Banknoten, Bank Australia
- Francois- Charles Oberthur Fiduciare, Paris, France
- Joh Enschede Security Print, Int. Div., England
- Bundes Druckeri GMBH, Berlin, Germany
- Orell Fuessli, Switzerland
- Polska Wytwornia, Warszawa, Poland
- Perum Peruri, Indonesia

The Bank invites tenders for printing the notes only from those pre-qualified security printers who have been selected through the global tender.

Rastra Bank has constituted a Work Management Committee with chief of the Currency Management Department as coordinator. The responsibilities of the Committee includes: preparation of tender form, tender, invitation letter, agreement letter and the note specifications as prescribed by the Note Design Committee. The Committee is also responsible for post tender activities such as opening and evaluation of tenders submitted by the security printers and submitting its report and recommendations to the Governor. Upon approval from the appropriate authority the Currency Management Department makes necessary arrangements for printing the notes by concluding an agreement with the company concerned.

Verification

Prior to issuance of any denomination notes Rastra Bank examines the suitability for their release from different perspectives. The process of examining whether or not the notes printed by the company match with specimen and specifications and segregating good and defective notes is called 'note verification'. Notes not complying with specimen and specification are called 'defective' notes.

As note verification is an extremely sensitive and critical task, the Bank is always alert to see that the notes identified as good ones are not mixed with defective notes. If defective notes are issued by mistake, it not only creates unnecessary confusion among the public but also lowers Bank's prestige and public confidence. Notes with the following defects are discarded during verification:

- With any blot print in the face of His Majesty.
- Without note number including prefix number.
- Without the signature of the Governor.
- With unclear numerical letters.
- With Governor's signature and note number in wrong places.
- With boarder cuttings not conforming with specified tolerance limit.
- With artwork and design not in confirmation with specimen.
- With different note numbers or note number on both sides.
- Printed on wrinkled paper.
- Printed on one side only.
- Letter, design, pictures depicted on one side are also visible from the other side.

Notes found defective during verification are stored separately in a vault. Such notes are destroyed upon receipt of reimbursement of such notes with ten percent penalty over the printing cost from the printing company

Note Destruction

Notes become soiled as they change hands in the course of economic transactions. Issued notes are returned back by the Bank in torn, burnt, decayed, defaced, soiled or fragmented conditions. The process of powdering such notes including those identified as unsuitable for reissue is known as "note destruction".

After the enactment of the present Nepal Rastra Bank Note Destruction Regulations, 2003, the notes are destroyed by incineration or shredding. Prior to that, the notes had to be destroyed by incinerating only. The provision of shredding was incorporated in the present regulation after the issuance of polymer notes. Polymer notes are destroyed by shredding and other paper notes by burning.

Currently, the notes segregated for destruction are destroyed either by incineration in the furnace or by shredding in the presence of the representatives of the concerned agencies. Before destruction, notes are counted and punched (two punches in notes of below Rs. 50 denomination and four punches in notes of Rs. 50 and higher denominations). Defective

notes and notes under claim are not required to be punched.

The task of note destruction was initiated by the Bank only after the enforcement of the Nepal Rastra Bank (Note Destruction) Regulations, 1961. By mid-July 2003, Nepal Rastra Bank had destroyed notes of different denominations equivalent to Rs. 77,192.4 million, which is 46.6 percent of total issued notes of Rs. 165,787.0 million (Table 10).

Table 10
Note Destruction*
(In Rs.)

Denomination	Notes Issued	Notes Destroyed	Percentage of Destruction
Mid-July 2000	**109,043,238,354**	**41,421,043,674**	**38.0**
Mid-July 2003	165,787,005,841	77,192,413,772	46.6

* New Print Notes.
Source: Nepal Rastra Bank.

In terms of pieces, the proportion of destruction was higher for notes below Rs. 50 denomination (Table 11).

Currency Chest

The principal objectives behind establishing the Currency Chest are to:

- promote circulation of the Nepalese currency,
- expand the pace of monetization,
- facilitate authorized commercial banks for smooth conduction of government transaction and,
- withdraw worn, torn and soiled notes from circulation and issue fresh ones.

The setting up of Currency Chest was initiated from April 7, 1960 onwards. Currently, Currency Chests are operated by eight offices of Nepal Rastra Bank, forty-three offices of Rastriya Banijya Bank and twenty offices of Nepal Bank Ltd.

The onus of operating the Currency Chests is that of the offices of commercial banks concerned. The responsibility of making arrangements for adequate and timely supply of money required by the Currency Chests, however, rests with Rastra Bank. The Bank does so through the mechanism of fund transfer. Rastra Bank also makes arrangement for the insurance of money kept in Currency Chest at its own cost.

The amount in the Currency Chests is the assets of Rastra Bank. Commercial banks are, therefore, required to follow the procedures and directives set by the Rastra Bank, while operating the Chest. The offices who operate Currency Chest are required to inform Rastra Bank details of the withdrawals/ deposits transactions conducted through the Chest on the same day. Moreover, the operators of the Chest can withdraw from or deposit to the Chest at

Table 11
Details of Note Destruction*
(In pieces of notes)

	Notes Issued		Notes Destroyed		Percentage of Descruction	
Denomination	Mid-July 2000	Mid-July 2003	Mid-July 2000	Mid-July 2003	2000	2003
1	601,479,612	648,580,594	436,058,941	469,422,813	72.5	72.4
2	263,664,156	312,165,156	168,263,409	200,388,492	63.8	64.2
5	424,155,516	494,256,529	323,776,040	399,194,358	76.3	80.8
10	432,538,033	519,038,865	357,547,434	424,362,502	82.7	81.8
20	143,308,766	187,909,742	102,416,670	141,699,502	71.5	75.4
25	25,149,804	39,999,786	5,079,147	24,027,460	20.2	60.1
50	123,573,650	156,825,591	87,531,205	124,307,099	70.8	79.3
100	177,308,716	227,297,941	120,627,073	174,705,650	68.0	76.9
250	249,820	499,820	5	10,501	0.0	2.1
500	48,366,628	82,865,171	11,554,092	28,322,795	23.9	34.2
1000	49,818,029	79,965,620	11,062,377	28,797,998	22.2	36.0

* New Print Notes.
Source: Nepal Rastra Bank.

a multiple of Rs. 50 thousand at a time. Similarly, the operators can deposit or withdraw in bundle of 1000 pieces of any denomination. In such events, the concerned bank branches should keep the money belonging to the Currency Chest separately without mixing it with the money generated from their regular banking transactions.

Remittance expenses presented in table 12 shows a substantial increase in fund transfer cost during 1999-2003 period. Fund transfer expenses, which was Rs. 43.2 million in 1999 increased drastically to Rs. 94.0 million by mid- July 2003. Transfer of fund by the nearest Rastra Bank office to the currency chest used to be made normally by road transport. Places not connected by fair road network were supplied funds through air transport. However, with the worsening security situation in the country the fund has to be transported through air transport in almost all places resulting in a substantial rise in the fund transfer expenses.

Table 12
Remittance Expenses
(Rs. in million)

Mid-July	Fund Transfer Expenses	Change (%)
1999	43.2	-
2000	51.3	18.7
2001	58.4	13.8
2002	82.3	40.9
2003	94.0	14.2

Source: Nepal Rastra Bank.

Challenges/Problems

(i) Central Banks all around the world are facing two major challenges regarding currency management: (a) achieving notes printing and issuing activities more cost- effective, and (ii) addressing incidence of counterfeits. There are many instances of attempts made by central banks to address these two fundamental questions. Most have been successful greatly in addressing counterfeiting issues by introducing additional security features but have achieved less success in addressing the cost issue. The same is true for Nepal Rastra Bank.

(ii) Until now, the Bank has been printing notes from security printers located abroad. The country has to spend large amount of hard currency for printing notes abroad, incur heavy miscellaneous expenses in Indian currency for transporting notes from Kolkata to Kathmandu and also in Nepalese currency for distributing them from kathmandu to other parts of the kingdom. One may suggest that establishment of security printing press within the country would save a huge amount of foreign currency and avoid unnecessary hassles in transporting notes as well as cut down the management costs. However, whether the huge investment needed for the establishment of note printing security press is affordable / justifiable or the country has the ability of operating such press at profit is a debate. In author's view, it needs a through and in-depth study before any decision is taken on this issue.

(iii) Though the Nepal Rastra Bank has adopted the FIFO (First In First Out) type inventory management policy in theory, this has not been effectively practiced in respect of note issue. Large volume of notes of different denominations printed during the tenure of ex- governors are still found to be lying in the stock, while the notes printed during the officiating Governor are in extensive circulation.

(iv) Nepal Rastra Bank has already adopted the policy of replacing small denomination notes by coins, but has not been able to supply the coins adequately.

(v) In view of the large volume of notes being issued by the Bank every year an utmost need exist for enhancing modernization process in the areas of counting, sorting, verification and destruction of notes.

Conclusion

The beginning of Nepalese monetary system dates back to the minting of the **'manank'** coins during the Lichhivi period. It took a great leap forward in 1945 when the Sadar Mulukikhana started issuing paper currency notes. Nepal Rastra Bank, the sole monetary authority for managing the issue and circulation of the Nepalese currency, started printing and issuing the currency notes from February 19, 1960.

The Nepalese currency was made the only legal tender currency all over the Kingdom by 1967. The Nepal Rastra Bank Act, 2002 defines **'Currency notes'** as the bank note in circulation in the form of cash including coins and **'Nepalese Currency'** as the currency of Nepalese rupee denomination. The **'Rupee'** is the monetary unit divided in one hundred **'Paisa'.**

Over the twelve different Governor's tenures notes of eleven denominations ranging from rupee one to thousand came in circulation. Polymer notes were first introduced in 2002.

Nepalese currency notes are printed in paper made out of cotton or polymer substrate. In the last decade, several security features using latest technology like STEP feature, FIT Medal, Iridescent coating, PEAK feature, Anti Copy Line Structure have been incorporated in the notes of higher denominations. This has led to a big increase in the cost of printing notes. The printing cost of higher denomination notes in 2004 has increased by more than 130.0 percent over the printing cost of 2000.

The notes are being printed by reputed security printers from among pre-qualified companies that are selected through global tender. The current pre-qualification list includes 10 security printers mainly from the Europe.

While printing notes, prior approval of the His Majesty's Government is required for changing the figures, size and denominations of the notes, whereas the Board of the Bank can make changes in invisible security features, internal security arrangements and the material for printing bank notes.

During the process of note design, special attention is paid to the denomination, colour, shape, type, size, etc of the note. Similarly, artwork, artistic design and figures that provide Nepalese identity in terms of royal institution, religion, art, culture, natural resources, wildlife are selected.

The Rastra Bank, despite monopoly over the issue of bank notes, can do so only after maintaining 100 percent security- at least fifty percent in the form of gold, silver, foreign currency and foreign securities, and the remaining percentage in Nepalese coins and Nepalese securities. In practice, the proportion of the first category assets constitute about 94 percent of total assets deposited as security against note issue. Currently, the price of gold and silver deposited as security is fixed at Rs. 175 per gm and Rs. 3,300 per kg respectively.

The Sadar Mulukikhana had issued a total of Rs. 54.9 million from September 17, 1945 onwards of which, notes of Rs. 39.7 million were in circulation as of mid- July 15, 1957. Beginning the date Nepal Rastra Bank started issuing notes the Bank issued notes equivalent to Rs. 165,787.0 million from the stock until mid-July 2003. Of this, Rs. 77,192.4 million (46.6 percent) have been destroyed and notes equivalent to Rs. 61,974.3 million (37.4 percent) are in circulation. The proportion of higher denomination notes in total currency in circulation was 86.5 percent in mid- July 2003. However, the maximum number of notes issued from the stock till mid- July 2003 was of Re. 1 denomination (648.5 million pieces), which reveals relatively high consumption of notes of smaller denominations.

The Currency Chests operated by Nepal Rastra Bank and authorized commercial bank branches in seventy-one places are the main channels of issuing notes.

Experiencing high printing and management costs and shorter life-span of smaller denomination notes, Rastra Bank has adopted the policy of stopping printing of notes of Re.1, Rs. 2 and Rs. 5 denominations and replacing them with the coins. The age of notes of Re. 1, Rs. 2 and Rs. 5 denominations is less than six months as against three years of Rs. 500 and Rs. 1000 denominations notes.

The torn, defaced and soiled notes are destroyed by incineration or shredding. The provision of shredding was incorporated in the appropriate regulation after the issuance of polymer notes.

Despite numerous constraints Rastra Bank has been trying its best in discharging its currency management role. To the Rastra Bank, there still exist challenges like rising printing cost, frequent counterfeiting, increased fund transfer expenses, dearth of technical expertise, lack of note printing manual, lack of effective FIFO system of inventory management and inadequate mechanization. Such challenges need to be tackled and streamlined through the adoption of appropriate policies and procedures.

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Domestic Debt Management

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Introduction

Domestic debt is one of the components of public debt, which consists of both domestic debt and external debt. We have the different definitions of domestic debt like " it is the debt denominated in local currency" or "it is the money borrowed by the government in local currency," "domestic debt is the loan enjoyed by the state in local currency" etc. By these definitions, we can say that the domestic debt is the money borrowed by the government (the government may be of any form like state government, central government or it may be federal government) and that the borrowed money will be in local currencies .In domestic borrowing the debtor will be the government itself and the lender may be the individuals or the institutions. In public borrowing, the government provides some guarantee to the lenders by issuing the security papers in the form of certificates. It may be a bond certificate or a bill certificate.

Concepts of Domestic Borrowing

Till the 3rd decade of the 20th century, the concept of government borrowing had not emerged and people were thinking that borrowing by the government was the misuse of the resources. During 1930 (economic depression period) the concept of deficit financing and use of idle resources emerged. Keynes was the founder personality of this concept. There are still two schools of thought. One school thinks that borrowing is not at all useful for national development. Some schools are expressing their views that only after the detailed impact study on economy of the borrowing, the government has to borrow. This second concept is more important for those countries, which are in the stage of infrastructure development.

The government announces its policy and programs annually through the budget. In the budget, the government also announces the projects to be implemented and the required expenditure for the implementation and completion of such projects.

The targeted projects should be completed during the prescribed period. For this, the government has to make the required resources available for on-going and for proposed projects. The required expenditure for the project has to be met by the government through revenue or from borrowing. It is the regular phenomena of the developing country that every time the government expenditure supersedes its income, the situation of deficit of resources may exist. That deficit may be for the shorter period or it may be for the longer duration (for the whole financial year). During this period also the government cannot stop the ongoing projects in the country. In such a situation, the government fulfills its needed expenditure through other sources like borrowing. The sources of borrowing may be the internal

borrowing or external borrowing or both. But the external borrowing may not be so reliable. So, the government may choose the most dependable source of deficit financing, viz., domestic borrowing. In this paper, the discussion will be focused on domestic borrowing and its management in Nepal.

Principle of Domestic Debt Management

Internal portfolio is the largest financial portfolio in the country. It has a big role to play for financial stability in the country and it may create a risk to the government's balance sheet. Hence, it has got an important role in the government's fiscal management system.

The debt management is the process of establishing and executing a strategy for managing the government's debt. The objective of the management should be to raise the required amount of funding, to minimize its risk and cost objective, to meet any other sovereign debt management goal, and to maintain an efficient market for government securities. So, the debt manager should be aware of the impact of government financing, requirement of government financing and the cost of borrowing on debt. To know whether the borrowing is sustainable or not, the debt manager should also visualize some important indicators like public sector debt service ratio, ratio of public debt to GDP and ratio of public debt to revenue, ratio of development expenditure to GDP, ratio of budget deficit to domestic borrowing, etc. The debt manager should also consider the maturity of the debt structure, crowding- out and roll over on the borrowing; then only we can say that the debt is well managed and well structured. If we do not consider all this while borrowing the debt it is considered as poorly managed.

There are many risks involved like interest risk, roll over risk, settlement risk, operational risk and so on. So, one of the important objectives of the debt management should be to minimize the risks. The risk of borrowing can be minimized by adopting techniques like increasing the maturity period of borrowing, deferring payment of higher rate security, making payment of higher rate securities by borrowing shorter duration securities on the basis of projected yield curve slop.

Debt management is also the coordination between the monetary and fiscal policy of the country. The debt manager, fiscal policy advisor, and central bank should share an understanding of the objective of the debt management. The debt manager should convey their views to the fiscal authorities on the cost and risk associated with government financing, requirements of government financing and the debt levels. Also, the debt manager should share the information on the government's current and future liquidity needs.

The management of debt includes many functions like planning of debt, issuing the different borrowing instruments, conduct of primary and secondary market of the government securities, public awareness program, roll-over and payment of debt. But the main objective of the debt management should be concentrated and well specified in terms of cost and risk involved in the borrowing. Efficient domestic capital market is an essential pre-requisite to strengthen the government security market. In some countries the debt is managed by establishing an autonomous debt management office. In Nepal, the Nepal Rastra Bank (NRB), the central bank of the country, is the domestic debt manager of the government.

Why Does the Government Borrow?

There may be the situation of the expenditure exceeding income for a short period or for the longer duration; in such a situation, the deficit of resources exists for the government. When the estimated expenditure exceeds the revenue or the estimated revenue is less than the expenditure, the government may go for domestic borrowing to meet the shortfall by issuing borrowing instruments like treasury bills for a short term period and bonds for a long term period. The government does not borrow from the public all the time; in general, in a situation when its treasury position goes short, the government will borrow. Sometimes the government borrows largely to meet the country 's emergency situation like war, famine, etc. when it feels the difficulty to finance for the extended activities

The government sometimes may borrow from its cash surplus position also. The objective of such borrowing is to speed up the economic activities in the country. Such burrowing will be used in financing development activities; especially, when the unemployment rate goes up, the government may increase the borrowing amount to improve the situation.

Though the government always tries to meet its regular expenditure and maximum portion of development expenditure through its revenue but due to the increasing trends in regular expenditure, total expenditure requirement is bigger than government revenue, and there will be a saving-investment gap. In such a situation, the development expenditure of the country should be met by the external and internal borrowing sources.

When the expenditure is equal to the total revenue of the country, the borrowing may not be needed. However, frequently the balance situation does not exist especially in the developing country like ours .The estimation of deficit budget is a normal process in many countries. The estimation of deficit budget may be a good intention, because many economists viewed that the deficit budget is an essential condition to speed up the economic development of the country. This deficit budget situation will force the government to borrow. When the government borrows, it will be invested in the productive and developmental activities in the country. This will lead to an increase in the economic activities and ultimately to an increase in income, saving and investment level.

The government borrows by issuing different borrowing instruments having different characters and targeting to different individuals and institutions. These borrowing instruments are known as the government securities papers. These instruments are guaranteed papers or agreement paper issued by the government against the borrowing amount.

Advantages of Domestic Borrowing

Though some people think that government borrows when it is in crisis and is lacking resources, this is true to some extent but is not true always. Some time it is essential to borrow even if the government is in comfortable treasury position. The government borrows to invest in the development projects. So, there are many advantages of domestic borrowing. They are listed below:

1. Collection of unused resources and using it on productive sectors: The small portion of the money held by the people and institutions may not be used or they may be insignificant for investment in the projects. When the government announces the borrowing program they can invest in the government securities and these collected money will be sufficient to be invested on big projects like irrigation, road construction, and transportation and so on. This leads to an increase in the economic activities of the country.
2. The government borrows the money by paying reasonable interest rate and discount rate for the borrowed amount as incentives for the investors.
3. Collection of resources from the large number of the small savers: When the government announces the borrowing scheme, a large number of the citizens will be ready to invest on the government securities. It is an opportunity for the small investors and small savers.
4. Collection of excess reserve from the banks and financial institutions: There may be a good amount of excess liquidity with the bank and financial institutions. This liquidity is the amount deposited by the public in the banks and deposit-taking institutions. They have to pay an interest on deposit even if they are unused. If this excess amount of money is not invested, the banks cannot pay the interest to the depositors. To motivate the people to deposit and save, the government has to mop up the excess liquidity by borrowing. So, the borrowing can be a good motivating tool for the depositors.
5. It helps the commercial banks and financial institutions to deploy their idle resources; it also helps them to reduce the cost of liquidity.
6. To achieve the target of monetary policy: The general target of the monetary policy may be the areas like price stability, exchange rate stability, money supply, inflation control, interest rate stability, etc. There will be a great distortion in the economy if these monetary policy targets are not achieved. So, to achieve the aggregate monetary target, the domestic borrowing could be an effective tool.
7. To fulfill the resource gap for development activities of the government: The ongoing projects of the government should not stop due to the resource constraints and should be completed in time. The halting of the ongoing projects and postponement of the pipeline projects is possible when the government expenditure exceeds the income, or when the government revenue collection is not as expected. Thus, to avoid the resource gap problem, the government can finance and make fund available through domestic borrowing.
8. To mop up the excess liquidity from the economy: There should be an optimum level of liquidity

reserve in the economy. Higher and lower than required level of liquidity is not desirable for economic stability. Excess liquidity will have an adverse impact on inflation, interest rate or cost of production and ultimately it will hinder the economic development process. So, if the liquidity is higher than the desirable level, it has to drain from the system .To minimize this spillover effect and maintain monetary stability, domestic borrowing can help. Through domestic borrowing, liquidity will be drained from the system. Borrowing by issuing government securities could be a very effective tool to keep the excess liquidity at the proper level.

9. To develop an infrastructure in the country: Infrastructure development is very essential for national development. Infrastructure development sectors like education, health services, transportation, communication and irrigation needs a substantial amount of expenditure. This deficit level of expenditure can be recovered through borrowing. Internal borrowing could be a reliable source for deficit financing for these sectors.

10 It is used as debt servicing instruments: During the recession period also the government has to make payment of principal and interest to the foreign loan as well as to domestic borrowing. Thus, the government can collect resources by domestic borrowing for the payment also.

11 To decrease the tax burden: For deficit financing either the government has to raise tax to increase revenue collection or it has to print the money; both are not easy jobs. By domestic borrowing the government can lower the tax burden of the people.

12 To increase the people's participation in the national development: The borrowed money will be invested in the development projects by the government. So, the people who have invested in the government securities would have a feeling that they have also participated in the national development activities. Thus, borrowing will help in developing the sense of belonging and sense of ownership of the national projects by the people.

Disadvantages of Domestic Borrowing

Despite these advantages of internal borrowing, there are disadvantages of domestic borrowing. Some of the disadvantages are as follows:

1) When the government borrows an excess amount, the possibility of undertaking unjustifiable projects by the government will be increased.

2) Internal borrowing implies the easy money being available to the government. By excess borrowing the government may have the tendency of spending on non-productive and non-feasible sectors. In such a situation the full burden of the debt will be postponed and the interest rate burden on government will go up unnecessarily which will lead to increase in interest rate and money will be diverted from private enterprises to government security. Finally, this may result in the government depreciating its currency and defaulting on its obligations.

3) The government securities are the risk-free areas of investment. Banks will try to invest on these risk- free areas; but there may be lack of private finance in the productive sectors due to the lack of resources. Thus, internal borrowing may affect private financing.

4) By borrowing for the longer period, the government tends to postpone its payment. This will shift the liability to future generations. Borrowing could increase the debt burden for the future generations. Likewise, if the government borrows beyond its repaying capacity, the debt trap possibility will be increased.

5) It is widely accepted that the productivity of the government sector's investment is lower than the private sector's investment. The management efficiency has been found more in private sector than in the government sector. So, the yield on investment will be low in the government's investment.

Classification of Debt Instruments

Generally the debt instruments are classified under the following basis:

Maturity Period Basis

The debt instruments are of different maturity periods. According to the maturity period they are classified as:

(a) Long-term security: Those debt instruments (securities) whose maturity period is more than one year are classified under long-term security. Long-term securities are known as bonds.

(b) Short-term security: Securities having less than one-year maturity period are classified under short-term security. These short-term securities are

also known as bills. Like other government securities, this instrument is also the government's obligation and is also guaranteed by the government.

Based on Objective of Borrowing

The government may borrow for some specific purposes like road construction, land development, electrification, etc. Hence, the name of the issued securities can be given after the purpose of borrowing of that particular instruments, like irrigation bond, electrification bond, Melamchi Drinking Water bond, etc.

Ownership Transfer Basis

On the basis of ownership transfer character, the debt instruments are classified as:

(a) tock: Stock security cannot be sold by holders simply by the endorsement process as they are registered in issue offices. If the bondholder likes to sell the stock instrument, he has to come to the issue authority with the buyers for the signature verification. This signature verification is doing by the NRB, Public Debt Management Department, which is the debt manager of the government

(b) Promissory note: This promissory type of instrument can transfer ownership by a simple process of signature endorsement between buyers and sellers. This type of security is registered in NRB's record during their primary issuing time only. At the time of selling, the owners need not to come to the NRB (issuing authority) for their signature verification.

Bearers Bond

With respect to this type of bonds, the bearer himself is supposed to get the payment. So, the signature verification of the bond's bearer is not important in such securities.

History of Domestic Borrowings in Nepal

Nepal Rastra Bank was established in 1956 as a central bank of Nepal under Nepal Rastra Bank Act-1955. One of the objectives stated in Nepal Rastra Bank Act 1955 is to mobilize the available local resources to the national development activities. To fulfill this objective, the Public Debt Act-2017 B.S. was introduced. For the management of the government's internal debt, a separate division of Public Debt was established in Research Department, NRB. Considering the importance and volume of the work of public debt, the NRB upgraded Public Debt Division to a Public Debt Department in 2023 B.S. as an independent department. The responsibilities given to this department under Public Debt Act-2017 B.S. and Public Debt Regulation-2020 B.S. were as follows:

a) To sale the government securities.
b) To collect the money borrowed by the government.
c) To deposit the borrowed money in the government account.
d) To make payment of the government securities (principal and interest amount).
e) To solve the problem of ownership conflict on government securities (bonds and bills).
f) To perform the advisory function of the government on borrowing, on interest rate, on designing of security papers, payment period, and so on.

After five years of the establishment of the NRB, the Public Debt Act-2017 B.S. was formulated and enacted. After the enactment of this Act, domestic borrowing was initiated in the country.

For the first time in 2018 B.S., the government borrowed Rs. 7.0 million by issuing treasury bills of 90 days maturity period. This treasury bill was issued in face value and in one percent annual coupon rate of interest. Thereafter, the internal borrowing by the government has become a regular process in Nepal.

Though HMG of Nepal has started borrowing since 1962, the sale of treasury bill by bidding auction was started only in 1984. The secondary market facility for treasury bill like re-purchase (repo), outright sale and outright purchase facilities from secondary window was started in 1994. In 1996 tap sale window for treasury bill was opened. For the first time in 1991, the NRB issued a central bank bond in the name of Nepal Rastra Bank Bond 2053 B.S. (Rastra Bank Rin Patra, 2053 B.S.) which was issued in 1991 and matured in 1996. The NRB bond was issued for the second time in 1996, which was the last bond issued in the name of central bank. At present, there are five types of domestic borrowing instruments (bills and bonds). The outstanding of total debt was Rs. 82411.5 million as of mid-January, 2005. The name and issued years of the bonds are presented in Table 1.

Apart from the above five types of borrowing instruments, some instruments like Land Development Bond, Land Compensation Bond, and Forest Development Bond were also issued by the

government of Nepal. These instruments were one time issued, so they are already matured and paid.

Existing Domestic Debt Instruments and Their Features

The existing five types of debt instruments are Development Bond, National Saving Bond, Citizen Saving Bond, Special Bond and Treasury Bill. The maturity period of these instruments ranges from 28 days to 20 years. They are either promissory or stock in nature .All the bonds are issued at coupon rate of interest and in face value. The treasury bill is the government's short-term borrowing instrument. They are issued at a discounted auction price and the bill holder gets the payment in face value at maturity. The difference between the purchase price and received amount at maturity is the yield of the treasury bill. They all are of promissory in nature.

Among these five types of instruments, the treasury bill is the oldest instrument and the Citizen Saving Certificate is the latest one introduced in Nepal. The National Saving Certificate, Citizen Saving Certificate are issued either in stock or promissory types as individuals demand, whereas Special Bonds and Development Bonds are issued as stock only. Bonds, which are issued for institutions, can be sold to the limited institutions. For example, the bonds which are issued for insurance companies can be sold only to the insurance companies. Treasury bills can be bought both by individuals as well as institutional lenders. Issue, purchase, repurchase and sale of the treasury bill are completely based on auction and discount price, whereas all other bonds are sold on the basis of face value and coupon interest rate.

Domestic Debt and Their Composition

The outstanding amount of borrowing in the respective instruments and their composition has been presented in Table 1.

As at mid-January 2005, the government's domestic debt amounted to Rs. 82,411.50 million. The composition of debt shows that the government has borrowed the highest amount by issuing treasury bills, which consists of more than 61 percent of the total borrowing.

Target Group of the Debt Instruments

The target groups of these above five types of existing debt instruments are different. Some instruments are targeted to individuals, some are to commercial banks and financial institutions and some to both. Instruments such as National Saving Bond and Citizen Saving Certificate are issued especially for the individuals. They cannot be purchased by the institutions. They are generally promissory notes in nature but they can be issued in stock nature if so demanded by the individual. Though the Development Bond and treasury bills are very familiar to the commercial banks and other financial institutions, these instruments can be bought by individuals, too. The treasury bill is issued as promissory note and Development Bonds are stock in nature. The Special Bonds are issued for special purposes as requested by HMG. All the special bonds are stock in character and they can not be bought by individuals.

Ownership Pattern of Domestic Debt

The highest amount of domestic debt is held by the commercial banks. They hold almost 63 percent out of total domestic borrowing of the

Table 1

Total Outstanding Amount and their Composition (Mid January 2005)
(Rs in million)

S.N.	Instruments	Issued Year (B.S.)	Total Outstanding	Percentage Composition
1	Development Bond	2020	17549.21	21.29
2	National Saving Bond	2040	9029.84	10.96
3	Treasury Bill	2018	50391.65	61.15
4	Special Bond	2028	4261.92	5.17
5	Citizen Saving Certificate	2058	1178.88	1.43
	Total		**82411.50**	**100.00**

Source: Nepal Rastra Bank, Public Debt Management Department.

government. They are holding the highest amount of treasury bills (86.8 percent) than any other debt instruments. Table 2 shows the ownership structure of the domestic borrowing.

Portfolio Mix and Maturity Structure

The debt manager should ensure the government's financing needs and its payment obligation. For this, he has to consider the debt portfolio mix in term of maturity profile, interest rate and portfolio creation. The portfolio mix and maturity structure of the domestic debt are shown in Table 3.
Management Department.

The above maturity structure shows that the maturity out of the total domestic borrowing of the government is the highest in the current fiscal year and goes on decreasing in subsequent years. Table 3 shows that out of total domestic debt outstanding, 51.71 percent is maturing within the period of one year (FY 2004/05) and 22.00 percent debt will mature on the next year (FY 2005/06); moreover, 9.34 percent out of total borrowing will mature on FY 2006/07 in comparison to only 0.05 percent in FY 2009/10. From the maturity mixing and risk minimizing aspects, this maturity structure seems to be good because the risk of shifting of government liabilities will be less in such a maturity structure. So, by fixing the shorter maturity period on the majority amount of borrowing, the risk of tendency of shifting liability of borrowing has been minimized.

Table: 2
Ownership Structure of the Domestic Debt (Mid-January ,2005)
(Rs. in million)

Ownership	Development Bond	Natonal Saving Bond	Treasury Bills	Special Bond	Citizen Saving Certificate	Total
Commercial Bank	6587.41	110.00	43755.00	944.60		51907.01(62.98)
Development Bank & Other Financial Institution	1194.95	220.24	510.00			1415.19(1.72)
Other Institution	7123.27	2651.26	1855.50	2453.30	3.71	14087.04(17.09)
Individual	209.80	5904.86			1127.58	7242.24(8.79)
Nepal Rastra Bank	2433.77	143.48	4271.15	864.03	47.58	7760.01(9.42)
Total	17549.20	9029.84	50391.65	4261.93	1178.87	82411.49(100.00)

The figures in parenthesis ( )show the percentage of holding out of total borrowing.
Source: Nepal Rastra Bank, Public Debt Management Department.

Table 3
Maturity Structure of Domestic Borrowing
(Mid -January 2005)

Maturity Fiscal Year	Development Bond	National Saving Bond	Special Bond	Treasury Bills	Citizen Saving Certificate	Total
2004/05	550.00	2670.00	1651.03	37747.50		42618.53 (51.71)
2005/06	2790.00	2700.0		12644.15		18134.15 (22.01)
2006/07	4282.09	2359.84	430.44		628.06	7700.43 (9.34)
2007/08	3511.69	400.00	1779.81		303.04	5994.54 (7.27)
2008/09	6.93	900.00	204.99		247.78	1359.70 (1.65)
2009/010			38.05			38.05 (0.05)
2012/013	6408.50		157.60			6566.10 (7.97)
Total	17549.21	9029.84	4261.92	50391.65	1178.88	82411.51 (100.00)
Percentage	21.29	10.96	5.17	61.15	1.43	

The figures in parenthesis ( ) show the percentage of holding out of total.
Source: Nepal Rastra Bank, Public Debt Management Department.

Regarding the portfolio mix, it shows that the highest amount out of total debt is by treasury bill which consists about 61 percent. Other long term bonds are less than treasury bill; altogether, they form only about 49 percent out of total .The treasury bill, Special Bond and Development Bonds are institution-targeted instruments (though treasury bills could be bought by an individual). Almost 87 percent out of the total government debt is the investment made by the institutions (Table 2).

Table 4 shows that the contribution of domestic borrowing to total expenditure and domestic borrowing to GDP is displaying a decreasing trend since FY 2002/03 while the ratio of domestic borrowing to revenue is increasing. All these indicators show that government is trying to increase its capacity in revenue collection and trying to reduce gradually its dependency on borrowings.

Aspects of Debt management

The following different aspects are taken into consideration with respect to debt management:

Transparency and Accountability: Different organizations especially Ministry of Finance (MOF), NRB and Financial Controller General's Office (FCGO) are closely related with each other for domestic debt management activities. The accountability of each organization has been clearly stated in the Domestic Debt Act-2059 and Domestic Debt Regulation-2059 B.S. Responsibilities are clearly allocated among the MOF, FCGO and debt manager for primary issue, secondary market arrangement, payment and settlement arrangements for trading of government securities and pubic discloser.

For public disclosure the Public Debt Management Department of the NRB publishes the monthly reports on domestic borrowing position and it prepares the weekly trading position of treasury bill in primary and secondary market. Also, the Banking Office of the NRB provides the information on the government's treasury position.

Coordination: The government announces the amount of domestic debt to be borrowed through its annual budget programs .On the basis of the government budget, the issue calendar prepared by the NRB will be approved by the Ministry of Finance (forwarded by the Open Market Operation Committee). The quarterly basis annual issue calendar is prepared on the basis of past trends of government revenue and government expenditure in each quarter.

To establish the cordial coordination between fiscal and monetary policy and domestic debt manager, there is a provision of Open Market Operation Committee (OMOC) under Public Debt Management Act 2059 B.S. The Deputy Governor of the NRB chairs this Committee, and Executive Directors of NRB from Research Department, Bank and Non-bank Institution Regulation Department, NRB Banking Office, Public Debt Management Department, Directors of Public Debt Management

Table 4
Some Important Indicators (Mid-January 2005)
(Rs in million)

Descrption	2000/01	2001/02	2002/03	2003/04	2004/05*
Total Expenditure	79835	80072	84006	92107	111690
Development expenditure	37066	31482	29033	32810	31577 @
GDP	411217	422676	456201	495336	537449 #
Total Revenue	48894	50445	56230	62330	72700
Domestic borrowing	7000	8000	8880	7312	6090
Total Deficit	3094	29626	27776	29777	38990
Domestic borrowing /GDP	0.02	0.02	0.01	0.01	0.01
Domestic borrowing /Devevelopment expenditure	0.19	0.25	0.31	0.22	0.29
Domestic borrowing /Revenue	0.14	0.16	0.16	0.12	0.12
Domestic borrowing /Total expenditure	0.09	0.10	0.11	0.08	0.08

* Estimated
@ Capital expenditure
Source: i) Budget Speech 2004/05 and 2003/04
ii) # Central Bureau of Statistics

Department and Joint-Secretary from Ministry of Finance and Financial Controller Office are also members of the Committee. The responsibilities of the OMOC are as follows:

- To decide on the amount, issue date, and maturity periods of the bills and the bonds to be issued.
- Plans for the new issue (on the basis of approved issue calendar).
- To announce the treasury bill's auction bidding and award the biddings.
- To recommend issuing new bonds to HMG.
- To recommend on the amendment of the domestic debt policy to the government.
- To decide on all other related issues on the treasury bill and domestic debt management.
- To maintain the optimum level of liquidity in the system through primary and secondary market operation. For this, the OMOC will decide whether the liquidity has to be injected in the system or has to be drained out from the system temporally or permanently.

The OMOC uses two general approaches to maintain the optimum level of reserve in the system. When a significant increase of liquidity is expected in the system for relatively a long period, the OMOC may decide to go for outright sale, reverse repos or fresh issue through primary market which will affect the size of central bank's portfolio and it will reduce the reserve in the system. Likewise, when the liquidity shortages are expected in the economy for the shorter duration, such liquidity can be adjusted in the market through purchase, repos and standing liquidity facility because portfolio growth is achieved through repurchase agreement and outright purchase and portfolio contraction is achieved through sales and reverse repurchase agreement and by allowing holding to mature without replacement.

Risk management: Long -term borrowing may be more risky than short-term debt in one situation whereas in another situation, the risk may be vice-versa. Borrowing on fixed interest and coupon rate of interest may be more risky; likewise, there should not be over concentration of borrowing on the same types of securities and on the same period of maturity to minimize the crowding risk. The maturity structure for the next seven years with respect to the borrowing instrument shows that most of the debts are borrowed for shorter period. But concentration of debt is higher on treasury bill because out of the total outstanding 61.15 percent debt is borrowed by issuing treasury bill (Table 3).

To make the risk management effective, the debt manager should be provided the information on past budgetary activity, present situation and projected budgetary position like revenue collection, expenditure, treasury balance, and so on. The debt manager should provide the published information on the stock, composition of the debt and financial assets including currency, maturity and interest rate to the government.

Auditing of the debt management activity: Audit should be done by the external auditors annually for the domestic debt management and all the suggestions from the auditors should be incorporated.

Legal framework: Functional responsibilities of the related organizations should be clearly stated and has to be guided by an act and regulations. In Nepal the different aspects of the domestic debt management are guided by Nepal Rastra Bank Act-2002., Public Debt Act–2059 B.S. Public Debt Regulation-2059 B.S. and Public Debt Management Working Guidelines-2060 B.S.

According to the Nepal Rastra Bank Act 2002, the government can borrow through overdraft facility from the central bank up to the amount of five percent of the total revenue of the last fiscal year. The total holding limit of the government securities by the central bank has also been limited to ten percent of the last fiscal year revenue of the government. By this legal limitation, the possibility of excess borrowing and risk of debt trap has been minimized.

Internal operation control: There may be the chances of risk of losses from inadequate internal operation control. So, there should be internal operation control accordingly and sound business practices including well-articulated responsibility for the staffs, clear monitoring, periodically reporting and control mechanism should be established. For this, the division of work, span of control, authority, and the working procedures are mentioned on the Public Debt Management working guideline of the department.

Domestic Debt Management Practices in Nepal

The Public Debt Department has given a new name as Public Debt Management Department since

2004. Under the Public Debt Act-2059 B.S. and Public Debt Regulation 2059 B.S. this Department on behalf of the NRB is undertaking the domestic debt management functions. The Public Debt Management Department is managing the domestic debt by adopting the following operational procedures:

Policy Recommendation

If some rectification and amendment is needed in the domestic debt act, borrowing policy and regulation, it will recommend to the government for the amendment and rectification.

Advising to the Government

It advises on the level of internal borrowing requirement for the government during the coming fiscal year. Basically this forecasting is based on the government expenditure, income, GDP level and deficit financing.

Preparation of Issue Calendar

This function of management starts when the government announces the budget for the fiscal year. The total targeted domestic borrowing amount is divided into four different quarters for primary issue. The amount to be issued is projected on the basis of the trends of the government income and expenditure, revenue collection level, and cash position projection for the periods. The government income and expenditure may not be distributed evenly throughout the fiscal year. In one quarter the income may exceed the expenditure while in the other quarter, the expenditure may exceed the income. Thus, the issue schedule is prepared according to the level of government's deficit projection. The amount proposed to issue in each quarter may not be equally divided. The issue calendar is finalized by OMOC and approved by the Ministry of finance. This approved calendar will be available in the bank's website for the information to interested people.

The preparation of issue calendar has started since the FY 2004/2005. This issue calendar will be helpful for investment planning and portfolio management of the banks and other financial institutions. It is equally useful for the government for their treasury management.

Primary Issue Management of Bonds

On the basis of the approved issue calendar, the following procedures are followed in primary issue of bonds:

(a) **Announcement of sale**: Sales announcement is published in the daily national newspaper with all the features of the instruments and selling and buying details like opening and closing date of selling, interest rate, offered amount, applying procedures, selling counters, eligibility of applicants, etc. All these features have to be approved by the Ministry of Finance. This announcement is important for those who are willing to invest in government security. Such announcement for primary issue is made for all bonds except for Special Bond.

(b) **Sale of security**: Selling starts in the announced date. The demand application form can be collected from the selling counters. The borrowers have to follow the prescribed procedures to apply for obtaining such securities. Applicants have to fill up the prescribed form. He/she has to mention his/her name, address, amount and types of certificate he likes to have (stock or promissory notes), denomination of the certificates, sign and stamps (stamps in case of institutions). After filling up the application, one can submit such demand form in the selling counter with their cash voucher and citizenship certificate attached. In the case of bonds, the applicant has to deposit the total demanded amount. The demand application form is free of cost for the bonds and can be obtained from all the selling counters .The borrowers can buy the bonds either in sole ownership or in joint- ownership. There is also the provision of buying the bonds in the name of infant by their guardians.

(c) **Closing of sale**: Generally, the sale of securities may stop at the announced date and time; but sometimes, the selling may be oversubscribed before the closing date that was announced. In such a situation the selling may close at the oversubscribed date.

(d) **Collection of demand applications and demanded amount**: When the selling of securities is closed, all the applications with their demanded amounts are collected from each of the selling counters (NRB, commercial banks and market makers outside the Kathmandu valley) and the demand list is also prepared.

(e) **Allocation of demand**: Demand allocation is done as per the OMOC's decision. If the demanded amount is equal to less than the offered amount, in general, the applicants receive the full amount in accordance to their demand; otherwise, if the demand is more than the offered amount, there

may be the chances of getting less than the demanded amount . In case of oversubscription, the OMOC allocates the amount, applying different techniques such as pro-rata basis, stratified basis, and multi-stratified allocation methods. But it has never used the lottery method for allocation. The OMOC tries to allocate the offered amount to the largest possible number of people. If the applicants do not get any amount of bond or if they get less than the demanded amount, the excess of the deposited amount will be refunded within 15 days of the decision taken by the OMOC for the allocation.

(f) **Preparation of the certificates**: On the basis of allocation sheet as approved by OMOC, the certificate has to be prepared in the applicant's name. These certificates are signed and stamped by the concerned authorities. Some of the very essential features like name of bond, types of bond, owner's name, face value of the certificate, registration number, serial number, issued date and maturity date, must be mentioned clearly on the certificate. There will be a separate certificate for principal and for interest amount. The amount of interest, date of payment and number of payment has to be mentioned on the interest certificate.

(g) **Distribution of the certificates**: The certificate is distributed from the same institutions from where the applicants have submitted their application forms. During delivery of the certificate, he/she has to keep in mind that the certificate should be delivered very safely. For safety purposes, the NRB delivers the certificate by hand inside and outside the Kathmandu valley. During delivery of the certificate to the applicants, the broken period interest has to be given. Especially for the individuals (Citizen Saving Certificate, National Saving Certificate), certificates are issued with open signature of the owners. So, there are chances of encashment of these certificates if they are stolen or lost. Thus, the bond-holders have to be very careful and keep these certificates safely.

Secondary Market Management of Bonds

The secondary market functions for the bonds are being provided through the market makers. The buying and selling of bonds are trading at par (face value) .The buyer has to pay the interest at the coupon rate of the bonds unto the previous day's transaction to the seller. There is no discount system and premium facility.

