EXECUTIVE SUMMARY

Foreign exchange management in Nepal, especially where trade deficit as a share of GDP is quite large and no stable and dependent source of foreign exchange has yet emerged, is crucially important for ensuring viability and stability on both the external and domestic fronts of the economy. From February 1993, Nepal substantially adopted current account convertibility --- that is the peg with INR continued but flexible exchange rate was adopted with the rest of the world.

Of particular interest is the policy whereby Nepal has adopted a fixed exchange rate with INR since April 1960. To maintain the peg with INR and to cater to the demand for INR, intervention by the Central Bank in the local foreign exchange market through purchase of INR against the USD has been increasing both in frequency and amounts in recent years. Thus, the accumulated foreign exchange reserves on account of remittance inflows have been used to maintain the peg with INR. Foreign exchange investment by the Central Bank has also been an important feature of Nepalese foreign exchange reserves management.

The overall objective of the study is to understand the process and explore the pertinent issues relating to the foreign exchange management in Nepal. The specific objectives of the study are to: (a) study the present situation of, and regulations with respect to, the foreign exchange market, (b) review the foreign exchange regime and identify the specific factors responsible for the choice of the exchange rate regime, (c) evaluate the sustainability of the fixed exchange rate regime with India and the variable exchange rate regime with the rest of the world, (d) study and analyse the foreign exchange market Intervention process, (e) study the pace and structure of integration with the outside world in terms of goods, services and capital transactions, (f) analyze and evaluate the foreign exchange reserves management practices, and (g) suggest strategies and measures for effective foreign exchange management.

The study is based on time-series data, both primary and secondary. The collected primary data on the informal market exchange rates from money changers, petrol pump

operators, goldsmiths, and businessmen in the vicinity of the border with India have also been used. Required financial management tools like ratio analysis and statistical techniques, viz., regression and significance tests, have been used and inferences have been arrived on the basis of the aforesaid methods. The study's limitations include the relationships postulated for the regression analysis and that it is not based on international comparative analysis.

The results point to a need to move away from the policy of pegging, which has remained unchanged since 1993. Unifying the exchange rate prevailing in formal and informal markets is the first precondition toward eliminating the existence and implications of the informal market. The corollary is the introduction of a market-based, flexible exchange rate. This calls for an environment of political stability, coupled with the pursuance of deeper economic reforms and an efficient financial system, to achieve macroeconomic soundness. Depending on the progress, capital account convertibility in Nepal could be carefully looked at in the long term. Additionally, since sources of foreign exchange reserves are fragile, Nepal should tap alternative avenues such as FDI in hydro-power and tourism for long term viability of the BOP.

Reserves management should be improved by portfolio diversification, currency-wise, instrument-wise, region-wise and tenure-wise. Investment in gold should be increased up to five to 10 percent from the present three percent, by reducing the portfolio weights of other reserve assets proportionately.

Meanwhile, until the measure of dismantling is taken, the prevailing intervention process needs many fundamental improvements for effective foreign exchange management. The intervention should be done at Central Bank's initiation rather than at the request of the individual BFIs. The process should be guided by the need of the economy rather than the benefit of the market participants.