Issue of Treasury bill by Bidding Auction

The treasury bills are issued on the basis of multiple price-bidding auctions and on discounted rate. Any interested institutions and individuals can participate in bidding auction. The bidders are classified into two groups: non-competitive and competitive. The commercial banks and development banks doing the commercial functions are classified under competitive bidders while the other bidders are classified under non-competitive bidders. Out of the total offered amount in each issue, 15 percent is allocated for non-competitive bidders. The bidding and bid awarding process for treasury bills are as follows:

(a) Call for bidding: Information on auctioning of treasury bill is published on national daily newspaper and also kept in the bank's website. Generally treasury bills are issued on Tuesday (for 91-day and 364-day treasury bills) and Thursday (for 28-day and 182-day treasury bills). In the notice, all the information like series number, issued date, maturity date, offered amount, whether fresh or renewal, last biding date and time are published. Apart from this information, other supplementary information like number of bidders, bid amount, offered amount, left over amount, accepted weighted average discount price, and maximum and minimum accepted bid price on the last auction are also published.

The bidder could obtain the bid form by paying Rs. 10.00 per form with the envelopes. This form can be purchased from the Public Debt Management Department in Kathmandu and any branch of Nepal Rastra Bank stationed outside Kathmandu. The bid forms are of different color for 91-day treasury bills, 364-day treasury bills and for non-competitive bidders. Before submission of the bid forms, the bidders have to mention every detail in their form such as series number of the demanded treasury bill, demanded amount, and bid price (discounted price). The bid price has to be mentioned on the basis of Rs. 100.00 for demanded amount. For the noncompetitive bidders the discount price need not to be mentioned. For each bid price, they have to submit the bid form separately. Lastly, they have to sign, in case of institutions by two authorities and stamps. The bidder has to mention the bid price in four decimals. The bid price is also known as the discounted price which means the bidders are ready

to invest that much of the price at present and the face value amount will be paid at maturity.

The voucher of the deposited earnest money could be attached with bid forms (2.5 percent of the bid amount). The earnest money can be deposited in the NRB's Banking Office Kathmandu and in any branch of NRB Kathmandu. The bid form should be enclosed in the envelope and should be dropped in the tender box in Public Debt Management Department of the NRB. The bidders from out of the Kathmandu valley can submit their bid form in the NRB's branches.

(b) Verification and recording: After the bid forms are opened, they should be verified. During verification, it has to be checked whether or not the bidders have mentioned the important information such as bidding, discounted price, bid amount, name and signature of the bidders, stamps so on. If such important information is missing, this will be minutely noted down and finally such bids will be discarded. The bids are recorded in the recording register as mentioned below (the case presented below is hypothetical):

Amount : (Rs in crore)

S.N.	Name of Bidders	Number of Bid Forms	Bid Amount	Remarks
1	K. Bank Ltd	2	6.00	
2	S . Bank	1	3.00	
3	N. Bank Ltd	2	40.00	
	Total	5	49.00	

Assumption : The amount to be issued is Rs. 40.00 crore.

In this case the amount is oversubscribed by Rs. 9.00 crore.

c) Computer entries: The recorded bids are entered in the computer-spread sheet. The details are entered in the following format:

S.N.	Name of Bidders	Bid Amount	Bid Price	Discount Rate
1	K. Bank Ltd	3 .00	98.4398	3.1699
2	K .Bank Ltd	3 .00	98.3763	3.3010
3	S . Bank	3.00	98.5128	3.0193
4	N .Bank Ltd	20.00	98.8875	2.2500
5	N . Bank Ltd	20.00	98.8631	2.2999
	Total	49.00		

Calculation of discount rate:

$$D.R = \frac{(100-B.P)*364*100}{B.P * Terms}$$

Where,

D.R = Discount rate (as quoted by bidders)

B.P = Bid price

Terms = Maturity period of the given treasury bill.

(d) Bid award: This being the multiple price auction, the successful bidders have to pay according to their quoted price for their bid amounts. So while awarding, the highest bid price should get the higher preferences. This is important in order to minimize the borrowing cost of this particular issue. For this, the above computer generated data are arranged in diminishing order of the bid price or in increasing order of the discount rate as follows:

S.N	Name of Bidders	Bid Amount	Bid Price	Discount Rate	Accepted
1	N . Bank Ltd	20.00	98.8875	2.2500	20.00
2	N . Bank Ltd	20.00	98.8631	2.2999	20.00
3	S . Bank	3.00	98.5128	3.0193	00.00
4	K . Bank Ltd	3 .00	98.4398	3.1699	00.00
5	K . Bank Ltd	3 .00	98.3763	3.3010	00.00
	Total	49.00			40.00

Award summary,

N. Bank LtdRs. 40.00 crore	Highest price	98.8875
	Lowest price	98.8631
	Highest Rate	2.2500
	Lowest Rate	2.2999
	Average Weighted Price	98.8753
	Weighted Average Discount Rate	2.2750

Calculation

1. Average Weighted Price (A.W.P)

$$A.W.P = \frac{\Sigma (B.P * Accepted\ amount)}{\Sigma\ Accepted\ amounts}$$

2. Average Weighted Rate (A.W.R)

$$A.W.R = \frac{\Sigma (D.R * Accepted\ amount)}{\Sigma\ Accepted\ amounts}$$

In the above situation, the N.Bank's bids have been accepted. By awarding the bids to the N. Bank which has quoted highest bid price, the cost of borrowing for this issue will be minimum than awarding to other bidders because the lowest rate or the highest price has given the preference; as a result of this decision, the interest risk and cost of borrowing will be reduced.

Although the rates are determined by the market, the rate should be representative of the current market rate and there should not be any indication of speculation and cartelling. So, the decision makers should keep their eyes on the current market situation. Additionally, they should be very conscious about

the possibilities of cartelling and unnatural response from the bidders. If they feel that the responses are not in normal trends and not representing the market, they have the right to fix the cut off price and the authority not to award the bidders. They should always keep in mind that a good pricing in auction is possible by good participation only.

(d) Account settlement: On the issued date, the biding account will be settled. Those who are not able to receive the treasury bill will get refund of their earnest money and the successful bidders have to deposit the difference amount (difference of discounted accepted amount and deposited earnest money). The N. Bank has to pay at the discount price of 98.8875 for Rs. 20.00 crore and 98.8631 for the next Rs. 20.00 crore. This difference amount should be deposited no later than the issue date. If the successful bidder fails to deposit the difference amount within the given time, the deposited earnest money will be seized. The certificate preparation and distribution process is the same as in the issue of bonds.

Secondary Market Management of Treasury Bill

The secondary market facility is provided to the bill holders by the NRB only. There is no market maker for the treasury bill. Presently, five windows are opened for secondary market; they are out right sale, out right purchase, repo, reverse repo and standing liquidity facility (SLF). All these facilities are auction based except the SLF. The SLF is collateral based and the interest rate is based on 91-day treasury bills auction rate. The SLF can be used at any time by the government securities holders whereas the other windows can be used only when the NRB announces for auction. The OMOC bears the full authority to take all the decisions on treasury bill auction.

Facility of Duplicate Certificate

In case the owner lost and tears his certificate, the NRB issues the duplicate certificate. To get the duplicate certificate, the owner has to submit the application in the nearest NRB's office with certain evidences.

Payment

It is HMG's obligation to pay the interest and the principal amount to the owners timely. On behalf of HMG, the NRB makes payment to the securities holders at the date mentioned on the certificates, even though the government delays the payment to the NRB. The payment of interest of the securities can be obtained through any of the commercial banks, development banks and market makers. They get the commission out of this interest payment. The reimbursement of payment and commission will be provided through the NRB.

Record Keeping

This is one of the important parts of the debt management. For this, the NRB maintains the data and furnishes this information to the concerned organizations. Details such as total borrowing, total liability of the government, increment level of borrowing each year, maturity structure, types of instruments used, ownership pattern, issue and maturity date of each issuance are clearly recorded and disclosed.

Promotional Activities of Government Securities

In order to promote and strengthen the securities market, the NRB is undertaking the following efforts:

(a) Public awareness program: The NRB, as a domestic debt manager, regularly conducts seminar, interaction program and talk program for the senior officials of the banks and financial institutions. It also conducts the training and interaction programs for other front, middle and back officers of the related institutions, for individuals and for the market makers. These programs are conducted in different regions of the country. From such program, people may enhance their knowledge relating to buying and selling of the government securities and their management.

(b) Development of market makers: The government securities are widely accepted. The securities holders are scattered throughout the country. The interested individuals should be able to buy and sell the government securities at any time and from their nearest agency. So, the NRB is providing the permission (license) to the interested banks, finance companies and cooperatives to do the function of buying and selling of such securities. They are known as market makers. Thee licenses of the market makers can be renewed each year. There are 46 such market makers for FY 2004/05. They are operating throughout the country. To be a market maker, they must meet the minimum paid up capital standards.

The market makers purchase and sell the government bonds in the secondary market under the prescribed norms and directives given by the NRB. They also help in selling the government bonds in the primary issue. By this arrangement, people need not to come to the central bank for buying and selling of government securities. They charge the commission for their secondary market transactions activities. For primary issue also, they are paid the commission by the government on the basis of amount of their sale.

Challenges and Suggestions for Debt Management

The size of the fiscal deficit that affects the size of internal borrowing is increasing every year. Hence, for the development of the government securities market, an efficient management system should be established. The following areas has to be developed and strengthened in the future:

(a) **Scripless system** : The size of domestic debt in terms of volume and quantities are increasing. The paper certificate system and the delivering of the documents physically are the time consuming process and certain risk are also involved in delivering the documents physically. For the prompt and efficient service, developing the scripless system is one of the important areas.

(b) **Networking** : Net working will make the communication and sharing of the information easy. For this, at least we need to go for the Local Area Network (LAN) or City Area Network (CAN) immediately.

(c) **Improvement in the debt recording system**: There are no consolidated debt records available in Nepal. Different organizations are involved in the debt management. Domestic debt is managed by the NRB, and external debt is managed by the Ministry of Finance and Financial Comptroller Office. The payment part is solely taken care of by the Financial Comptroller Office. However, these organizations are found to be working without any close cooperation. So, to have an efficient and consolidated data recording, a need-based and a user friendly debt management recording software is a prerequisite.

(d) **Development of security market**: The primary and secondary market functions of government securities are done by the NRB in Nepal, though there are some market makers undertaking a limited function on government securities. These market makers are mostly concentrated in the Kathmandu valley. As a result, the market facilities are not yet well spread throughout the country.

(e) The policy is underway for trading and listing of the government securities through security exchange market. By trading the government securities in the security exchange market, the investors will be certainly benefited and trading will be on the basis of market demand and supply. Trading will reflect the real market situation. The securities will be traded on either premiums, discount or par value. But maintaining the investors' confidence is a must for the well-functioning of the security markets. Before going to real trading on the security markets, there should be wide trading network, good infrastructure, efficient manpower, transparent floor trading system and settlement. Otherwise, the impact will not be as expected.

(f) **Central depository system**: To be an efficient security market the settlement of the transaction should be completed within a very short period of time. Only through the central depository system can we make the existing settlement duration shorter.

(g) **A higher-level debt policy coordination committee**: As this high level apex committee will be responsible for the national debt strategy and debt policy, there should be a provision of such central committee for the policy formulation and effective implementation.

(h) **Monitoring mechanism**: It is widely accepted that the borrowing amount should not be used in non-productive sectors like regular expenditure of the government, buying for arms and ammunition. Otherwise, the situation would be like "debt for debt payment" which will lead to a debt trap. Thus, there should be a monitoring mechanism for the borrowed money.

Conclusion and Suggestion

To manage the government borrowing efficiently, development of an efficient government security market is a must. The borrowing should be invested in the productive sector. The financial return to government out of these investments should be greater than the cost. The assets created out of such borrowing (yield) should be at the higher level. The borrowing cost and return should be widened every time. The objective of borrowing should not be for making easy money for the government. If the return

is less than the borrowing cost, this will result in the gradual deterioration in the paying capacity of HMG and finally the public will have less confidence on HMG.

The borrowing instruments can be used for maintaining monetary balance as well as for HMG's financing. So, there should be a cordial coordination between fiscal and monetary policy maker and debt manager. They should share their common interests to attain both the goals.

The borrowing should not be for the payment of interest and principal amount. It should be invested in the productive sector so that return from such investment will be sufficient for repayment. Hence, an efficient monitoring mechanism should be developed. While the quantitative increase in the domestic borrowing is not that important, the meaningful use of such borrowing is more crucial.

For the implementation of the issue calendar a very cordial coordination is needed between the fiscal manager and domestic debt manager of the country. Through the primary issue of the government securities liquidity will be drained and there will be a decline in the reserve position in the financial system. So, the fiscal manager should be aware of this effect on the monetary sector. Likewise, the monetary authority should also bear in mind that it is also used for fiscal management of the government.

The supply of government securities can be more efficient by developing an efficient primary market, projection of government treasury position, and safe and efficient channel for distribution of securities. For this, we can create auction syndicates, primary dealers and brokers. Likewise, establishment of a clear line of control, transparent record-keeping and disclosure system, good floor trading arrangement, prompt settlement systems, etc. could enhance the demand of such government securities.

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International Relations

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Introduction

NRB is related with the international financial organizations, that provide financial facilities and technical assistance, like the IMF, World Bank, and Asian Development Bank. NRB has also been related with the regional organizations such as South East Asian Central Banks Research and Training Center (SEACEN) and the South East Asia, New Zealand and Australia (SEANZA) central banks group, Asian Clearing Union, and the SAARCFINANCE (forum of the SAARC central banks).

International Monetary Fund

The Depression of the 1930's weakened the economic activities and the Second World War of the early 1940's destroyed the infrastructure of the major industrial countries. After the outbreak of the war, consideration of the post-war world financial system began in both the United Kingdom and the United States. British economist John Maynard Keynes wrote a proposal for the establishment of the International Clearing Union known as "Keynes Plan" and the American economist Harry Dexter White wrote proposals for International Stabilization Fund and a Bank for Reconstruction and Development known as "White Plan". Two plans were taken up at the Bretton Woods conference in July 1-22,1944 when representatives from 44 countries met at the United Nations Monetary and Financial Conference - popularly known as the Brettonwoods Conference. The conference decided to establish the two institutions, International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) known as World Bank today. When these two organizations were established, an organization to promote world trade liberalization was also contemplated. But it was not until 1995 that the WTO was set up. In the intervening years GATT tackled trade issues.

The IMF came into existence in December 1945 and began financial operations in March 1947.It is an independent specialized agency of the UN, encompassing 184 member countries.

IMF 's purposes as stipulated in its Articles of Agreements are:

- to promote international monetary cooperation,
- to facilitate the Expansion of international trade;
- to promote exchange stability, and assist in the establishment of a multilateral system of payments,
- to provide temporary financial assistance to countries under adequate safeguards to help ease balance of payments adjustments.

The IMF's accounting unit is the Special Drawing Rights (SDR). It is international reserve asset introduced by the IMF in 1969.SDR's sometimes known as paper gold, although they have no physical form -have been allocated to member countries (as

book keeping entries) as a percentage of their quotas. The SDR's value is set daily using a basket of four major currencies; the Euro, the Japanese Yen, the Pound Sterling and the U.S Dollar. The composition of the basket is reviewed in every five years to ensure that it is representative of the currencies used in international transactions, and the weights assigned to the currencies reflect their relative importance in the world's trading and financial system. As of May 27, 2005 1SDR =1.48516 US $.

Resources of IMF

The IMF's resources come mainly from the quota (capital) subscriptions that countries pay when they join the IMF. Countries pay 25 percent of their quota subscription in Special Drawing Rights (SDR's) or major currencies. The remaining subscription payable in the member's own currency. Unlike some international organizations that operate under a one-country one-vote principle, the IMF has a weighted voting system. , The larger a country's quota in the IMF the more votes it has but the board does not make always decisions based on formal voting's; rather most decisions are based on consensus among its members and are supported unanimously. Quota determines the country's subscriptions payments, its voting power, the amount of financing that it can receive from the IMF and its share in SDR allocation. Quotas are intended broadly to reflect member's relative size in the world economy. The larger a country's economy in terms of output and the larger and more variable its trade the higher its quota tends to be. The United States of America, the world's largest economy contributes 17.50 percent of total quota whereas Palau's contribution is 0.001 percent of total quota. Quota is generally reviewed in every five years. The most recent (eleventh) quota review came into effective in January 1999,raising IMF's quota by about 45 percent to SDR 212 billion (almost US$ 290 billion).

If necessary the IMF has two sets of lending arrangements to borrow to cope with any threat to the international monetary system as General Arrangements to Borrow (GAB) and New Arrangements to Borrow (NAB).

IMF's Activities

IMF provides services to its member countries basically in three ways that are as:

(a) It reviews and monitors the national and global economic and financial developments and advices its members on the improvement in their economic policies (Surveillance)

(b) It lends the member countries the hard currencies to support their adjustment and reform policies which was designed to correct balance of payments problems and promote sustainable growth (lending)

(c) It also offers a wide range of technical assistance as well as trainings for government and central bank officials. Training by the institute has helped to standardize the methods of gathering and presenting balance of payments, monetary, government finance and financial statistics.

Surveillance

A core responsibility of the IMF is to promote a dialogue among its member countries on the national and international consequences of 'surveillance'. The IMF has a mandate under Article IV of its Articles of Agreement to exercise surveillance over the exchange rate policies of its members in order to ensure the effective operation of the International Monetary System. Article IV consultations usually take place once a year .IMF economists visit the member countries to gather information and hold discussions with government and central bank officials, Upon their return the mission submit a report to the IMF's Executive Board for discussion. The Board's views are subsequently summarized and transmitted to the concerned country's authorities. Before 1977,the IMF's assessments of member countries policies were treated as confidential documents. In recent years it has become increasingly transparent. Surveillance today covers a wide range of economic policies. The topics covered under the surveillances are exchange rate, monetary and fiscal policies, structural policies, financial sector issues and the institutional issues. Now a day's assessments of risks and vulnerabilities stemming from large and sometimes volatile capital flows have become focal issue to IMF surveillance.

The IMF also continuously reviews global economic trends and developments, which is known as global surveillance. The main reviews of this kind are based on World Economic Outlook reports prepared by IMF staff normally before the semi-annual meetings of the International Monetary and Financial Committee. It also examines policies

pursued under regional arrangements as the Euro Area, the West African Economic and Monetary Union. IMF management and staff also participate in surveillance discussions of such group of countries as the G-7 and APEC.

Conditionalities

IMF's lending is conditional on policies. The borrowing country must adopt policies that promise to correct its balance of payments problems. The conditionalities associated with IMF lending helps to ensure that by borrowing from the IMF a country is able to strength its economy and repay its loan. The country and the IMF must agree on the economic policy actions that are needed.

Technical Assistance and Training

Besides supervising the international monetary system and providing financial support to member countries, the IMF assists its member countries by running an training institute in Washington D.C. and other regional training institutes, by making technical assistance available to member countries in certain specialized areas of its competence, and by issuing a wide variety of publications relating to monetary, government finance and balance of payments.

The institute offers courses and seminars from all member countries whose work is closely related with the work of the Fund. Most participants would be the employees of finance ministries, central banks, and other financial institutions. Training by the institute has been helping to standardize throughout the world the methods of gathering and presenting balance of payments, monetary and financial statistics to the benefit of the entire memberships.

Governance and Organization

The IMF is accountable to the governments of its member countries. At the apex of its organizational structure is its Board of Governors, which is the highest authority governing the IMF. It consists of one governor from each of the IMF's member countries - usually the country's minister of finance or the governor of the central bank. All the Governors meet once each year at the IMF-World Bank Annual Meetings. The Board of Governors decides on major policy issues but it has delegated the day-to-day decision -making to the Executive Board. The Executive Board consists of 24 Executive Directors, with the managing director as the chairman. The executive Board usually meets three times a week. The IMF's five largest shareholders - the United States, Japan, Germany, France and the United Kingdom and China, Russia, and Saudi Arabia - have their seats on the Board. The other 16 Executive directors are elected for two - year terms by group of countries, known as constituencies. The chief executive selects the Managing Director, who works as the chairperson of the board and also is the chief of the IMF staff. The managing director is appointed for a five-year term and is assisted by Deputy Managing Directors. At present, Mr. Rodrigo de Rato, a Spanish national, is the Managing Director of IMF from June7, 2004, succeeding Mr.Horst Kohler.

Nepal Rastra Bank and the IMF

Nepal became the member of IMF on September 6, 1961. Nepal's initial quota at the Fund when it joined was US$ 7.5 million which increased to US$ 10.0 million in 1966,SDR 10.40 million in 1971, SDR 10.90 million in 1978, SDR 20.85 million in 1983 and SDR 52.0 million in 1990. At present Nepal's quota at the Fund is SDR 71.3 million, which is 0.03 percent of total quota of IMF. Total votes of Nepal amounted to 963, which is 0.04 percent of total votes. In view of its small size, Nepal disseminates opinions and decisions on various policy issues with the South East Asian Voting Groups comprising Fiji, Indonesia, Lao Democratic Republic, Malaysia, Myanmar, Singapore, Thailand, Tonga, and Vietnam. The group's total combined quota represents SDR 6548.7 million. Which is 3.1percent of the Fund's total quota and total combined votes are 65730 (3.2 percent). Nepal exercises its voting rights independently through its representative at the Board of Governors. As each member country appoints a governor - usually the country's minister of finance or the governor of the central bank - and an alternate governor. The governor of Nepal Rastra Bank represents Nepal in the Fund's governing board.

Facilities used by Nepal

IMF makes its financial resources available to member countries through a variety of financial facilities The IMF levies charges on these drawings and requires that members repurchase (repay) their own currency from the IMF. Nepal has used the following facilities from IMF:

First Reserve and Credit Tranches

Though Nepal become member of the IMF in 1961, it had only begun to take assistance since 1976. The first facility used by Nepal was First Reserve and Credit Tranches. Under this facility, countries may borrow 25 percent of quota called Reserve Trances, without requiring any explanation. This amount is part of the country's international reserves. Under this facility, Nepal had borrowed SDR 7.6 million in 1976.

Compensatory Financing Facilities

This facility was set up by IMF in 1963 to help member countries that produce primary commodities cope with temporary shortfalls in export earnings, including as a result of price decline. An additional component to help countries deal with temporary rises in cereal import costs also was added in 1981. During 1976/77, Nepal also faced a severe drought situation and agricultural production had declined by nearly 4 percent. To face with this problem Nepal had purchased SDR 20.0 million in 1978 under this facility.

Trust Fund Facilities

IMF has been providing financial assistance on concessional terms to low-income member countries since the mid 1970's. This was the first facility IMF has created for its members. Nepal had borrowed SDR 13.7 million under this facility in 1978.

Stand by Arrangements (SBA)

This facility was designed by IMF in 1952 to provide short-term balance of payments assistance for deficits of a temporary or cyclical nature. Such arrangements are made typically for 12-18 months. Drawings under this facility are phased on a quarterly basis and the release of the amount is made conditional on meeting performance criteria. Repurchase are made 3.75 to 5 years after each purchase. In the early 1980's Nepal had faced rigorous internal and external imbalances. These imbalances were reflected in low output growth, huge fiscal deficit, overvalued exchange rate, and declining exports. Fiscal deficit had increased from 3.2 percent of GDP in 1980 to 8.6 percent in 1983. As a result, Nepal faced balance of Payments deficits of Rs 1.67 billion during 1983-1985. Balance of payments had registered a deficit of up to 2 percent of GDP in 1985. The foreign exchange reserve of the country had gone down to less than two months of merchandise imports equivalent. To overcome this situation Nepal borrowed SDR 18.65 million from IMF in FY 1985/86 under these arrangements and implemented various policy measures including the devaluation of Nepalese currency by 14.7 percent in November 1985. This amount was around the 50 percent of Nepal's quota at that time. Nepal had borrowed that amount for the period 12.23.1985 to 4.22.1987.

Structural Adjustment facility (SAF)

Beginning March 1986,IMF provided the concessional financing through Structural Adjustment Facility (SAF) for its low income member countries to implement economic policies that foster growth and raise living standard through its advise, technical assistance and its financial support. The focus of the structural adjustment programme was to attain the 4-5 percent reasonable growth of the economy. To keep current account deficit (before grant) to less than 8 percent of GDP, reduce the net domestic borrowing of the government to less than 1 percent of GDP and maintain price rise at 5 percent by the end of the programme. A country eligible for the SAF facility should prepare the Policy Framework Paper (PFP), which includes the quantified targets, or ceilings for bank credit, the budget deficit, foreign borrowings external arrears and international reserve. Nepal also borrowed SDR 26.0 million from 10.14.1987 to 10.13.1990 from the SAF and had implemented various reform programmes.

Enhanced Structural adjustment Facility (ESAF)

IMF has been providing concessional lending to help its poorest member countries to achieve external viability, sustainable economic growth and improved living standards since the late 1970's.Between 1986 and 1999 many developing countries of the world drew on low interest loans under the SAF and its successor the ESAF designed the need to help the IMF's poorest members in their efforts to achieve stronger economic growth and sustained improvement in their balance of payments. Nepal had faced a 21 percent rate of inflation and current account deficit at 8 percent of GDP in 1991/92. Nepal entered into ESAF in October 1992. It had received approval from IMF SDR 33.57 million for a period of three years (May 1992 to April 1995). Of this approved amount Nepal could only withdraw SDR 16.79 million.

These facilities from IMF made significant contributions to the development efforts in low-income countries. But despite substantial assistance from the IMF and the broad donor community, many of these countries did not achieve the gains needed for lasting poverty reduction. This prompted an intense reexamination of development and debt strategies by the years by governments, international organizations and others. At the 1999 joint annual meetings of the IMF and the World Bank, ministers from member countries endorsed a new approach. They decided to make country-generated poverty reduction strategies of all IMF and the World Bank concessional lending and debt relief. The PRSP approach initiated by the IMF and the World Bank in 1999,results in a comprehensive country-based strategy for poverty reduction. It aims to provide the crucial link between national public actions, donor support and the development outcomes needed to meet the United Nations Millennium Development Goals (MDG's) that are centered on halving poverty by 2015.

The Poverty Reduction and Growth Facility (PRGF)

The Poverty Reduction and Growth Facility (PRGF), established in 1999, is the IMF's low-interest lending facility for poor countries. Through the PRGF, the IMF aims to integrate the objectives of poverty reduction and growth more fully into its operations. Programmes supported by PRGF are framed around comprehensive country owned Poverty Reduction Strategy Papers (PRSP}. PRSP are prepared by government with active participation by civil society - including the poor and other development partners. The targets and policy conditions in PRGF supported programmes are drawn directly from the country's PRSP. The five core principles of the PRSP approach should be (a) Country-driven, promoting national ownership of strategies through broad based participation of civil society, (b) Result-oriented and focused on outcomes that will benefit the poor, (c) Comprehensive in recognizing the multidimensional nature of poverty, (d) Partnership-oriented, involving coordinated participation of development partners (e) Based on a long-term perspective for poverty reduction. Eligibility of a country is based principally on the IMF's assessment of a country's per capita income drawing on the cutoff point for eligibility to World Bank's concessional lending (per capita gross national income of $875 of 2001). Loans under the PRGF carry an annual interest rate of 0.5 percent with repayments made semiannually beginning 5.5 years and ending 10 years after the disbursement.

HMG also submitted the Letter of Intent, Memorandum of Economic and Financial Policies and Technical Memorandum of Understanding on October 31,2003 requesting for the three years PRGF facilities from the IMF in the amount of SDR 49.9 million. (10 percent of quota). The first annual programme under the PRGF had supported policies to be implemented over the period July16, 2003 to July15, 2004. In November 24,2003, The Executive Board of the IMF finalized its earlier in principal approval of a three year SDR 49.9 million (about US $72 million) PRGF arrangements for Nepal. The Executive Board of IMF after completing the first review of Nepal's economic performance under the three year PRGF arrangement has noticed that Nepal's PRSP continues to provide a sound basis for achieving higher growth and poverty alleviation. The main elements of the PRGF supported programmes - sound macroeconomic management; better expenditure prioritization and enhanced efficiency, structural reform in major economic sectors and improved governance are geared to delivering conditions for sustained growth and enhancing the pro poor focus of budget spending. On October 20,2004, IMF approved Nepal to draw an amount equivalent to SDR 7.1 million (about US$ 10.6 million) as a second installment which made the total disbursement under the programme to SDR 14.3 million (US$ 21.2 million). The PRSP policy measures aim to push up the real GDP growth rate to 5-6 percent over the medium term and reduce the poverty rate by 8-10 percentage points (from around 40 percent) in five years. It also aims at significant improvements in human development indicators. The PRSP strategy consists of four pillars; broad based economic growth; social sector development; targeted programmes for the poor and deprived groups and good governance. The PRSP notes that the growth strategy should be rooted in macroeconomic stability and that a reduction in the domestically financed budget deficit over the medium term would help achieve this goal. The PRSP outlines plans for financial sector public sector and governance reforms to improve growth

prospects. The PRSP acknowledges that achievement of the targeted growth rates would depend on progress in the peace process, implementation of structural reforms and a favorable external environment. With these factors in mind in the PRSP's base case scenario, resolution of political uncertainties and speedy implementation of reforms are projected to generate average annual growth of 6.25percent over 2002/03 to 2006/07.In the lower case scenario, continued political difficulties and delays in reforms would limit average annual growth rate to 4.25 percent over this period. Inflation is projected to remain around 4.5-5 percent.

Policy actions to achieve its goals are outlined in the PRSP matrix as;

(a) Macroeconomic Stability – It is linked to prudent fiscal policies as mobilize revenue and reduce domestic budget financing, prioritize public spending through the medium term expenditure framework, conduct monetary and exchange rate policy to support the exchange rate peg and keep inflation low and maintain balance of payments and international reserve position.

(b) Structural Reforms include the financial sector reform including the reengineering of NRB, restructure state owned commercial and development banks and improve loan recovery, public enterprise reforms, civil service reforms, governance and trade (WTO accession)

(c) Sectoral policies include improvement in agricultural policies industrial policies and improve in infrastructure development

(d) Social sectors include improve in the educational sector and health sector policies.

(e) Targeted poverty alleviation programmes include budget allocation for deprived communities and areas, improve poverty monitoring and increase scholarship.

Technical Assistance and Training

The IMF has provided various technical assistances to Nepal at its request. Expert advisory support has been provided in case of various projects and programmes including the cost of living Indices (1977), review of financial system (1984), budget projection (1984), design and package of tax and other revenue measures, financial sector development programme (1987), bank supervision (1987), simplification of export procedures (1987), central bank and banking reform (2001), monetary policy (2003), monetary operation, foreign exchange reserve management (2004), implementation of the large taxpayer unit (2003), review of tax policy and VAT administration (2003), tax and custom administration reform (2003), follow-up on the LTO and customs administration reform (2004), redrafting of income tax laws (2001), multisector statistics mission(2001), balance of payments statistics advisor (2002-2003), producer price statistics (2002-2003), monetary statistics (2003), etc.

Liaison with IMF

Each member country appoints a governor - usually the country's minister of finance or the governor of its central bank -and an alternate governor. It is the board of governors on which all member countries are represented, is the highest authority governing the IMF. It usually meets once a year, at the annual meetings of the IMF and the World Bank. The Board of Governors decides on major policy issues but has delegated day-to-day decision making to the executive board. The Governor of NRB acts as the Governor of Nepal to the Fund. HMG also nominates a senior official, usually a joint secretary, from the ministry of finance, as alternate governor to the Fund. Every year around September-October the IMF and the World Bank host annual Fund - Bank joint meetings where Finance Minister and Finance Secretary also take part along with the NRB Governor. A member country exercises its options through its Executive Director.

IMF has nominated a resident representative in Kathmandu since 1985. Resident representative coordinates agenda for discussion between Nepal and the Fund whether in regular article IV consultation mission or if the country is under going any fund supported programmes such as PRGF. The resident representative also attends Aid Nepal Consortium (currently called Nepal Development Forum) meetings in Paris.

World Bank

The IMF and the World Bank are sister institutions in the United Nations system. They have the same international membership and share the same goal of raising living standards in their member countries. Their goal is complimentary with the IMF focusing on ensuring the stability of the international financial system. IMF loans are relatively short term, and funded mainly by the pool of quota contributions

provided by its members. IMF staffs are primarily economists with wide experience in macroeconomic and financial policies. The World Bank concentrates on long term economic development and poverty reduction. World Bank loan is generally long term and is funded both by member country contributions and through bond issuances. The World Bank staffs are often specialists in particular issues, sectors or techniques.

Purposes of the World Bank

As mentioned in the Article I of the Articles of Agreement (amended in February 16, 1989) the World Bank has the following purposes:

- to assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes.
- to promote private foreign investment by means of guarantees or participation in loans and other investments made by private investors
- to promote the long-range balanced growth of international trade and maintenance of equilibrium in balance of payments.
- to arrange the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, will be dealt with at first.
- to conduct its operation with due regard to the effect of international investment on business conditions in the territories of members and in the immediate post war years ,

Under the Articles of Agreements of IBRD, to become a member of the bank a country must first join the IMF. Membership in IDA, IFC, and MIGA are conditional on membership of IBRD.

Organization

Board of Governors

According to the Bank's Articles of Agreement each member country appoints one governor and one alternate governor. Generally, these governors are ministers of Finance. Both of them serve a five year term and may be reappointed. They are the ultimate policy makers of the Bank. Under the articles, all powers of the Banks are vested in the Board of Governors. The Board of governors meets once a year at the Bank's annual Meetings. If the member of the bank is also a member of IFC or IDA, the appointed governor of the bank and his alternate also serve ex-officio as Governor and Alternate on the IFC and IDA Boards of Governors. MIGA Governors and Alternate are appointed separately. The Governors admit or suspend members, increase or decrease the authorized capital stock, determine the distribution of net income, review financial statements and budgets, and exercise other powers that they have not delegated to the Executive Directors.

Boards of Directors

The World Bank Group Boards of Executive Directors are responsible for conducting the day-to-day business of the World Bank. The Boards are composed of 24 Directors, who are appointed by member countries or by group of countries. Regular meetings are usually held once or twice a week and other meetings are held at various other times whenever required. The five largest shareholders - France Germany, Japan, United Kingdom and the United States appoint an Executive Director, while 19 Executive Directors represent other member countries.

President

The Bank's president is, by tradition, from the United States, which is largest shareholder. The president is elected for a five-year renewable term. The president chairs meetings of the Board of Directors and is responsible for overall management of the Bank.

The World Bank Group

The World Bank consists of five closely associated institutions, all owned by member countries. Each institution plays a distinct role in the mission to fight poverty and improve living standard. The World Bank's group member the International Bank for Reconstruction and Development (IBRD) was established in 1944 along with the IMF to help Europe recover from the devastation of World War II. After the establishment of the other financial institutions it has become the wing of the World Bank which aims to reduce poverty in middle income and creditworthy poorer countries by promoting sustainable development. Today, it has almost global membership of 184 countries. The success of that institution led the Bank to turn its attention to the developing countries. By the 1950's ,a group of bank member countries decided to establish that could lend to the poorest countries on the most favorable

terms. As a result, International Development Association (IDA), the soft lending window of the World Bank, was established in 1960 and now it has 164 member countries. It helps the world's poorest countries to reduce poverty by providing interest free loan and programmes aimed at boosting economic growth and improving living standards. IDA lends to those countries that had income less than US$ 865 per person in 2002. Some 81 countries are currently eligible to borrow from IDA these countries are home to 2.5 billion people half of the total population of developing world of which an estimated 1.5 billion people survive on incomes of $2 or less a day. A country must be a member of IBRD before it can join IDA. IDA credits have maturities of 20, 30 or 40 years with a 10-year grace period before repayments of principal begins. There is no interest charge but carry a small service charge of 0.75 percent on funds paid out. IDA is funded largely by contributions from the governments of the richer member countries. Their cumulative contribution since IDA's establishment to June 2003 is US $118.9 billion.

The International Finance Corporation (IFC), the other wing of the World Bank, promotes economic development through the private sector. It invests in sustainable private enterprises in developing countries without accepting government guarantees. The Multilateral Investment Guarantee Agency (MIGA) established in 1988 and now with 164 members help to encourage foreign investment in developing countries by pro guarantees to foreign investors against losses caused by non-commercial causes. It also provides technical assistance to countries to disseminate information on investment opportunities. The International Center for Settlement of Investment Disputes (ICSID) established in 1966 and now with 140 members helps to encourage foreign investment by providing international facilitation, conciliation and investment disputes in this way helping to facilitate the atmosphere of mutual confidence between states and foreign investors. Nepal became the member of IFC, IDA and MIGA in 1966, 1968 and 1994 respectively.

The World Bank Group and Nepal

Nepal became the member of the World Bank on the same day with IMF. Nepal and World Bank partnership began when it fielded its first economic mission to the Kingdom in 1963. Since then the Bank has been assisting Nepal in a number of ways, through lending in support of development projects and programmes, through macroeconomic policy dialogue and advise and by assisting Nepal to finance development activities The first World Bank's credit of $ 1.78 million was approved for a telecommunication project from the IDA in 1969. Since then the Bank has approved credits with a cumulative total of almost $2.0 billion active credits total $ 302 million as of June, 2004. Since 1970's the Bank has funded six road projects which have supported road rehabilitation and maintenance and have helped the government develop sustainable funding for the sector. The World Bank financed basic and primary education project is strengthening educational institutions at national, district and school levels. The Bank is currently the largest provider of external assistance in Nepal. Initially much of the lending supported in agriculture, irrigation and infrastructure but increasingly a large part of the lending has focused on the social sectors.

In Nepal, the World Bank works with multiple development partners, His Majesty's Government, other bilateral and multilateral donor organizations, non-governmental organizations (NGO's), the private sector and the general public-including academicians, scientists, economists, journalists, teachers and local people involved in development projects. The Bank's main objective is to provide financing and advice for projects which are owned and supported by the Nepali people and which are a logical part of a comprehensive and efficient overall development agenda.

Recently, the World Bank has developed an action plan known as the Nepal Country Assistance Strategy (CAS) covering a period of three years beginning in 2004. The CAS was designed to support the Poverty Reduction Strategy of the Government. It is built around four pillars identified in Nepal's Poverty Reductions Strategy Paper (PRSP's) as:

(a) To achieve sustained and broad based economic growth, focusing on the rural economy. Since economic growth is a engine of poverty reduction, the Bank's assistance focus on removing some of the bottlenecks of growth, such as the excessive role of the state, and lack of adequate infrastructure. The Bank's assistance over the last few years has focused on strengthening the quality of public expenditure, the soundness of the financial system and the investment climate.

(b) To accelerate human development through a renewed emphasis on effective delivery of basic social services and economic infrastructure.

The standards of education and health directly influence the quality of life and labor productivity of the people; the Bank's assistance to Nepal has focused on improving the quality of education and health care. With funding and technical assistance from the Bank, Nepal is moving towards decentralized management of education and improving the quality of education.

(c) To ensure social and economic inclusion of the poor, marginalized groups and less developed regions.

The Bank is working with HMG/N and other development partners in strengthening the policy dialogue reaching out to marginalized groups, which are often overlooked by existing institutions as community-based projects, like the Rural Water and Sanitation Project.

(d) To vigorously pursue good governance, both as means of delivering better development results and ensuring social and economic justice.

To improve governance the Bank has advised on better allocation and release of public funds, greater transparency and monitoring of public expenditure and the government's decentralization programme.

Asian Development Bank

The first ministerial conference on Asian Economic Cooperation held in Manila in December 1963, under the auspices of ESCAP, passed a resolution endorsing a proposal to establish a Regional Development Bank for Asia. The Asian Development Bank (ADB) was established in December 1966 with 31 members and its headquarters in Manila, Philippines. Over the years the membership of the bank has grown to 63, which are 45 from Asia and Pacific, and 18 from other parts of the world. It is a multilateral development financial institution and also is an entirely independent international financial institution. But it has close working relationship with other international organizations through project co financing, consultations and regular exchanges of information about work in the region. The Bank is engaged in promoting the economic and social progress of its Developing Member Countries (DMC's) in the Asian and Pacific region. In its 38 years of operations, ADB has become a major catalyst in promoting the development of the most populous and fastest growing regions in the world today. The bank in addition to providing to loans, equity investment, and technical assistance -has identified five strategic objectives .As such, the bank aims to promote economic growth, reduce poverty, improve the status of woman, develop human resources,
(including family planning) and help bring about sound management of natural resources and the environment.

The ABD provides its lending arrangements to its member countries through the Asian Development Fund (ADF) and through Ordinary Capital Resources (OCR). Asian Development Fund is ADB's concessional or soft loan window and ADB's donor member countries provide the fund. ADF loans carry very low interest rates, and are for the poorest borrowing countries. Ordinary capital resources are replenished by borrowings from the world's capital market. These loans are made to market interest rates to better -off borrowing countries. Most of the lending of the ADB goes to the public sector, and to governments. It also provides direct assistance to private enterprises of DMC's through equity investment and loans. Traditionally, agriculture and rural development – the mainstay of many Asian economies – have received most ADB support. In recent years, however, the social infrastructure sector -including health, education, and water supply has increased in importance. It reflects the ADB's poverty reduction drive.

As one-fifth of the population of the Asia Pacific region is still poor and this region still represents the two-thirds of the world's poor, the main focus of the ADB's lending programmes are on poverty reduction. ADB has announced a Poverty Reduction Strategy (PRS) in 1999 under which it adopted poverty reduction as the overarching goal of its operation. The strategy is framed in terms of three mutually reinforcing 'pillars' as pro-poor sustainable economic growth, social development and good governance. The pro-poor sustainable economic growth emphasizes the need to stimulate environmentally sound economic growth that benefits the poor, such as promoting sound macroeconomic management and assisting projects that increase employment and boost productivity. Similarly, the social development pillars include human capital development, population policy, gender

equality and social protection, The good governance includes support for pro-poor policies, government accountability, transparency and anti-corruption.

In 2002, the United Nations General Assembly adopted the Millennium Development Goals (MDGs) which set light goals for development and poverty eradications to be achieved by 2015. These goals are consistent with the comprehensive approach to poverty reduction adopted by the ADB. Overall, ADB increased its lending volume to the projects classified as 'poverty Interventions' or 'Core Poverty Interventions' by exceeding its 40 percent lending target in both 2002 and 2003.

Nepal and ADB

Nepal is one of the 31 founding members of ADB. Nepal is the 24th largest shareholder in ADB among its regional members and 32nd largest shareholder overall. The number of shares held by Nepal is 5,202, which is 0.15 percent of total shares. Total votes of Nepal are 19087, which is 0.44% of total membership, and 0.67 percent of total regional membership. Overall capital subscription is US $77.30 million and paid in capital subscription is US $ 5.42 million. The parternership between Nepal and ADB began in 1968 with a technical assistance (Grant) followed by a concessional loan of US$ 6 .0 million in 1969 for Air Transport Development. Since then ADB has become as a key development partner of Nepal and has continued to support development financing, reforms and provide policy advice and technical assistance. It has remained focused on helping the government to reduce widespread poverty. As of December 31, 2004, total commitments by the ADB consisted of 104 loans amounting to US$ 2.1 billion covering projects in agriculture, energy and natural resources, finance and industry, social infrastructure, transport and communication and others. Nepal has received all the loans from the Asian Development Fund resources except one small loan ($2.0 million) from Ordinary Capital Resources approved in 1970. Of these, 81 loans are closed with a total of about $ 1.1 billion disbursed. As of June 30, 2004, 21 public sector loans were ongoing with a total net loan amount of about $ 615.7 million. In addition there were five private sector loans totaling about $59.0 million, including three equity investments amounting to about $3 million. Since 1968 ADB has provided Nepal with technical assistance in most sectors. As of June 30, 2004, total technical assistance commitments consisted of 238 projects for a total of about US $ 109.5 million. There were 35 active TA's for a total of about $ 32.4 million. Moreover, the ADB has been working through its lending and technical assistance programme to create a policy and legal environment in Nepal that promote private sector development. ADB's assistance to Nepal has been focused on three sectors, which accounted for 82 percent of its public sector loans. They are social infrastructure (38.7 percent), energy (25.4 percent), and agriculture and natural resources (17.9 percent).

The Board of Directors of ADB has endorsed a Country Strategy Programme (CSP) for Nepal for the period 2005-2009. The overarching objective of the CSP is to achieve sustained poverty reduction by fostering more inclusive processes of broad based growth, social development and good governance. ADB's programmes during 2005-2007 will focus on assisting the government to promote a greater balance between different regions of the country and improve access of the poor to basic services and opportunities for advancement. It will also address the needs of the most disadvantaged groups, such as women, ethnic groups, and lower castes. The strategies and sectors prioritized in the CSP are based on an assessment of poverty and wide consultations with all levels of government, civil society, beneficiary communities, and development partners. The CSP proposes lending programmes of $350 .0million for the first 3 years (2005-2007),which corresponds to an average assistance programmes of $117.0 million per annum consisting of 11 projects. To complement the lending programmes 26 technical assistance projects and five studies are planned for 2005-2007amounting to about $4 million per year. The TA will support project preparation, institutional development, training, and managing for development results. For promoting broad based economic growth ADB has focused on projects on Transport and Communication, Agriculture and Rural Development, Finance and Private Enterprises Development (including small and medium enterprises), Energy and Regional Development. For fostering social development it has proposed the projects on Education, Water Supply, Sanitation and Urban Development, and Social Protection. Similarly on promoting good governance ADB has focus its support for good governance on building the

capacity of key public institutions, especially at the local level. They will deliver essential services, thereby improving the quality and inclusiveness of the public service and helping combat corruption.

The South East Asian Central Banks Research and Training Centre (SEACEN)

The South East Asian Central Banks Research and Training Center (SEACEN) was established in 1982 as a legal entity with eight member central banks/ monetary authorities of Bank Indonesia, Bank Negara Malaysia, Central Bank of Myanmar, Nepal Rastra Bank, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, Central Bank of Sri lanka, and Bank of Thailand. The Centre has grown to thirteen members with the inclusion of the Bank of Korea in 1990, the Central Bank of China, Taipei in 1992, the Bank of Mongolia in 1999, the Ministry of Finance, Brunei Darussalam in 2003 and the Reserve Bank of Fiji in 2004.

Besides this full member status, the Center also has five central banks/monetary authorities which obtained observer status. These are state Bank of Vietnam, Bank of the Lao PDR, National Bank of Cambodia, National Reserve Bank of Tonga and Bank of Papua New Guinea. This status provides a privilege to attend the annual SEACEN Governor's Conferences, which is a forum to exchange information, experiences and views on financial, monetary, banking and economic developments in their countries and in the region as a whole. The conferences also invite experts from various international institutions such as the IMF, BIS and ADB. The other nine central banks and monetary authorities in the Asia Pacific region have received the status of invitees to the training activities of the Center. The status has been received by the Central Bank of Solomon Island, Hong Kong Monetary Authority, Reserve Bank of Australia, Reserve Bank of New Zealand, Bank of Japan, Royal Monetary Authority of Bhutan, Central Bank of the Islamic Republic of Iran and the State Bank of Pakistan. The eligibility and responsibilities of these central banks and monetary authorities are different depending on their status as members, observers or invitees. On the SEACEN Board of Governors meetings, only the SEACEN member banks are invited. Only the member can send their staff to the Center to undertake research studies. The members are obliged to contribute to the annual SEACEN budget on an equal sharing basis.

Objectives

The objectives of the SEACEN Center as stated in the Memorandum and Articles of Association dated January 27, 1982 are as follows:

(a) to promote a better understanding of the financial monetary, banking and economic development matters which are of interest to the central banks and monetary authorities of the countries in South East Asia or of interest to the region as a whole;

(b) to stimulate and facilitate cooperation among central banks and monetary authorities in the area of research and training.

To achieve these objectives, the Center undertakes research into the fields of financial, monetary, banking and economic development matters and related matters, organize and conduct training courses, collect, publish and distribute results of research and studies and such other information related to the objectives of the Center, arrange and organize seminars, workshops and conferences, provide advisory and technical services to the South East Asian central banks and monetary authorities, cooperate with other institutions to promote the objective of the Center and undertake any other activities to further the objectives of the Center.

Membership

At the 21st meetings of Board of Governors (BOG), it was agreed that admission of new members must be based on consensus and only the BOG can decide for admitting a new member and new observer at the SEACEN. The BOG approved the guidelines for consideration that the institution should be a central bank or monetary authority or a government agency performing the functions of a monetary authority, the country belongs to the same geographical area as most existing members, the fundamental character of the SEACEN Center will not be altered after admission; and the SEACEN groups remains at manageable size.

Organization and Governance

The organization and governance of the SEACEN Center has been guided by the agreement of February 3, 1982. In the agreement it is stated that as the BOG is the supreme decision-maker of the Center. The Center undertakes and exercises its powers and discharges its duties under the direction and supervision and consultation with BOG. The

policies of the Center, its budget, work programmes, annual reports and accounts require the approval of the BOG. The BOG meetings on June 1, 2001 in Singapore agreed to appoint an Executive Committee (EXCO), which advises the BOG in the policy, issues concerning the center's activities. The 21th SEACEN BOG meetings held in Ulaanbaatar, Mongolia, has approved the proposal of the EXCO's Terms of Reference (TOR) and has agreed to delegate the EXCO most of the detailed supervision of the Center. This has allowed the BOG to concentrate on deliberation of international economic and financial developments and higher-level policy issues of strategic importance. The BOG, with the recommendations of the EXCO, makes decision on the appointment of Executive Director of the Centre, admission of new members and observers and other matters of strategic importance to the Centre. The Board of Directors (BOD) manages the affairs of the Centre. The BOD consists of Governor (as chairperson) and Deputy Governor of Bank Negara Malaysia and the Executive Director of the SEACEN center. BOD formulates the policy on all matters of the activities of the center and other management functions. According to the terms of reference, the Governor of the central bank or monetary authority currently chairing the BOG chairs the EXCO. The rest of the EXCO comprises Deputy Governors of all member central banks. In addition to other works, the EXCO consider and approve the funding for the Center's annual budget submitted by the Executive Director. The budget is then submitted to the Board of Governors for their ratification. The EXCO is to meet at least once a year. The Center submits the proposed research and training programmes and activities for each operating year to the EXCO for review and approval before the end of the preceding operating year. In formulating the research and training programme and other activities for each operating year, the Centre works in close consultation with the Directors of Research and Training (DORT) of the SEACEN member central banks/monetary authorities.

The SEACEN Centre is headed by the Executive Director and composed of two divisions, i.e., Research Division, and Training and Administration Division. Research Division consists of three sections as Research Department, Seminars and Publications Departments and library Unit. Similarly Training and Administration Division consists of Training Department, Administration Department and Information Technology Unit.

Training Seminars and Workshops

The training courses conducted by the Centre are generally of longer duration, usually more than a week, which are interactive learning events to enhance the capacity building of member central banks. In a seminar the topic is of current interest and discussions are policy oriented in nature. In a workshop, the topic is generally technical in nature and involves hands on practical sessions Participations in the programmes are by invitation only. Twenty-six central banks and monetary authorities in the Asia Pacific region are invited to the programmes. The Centre started to operate on an informal basis in 1972 by conducting training courses at Staff Training Centre of Bank Negara Malaysia. At that time it did not have own staff, facilities and buildings. The first SEACEN course was on 'Management of Financial Institutions' from April 17 to May 13, 1972. Twenty-two participants from Indonesia, Cambodia, Laos, Malaysia, Nepal, the Philippines, Singapore, Sri Lanka, Thailand and Vietnam attended the training. Since 1972 to Dec ember 2004 the Centre has trained altogether 7062 participants. During this period, the Centre has conducted 121 training events, 95 Seminars and 57 Workshops. It has been the practice of the Centre to formulate its proposed programmes in close collaboration with the member central banks, so that the programmes of activities is relevant to the current needs and interest of member central banks. In recent years the Center has expanded its collaboration with other reputable international financial institutions such as IMF, World Bank, ADB, BIS, Federal Reserve System-USA, Financial Stability Institute (FSI), APEC Training Initiative, Toronto Leadership Centre, etc. To establish the Center as a separate legal entity commenced in 1973 so that the Center will be able to recruit international professional staffs to carry out its functions and activities. On February 3, 1982, the agreement among the central banks of SEACEN countries was signed by governors of Bank Indonesia, Bank Negara Malaysia, Nepal Rastra Bank, Central Bank of the Philippines, Central Bank of Ceylon, Bank of Thailand and Managing Director of Monetary authority of Singapore. On January 27,1982, the SEACEN Center was registered as a company limited

by guarantee without a share capital under the Companies Act 1965 of Malaysia. The first meeting of the SEACEN Board of Governors convened in February 1982 in Bangkok.

SEACEN Trust Fund (STF)

The Board of Governors at the 5th meetings in January 1986 held at Philippines discussed the proposal to establish a trust fund that would provide scholarships to SEACEN training participants. The STF deed was signed at the 7th SEACEN Board of Governors meetings in Singapore on January 22, 1988. The board of trustees comprises five members with the Governor of Bank Negara Malaysia as the chairman. Three members hold a three year office tenure, and comprise a senior official from Bank Negara Malaysia and the governors of two other SEACEN member central banks/Monetary authorities based on a rotational basis. The Executive Director of the Center is appointed on an ex- officio basis. The capital base of the STF is derived from contributions from the SEACEN members. Members contributions has been increased from RM 50,000 in the FY 1988/89 to RM 1,349,853 by FY 2003/04. Since 1994 scholarships have been made available to candidates from eligible SEACEN members to attend training courses. Under the STF Grant and Scholar Scheme, candidates from SEACEN member countries with per capita income of $ 1,000 per annum or less are eligible for scholarships. One scholarship is also allocated each year to a candidate for an observer central bank. At present, the Governor of NRB is the member of the STF Board of Trustees.

Nepal and the SEACEN Centre

Nepal is the founding member of the SEACEN Centre. The former Governor Mr. Kalyan Bikram Adhikary was one of the signatories of the establishment of the SEACEN Centre in February 3, 1982 along with other 6 signatories of the Governors of the central banks and Managing Director. Nepal is taking part in all the training/ activities conducted by the Center. According to the agreements at the 20th Board of Governors (BOG) meeting in Singapore, Nepal is sharing equally the core programme budget prepared by the Centre. Based on the agreed formula of cost sharing among the member Central Banks and Monetary Authorities, the estimated amount of core programme budget as paid by Nepal in FY 2004 was RM 382,923, equivalent to US $ 100,769. From 1972 to Dec. 2004, 824 officers from NRB have participated at the various training activities conducted by the Centre.

Three governors conference and twelve training events have been held in Nepal. The Ninenth (March 4-6,1994), the 13th(January 16-18, 1978), and the 22nd (January 20-21, 1987) SEACEN Governors conference were held in Nepal. The following training events were held in Nepal:

Trainings

1. Inspection and Supervision of Financial Institutions (1983 and1990), Examination and Supervision of Financial Institutions (1993), Currency Operation Management (2001), Macro Economic Management (2002).

Seminars

Role of Central Banks in Development Finance (1982), Country Risk and Treatment of Non-performing Loans (1983), Current Problems and Issues in International Trade (1987), Domestic Resource Mobilization in the SEACEN Countries (1988), Bank Regulation of Off-Balance Activities in the SEACEN Countries (1993), Monetary Policy in a Liberalized Financial Environment (2000), WTO and Liberalization of the Financial Services Sector (2003).

Workshop

Regulatory Responses to Derivatives Trading and other Financial Innovations (1997).

The Research officials of the member banks also got opportunity to work at the Centre So far, NRB has deputed six research officers to the Centre.

Asian Clearing Union (ACU)

The need for the formation of clearing unions was felt after the great depression of 1930's Foreign exchange shortages, the breakdown of the gold standard and the collapse of the international capital markets forced the governments of the western countries to introduce controls on foreign exchange and foreign trade. In the early 1940's, J.M. Keynes had proposed a International Clearing Union (ICU) that would operate on a multilateral basis. At the end of the second world war, scarcity of hard currencies in Europe led the Western European countries to sign numerous bilateral agreements .In mid-1950, 18 Western European Countries joined in a multilateral

clearing union known as the European Payments Union (EPU). In this system, at the end of each settlement period, the balance would be settled by US Dollar. Success of EPU encouraged the developing countries to set up similar clearing unions in Asia and Pacific Region.

The Asian Clearing Union (ACU) was established at the initiative of the United Nations Economic and Social Commission for Asia and Pacific (ESCAP), after considerable rounds of efforts and discussions. The draft agreement establishing the ACU was finalized at a meeting of senior officials of the governments and central banks held at Bangkok in December 1974 and were signed by India, Iran, Nepal, Pakistan, and Sri Lanka. Bangladesh and Myanmar joined the Union as the sixth and seventh members in 1976 and 1977 respectively. The number of the members reached eight after Bhutan signed the agreements in 1999. The ACU started its operation in November 1975 with its headquarters in Teheran.

The main objectives of the clearing unions are to facilitate payments among member countries for eligible transactions, thereby economizing on the use of foreign exchange reserves and transfer costs, as well as promoting trade among the participating countries. The ACU also is a clearing union among other clearing houses/payments operating in various region s of the world.

The objectives of the ACU as mentioned in its Article of Agreements are:

(a) To provide a facility to settle on a multilateral basis, payments for current international transactions among the territories of participants;

(b) To promote the use of participants 'currencies in current transactions between their respective territories and thereby affect economies in the use of the participants exchange reserves;

(c) To promote monetary cooperation among the participants and closer relations among the banking system in their territories and thereby contribute to the expansion of trade and economic activities among the countries of the ESCAP region.; and

(d) To provide for currency swap arrangement among the participants so as to make Asian Monetary Units available to them temporarily.

The accounts of the ACU are kept in a common unit, of account designated as the Asian Monetary Unit (AMU). With effect from January 1,1996 the value of one AMU is equivalent to one US Dollar. Previously, it was equivalent to one Special Drawing Rights (SDR). Settlements of the balances and accrued interests are made at the end of each two monthly settlement period. However, the Board of Directors may change the length of the settlement periods by a decision taken by unanimous vote of all of the directors. Each participant is notified from the secretary general of its net position at the end of each settlement period and debtors make payments within four working days of the notice in international reserve assets. If the balance of a debtor remains unpaid after fifteen days from the date it was due, the participant is deemed to have defaulted. However, the experience of the ACU's operations from the inception to date shows that there has been no default by any member in meeting its obligation for the settlement of its net position within the stipulated time. The payments of India with Nepal and Bhutan are still considered ineligible to be made through the clearing facility. The seventeenth annual meetings of the Board of Directors established SWAP arrangement whose objective is to extend short-term foreign exchange support to any member finding itself in deficit with any other member during a settlement period

Organization

Each central bank appoints one Director and one Alternate Director to represent it on the Board of Directors for a term of two years subject to reappointed. The board elects a chairman and vice-chairman from among its members for a period of one year. The Board meets at least once a year. In addition, the chairman may call the meetings if requested by two directors or when then chairman considers it necessary. All the decisions are taken by a majority of the votes of all the directors The Board of Directors may make arrangements with a central bank or monetary authorities of a member to provide necessary services and facilities for the operation of the clearing facility. The board has accepted the offer of the central bank of the Islamic Republic of Iran to act as agent for the Union. The board is authorized to appoint a Secretary General for a term of three years. Unlike any other institutions, membership in ACU does not impose any financial obligation or membership quota. All expenses and cost of running the ACU secretariat has-been covered by the Central

bank of Islamic Republic of Iran as the agent bank since the inception of the ACU.

Since its inception in 1975, the ACU facilitated smooth and easy trading among member countries in the region. Unlike any other payments union it has not experienced any default. During this period the economic policies and the environment in which the ACU was established have changed. There has been a considerable growth in trade among the ACU countries. The volume of transactions has increased from US $0.44 million in 1975 to US $ 4546.30 million in 2003. In 1975, 20 percent of the total transactions cleared in the system and 80 percent was settled in foreign exchange. Whereas in 2003, 41 percent was cleared in the system and 59 percent settled in foreign exchange. The total ACU transactions (one way plus accrued interest) which have been routed through the ACU mechanism since 1975 to 2003 amounted to US $ 43707.38 million of which 52 percent (US$ 22521.26 million) cleared in the system and 48 percent (US$ 21186.12 million) settled in foreign exchange.

Nepal and the ACU

Nepal is one of the founding members of the ACU. The Governor of NRB is the Directors in the ACU Board of Directors. The Executive Director of the Foreign Exchange Management Department acts as alternate to the ACU Board of Directors from Nepal. The officer in charge to look after the transactions involving ACU is also deputed from the same department. Since Nepal joined the ACU, NRB hosted meeting of Board of Directors on three occasions. In 2003, Nepal make debit (-) of US $6.5 million and credit (+)of US$7.3 million, making net position of 0.8 million under the ACU mechanism. Nepal cleared 89 percent in the system and 11 percent settled in foreign exchange.

South East Asia New Zealand and Australia (SEANZA)

SEANZA was established in 1956 by the central banks of the five British Commonwealth countries; Australia, India, New Zealand, Pakistan and Sri Lanka after a meeting in London. The motive behind the establishment of SEANZA was to conduct the intensive and systemic training course of Central Banking to develop promising officers for further advancement.

Over the years the membership has expanded from five member banks in 1956 to twenty. The member banks are currently from Australia, Bangladesh, China, Hong Kong, India, Indonesia, Iran, Japan, Korea, Macao, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Papua New Guinea, the Philippines, Singapore, Sri Lanka and Thailand. Apart from member institutions, central bank employees from US Canada, Germany, Pacific Islands and BIS took part at the training programmes. Till now, SEANZA has conducted 25 Central Banking Courses. The first SEANZA Central Banking Course was held in Australia at 1957.

The SEANZA Central Banking Course is held every two years. The objectives of the Course are:

(a) to assist in the development and training of senior officers for higher central banking executive positions;

(b) to build up knowledge of central banking, with particular reference to conditions in the SEANZA countries;

(c) to promote understanding of the problems of the developing countries; and

(d) to foster friendly relations and technical cooperation among central banks in these regions.

The highest policy making body of the SEANZA is Council of Governors who meet every two years. The Council of Governors meets in between SEANZA Courses to approve the report on cost and sharing. Advisors meeting is held a year before the Central Banking Courses and Governors Symposium. The meeting sets broad parameters for the SEANZA Central Banking Course and to suggest themes for discussion at the Governors' Symposium. Course expenses are equally divided among the participants.

Nepal and SEANZA Countries

Nepal joined this association in 1968. The Governor of NRB takes part at the council of Governors. Nepal has successfully conducted the fifteenth Central Banking Course at Katmandu in April-June1985.

Asia Pacific Rural and Agricultural Credit Association(APRACA)

APRACA is an autonomous body having the capacity of legal personality with its office premises in Food and Agriculture Organization (FAO) Regional Office for Asia and the Pacific, Bangkok, Thailand. It is an association of government and non-governmental, institutions, bodies and agencies in Asia and the Pacific Region involved directly or indirectly

in rural and agricultural credit, in particular, and development of rural and agricultural sector in general. At the beginning the Association consisted of 28 institutions from nine countries. Presently it has more than 55 member institutions from 23countries.They are from Australia, Azerbaijan, Bangladesh, Cambodia, China, East Timor, India, Iran, Japan, Korea, Kyrgyztan, Malaysia, Mongolia, Myanmar, Nepal, Pakistan, Philippines, Soloman Islands, Sri Lanka, Thailand, Uzbekistan and Vietnam. Any government department or governmental agency involved in rural finance and agricultural credit, any central bank or monetary authority, any national level financial institution, or national level federation or association of financial institutions actively pursuing rural and agricultural financing and development, any national level training or research and development institute related to rural finance and agricultural credit are eligible for membership of APRACA. The establishment of APRACA was first proposed at a regional seminar on Agricultural Credit for Small Farmers in Asia on October 1974. Subsequently, rural finance and agricultural credit institutions of the region formally launched APRACA during its first General Assembly Meeting in New Delhi, India, on October 10-14, 1977. Its constitution and by-laws were also adopted during the meeting.

The vision of the APRACA aspires to work for rural growth and development, with priority emphasis on the upliftment of the poor. The mission is to promote efficiency and effectiveness of rural finance and access to sustainable financial services. The strategy is to realize the vision and fulfill the mission through innovations in rural finance as well as accessible and sustainable financial programme.

The Objectives of the APRACA are:

(a) to stimulate cooperation in improvement and planning of financial arrangement for rural and agricultural development,

(b) to establish among its members, a machinery for systematic interchange of information on sustainable rural and agricultural financial services,

(c) to encourage and assist in undertaking inter-country studies on matters of common interest in the field of rural finance experts among the members,

(d) to provide services related to consultancy, research and publications in the field of rural finance,

(e) Facilitate cooperation on rural finance projects between the members and donors.

Principal Organs and the Agencies

(a) General Assembly: It is the highest policy-making body and consists of all APRACA members. It convenes once in two years to review the past performance and decide upon the future direction of the Association. It elects the members of executive committee to oversee its programmes and activities for the period of next two years.

(b) Executive Committee: The executive committee of APRACA consists of 12 members .It is composed of chairman, Vice-chairman, Eight members and two ex-officio members. The Ex-officio members are the representative of FAO and Secretary General of APRACA..

(c) Secretariat: The secretariat is headed by the Secretary General who is responsible for the day-to day administration of the association. The secretariat conducts all activities approved by the General Assembly. It also coordinates the activities of APRACA agencies.

(d) Agencies: APRACA and its agencies are non - profit organization working for public benefit for raising the standard of living of rural people with emphasis on the rural poor through rural and agricultural development in general and rural finance innovations in particular. These agencies are APRACA Centre for Training and Research in Agricultural Banking (CENTRAB) and it is responsible for conducting training programmes. Its office is located in Manila. The training courses conducted by the Center are classified into Core Courses, Courses on Current Issues and auxiliary courses. The core courses focus on subject matters relating specifically to rural finances and are offered regularly. The courses on current issues are conducted on need basis. APRACA consultancy Services(ACS), located in Jakarta is the consultancy arm of APRACA. It renders consultancy/advisory services to member institutions ,international and regional agencies as well as other institutions and APRACA Publications (AP) located in Mumbai undertakes the activities of collecting and editing relevant rural finance materials for publications in APRACA Journal. It also publishes other technical books on rural finance.

Nepal and APRACA

NRB is the founding member of APRACA. NRB, Agricultural Development Bank of Nepal (ADB/N), Nepal Bank Limited (NBL), and Rastriya Banijya Bank (RBB) are members from Nepal. NRB

successfully conducted the 6th General Assembly meeting on December 8-11, 1986. Similarly the 31st meeting of the Executive Committee was held at 1994 in Kathmandu. The Governor of NRB inaugurated 44th Executive Committee meetings held in Nepal during 14-18 October 2001.

SAARCFINANCE

The SAARCFINANCE was established in 1998 as a regional network of the SAARC Central Bank Governors and Finance Secretaries. It has held nine meetings since its inception on 9th September 1998 following the 10th SAARC summit held in Colombo, Sri Lanka. The Terms of Reference of the SAARCFINANCE were approved at the 11th SAARC summit held at Katmandu in January2-3, 2002. The Terms of Reference (TOR) include the structure and the broad objectives of SAARCFINANCE. According to the TOR, the broad objectives of SAARCFINANCE are to promote cooperation among central banks and finance Ministries in SAARC member countries by staff visits and regular exchange of information, consider and propose harmonization of banking legislations and practices within the region, work towards a more efficient payment mechanism within the SAARC region and strive for higher monetary and exchange cooperation, forge closer cooperation on macroeconomic policies of SAARC member states and to share experiences and ideas, study global financial developments and their impact on the region including discussions relating to emerging issues in the financial architecture IMF and World Bank and other international lending agencies, monitor reforms of the international financial and monetary system and to evolve a consensus among SAARC countries in respect of the reforms, monitor international currency and capital flows and to work towards a common SAARC position., evolve wherever feasible joint strategies ,plan and common approaches in international for a for mutual benefit particularly in the context of liberalization of financial services, undertake training of staff of the ministries of finance, central banks and other financial institutions of the SAARC member countries in subjects relating to economics and finance, explore networking of the training institutions within the SAARC region specializing in various aspects of monetary policy ,exchange rate reforms, bank supervision and capital market issues, promote research on economic and financial issues for the mutual benefit of SAARC member countries, and consider any other matter on the direction/request of the SAARC finance ministers, council of ministers or other SAARC bodies.

The SAARCFINANCE is a permanent body at the level of Governors of Central Banks and Secretaries of Finance of SAARC member countries. It submits its report to the SAARC Council of Ministers through SAARC Finance Ministers. Each Central Bank should establish a cell to coordinate the activities of SAARCFINANCE. The SAARC secretaries would assist and coordinate activities of SAARCFINANCE. SAARCFINANCE meetings of Central Bank Governors and the Secretaries of Finance is held at least twice a year at the time of the spring and annual meetings of the IMF and the World Bank.

The SAARCFINANCE chair moves in rotation with the change of the SAARC Chair. The Governor of NRB took over the Chair of the SAARCFINANCE with the change of the SAARC Chair to Nepal in January 2002. NRB Governor made the presentation at the 23rd SAARC Ministerial Meetings held in Kathmandu during August 21-22, 2002 and at the 24th Ministerial Meeting held in Islamabad during January 2-3, 2004. The formal handling over of the SAARCFINANCE Chair from Nepal to Pakistan took place in the 10th SAARCFINANCE meetings held on April 24,2004 in Washington DC.

SAARCFINANCE Meetings

The SAARCFINANCE has held nine meetings since its inception on 9th September 1998 following the 10th SAARC summit held in Colombo. The 9th meeting of SAARCFINANCE governors and finance secretaries was held on, September22, 2003 in Dubai, United Arab Emirates. The meeting decided among others the coordination of the SAARCFINANCE be done at the central bank's level and it would be the responsibility of the coordinators of the central banks to duly report the activities to the MOF. The meetings also decided that the institutions that are under the regulatory purview of the central banks could be invited in the activities like research, trainings, seminars etc. The matters of the cost sharing were also left entirely to the countries concerned. The multilateral institutions like the World Bank, IMF, ADB and BIS also could be involved

for technical matters in the training and seminar programmes.

SAARCFINANCE Coordinators Meeting

As decided in the 5th SAARCFINANCE meeting, the first meeting of the SAARCFINANCE Coordinators was held in Colombo, Sri Lanka, on January 7, 2002. The meeting discussed various activities as well as future course of action of the SAARCFINANCE. The second and third meetings of the coordinators took place in Kathmandu on August 7, 2002 and August 11, 2003. The meetings generally tried to expedite the issues that were raised during the SAARCFINANCE meetings.

Seminars and Special Studies

The SAARCFINANCE members conducted the various study, seminars and workshops at different member countries. Bangladesh Bank conducted two seminars on" Global Financial Crisis and Recessions " in November 1999 and "Micro -Credit Operations" in December 21-23,2003 at Dhaka, Bangladesh. Reserve Bank of India conducted the seminar/workshop on "Supervision of Financial Institutions' during January 27-30,1999 and "E-Commerce in India" during November 11-12, 1999. NRB undertook a study on "The Feasibility of Using National Currencies in SAARC Trade" in 2000. NRB also conducted two seminars on "Issues in Exchange Rate Management" during February 12-14, 2001 and " Promoting Financial Stability: the Role of Central Banks" during March 15-18,2004. All the programmes were launched in Kathmandu. The State Bank of Pakistan (SBP) conducted a seminar on "Financial sector Assessment" during October 24-25,2002 and a study on "Financial Sector Assessment "in 2002. The Central Bank of Sri Lanka (CBSL) conducted two seminars on "The Year 2000 Problem and Regional Cooperation for Business Community in the Banking Sector" during July 12-15, 1999 and "Issues in External Sector Management" during January 8-9.2002 in Colombo, Sri Lanka.

The countries also have the mutual agreements on staff exchange programme. Under this programme all together 134 officers of the member countries have exchange their knowledge at various issues at the member Central Banks. Under this programme, a number of training institutions in India (The Banker's Training College, Mumbai, The Reserve Bank Staff College, Chennai, The College of Agricultural Banking, Pune), Bangladesh (Institute of Bank Management in Bangladesh) and Sri Lanka (Centre for Banking Studies of CBSL) granted full tuition-fee waivers to the training participants from the SAARC countries.

Planned Activities

The Central Banks of the SAARCFINANCE have completed a number of studies and are planning various seminars on relevant topics. During January 2-3, 2004, the 24th session of the council of ministers was held in Islamabad which recommended the SAARCFINANCE to conduct many activities, especially the study and recommendations on early and eventual realization of a South Asian Economic Union (SAEU).

Bank for International Settlement (BIS)

Established on May 7, 1930, Bank for International Settlement (BIS) is the world's oldest international financial organization which fosters international monetary and financial cooperation and serves as a bank for central banks. The head office is in Basel, Switzerland, and there are two representative offices: in the Hong Kong Special Administrative Region of the People's Republic of China and in Mexico City. The BIS works:

(a) As a forum to promote discussion and facilitate decision-making processes among central banks and within the international financial community

(b) A center for economic and monetary research,

(c) A prime counter party for central banks in their financial transactions,

(d) Agent or trustee in connection with international financial operations.

The BIS was established in the context of the Young Plan (1930), which dealt with the issue of the reparation payments imposed on Germany by the treaty of Versailles following the First World War. It was also created to promote central bank cooperation in general. The reparations issue quickly faded, focusing the bank's activities entirely on cooperation among central banks and other agencies in pursuit of monetary and financial stability. Since 1930, central bank cooperation at the BIS has taken place through the regular meetings in Basel. The BIS was also the agent for the European Payments Union (EPU) during 1950-58, helping the European countries restore convertibility after the Second World War. Similarly it has also acted as an agent for various

European exchange rate arrangements, including the European Monetary System, which preceded the move to a single currency. It has also provided organized emergency financing to support the international monetary system when needed. During 1931-33 financial crisis, the BIS organized support credits for both the Austrian and German central banks. It has also provided finance in the context of IMF-led stabilization programmes for Mexico in 1982 and Brazil in 1988.

Basel Committee on Banking Supervision

The central bank governors of the group of ten countries established the Basel Committee at the end of 1974 comprising from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. Countries are represented by their central bank and also by the authority with formal responsibility for the supervision of banking. The committee formulates broad supervisory standards and guidelines and recommends statements of best practice so that the individual countries will take steps to implement them, which are best, suited to their own national system. The committee reports to the central bank governors of the group of ten countries and seeks the governor's endorsement for its major initiative. One important objective of the committee's work has been to close gaps in international supervisory coverage in pursuit of two basic principles; that no foreign banking establishment should escape supervision; and that supervision should be adequate. In 1988, the committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8 percent by 1992. Since 1988, this framework has been implemented not only by its member countries but virtually all the countries of the world with a active international banks. In 1999, the committee proposed a New Capital Adequacy Framework, which would replace the 1988 accord. The proposed capital Framework (Basel II) is likely to exert a strong influence on the behavior of internationally active banks-and hence on their lending to developing countries. The revision is designed to enhance the safety and soundness of the banking industry worldwide aligning regulatory capital with bank's credit, market and operational risks. The Basel Committee on Banking Supervision (BCBS) plans to implement it by the end of 2006 in BCBS member countries.

Over the past few years, the committee has moved more aggressively to promote sound supervisory standards worldwide. The committee in 1997 developed a set of 'Core Principles for Effective Banking Supervision' in close collaboration with many non-G-10 supervisory authorities. To facilitate implementation and assessment, the committee in 1999 developed the 'Core Principles Methodology'. The committee's Secretariat is in the BIS at Basel.

Nepal Rastra Bank and the BIS

The BIS has currently had 55 members central banks or monetary authorities. All the members are entitled to be represented and vote in the general meetings. NRB is not the member of BIS, but the NRB has prepared the regulatory framework and Inspection Manual with international standard mostly based on the Basle Core Principles. The manual provides a comprehensive blueprint for an effective supervisory system. To provide the skilled supervisors NRB sends its officers to take part in the trainings and seminars conducted by the BIS and the Financial Stability Institute.

Center for International Cooperation and Training in Agricultural Banking (CICTAB)

The CICTAB was set up in January 1983 by ministry of Agriculture, Government of India as an autonomous institution to serve as an international forum in agricultural banking as sub regional center for Bangladesh, Nepal, Srilanka and India. In the year 1991, the General Council of CICTAB decided to revive the development of CICTAB activities as focal center of HRD efforts in the relevant fields for all the countries of the SAARC region. It is also expected that CICTAB will provide an effective forum for exchange of experience in agricultural banking and related fields between different developing countries in Asia and Africa. It conducts international training programmes for member countries and countries of SAARC regions with special focus on cooperative development for experience and information sharing by providing a common platform to the agricultural and rural development.

Participants for CICTAB's training programmes and other allied activities are senior personnel in related departments of Government, Central Banks,

Cooperative and rural development financing institutions, banks dealings with policies and programmes of their respective institutions and trainers from national level or regional level training institutions concerned with training of personnel from Rural Financing and Development Organization.

The major activities of CICTAB are:

(a) Organization of National Workshops
(b) Organizations of collaborative programmes
(c) Delegation's visits to member countries and
(d) Organization of training courses and other programmes.

During the period FY1983-84 to FY 2003-04, CICTAB conducted four national level workshops, two collaborative programmes, five delegations to different SAARC countries and 98 training programmes and provide training facilities to 2180 employees, including SAARC and other countries of Asia-Pacific. Course design and contents of these programmes were prepared by CICTAB in consultation with respective sponsoring member institutions and their lead national level training institutions. Programme design and contents were revised/modified from time to time to reflect the evaluation feedback and to make the courses more relevant to the training needs of the participants, member institutions and member countries.

Management

The General Council and Managing Committee consisting of representatives from member institutions in member countries manage CICTAB. The general Council consists of all the National Level Institutions of member countries in the SAARC region who have subscribed to the membership of CICTAB. Managing Committee consists of representatives of member institutions in the member countries. The chairman of managing Committee is the additional Secretary of Ministry of Agriculture, India. The Committee guides the operation and activities of CICTAB.

Nepal and the CICTAB

CICTAB was set up to provide training programmes for Bangladesh, India, Nepal and Sri Lanka. The countries of the region participating in CICTAB progarmmes have more or less common features and comparable experience and problems in their rural economy and in the various development programmes undertaken by them. Nepal Rastra Bank, Nepal Bank Limited, Rastriya Banijya Bank, Agricultural Development Bank and National Cooperative Development Board are the members of this institution. During the period 513 staffs of Nepal has been trained from this institution. The National Workshop to review training arrangements in Nepal was organized on 1988 with Agricultural Credit Institute of Agricultural Development Bank of Nepal as lead institution. Similarly the delegation of CICTAB visit Nepal at the end of the 1992. The objective of the delegation visit was to have an opportunity of personal dialogue and discussions with the various authorities and national level agricultural banking, cooperative and rural development institutions. In 1992-93 Ministry of Agriculture, HMG, Nepal Rastra Bank, and Agricultural Development Bank had organized a workshop on Strengthening Training Arrangements for the personnel of Agricultural Banking, Cooperatives and Rural Development. Over the last decade, CICTAB and its member institutions in Nepal have been jointly organizing agricultural and rural financing training courses in Nepal.

Conclusion

The Bank represents the Kingdom of Nepal in various bilateral multilateral, regional and international financial institutions. As a result, it is natural that NRB is associated with the international financial institutions that provide financial assistance and trainings and seminars related to it. Nepal has become the 147th member of the World Trade Organization (WTO) on April 23, 2004. Nepal has made a whole range of commitments in various sectors. These commitments will make effect on trade and payments and naturally the supply of foreign exchange and the balance of payments. Nepal also has become the member of The Bay of Bengal Initiative for Multi-Sector Technical and Economic Cooperation (BIMST-EC) on January 23, 2004. The member countries of BIMSTEC have committed to establish the free trade area by 2017. The free trade between the members will have direct effect on the foreign exchange reserve of the countries. So, in the coming years, the relationships of NRB with the international financial institutions will be further enhanced.

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Open Market Operations

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Introduction

The open market operations (OMO) is the major instrument of monetary control around the world. The OMO allow greater flexibility to the central bank in the timing and volume of monetary operations at its own initiative by encouraging association with the market participants and provide a means of avoiding the inefficiencies of direct control. The initiation of indirect monetary control is important to the process of economic development because direct control tend to become less effective. However, other monetary instruments now in place need to be adjusted and the market infrastructure must be transformed. As the central bank of the country, the NRB is solely responsible for the formulation and implementation of monetary policy. Monetary policy is the means whereby a central bank attains price stability in the economy by regulating the cost and the availability of money (i.e., interest rate and credit availability). The formulation of monetary policy involves developing a plan to accomplish the goals of stable prices, favourable balance of payment situation, efficient payment system, full employment and a stable financial environment in the country. In implementing that plan, the NRB uses the tools of monetary policy to induce changes in interest rates and the amount of money and credit in the economy. Through these financial variables, monetary policy actions influence the levels of spending, output, employment and prices with considerable time lags.

The Nepal Rastra Bank Act, 2002 provides the central bank a greater operational independency followed by rules of transparency and accountability in the formulation, announcement and implementation of the monetary and credit policy. The Act has also envisaged achieving price stability, balance of payment stability, financial stability and efficient payment system as the basic objectives of monetary policy. It has also clearly spelt out that the major instruments of monetary policy could be cash reserve ratio, bank rate/refinance rate and OMO.

The formulation of monetary policy has undergone momentous shifts over the years. In the early 1980s, the NRB gave special emphasis on objectives for the monetary aggregates as policy guides for indicating the state of the economy. The monetary policy was implemented by targeting a quantity of bank reserves that was based on numerical objectives for the monetary aggregates. As the NRB reduced its reliance on the monetary aggregates and familiarized its policy decisions on a wide range of indicators, the implementation strategy shifted towards bank reserves and money market conditions consistent with broader policy goals. Since that time, ongoing and far-reaching changes in the financial system have reduced the value of the monetary aggregates as policy guides. Consequently, monetary

policy plans are now based on a much broader range of indicators. However, the monetary aggregates still play a useful role in judging the appropriateness of financial conditions and in making monetary policy plans.

No one approach to implementing monetary policy can be expected to prove satisfactory under all economic and financial circumstances. The actual approach has been adapted from time to time in light of different considerations and the desire to deal with uncertainties resulting from the structural changes in the financial system. Thus, it is fair to say that the current implementation approach is likely to continue to evolve in response to changing circumstances. Regardless of the particular approach, implementing monetary policy involves adjustments in the supply of bank reserves and financial market conditions. Among the policy instruments used by the NRB, none is more important for adjusting bank reserves than OMO, which add or drain reserves through purchases or sales of government debt securities in the market. Indeed, OMO are the most powerful and flexible tool of monetary policy.

Historically, a central bank can expand or contract the amount of reserves in the banking system and can ultimately influence the country's money supply by buying or selling government debt securities like treasury bills, development bonds and other financial instruments in the market. When the central bank sells such instruments it absorbs money from the system. Conversely, when it buys it injects money into the system. This method of trading in the market to control the money supply is called open market operations. OMO play an important role in steering interest rates, managing the liquidity situation in the market and signaling the monetary policy stance in the economy.

The NRB's OMO are generally conducted on the government debt securities. In the Nepalese debt market, the government debt securities are divided into two categories, i.e., *discount* and *coupon* government debt securities. *Discount securities* comprises all securities with maturity of one year or less and pay only a contractually fixed amount at maturity, called face value. In this case, the return to investors is the difference between the maturity value and the issue value. The treasury bills are classified as discount securities. *Coupon securities* comprise all securities with maturity of more than one year and pay interest every six months, plus principal at maturity. Till date the Development Bonds, Special Bonds, National Saving Certificates and Citizen Saving Certificates are considered as coupon securities. Some of the government debt securities are non-marketable and non-interest bearing that could not be sold directly to the general public. However, the bulk of government debt securities are marketable, that is, they can be traded in the secondary market at prevailing market prices through licensed market makers.

Relevance and Importance of Open Market Operations in the Monetary Management Process of the Nepal Rastra Bank

The OMO affect the money supply and related financial measures through their impact on the reserve base of the banking system. As a matter of monetary policy tactics in controlling these reserves, OMO could be conducted in one of two ways. In an *active way*, the OMO are conducted by targeting for a given quantity of reserves, which allows the price of reserves (i.e., the interest rate) to fluctuate freely. However, in the *passive way*, the OMO are conducted by aiming at a particular interest rate, allowing the amount of reserves to fluctuate. The developed countries, with well-developed and sensitive markets, normally employ a passive approach, although there have been exceptions. A passive approach also appears to be the norm in emerging markets that have reached a certain level of sophistication. There are advantages to a more active approach in developing countries. However, the absence of efficient interbank markets to transmit the influence of monetary policy might be the reason for an active approach in the developing countries. Another reason might be that the active approach allows the central bank to define its policies more clearly, especially when control of inflation is the overriding goal.

While conducting OMO, the NRB needs to collect figures on the supply of and demand for bank reserves being indifferent to any of the approaches. An up-to-date flow of data on bank deposits is particularly important for implementing policy changes in order to offset undesired trends. Even with a passive approach to OMO strategy focusing on interest rates, the prompt availability of deposit data will enable the central bank to make better projections of the demand for reserves, helping to

judge the effect of OMO on money market conditions. The NRB would also require estimates of other factors affecting reserve supply, such as government deposits, currency in circulation, foreign exchange and the float arising from timing differences between crediting and collecting funds in the central bank clearing system. Many of these estimates require close cooperation with the government at a working level.

In practice, the accuracy of reserve estimates needs to be reviewed against incoming evidence on interest rates from the interbank or money market, which reveals the liquidity pressures in the system. Interpretation of this information should be supported by continuing contacts with the market. The designated officers from the NRB should be continually speaking with the market participants in an effort to understand the factors influencing market conditions and enabling policymakers to better assess market psychology. A short-term market rate may usefully serve as the primary guideline for OMO. Thus, the prompt collection of statistics affecting the demand and supply of reserves is very much required. An inadequate statistical base would greatly hamper the NRB in its ability to evaluate the money market rate movements.

For the last many years, the NRB has been setting the objectives of maintaining price stability and a reasonable surplus in the balance of payments for achieving a sustainable economic growth in the country. To achieve these objectives, the central bank has set up the monetary aggregates namely narrow money (M_1) and broad money (M_2) as intermediate targets. These targets are set on the basis of central bank's confidence on their controllability and accurate predictability. These variables have also shown a significant and economically valid relationship with prices and income, which are also the major objectives of the monetary policy itself. To influence the intermediate targets, the NRB has used net domestic assets (NDA) of the monetary authority's account and short-term interest rates as operational targets. The operating targets are used to influence intermediate targets, which ultimately helps to achieve the final targets. This process as a whole could be referred as the monetary management process of the NRB.

While implementing the monetary management process in the NRB, the basic link between monetary policy and the economy is established through the market for bank reserves (i.e., excess deposits held by banks and financial institutions at the NRB). The commercial banks are at the center of the money market with their customer deposits and their own reserve balances at the NRB serving as the core element in the flow of funds. In the market, commercial banks and financial institutions trade their non-interest bearing reserve balances held at the NRB with each other, usually on an overnight basis. The banks and financial institutions facing short of desired reserve positions borrow from others having excess reserve positions. The NRB's monetary policy actions have an immediate effect on the supply of or demand for reserves and the interbank rate, initiating a chain of reactions that transmit the policy effects to the rest of the economy.

In making monetary policy plans, the Monetary Management Committee (MMC) of the NRB is involved in a complex and dynamic process. The Monetary Management Committee estimates when and to what extent its own policy actions will affect money, credit, interest rates, business developments and prices. Since the state of knowledge about the way the economy works is quite imperfect, the policymakers' understanding of the effects of various influences, including the effect of monetary policy, is far from certain. Moreover, the working of the economy changes over time, leading to changes in its response to policy and non-policy factors. On top of all these difficulties, policymakers may not have up-to-date and reliable information about the economy, because of lags in the collection and publication of data. Even preliminary published data are frequently subject to significant errors that become evident in subsequent revisions. Meanwhile, the government's budgetary policies influence the economy through changes in tax and spending programs. Shifts in business and consumer confidence and a variety of other market forces also affect saving and spending plans of businesses and households. In view of all these economic parameters, the NRB could change reserves market conditions by using three main instruments, namely the reserve requirements, the bank/discount/refinance rate and open market operations.

The high level Open Market Operations Committee (OMOC) formed in the Public Debt Management Department of the NRB directs the

most flexible and actively used instrument of monetary policy to effect changes in bank reserves. Under the *Rules on Public Debt Management, 2002*, the Open Market Operations Committee is empowered to conduct open market operations effectively for achieving monetary policy targets. The role of the committee is to coordinate between the monetary and fiscal policy stance and to make the decision for the auctioning and issue of government debt securities.

Decisions, Developments and Status of the Open Market Operations

As stated earlier, the most important monetary policy instruments are the reserve requirements, OMO and discount window in the central banking perspectives. The reserve requirements consist of reserves of the banking system. The commercial banks are obliged to hold certain percentage of their deposits as balance with the NRB. The reserve requirement instrument is not flexible and also not compulsory for other financial market participants. An increase or decrease in reserve requirement ratio makes banks to hold more or less reserves in the NRB. An increase in reserve requirement reduces money multiplier effect, which reduces banks' ability to extend credit and creation of broad money via deposit expansion. However, during the last few years, the reserve requirements of the commercial banks were gradually reduced for increasing the credit expansion capacity and reducing the daily volatility of overnight interest rates. The reserve requirement instrument is very effective in the case of structural liquidity shortage or surplus problems in the market.

In Nepal the OMO are referred broadly to the purchase and sale of government debt securities by the NRB for the monetary management purpose. Generally, government debt securities are traded in the efficient capital market. They are realized in voluntary basis and more flexible than other monetary instruments. For example, if monetary authority aims to withdraw currency from circulation or decrease the excess reserve in the banking system, it engages in open market sales and for an expansionary monetary policy it buys securities from the market participants.

The rediscount window is related to the monetary authority's lender of last resort role. As such, the NRB may lend reserves to banks and financial institutions on the bank rate for 180 days. On the same way, the current monetary policy announcement for the fiscal year 2004/05 also allowed the NRB to provide Standing Liquidity Facility (SLF) to the commercial banks for maximum period of 5 days on penal interest rate based on discount rate derived from the regular 91-day treasury bills auction. If the NRB aims to follow expansionary monetary policy, it reduces price of its credit. The discount rate also has announcement effects that send signals to markets about stance of monetary policy. A higher discount rate can be used to indicate a more restrictive policy, while a lower rate may signal a more expansionary policy. The NRB may also determine the type of acceptable collateral and quantum of borrowing to affect banks' credit allocation.

The NRB started OMO by auctioning treasury bills since November 1988. The 91-day treasury bills auction system was introduced to mop up excess liquidity in the banking system, which also discovered market oriented interest rates. In that time it was agreed by the government that the treasury bills could be issued even if there was no need of cash flow for the government. However, the interest cost had to be borne by the NRB. Although the purpose of open market operations is to control the liquidity of the banking system and implement monetary policy, these operations also contribute to the sale and purchase of government debt securities. This has, however, contributed to the formation of a secondary market for the government debt securities and pursuit of domestic borrowing policy in conformity with daily requirements. Generally, the open market operations policy of the NRB is formed in conformity with the economic policies implemented by the government. During the implementation of operations, deviations of the realized magnitudes of both narrow money supply (M_1) and broad money supply (M_2), from their predicted values, are taken into account.

With the irregular auctions of 91-day treasury bills since November 1988, the 182-days treasury bills were introduced in July 1989 to mop up excess liquidity in the economy. But until the end of 1990, these bills were auctioned very irregularly. Till 1991, treasury bill auctions were conducted twice a month, one for 91 days and another for 182 days. As the yields were market oriented, the treasury bills were popular financial instruments in the money market. The NRB has also started issuing Nepal Rastra Bank Bonds since December 31, 1991 to mop up excess liquidity of the economy arising from the widening

fiscal deficit of the government. The issue of NRB Bonds was continued till July 1994 to squeeze excess liquidity through indirect monetary instruments. The outstanding issue of NRB Bonds reached Rs. 5.39 billion in mid-July 1994. The conduct of OMO has had two important implications for the monetary management process. The NRB was able to partly attain internal price stability due to the heavy injection of treasury bills and NRB Bonds in the economy, which was able to squeeze monetary expansion. On the other hand, the open market sales of treasury bills and NRB Bonds pushed up money market interest rate structure, which had helped in correcting the negative real interest rate.

During the course of time, the issues of 182-day treasury bills were dropped and new treasury bills of 364 days were issued in mid-July 1994 to mop up excess liquidity of the economy created by the widening fiscal deficit of the government. In addition, 28-day and 182-day treasury bills were also introduced through auctions, since 11 September 2004, to provide additional financial instruments to the investors. The issue calendar was first ever publicized through the bank's website on August 20, 2003 with all pertinent information. The issue calendar was made public with an objective of making the government domestic debt management simpler and transparent for attracting the investors to invest in government debt securities and ease the short-term liquidity management for them. All of these measures had helped the NRB to conduct effective OMO.

Until mid-July 2004, the OMO were conducted under the rules set by the Open Market Operations Committee, which established a portfolio of government debt securities for tap sale, outright sale/ purchase and repos. As per the prevalent rule, the quantity of sale and purchase of treasury bills in the secondary market was determined on the basis of yield curve. Under these provisions, the NRB fixes the rates based on the market, which ultimately determines the quantum of treasury bills in the secondary market transactions. The NRB used to mop up excess liquidity through outright sale of the treasury bills in the secondary market provided the quotes of commercial banks were below the yield curve determined rates. The NRB was also absorbing liquidity through the tap sale of treasury bills. The rates on tap sale were determined by deducting ten basis points in the weighted average discount rate of corresponding treasury bills. On the other hand, the NRB injects liquidity in the economy through the outright purchase of treasury bills in the secondary market at the penal rate, where the rates were fixed by adding two hundred basis points to the yield curve determined rates. The repo facility for seven days maturity was also provided to the investors of the treasury bills to meet their short-term liquidity requirement. The repo rate was also fixed at the penal rate by adding fifty basis points in an average of weighted average discount rate of the latest four auctions of the 91-day treasury bills. However, all these provisions pertinent to OMO were abolished on July 19, 2004 through the announcement of new monetary policy guidelines for FY 2004/05.

Under the previous system, the prices in outright sales/purchases and repos were determined by the NRB. However, with the announcement of new monetary policy for FY 2004/05 on July 19, 2004, the NRB started arranging auctions for outright sales/ purchases, repos and reverse repos. The purpose of this procedural change was to allow the prices to be market oriented. In doing so, it was envisaged that the prices would follow a stable trend and reflect the real market conditions. An important procedural change in the reverse repo transactions occurred when the system changed to an auction system since July 19, 2004. These changes had helped the NRB to conduct OMO more frequently and effectively. The NRB has conducted OMO sometimes together with the interbank money market and the foreign exchange market and sometimes alone to manage the liquidity in the market in accordance with the monetary policy stance. This has immensely helped to preserve the stability of the markets. The NRB has also used OMO extensively during the liquidity squeeze resulting from adverse economic situations.

Since the start of the OMO, it is merely guided by the liquidity position of the economy. The desired level of liquidity in the economy is adjusted either by increasing the liquidity level through outright purchases of treasury bills or through repurchase agreements (repo) or by decreasing the level of liquidity through outright sale of the treasury bills or through reverse repurchase agreements (reverse repo). The weighted average discount rates (or auction/interest rates) for OMO reflect the liquidity condition of the economy. The OMO of the NRB ensured a reallocation of liquidity level in the

economy and also enabled the commercial banks to manage their investment portfolios rationally.

For the last one-decade, OMO were being used as the flexible short-term monetary instrument. The auction of treasury bills in primary as well as secondary market and repo auctions are being undertaken under the conduct of open market operations since the beginning of FY 2004/05. According to the new system, the quantity of outright sale/purchase, repo and reverse repo auctions in secondary market are determined by the NRB based on the Liquidity Monitoring and Forecasting Framework (LMFF) and also the trends of monetary targets. The NRB mops up liquidity through outright sale of treasury bills in the secondary market when the regular auctions indicate very low discount rate, whereas it injects liquidity through outright purchase of treasury bills. The market, based on the quantities fixed for such transactions, will determine the secondary market discount/interest rate.

Till July 18, 2004 the commercial banks were taking initiative for the open market transactions. After announcement of new monetary policy for FY 2004/05, the NRB is taking such initiatives on the basis of liquidity position in the economy as indicated by the LMFF. These new provisions of open market operations have helped to set up more market-determined transparent process in the monetary management and also contributed significantly in the development of government debt securities market.

The primary objective of monetary policy for FY 2004/05 is to maintain price stability and to consolidate the balance of payment. The inflation has been targeted at 4.0 percent while the balance of payment surplus has been projected at Rs. 5.50 billion. The excess liquidity of commercial banks had been taken as the operating target of monetary policy for FY 2004/05. In order to monitor and forecast short-term liquidity position, the LMFF has been made operational since the beginning of the current FY 2004/05. The treasury bills with different maturities, viz., 28 days, 91 days, 182 days and 364 days were transacted through outright purchase/sale in the secondary market. However, priority had been given to the issue of short-term treasury bills for influencing the overnight interbank rate and to make the open market operations more effective. The open market sales and reverse repo auction had been used to mop up the excess liquidity from the commercial banks. On the contrary, the open market purchase auction and repo auction had been used to provide liquidity to the commercial banks.

Since FY 2004/05, the NRB has also provided Standing Liquidity Facility to the commercial banks for maximum period of 5 days to meet their short-term liquidity requirement. At the moment, the quantum of the Standing Liquidity Facility has been determined at fifty percent of the holding of treasury bills and development bonds by the commercial banks. The quota of total Standing Liquidity Facility has been set for each of the commercial banks on the revolving basis. However, this facility has been provided only to the commercial banks at their initiative.

As the Standing Liquidity Facility is the alternative to the secondary market sale of treasury bills and inter-bank market borrowing, the rate on such facility has been fixed at a penal rate. As such, the Open Market Operations Committee has fixed the rate by adding two hundred basis points on the latest weighed average discount rate of 91-day treasury bills with a view to check the misuse of the facility and prevents adverse effect on secondary market and inter-bank transactions. This new policy guideline has envisaged that the rate of regular auction would remain as a floor rate in the short-term money market, whereas the rate determined under the Standing Liquidity Facility would act as the ceiling rate. These two rates would create a tunnel/corridor rate at which the inter-bank transaction rate is expected to fit around (Table 1).

During the conduct of effective OMO, the NRB has issued the treasury bills amounting to Rs. 21.95 billion through the Outright Sale and Rs. 5.30 billion through the Tap Sale for absorbing excess liquidity in the economy during FY 2003/04. On the other hand, the NRB has purchased treasury bills amounting to Rs. 16.21 billion for providing liquidity to the economy in the same period. Likewise, the NRB has provided temporary liquidity facility to the commercial banks amounting to Rs. 51.40 billion through the Repo transactions during FY 2003/04 (Table 2).

With the initiation of the new OMO modality, the NRB has mopped up excess liquidity of the long-term nature amounting to Rs. 11.70 billion from the banking system during first six months of the current FY 2004/05 through the auction of

Table 1
Conduct of Open Market Operations in Nepal Rastra Bank
(For FY 2003/04)

	No. of Trade					Trading Amount (Rs. in Crore)				
	Outright		Sale			Outright		Sale		
Mid-Month	Puchase	Repo	Outright	Tap	Total	Purchase	Repo	Outright	Tap	Total
August	0	3	32	0	32	-	66.60	510.90	-	510.90
September	7	32	24	2	26	43.00	832.28	200.50	45.00	245.50
October	9	27	22	6	28	329.00	675.91	281.73	226.00	507.73
November	6	13	34	0	34	124.80	227.26	357.94	-	357.94
December	11	13	8	0	8	162.00	386.66	80.00	-	80.00
January	3	8	12	0	12	73.71	240.75	155.00	-	155.00
February	1	33	3	2	5	45.00	1,029.47	70.00	40.00	110.00
March	5	7	7	0	7	141.00	134.90	79.00	-	79.00
April	0	0	2	6	8	-	-	55.00	50.00	105.00
May	0	3	3	1	4	-	122.00	65.00	5.00	70.00
June	0	4	22	10	32	-	141.55	270.00	79.00	349.00
July	8	27	8	8	16	702.76	1,283.22	70.00	85.00	155.00
Total	50	170	177	35	212	1,621.27	5,140.60	2,195.07	530.00	2,725.07

Source: Public Debt Management Department, Nepal Rastra Bank.

Table 2
Conduct of Open Market Operations in Nepal Rastra Bank
(For the First Half of FY 2004/05)

	No. of Trade					Trading Amount (Rs. in Crore)				
	Outright Purchase Auction	Repo Auction	Outright Sale Auction	Reserve Repo	Total	Outright Purchase Auction	Repo Auction	Outright Sale Auction	Reverse Repo	Total
August			2		3	-		65		123.500
September			2		10			65		337.445
October			6	2	14			955	150	1,516.330
November	1	1			47	4.96	105			1,693.643
December		1			8		161			397.250
January			2	1	3			85	257.	342.000
Total	1	2	12	3	85	4.96	266	1,170	407	4,410.168

Source: Public Debt Management Department, Nepal Rastra Bank

outright sales of treasury bills. Meanwhile, it was able to squeeze short-term liquidity through the auction of reverse repo of treasury bills amounting to Rs. 4.07 billion during the first six months of the current FY 2004/05. On the other hand, the NRB has injected long-term liquidity on the economy through the auctions of outright purchase of treasury bills during first six months of the current FY 2004/05 amounting to Rs. 0.05 billion and injected short-term liquidity in the economy through the auction of treasury bills repo of Rs. 2.66 billion. The quantum of treasury bills auction indicates that the OMO were able to manage the liquidity in the economy in line with the attainment of the monetary policy targets.

Modus Operandi of Open Market Operations in the Nepal Rastra Bank

The OMO involve the buying and selling of government debt securities and central bank securities in the open market by the central bank. However, in the Nepalese context, the OMO are only the buying and selling of treasury bills in the secondary market

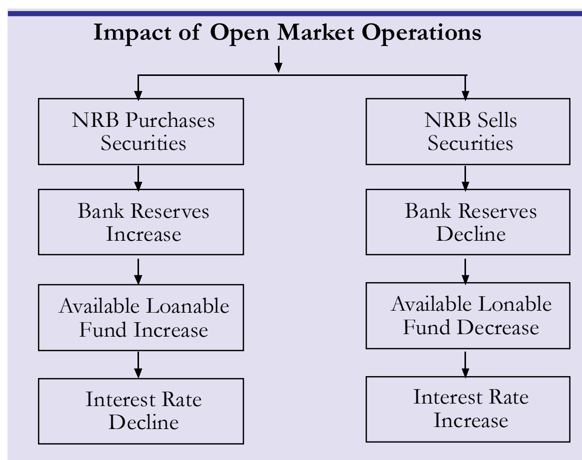
in order to expand or contract the amount of money in the banking system. The purchases of government debt securities inject money into the banking system and stimulate growth while sales of securities do the opposite. As such, the NRB could offset swings in reserves caused by changes in the public's demand for cash and numerous other factors through the effective conduct of OMO. The NRB's goal in using this principal tool of monetary policy is to adjust liquidity in the economy through the short-term interest rate, i.e., the rate at which banks borrow reserves from each other.

According to the section 45 of the *Nepal Rastra Bank Act, 2002*, the NRB may conduct OMO against debt securities issued by the government or bank itself with outright purchase/sale of securities, repurchase (repo) and reverse repurchase (reverse repo) agreements. The OMO are conducted with the objective of effectively regulating the money supply and liquidity in the economy within the framework of monetary policy targets. The conduct of OMO including its procedures, conditions, the amount of issue, the time of issue, the type of instruments, the interest rates and the maturity date is determined by the high level Open Market Operations Committee headed by the Deputy Governor of the NRB. The Committee also consists of representatives (Joint Secretary) from the HMG/N, Ministry of Finance, Executive Directors of Research Department, Banks and Financial Institutions Regulation Department, Banking Office and Public Debt Management Department. The Director of the Public Debt Management Department serves the Committee as a member secretary.

The NRB, in the scope of OMO, may issue monetary bills/bonds for its own account and behalf. However, matters such as the prevention of the monetary bills/bonds from being a permanent alternative investment tool and the limitation of the issuance of the bills/bonds to promote the effectiveness of OMO shall be taken into consideration. The OMO shall be conducted only for monetary policy purposes and shall not be conducted to provide credit to the government, to public establishments and institutions. The sequential impact of the OMO conducted by the NRB could be illustrated in the following diagram.

Each year, in mid-July, the Governor of the NRB makes an announcement of the monetary policy, which focuses on the performance of the economy

Table 3



and its monetary policy plans for the current fiscal year. The report on monetary policy is based on a comprehensive review of the economic and financial situation of the country. The report reviews a wide range of indicators for determining the course of monetary policy and includes specific annual growth ranges for money and debt aggregates, consistent with expectations for inflation and output. The report also discusses about the foreign exchange market development, domestic financial market developments and open market transactions in government debt securities.

The domestic policy directives indicated in the monetary policy announcement guides the modality of OMO. For example, if the short-term interest rate is persistently above the intended level, the Open Market Operations Committee would expand the supply of reserves to restore the appropriate reserve market conditions, thereby bringing down the interest rate to the intended level. To implement these policies, the Public Debt Management Department of the NRB would have to translate the monetary policy directives into the operating objectives. The detailed forecasts of the LMFF serve as the core elements for judging reserve conditions for the effective conduct of OMO.

As advised by the LMFF, the OMO is conducted with buying and selling of government debt securities in the secondary market in which previously issued government debt securities, especially the treasury bills, are traded. When the NRB buys securities from the commercial banks, it pays by crediting the bank account of the investors at the NRB. Since this transaction involves no offsetting changes in reserves

at other banks, the rise in the reserves of the bank increases the aggregate volume of reserves in the monetary system. When the NRB sells securities to banks and financial institutions, the reserve consequence is exactly the opposite in which the payment by the banks and financial institutions reduces their reserves.

By and large, the seasonal swings in the public's currency holdings are the dominant source of short-run currency variation. Some of these swings represent intra monthly patterns reflecting such routine transactions as payments of salaries and other social spending. Others result from the effects of somewhat longer seasonal cycles on business activity during the year. For example, currency in circulation rises substantially during the festive season, from early September-to-October end and much of this bulge reverses in the following month. Most short-term variations in currency movements are reasonably predictable, since they follow recurrent seasonal patterns. Meanwhile, the NRB attempts to offset recurrent contractions and expansions in reserves associated with seasonal swings in currency through its OMO. If the NRB did not do so, banks and financial institutions would be compelled to adjust their reserve positions by lowering or raising their investments and short-term loans. Such actions would cause significant fluctuations in the interbank rate and other short-term rates and could lead to serious market disturbances.

The reason for creating the Monetary Management Committee at the NRB was to avoid the undesirable effects of seasonal swings in the public's currency holdings. However, the OMO is required, not only to offset seasonal and other short-lived influences on the supply of bank reserves, but also to deal with changes in bank and financial institutions' demand for reserves. Specifically, in managing the supply of bank reserves, the NRB would make appropriate adjustments so as to create money market conditions to be consistent with the desired monetary policy objectives. Thus, the OMO have both defensive and dynamic aspects.

It is noteworthy that the NRB normally conducts its OMO in the government debt securities market, which is the broadest and most active of Nepalese financial markets. The breadth and depth of this market, as evident in its capacity to accommodate all types of transactions without distortions and disruptions, are essential for the effectiveness of OMO. The government debt securities do not bear credit risk and so they are the most suitable instruments for OMO. These characteristics of the government debt securities market enable the NRB to buy and sell quickly at its own convenience and in any amount that may be required to keep the supply of bank reserves in line with policy objectives.

The NRB uses two general approaches to add or drain bank reserves through changes in the portfolio of government debt securities in the system. When significant reserve shortages or excesses are expected to persist for a relatively long period, the NRB may make outright purchases or sales of government debt securities of its holding that permanently affect the size of the monetary system and the supply of reserves. Aside from the long-term upward trend, most of the time reserve surpluses/shortages are expected to be short-lived, either because seasonal factors are expected to be offset or because the outlook for reserves is uncertain. In these cases, the NRB undertakes transactions that only temporarily affect the supply of reserves. The NRB uses repurchase agreements to add reserves and reverse repurchase agreements (matched sale purchase agreement) transactions to drain reserves on a temporary basis. Such temporary transactions are designed to minimize fluctuations in the overall supply of reserves. They are used routinely and much more frequently than are outright transactions.

Generally, the NRB (Public Debt Management Department) conducts outright transactions in the market through auctions in which the commercial banks are requested to submit bids to buy government debt securities from the Public Debt Management Department or offers to sell government debt securities of a particular type and maturity. While awarding the bids, the Public Debt Management Department selects bids with the highest prices (lowest yields) for its sales and offers with the lowest prices (highest yields) for its purchases. Typically, the outright operations are arranged for delivery of the government debt securities within the next day. The timing of outright transactions is driven primarily by the expected persistence of excesses or shortages in reserves. The exact timing of such operations also considers market conditions as the NRB attempts to avoid rapidly rising or falling market rates and other possible events resulting in market volatility.

The NRB uses short-term repo auctions with banks to add reserves on a temporary basis. Under the repo arrangement, the Public Debt Management Department buys treasury bills from commercial banks that agree to repurchase them at a specified price on a specified date. The added reserves are extinguished automatically when the repos mature. It is much more convenient for the NRB to inject large amounts of reserves on a temporary basis through outright purchases. Repos allow the NRB to respond quickly when reserves fall short of desired levels and they can smooth the pattern of reserves for the maintenance period by meeting needs for particular days. Moreover, transaction costs for repos are very low and the acceptable collateral is the treasury bill. The distribution of repo transactions among commercial banks is determined by auction in which banks bid for a specific amount of repos at a specified bid price. With all the offers arranged in descending order of bid price, the Public Debt Management Department accepts offers that carry the lowest bid prices up to the desired amount.

The OMO from one day to the next are closely related. In its every auction, the NRB responds to the market with the pertinent information. It also takes into account the implications of its own immediate past operations. The NRB faces considerable risk that it might add or drain more reserves on any given day than specified, which may cause the short-term rate to move away from the desired level. To minimize this risk, the NRB responds cautiously to the projections of large uncertain reserve shortfalls or excesses. Nevertheless, the Public Debt Management Department does add or drain reserves as indicated by the LMFF. Usually, the consequences of any such actions can be remedied quickly, since revised information and operations of the previous day are routinely factored into the daily reserve picture. As mentioned above, the aim of OMO is adjusting the reserve level, money supply and liquidity in the economy. When the NRB decides to realize, it announces the relevant information before the auction day. Generally, the NRB publishes the auction notice in the daily newspaper (*Gorakhapatra*) prior to the auction day and also release the information from the website. Bids are accepted till 3.00 p.m. on the stipulated auction day and the settlements are done on the next day.

Instruments used in the Open Market Operations

In the absence of an active secondary market in government debt securities, OMO are conducted in the primary market. Typically, such operations include auctioning newly issued government debt securities to absorb reserves or auctioning central bank credit to provide reserves. The much used OMO involve the issue of new government or central bank securities in order to absorb excess liquidity. If the central bank offers new treasury bills to absorb reserves, it should be considered as a monetary operation only if the incoming funds are not available to government for spending. The cleanest approach in this regard is to set the funds aside in a special account created purely for purposes of monetary policy. This approach would ensure that bank reserves are reduced permanently by the operation. If the surplus of reserves is overestimated, the central bank could buy back the securities before maturity, leaving the special account balance unchanged. Such repurchases before maturity, perhaps followed by subsequent resale, could have the additional advantage of helping to develop a secondary market.

The OMO, by issuing special securities, is of most practical use when the banking system is having excess liquidity. These securities can be bought back before maturity and resold. They can also be employed to adjust the variation of liquidity pressure. But they do not provide the same flexibility as OMO in the secondary market. In the absence of an active money and interbank market, the central bank is underprivileged of ongoing information about actual and emerging liquidity conditions, which makes planning of the timing and size of operations more difficult. The special issue, guaranteed by the government, may help strengthen and diversify the central bank's balance sheet.

In view of the monetary policy guidelines for FY 2004/05, the instruments of OMO could be categorized as outright purchase, outright sale, repurchase agreements (repo) and reverse repo. Although the outright purchase and repo injects liquidity into banking system, the outright sale and reverse repo withdraws liquidity from banking system.

Repos and reverse repos are ideally suited for offsetting short-term fluctuations that affect bank reserves. They are also useful for offsetting large shifts

in liquidity caused by a gesture of capital inflows or outflows, which can be expected to become the dominant tool for open market operations. The outright purchases and sales of treasury bills in the secondary market are also used to provide or absorb reserves on a more permanent basis. They are also considered an important instrument of monetary control. A brief description of each instruments used in OMO are highlighted as below.

Outright Purchase

The OMO through the outright sale of treasury bills are realized when there is structural or permanent liquidity shortage in the economy. If this is the case, the Open Market Operations Committee decides on the kind of treasury bills that to be purchased. The Public Debt Management Department declares its intention to the market participants through the auction notice. The commercial banks that want to sell specified securities may participate in the auction and offers their bids to the NRB. The NRB evaluates commercial banks' offers by considering desired or planned amount and announces results. Auction winners' bank accounts in the NRB are credited and NRB's investments in relevant securities accounts are debited. As a result of outright purchase, banking system's reserves increase permanently.

Repurchase Agreement (Repo)

Repo is realized when there is temporary liquidity shortage in the economy. Repo is a forward transaction and it consists of spot purchase of an asset and simultaneous forward sale of the same asset. In that framework, repo can be thought of as collateralized lending. The repo rate is the difference between purchase price and sale price of the related government security. During the repo transaction, repo rate and sale date would be determined in the spot date (purchase date). If the NRB aims to increase the system's reserves temporarily, the Public Debt Management Department declares repo auction to the market participants through the auction notice. The commercial banks that want to sell specified securities to the NRB may participate in the auction and offers their bids. The Public Debt Management Department evaluates offers by considering desired or planned amount of repo purchase and announces results of repo auction. Auction winners' bank accounts in the NRB are credited and the NRB's investments in relevant securities accounts are debited. As a result of the first leg of repo transaction, the banking system's reserves increase. In the forward date (second leg), the NRB sells government debt securities at predetermined price so that the reserve level in the system decreases. At the moment, the maturity period of repo transactions is 7 days.

Outright Sale

Outright sale is the reverse of outright purchase and it is realized when there is structural or permanent excess liquidity in the economy. The Open Market Operations Committee decides the type of treasury bills that need to be sold. Then the NRB declares its intention to the commercial banks through the auction notice. The commercial banks that want to buy specified securities may participate in the auction and offers their bids. The Public Debt Management Department evaluates offers by considering desired or planned amount of outright purchase and announces results. The auction winners' bank accounts in the NRB are debited and the NRB's investments in relevant securities accounts are credited. As a result of outright sale, the banking system's reserves diminish permanently.

Reverse Repo

As the name demonstrates, this operation is reverse of repurchase agreement. Reverse repo is realized when there is temporary excess liquidity in the economy. Reverse repo is also forward transaction that it consists of spot sale of an asset and simultaneous forward purchase of the same asset. Repo rate is the difference between sale price and purchase price of the related government security. The repo rate and purchase date would be determined in the spot date (purchase date). If the NRB aims to decrease the banking system's reserves temporarily, it declares reverse repo auction to the market participants via the auction notice. The commercial banks that want to purchase specific government debt securities from the NRB may participate in the auction and offer their bids. The Public Debt Management Department evaluates market participants' offers by considering desired or planned amount of reverse repo purchase and announces results of reverse repo auction. Auction winners' bank accounts in the NRB are debited and the NRB's relevant securities accounts are credited. As a result of first leg of reverse repo transaction, the banking system's reserves decrease. In the forward

date (second leg), the NRB purchases government debt securities at predetermined price so that the reserve level in the system increases. At the moment, the maturity period of reverse repo transactions is 7 days.

Coordinated Efforts of the Government and the Central Bank in Conducting Open Market Operations

The government decisions on debt management and cash balances with the central bank obviously have an impact on the use of OMO. Sometimes the government can facilitate the operations. At other times, they can complicate the task. All the time, the government and central bank work together on these issues, though with varying degrees of tension and power. On pure debt management decisions, the government in most cases makes the final decision, with the central bank serving as its agent. The central bank normally has a bigger say in areas where governmental operations have a more direct impact on bank reserves. Whatever the relationship, OMO will be the most effective monetary instrument where the central bank has control over factors that affect the reserve base of the banking system.

For the effective OMO, it is particularly important for the central bank to be able to influence the fluctuations of the government's operating balance with the bank, which affect the supply of bank reserves. It is unusual for the central bank to be given substantial discretionary power over government deposits, but there are exceptions. However, the government may allow the central bank to use its excess cash balance, stood in excess of the specified ceiling, for redemption of non-marketable securities.

As an economy grows, financial markets can be expected to broaden and deepen, but experience shows that the pace and pattern of market development may need guidance from the monetary and government authorities. The associated development of open market policy instruments tends to occur in two stages. First, there is a shift away from direct controls toward use of open market operations in the primary market through auctions of new issues of securities. Later, there will be a further shift toward the use of fully flexible two-way operations in existing securities as active secondary markets develop. The OMO in primary market could be viewed as a prelude to the evolution of active secondary market.

The focus of monetary policy is to provide adequate liquidity to support economic recovery and to avoid the build up of inflationary pressure. With a view to facilitating more effective management of market liquidity and to achieve its monetary policy objectives, the NRB moved to more active OMO since August 2004. The key features of the new OMO system are very frequent auction to inject or absorb liquidity. This has also helped to establish an interest rate corridor formed by the repo and reverse repo rates. Under this system, the volume of liquidity to be injected or absorbed under OMO is decided by Open Market Operation Committee with the feed back of the liquidity condition indicated by the LMFF based on the monetary policy stance and market liquidity situation.

Since the commencement of more active OMO, the NRB has conducted repo auctions very frequently as there was excess liquidity in the market. The NRB also began conducting outright sales to absorb liquidity on a longer-term basis. It has also offloaded the government debt securities under its holding for OMO during December 2004 to mop up liquidity as its net domestic assets portfolio had dwindled due to the performance criteria set in the Poverty Reduction Growth Facility (PRGF) for Nepal.

When the NRB tightens monetary policy by draining bank reserves through open market sales of government debt securities, the inter-bank rates and other short-term interest rates rise more or less immediately, reflecting the reduced supply of bank reserves in the market. Sustained increases in short-term interest rates lead to lower growth of deposits and money as well as higher long-term interest rates. Higher interest rates raise the cost of funds and have adverse consequences over the time for business investment demand. This is the conventional money of "interest rate channel" of monetary policy influence on the economy. A firming of monetary policy also may reduce the supply of bank loans through higher funding costs for banks or through increases in the perceived riskiness of bank loans. Similarly, non-bank sources of credit to the private sector may become scarcer because of higher lending risks associated with tighter monetary condition. The reduced availability of loans may have negative effects on aggregate demand and output. This is the so-

called "credit channel" that may operate alongside the interest rate channel. Higher interest rates and lower monetary growth also may influence economic activity through the "wealth channel" by lowering actual or expected asset values. For example, rising interest rates generally tend to lower bond and stock prices, reducing household net worth and weakening business and household spending may suffer.

By causing changes in interest rates, financial markets and the exchange rate, monetary policy actions have important effects on output, employment and prices. These effects work through many different channels affecting demand and economic activity in various sectors of the economy. Changes in the cost and availability of credit, reflecting changes in interest rates and credit supply conditions, are the most important sources of monetary policy effects on the economy. All these changes, in due course, affect economic activity and prices in various sectors of the economy.

Outcomes and Impact of Open Market Operations

The monetary management process in Nepal has been improved by recent introduction of monetary instruments, especially the effective OMO through auctions of outright sale, outright purchase, repo and reverse repo of treasury bills. The limit on access to the Standing Liquidity Facility has been reviewed and reduced the potentiality of injecting liquidity so that the monetary targets are achieved. The new monetary approach has been able to provide market oriented interest rates through the effective OMO. The monetary management process in Nepal has significant effects on employment and output in the short run; however, it affects primarily prices in the long run. The short-run variability of deposits results in part from the influence of cyclical and other short-term developments in the business activity. These developments go hand-in-hand with short-run changes in interest rates, which affect credit flows and the holdings of various earning assets, such as shares, bonds, debentures and time/saving deposits, relative to currency and demand deposits that yield no income. Seasonal adjustments and related procedures can be applied to sort out recurrent patterns of deposit movements. The actual behaviour of deposits and credit in the economy reflects the interaction of banks and financial institutions, businesses, households and the NRB as well.

The initial link between monetary policy and the economy occurs in the market for bank reserves. When the monetary policy influences the demand for and/or supply of reserves at commercial banks, the effects are transmitted to the rest of the economy. Therefore, one should understand the function and structure of bank reserves to know how monetary policy is related to the economy. Before the implementation of OMO, the central bank should have information and statistics about demand for and supply of bank reserves.

Generally, the demand for reserves consists of required reserves and excess reserves. The required reserves are a fraction of predetermined deposits, which is also called cash reserve ratio (CRR), determined by the NRB. The total required reserves increase or decrease with the level of deposit volume subject to required reserves and required reserve ratio. Generally, licensed bank and financial institutions hold reserves in the form of vault cash and required reserve balances with the NRB. In addition to required reserves, some banks and financial institutions might prefer to hold additional balances in the form of excess reserves that is the second component of demand for reserves. Many factors affect supply of reserve in the system. Such factors are changes in currency holdings of the public and the government's cash balances at the NRB. Currency demand is the largest factor that requires reserve injections to the system. Changes in currency demand may come from swings in business activity and seasonal factors such as payments of salaries or shopping at festive and holiday seasons. Most short-term variations in currency movements are predictable and the NRB attempts to offset seasonal swings in currency through the OMO. As such the disturbing volatility in the short-term interest rates is eliminated.

In general, the government maintains its bank account at the NRB for making and receiving payments. An increase in the bank balance absorbs reserves from system and decrease in these balances injects reserves to banks. The NRB also considers government cash balances during the daily liquidity management. Therefore, the high-level cooperation between the NRB and government should be ensured. When forecasts of reserves indicate that the supply of reserves will probably continue to need adjustment, the NRB may engage in outright purchases or sales. When projections indicate only a

temporary need to alter reserves, the NRB may engage in the repo/reverse repo transactions that only temporarily affect the supply of reserves. As a result of these temporary transactions, fluctuations of reserves may be diminished. The accuracy of estimation may be judged by using money market and/or interbank interest rates. Changes in these may reveal pressures in the market. In addition to that, the NRB would be communicating continuously to the market participants with the assistance of Open Market Operations Committee designated traders. So, the NRB provides information about liquidity level or abnormality in the market as soon as possible. The banks and financial institutions may trade reserves held at the NRB among them, usually overnight. The benchmark rate of interest charged for the short-term use of these funds is called the interbank rate. Changes in that rate reflect the basic supply and demand conditions in the market for reserves. Equilibrium is satisfied in the reserves market if demand for bank reserves is equal to supply of reserves. Allowing to interest rate changes and/or changes in reserve amount in the system may eliminate disequilibria in the reserves market.

As described earlier, the NRB supplies reserves to the banking system mainly in two ways, i.e., lending through discount window and buying government securities from the market. In the first case, loans are provided to banks and financial institutions at a discount/penal rate. Discount window facilities are uniquely suited to the task of meeting the temporary liquidity needs of individual banks. But OMO are better suited to implementing the short-term adjustments to the availability of aggregate reserves that are necessary in conducting monetary policy. In addition to that, adjustments to the basic discount rate can be important in signaling and conducting monetary policy.

The main rationale for reserve requirements was ensuring insurance to deposit withdrawals. But the rationale for reserve requirements changed over time. At present, in addition to its old rationale, reserve requirements assist in conduct of OMO by helping to ensure a stable, predictable demand for reserves, which increase the central bank's control over short-term interest rates.

The OMO may create trading loss for the central bank. For example, the market prices or the discount rates of eligible debt securities may change during the life of the OMO. Any fall in the price of a security would pose a credit risk to the central bank. Therefore, the NRB may demand securities with a greater market value than the amount of liquidity provided.

To reach monetary ends by implementing OMO needs restrictions on discount window monetary instrument. Otherwise, OMO could not be used as the basic monetary instrument for controlling bank reserves. For example, banks may get funds from discount window when a contractionary OMO has been realized. However, the discount window policies could be used to discourage short-term borrowing from the NRB. In totality, the NRB should be able to determine the linkages among monetary instruments very carefully. Reserve requirement instrument may assist OMO of the NRB. Thus, the NRB may send more clear signals by using OMO with reserve requirement.

Problems and Challenges in the Conduct of Open Market Operations

The OMO should be undertaken in markets that may not be entirely ideal but are at varying stages of development toward a deregulated, competitive system. In such cases, OMO may need to be limited in size or employed only periodically. A central bank would be able to function more effectively if markets perceive that its portfolio of assets is highly liquid and essentially risk free. The markets most suitable for flexible OMO is normally those where short-term instruments are traded. Well-developed markets are characterized by a large and continuous volume of trading by a variety of participants, including government, financial institutions and other businesses. These sectors present the best opportunities for effective OMO. These are the markets for government and central bank securities, for interbank debt and for short-term instruments issued by financial institutions and other corporate entities, including commercial paper and bank certificates of deposit.

If the amount of government debt is low, the OMO should be conducted on the private money market instruments. If a significant government debt market does not exist, a central bank may decide to create a similar balance sheet effect by developing debt instruments of its own or through the use of a special government issue employed only for monetary policy purposes.

The government debt securities market is generally regarded to be free of credit risk and therefore the best medium for OMO. Unstable political and economic conditions may make it impossible to maintain a viable market for issuing government debt securities. Political stability and a sustained government record of meeting interest payments and redemption schedules are essential to the use of OMO. Apart from a failure to meet such contractual obligations, a government securities market can also dry up if the central bank pursues an inflationary policy that drives investors out of the market by eroding the real value of outstanding debt. Thus, keeping inflation within acceptable bounds is also a vital precondition for effective OMO.

With these backdrops, the NRB's new approach in monetary policy implementation should focus on adjusting short-term liquidity and allow for a larger degree of market determination of interest rates. A more active management of banking system liquidity would therefore require a strategy for the central bank's stance of monetary policy which should be implemented mainly through conducting OMO.

Corrective Actions, Policy Options and Future Agenda for Conducting Effective Open Market Operations by the Nepal Rastra Bank

For conducting efficient OMO both the NRB and the government need a reliable marketplace for government debt securities, where participants feel secure that counter parties will perform according to their obligations and which is transparent enough to encourage wide participation. To obtain its objectives through OMO, the NRB should establish performance standards for participants. This is also the natural focal point for market surveillance through gathering statistics and publishing market aggregates. The NRB may not wish to go beyond these functions by assuming direct regulatory and oversight responsibilities, which may unduly tax its limited personnel resources as well as a loss of credibility creating rumors in the government debt securities market, as they sometimes do.

A demarcation between monetary management and debt management may serve a better monetary management process. The general public would tend to rely on the NRB as bearing some responsibility for markets in which it operates. For this reason, the NRB should take steps that help rationalize the market's architecture and enhance its performance. The NRB should prefer to operate in a transparent market that trades continuously, where communication of its operations is prompt and in which its purposes are well understood. Thus, it should take steps to help achieve these goals by promoting an interbank market, designing proper market instruments and trading infrastructure, providing financing facilities, establishing criteria for dealing with the open market function, collecting and disseminating statistics and encouraging safe payments and clearing mechanism.

Apart from these, the issue of the NRB bills/ bonds should be initiated especially for the purposes of monetary policy. Choosing between the two types of instruments, i.e., the NRB securities and government securities, therefore depends mostly on institutional and market considerations. The issue of the NRB securities may be useful to conduct OMO, when the government securities are not allowed to use in conducting open market operations. However, the development of an active government debt securities market would be delayed, rather than stimulated, by large-scale issues of the NRB's own bills/bonds. Thus, the government should take it seriously that the issue of the NRB's bills/bonds would be complicating its policies on determining cost of debt management and segmenting a thin debt market.

If the OMO are taken as the principal policy instrument for the monetary management process in the country, other monetary instruments obviously need to be given less importance, particularly the discount window, where the banking system can obtain reserves on its own initiative simply by borrowing from the NRB. For OMO to be effective, limitations need to be placed on the access of banks to borrowing from the NRB at the discount window. Without such limitations, OMO could not be used as the principal monetary instrument for controlling bank reserves and overall financial conditions. The discount window should therefore be designed to make access to the NRB's credit less attractive in one way or another, perhaps through a high penalty rate or restrictive guidelines in providing Standing Liquidity Facility. Restrictions on the discount window need, however, to be handled with care. If a penalty rate is set well above current market conditions, the system might not react quickly enough to unanticipated liquidity demands. The regulations that

restrict access to the window have to permit smooth adjustment when reserve shortages occur.

In a tight monetary policy implementation period, borrowing from the NRB for very limited periods allows banks to make more orderly portfolio adjustments. Such short-term borrowing at the discount window, viz., Standing Liquidity Facility, should be differentiated from longer-term structural borrowing, i.e., Refinance Facility, which allows emergency long-term advances to banks and financial institutions in severe operating difficulties. Other adjustments may also be needed, depending in part on the particular strategy adopted for conducting OMO.

It is always better to implement monetary policy through OMO in the secondary market, mainly in the form of repos and reverse repos. The repos provide temporary financing of reserve shortages and surpluses but do not directly influence demand and supply in the security that serves as collateral. Most positively, repos tend to enhance liquidity in the underlying securities by helping to develop a more active secondary market. The use of repos with a short maturity would encourage participants to develop as many alternative sources of short-term lending and borrowing as possible. Repos can be used in various maturities, although short-term operations tend to dominate. If the repos have become the main instrument, the OMO should be undertaken through informal auctions on a daily basis with maturities generally overnight. However, outright transactions run a high risk of dominating the market and impeding further development, when secondary markets are still comparatively thin. As the repos is the most flexible and convenient form of financing, it could also be seen as an effective instrument for increasing market liquidity and helping to smooth the way to broader market development.

HMG/N should have greater interest in competitive trading, given that the cost of national debt should fall as government securities become more liquid. For this purpose, an active interbank market is particularly important because it helps in clarifying the timing and volume of OMO. The NRB should also encourage market practices conducive to competitive trading. It could encourage a computerized system of bids and offers for securities that protects anonymity. To foster market transparency, it should also discourage trading from outside the established markets. As such, the issue of securities in the form of promissory notes and the practice of secondary market transactions with an unofficial endorsement should be abolished.

To have a clear separation between monetary and fiscal policies, it is most desirable that all the government debt securities should be issued through the auctions. The non-interest bearing and non-marketable government debt securities should also be paid by the government or made marketable with market-oriented coupon to avoid any potential conflict between debt management and monetary policy needs. The timely initiation of planned auction of long-term government securities would also help to develop a competitive and deregulated market system. This also avoids pressure on the NRB to facilitate primary market issues at a predetermined rate.

To minimize the credit, delivery and settlement risks associated with the securities transactions and to make OMO more effective, the NRB should institutionalize Primary Dealers System (PDS) for selecting trading counter parties for its OMO. As such, the NRB could also encourage market development by setting down ground rules for parties with which it deals. The primary dealers must be either commercial banks or highly capitalized financial institutions or big corporate discount houses. The primary dealers should be able to handle large orders efficiently, quickly and safely. If a primary dealer fails to meet the specified standards, the NRB should discontinue its trading relationship with that dealer. The primary dealers have an obligation to make reasonable bids and offers when the central bank enters the market, as well as in the regular auctions. If the market participants are very few, the creation of a primary dealer system may be more problematic and impractical. In order to avoid charges of favoritism and market collusion, the number of primary dealers should be fairly large. By establishing such dealers, the NRB would be in a stronger position to encourage dealers to establish better market-making standards, such as minimum transaction sizes for dealing at quoted prices. Of course, ongoing rapid technological changes would also influence the best approach for the NRB to take toward market structure and its own counter parties.

The NRB is the focal point for collection and dissemination of financial market statistics. The process of data collection, including daily figures on

positions, transactions volume and financing by type of issue, should begin perfectly at the very earliest stages of development. These figures provide the basis for surveillance. Thus, the NRB should be able to release aggregate data on market activity as quickly as possible in order to enhance market transparency. Publication should be timed with sufficient lag, perhaps a week, depending on the instrument, to avoid market overreaction.

The NRB should also encourage the market to set delivery and payment standards. There would not be effective market functions without reasonable assurance that securities would be delivered on time and paid for as agreed. The speed and reliability of the clearing and payments systems depend on the market's technical capacity and institutional arrangements. The NRB can also work together with the government to introduce up-to-date technology in the government debt securities market. Such technological developments would be to introduce a book-entry (scripless) system to record security ownership and a simultaneous delivery-versus-payment procedure through the central bank's deposit accounts as the central depository. The initiation of secondary market transaction through the Nepal Stock Exchange (NEPSE) would also be the milestone in the development of a vibrant capital market in Nepal. To accommodate all these features, the prevailing rules and regulation for the transaction of the government debt securities and open market operations are not sufficient. Thus, there is a greater need of having appropriate legal, regulatory and infrastructure base through proper amendments in the prevailing rules and regulations.

For ensuring most economic, efficient and effective OMO in the NRB, the issue calendar of government debt securities should be announced immediately after the announcement of government budget. The issue calendar should be followed strictly with the least amendments. Moreover, the notification of the forthcoming OMO should be released to the market, at least, three days before the auction. Last but not the least, as the backbone of the OMO, the people involved in the operations should be well educated, trained with sufficient exposures on debt and monetary management. The management theory of "right man in the right place" should strictly be followed for this purpose.

Concluding Remarks

The monetary policy formulation is not a simple technical matter. It is clearly an art that greatly depends on experience, expertise and judgment. In the last few years, OMO have become the most important monetary instrument in the monetary management process of the NRB. It is realized in voluntary basis and more flexible than other monetary instruments. However, the NRB conducted OMO sometimes together with the foreign exchange market to manage the liquidity in the market in accordance with the implemented monetary policy and to preserve the stability of the markets.

Generally, the NRB uses OMO extensively during the liquidity squeeze. The OMO of the NRB ensure a reallocation of liquidity level in the economy and also enable banks to manage their securities portfolios rationally. In the near future, the NRB would continue to use OMO frequently during the inflation targeting monetary policy implementation. The Open Market Operation Committee would still set interest rates for different maturities and the Public Debt Management Department will be engaged in transactions that yield desired liquidity level in the market in order to achieve inflation target. The OMO will remain a major instrument to ensure equilibrium in the demand and supply of bank reserves.

In practice, the OMO would function most effectively when the authorities abide by a clear division between debt management and monetary policy operations. This usually involves an agreement to neutralize the monetary effect of the government's cash balance with the NRB or to delegate substantial control over it to the NRB. Virtually, the debt management decisions are made with ongoing input from the NRB, both informally and through formal committee structures.

Reliable market for government debt securities is essential for OMO. The market participants should feel secure that counter parties will perform their obligations. Therefore, the NRB should establish performance standards for market participants. It should aim to operate in a transparent market in which trading is done continuously. It should communicate about the proceedings of the OMO to the participants with clear purposes. The NRB needs to develop interbank market, design market instruments, devise trading infrastructure, provide financing facilities, establish criteria for dealing with

its open market function, and collect and disseminate statistics. It should also ensure required technical assistance and develop electronic transfer and settlement mechanism.

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Interest Rate

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Introduction

Nepal Rastra Bank (NRB) is the Central Bank of the Kingdom of Nepal. The Bank was founded over 49 years ago and is entering the fifth decade of its establishment. Over the years, NRB has initiated a number of policy changes. Alongside the theoretical and economic developments of the country, the domestic monetary policy has experienced a number of shifts. A shift in interest rate policy regime is one of them. Almost fifty years ago, Nepal had a tightly administered interest rate regime. Presently, the domestic interest regime has completely liberalized. The evolution of the interest rate regime from an administered one to one of full liberalization has been via a gradual process, with the interest rate policy having been the most intensively used monetary policy instrument in Nepal. It was made use of achieving a number of objectives ranging from: achieving stability in balance of payments (BOP); accelerating resources mobilization; combating inflation; deploying resources to the preferred sectors of the economy to enhancing competition in the financial sector and increasing efficiency of resource allocation.

Before we discuss the evolution of interest rate policy in Nepal, it is important that we highlight the analytical use and policy implication of interest rates. Interest rates are indeed very important economic variables. There are many uses of interest rate data. First, they indicate the conditions in financial markets. Hence, they are used to assess the financial conditions in the economy. Second, they are indicators of expectations about inflation. If the long-term interest rates are lower than that of short term, they can be inferred that the market participants have lower inflation expectations. This aspect is crucial for the conduct of monetary policy. Third, interest rates are indicators of the result of monetary policy actions. Therefore, interest rate data can be used to analyze the ex-post monetary policy stance. Fourth, interest rates can be used as monetary policy targets. Many central banks, in recent years, have moved towards interest rate targeting from monetary targeting. Fifth, interest rate data can be used to analyse exchange rate movements. The last but not the least, the interest rate data can be used to macroeconomic analysis of consumption, saving and investment. In this context, it must be noted that interest rates play a key role in monetary analysis, as they are a key element in the transmission process of monetary policy.

The impact of interest rates on consumption, savings and investment is well established in the literature. Interest rates influence the growth process by affecting the components of aggregate demand and savings. Classical and Neoclassical economists took a position that higher interest rates resulted in high savings and lower level of consumption. Keynes,

on the other hand, argued that low interest rates increased investment and income, and thereby generating higher savings. Keynes put forward his ideas on interest rates in his seminal book, General Theory of Employment, Interest and Money in 1936. He strongly established a negative relationship between the level of investment and interest rate. In order to boost investment, he suggested a lower nominal interest rate. He argued that given marginal efficiency of investment, a lower interest rate would encourage investment, which, in turn, would increase output. This phenomenon, in economic literature, is known as Keynes effect. In case, nominal interest rate could not be lowered, he suggested for expansion in money supply, leading to a rise in inflation. A rise in inflation would lower real interest rate. This, in turn, would boost investment.

Following Keynes, Tobin also developed a model of money and economic growth. Tobin argued that households would maintain their portfolio between money and productive capital assets. He argued that if the return on capital were to exceed the return on money, the demand for capital in relation to money would increase, resulting in an increased capital to labor ratio. This would enhance labor productivity. With increased labor productivity, per capita income would go up. This analysis suggests for keeping nominal interest rates lower. In case, nominal interest rates could not be maintained at low level administratively, a case was made for an expansion in the money supply. This would generate inflation, driving down real interest rates. Against this theoretical background, most of developing countries had controlled interest rate policy in 1960s, 1970s and even 1980s (Fry, 1988).

Administered Interest Rate Policy Regime

When NRB began controlling interest rates in 1966, the above were not the apparent considerations. The context of introduction of controlled interest rate regime, therefore, requires the discussion on the historical circumstances, which compelled NRB to administer interest rates. NRB came into existence in 1956. But it did not use any monetary policy instruments during its first decade of existence. Managing note issuance, ensuring the circulation of Nepalese currency (NC) throughout the Kingdom of Nepal and achieving the exchange rate stability of NC with Indian currency (IC) were the important areas on which NRB was focusing. Institutional and legal measures were introduced to increase the circulation of NC in place of IC, which was in circulation along with NC. These two measures alone were not sufficient enough to help secure the full circulation of NC throughout the Kingdom of Nepal. IC continued to co-circulate. People in general and business people and industrialists in particular continued to hold IC to store their wealth. As the people had stronger faith in IC than NC, this trust needed to be broken. Therefore, to break the faith of the general public in IC, NRB used the exchange rate as an instrument. In May 1966, NC was revalued by 57 percent to Rs 101 from Rs 160 per 100 IC. Those who held IC for storing their wealth incurred significant losses. This was a big blow to those who held IC. This destroyed the faith in IC and thus helped the full circulation of NC throughout the Kingdom of Nepal.

This achievement, of course, has entailed economic cost. The revaluation of NC against IC made the Nepalese exports less competitive and made imports from India cheaper. This created a serious BOP problem with India. For example, BOP deficit with India stood at Rs 126.1 million in 1965/66 and Rs 22.0 million in 1966/67 (NRB, 1981). In order to solve this problem, NRB, for the first time, introduced a host of monetary policy instruments such as cash reserve ratio (CRR), margin requirement, refinance rate, statutory liquidity ratio (SLR) etc. Interest rate policy was one of those policy instruments. In the light of a deficit in the BOP, NRB revised the prevailing deposit interest rate structure of commercial banks for the first time in 1966. Savings deposit rate was increased to a minimum of 4 percent from 3 percent. One-year deposit rate was increased from 4 percent to 6 percent. Interest rates were fixed on an ad hoc basis. However, commercial banks were given freedom to offer higher than the minimum interest rates fixed by NRB. Clearly, NRB began administering interest rates on deposits by fixing the floor (the lower limit) of interest rate. As regards lending rates, commercial banks could fix themselves with the prior approval of NRB. Any way, interest rate policy was used to correct the BOP deficit and also to influence lending rates so as to control domestic credit. To correct the BOP deficit, it was important to attract the capital which had leaked out to India and deter further capital flight to India. Deposit rates were also used to influence

lending rates with the aim of contracting domestic credit, which was aimed at improving the BOP position of the country. Clearly, the BOP stability was the major motive when interest rate policy was introduced for the first time. NRB succeeded in achieving a surplus in BOP with India in 1967/68.

Although NRB began to control deposit interest rates in 1966, lending interest rates were untouched. With an objective of reviewing the existing interest rate structure of the commercial banks and term lending institutions, NRB constituted a high level of committee under the chairmanship of a Deputy Governor of NRB in 1969. The committee consisted of representatives of the organizations of commerce and industries. The committee submitted its report in August 1970. On the basis of report, NRB established a new interest rate structure effective April 14, 1974. Deposit rates were increased to 5-8.5 percent from 4.5-7 percent and lending rates were increased to 7.5-13 percent from 7-12 percent. With this, NRB began to administer both deposit rates and lending rates.

After successfully overcoming the BOP problem, interest rate policy was used to accelerate the rate of domestic saving mobilization and help divert bank credit to the productive sectors of the economy. To achieve these twin objectives of increasing domestic savings and diverting bank resources to the preferred sectors, NRB adopted two approaches to interest rate policy. First, it began to effect changes in the level of interest rate from time to time so as to influence domestic saving mobilization. Second, NRB commenced the differential interest rate policy for different types of bank credit, discriminating one type against the other. In order to extend the flow of bank credit to the preferred sectors of the economy, lower rates of lending were fixed and in order to discourage the bank credit to some other sectors, higher rates of lending were fixed. In this context, to achieve the goal of diverting the bank credit to the productive sector, besides adopting the differential interest rate policy, NRB also directed commercial banks to extend loans to the agricultural and small sector a minimum of 5 percent of their total deposit in 1974. Such directed loans were renamed as priority sector loans in 1976 and the proportion of such loans was raised to 7.0 percent. To support the differential interest rate policy, NRB introduced an intensive banking programme in 1981. This was meant for rural development. Under this programme, commercial banks were directed to extend loans at a minimum 10 percent of their deposit to the priority sectors. In 1984/85, commercial banks were directed to provide a minimum 25 percent, including 8 percent to the priority sectors of their total loans to the productive sectors. The proportion of productive sector was raised to 40 percent, which included a minimum 12 percent to the priority sectors in 1990. In the context of recent liberal interest rate policy, NRB decided to gradually phase-out the priority sector-lending programme in 2002/03. For the current fiscal year 2004/05, the priority sector-lending ratio stands at 4 percent. In subsequent two years, it will be 2 percent and it will not be compulsory after 2006/07.

In early 1970s, the general level of prices began to rise in the wake of oil price shock. For example, in 1972/73, inflation increased by 11 percent, followed by 18.8 percent in 1973/74 and 16.5 percent in 1974/75. The bank credit to the private sector was also accelerating. The rate of growth of time deposit was decelerating. In this context, interest rate policy was used to contain inflation. With effect from July 16, 1974, average savings rate was increased from 5.0 percent to 6.5 percent and one-year deposit rate from 7.5 percent to 9.5 percent. Lending rates were increased to 8-15 percent from 6.5-13 percent. Interest rates were directed at increasing saving, thereby helping reduce consumption expenditure, one of the components of aggregate demand. Interest rates were also increased to discourage at least low yielding private sector investment, another component of aggregate demand. Among other factors, an increase in interest rates did help contain inflation. For example, the general price level declined by 0.6 percent in 1975/76.

In the face of a rapid rise in general level of prices in early 1970s, with given nominal interest rates, real interest rates were falling. For example, one year real deposit rate was negative 3.5 percent in 1972/73 and declined further to negative 9.3 percent in 1973/74. Therefore, besides containing inflation, another objective of interest rate policy was also to keep real interest rates positive. In the process, big changes in interest rates were undertaken in the middle of 1970s. Deposit rates were hiked as high as 16 percent and lending rates were as high as 18 percent in 1975. With the hike of nominal interest rate, one year real deposit

rate improved but still remained negative at 1.5 percent. Real deposit rates turned positive only after 1975/76 when the general price level declined. The objective of increasing deposit rates was to attract savings into the banking sector and make deposit rate structure in Nepal competitive with that of India. During this period, the credit of the banking sector was expanding. Interest rates were also used to control credit of the banking sector. To control credit, credit ceilings were also imposed since 1974. With the substantial hike in interest rates, the growth of bank credit decelerated. Time deposits with the commercial banks increased by 35.9 percent, 30.1 percent and 19.2 percent in 1975/76, 1976/77 and 1977/78 respectively. The general price level declined and BOP improved. In the context of increased financial resources relative to bank credit, time deposit rates were lowered by one percentage point to 14-15 percent with effect from July 1976. Interest rates were lowered further in March 1977. For example, one year and two-year deposit rates were lowered by one percentage point to 12 percent and 13 percent respectively.

Partial Deregulation of Interest Rates

In early 1980s, Nepal witnessed a critical BOP problem. There was a deficit in BOP for consecutive three years, 1982/83 through 1984/85. For example, the BOP deficit stood at Rs 675 million in 1982/83, Rs 126 million in 1983/84 and Rs 866 million in 1984/85. The persistent deficit in BOP led to the depletion of international reserves. To overcome the critical BOP problem of that magnitude and persistent nature, Nepal adopted economic stabilization programme in December 1985, which was supported by an 18-month stand-by arrangement with IMF. As a part of economic stabilization programme, NC was devalued by 14.7 percent against all major currencies; a tighter budgetary policy was adopted; and bank credit to the government and government enterprises was reduced. After successfully implementing stand-by arrangement, Nepal decided to go for Structural Adjustment Facility (SAF) of IMF. Under the framework of SAF, a number of reform measures were introduced. Among others, Nepal relaxed entry barrier in the financial sector and thus opened the banking sector for the private sector. Following this, three joint venture commercial banks were established in the private sector. Nepal Arab Bank (NABIL), a joint venture with United Emirates was established on July 12, 1984. Nepal Indosuez Bank in collaboration with Indo-Suez Bank of France and Nepal Grindlays Bank in collaboration with Grindlays Bank of UK were established in 1986 and 1987 respectively.

The BOP deficit induced economic crisis proved to be a turning point in the annals of economic policy of Nepal. Nepal, as stated before, began to move gradually away from closed economic policies to open economic policies, signifying a shift in economic policy regime. Along with the shift in policy regime, financial sector reforms were initiated. Partial deregulation of interest rates was one of the components of the financial sector reforms initiated in early 1980s. Thus, the era of interest rate liberalization began with the partial deregulation of interest rates announced in 1984. Under it, commercial banks were given an autonomy to fix interest rates over and above the interest rate fixed by NRB by 1.5 percentage points higher in case of saving deposits and 1.0 percentage point higher in case of fixed deposits. It must be stated here that Nepal began to administer interest rates in 1966 when it faced the BOP problem and began to liberalise interest rates, albeit partially when it faced BOP problem again in early 1980s. In both the occasions, it began to administer interest rates with deposit rates and began to liberalise interest rates with deposit rates.

Objective of Partial Deregulation of Interest Rates

However, this time, the direct objective of the change in interest rate policy was not overcoming the BOP problem. Nor was it directed at combating inflation. The objective of partial deregulation of interest rates was to create a competitive environment in the banking industry. The goal of partial deregulation of interest rates was also to make it consistent with the liberal domestic financial sector policy. The objectives of interest rate deregulation were also to achieve (i) allocative efficiency, (ii) operational efficiency and (iii) dynamic efficiency. It was thought that liberal interest rates rather than controlled interest rates were the best way to achieve allocative efficiency of resources. Deregulation of interest rates provides operational efficiency for banks and financial institutions. This is achieved through improved competition in banks and financial institutions. This helps lower financial intermediation cost which would have a direct bearing on economic

growth. Interest rate deregulation provides a sense of freedom, which stimulates financial providers to bring out various products benefiting both depositors and borrowers. This is the dynamic efficiency of interest rate deregulation. The partial deregulation of interest rates helped increase competition among banks and financial institutions. Commercial banks actively competed among themselves by increasing deposit rates. For example, some commercial banks offered saving rates as high as 9.5 percent against 8.5 percent minimum rate fixed by NRB. This had a positive impact on savings as inflation rate was 4.0 percent.

The interest rates were further liberalized with effect from May 29, 1986. Banks and financial institutions were permitted to provide any rates higher than the minimum rates fixed by NRB. Likewise, lending rates were set free for all sectors except for the priority sector, which was not allowed to exceed 15 percent.

Complete Liberalization of Deposit and Lending Rates

The work of McKinnon and Shaw in early 1970s provided the theoretical background of interest rate deregulation in developing countries. McKinnon (1973) and Shaw (1973) argued that controlled interest rates retarded economic growth. McKinnon and Shaw contended that the deregulation of interest rates was important because it discouraged domestic investment in those areas, which were not yielding adequate rate of return in the long run. Ceteris paribus, higher real interest rates increase domestic as well as foreign savings and total savings. It also increases the flow of savings through financial intermediaries so that the overall efficiency of savings-investment process is enhanced. It is argued that liberalization of interest rate would reduce the monetisation of budget deficit.

In the light of above theoretical background, interest rates, both deposit rates and lending rates have been completely liberalized since August 31, 1989. The objective has been to create a more competitive environment in the financial sector. In fact, there have been two objectives of a complete deregulation of interest rates of banks and financial institutions. The first is to encourage banks and financial institutions mobilize financial resources. The second is to help banks and financial institutions allocate resources optimally. To support the complete deregulation of interest rates on deposits and lending, a number of policy changes in the financial sector were initiated. To begin with, there was a shift towards, indirect monetary policy stance. There was a gradual relaxation of direct monetary policy instruments. Direct instruments such as credit ceilings and margin requirement were gradually removed. Directed credit progrmmes such as priority sector lending requirement is now being gradually phased out. There is now a greater reliance on open market operations as instruments of monetary policy. Along with this, a number of prudential norms of international standards are put in place.

Interest Rate Related Developments in the Post 1989 period

Some anomalies appeared after the complete deregulation of deposit and lending interest rates. One such anomaly was that commercial banks started offering higher interest rates to some depositors and lower to some other. Discrimination of depositors in terms of interest rate differential without economic basis destroys the trust of the general public in the banking industry. This also puts small savers in a disadvantageous position. Likewise, discrimination of borrowers in terms of interest rate differential for the same type of loans also creates distortions in the banking industry. These practices needed to be checked. Hence, against the background of these distortions and other developments, the following regulatory and policy measures were introduced.

As a first measure, on August 22, 1993, commercial banks were asked to fix interest rate for at least one-year time deposit. No difference of more than one percentage point was allowed in the interest rate on credit to be provided for the same type and purposes. Banks were also prohibited to fix flat interest rate.

The second measure was the fixation of interest rate spread. As it is obvious, one of the objectives of interest rate deregulation was to help lower the financial intermediation cost in the form of interest rate spread i.e. the difference between deposit rate and lending rate through competition. However, it was found that after the deregulation of interest rates, commercial banks lowered deposit rates and did not lower lending rates to the extent at which they lowered deposit rates. Likewise, when they increased lending rates, did not increase deposit rates to the

extent at which they increased lending rates. In both cases, the result was increased interest rate spread. At the time of interest rate deregulation, it was hoped that both depositors and borrowers would benefit, because commercial banks would compete among themselves through interest rates, offering higher deposit rates and charging lower lending rates. In the process, interest rate spread would come down. But this did not happen. On the contrary, interest rate spread increased after the deregulation of interest rates.

Generally speaking, a high spread is indicative of inefficiency of commercial banks. This is true for large domestic commercial banks. But this is not the case of joint venture private commercial banks. Ironically, joint venture commercial banks maintained relatively higher spread. It appeared that there was no competition among the commercial banks. But the fact was that Joint venture private commercial banks instead of conducting their business competitively appeared to prefer benefiting from the inefficiency of large domestic banks. That is to say that joint venture private banks benefited but the general people at large and the economy did not. There were a number of causes for higher spread for large domestic banks. Mounting non-performing loans, overstaffing and a large number of unproductive staff, collection and extension of small amounts of loans, unviable branches in remote areas and priority sector lending were some of the factors for higher spread for large domestic commercial banks with the government involment. These were not the issues for joint venture commercial banks. In a way, instead of competing among themselves for their business expansion through interest rate, commercial banks entered into a collusion. In this context, it was argued that private sector banks took advantage of the weaknesses of the two large domestic banks, namely, Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB). For example, unweighted interest rate spread went up as high as 7 to 8 percent. Following the interest rate deregulation, this was considered to be very high compared to 2 to 3 percent spread in other countries. This was also in contrary to what was expected following the financial sector reforms. High spread tends to reduce financial intermediation with obvious impact on economic growth.

The above was the background against which the interest rate spread was imposed. The imposition of upper limit for interest rate spread at 6 percent was introduced since August 22, 1993. The spread, as discussed above reflects the financial intermediation cost and it is considered to be an important indicator of financial market. To put it differently, the spread is the barometer showing the level of efficiency of commercial banks. Needless to say, the lower is the spread, the higher is the efficiency and the higher is the spread, the lower is the efficiency of commercial banks. To begin with, moral suasion was used to limit the spread at 6 percent. The system of penalty was not introduced in the event of violation of interest rate spread. When it was found that commercial banks did not pay attention to NRB's moral suasion, the matter was taken up seriously. Hence, the interest rate spread ceiling was reviewed and made stringent further by lowering it to 5 percent on July 16, 1998. The main objective of the imposition of stringent interest rate spread was to increase financial intermediation by forcing commercial banks to lower their financial intermediation cost.

NRB, in the mean time, adopted a number of measures aimed at helping reduce the spread. CRR was one of the instruments that were used to help commercial banks lower their spread. As CRR acts as a tax on financial intermediation, the higher level of CRR increases the financial intermediation cost implying a higher interest rate spread. In the light of this fact, to begin with, the level of CRR was reduced from 12 percent to 10 percent in 1998. It was further reduced to 9 percent in December 2001 and 8 percent in 2002. CRR was cut further to 6.0 percent in 2003. On July 19, 2004, CRR was reduced further by one percentage point to 5.0 percent (Table 1).

Likewise, the bank rate was gradually lowered. To begin with, the bank rate was reduced to 9 percent from 11 percent in 1997. The bank rate was further lowered to 7.5 percent on April 14, 2000, 6.5 percent in July 2001 and 5.5 percent on December 20, 2002. Likewise, between 1998 and 2005, other refinance rates were also lowered from 7.0 percent to 1.5 - 3.25 percent. Besides this, with a view to help commercial banks increase their profitability by parking their idle reserves in the short-term government securities, non-marketable government securities held by NRB and the government overdraft from NRB amounting to Rs 29 billion were converted into marketable treasury bills between

March 9, 1999 and December 1, 2002 (Table 2). Such treasury bills were sold to the commercial banks through the secondary open market operations. These monetary policy measures had intended effects on the level and the structure of interest rates (Table 2).

NRB announced the withdrawal of the interest rate spread fixed at 5 percent with effect of July 16, 2002. There were many reasons for the withdrawal of the spread. First, following the imposition of the spread limit, criticisms began to pour in. It was argued that the fixation of interest rate spread destroyed the spirit of interest rate deregulation. The removal of interest rate spread was also in keeping with this criticism. Second, almost all commercial banks had maintained the spread within the limit. In a way, it was also easy for the commercial banks to keep the spread within the limit. The 5 percent spread was the weighted spread. Weighted deposit interest rates were supposed to be calculated by multiplying interest rates with the weight of corresponding deposits. Likewise, lending rates were supposed to be calculated by multiplying interest rates with weights with corresponding loans. However, the methodology of weighted spread was the ex-post rather than ex-ante as discussed above. While calculating the weighted spread, the realized interest incomes on loans and investment and the actual interest paid to the depositors were taken. As per this methodology, those commercial banks, which had problem loans and had difficulties in collecting interest or loans, had lower level of spread. Therefore, the actual spread did not reflect the true picture of the efficiency of commercial banks. The fact also paved the way for the removal of interest rate spread (Table 3).

Interest Rate Structure in Nepal

There are different types of interest rates in Nepal. Let us begin with the central bank interest rates. Among the central bank interest rates, the bank rate is very important. The bank rate is interest rate charged by NRB whenever commercial banks

Table 1
CRR (in percent)

		1990	1998	2001	2002	2003	2004
A	CRR with NRB	8.0	Avg. 7.0	Avg. 6.0	Avg. 6.0	6.0	5.0
1	Of demand deposit	-	8	7	7	-	-
2	Of saving deposit	-	8	7	7	-	-
3	Of fixed deposit	-	6	4.5	4.5	-	-
B	Vault CRR	4	3	3	-	-	-

Table 2
Bank and Refinance Rates

		Refinance Rates (Percent)		
	Bank Rate	Foreigh Currency Loans	Export Loans in Domestic Currency and RDB	Sick Industry Loan
1967	6.0	-		-
1975	15.0	-	-	-
1989	11.0	-	-	-
1991	13.0	-	-	-
1997	9.0	-	-	-
1998	9.0	5.5	7.0	-
2000	7.5	5.5	6.5	-
July 16, 2001	6.5	4.0	5.5	4.5
December 18, 2001	5.5	2.0	4.5	3.0
July 28 2003	5.5	2.0	4.5	2.0
July 19, 2004	5.5	2.0	3.0	1.5
May 31, 2005	5.5	3.25	3.0	1.5

Table 3

Conversion of Overdraft and Special Bond into Treasury Bills

Rs. in million

Conversion Date	Maturity Period	Interest Rate	Amount
March 9, 1999	364 days	5.5	3980.4
March 23, 1999	364 days	3.8	2224.0
April 25,2000	91 days	2.7	930.0
Sep.26, 2000	364 days	4.0	3785.0
April 17, 2001	91 days	4.8	590.0
October 2, 2001	364 days	5.0	5449.0
Sept. 5, 2001	364 days	5.0	6546.7
Dec. 1, 2002	364 days	4.7	5898.3
Total			**29,403.4**

borrow from it as a last resort measure. Currently, the bank rate is 5.5 percent. The current bank rate at 5.5 percent is in effect since December 2001. Prior to this, the bank rate was 6.5 percent. The bank rate is rather notional (benchmark) rate. The bank rate has been used to indicate the stance of monetary policy. In recent times, commercial banks have not borrowed from NRB at the bank rate. It has also been de-emphasized in recent times. But it is still put in place so that under extra ordinary circumstances, commercial banks can borrow. NRB makes refinancing to rural development banks and exporters for their export loans at local currency. The refinancing rate for these types of loans provided by NRB is currently 3.0 percent. NRB also makes refinancing available in foreign currency for export loans in foreign currency. Refinancing rate for this type of loans was 2 percent until May 31, 2005 when it was raised to 3.25 percent. Refinancing rate for sick industry loans is currently 1.5 percent.

Of the interest rates on government securities, interest rates on treasury bills are market determined. The system of auction for the primary issuance of treasury bills began since November 25, 1988. Ever since Treasury bill rates are market determined. Currently, 28-day, 91-day, 180-day and 364-day treasury bills are issued and all of them are issued on the basis of auction. The wide spectrum of Treasury bill rates gives us the benchmark yield curve especially for commercial banks. The interest rates on these securities are reflective of market liquidity conditions.

With effect from June 16, 1994, NRB began to operate secondary open market operations (OMOs). Under it, NRB started to sell government securities to suck in liquidity and buy securities to inject liquidity. To begin with, the yield curve was the basis of determining interest rates for such operations. NRB used to suck in liquidity from commercial banks if they bid interest rate below the yield curve and used to inject liquidity by adding some mark up to the yield curve rate.

With effect from March 25, 1997, NRB introduced repo as a short-term instrument with the maximum maturity period of seven days to inject liquidity into the system. Repo rate was fixed by adding 0.5 percent to the market determined simple average of weighted average of 91-day treasury bills in the last four auctions.

Although, interest rates of secondary open market operations were based on market interest rates, they were not directly market determined when such operations were conducted. Auction was not the basis of such operations. Therefore, it was argued that interest rates on such operations were not transparent to market participants. As against the background of this criticism and also with a view to make interest rates of such operations market determined, NRB introduced a system of sale auction, purchase auction, repo auction and reverse repo auction since July 19, 2004. With this, now we have market determined interest rates for all open market operations.

Open market operations discussed above take place with NRB's initiative. The purpose of these operations is to achieve monetary policy objectives. When these operations are not undertaken and commercial banks require liquidity, standing liquidity facility (SLF) has been introduced to provide an automatic but fully collateralized liquidity facility for commercial banks for a maximum period of 5 days. This is a safety valve for domestic payments system. The SLF rate is based on the latest average 91- day treasury bills rate. With a view to check the misuse of this facility, a penal rate is added to the latest 91-day treasury bills rate. Currently, the penal rate is 2 percent. When the bank rate is completely de-emphasized and in case abolished, the penal part of SLF rate is likely to be the monetary policy rate. This rate will act as a signaling rate of monetary policy stance.

Besides treasury bills, the government borrows from the market by issuing development bonds, national saving certificates and citizen saving certificates. While development bonds are basically meant for banks and financial institutions, national savings certificates and citizen savings certificates are

for households. Since June 2, 2005, the system of auction has been introduced for the primary issuance of development bonds. Development bonds issued on June 2, 2005 and June 9, 2005 carried a coupon rate of 5.5 percent. They were sold on premium. These development bonds listed in Nepal Stock Exchange for the secondary transactions. The objective of this new system is to find out the market interest rates for these bonds. The idea is to take these interest rates into consideration while fixing coupons fresh development bonds. However, interest rates, on national savings certificates and citizen saving are fixed administratively. Hence, these debt instruments carry coupons, implying fixed interest rates. For the time being, no auction for secondary transactions of national savings certificates and citizen savings certificates is planned. Therefore, national savings certificates and citizen savings certificates will continue to carry coupon rates without market determined proxy interest rates.

Interest Rate Determination

Whether market determined or determined administratively, there are two aspects of interest rates. The first aspect is the level of interest rate and the second aspect relates to the structure of interest rates. In an interest rate deregulated economy, market forces determine the level and the structure of interest rates. With respect to the former, one of the questions that is very often asked is about the appropriate level of interest rate. For that matter, one can ask: what is an optimal rate of interest for an economy? Whether interest rates are market determined or administered, it is difficult to get a right answer to the question of the optimal level of interest rate. Nonetheless, there could be a number of ways of judging the appropriate level of interest rate. First, one such way is the real rate of interest. It should be positive. A positive real interest rates encourages savings. It discourages low yielding investment and thus has positive impact on growth. Again the question remains unanswered. The question that again can be asked is as to what should be the optimum level of real interest rate. If some inferences can be drawn from the Taylor's monetary policy decision rule, the level of real deposit rate should be 2.0 percent. Once we agree to this and add the inflation rate to the 2.0 percent desired real interest rate, optimal nominal interest rate can easily be calculated. Second, interest rates abroad should be also taken into account while judging the optimum level of domestic interest rate. It is important to attract foreign capital. In this case, it must be higher than international interest rates. In Nepal's case, Indian interest rates could be reference rates. Third, returns on investment projects are also important factors to judge the appropriate levels of interest rates. Fourth, in a developing country like Nepal, interest rates in unorganized markets can be also used to judge the appropriate level of interest rate.

There are various theories, which explain the determination of interest rates. Classical theory posits that interest rate is a real phenomenon and hence real factors determine the level of interest rate. The real factors are the supply and demand for capital. It is argued that the supply of capital comes from savings (thrifts) and the demand for capital comes from the productivity of capital. Interaction of supply of and demand for capital gives us the equilibrium level of interest rate. Therefore, if there is recession in the economy, the return from investment will be low. This will bring down the overall demand for capital. Given the level of savings (the supply of capital), the lower level of demand for capital will bring down the level of interest rates. Thus, according to the classical economists, interest rate is a real phenomenon.

The Neoclassical theory is based on loanable theory of interest rate. The loanable theory includes both real and monetary factors. This is an acknowledgment of the fact that monetary factors also influence the level of interest rates. According to Keynes liquidity preference theory, interest rates are purely monetary phenomena. Demand for and supply of money determine the level of interest rate. Thus, according to Keynes, monetary policy, for that matter, money supply can be used to influence the level of interest rate in the economy.

On the basis of these theories, a number of factors, which influence the level of interest rate, can be discussed. Among the factors influencing the level of interest rates, the size of government borrowing is very important. The higher the size of the budget deficit, the higher is the level of interest rate and the lower is the size of the budget, the lower is the level of interest rate. This fact has been one of the factors affecting the level of interest rate in Nepal. It is to be noted that both the government and the private sector borrow from the domestic market. Obviously, funds that can be borrowed from the domestic financial

market are given. With the given funds in the domestic financial market, when the government domestic borrowing increases, it puts pressure on domestic interest rates. In the process, interest rates rise to clear markets. With the rise in domestic interest rates, the government borrowing crowds out the private sector investment. In the past, the government used to resort to relatively a large budget deficit. Some portion of budget deficit used to be domestic financed. The government borrowing from the domestic market on a large scale used to drive up market interest rates. Recently, the government domestic borrowing has decelerated. So have the market interest rates. In some cases, public debt management policy also influences the level of interest rate. Some times, a lower level of interest rate policy is adopted to reduce the cost of borrowing for the government. It can also be used to discourage government from borrowing.

The second factor relates to business conditions. When economic recovery takes place, economic activities increases. In the process, the demand for funds increases, putting an upward pressure on interest rates. On the other hand, when the economic is in recession, the demand for funds declines, leading to fall in interest rates. Currently, the economic activities are at a low level in Nepal. This explains the current low level of interest rates in Nepal.

The third factor relates to the role of lobbies and pressure groups. In the society, the different interest groups play their roles in raising or lowering interest rates. Retirees will like to see deposit rates going up. Likewise, households will also prefer higher interest rate on their deposits. On the other hand, industrialists and business community will put pressure for lower interest rates. Thus, lobbies and absence of lobbies from business community, industrialists and households also influence the level of and structure of the interest rates. In the Nepalese context, industrialists and business have been found exerting pressure on monetary authorities and the political authorities for a lower level of interest rate.

Relationship between Money Supply and Interest Rates

In the light of above discussion, it is important to understand the relationship between money supply and interest rates. There is one school of thought, which establishes a negative relationship whereas the other establishes a positive relationship. To understand the conflicting relationship between money supply and the level of interest rates, it is important to know the process through which the changes in money supply are transmitted into interest rate changes. The economic literature discusses four effects in this regard. These are income effect, price level effect, expected inflation effect and liquidity effect. It is argued that an increase in money supply leads to an increase in investment, which increases income of the people. A rise in income increases demand for money. Given the supply of money, an increase in money demand drives up interest rate. It is also argued that a rise in money supply causes the overall price level to go up. In response to a rise in the price level, nominal interest rates also go up. Likewise, it is contended that an increase in money supply leads people to expect a higher price level in the future, leading to a higher inflation expectation This also causes nominal interest rates to go up.

The other view is that an increase in money supply causes liquidity to go up. An increase in liquidity in turn drives down the interest rates. Of the four effects of money supply such as income effect, price level effect, expected inflation effect and liquidity effect, the first three indicate a rise in interest rates and the last one indicate a fall in interest rates when money supply increases. It is also to be noted that while the first three take time to generate effects, the last one generates the immediate effect. The trend of interest rates over the last few years is any guide; money supply relative to money demand to some extent has contributed to the fall in interest rates. However, it is difficult to tell which effect is dominant in Nepal by looking at data. Only empirical test will settle the issue. Therefore, in order to make an empirical study of money supply-interest rate relationship, the quarterly polynomial distributed model is estimated. The sample period is between the third quarter of 1993 and the fourth quarter of 2004. Owing to lack of quarterly data on interest rate, the sample period could not be expanded before 1994. One-year average deposit rate and industrial average lending rate are regressed on money supply (M1). The polynomial distributed lag model has been used to see both the size and speed of adjustment of interest rates with the changes in money supply.

The polynomial distribution lag model showing the pass-through effect of money supply to deposit rate (one year) reveals that money supply has impact on deposit rate. The regression result shows that

the immediate impact of 10 percent increase in money supply is 5.0 percent decline in on one-year nominal deposit rate. The polynomial distributed model shows that money supply changes have impact on deposit rate distributed over three quarters. The sum total impact of 1 percent change in money supply distributed over three quarters is 1.31 percent on deposit rate (Table 4). The regression result shows that the pass-through impact of money supply on deposit rate is greater than unity.

Likewise, a polynomial distributed lag model of industrial average lending rate as dependent variable and money supply as independent variable has been estimated. Unlike the deposit rate, immediate impact of money supply on lending rate does not exist. In fact, the coefficient of lending rate regressed on contemporaneous money supply does not have a priori sign. The sum total effect of money supply spreading over three quarters is a negative of 0.49. This indicates that one unit change in money supply drives down lending rate by 0.49 over the period of three periods (Table 5).

Table 4
One-Year Average Deposit Rate Regressed on M1

Lag distribution of log (M1)	Coefficients	t-statistics
0	-0.50	-2.34
1	-0.48	-3.45
2	-0.32	-2.17
3	-0.01	-0.06
Sum of lags	-1.31	-3.63
Adjusted R^2 = 0.98		
DW Statistics = 2.14		

Table 5
Industrial Average Lending Rate Regressed on M1

Lag distribution of log (M1)	Coefficients	t-statistics
0	0.12	0.76
1	-0.26	-2.98
2	-0.32	-3.13
3	-0.04	-0.28
Sum of lags	-0.49	-6.44
Adjusted R^2 = 0.96		
DW Statistics = 2.41		

The regression results shown in Table 4 and 5 show that the response of deposit rate to changes in money supply is larger than the response of lending rate to changes in money supply. This means commercial banks adjust deposit rate quicker and in larger proportion in response to changes in money supply relative to lending rates.

Interest Rate Pass-through

As interest rates are deregulated since 1989, NRB cannot determine market interest rate directly. However, monetary policy measures have been used to influence market interest rates indirectly. A number of monetary policy measure have been used to influence interest rates. Of the monetary policy measures, the bank rate and refinance rates have been actively used to influence the market interest rates especially in recent years. For example, the bank rate has been changed in seven times during the post interest rate liberalization period. It was 11 percent in 1989 and increased to 13 percent in 1991. The bank rate was gradually lowered to 5.5 percent in 2001 (Table 2). Keynes, contrary to old quantity theory, established the relationship, albeit indirect, between money supply and real output. The missing links between money supply (or monetary policy) and real output are interest rates and investment. The first step in the Keynesian transmission of monetary policy is the relationship between money supply relative to money demand and interest rate. Obviously, the Keynesian relationship between money supply and the rate of interest is negative. It refers to that an increase in money supply, other things remaining the same, reduces interest rates. However, this is the ex-post analysis of monetary policy. The ex-ante monetary policy stance can be depicted in the form of the bank rate. For example, the lower level of bank rate reveals the accommodative monetary policy ex-ante. The higher bank rate will reveal the tight monetary policy ex-ante. The interest rate pass-through effect in the Keynesian framework is anlysed in terms of the impact of changes in the bank rate on deposit rates and lending rates.

Testing the model as discussed above, the immediate pass-through effect of the bank rate to one-year deposit rate is 0.05. This means that one unit change in the bank rate brings about 0.05 changes in one-year deposit rate immediately. The polynomial distributed model applied shows that the sum total impact of bank rate on one-year average deposit rate is 0.30 (Table 6).

In the case of lending rate, the pass-through effect is higher than that of deposit rate. The sum total of pass-through effect of bank rate to lending rate is 0.64, implying one unit increase in bank rate drives up the lending rate by 0.64 unit. However, the model is not robust in terms of t-statistics, adjusted R^2 and Durbin-Watson statistics. It is not clear from the model whether the response will prevail in case of cut in the bank rate or not (Table 7).

Table 6
Pass-through effect of Bank Rate to One Year Average Deposit Rate

Lag distribution of log (M1)	Coefficients	t-statistics
0	0.05	0.42
1	0.07	083
2	0.09	097
3	0.09	0.88
Sum of lags	0.30	1.19
Adjusted R^2 = 0.03		
DW Statistics = 1.51		

Table 7
Pass-through effect of Bank Rate to Industrial Average Lending Rate

Lag distribution of log (M1)	Coefficients	t-statistics
0	0.20	1.39
1	0.05	0.47
2	0.08	0.75
3	0.30	2.4
Sum of lags	0.64	2.05
Adjusted R^2 = 0.09		
DW Statistics = 2.5		

Future Agenda on Interest Rate Policy

The above discussion shows that almost all interest rates except for coupon rates for national saving certificates and citizen saving certificates are market determined. So far, the objective of complete deregulation of interest rates has been to leave market forces free to determine the optimum level of interest rates for the economy. The fixed exchange rate regime with the Indian Currency but floating with other currencies, serves as the nominal anchor of monetary policy. Under the circumstances, depending upon the macroeconomic situation and evolving monetary conditions, basically quantities rather than prices are used to influence the market and thereby to achieve the objective of monetary policy.

The economy is not doing well at the present juncture. The financial health of some dominant banks and financial institutions still remains fragile. Although the current account has been opened, the capital account is yet to be fully opened. Upon the consolidation of the financial sector stability and opening up the capital account, it will not be necessary and sustainable either to continue the pegged exchange rate regime. In that eventuality, Nepal will have to look for an alternative framework for monetary policy. Nepal will have to choose one from remaining three options. Formal targeting of monetary policy is one option. But this framework to be viable requires the stable money demand function. As Nepal is undergoing the process of financial sector reforms and institutional restructuring, stability in money demand function will be untenable. Under such circumstances, monetary targeting will not be favored. Then two options for monetary policy framework are left: inflation targeting and interest rate targeting. Inflation targeting is more of institutional arrangement involving the setting up of goal function through the political process, setting up of monetary policy reaction function (policy decision rule), and estimating core inflation, transparency, credibility and instrument independence of central bank. Moreover, the role of Indian prices in influencing the Nepalese prices cannot be ignored. In case, available resources did not allow us to go for inflation targeting, Nepal will be left with only one option of interest rate targeting. Even if we were to adopt inflation targeting or flexible exchange rate targeting, interest rate will be operating target. Therefore, the future agenda for Nepal is to prepare groundwork either for full-fledged interest rate targeting or interest rate as operating target of monetary policy.

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International Trade and Payments

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Introduction

Because of the rapid economic and technological development, no country can remain isolated from others. All countries are directly or indirectly dependent on each other. Even the communist countries, which earlier used to be isolated from the rest of the world, are now almost open for trade and other economic activities. Highly developed countries rely heavily on the markets of the developing countries. Likewise, developing countries have to import development materials and manufactured products from developed as well as developing countries, and have to export their primary and manufactured goods on the production of which they have comparative advantage. In order to raise employment, income and thereby living standard of people, economic activities need to be expanded. For this, in the inadequacy of domestic capital, efficiency, and willingness, foreign capital and technology can be very useful in two ways: to acquire goods and services from abroad in reasonable value, and to utilize abundant domestic resources and enhance production for internal and international consumption. Therefore, in today's world, external sector performance has been growing rapidly. Nepal's external sector activities are also growing significantly. Its trade relation with India and Tibet is very old. Now, Nepal has such relations with more than one hundred countries. Similarly it has acquired financial support from many countries and donor agencies. In this regard, international transactions activities are becoming very crucial.

This paper first discusses the theoretical aspects of international trade briefly. Next, the external sector policies as well as trade pattern of Nepal are summarized from the historical perspective. A review of the balance of payments statistics is also undertaken. Before concluding the paper with some concrete suggestions, major problems are also identified.

Theoretical Aspects of International Trade

Concept of International Trade

The concept of international trade deals mainly with transactions of goods and services among the residents of different nations of the world. The field has grown wider as international trade activities also include financital flows and the movements of factors of production, such as labour, capital and entrepreneurship along with the transactions of goods and services. Therefore, international trade can be defined as "the business activities" of exchanging goods and services among residents of different countries. In general, a country forwards its goods and services to the rest of the world, in which it is efficient in production. Similarly, goods and services that can be acquired at lower prices abroad than at home is imported from the rest of the world. In

this way, the fundamental basis of foreign trade lies in the fact that all countries are not equally efficient in the production of all things they need. This is because of the unequal distribution of natural resources, different geographical situation, less substitutability of factors of production among countries, different level of development and so on. International trade is considered as the important medium of raising people's living standards and the prosperity of economies. Therefore, it is said that a great deal of economic well being of most nations rests on international interdependence. The larger volume of world trade than that of the world output justifies that such interdependence among countries is growing extensively.

Importance of International Trade

International trade plays a very important role for all countries. It provides a very good market for the manufactured and other commodities. In the system of international trade, a country can specialize in those products in which they have comparative advantage and can export them in the international markets after fulfilling the domestic needs of those goods. Similarly, it can import those goods and services, which are relatively more expensive and difficult to produce within the country. In other words, the country specializes in the production of only a small number of goods in which a great comparative advantage can be achieved. Similarly, benefits from trade are also acquired on economies of scale. A country can gain considerably by importing goods that can be produced cheaply on a large scale in foreign countries. The central idea of international trade is to provide an array of benefits to a country through the provision of material means, e.g., capital goods, machineries and raw materials. International trade is a medium for the transmission of technological knowledge. Likewise, it is considered as a vehicle for the international movement of capital from developed countries to less developed countries. Similarly, free trade fosters healthy competition and brings efficiency in the industrial sectors wiping out all inefficient industries.

In a free trade system, a country's products have access to the international market. Because of this, domestic production activities can be enhanced based on the endowment of resources. Such enhancements promote incomes, thereby demand. It is very obvious that the size of the market limits the extent of the production, employment, and income. And thus, demand for goods and services increases, motivating the expansion of production activities and trade. Likewise, improved performance can be stimulated by competition from imports. This is because, as mentioned earlier, import competition helps in removing inefficient domestic firms and drives others to higher performance standards. Trade checks the power of local monopolies to exploit their domestic markets through high prices. Thus, free and fair trade favours the consumers by providing standardized goods and services in competitive prices.

However, international trade in unlimited manner may not be desirable in all the circumstances. Therefore, the objective of trade policy should be of a balancing type. Trade should not deprive any nation of the benefits from learning to produce goods and services that could be imported. Trade should not hamper the growth process; rather it should be adapted as a medium to fulfill the requirements of growth and development. Export augmentation is an important element of growth and development. A substantial expansion of exports is very imperative for sustained economic growth. Exports are also required to compensate for the imports of necessities and goods for productive purposes to capture the benefits of specialization.

By participating in the international capital markets, countries can grow faster. By borrowing from those markets, countries can supplement domestic savings and raise their rates of capital formation. From the point of view of capital providers, by lending on those markets, countries can put their savings in more productive place. International trade in claims and liabilities raises the efficiency of an economy.

Improvement in technology developed in one country is shared automatically with other countries. They are shared directly when they are embodied in new capital equipment that is sold on world markets. They are shared indirectly when they raise efficiency or product quality in the export industries of the country in which they originate.

The importance of international trade can be summarized as:

- It fulfils the necessities of material means, i.e., capital goods, machineries, and raw materials for industrial activities.
- It is the useful instrument for the transmission of the technological knowledge.

- It acts as the vehicle for the international movement of capital from developed countries to less developed countries.
- It fosters healthy competition and keeps in check inefficient industries.
- It enables a country to specialize based on its abundant resources.
- It provides consumers a better access for commodities.

There are some arguments about international trade and finance as they raise economic problems by affecting the international behavior of each national economy. They raise political problems by affecting relations among governments. Likewise, events in the international markets can affect levels of domestic employment and inflations rates. The unprecedented increase in the world price of oil that began in 1973 was the major cause of stagflation (the painful combination of high unemployment, slow growth and rapid inflation) in oil importing countries. Changes in the price of raw materials affect the export earnings of developing countries by raising the cost of production and then reducing competitiveness. Export earnings determine the ability to import machineries and other capital goods. In this way, such price movements in the international markets influence the pace of development.

The Growth of Economic Interdependence

The rapid growth of international transactions has strong links between economies. An increase in one country's income will raise its demand for imports. And the imports of one country are exports of other. Therefore, the increase in one country's income will raise the other countries' exports and thus raise their incomes. Similarly, an increase in one country's interest rates will attract capital from other countries and thus tend to raise other countries' interest rates.

Interdependence between national economies leads to the interdependence between national policies. When a government cuts taxes to stimulate domestic demand, it stimulates demand in international markets too by raising its imports, and thus helping to raise other countries' exports. Other governments must, therefore, modify their policies in order to stabilize their own economies. A change in one country's exchange rate translates automatically into changes in the other countries' exchange rates. The domestic effects of a change in the exchange rate are less obvious in large economies and reverse is the case for small economies.

Growth of International Trade

It is difficult to say when the idea of trade actually developed. The development of trade has been expanding with greater choice of goods among people in different countries. Development in technology and transportation are other responsible factors for the expansion of international trade. It is said that the history of international trade is as old as human civilization. However, the growth of international trade can be reviewed as below:

- "Archaeological discoveries show the evidence of trade practices even prior to recorded history. The significance and the scope of trade were already well identified by the Egyptians, Greeks, Romans and Phoenicians thousands of year ago" (Shakya, 1991). At that time, goods traded were, of couse, in small number and consisted of agricultural and primary products.
- Mercantilism, the economic philosophy of merchants during the 16th and 17th centuries remained till the late 18th century. The basic doctrine of mercantilism was to accumulate wealth (gold and silver) at the expense of other countries. In other words, the theme of this philosophy was extreme export promotion and discouragement of import. This philosophy developed the ideas of protectionism and it introduced arrays of trade barriers. However, the industrial revolution replaced the doctrine of mercantilism. The classical thought of laissez-faire policy overtook mercantilist philosophy.
- Because of the industrial revolution of mid-eighteenth century, which developed new technologies in European industries, the production capacity was enhanced in great manner. The growth of industrialism dominated mercantilist thought and economic policies. More liberal and freer laissez-fair policy minimized the government role in economic activities. The liberalization in the economies helped world trade to flourish. The classical economists measured the gain from trade by the increase in efficiency that could be achieved by concentrating on those activities in which an economy had a comparative advantage. Emphasis was also given on the exploration of more raw materials sources to meet the demand for industrialization. Similarly,

sources of agricultural products were also developed for many countries. Demand for these products and the chain of innovations caused changes in economic and trade activities.

- Modern economists measure the gains from trade in much the same way as the classical economists. However, they pay much attention to the role of government.

Massive innovations in various fields of production and economic and commercial competition gradually strengthened the world economy and trade before the First World War. However, the war hampered the production capacity and thereby trade. But the post-war reconstruction along with foreign loans helped to increase the activities of the external sector. Accordingly world trade increased drastically. The Great Depression of 1929 caused massive unemployment, financial instability and economic insecurity. As a consequence of the depression, development of protectionism and groupings among countries for trade appeared which developed the impediments in free flow of world trade. Due to the negative impact of the Second World War, the external sector activities deteriorated. However, the postwar reconstruction and independence of several colonies created new markets all over the world leading to greater scope in international trade. International co-operation like General Agreement on Tariff and Trade (GATT) set up in 1947 to reduce trade barriers among nations and United Nations Conference on Trade and Development (UNCTAD) set up in 1964 for solving trade problems of less developed countries had basic objectives of minimizing restrictions on international trade and boosting it entirely. Similarly, regional organizations were also established to expand trade and financial flows in regions.

Theoretical Basis of International Trade

Gains from trade were systematically presented on theoretical basis by Adam Smith in his book "The Wealth of Nations" in 1776. The reasons for and gains from trade were analysed through the absolute cost difference in the production processes among various nations. That is why his version is known as Absolute Cost Theory of Trade.

Absolute Cost Theory

The Absolute Cost Theory was developed on the basis of the principle of division of labour and free trade system. As there is a greater tendency of advantages from the division of labor in production, free trade is also desirable for international division of labour, which allows every country to specialize in the production of those commodities in which it has greater advantages. The main argument of this theory was such that if a country gains absolute cost advantages in a particular commodity and disadvantages in another commodity over the other countries, there is a possibility of trade and participating countries can gain from it. Accordingly, specializing on a product in which it experiences an absolute cost advantage, and to export it in exchange for the product in which it has an absolute disadvantage, not only the participating countries maximize their production but the world output can also be maximized without increase in the cost of production. However, this theory does not answer questions about what happens if one of the countries produces both the commodities more efficiently and cheaply than the other. Adam Smith's follower, David Ricardo, corrected the weakness of this theory.

Comparative Cost Theory

David Ricardo's Comparative Cost Theory is the modification of Absolute Cost Theory of Adam Smith. This theory shows the possible benefit that the trading nations can gain even if one country gains absolute advantages in both the commodities and the other experiences absolute disadvantages. A country which experiences absolute advantages in both of the commodities should specialize in that production which provides it comparatively greater advantages over the other commodity; and the other country should specialize in that commodity which provides it less disadvantages. By exchanging two specialized products between the two countries, they can mutually benefit from trade.

Some limitations such as labour being the only element of cost of production, homogeneous labour, constant returns in production, no trade barriers, no transportation cost are the main arguments put forward against the comparative cost theory. However, other economists later worked to overcome the weaknesses of Ricardo's trade theory..

Opportunity Cost Theory

Gotterfried Haberler in 1933 developed a theory in terms of the opportunity costs by including all the factors in the valuation of goods. Opportunity cost means the rate at which one commodity is being

sacrificed for obtaining a certain amount of other commodity. This theory says that cost of a commodity is the amount of the second commodity that must be given up in order to release just enough factors of production or resources to be able to produce one additional unit of the first commodity.

Heckscher-Ohlin Theory

Eli Heckscher in 1919 and Bertil Ohlin in 1935 developed the factor proportions theory which is known as Heckscher-Ohlin theory. This theory says that a country will specialize in the production and export of goods whose production requires a relatively large amount of the factors with which the country is relatively well endowed. According to the theory, trade between nations is profitable when it enables itself to take advantage of the differing factor endowments. Therefore, it is advantageous for labour-abundant countries to specialize and export labour intensive goods and for capital-abundant countries to specialize and export capital-intensive goods. The theory considers factor endowment in relative terms, i.e, comparison of ratio of one to other factors of production.

Protectionism in Trade

Gains from trade as stated by the trade theories can be attained only in the case of free trade without any restriction. However, in practice, countries impose trade restrictions through various forms of import control measures, namely, tariffs and non-tariff barriers. Tariffs are custom duties whereas non-tariffs are fixation of quota, exchange control measures and determination of product standards and so on.

International Trade in Nepal

Although the foreign trade statistics of Nepal has been recorded since only the fiscal year 1956/57, the Nepalese history gives the evidence of the occurrence of foreign trade in the country with neighboring countries, India and Tibet, much before that. After the Rana regime, Nepal's trade relation began to expand along with other modernization process of the country. Institutionalizing the external sector performance of Nepal was started with the beginning of development plans in 1956. Realizing the fact that foreign trade is the appropriate means for rapid economic development, the country is giving importance to the sustainable development of the external sector adopting trade promotion policies in different times. Consequently, the volume of trade has been increasing gradually and the country has established trade relations with more than hundred countries.

Trade Promotion Efforts in Development Plans

Nepal virtually had a free trade policy before 1956. With the launching of the development plans since 1956, external sector has been given an important place as depicted below:

- The first Five Year Plan (1956-61) emphasized on the establishment of industries producing basic necessities and exportable. The focus of the plan was to develop industrial sector, to enhance production and to expand export, giving priority to attain balanced development of the economy. Market expansion also was emphasized in this plan. During the plan period, an Import-Export Advisory Board was established comprising the combination of private sector and the government. In 1961, the industrial legislation was introduced which was the beginning step to protect the domestic industries on the ground of infant industries argument, balance of payment adjustment and employment creation. As a result, many import-substituting industries were developed behind the restrictive trade regime. However, there were only a few export industries. The primary products, such as rice, oil, timber and raw-jute dominated exports. Exports were regulated through export licenses and taxes, which were mainly designed to raise government revenue and ensure adequate supply to the domestic market at low prices.
- The subsequent plan, i.e., Second Three Year Plan (1962-64) placed a heavy emphasis on increasing industrial production, employment creation and diversification of trade. Stress was also given to reduce import of consumption goods, to increase foreign exchange earnings and to improve the balance of payments position.
- The Third Five Year Plan (1965-70) stressed on the increase in the production of existing and potential exportable goods, expansion of trade towards overseas countries and maintenance of quality, change in the composition of imports by reducing imports of consumer goods, and diversification of trade. In the plan, emphasis was given to export promotion to earn foreign exchange so that capital goods required for the

industrial growth could be imported in adequate manner.

- The Fourth Five Year Plan (1971-1975) stressed on the provision of necessary assistance as an incentive to promote the export of manufactured goods. The plan emphasized on the export of semi-processed and processed goods instead of exporting them in the form of raw materials. It was planned to double export to other countries gradually adopting the policy of commodity and country diversification during the plan period. Quality improvement and extension of credit facilities were the objectives set forth in this plan.
- The Fifth Five Year Plan (1976-77) included such trade policy that laid emphasis on increasing and diversifying the international trade. The objectives of the plan were to regularize and guide internal and external trade for economic and social development, to manage and supply regularly consumer goods as well as developmental materials, to maintain favourable trade balances, to change trade structure and diversify the trade on country-wise and commodity-wise basis. For the fulfillment of the objectives, some policies were addressed in the plan period, such as to prohibit and discourage the import of luxurious goods by increasing custom tariffs, to operate the foreign trade in an organized and institutionalized way, and in the context of trade diversification, to emphasise on neighbouring countries for increasing trade on the basis of economic viability.
- The Sixth Five Year Plan (1982-87) set forth the trade related objectives separately for export and import business. The export related objectives were: to provide employment and income resources to the people through export trade, to increase export capacity and support balance of trade, and to develop international relations through technology and skill development. Similarly, the import related objective was to facilitate imports of capital goods, construction materials, and high volume products not available in the country. In order to fulfill these objectives, some working policies were also set forth, such as to increase the export of low weight and high value products, to develop the "Export and Import Plan", and to protect national industry by strengthening "Border Administration". A major change occurred in the export structure during the plan period with woolen carpet replacing jute and jute goods as the main item of export. However, the increase in the international price of construction materials, petroleum products, chemical fertilizer and other commodities essential for development programs exerted upward pressure in imports.
- The Seventh Five Year Plan (1986-91) gave emphasis to export promotion setting the objectives as: to make the balance of payment situation more favourable gradually through expansion and development of the export sector, to create necessary infrastructure to make the imports of goods essential for national development, and to maximize the benefits from foreign trade to the national economy by making the transit system more efficient and less expensive.

  In order to fulfill these objectives, some major policies were also adopted as to expand export sector through the increase in domestic production and through standardization of the produced goods to make necessary amendments in related rules and regulations, to expand the role of private sector for export promotion, to enhance the effective trade and supply activities mobilizing the Trade Promotion Center, Nepal Transit and Godown Co. Ltd., National Trading Ltd., Cottage Industries Export Development Project, Nepal Oil Corporation and so on. Some major changes made in the external sector during the Seventh Plan were: devaluation of Nepalese currency by 14.7 percent under the Structural Adjustment Program (SAP) in December 1985, introduction of open general license (OGL) and auction system, cash subsidy scheme etc. In order to promote export and import trade, warehouses were constructed in the border customs areas.
- The Eighth Five Year Plan (1992-97) set the trade related objectives as: to create more income and employment opportunities, to attain a favourable balance of payments enhancing the export business, to diversify international trade by promoting backward linkages, to expand employment oriented trade in harmony with other economic sector, and to make transit facilities efficient and effective in order to channel optimum benefit from foreign trade to the economy. To

achieve these objectives, some policies were set forth, such as to adopt the liberal and dynamic trade policies, to define the role of government as a facilitator, to put emphasis on quality production of goods and services, to increase commodity-wise and country-wise trade, to correlate trade sector with other sectors, to design appropriate monetary and fiscal policies, to provide necessary institutional facilities and information network, to implement promotional programs, and to provide warehousing facilities to reduce the transit cost and so on. The major working policies were to implement product diversification and enhancement of quality standards of existing commodities, such as woolen carpets, readymade garments, leather and leather goods, handicrafts and jewelleries, lentil and spices, the extension of sheep farming for raw materials, development of textile industries through the attainment of increased production of cotton crops, promotion of foreign and joint investment, changes in production technology and promotion of new export markets. During the Eighth Plan, a new commerce policy was implemented in 1992 in accordance with the aim of making the commerce sector liberal, competitive and market oriented. Similarly, an Export Promotion Fund was established to formulate, monitor, and evaluate export promotion program and trade agreement between Nepal and India was renewed with comprehensive amendments. The other development included initiating action to join the World Trade Organisation (WTO).

- The Ninth Five Year Plan (1997-2002) had set the trade related objectives as: to make maximum utilization of commerce sector for economic development of the country, to expand the benefits of foreign trade to rural areas, to diversify international trade and strengthen backward linkages in order to make export trade stable. In order to fulfill these objectives, emphasis was given to enhance the export-oriented productions that have comparative advantages, to utilize the locally available resources and materials, and to promote the export of low weight and high value products. A number of programs for implementation, such as product development program, market development and expansion program, quality standardization and improvement of export products, special export promotion program, import management and simplification program, infrastructure building, and organizational arrangements were included in the plan. During this plan period, Nepal India Trade Treaty was signed with very favourable provisions to Nepal's exports to India, which helped to expand trade activities with that country in a beneficial manner. The construction of Dry Port was completed during the Ninth Plan period. During the same period, an export promotion seminar was held in Kathmandu with a view to expand foreign trade to various countries and to familiarize Nepal's trading image in the international market. The liberal provisions accorded by the Nepal India Trade Treaty, 1996 helped to enhance industrialization in Nepal. With a view to promote export of readymade garments and make it sustainable, an agreement was reached with the European Union in 1999.
- The Tenth Five Year Plan (2002-07) stressed on the objective of expanding foreign trade and policies and programs for making the trade sector liberal and market-oriented. The long-term vision of the plan has been stated as "the trade sector will be integrated to the globalization process and will be made competitive and market-oriented to develop it as a strong foundation of the economy". The major objectives of trade sector are to integrate import to industrial development, to promote export so as to increase the overall contribution of the trade sector to the GDP, and to enable people at all levels to utilize gains of domestic and foreign trade through maximum participation of the private sector under liberal, competitive and market-oriented economic environment. The major strategies of the Tenth Plan are: making the trade sector liberal and market-oriented to speed up foreign trade, diversification of exports both commodity wise and country wise, maximum use of local raw materials in domestic industries, strengthening of forward and backward linkages of exportable items, integration of the trade sector in globalization process, continuity to promote the participation of the private sector and to make the overall trade sector open and competitive. Similarly, membership of WTO, integration of

import with industrial development, identifying new exportable products of comparative advantage and improvement of their quality are the other strategies. The strategies for policy level changes are to design and implement a long-term action plan based on the study of long-term trade and export policy through the participation of the private sector, to improve and simplify the existing laws and procedure, to limit the role of the government to a facilitator, regulator and evaluator. The major strategies for import are to identify the areas of comparative advantage and to create the environment for investment in those sectors, to develop import trade as a component to the industrial sector and to process and export locally available natural and other resources establishing small and medium scale processing industries.

- Nepal's accession process in WTO was finally completed when its membership was approved by the fifth Ministerial Conference at Cancun, Mexico and Nepal became the 147th member of the Organization on April 23, 2004.

Trade Policy 1992

The major objectives of Trade Policy, 1992 were: to increase domestic and international trade through the creation of open and liberal environment in the economy with the growing participation of the private sector, to diversify trade by identifying, developing and producing new exportable products through the promotion of backward linkages for making export trade competitive and sustainable establishing backward linkages, to expand trade on a sustainable basis through the gradual reduction in trade imbalances, and to establish co-ordination of trade with other sectors by expanding employment-oriented trade.

The policies adopted to achieve the above mentioned objectives were: to minimize the role of public sector and to expand the role of private sector in trade, to pursue a liberal and dynamic trade policy with the objective to improve balance of payments position by promoting exports, to increase production of quality goods and services for internal consumption as well as for exports through effective and appropriate utilisation of economic resources, to make special efforts to promote and diversify trade both in the range of commodities and country destinations, to adopt liberal procedures for encouraging interactions between trade and industry for sustained export promotion and for fulfillment of internal demand through increased domestic production, to give emphasis on modernising management and technology, promoting market and attracting foreign direct investment in order to identify and develop new products. Similarly, the policies for institutional improvement were to privatise gradually the public sector trading corporations, to formulate appropriate monetary, foreign exchange and fiscal policies and implement them in an efficient, smooth and transparent basis, to simplify taxation system by introducing necessary changes in order to foster competition in trade, to emphasize on institutional development and information network as well as on monitoring system and quality improvement, to implement the existing trade treaties and agreements with various countries and international agencies effectively, and to conclude new treaties and agreements as and when necessary.

The major policies for export promotion were to promote exports by increasing the quality and quantity of production of traditional as well as new products, to diversify exports of goods and services, to place more emphasis on the export of profitable but processed and finished products, and to identify new markets. Export of hydro-electricity on a profitable basis, transparent, smooth and efficient administrative procedures, effective implementation of the duty drawback scheme for the refund of import duty paid on the importation of raw materials and intermediate goods required for the production of exportable products, exemption of duty on import of raw materials taking into consideration the needs and the introduction of bonded warehousing system for the storage of such materials, establishment of Export Promotion Zones (EPZ), simple and convenient procedures relating to pre- and post-shipment credits on a priority basis and so on were the export strategies. Likewise, some import strategies were to plan imports as a medium of export promotion, to create a competitive industrial and trade environment, to ease the supply of materials required for the country through the optimum utilisation of available resources were the major import policies. In this context, to simplify import licensing and control system, to reduce transit costs and to minimise pilferage and to make import procedures and documentation short and simple and so on.

Foreign Exchange Arrangements for Export Promotion

In order to increase exports, the production base must be enhanced, which requires adequate level of investment. In case of inadequate domestic capital, it would be desirable to attract foreign investment. However, foreign investment can be expected where trade environment is favourable and attractive because investors would expect better physical and financial infrastructure, existing rules and regulations, and backward linkage and forward linkage facilities before investing. In this context, improvement of trade, both of import and export, is essential. This is because, for the enhancement of production base and export, capital goods and raw materials are to be imported and it needs adequate foreign exchange which can be obtained from exports. Considering this, Nepal has been undertaking various measures from time to time for export promotion and diversification. In this context, Nepal's efforts to promote exports through the foreign exchange arrangements are discussed below.

Exporter's Exchange Entitlement Scheme (1963)

This scheme used to be known as the Bonus System, which existed for about 15 years. Under this system, exporters who were capable of exporting the countries other than India and earning convertible currencies used to be provided bonus certificate, which was to be used for the purpose of importing goods from those countries. Thus, in order to import from third countries one had to export first and get bonus certificate. This system contributed significantly in the process of diversification of Nepal's exports to third countries. However, some problems like uncertainty in bonus premium value and price instability could not persuade exporters to envisage vigorous endeavor to undertake sound and persistent export efforts. Besides, it was not sufficient to create an environment for adequate supply of essential and development related goods. Therefore, the country adopted the dual exchange rate system.

Dual Exchange Rate System (1978)

For the correction of lacunas, the bonus system was replaced by the dual exchange rate system. In this system, there were two rates: basic rate (lower) and second rate (higher). All the foreign currencies earned through exports were to be exchanged at the second rate. For all imports, except of specified list of goods, foreign exchange used to be provided in the second rate as well. Through this system, effort was made to provide a stable basis for export promotion as all the exporters were guaranteed a fixed and attractive exchange rate for their proceeds. However, the expected result could not be achieved due to the tendency of over-invoicing for exports and under-invoicing for imports. As mentioned above, exporters could obtain exchange facility at a higher rate for their proceeds and earn more money in terms of Rupee. So, their tendency became over-invoicing the exports. Similarly, as importers would have to buy foreign currencies at a higher rate, they tended to under-invoice their imports to avoid the larger custom duty.

Adoption of Flexible Exchange Rate System [Currency Basket System] (1983)

For the enhancement of export competitiveness in international market, a country's exchange rate should have a reasonable value. Such reasonable value could be obtained through the flexible exchange rate regime. Considering this, Nepal shifted towards flexible exchange rate regime partially, adopting the currency basket system in 1983. In this system, exchange rate of Nepalese Rupees used to be adjusted with the change in the value of major trading currencies except Indian Currency (IC). After the adoption of this policy, exports increased significantly. When the basket system was adopted, exchange rate of US dollar was Rs. 14.20 and when the system was removed formally in 1992, it surged up to Rs. 43.10. Out of total increase of Rs. 28.90, about two-third depreciation was through self-adjustment (Nepal Rastra Bank, 1996). However, in the context of fixed exchange rate with IC, such system would create broken cross rates between Nepalese and other convertible currencies. In order to correct such discrepancies, the Rupee was devalued in three occasions by the government. In order to further facilitate foreign trade, Nepal adopted partial convertibility system in1992 and then subsequently full convertibility in 1993 in current account.

Forward Exchange Rate Facility

After the giving up of fixed exchange rate regime, some uncertainty was introduced in the domain of convertible exchange rate. The worry of importers was the expected increase in exchange rate and of

exporters, the probability of exchange rate going down. Considering that importers normally have the option of passing on the burden of depreciation of currency to consumers, but exporters have to compete in the global market and therefore, any additional cost which they might have to incur due to the adverse movement of the exchange rate would have to be absorbed by themselves, the system of forward exchange rate facility was introduced in the country only for the interest of exporters. This facility was to be made available only in the case of US dollar through the commercial banks. All the transactions conducted with the clients by the commercial banks were to be covered with the central bank.

Since the system was for the protection of exporters from any unforeseen downward movement of the foreign currency, the rate quoted by the central bank always used to be in discount rate. The logic behind this was that the exporters would go for such facility only when there is a probability of exchange rate going down. Throughout the period, since the normal movement of US dollar/rupee exchange rate implied consistent depreciation of the domestic currency, practically exporters did not have any pessimistic view of the changes in the exchange rates. Therefore, the exporters seldom used this facility. Such system was ceased by the NRB after the adoption of partial convertibility in 1992.

Import License Auction System

Exports and imports are usually interlinked. In order to enhance production base and thereby exports, adequate capital goods and raw materials have to be imported. For example, the boom in the export of carpets took place only when the import of raw wool required for it was made open in 1987. Before that, only a few importers were allowed to import raw wool from abroad. As a result, wool always used to be in shortage and used to carry premium in the market. Consequently, the country could not manufacture and export the woolen carpets to the extent it was possible, using the competitive strength of the country. Therefore, imports also needed to be liberalized and facilitated. Considering this, the import license auction system for the import of 88 classes of commercial goods was introduced dividing these goods into 3 sub-groups in 1986 and further refining and increasing the groups into 5 in 1990 as Group A: essential raw materials, Group B: basic consumer goods, Group C: luxury goods, Group D: goods which are highly liable to deflection to India, and Group E: those consumer goods which are largely handled by small traders who could not meet the minimum required amount of an import license.

Open General License

Along with the adoption of foreign exchange liberalization through the introduction of partial convertibility, open general license (OGL) facility was implemented in a phase-wise basis. Except for certain specified items, all other items came under OGL. With the facility of OGL, both imports and exports took a marked speed. Exports reached Rs. 19.3 billion in 1993/94 from Rs. 5.2 billion in 1989/90 and registered the annual growth of 43.3 percent in 1990/91; 85.5 percent in 1991/92; 26.0 percent in 1992/93 and 11.7 percent in 1993/94. However, in 1994/95, exports declined because of not maintaining the international requirement in carpet production. Similarly, imports reached Rs. 51.6 billion in 1993/94 from Rs. 18.3 billion in 1989/90. During this period, diversification also took place in a significant manner.

Partial Convertibility

In order to facilitate trade and thereby to promote export, “partial convertibility” policy was adopted in 1992 allowing the exchange rate of convertible currencies to be determined by the market forces. In this system, market rate was applicable to 65 percent of export earnings in the beginning and subsequently it was increased to 75 percent.

Full Convertibility

Nepalese rupee was made fully convertible for the current account transactions in 1993. Under this policy all the foreign currency proceeds were permitted to convert at market rates. Exporters were permitted to retain 100 percent of their earnings in their foreign currency accounts and foreign exchange facility for a large number of items was easily made available. This system exists now as well.

After the full convertibility, Nepalese export has taken relatively a higher speed. It has increased throughout the years (except in 1994/95 due to the fall in carpet export as mentioned above).

Along with full convertibility, there are other policies in effect to encourage export-oriented

industries for capacity enhancement and diversification of export. Exporters and other foreign exchange earners are allowed to open foreign exchange account and to keep 100 percent of their foreign exchange earnings in such account. In order to enhance the export base, exporters are provided export and pre-export credit at a concessional interest rate. Similarly, exporters and tourism related bodies are provided a facility of foreign exchange for the opening up and operation of the liaison office and sales and exhibition premises abroad. For the utilization of this facility, exporters have to fulfill some conditions. For the removal of procedural hindrances in the export of the petty items, exporters are allowed to export on bank guarantee rather than letter of credit up to a certain limit. Tourists are allowed to carry handicraft products and carpets up to a certain amount. In order to facilitate exporters to have necessary capital at the least cost, pre-shipment and post shipment credit in US dollar are made available at a concessional interest rate abiding by the existing rules and regulations.

Trends of International Trade

Till the decade of 1960s, almost all of Nepal's trade was confined with India. The effectiveness of trade promotion and diversification policies could be experienced since the decade of 1970s. The bonus system along with other steps taken by the government contributed in the process of trade diversification. That is because, during the 1970s, the share of other countries in total trade began to surge up. In 1956/57 and 1966/67, export to third countries was only 1 percent of total export, while in 1976/77 it went up to 33.1 percent and in the following year to 52.4 percent.

During the dual exchange rate regime, although the system was introduced to encourage exports, to facilitate imports of industrial raw materials, machineries, and other necessities and discourage other (luxurious) imports, the attitude of over-invoicing of exports and under-invoicing of imports swept the good points of the system. During this regime, exports could not increase; rather imports surged up nearly three times. Exports increased only to Rs. 1.5 billion in 1981/82 from Rs. 1.0 billion in 1977/78. Moreover, in 1982/83 it decreased to Rs. 1.1 billion. But, import reached to Rs. 6.3 billion in 1982/83 from Rs. 2.5 billion in 1977/78. After the adoption of trade liberalization measures in mid 1980s, exports have been increasing in a marked speed except in fiscal years 1986/87, 1994/95 and 2001/02. During this period, export diversification also could be observed in an adequate manner. For example, in 1983/84, the share of export to India in total export was 68.1 percent and that to other countries was 31.9 percent. In 1988/89, the former came down to 24.7 percent and the latter went up to 75.3 percent. Similarly, in 1993/94, the share of India in total export descended further to 12.5 percent and the share of other countries surged up to 87.5 percent. Due to the favourable provisions accorded by Nepal-India Trade Treaty 1996, Nepal's export performance remained very encouraging especially towards India. In 1996/97, the share of exports to India was 23.1 percent and that to other countries was 64.9 percent. In 1999/2000, the former went up to 42.6 percent and the latter came down to 57.4 percent. Although in 2001/02 and 2002/03, export growth to India were discouraging due to the rigid provisions made by the amendment of the Trade Treaty, in 2003/04 and in the six months of 2004/05, export to India could contribute to total export to grow despite the sharp reduction in export to third countries. After 1995/96, export to other countries increased continuously up to 2001/02. But in 2001/02, it declined mainly attributing to the fall in the export of woolen carpet, readymade garments and pashmina resulting from the global recession. Because of very poor performance of export to other countries, total export declined by 15.6 percent in 2001/02. As the world economy started to revive, export of garments promisingly increased in 2003/04 contributing to export to other countries to increase significantly. However, due to the worsened internal security situation, garment industries began to close and the export of such item witnessed a decreasing trend in 2004/05. As the Multi-Fibre Agreement terminated by the end of 2004, garment export is facing a tough situation. However, carpet export has shown a positive trend during 2004/05.

After the adoption of liberalized policies, import activities also increased markedly except in 2001/02 attributing to the decrease in exports, as the Nepalese exports are tied up with the imports of raw materials and capital goods.

Features of Nepal's International Trade

Huge share with India

Because of its geography, history, culture and tradition, India has remained Nepal's major trade

partner. Till the decade of 1960s, before adopting trade diversification policies, almost all trade used to be with India. For instance, in 1956/57, 98 percent of total trade was with India, of which export was 98.8 percent and import was 97.6 percent. After a decade (in 1966/67), share of India in total trade was 97.6 percent. India's share in total trade continuously diminished after the trade diversification policies adopted by the country. For example, in 1976/77 such share was 66.9 percent, in 1986/87 it was 40.0 percent and in 1996/97 it was 25.9 percent. However, because of the easy access of commodities to and from these countries provided by Nepal-India Trade Treaty 1996, the share of India in total trade began to increase again. It went up to 57.6 percent in 2003/04.The share of India in total export was 23.1 percent and that of import was 26.6 percent in 1996/97. The respective shares in 2003/04 reached 57.1 percent and 57.8 percent (Table 1).

Heavy Share of Import in Total Trade

Nepal is heavily dependent on imports to meet the demand for both investment and consumer goods. Since the trade data were recorded, Nepal's import has been keeping a dominant share in total trade. In 1956/57, the share of import in total trade was 64.3 percent. In 1966/67 and 1976/77, such share was 53.0 percent and 63.3 percent respectively. Similarly, in 1986/87, 1996/97 and 2003/04 it was 78.5 percent, 80.5 percent, and 71.7 percent respectively (Table 2).

Table 2
Share of Export and Import in Total Trade (In percent)

	1956/57	1966/67	1976/77	1986/87	1996/97	2003/04
Export	35.7	47.0	36.7	21.5	19.5	28.3
Import	64.3	53.0	63.3	78.5	80.5	71.7

Source: Quarterly Economic Bulletins and Trade Statistics, Nepal Rastra Bank

Huge Trade Deficit in Traditional Manner

Due to the heavy share of import in total trade, Nepal's trade balance has remained always negative. For example, trade deficit was Rs. 75.4 million in 1956/57 , Rs 55.0 million in 1966/67, Rs. 843.3 million in 1976/77, Rs. 7.9 billion in 1986/87, Rs. 70.9 billion in 1996/97 and Rs. 82.4 billion in 2003/04. As percent of Gross Domestic Product (GDP), trade deficit was 5.1 percent in 1976/77. It was 13.2 percent in 1986/87, 25.3 percent in 1996/97 and 16.6 percent in 2003/04.

Export/Import Ratio

Till the 1970's decade, export/import ratio used to be more than 50 percent. At that time, there were restrictions on trade, especially on import. For instance, in 1956/57, 1966/67 and 1976/77, total export respectively covered 55.6 percent, 88.6 percent, and 58.0 percent of total import. Since the middle of 1980s, Nepal started to move toward liberalization. The effect of liberalization appeared in the external sector also. Because of this, both

Table 1
Share of India and Other Countries (In percent)

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Export								
India	23.1	32.0	35.1	42.6	46.8	59.6	52.9	57.1
Other Countries	76.9	68.0	64.9	57.4	53.2	40.4	47.1	42.9
Import								
India	26.6	30.7	36.7	36.6	47.3	52.7	57.0	57.8
Other Countries	73.4	69.3	63.3	63.4	52.7	47.3	43.0	42.2
Trade Balance								
India	27.7	30.1	37.8	31.4	47.8	47.4	59.8	58.2
Other Countries	72.3	69.9	62.2	68.6	52.2	52.6	40.2	41.8
Total Trade								
India	25.9	31.0	36.2	38.5	47.1	54.8	55.9	57.6
Other Countries	74.1	69.0	63.8	61.5	52.9	45.2	44.1	42.4

Source: Quarterly Economic Bulletins and Trade Statistics, Nepal Rastra Bank

export and import volume began to increase tremendously. Nepal's export increase is backed by import growth. For the production of exportable to India, raw materials are mainly imported from other countries, whereas for exports to other countries, raw materials are imported from India. Similarly, since the adoption of liberalization policies in mid-1980s, infrastructural development and other production activities began to flourish which contributed to a surge in the import of capital goods. Moreover, as the import volume was relatively very high, the export/import ratio revealed a downward trend. For example, in 1986/87 such ratio was 27.4 percent and in 1996/97 it was 24.2 percent. After that, ignoring the rear cases, such ratio recorded the range of 40 to 50 percent till 2002/03. However, because of the rigid provision made by the Nepal India Trade Treaty and lower demand for Nepalese goods from third countries, the import-coverage capacity of export fell further in 2003/04 reflecting 39.7 percent export/import ratio. The export/import ratio towards India was 56.3 percent in 1956/57, 21.0 percent in 1996/97, and 39.1 percent in 2003/04. Similarly, such ratios towards third countries were 26.8 percent, 25.3 percent and 40.2 percent in 1956/57, 1996/97 and 2003/04 respectively (Table 3).

Composition of Trade

During the 1970s, around 85 percent of export was covered by primary commodities. During the 80s, there can be seen a gradual shift towards the export of manufactured commodities. For instance, in 1986/87, 44 percent of total export was covered by primary commodities. In 1996/97, the share of primary commodities dropped to 16.1 percent. After that, it is around 20 percent. Accordingly, the share of manufactured products in total export began to increase since the middle of 80s and reached to above 80 percent in 2003/04 (Table 4).

While looking at the composition of import, the share of primary commodities was 28 percent in 1976/77. It was about 26.9 percent and 22.4 percent in 1986/87and 1996/97 respectively. From 2001/02 there was upward sign in such share and reached to 37.2 percent in 2003/04. Accordingly, the share of manufactured commodities in total import was

Table 3
Export/Import Ratio
(In percent)

	1956/57	1966/67	1976/77	1986/87	1996/97	1999/00	2000/01	2001/02	2002/03	2003/04
Total	55.6	88.6	58.0	27.4	24.2	45.9	48.1	43.7	40.2	39.6
India	56.3	90.5	58.0	30.6	21.0	53.5	47.6	49.4	37.3	39.1
Other	26.8	34.6	58.0	25.4	25.3	41.5	48.6	37.4	44.0	40.2

Source: Quarterly Economic Bulletins and Trade Statistics, Nepal Rastra Bank

Table 4
Share of Primary and Manufactured Commodities
(In percent)

	1976/77	1986/87	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Export										
Primary Commodities	85.5	44.0	16.1	21.0	22.0	16.4	17.4	28.3	22.7	19.4
Manufactured Commodities	14.5	56.0	83.9	79.0	78.0	83.6	82.6	71.7	77.3	80.6
Import										
Primary Commodities	28.0	26.9	22.4	27.3	30.6	29.8	27.1	34.3	37.3	37.2
Manufactured Commodities	72.0	73.1	77.6	72.7	69.4	70.2	72.9	65.7	62.7	62.8

Source: Quarterly Economic Bulletins and Trade Statistics, Nepal Rastra Bank

around 72 percent from 1976/77 to 2000/01. However in 2001/02, 2002/03 and 2003/04, such shares slightly declined to 65.7 percent, 62.7 7 percent and 62.8 percent respectively (Table 4).

Trade Regime

Nepal's trade performance has been highly vulnerable. The small basket of exports and a few destinations have been the chronic characteristics. Nepal's export basket is narrowly concentrated in a few products (garments, carpets, and pashmina). These three products accounted for more than 75 percent to 80 percent of third countries export and 30 percent to 35 percent of total export in recent years. Moreover, they depend on limited external markets. Carpets are exported primarily to Germany and garments to the US. Export of pashmina has suffered due to the deterioration of quality. With the renewed bilateral Trade Treaty between Nepal and India in 1996, the export of manufacturing products like vegetable ghee, toothpaste, acrylic yarn, copper wire, toilet soap, zinc-oxide and MS pipe showed an encouraging trend in the years following the signing of the Treaty. However, due to the rigid provisions accorded by the amendment of the Treaty in 2002, the major contributing items have suffered.

Nepal started market oriented economic reforms in early 1990s increasing its integration into the world economy. The major reforms in this context included liberalization of trade and formulation of commerce and industrial policies, rationalization of foreign exchange regime, adoption of full convertibility in current account, and substantial depreciation with the US dollar. Because of the adoption of liberalization measures in the external sector, total trade to GDP ratio increased significantly i.e. from 23 percent during the 1980s to about 40 percent in the recent years. Improved trade environment contributed to export growth markedly during the 1990s. The major commodities that contributed to this increase were jute goods, pulses, cardamom, rosin, tooth paste, vegetable ghee, soap and so on towards India and garments, carpets, pashmina, jewelleries, pulses and so on towards third countries. However, quality problems and concern over the use of child labour of importing countries in certain factories adversely affected the export of carpets resulting in the deceleration of its export in the second half of the 1990s. Till 2002/03, the export of carpet was not recovered although many problems were resolved. However, in 2003/04, it performed better.

Exports treatment under the Multi-Fiber Arrangement (MFA) placed an encouraging trend for the export of garment. However, it suffered since the latter part of 1990s due to the decrease in demand. Nepalese garments have relatively less price competitiveness than those of other South Asian countries and Sub-Sahara countries because of its landlocked situation and not getting the facility of duty free and quota free access in the USA as the Sub-Sahara countries.

Trade Diversification

Till 1951, Nepal was kept in a state of virtual isolation from the outside world. Even in the launching of First Five Year Plan in 1956, there was no concrete attempt for trade diversification. The country's overall trade was solely confined to India alone. However, in 1961, the Bonus system was introduced as a step for diversification by the provision of incentives to the exporters to compensate them for the high transit cost due to the land locked character. However, due to some weaknesses like export products not being subject to the discipline of the international market forces and the economy not being able to identify its real comparative advantages, the expected achievement could not be attained.

Major Trade Partners in Third Countries

In terms of exports, the major trade partners of Nepal (other than India) with their respective shares in total exports are: USA (18 percent), Germany (7 percent), UK (3 percent), Italy (1 percent) and so on. Similarly, with respect to imports, the major trade partners are: Singapore (6.2 percent), China P.R. (3.9 percent), Thailand (3.1 percent), Malaysia (2.7), Indonesia (2.3), and Korea (2.2), etc.

Balance of Payments

To choose the right monetary, fiscal, and exchange rate policies, it is necessary to have a deep understanding of how the international macro economy works (Lin Dert, 2002). In this context, the balance of payments (BOP) accounts are very useful. These accounts show all the real and financial flows between one country and the rest of the world. Many policy judgements require this type of accounting information, such as:

- Judging the stability of an exchange rate system is easier with the help of a record of exchanges between nations.
- To spot whether it is becoming more difficult (or more costly) for debtor countries to repay foreign creditors, one needs BOP accounts.

Definition

According to Kindleberger "The balance of payments of a country is a systematic record of all economic transactions between residents of the reporting country and residents of foreign world during a given period of time". The balance of international payments is a comprehensive summary of the international transactions of a country in a given period of time. An economic transaction is any exchange of value - typically an act in which title to economic goods is transferred, an economic service is rendered or title to assets is transferred from residents of one country to residents of another. In this regard, it is necessary to have a good understanding of the distinction between residents and non-residents of a country.

The International Monetary Fund (IMF) formulates the appropriate guidelines for the compilation of BOP statistics of its member countries. Such guidelines are incorporated in the BOP Manual, which is amended time to time in line with the changing pattern of the external transactions. The latest or the fifth edition of Manual, that was implemented in 1993, has defined BOP as a "statistical statement that systematically summarizes, for a specific time period, the economic transactions of an economy with the rest of the world." In other words, a systemic record of all transactions between residents and nonresidents during a given period of time is balance of payments. Residents in this context represent individuals, companies, governments and so on that are present in the reporting economy for more then one year. Similarly, nonresidents are those who are out of the reporting economy for more than one year. As per the definition, a citizen of a country may not be the resident of the same country. Likewise, a non-citizen may be the resident. Foreign embassies, diplomatic missions and the offices of the international organizations are not residents even though they live for a long time in the reporting country.

In BOP, any transactions have two sides: credit and debit. A credit is an outflow of value for which an offsetting inflow of value, or payment, is due to the country. A debit is an inflow of value for which residents of the reporting country must make a payment. Generally inflows are credit and outflows are debit. Although total credits must equal total debits in balance of payments, it is useful to draw lines through the accounts dividing some flows above the line from the other below. Doing so leaves a net surplus or deficit of credits above the dividing line (Lindert, 2002). All credits and debits relating to goods, services, income and transfer are placed above the line. All assets flows, both private capital and official reserves, are entered below the line. Under the BOP, the trade balance is the export surplus of goods or merchandise alone. Trade balance is relatively quickly available. As in most practices, trade statistics can be rapidly collected and reported from customs.

Current account balance is regarded as most informative balance, that is, the net receipts over payments for goods and services plus net transfer. A current account surplus, i.e., more credits than debits in goods, services and transfer, is a measure of how many new claims the nation is acquiring on foreigners and adding to its net foreign wealth. In other words, a current account surplus represents a net foreign investment inclusive of reserve accumulations. Conversely a deficit on current account means that the nation is disinvesting abroad, or becoming more of a net debtor in order to pay for the extra net imports of goods, services and outward giving (Lindert, 2002). Thus, the current account balance is equal to the gap between national production and national spending.

Besides, there are capital and financial balances, i.e. net inflows over outflows of capital and financial assets. The overall balance compares reserve accumulation with the growth of liquidity liabilities. In principle, balance of payment should be zero, i.e., receipts and payments should equal. But in most of the time, we can see surplus or deficit. When the receipts from abroad exceed the payments made abroad or inflows are greater than outflows, the BOP is said to be surplus and vice versa.

Correction of BOP Disequilibria

Disequilibrium in the BOP involves inequality between demand for and supply of foreign exchange. The equality between demand for and supply of foreign exchange may be achieved through any of the following measures:

(i) Restrictions of imports
(ii) Artificial stimulation of exports through subsidies and other measures
(iii) Depreciation of domestic currency
(v) Deflation of domestic income and prices
(v) Attraction of foreign investment/capital by raising interest rates and offering other incentives.

There are mainly three methods to deal with the condition of disequilibrium (i) changes in relative prices involving changes in internal price level and changes in exchange rates, (ii) income changes (iii) direct public intervention to shift demand and supply curves.

Balance of Payments in Nepalese Context

Nepal started the compilation of BOP statistics from 1974/75. For compiling the BOP statistics, the guidelines contained in the BOP Manual of the International Monetary Fund are followed. The Fund formulates appropriate guidelines for the compilation of balance of payments statistics of its member countries, which are amended time to time in line with the changing pattern of the external transactions. The first edition of the Manual was published in 1948. All member countries are supposed to follow such guidelines for compiling their BOP. By this, not only the Fund can supervise and monitor the external position of its member countries, the particular country can also have a consistent BOP statistics, which accommodates external transactions in a much larger extent. Similarly, more accuracy in global BOP can be appeared. Moreover, by doing so, cross-country comparison also becomes much easier.

When Nepal started to compile the BOP statistics, the third edition of the Manual was being implemented. The fourth edition of the Manual was published in 1977 and implemented till 1992. Although the 5th edition was introduced in 1993, Nepal was following the fourth one till April 2003. However, from May 2003, it began to publish the BOP data according to the latest edition of the Manual. The currently used BOP statistics format is relatively more detailed. With a view to accommodate more and more transactions with the rest of the world, some estimates also are made in some headings.

There are three main accounts in the present BOP statistics: current, capital and financial accounts. Before, there were only two main accounts: current and capital accounts. Different components of BOP and Nepal's practice of compiling them are discussed below:

Current Account

In the current account, there are three main headings as described below.

Goods

There are two components of goods: exports and imports, which are recorded in f.o.b. (free on board) value.

Normally, oil (petroleum products) is imported from other countries; it is sold to India from Haldia port and is imported again from India through different custom points according to the need of Nepal. Before, only the net import of oil (petroleum) from India used to be recorded in the BOP; but now, if it occurs, all three transactions (import of oil from other countries, its re-export to India and re-import from India) are recorded. This is because we can see the export of oil in new format though it is not produced in Nepal. However, due to some reasons, since 2002/03, oil is being imported from India only.

Border trade with India, which is not captured in trade returns, are also adjusted in exports and imports in BOP. Such data are estimated on the basis of the results of surveys of Indian currency notes offered for conversion into Nepali rupees and vice versa in the border areas.

Other adjustments that are incorporated in BOP relate to (i) goods procured by non-resident carriers in Nepal and resident carriers abroad as export and import respectively and (ii) exports and imports of electricity to and from India respectively.

Data on trade returns are obtained from customs. Electricity sale and purchase data are the records of Nepal Electricity Authority and are obtained from the same body. Similarly, data on the procurement of aviation fuel of domestic airlines are provided by the airlines themselves. Other data are obtained from the International Transactions Reporting System (ITRS).[1]

Services

Another component of current account, services consist of transportation, travel, government services not included else (n.i.e.), communication services, insurance services and other services which are discussed below.

Transportation: Under transportation services, there are passenger services, freight and other transportation.

Earnings of domestic airlines from non-residents on international flights come under the sub-heading of passenger services credit. Payments of residents to foreign airlines on international travel are passenger services debit. Freights are the charges paid to the non-resident carriers for carrying goods towards the destination. As Nepal is a landlocked country, normally it does not have receipts of such services except of cargo services. Other transportation includes cargo services and other related services that are not included elsewhere. Data on transportation are mainly derived from the ITRS. However, some data are obtained from Royal Nepal Airlines Corporation (R.N.A.C.) and non-resident airlines as well.

Travel: The expenditure by nonresidents in Nepal for sight-seeing, entertainment, education, training, seminar, health treatment, and so on are incorporated in the credit side of travel; and expenditure by residents for the same purpose as mentioned above are incorporated in the debit side. Briefly put, the receipts and payments relating to tourism, medical, educational, recreational and so on come under credit and debit of travel heading. Data on travel are also collected from the ITRS.

Government services (n.i.e.): Expenditures by foreign diplomatic missions and by the offices of international organizations in Nepal are recorded as credit where as expenditures of Nepal's diplomatic missions abroad are recorded as debit. Such data are collected from the ITRS as well.

Other services: Other services comprise receipts and payments relating to communication services, insurance services, construction services, professional and technical services, financial services, royalties and license fees, cultural services, recreational services, business services, etc.

Income

The income account was segregated from the services account of the former format which comprises compensation of employees and investment income. Under compensation of employees, earnings of Nepalese workers (residents) going abroad for short period are recorded as credit and payment to non-resident short-term workers by Nepal are recorded as debit. Here, short term or short period implies less than one year.

Under investment income, credit entries reflect the interest received by NRB and commercial banks on their holdings of foreign government bills and securities. In this subhead, if occurred, dividend receipts also are included. Since Nepal does not have foreign direct investment abroad, such receipts for the time being do not occur. Debit entries represent payments for electricity purchased from foreign owned electricity generating enterprises that transfer these amounts abroad as dividends, e.g., Khimti and Bhote-Koshi electricity projects, and dividends paid by other direct investment enterprises to their parent companies abroad. Similarly, interest payments for external debt are also included in debit entries.

Current Transfer

Current transfers involve those flows that do not incur liability. Under current transfer, there are four heads: grants, workers' remittances, pensions and others in credit.

Grants: Grants include government and non-government grants which are recorded separately in the detail BOP presentation. The government grants are also separated as cash grants and kind grants in detail presentation. Under the current transfer, only those grants are recorded which are granted as food aid, emergency and relief assistance and other types which are not of investment nature. Grants of investment nature, e.g., project grants and investment related technical cooperation, are recorded in capital transfer under the capital account. Data on cash grants are derived from the ITRS and grants in kind are obtained from the custom records.

Workers' remittances: Workers' remittances are earnings of Nepali workers abroad, which are sent to their families in Nepal. Earlier, only the remittances coming through the formal channel were recorded. But some surveys and studies conducted in private sector claimed that the recorded remittances did not reflect a significant portion of inflows, which come through the informal channel, namely Hundi. During the mid 1990's gold import was very high, e.g., gold import in 1996/97 was worth Rs. 31 billion. But such huge import was not financed from the country; rather it was financed from outside the country. Such huge financing from abroad also justified that huge portion of remittances was not being recorded. Considering the continuous outflow of Nepalese workers and still inconsistent inflow of remittances through the banking channel, a methodology has been developed by the NRB to estimate remittances. This methodology was developed through the interaction with the Labour Department of His Majesty's

Government, different employment agencies and other related offices. The methodology considers the trend of the outflow of Nepalese workers, their earnings and the valid period for their stay abroad.

In detail BOP presentation, remittances are shown in two heads: institutional and other. Remittances that flow through the formal channel are put under institutional subhead and estimated remittances are put under the other subhead. However, in summary balance of payments, both are combined and put under the heading of workers' remittances.

Pensions: Pensions represent receipts by retired Nepali solders from British and Indian government. Up to now, there is no record of pension payment.

Other (Indian Excise Refund): Excise duties levied on imports from India, which are imported directly from manufacturers, are refunded to the Nepalese government by the Indian government. Such amounts are kept under "other" heading of current transfer in the balance of payment. Institutional remittances, pensions and other transfers are obtained from the ITRS as well.

The combined performance of goods, services, income and transfer accounts reflect the position of the current account. In Nepal, ignoring the exceptional cases, deficit in current account had been a traditional characteristic of BOP in the past. However, at present, as the workers' remittances have increased substantially, a significant surplus appears in the current account.

Capital Cccount

The former capital account (of earlier format) has been expanded and redesigned as the capital account and financial account. Capital account in the present BOP format consists of two categories: (i) capital transfers and (ii) acquisition or disposal of non-financial assets. In the former BOP presentation, capital transfer also was kept under the current transfer. Capital transfer is the transfer of investment nature. It may be in cash or kind. Debt forgiveness is also included in capital transfer if it occurred. Similarly, if it can be captured, migrants' transfer is also included in capital transfer of other sectors.

Financial Account

Financial account consists of direct investment, portfolio investment, other investment and reserve assets.

Direct investment: Direct investment abroad and direct investment in reporting economy are accommodated under direct investment heading. Since there is no record of direct investment abroad, only the direct investment in Nepal is shown in BOP presentation. However, there is a problem of capturing data of such transactions. A sample survey was conducted to collect direct investment data in 2003 without any beneficial results. The sub-categories of direct investment are equity capital, re-invested earnings and other capital. There is no record of portfolio investment in Nepal.

Other Investment: Other investment is a residual category not covered in direct investment and portfolio investment. Under this heading, assets and liabilities are shown separately and subdivided by instruments, by sectors of creditors and debtors. Such instruments are trade credits, loans, currency and deposits, and other assets and liabilities.

Trade credits: Trade credits are the difference between the amount actually exported or imported and the amount actually received from and paid for those trading activities. Trade credit assets for India are calculated as the difference between actual exports and foreign exchange received, whereas trade credit liabilities are calculated as the difference of the actual imports and foreign exchange paid. For third countries, data on trade credit assets and liabilities are compiled on the basis of change in export bills outstanding and import letters of credit outstanding respectively by taking the difference of such data from point to point basis. If trade credit assets increase, the amounts are shown in negative sign and vice versa, whereas if trade credit liabilities increase, the amounts are shown in positive sign and vice versa.

Other assets: Other assets reflect the contra-entry of estimated remittances remaining after deducting gold and silver imports. As mentioned earlier, such imports are financed from outside the country. The remainder of estimated remittances are supposed to be the addition of assets of the other (private) sector.

Under loan liability, government and other sector drawings and repayments are included. Data on government drawings and repayments are obtained from Financial General Comptroller Office, (FCGO) and other sector's drawings are collected from commercial banks.

Currency and Deposits: Currency and deposit heading comprises the deposits of nonresidents with NRB and commercial banks. Data on currency and deposits are derived from the balance sheets of NRB and commercial banks.

Net Errors and Omissions

Unidentified and missing amounts of different headings fall in net errors and omissions heading.

Reserves and Related Items

The reserve assets of NRB include monetary gold, holdings of SDRs (Special Drawings Rights), reserve position in the IMF and foreign exchange holdings of the NRB. Reserve assets of commercial banks are their holdings of foreign exchange. Use of fund credit is treated as reserve related item because such item is obtained for the BOP purposes. If it occurs, exceptional financing is also related with the reserves because such amount is obtained to fulfill the deficit in BOP situation.

Structure of BOP

In Nepal, balance on goods is traditionally negative. Around three-fourth of total trade is covered by import. However, service account experiences the surplus mainly attributing to the significant inflow in travel head. As the payment elements are more than receipts, the trend of income account is negative. But due to the significant inflow of grants and workers' remittances and relatively a negligible outflow of these headings, transfer account has been remaining in surplus traditionally. In the past, ignoring the exceptional cases, deficit in current account had been the traditional characteristic of BOP. However, at present, as the inflow of workers' remittances has been substantial, a significant surplus has appeared in the current account. If transfers were excluded from current account, there would be a huge deficit.

In Table 5, balance on goods reveals a huge deficit for all years. In Nepal, although the services account remains in surplus, it offsets only around 10 percent of trade deficit. Moreover, as the payments are more than the receipts, the trend of income account is negative. That is because balance on goods and services as well as balance on goods, services and income also show a huge deficit. Current account

Table 5
Position of Current Account
(Rs. in billion)

	2000/01	2001/02	2002/03	2003/04
Balance on Goods	-56.4	-53.4	-70.3	-77.7
Balance on goods & services	-47.1	-49.4	-63.2	-68.6
Balance on goods, services & income	-45.4	-50.0	-63.9	-70.3
Current Account Balance	20.2	18.2	11.6	14.6
Overall BOP	5.2	-3.3	4.4	16.0

Source: BOP Statistics, NRB

surplus as percent of GDP in 2000/01, 2001/02, 2002/03 and 2003/04 were recorded as 4.9 percent, 4.3 percent, 2.6 percent and 2.9 percent respectively. The overall BOP of Nepal normally remains in surplus contributed by the current account surplus and inflows of miscellaneous capital. In Table 5, the overall BOP is in deficit by Rs. 3.3 billion in 2001/02, whereas in 2000/01, 2002/03, and 2003/04 it is in surplus by Rs. 5.2 billion, Rs. 4.4 billion and Rs. 16.0 billion respectively. With the favourable BOP, foreign exchange reserve of the banking system has remained at a comfortable level of Rs.130.2 billion with the import coverage capacity of goods for 11.5 months and of goods and services for 9.7 months as at mid-July 2004.

Nepal-India Trade Relation

Traditionally, the history of trade between Nepal and India is very old. The bulk of Nepal's trade has been confined to India. The geographical factor is the most important reason for this as Nepal is locked with India in east, west and south. Although there is China in the north, the presence of high Himalaya region along the border does not provide that much access to trade flow towards China as compared to India. Other reasons for the concentration of trade with India are religious, cultural and social as well as free access for both countries' people into each others territories. Thus, Nepal's landlocked position, its association with the Indian market and its reliance on India for transit routes are responsible for creation of special relationship in trade between these two countries.

Trade Treaties between Nepal and India

Various trade treaties have been concluded between Nepal and India. The first treaty took place with British-India as early as 1923 (Jha, 1987). This treaty waived custom duty on goods imported by the government of Nepal through British-India ports (Shrestha, 1974). Nepal concluded treaty of Trade and Commerce with India in 1950 which recognized Nepal's right of commercial transit of all sorts of manufactured and non-manufactured products with the overseas countries through the Indian territory or ports. Provisions like common tariffs for materializing the concept of free trade area between the two countries were made. Nepal was to levy export duty for those goods in order to make them not expensive than those goods produced in India. Nepal and India both were expected to follow the same tariff policy

not only in imports and exports of goods between them but also with other countries (Jha, 1987).

The Treaty of Trade and Commerce was substituted by the Treaty of Trade and Transit of 1960. The goods originating in either country and intended for consumption in the territory of the other were to be exempted from custom duties, other duties as well as quantitative restrictions. In this way, a provision was made to expand mutual trade of such goods, which originated in both the countries. Both countries agreed to provide transit facility to one another for their trade with third countries as well. The Treaty of Trade and Transit concluded on August 13, 1971 made such provisions that both countries would provide each other no less favourable treatment than they provide to any of the third countries in levying custom duties and other changes in the import and export of goods as well as import regulations including quantitative restrictions. Thus, the most favoured nations (MFN) treatment was to be prescribed by the countries to each other's goods. Easy access to the primary products of Nepal to the Indian market (exempt in customs duty and quantitative restrictions), non-reciprocal treatment in respect of custom duty and quantitative restrictions in the export of industrial products exported into India, which constituted not less than 90 percent of Nepalese or Nepalese and Indian materials, freedom of transit across the territories of either of the two countries for legitimate interests, prevention of re-export of goods if it contained more than 50 percent of ex-factory value were the provisions made by this treaty. Goods imported from small units in Nepal were rendered similar concessions in excise duty given to small units in India. The treaty accorded priority to the expansion and diversification of mutual trade of the two countries in goods produced in their territories. Nepal was free to impose import duties on Indian products on the MFN basis. It was agreed that excise and other duties collected by India would be refunded to the Government of Nepal to the degree of the import duty charged in Nepal. The two countries agreed to co-operate with each other to block infringement and circumvention of foreign exchange and foreign trade laws and regulations (Pant, 1994). Similarly, transport of goods by road between Calcutta and Nepal was permitted by the treaty. Warehousing facilities and simplification of customs procedures were other provisions in this treaty.

The Treaty of Trade and Transit between Nepal and India concluded in 1971 was replaced by two separate treaties, Treaty of Trade and Treaty of Transit, on March 25, 1978. The former was effective for five years and the latter for seven years, after which they were renewed. In the Treaty of Trade, both Nepal and India agreed to extend all possible facilities to each other for free flow of essential goods. Both countries confirmed that they would not be accorded less favourable treatment with respect to custom duties and changes in the import and export of goods and services and import regulations including quantitative restrictions. Similarly, India agreed to grant special favourable treatment on the Nepalese exports of manufactured products to India in custom duty on non-reciprocal basis. The norm of this agreement was to help promote the industrial development of Nepal. Therefore, such Nepalese manufactured goods containing at least 80 percent of the Nepalese materials or Nepalese and Indian materials were to be exempted from basic customs duty and quantitative restrictions on their export to India. They agreed to remove the basic custom duty and quantitative restrictions of the import of primary product from each other. Both countries committed to facilitate the free flow of primary products. Preferential treatment was accorded to the primary product on reciprocal basis. Also, they agreed to cooperate effectively to each other to prevent infringement and circumvention of laws, rules and regulations of either country regarding matters on foreign exchange and foreign trade. The Trade Treaty 1978 and Transit Treaty 1978 were for five and seven years, respectively. The former was renewed for next five years and the latter was extended up to March 23, 1989. After that, these treaties could not be renewed due to some differences among the partner countries. All trade over surface routes with India was restricted to just two border points. This was applicable to trade with India, third country trade crossing India, and intra-Nepal trade between central and western Nepal. (Pant, 1994). MFN treatment was given to each other's trade. Thus, Nepalese export which had a free access into India had to face relatively high customs duties, which were MFN custom duties of India. From March 23, 1989 to June 10, 1990 Nepal underwent a phase of non-treaty regime. A troublesome environment hindered the trade between Nepal and India.

However, with the agreement of June 10, 1990, India was to restore 22 border points for entry of goods into Nepal, to resume supplies of essential commodities like coal and petroleum to Nepal. The Nepalese products possessing not less than 65 percent of Nepalese or Nepalese and Indian materials were to be exempted from the Indian basic custom duties and quantitative restrictions. Similarly, Nepal was having the benefit of duty-free facilities, as India was not to impose export duties on its exports to Nepal. However, imports of some essential commodities for consumption, raw materials and construction materials from India were under quota arrangements. Exercise duties imposed on the imported goods were to be refunded by India to the government of Nepal under the duty refund procedure. Similarly, Nepal was to resume tariff preferences to Indian goods. After the normalization of relations between the two countries, two separate treaties on trade and transit were concluded on December 6, 1991 with the new arrangement for cooperation in controlling unauthorized trade. The term of this trade treaty was five years with a renewal provision for another five years and that of the transit treaty was for seven years. The new trade treaty comprised some new facilities and concessions for Nepalese exports to India like reduction of Nepalese or Nepalese and Indian material content from 65 percent to 55 percent for duty/quota free access into India. However, due to the procedural hindrances and Nepal's poor industrial base, the provision of 55 percent material content could not work fully. For instance, though there were 91 Nepalese products that were allowed preferential entry into India, the actual figure turned out to be 25 products. A situation of uncertainty prevailed among exporters for the time period of processing the proforma forms. Due to slow approval process and levy of custom duty in India on the items eligible for preferential treatment, exports did not rise as expected.

In order to simplify the procedure for export of Nepalese items to India, an agreement was signed in 1991. Some modifications were incorporated in the trade and transit treaty of 1991. These included abolition of proforma clearance and its replacement by a certificate of origin to be issued by the government of Nepal, consideration of Nepalese labour in evaluating the eligibility of a Nepalese product for entry to the Indian market free of custom duties and quantitative restrictions. In other words, if the total percentage of the three components, i.e. the Nepalese labour content, the Nepalese material content and the Indian material content is more than 50 percent, the product would have duty free and quota free access to the Indian market. Except a few commodities, all Nepalese export was covered by these provisions (Pant, 1994). In order to facilitate the import of some fixed items, raw materials and capital goods from India, provision of payment in convertible currency was made. Similarly, movement of Nepalese private commercial vehicles from the Nepalese border to Calcutta and Haldia were allowed based on the permission given by the Nepal Transit and Warehousing Company Limited or Nepal Transport Corporation.

Nepal India Trade Treaty 1996 signed on December 3, 1996, gave a new direction in the trade related areas as well as a scope for the trade improvement especially to Nepal. Some of the provisions made in the earlier treaties were replaced and modified making the procedures simple and straight in order to remove the procedural delays. It committed the cooperation in more specific and extended manner. Some of the provisions of the treaty are:

- Access to the Indian market free of customs duties and quotas for all articles (except the negative list[2]) manufactured in Nepal.
- Certificates of Origin of such products were to be issued by the agency designated by the Nepalese government.
- Each consignment of products manufactured in the small-scale units in Nepal was to be treated equally as the similar products produced in India.

Although the validity of treaty was for 5 years, there was a provision for automatic renewal unless either of the parties gives to the others a written notice of its intention to terminate the treaty. This treaty was to a greater extent in favor of Nepal.

Transit Treaties and Agreement of Cooperation to Control Unauthorized Trade

In order to facilitate the Nepalese trade to third countries through India, as mentioned earlier, treaties of transit were concluded in different dates normally with the term of seven years. The latest was concluded in 1999 with the provision of automatic renewal after seven years unless either country gives to the other a

written notice for amendment six months in advance. According to this treaty, both countries shall have freedom of transit across their territories through routes mutually agreed upon. With a view to offer convenience of traffic in transit, the contracting parties agreed to provide, at points of entry or exit, warehouse or sheds, providing treatment no less favorable than that accorded to ships of any other foreign country in respect of matter related to navigation, entry into and departure from the ports, use of ports and harbor facilities, loading and unloading dues, taxes and other levies. Some provisions of the former treaty were revised, e.g., only to check the "one time lock" of the containers put on by the shipping agent or carrier. In case of broken or defective found, after the thorough check, again "one time lock" would be posted. There are 22 land-border points specified for mutual trade between Nepal and India. Calcutta and Haldia ports have been specified as port of entry for Nepal's third country trade by sea. Fifteen land border points have been specified for the passage of Nepal's third country trade. The present transit facilities provided by India to Nepal are:

- India allows freedom of transit for Nepalese third country trade across its territories through routes mutually agreed upon.
- Permission is given for the movement of Nepalese trucks to and from the nearest railway stations to pick up the export and transit cargo to Nepal.
- Traffic in transit is exempted from custom duty and from all transit duties or other charges, except charges for transportation and service charges.
- Facilities are provided for warehousing and storage of goods in transit awaiting custom clearances before inward transportation in Nepal through the Indian territory.

In order to control unauthorized trade between two countries, agreements were signed in different dates, the last being in 2002. According to this agreement, both countries would prohibit and cooperate with each other to prevent re-exports from its territory to each country of goods imported from third countries.

Problems and Challenges

Despite the implementation of a number of policy and procedural reforms to promote the trade sector, several problems still exist. The major internal reasons such as closure of industries due to the security problem, high investment in industries yielding low value addition, lack of control in quality standard coupled with international factors such as economic recession and terrorist attacks had negative implications in industrial production. This led to a serious decline in the production of exportable items and in turn exports, especially third country exports. Moreover, the inability to develop industries based on viability and comparative advantage, low inflow of foreign direct investment, limited expansion of industries in the rural areas, low competitiveness, absence of forward and backward linkages, and lack of industrial development based on domestic resources, human resources and raw materials are the major problems in the trade sector. Among the major exportable items, the export of carpets was adversely affected by the use of low-quality wool, export of inferior carpets from other countries, and issues related to child labour. Another concern is Nepal's inability to fully use the transit route via Kakarbhitta-Fulbari-Banglaband to expand foreign trade.

With the expiry of the Multi-Fiber Agreement on December 31, 2004 and in the absence of the alternative market, the garment industry is facing a tough situation. For the development of the external sector, the private sector should be active, sensitive and capable as this sector is the actual player in this field. With the accession into the WTO, the country still encounters more challenges to survive in the global market by increasing the competitiveness with the enhancement in quality and quantity of the production. A small basket of exports and very limited markets are the other serious concerns.

Conclusions and Recommendations

Due to relatively a much larger magnitude of imports, the high trade deficit has been a salient feature of the country's trade from the beginning. Since the implementation of development plans, trade promotion efforts have been going on. However, the expected results have not been achieved. Concentration of export trade in a few items and destinations, dependence on the import for raw materials, weak forward and backward linkages, widening trade deficit, and lack of development of infrastructures are the major challenges in the trade sector. Similarly, the failure to expand trade with China, despite huge business potential, is another weakness of the country's foreign trade regime. Unless and until there is adequate development of

infrastructure and utilization of locally available natural and other resources, the attainment of comparative advantage on the production and expansion of trade is not possible. With the enhancement of quality and quantity of production, trade should be diversified country-wise and product-wise. In order to increase exports, production of exportable must be enhanced. New exportable items that have comparative advantage should be identified. Economic liberalization should be reflected in the expansion of production activities, export promotion and higher level of import competing rates. In this respect, as the country has been able now to use the dry ports constructed in Birgunj, Biratnagar and Bhairahawa, the competitiveness of the country's foreign trade can be expected to increase with the reduction in cost.

The government has facilitated the imports of industrial raw materials and capital goods. There are more than 60 items that can be imported from India by paying convertible currencies. But this is not enough. Physical infrastructure must be developed. Then only can industries be established at a local level by utilizing local resources. Consequently, income and employment generating activities would be created for the marginalized group through the promotion of small enterprises and through an integrated program to improve skills, entrepreneurship, investment and technology transfer. This will significantly contribute to poverty alleviation also. The production of agricultural and other primary goods would also be enhanced as the modern tools, seeds, fertilizers, etc. could reach all regions of the country. Products would be consumed in the domestic as well as international markets. Moreover, enhancement in the production of existing goods that have remarkable contribution in exports such as woolen carpet, ready-made garments, pashmina, vegetable ghee, pulses, and toothpaste should be emphasized.

The end of the Multi-Fiber Agreement has forced the garment industry to look for international markets based on its competitiveness. It is important to accord priority to the creation of investment-friendly environment, reduction in the cost of readymade garments, promotion of quality products, and timely import of the required raw materials to meet the future challenges. For the better performance of the external sector, some suggestions are presented below:

- Areas of comparative advantage should be identified and environment for investment should be created in those sectors. Moreover, import trade should be developed as a component of industrial development.
- In order to utilize the locally available resources, enhance production at a lower cost and create competitiveness, suitable industries should be established on local basis. Emphasis should be given to quality production.
- Necessary arrangements should be made for the promotion of foreign investment and technology.
- Dry ports should be used to the maximum with the norm of ports not to be just a parking area.
- Although establishment of export processing zones in major custom points has been announced in various plans, it has not been implemented yet. The process of setting up of export processing zones should be accelerated.
- Enhancement of the competitiveness of the trade sector in harmony with SAARC, SAPTA and SAGO agreements has been emphasized in the Tenth Plan. This should be expedited as well.
- Emphasis should be given to the identification of new exportable and enhancement of their production. Quality and quantity promotion of existing exportable items such as, woolen carpets, ready-made garments, pashmina and handicrafts should be expanded.
- Institutional capacity of governmental, non-governmental and private institutions related to export promotion should be enhanced.
- The role of private sector should be made decisive in the development of external sector. Coordination between government and private sector is necessary for identification and expansion of international markets.
- It is necessary to reform trade, industrial, foreign investment and other related policies making them friendly to the open and market-oriented economy.
- With the accession of Nepal into the WTO, it has been a must for the country to make foreign trade more simple, reliable, and cost effective. In this regard, there should be reform in the area of laws, rules and regulations as soon as possible.
- Nepal's external sector policy should focus on creation of tourism friendly environment.
- By mobilizing Nepalese foreign agencies, it is very urgent to make good arrangement of foreign employment of Nepalese workers and to regulate the inflow of remittances. These agencies should be activated also for promoting FDI for industrial development.

- Promotion of foreign investment and technology in the area of competitive advantage, based on the study of demand and supply of goods in the international markets, is necessary. Investment friendly atmosphere is a must.

Endnotes

[1] ITRS is one of the Data Sources to compile BOP Statistics. An ITRS measures individual BOP cash transactions (passing through the domestic banks and foreign bank accounts of enterprises) and no stock positions. Statistics are compiled from forms submitted to domestic banks and from forms submitted by enterprises to the compiler.

[2] Negative list of articles that are not allowed preferential entry from Nepal to India on the basis of "certificate of origin" (CoO) include:

i. Alcoholic liquors/beverages and their concentrates except industrial spirits,
ii. Perfumes and cosmetics with non Nepalese/ non Indian brand names, and
iii. Cigarettes and tobacco.

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WTO and Financial Services Sector

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Introduction

Nepal had recently become the 147th member of the global rule based trading organization known as World Trade Organization (WTO); this organization comprehensively covers international trade in goods and services as well as intellectual property rights and provides both a certain and stable environment for exchange in goods and services (for background see WTO, 2003). Nepal's membership in WTO on 23 April 2004 marked the culmination of a process that had commenced in 1989 with application in the General Agreement on Trade and Tariff (GATT), which had evolved into the WTO on 1 January 1995 (WTO, 2004).[1] The continued motivation for membership in WTO had been to reinforce the process of trade liberalization, initiated in the mid-1980s (NRB, 1996),[2] which was reinforced by the belief that (trade liberalization) it would both facilitate integration with the global economy and contribute benefits to the domestic economy.[3]

Nepal's membership in WTO presents a wide spectrum of challenges along with opportunities that are waiting to be grabbed (although for a contrary view see, Mattoo and Subramanian (2004) and Rose (2004)). The challenges are many but can be reflected most saliently in the need for having a transparent set of legal rules which are also consistent with that of WTO; while the opportunities can best be reflected in having a stable trading environment which can act as an accelerator for domestic economic growth and development. In sum, WTO captures a very broad foot print which encompasses all aspects of trade in goods and services. This paper, however, is focused to the Financial Services Sector (FSS) of the General Agreement of Trade in Services (GATS).[4]

The FSS is crucial for economic growth and development in general, and particularly so for a developing country like Nepal which has a per capita GDP of $269 (His Majesty's Government of Nepal [HMG/N], Economic Survey, 2003/2004). The FSS has a cross-cutting nature across all sectors of the economy for facilitating (1) financial intermediation in the economy (i.e. mobilization and allocation of funds) and (2) efficient financial transfers and payments.[5] In other words, a healthy and stable FSS is essential for sustainable economic growth (Levine, 2001). Conversely, instability in FSS can potentially have a disastrous economy wide effect seen most dramatically in the East Asian crisis where fragility in the financial system spilt over to other countries in the region.[6,7]

Nepal is fully aware that with entry into WTO, the country has to make necessary arrangements to maximize the potential benefits of this opportunity. Nepal Rastra Bank (NRB), the Central Bank of the country, has been given the important responsibility for ensuring domestic financial stability (NRB Act of 2002). Specifically, NRB is required to (1) regulate and supervise the portion of FSS called Banking and

Other Financial Services (BOFS as described in more detail below); and (2) ensure stable mechanism for trade and payments. In this regard, NRB has established a high level committee on WTO matters (henceforth known simply as HLC) on May 12, 2003 coordinated by the senior Deputy Governor of the Bank[8] with members the other Deputy Governor[9], and heads of identified departments/division namely: Bank and other Financial Institutions Regulation Department (BFIRD); Bank Supervision Department (BSD)[10]; Foreign Exchange Management Department (FEMD); Research Department (RD); and Legal Division (LD); with the Director of RD in charge of the Special Study Division (SSD) being the member-secretary of the HLC. Further the Secretariat of HLC is presently located in the RD. This paper aims to overview the process by NRB to address the potential challenges with Nepal's membership in WTO with focus on FSS. The specific objectives of this paper are to:

- Provide a brief background of WTO and the history of Nepal's membership process;
- Present stylized facts on the Nepalese FSS;
- Describe the commitments made by HMG/N in regard to FSS; and
- Provide the (proactive) activity of NRB.

Background of WTO and History of Nepal's Membership Process

This section provides a brief overview of WTO and gives a brief history of Nepal's accession process into this organization.

Brief Overview of the WTO, the Global Rules-based Trading System

The current institutional framework of the global trading system – the WTO – was created on 1 January 1995 replacing the then GATT. WTO is a global organization dealing with the rules of trade and presently has 148 member countries (WTO home page). Prior to establishment of this organization, trade rules had been developing under GATT to meet the evolving needs of the participating countries and the global community. GATT entered into force in January 1948 by 23 founding member countries (officially "contracting parties") to salvage what was left of the original proposition called the Havana declaration, whose objective was to establish the International Trade Organization. GATT was instrumental in the creation of a strong multilateral trading system that introduced successive rounds of more liberalized, stable and predictable trading rules.

The general principle of WTO is to have freer, fairer, and more predictable trade without discrimination and being more beneficial for less developed countries. The most important principles built into the foundation of the multilateral trading system are further discussed:

- *Trade without discrimination*
  - *Most-favored nation (MFN): treating other nations equally* – a tariff reduction granted to one country that has to also be extended to all the members countries in the GATT; this is a multilateralization of the bilateral liberalization.
  - *National treatment: treating foreigners and locals equally* – countries should not discriminate between it's own and foreign products once they have crossed the border and entered the market.
- *Freer trade: gradually through negotiation* – the objective is to gradually reduce trade barriers as one of the most obvious means of encouraging trade.
- *Predictability: binding commitments* – provide stability and predictability which in turn widens business opportunities; a change in binding has high opportunity costs.
- *Promoting fair competition* – a system of rules dedicated to open, fair and undistorted competition.
- *Encouraging development and economic reform:* contributes to development, special assistance and trade concession for developing countries, flexibility in WTO agreements.

The original GATT rules (consisting of 38 articles and nine annexes) have been modified to address new international trade challenges but the basic principles have remained the same. One major area of modification occurred with respect to the treatment of developing countries when Part 4 (Trade and Development) was added to the original rules. This ministerial decision was adopted at the end of the Uruguay round, which offers least developed countries extra flexibility in implementing WTO agreements. Another major reform occurred with the last negotiation rounds, the Uruguay Round, when the entire system was revised and updated to meet the challenges of introducing new areas into negotiations. The revised set of rules is now known as GATT 1994 to differentiate it from the original rules (GATT, 1947).

During the period of 1948 to 1994, GATT presided over eight multilateral liberalization rounds (see Table 1). Several early rounds were most focused on reducing tariffs and it was not until the Tokyo Round that the non-tariff barriers and other issues were introduced into the negotiations. The results of negotiations on those issues were stipulated in several "codes" which were binding only for the contracting parties who signed a particular code (there were nine codes, including *inter alia* codes on subsidies and countervailing measure, technical barriers to trade, government procurement, customs valuation, anti-dumping and trade in civil aircraft). Finally, the longest round so far, the Uruguay Round, introduced negotiations of 15 subjects including three new areas: agriculture, services and intellectual property.

In addition, the Uruguay Round resulted in the establishment of the WTO that replaced GATT as a separate international agency although GATT, as the set of internationally agreed rules on trade in an updated form, continues to be at the center of the WTO system. There are, however, important differences between GATT and WTO (WTO, 1998, p. 14) which are:

- While GATT had a provisional nature, the WTO and its agreements are of permanent nature and WTO has the recognition of international economic organizations.
- While GATT as a legal text had "contracting parties", WTO as an organization has members.
- While GATT was dealing only with trade in goods, the WTO covers trade in services and intellectual property rights as well.
- While GATT's Dispute Settlement System was slow and suffered from countries being able to veto the process, the WTO's system is faster and cannot be blocked.

History of Nepal's Accession Process

HMG/N had formally applied for GATT membership on May 1989, following a trade dispute with India, which had resulted in the establishment of the Working Party for Nepal's membership in GATT. However, the trade dispute with India lasted for 15 months and concluded with new treaties being signed. Hence, the urgency for Nepal to become a GATT member, so as to be protected under GATT Article V on transit rights, weakened with Nepal's accession under GATT 1947 resuming only in 1995 as WTO accession under Article XII.[11] It was in December 1995 that Nepal became an observer[12] to the WTO and converted the application for membership in GATT to membership in WTO, thus the working party established for Nepal's accession to the GATT was likewise transformed into the Working Party on Accession to the WTO. Subsequently in July 1998, Nepal, in accordance with WTO procedures for accession, had submitted to the aforementioned Working Party a Memorandum of Foreign Trade Regime. On August 1998, the WTO Secretariat circulated Nepal's Memorandum on Foreign

Table 1
Multilateral Liberalization Rounds

Year	Liberlization Rounded	Subjects Covered	Average Tariff Reduction for Industrial Goods in %	Number of Countries Taking Part in Negotiations
1947	Geneva Round	Tariffs	19	23
1949	Annecy Round	Tariffs	2	13
1950 – 51	Torquay Round	Tariffs	3	38
1955 – 56	Geneva Round	Tariffs	2	26
1960 – 61	Dillon Round	Tariffs	7	26
1964 – 67	Kennedy Round	Tariffs and anti-dumping measures	35	62
1973 – 79	Tokyo Round	Tariffs, non-tariff measures, "framework" agreements	34	102
1986 – 94	Uruguay Round	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO etc.	40	123

Source: WTO (1998) *Trading into the future*, p. 8 – 9

Trade Regime to the WTO member countries and invited any queries and comments from members. The WTO Secretariat compiled all the queries and comments on the Memorandum of Foreign Trade Regime, which were forwarded by the member countries, and passed them to HMG/N in January 1999. There were altogether 364 questions (based on Nepalese laws) – 24 on economy, economic policies and foreign trade, 178 on the framework for making and enforcing policies affecting foreign trade in goods and services, 114 on trade-related intellectual property rights regime and 48 on trade-related service regime. HMG/N responded to the queries/questions raised on the Memorandum by WTO members in 1999 and 2000. It was also on July 1999 that the project, "Nepal's Accession to the World Trade Organization (WTO)", was formed.[13]

The first meeting of the Working Party was held on 22 May 2000 at the WTO Secretariat, Geneva. For this meeting, the Nepalese negotiating team was led by the Honorable Minister of Commerce of Nepal.[14] After the first Working Party meeting, the WTO Secretariat transmitted additional questions that had been raised both during the first Working Party Meeting which had been submitted in writing by member countries. In response to the development of the First Working Party Meeting, Nepal had submitted a schedule of tariff concessions and schedule of initial commitments on services sector in July 2000, which again resulted in additional questions from the Working Party. Subsequently, the team led by the Secretary, Ministry of Commerce of Industry Commerce and Supplies (MOICS) of HMG/Nepal,[15] participated for second round of negotiations[16] in Geneva on September 2000. In this regard, there have been consultations with different stakeholders (such as for accountancy services, legal services, etc.) for obtaining feedback to form necessary strategies of HMG/N in the ensuing WTO negotiations. The second and third Working Party Meetings were held on 12 September 2002 and 15 August 2003 and were led both times by the Secretary, MOICS of HMG/N.[17] The third and last working party meeting, chaired by Ambassador Pierre-Louis Girard of Switzerland, was satisfied with Nepal's tariff binding commitments and the services sector liberalization offers. A draft decision and protocol of accession (WTO, 2003 b,c) developed by the working party was presented at the General Council of the WTO held on 11 September 2003, in Cancun, Mexico, which had been approved by the majority of the General Council (WTO, 2003 a) with His Excellency Mr. Hari Bahadur Basnet, Minister of Industry, Commerce and Supplies leading the Nepalese delegation in the signing ceremony for the protocol of accession into WTO. Subsequently on 24 March 2004, HMG/N notified the WTO that the process of ratification and acceptance of the Protocol of Accession had been completed with WTO subsequently informing Nepal of entry into force of the Protocol with the country becoming the 147th member of WTO (WTO, 2004).

The different milestones in the accession process for Nepal's membership in WTO are given in the table below:

Stylized Facts on Nepalese FSS

As had been mentioned, the focus of this paper is on FSS. As an introduction, the description of the Nepalese FSS follows the classification by WTO into three sub-sectors namely: All insurance and insurance-related services (AII); Banking and other financial services (excluding insurance; BOFS); and other. In this regard, a short historical description of FSS in Nepal is given below.

Process	Date
Application for accession	May 1989
Working Party Establishment	1989 GATT Working Party converted into WTO Working Party on December 1995
Submission of Memorandum on Foreign Trade Regime	July 1998
Clarification on Memorandum on Foreign Trade Regime	June 1999June 2000
First Meeting of Working Party	22 May 2000
Tariff Offers	July 2000
Service Offers	July 2000
Second Meeting of Working Party	12 September 2002
Third Meeting of Working Party	15 August 2003
5th WTO's Ministerial Conference, at Cancún (Mexico), approved the accession package.	11 September 2003
HMG/N notified the WTO that the process of ratification and acceptance of the Protocol of Accession had been completed	24 March 2004
Entry into force of the Protocol with Nepal becoming the 147th member of WTO	23 April 2004

Source: NRB (2002) and updated

FSS in Nepal is a fairly recent phenomenon that commenced with the establishment in 1937 of Nepal Bank Ltd., in cooperation of Imperial Bank of India.[18] Prior to this, there had been absence of formal financial institution to facilitate financial intermediation, where this role was taken up by informal institutions viz. *indigenous money lenders* and the *Sarafis* (NRB, 1996), which tended to charge high interest rates. Similarly the first insurance company, Nepal Maalchalaani and Insurance Company [now simply Nepal Insurance company], had a late start and was set up with the initiative of Nepal Bank Limited and was established in 1947. The NRB[19] was established in 1956 with other major financial institutions being, in chronological order: Nepal Industrial Development Corporation in 1959 [initially established as Industrial Development Bank in 1957]; Employee's Provident Fund Corporation in 1962; Rastriya Banijya Bank in 1966; Agricultural Development Bank in 1968 [initially established as cooperative bank in 1963 and merged]; National Insurance Corporation Ltd. in 1967; Credit Guarantee Corporation in 1974; Postal Saving Offices in 1977; Securities Exchange Centre in 1984 [converted into Nepal Stock Exchange Ltd. in 1992]. Trade in financial services had started much more recently, in mid-1980 with the operation of Nabil Bank Ltd. on 7/12/1984, a joint venture financial institution with then National Bank of Bangladesh. This had likely heralded deregulation of the domestic financial sector, which had been initiated in mid-1986 (NRB, 1996).

Deregulation has had an impact on the number of commercial banks – this had risen by two institutions in the years up to 1990, which saw further liberalization of the domestic economy including the financial services sector. The period since 1990 experienced an increase in the number of commercial bank, averaging about one a year, however the non-bank financial system saw spectacular growth in both breadth and depth. It is important to clearly define the non-bank financial system vis-à-vis the bank financial sector composed of NRB, commercial banks, development banks and grameen bikash banks, where the non-bank financial system comprises finance companies, contractual saving institutions, cooperative financial institutions, non-governmental organizations conducting limited banking activities, postal saving offices and Nepal Stock Exchange, in addition to other quasi financial institutions (NRB, 1996). Specifically, the first finance company [Nepal Housing Development Finance Co. Ltd.] was established in 1992; the first cooperative society with limited banking transaction [Navajiban Co-operative Society Ltd.] was established in 1993; the first Non-government organization with limited banking transaction [Swabalamban Bikas Kendra] was established in 1994 – all these were broadening the non-bank financial system which can also be seen with the formation of the Nepal Insurance Board as an autonomous body by the Insurance Act of 1992; this new act had repealed the existing Insurance Act of 1968.[20]

As of mid-July 2004, the financial network of the country has been both deepened and widened with the operation of 17 commercial banks, 20 development banks, 5 rural development banks, 59 finance companies, 21 co-operatives and 44 NGOs and microfinance performing financial activities, as per the instructions and guidelines of NRB, along with 17 insurance companies (NRB, 2004). It is important to note that the evolving nature of FSS had highlighted the necessity of a dynamic NRB, which had been reflected in the promulgation of a new Nepal Rastra Bank Act, 2002; further those different financial institutions are being guided by the Bank and Financial Institution Ordinance, 2060[21], Insurance Act 1992 along with Foreign Exchange (Regulation) Act 1962 etc, which are also in process of being made consistent with WTO.[22]

Nepal's FSS Commitments

This section provides information of Nepal's FSS commitments, however prior to describing those, it is important to have a clear idea of what is classified as GATS; the FSS in particular; the language of commitments; and finally to describe what Nepal has committed to during the accession process.

Background Information on the Concept of GATS, FSS and of FSS Liberalization

The objective of this section is to provide answers to those questions. GATS is the first ever set of multilaterally, legally enforceable rules, covering international trade in services. It was negotiated in the Uruguay Round. Like the agreement on goods, GATS operate on three levels: the main text containing general principles and obligations; annexes dealing with rules for specific sectors; and individual countries specific commitments to provide access to their markets. Unlike in goods, GATS has a fourth special

element: lists showing where countries are temporarily not applying the "most-favored-nation" principle of non-discrimination. These commitments, like tariff schedules under GATT, are an integral part of the agreement. So are the temporary withdrawals of the most-favored nation treatment.

The basic principles of GATS are:

- All services are covered by GATS
- Most favored nation treatment applies to all services, except the one-off temporary exemptions
- National treatment applies in the areas where commitments are made
- Transparency in regulations, inquiry points
- Regulations have to be objective and reasonable
- International payments: normally unrestricted
- Individual countries' commitments: negotiated and bound
- Progressive liberalization: through further negotiations

In regard to the scope and coverage of GATS, the agreement applies to all trade in services by WTO members. The exception is the services supplied in the exercise of governmental authority such as central banking and social security, which are neither supplied on a commercial basis nor in competition with other service suppliers. The GATS schedule largely follows a classification based on the United Nations Central Product Classification system, which identifies 11 basic service sectors plus a twelfth category for miscellaneous service. These are:

- Business (including professional and computer) services
- Communication services
- Construction and related engineering services
- Distribution services
- Educational services
- Environmental services
- Financial (insurance and banking) services
- Health-related and social services
- Tourism and travel-related services
- Recreational, cultural and sporting services
- Transport services, and
- Other services not included elsewhere

This section, however and as stated earlier, focuses on FSS only and the commitments made by Nepal. Prior to actually analyzing those commitments, it is felt necessary to be clear on the description of FSS. There are a number of ways for representing a country's FSS such as through the United Nations Central Product Classification or national classification. Because of the varying classification standards, there have been confusion and problems with cross-country comparison. This paper consistently uses the format provided by the GATS Annex on Financial Services, which is presented below[23]:

FINANCIAL SERVICES

A. All insurance and insurance-related services:

a. Life, accident and health insurance services;
b. Non-life insurance services;
c. Reinsurance and retrocession;
d. Services auxiliary to insurance (including broking and agency services).

B. Banking and other financial services (excluding insurance):

a. Acceptance of deposits and other repayable funds from the public;
b. Lending of all types, including, *inter alia*, consumer credit, mortgage credit, factoring and financing of commercial transaction;
c. Financial leasing;
d. All payment and money transmission services;
e. Guarantees and commitments;
f. Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following;
   - money market instruments (cheques, bills, certificate of deposit, etc.);
   - foreign exchange;
   - derivative products including, but not limited to, futures and options;
   - exchange rate and interest rate instruments, including products such as swaps, forward rate agreements, etc.;
   - transferable securities;
   - other negotiable instruments and financial assets, including bullion.
g. Participation in issues of all kinds of securities, including under-writing and placement as agent (whether publicity or privately) and provision of service related to such issues;
h. Money broking;
i. Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial depository and trust services;
j. Settlement and clearing services for financial assets, including securities, derivative products and other negotiable instruments;

k. Provision and transfer of financial information, and financial data processing and related software by providers of other financial services;
l. Advisory services on all the activities listed above.

C. Other

Commitment for liberalization of FSS entails that the existing financial regulations are accommodative to greater financial intermediation along with greater financial transfers and payments; the later will eventually be reflected in higher inflow and outflow of funds. This also necessitates that there be deregulation of various financial service activities and increase in industry competition. It is important to point out that this does not touch on the ability of the "central bank or monetary authority" for providing domestic regulation, as clearly spelled out in the second point of the Annex of Financial Services[24]; WTO is cognizant that financial liberalization and financial services trade has implication for financial stability and shall not prevent measures for prudential reasons.

Review of WTO Schedule Format

This section reviews the WTO schedule format for service sector commitments and accurate submission of factual information, and is based on WTO (1996). It should be noted that in contrast to commitments with regard to goods, services are a bit complex as there are two sorts of provisions under the GATS: the first are general obligations, some of which apply to all sectors (e.g. MFN, transparency, etc.); while the second are specific commitments which are negotiated undertakings specific to each member, also services can be supplied in four different ways. These commitments can further be broken down into horizontal and specific commitments. Horizontal commitments affect all sectors, and sub-sectors, equally; this is usually at the top of the Schedule of Service Sector Commitments.[25] Specific commitments to open markets, on the other hand, are specific to the sector and are provided for market access (e.g. whether there are restrictions to foreign ownership) and national treatment[26] (e.g. whether some rights granted to local companies will not be granted to foreign companies) which are generally put forward with two separate columns. [27] [28]

In the columns for market access and national treatment, the various categories under each sub-sector of a particular sector, are listed. So, in the case of FSS, the first column includes the sub-sectors of "All insurance and insurance-related services", "Banking and other Financial Services (excluding insurance)" as well as the "Other" sub-sector along with the different categories described earlier. In the second column information relating to market access are included for each category based on the four modes of supply by which any service can be supplied and are: *Cross border supply* (i.e. the service supplier is typically not present within the territory of the government where the service is delivered with some examples being international transport, the supply of a service through telecommunications or mail, and other such services embodied in exported goods [e.g. a computer diskette, or drawings]); *Consumption abroad* (i.e. this mode of supply is often referred to as "movement of consumers" whose essential feature is that the service is delivered outside the territory of the government concerned and typically includes crossing for the border of the consumer as, for example, in tourism services[29]); *Commercial presence* (i.e. this mode covers not only the presence of juridical persons in the strict legal sense, but also that of legal entities which share some of the same characteristics includes, *inter alia*, corporations, joint-ventures, partnerships, representative offices and branches); *Presence of natural persons* (i.e. this mode covers natural persons who are themselves service suppliers, as well as natural persons, who are employees of service suppliers). The four modes of supply are simply stated as Mode 1, 2, 3 and 4 for cross border supply, consumption abroad, commercial presence and presence of natural persons respectively.

Commitments are recorded in the WTO schedule format in the table for market access and national treatment, through a number of ways. First, as mentioned earlier there are horizontal commitments which apply to trade in services in all scheduled services sectors unless otherwise specified; it is in effect a binding either of measures which constitutes a limitation on market access or national treatment, or of a situation in which there are no such limitations. Second, there are sector specific commitments which apply to trade in services in a particular sector; it is in the context of such a commitment, when a measure is maintained which is contrary to GATS Article XVI or XVII, it must be entered as a limitation in the appropriate column (either market access or national

treatment for the relevant sector and modes of supply). Third are recordings of the various levels of commitments; their presentations are extremely important and have to be very precise since the terms used create legally binding commitments indicating the presence or absence of limitations to market access and national treatment. Depending on the extent to which a member has limited market access and national treatment, for each commitment with respect to each mode of supply, four cases each for market access and national treatment, can be foreseen:

- *Full commitment* – Members do not seek in any way to limit market access or national treatment in a given sector and mode of supply through measures inconsistent with GATS Article XVI and XVII. In this situation, the appropriate column is marked with NONE. However, any relevant limitations listed in the horizontal section of the schedule will still apply.
- *Commitment with limitations* – Where market access or treatment limitations are inscribed, the member must describe in the appropriate column the measure maintained which are inconsistent with GATS Articles XVI or XVII. The entry should describe each measure concisely, indicating the elements which make it inconsistent with GATS Articles XVI or XVII. Further, in some cases, members may choose to partially bind measures affecting a given category of supplier. This may be achieved through an indication in the horizontal section of a schedule with the corresponding sectoral entry under the relevant mode of supply (i.e. it may thus read "Unbound except as indicated in the horizontal section").
- *No Commitment* – In this case, the Member remains free in a given sector and mode of supply to introduce or maintain measures inconsistent with market access or national treatment. In this situation, the Member must record in the appropriate column the word: UNBOUND. This case is only relevant where a commitment has been made in a sector with respect to at least one mode of supply.[30]
- *No commitment technically feasible* – In some situations, a particular mode of supply may not be technically feasible. An example might be the cross-border supply of hair-dressing services. In these cases, the term UNBOUND* should be used. The asterix should refer to a footnote which states "Unbound due to lack of technical feasibility."

It is in "Commitments with limitations" that acceding government may limit market access horizontally or to any specific service sector. Such limitations for market access includes, according to both Article XVI and XVII of GATS: (a) Limitations on the number of service suppliers (e.g. ceilings on the total number of banks); (b) Limitations on the total value of transactions on assets (e.g. foreign bank subsidiaries limited to X per cent of total domestic assets of all banks); (c) Limitations on the total number of service operations or on the total quantity of service output (e.g. restrictions on broadcasting time available for foreign firms); (d) Limitations on the total number of natural persons (in particular non-nationals) that may be employed in the sector (or the share of wages paid to foreign labor); (e) Restrictions on, or requirements of, specific types of legal entity through which that service may be supplied (e.g. commercial presence exclude representative offices, foreign companies required to establish subsidiaries, commercial presence must take the form of a partnership); (f) Limitations on the participation of foreign capital. In addition to these limitations, it is suggested that clear reference will also have to be made to the relevant laws or regulations.

For completeness an additional column is usually provided for additional commitments with respect to measures affecting trade in services not subject to scheduling under market access or national treatment. Thus, additional treatments are expressed in the form of undertakings, not limitations. In the schedule, the additional comments column would only include entries where specific commitments are being undertaken, and need not include those modes of supply where there are not commitments undertaken.

Commitments in FSS by Nepal

Having understood the background of Nepal's accession to WTO, as well as obtained a flavor of reading GATS schedule of commitments, this section is describes the actual commitments in FSS by Nepal.

To initiate this, it is important to understand the horizontal commitments which are applicable to all sectors and sub-sectors. These horizontal commitments are guided in part by Nepal's

acceptance of the eighth Article of the Article of Association of the International Monetary Fund, which prohibits members, except with the approval of the Fund, from imposing restrictions on the making of payments and transfers for current international transactions or engaging in multiple currency practices or discriminatory currency arrangement. For the horizontal commitments and in regard to market access, Nepal has committed to having no restriction for the first mode, second and third modes of supply except for restriction on the second mode requiring "convertible currency limit of US$ 2,000 applies to Nepalese citizens on personal travel" and the third mode requiring "The conditions of ownership, operation and juridical form and scope of activity as set out in a license or other form of approval establishing or authorizing the operation and supply of services by an existing foreign service supplier, will not be made more restrictive than they exist as of the date of Nepal's accession to WTO". It is important to note that Nepal has not committed to liberalization of the fourth mode "except for temporary entry and stay of natural persons of another Member in the following categories:

> *Service sales persons:*
>
> Persons not based in the territory of Nepal and receiving no remuneration from a source located within Nepal, who are engaged in activities related to representing a service supplier for the purpose of negotiating for the sale of services of that supplier where:
>
> a. such sales are not directly made to the general public, and
>
> b. the sales person is not engaged in supplying the service.
>
> Entry for persons named in these two categories is limited to a ninety-day period, which may be renewed.
>
> *Persons responsible for setting up a commercial presence*
>
> Persons who are employees of an enterprise not having commercial presence in Nepal and who stay temporarily in Nepal for the purpose of setting up a commercial presence of that enterprise in Nepal. Personnel engaged in setting up commercial presence shall present proof of the commencement of business operation within one year of the date of entry of that person.
>
> Entry for the above-listed persons is limited to one year period, which may be renewed.
>
> *Intra-corporate transferees*
>
> Managers, executives and specialists as defined below who are employees of firms that provide services in Nepal through a branch, subsidiary or affiliate established in Nepal and who have been in the prior employment of their firm outside Nepal for a period of not less than one year immediately preceding the date of their application for admission and who fall with one of the following categories:
>
> (A) Executives and Managers: persons within an organization who primarily direct the organization or a department or sub-division of the organization, supervise or control the work of their supervisory, professional or managerial employees, have the authority to hire and fire or recommend hiring, firing or other personnel actions (such as promotion, or leave authorization) and exercise discretionary authority over day-to-day operations.
>
> (B) Specialists: persons within an organization who possess technical knowledge at an advanced level of continued expertise and who possess propriety knowledge of the organization's services, research techniques or management techniques. (Specialists may include but are not limited to members of licensed professions.)
>
> Entry for the above-listed categories of intra-corporate transferees is limited to a 3 years initial period that may be extended for up to 7 years for a total period not to exceed 10 years.
>
> Temporary entry and stay of natural persons considered to be intra-corporate transferees may be limited to 15 percent of local employees. This commitment shall be further liberalized after five years from the date of accession."

Similarly, in the horizontal commitments made by Nepal for national treatment, there is no restriction on the first, second and third mode of supply except in the first mode "with respect to foreign exchange provided to foreigners (excluding those categories of persons covered by commitments in this agreement) to pay for any cross-border services" and the third mode of supply except for:

> "- A foreign investor reinvesting earnings is required to obtain the permission of the Department of Industry.
>
> - All foreign investments except for Financial Services require approval by the Department of Industry.
>
> - Incentives and subsidies are available only to enterprises wholly owned by Nepalese nationals."

There has not been commitment for liberalization of the fourth mode of supply except for measures concerning the categories of natural persons referred to in the market access column: Selling and buying real estate is the constitutional right of every Nepalese citizen. The Civil Code prohibits anyone from selling, mortgaging, gifting or endowing or disposing any real property to a foreign individual."

Likewise, there have also been a number of additional commitments made by Nepal namely that:

> "Except where an environmental impact assessment is required, decisions of the Department are normally provided within 30 days of the date of application.

Approval of an investment will not normally be withheld except for failure to meet environmental standards.

A foreign investor making an investment in foreign currency shall be entitled to repatriate the following amount outside Nepal:

a) The amount received by the sale, in whole or part, of the investors share of equity;
b) The amount received as profit or dividend as a result of an equity investment;
c) The amount received as the payment of the principal of and interest on any foreign loan; and
d) The amount received under an agreement to transfer technology approved by the Department of Industries or the Department of Cottage and Small Industries."

Likewise, the general commitments made by Nepal in regard to the FSS sector are provided below:

"The commitments in financial services are made in accordance with the General Agreement on Trade in Services and the Annex on Financial Services. All the commitments are subject to entry requirements, domestic laws, rules and regulations and the terms and conditions of the Nepal Rastra Bank (the central bank of Nepal), Insurance Board and any other competent authority in Nepal, as the case may be, which are consistent with Article VI of the GATS and paragraph 2 of the Annex on Financial Services.

The commitments in Insurance Services are given to the nationals and financial institutions of the Members whose law and policies do not bar the provision of similar commitments to the Nepalese nationals and financial institutions. No such limitation will exist as of 1 March 2004.

Financial Services in the form of operations identified below in the Schedule can be carried out in Nepal through a locally incorporated company. Branches will be allowed for insurance services and wholesale banking as of 1 January 2010. Only a licensed commercial bank, a licensed specialized bank or a registered finance company may accept deposits. Only a licensed commercial bank may accept deposits, which are repayable upon demand. Only financial institutions with rating of at least 'B' by Credit Rating Agency e.g. MOODI, Standard & Poor can have commercial presence in Nepal. The total foreign shareholding in any institution providing financial services is limited to 67 per cent of the issued share capital. It has, nevertheless, been bound for the existing foreign financial service providers as to their scope of operation and equity structure. The shares held by foreign

1. Insurance and Insurance Related Services		
(i) Direct Insurance		
(a) Life	(1) None (2) None (3) None, except As indicated in general conditions. (4) Unbound, except as indicated in horizontal section.	(1) None (2) None (3) None, except as indicated in general conditions and horizontal section. (4) Unbound, except as indicated in horizontal section.
(b) Non-life	(1) None (2) None (3) None, except as indicated in general conditions (4) Unbound, except as indicated in the horizontal section.	(1) None (2) None (3) None, except as indicated in general conditions and horizontal section. (4) Unbound, except as indicated in horizontal section.
(ii) Re-insurance and Retrocession	(1) and (2) None except, mandatory reinsurance up to USD 25,000 must be placed with domestic insurance company until 31 December 2007.	(1) None (2) None (3) None (4) Unbound, except as indicated in the horizontal section.
(iv) Services Auxiliary to Insurance (Insurance broking and agency services (CPC 81,404)	(1) None (2) None (3) None, except as indicated in general condition. (4) Unbound, except as indicated in the horizontal section	(1) None (2) None (3) None (4) Unbound except as indicated in the horizontal section.

> nationals and foreign financial institutions in their locally incorporated companies are not transferable without the prior written approval of the Nepal Rastra Bank (the central bank) or any other competent authority as the case may be. Representative offices may not be engaged in commercial business. The members of the Board of Directors of a financial service supplier will be in proportion to equity representation of that financial service supplier."

The general commitments provide the broad environment of FSS in Nepal. These can be further broken down into sub-sector service commitment by limitations on market access and limitation on national treatment, and are given as below:

The above provide two aspects for the "Insurance and insurance related services" of FSS for Nepal. In the second column of limitations on market access, where mode 1, 2 and 3 there are no restrictions except for "re-insurance and retrocession" where in mode 1 and 2 it is "mandatory reinsurance up to USD 25,000 must be placed with domestic insurance company until 31 December 2007" and mode 3 is unbound until 31 December 2007 "thereafter non,

2. Banking and Other Financial Services		
(a) Acceptance of deposits and other repayable funds from the public (b) Lending of all types, including, inter-alia, consumer credit, mortgage credit, factoring and financing of commercial transactions. (c) Financial leasing (d) All payment and money transmission services (e) Guarantees and commitments (f) Trading for own account or for account of customers, whether on an exchange, an over-the-counter market or otherwise, the following: - money-market instruments (cheques, bills, certificates of deposits, etc.) - foreign exchange - derivative products including, but not limited to, futures and options - exchange rate and interest rate instruments, other than swap. - transferable securities - other negotiable instruments and financial assets, including bullion. (g) Participation in issues of all kinds of securities, including under-writing and placement as agent (whether publicly or privately) and provision of service – related to such issues. (h) Money broking (i) Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial depository and trust services. (j) Settlement of and clearing services for financial assets, including securities, derivative products, and other negotiable instruments (k) Provision and transfer of financial information, and financial data processing and related software by providers of other financial services. (l) Advisory services on all the activities listed above	(1) Unbound, except for (k) provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services and (l) advisory services on all the activities listed above were none (2) Unbound, except for (k) provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services and (l) advisory services on all the activities listed above were none (3) None, except as indicated in general conditions. For derivative products under sub-sector 'f' and settlement of and clearing services for financial assets, including securities, derivative products, and other negotiable instruments under 'j' unbound until HMG/Nepal determines what types of entities can conduct these services, the related laws and regulations are established and such business is authorised by the government or other designated authority. (4) Unbound, except as specified in the horizontal section. (5) Unbound, except as indicated in horizontal section.	(1) None (2) None (3) None, except as specified in the general conditions and horizontal section

except as indicated in the general conditions". The fourth mode of supply, on the other hand, is unbound. Likewise in the third column with respect to the limitations on national treatment Nepal has committed to "None" for mode 1, 2 and 3 while for mode 4 it is unbound as above.[31]

The above provides two aspects for the "Banking and other financial services (excluding insurance)" of FSS for Nepal. In the second column is the limitations on market access, which are unbound for mode 1 and 2 except for "provision and transfer of financial information and financial data processing and related software by suppliers of other financial services" and "advisory services on all the activities listed above" are none. Likewise for mode 3, there is no limitations, except those as indicated in the general conditions shown above; this excludes those for derivative produces under sub-sector "f" and settlement of and clearing services for financial assets, including securities, derivative produces, and other negotiable instruments under "j" unbound until HMG/Nepal determines what types of entities can conduct these services, the related laws and regulations are established and such business is authorized by the government of other designated authority". Further, mode 4 is unbound. Likewise, in the third column with respect to the limitations on national treatment, Nepal has committed to "None" for mode 1, 2 and 3 while mode 4 is unbound.[32]

There are three observations in regard to the above commitments by Nepal. First, it is felt that the mentioned commitment, arguably in one way, maintain the domestic status quo, and thus reflect the country's macroeconomic fundamentals[33] although it should be emphasized that, by the very fact of committing, this signals the seriousness of Nepal in regard to maintaining liberalization of the FSS (Tamirisa et al., 2000). Secondly, the commitment of 'None' in regard to national treatment for modes 1, 2 and 3 conveys that there will not be any discrimination vis-à-vis domestic supplier in these modes of supply. Lastly, the restricted nature of fourth mode of supply is common with other countries which may likely reflect the different labor and immigration laws of the specific countries, and is also true for Nepal.[34]

Activities of NRB

The above description of FSS commitments with Nepal's WTO membership suggests that there are both opportunities and challenges for Nepal's financial sector. The focus of this section is on those activities by the NRB related to FSS. As FSS covers two sectors: namely AII and BOFS with the prior being the responsibility of the Insurance Board of Nepal[35] while the later being the responsibility of NRB[36], the paper focuses mainly on BOFS which is the purview of the NRB, and is broken down into three parts namely: (1) HLC; (2) HLC Secretariat; and (3) HLC established taskforces.

V.A. HLC: NRB, aware of this enormous responsibility to the FSS and to the overall national growth and economic development, has decided to proactively address this challenge. This decision is reflected in the establishment of the HLC, as had been mentioned earlier. The HLC was represented during most of the negotiations concerning Nepal's WTO accession negotiation, both in the country and abroad. The present stability in the financial sector makes it safe to conclude that NRB had discharged the responsibility and provided sound and timely advice, which helped minimize any possible adverse effects resulting from WTO membership.

However, having become the first LDC[37] to have gained membership in WTO via full accession process, the HLC was aware of the enormous responsibility which lay ahead in ensuring the maintenance of domestic financial stability – as had been mentioned earlier, it was felt that domestic financial stability would facilitate domestic economic growth and development. In this regard, the first and most important role for the Bank, as felt by the HLC, was to ensure coordination of both information collection and dissemination from NRB. As such, the member-secretary of the HLC, who is the Director in charge of SSD, has been made the WTO Focal Point at NRB. This necessarily suggests that all information to and from NRB pertaining to WTO related matters, has to come to the attention of the Bank's WTO Focal Point. It is felt that this important step will ensure that NRB will speak with one consistent voice, to enhance credibility and eliminate any possible confusion that may arise.

A salient achievement of the HLC was hosting an interaction program held on 14 November 2003 at the Soaltee Crowne Plaza, Kathmandu, which had been chaired by the Coordinator of the HLC, Deputy Governor Mr. Ram Babu Pant, with presentation by Dr. Zdenek Drabek, Senior Adviser at the World

Trade Organization with participation of Mr. Bijaya Nath Bhattarai, Deputy Governor, Nepal Rastra Bank; Dr. Subarjo Joyosumarto, Executive Director of the South East Asian Central Banks (SEACEN) Research and Training Centre; Mr. Narendra K. Bhattarai, Chairman of the Banker's Association of Nepal; Mr. Prem Shankar Shrestha, Chief of the Credit and Information Bureau; as well as most of the Executive Directors and Directors from the NRB. This interaction program followed the successful hosting of the SEACEN Seminar entitled "WTO and Liberalization of the Financial Services Sector in SEACEN Countries", November 11 - 14, 2003, Soaltee Crowne Plaza, Kathmandu, Nepal

V.B. HLC Secretariat: Further to the above, the HLC acutely felt the need to be aware of development in WTO-FSS matters. As such, this responsibility was added to those existing by the HLC Secretariat whose specific responsibilities are: (a) to continuously monitor major development in WTO-FSS related issues nationally and internationally, mainly dealing with services sector of concern to the bank; (b) to interlink with relevant authorities both in Nepal [e.g. MOICS of HMG/N, Non-Government Organization's etc.] as well as internationally [e.g. WTO Secretariat, SEACEN, South Asian Association of Regional Cooperation (SAARC) etc.] to facilitate the process of information collection; (c) to develop and maintain periodic briefs which update developments in WTO-FSS related issues and provide critical analysis, as necessary, along with provision of a series of single/joint publications [in the medium/long term]; (d) to identify relevant areas for policy changes compatible with WTO commitments and provision of safeguards to be taken in consultation with appropriate authorities and to initiate necessary action, in this regard; and (e) to conduct seminars and training programs to create awareness about WTO-FSS both among the officials at NRB and the stakeholders. The HLC Secretariat is housed in the Research Department, whose head is the Deputy Director of the SSD.

V.C. HLC established taskforces: It is with awareness of the objectives mentioned earlier that the HLC in their 27th August 2003 (10th of Bhadra 2060) meeting, decided to direct the HLC Secretariat to produce two concept papers in regard of: (1) foreign bank branches and the health and stability of Nepal's financial system and the other on (2) Nepal's service sector commitments and its impact on domestic balance of payments (BOP) situation. Both of those concept papers were presented to the HLC and in their 9th of December 2003 (23rd of Mangsir 2060) meeting, both were endorsed and two separate task forces were established.

- The first task force was established to provide necessary rules and regulation for foreign bank branches in Nepal and to ensure a healthy domestic financial intermediation and ensure stability of the domestic financial system. The basic objectives of the Task force as set out in the 2 January 2003 (18 Poush 2060) of the HLC are as follows [unofficial translation]: (a) to study the legal provisions regarding the nature and working procedures of foreign bank branches of different countries; (b) to study the regulation and supervisory system of foreign bank branches; (c) to study the comparative and detailed analysis of the experiences on the operation of foreign bank branches in SAARC, SEACEN and other countries and the policy adopted by these countries regarding the foreign bank branches; (d) to recommend the appropriate policy, directives and rules regarding the opening of foreign bank braches in Nepal; to study the contribution and the role of foreign bank branches in the enhancement of financial intermediation and to meet the productive investment of Nepal; and (e) to study on other related matters on foreign bank branches, as necessary. This task force is composed of inter-departmental members coordinated by a Director of BFIRD with three Deputy Directors each from LD, BFIRD and RD (SSD), an Assistant Director from BSD along with the member-secretary being the Assistant Director from RD (SSD).

The taskforce had formally commenced work in May 2004 and has been able to collect information from identified countries in both South and East Asia (India, Pakistan and Sri Lanka in South Asia and Indonesia, Philippines and Thailand in East Asia), based on an agreed format which includes both Legal, Banking and Supervision perspectives.[38] It is important to note that this format builds on the strength of the task force composition. Information has been obtained and those are in process of being place

in the mentioned categories, with necessary analysis to take place from the concerned taskforce members in addition to a comparison with existing domestic situation. Further, and with the desire to enrich the report output, appropriate experts in this field have been identified with interview in process. Once those are completed, it is hope that the development of the final report will also be shortly completed.

The task force is expected to have work finished by mid-2005.

- The second task force has a more difficult task to determine foreign exchange management and impact on the BOP with Nepal's membership in WTO. The specific terms of reference, as decided by the 9th meeting of the HLC on 2 January 2003 (18 Poush 2060), are presented as follows [unofficial translation]: (a) to analyze clearly the different possible impacts of services sector commitments on Nepal's BOP and monetary management; (b) to study in detail about the steps to be taken for the foreign exchange management to ensure a more effective and healthy payment system and the international trade; (c) to recommend the safeguard measures that can be applied consistent with the WTO rules and other accepted practices in case there is a BOP crisis; (d) to recommend the amendments or changes that is necessary to meet the above [third] objective; and (e) to study other relevant matters concerning the impact of opening of services sector on foreign exchange management and BOP situation. This task force is composed of inter-department coordinated by a Director of RD (BOP) with the four Deputy Directors from LD, FEMD, RD (BOP) and RD (Monetary Division) and the member-secretary being the Deputy Director of RD (SSD).

This task force has agreed on a conceptual model linking the service sector commitments to the BOP via the channel of the modes of supply, and is shown schematically in the first appendix. Utilizing this conceptual model, a draft survey questionnaire had been produced which was refined through discussion with selected WTO experts with development of three separate types of questionnaires. It is important to note that during discussion, the necessity of having an interaction with WTO focal points (as designated by HMG/N and others) to convey important aspects of the survey questionnaire and field questions, had been voiced. An interaction program had been approved by the HLC and this had taken place on 11 November 2004 chaired by the Coordinator of the HLC, Deputy Governor Mr. Ram Babu Pant, with participation of Mr. Bijaya Nath Bhattarai, Deputy Governor, Nepal Rastra Bank and other HLC members along with HMG/N identified WTO-Focal points. This interaction had been based on a presentation by Mrs. Shiba Devi Kafle, Coordinator of the mentioned task force and Act. Director, Research Department.

The successful completion of the interaction program heralded an auspicious beginning for the actual survey in process. This is presently ongoing with the taskforce members delivering questionnaire to designated WTO focal points from: Nepal Attorney General's Office; MOICS of HMG/N; Ministry of Finance of HMG/N; Ministry of Health of HMG/N; Ministry of Education and Sports of HMG/N; Ministry of Forestry and Soil Conversation of HMG/N; Ministry of Law, Justice and Parliamentary Affairs of HMG/N; Ministry of Information and Communication of HMG/N; Ministry of Science and Technology of HMG/N; Federation of Nepalese Chamber of Commerce and Industry; Nepal Chamber of Commerce; and Confederation of Nepalese Industries. The obtained survey data were incorporate into previously developed templates to facilitate projection analysis on foreign exchange implications; these projections are form the short, medium and long term.[39] These foreign exchange projections have contributed both to an analysis of monetary implication and creation of a Strength, Weakness, Opportunity and Threat (SWOT) analysis; the later results provided necessary input to facilitate development of appropriate recommendations, reflected in report publication. The draft report has been submitted to the HLC, which it is hoped will be refined through necessary feedback and suggestion before production of the final report.

The taskforce is likewise expected to have its report completed by late 2005.

Concluding Discussion

The prior discussion suggests that with Nepal's membership in WTO, the NRB has been proactive in addressing the potential challenges. However, it is also clear there are many other many other potential trials for domestic financial stability – volatility in capital flows; fragility of domestic financial sector with new technologies; and necessity for addressing safeguard measures as and when necessary - resulting from the dynamic nature of FSS. This nebulous nature of FSS can perhaps be reflected in the many and diverse communications to the Council of Trade in Services [Committee on Trade in Financial Services] from countries as Australia (2001), Colombia (2001), Cuba (2002), Korea (2001), Malaysia (2003), Switzerland (2001) etc. – for example, Switzerland (2001, p.3) has described that financial innovation has made the distinction between mode 1 and mode 2 supply fuzzy and has proposed "to examine the possibility of merging these two modes in the area of financial services." These communications suggest that NRB should also monitor and actively participate for developments in the important aspects of FSS which are currently taking place. Those above mentioned communication highlight three major areas which are important presently for Nepal, namely:

- *Issues relating to capital account:* Liberalization in FSS and financial services trade can have profound implications on the capital account.[40] It is thus important to have appropriate liberalization of FSS, for reaping the maximum possible benefits for the country without affecting the existing policy on the capital account; past crisis suggest that preparation has been able to reduce the cost of monetary and exchange rate crisis. Further in the future, it is important to ensure that FSS liberalization moves in parallel with prudential regulations, along with the necessary mechanism for supervision and inspection or potentially face significant repercussions on maintaining domestic financial stability, especially if those are not in place (IMF, 2001).[41] This is especially true in Nepal with there presently being significant Non-Performing Assets of the commercial banks in the domestic financial markets, despite the continuing efforts in the area of financial sector reform.[42] In this regard, it is felt that unless these issues are addressed, further liberalization of FSS may be detrimental to domestic financial stability.
  - *Issue relating to coordination with relevant actors in domestic FSS* – it is also important to coordinate with relevant actors in regard to FSS to ensure that implementation is done in a unified manner. This may be with the private sector, and as is already happening with in the BOFS. However, there is necessity that there has to be coordination between the NRB and IB, as well as with other stakeholders both in the government and outsice, in domestic FSS.
- *Issues relating to E-commerce* – This is an important issue driven by technological advances, which has up to now greatly facilitated financial payments.[43] These developments have not escaped the Nepalese economy that has witnessed innovations in the FSS sector reflected in the promulgation of a cyber law or "Electronic Transaction and Digital Signature Act - 2004". The cyber law has given legal status for various banking transactions through electronic media, and it is hoped that this will be instrumental in boosting, through facilitation, economic activities throughout the world via Internet.[44] In other words, this channel will spurt economic interactions. However to ensure that the benefits will be reaped, an important question which NRB - as is being asked by other central banks (Kusmiarso, 2004) – is grappling with is what type of regulatory and supervisory framework is necessary? It is felt that this question is of crucial importance especially since there are significant potential impacts on the economy and the financial system such as increased possibility of financial reversals which lead to financial crisis[45] etc.
- *Issues on Emergency Safeguard Measures for Services* – The above suggests that WTO provides a stable rule based trading environment which will likely facilitate trade, however an unexpected situation may arise were there is BOP crisis; this would necessitate NRB to take strict action for maintenance of domestic financial stability. This action is described by WTO (2003) as those whereby "a WTO member may restrict imports of a product temporarily (take "safeguard" actions) if its domestic industry is injured or threatened with injury caused by a surge in imports." In other words, emergency action is necessary to protect a specific domestic industry from an unforeseen increase of imports of any

product which is causing, or which is likely to cause, serious injury to the industry. While for trade in goods there is a separate agreement of Emergency Safeguard Measures, for services is not clear when and by what means this should take place. The field is quite fluid with there being different proposal for interpretation, such as that proposed by ASEAN (WTO, 2000). Due to the importance of this issue, it is important for NRB to be clear on what stance it should take in this regard, as well as for the need to incorporate the provisions in relevant acts, etc (Maskay, 2004 b). In this regard, it is felt that there be necessary consultations and interactions.

Endnotes

1. Membership is WTO was based on the approval given on 11 September 2003 (WTO, 2003) at the fifth Ministerial Conference at Cancun, Mexico (WTO, 2004).

2. A reflection of this process can be seen with Nepal having accepted the IMF's Article of Association VIII on 30 May1994.

3. This later can be reflected in greater competition, with lower cost and higher quality goods, as well as the opportunity for reaching the potential inherit in the country's comparative advantage (WTO, 2001), as well as for greater pace of economic development.

4. There are twelve sectors in GATS namely: Business (including professional and computer) services; Communication services; Construction and related engineering services; Distribution services; Educational services; Environmental services; Financial (insurance and banking) services; Health-related and social services; Tourism and travel-related services; Recreational, cultural and sporting services; Transport services; and Other services not included elsewhere).

5. An example will help clarify the importance of this later service provided by FSS. Take a foreign transport service, this is an arbitrarily chosen service which can be applied to any of the other services, that is consumed in the domestic economy. For consuming that foreign transport service, payment must be made to the foreign transport service company. The role of FSS is to facilitate the payment mechanisms as funds in domestic currency are converted to foreign currency and transferred to the foreign account.

6. The financial services annex says that governments have the right to take prudential measuring, such as those for the protection of investors, depositors and insurance policy holders, and to ensure the integrity and stability of the financial system. It also excludes from the agreement services provided when a government exercises its authority over the financial system, for example central bank's services. Negotiations on specific commitments in financial continued after the end of the Uruguay Round and ended in late 1997.

7. The only exception to this is when there are BOP difficulties and even then, the restrictions must be temporary and subject to other limits and conditions.

8. Presently Deputy Governor Mr. LN Bhusal; the first coordinator had been Deputy Governor Mr. RB Pant

9. Presently Deputy Governor Mr. KB Manandhar; the first member Deputy Governor was Mr. BN Bhattarai

10. BSD was included at a later date.

11. This is with the terms of reference "to examine the application of the Government of Nepal to accede to the World Trade Organization under Article XII, and submit to the General Council recommendation which may include a draft Protocol of Accession."

12. It must be noted that WTO provides for observer status for governments to allow them to familiarize themselves with the organization and to prepare for accession negotiations.

13. It should be noted that prior to this, there had been some preparatory assistance by United Nation's Development Program as far back as 1997.

14. Then Mr. Ram Krishna Tamrakar

15. Then Mr. Mohan Dev Pant

16. While this is the second round of negotiations, it is the first round of bilateral negotiations with interested member countries on the market access based on Nepal's schedule of tariff concessions and schedule of initial commitments in services sector.

17. For the prior this had been led by thensecretary of MOICS Mr. Bhanu Acharya while for thelater this had been led by the then secretary of MOICS Mr. Labha Prashad Devkota.

18. The *Tejarath Adda* had been established in 1880 however, as it had been only a credit institution, it did not play the essential role of financial intermediation.

19. For further information seewww.nrb.org.np

20. For further information see www.bsib.org.np

21. The umbrella act repealed and covers earlier acts such as the Commercial Bank Act 1974, Development Bank Act 1996 and Finance Company Act 1986.

22. There also exists the International Financial Transactions Act, 1998 however the goal of offshore banking has not actualized.

23. The rationale for using this system, versus other comparable systems, is given in (WTO, 1998).

24. This is show in the second article entitled "Domestic Regulation" which is as: (a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement. (b) Nothing in the Agreement shall be construed to require a Member to disclose information relating to the affairs and accounts of individual customers or any confidential or proprietary information in the possession of public entities.

25. The discussion will be consistent with the schedule of the selected SAARC member countries' FSS is provided on the Internet web home page of Nepal Rastra Bank at www.nrb.org.np as the first and second appendix for market access and national treatment respectively for the interested to look into its details.

26. he GATS states that "in the sectors covered by its schedule, and subject to any conditions and qualifications set out in the schedule" each member shall give treatment to foreign service and service suppliers treatment, in measures affecting supply of services, no less favorable than it gives its own service and suppliers.

27. For case of understanding, the general [skeleton] table format for market access, which is also true for national treatment, is presented below in tabular form:

Financial Service Sector – limitations to market access	
All insurance and insurance-related services	1) Cross-border supply 2) Consumption abroad 3) Commercial presence 4) Presence of Natural persons
Banking and other Financial Services (excluding insurance)	1) Cross-border supply 2) Consumption abroad 3) Commercial presence 4) Presence of Natural persons
Other	1) Cross-border supply 2) Consumption abroad 3) Commercial presence 4) Presence of Natural persons

This is likewise demonstrated in the example of Nepal FSS commitments, as shown in the attached appendix.

28. An example from WTO (1998) will clarify this "if a government commits itself to allow foreign banks to operate in its domestic market, which is a market access commitment. And if the government limits the number of licenses it will issue, then that is a market access limitation. If it also says foreign banks are allowed one branch while domestic banks are allowed numerous branches, that is an exception to the national treatment principle."

29. Although activities such as ship repair abroad, where only the property of the consumer moves, or is situated abroad, are also covered.

30. Where all modes of supply are "unbound", and no additional commitments have been undertaken in the sector, the sector should not appear on the schedule.

31. NRB (2002) finds for India, Pakistan and Sri Lanka, those countries in SA which have made commitment in IIRS of FSS generally have restriction on mode 1, 2 and 4 although varying in terms of commitment in mode 3.

32. NRB (2002) finds for India, Pakistan and Sri Lanka, those countries in SA which have made commitment in BOFS of FSS generally have restriction on mode 1, 2 and 4 although varying in terms of commitment in mode 3.

33. The importance of this was pointed out be (Valckx, 2002).

34. Sorsa (1997) observed that many countries with developed financial markets made narrow

commitments while those with less developed financial sectors made very liberal commitments. The author then concluded that the results suggest that "mercantilist bargaining rather than economic, explains the bulk of the GATS liberalization commitments."

35. For further information seewww.bsib.org.np

36. Before proceeding, it is important to point out that with financial sector development, the distinction between insurance and BOFS is blurred with both services converging rapidly in developing countries – as had been mentioned by Switzerland (WTO, 2002).

37. A country designated by the United Nations as least developed based on low per capita GDP (the threshold of inclusion is generally $800), weak human resources (life expectancy at birth, per capita calorie intake, combined primary and secondary school enrolment, and adult literacy) and a low level of economic diversification (share of manufacturing and other measures). As of 2002, there were 49 LDC's of which Bangladesh, Bhutan, Maldives and Bhutan are from the South Asian region. It is also important to note that the criteria for determining the list of LDC's are under review where the committee for Development Policy has recommended the diversification index be replaced by an economic vulnerability index to reflect the main external shocks (UNCTAD, web page).

38. Information has been obtained with the help of SAARCFINANCE and SEACEN.

39. During the discussion and analysis, it had been noted that the projection are based of a static nature.

40. These are clarified Kono and Schuknecht (2000) and elaborated in Maskay (2002) for the Nepal case, who make the distinction between financial services trade (i.e. if financial service is provided by the foreign financial service supplier in the domestic economy) or for international capital flows (i.e. supplying foreign capital in the domestic economy). Those articles suggest that liberalization of FSS can be differentiated from liberalization of the capital account.

41. For Nepal, a similar conclusion was drawn by Maskay (1999) who also pointed at the potential for financial and exchange crisis with an increase in international capital flows.

42. Nepalese financial system may face the challenge of the deteriorating corporate governance, along with concerns about the professional management in the financial institutions..

43. The importance had been acknowledged by the Geneva Minister Conference (1998) who adopted a declaration of Global electronic Commerce; this is more fully described in Dasgupta (2002).

44. Mention should also be made of asymmetric application of technological development with the government owned commercial banks, due in part to their large working network even in the rural areas and the presence of a large number of untrained staff, been less likely to take advantage of this.

45. This would be through contagion effect and self-fulfilling behavior.

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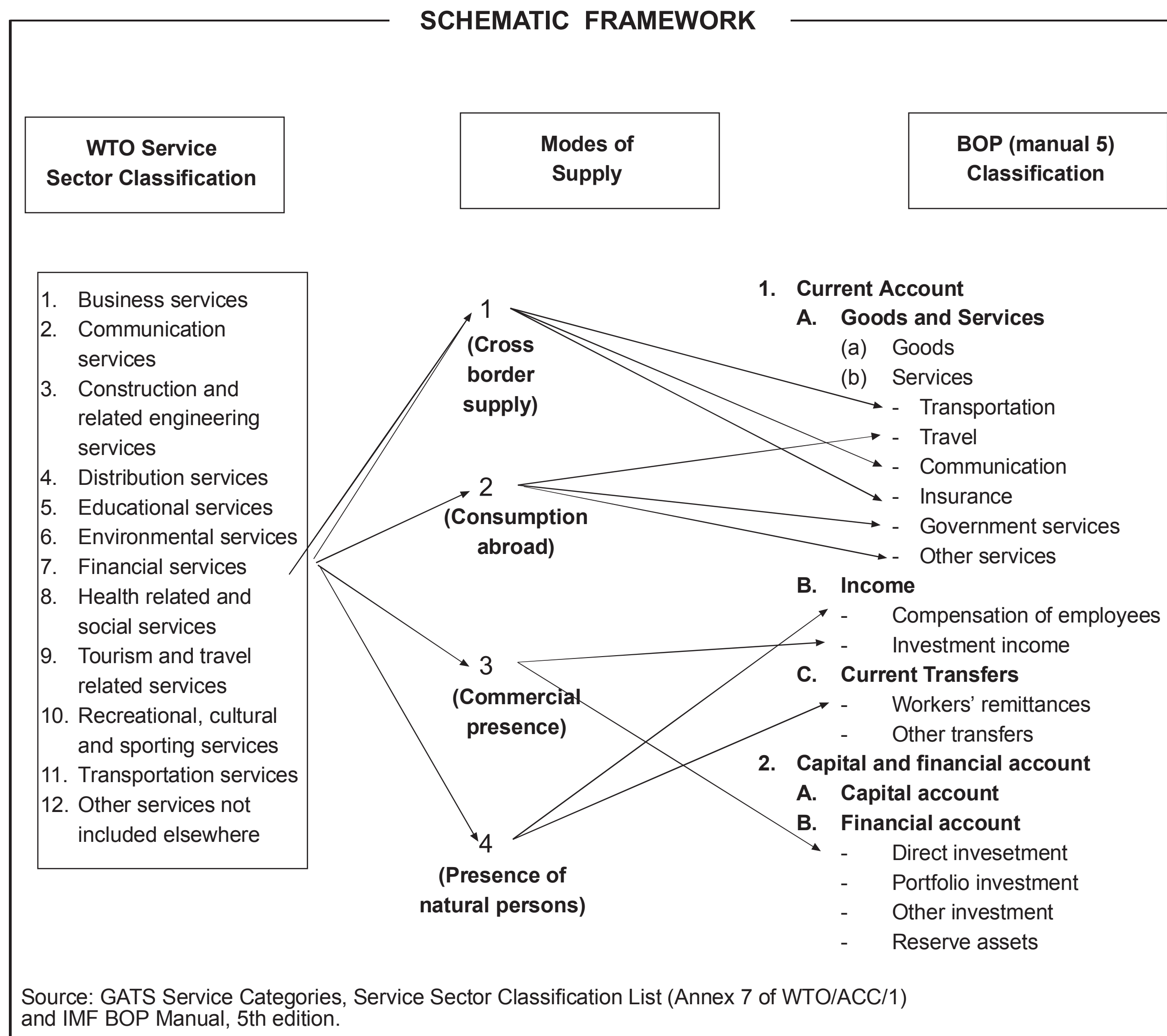
Appendix 1

Schematic framework for WTO-GATS impact on Nepal's BOP



Source: GATS Service Categories, Service Sector Classification List (Annex 7 of WTO/ACC/1) and IMF BOP Manual, 5th edition.

The above schematic is taken from the mentioned second taskforce. The left hand side of the model includes the WTO classified service sectors, while the right hand side of the model includes the different classifications of the BOP. Both are linked by methods of supplying the service, as defined by WTO, viz. cross border supply; consumption abroad; commercial presences; and presence of natural persons.

Specifically and for the Nepal case, for the study assumes via empirical observation that the major impact of mode 1 will be on the Communication Service and Transportation Service sub head of the BOP. Similarly, mode 2 affects mainly the Travel subhead and Government Services sub head of the Service Account. Mode 3 affects the FDI of the financial account and thereby Investment Income of the Income Account. It should be noted that the FDI sub head of the BOP statistics include both the manufacturing and the service sector. However, in the mentioned task force study, the trend of FDI in the service sector is only examined. Lastly, transactions through mode 4 in the services affect the Compensation of Employees sub head of the Income Account and Worker's Remittances of the Current transfers account.

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