



Review of Nepalese Monetary Policy Framework

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Outline

- Current Monetary Policy Framework (MPF) in Nepal
- Institutional Set-up of the Current MPF
- MPF in Neighboring Countries
- Modernization Process of the MPF at the Global Level
- Major Concerns of the MPF in Nepal
- Monetary Policy Environment in Nepal
- Topics for Discussion

Current Monetary Policy Framework in Nepal

Major building blocks of current framework

- a) Statutory mandate: Multiple goals as enshrined in the NRB Act 2002:
 - i. Price stability
 - ii. External sector stability
 - iii. Facilitating growth
- b) Nominal anchor: the currency peg
- c) Intermediate target (information variables): Multiple. They are monetary and credit aggregates.
- d) Operational target: Excess reserves of the counterparties

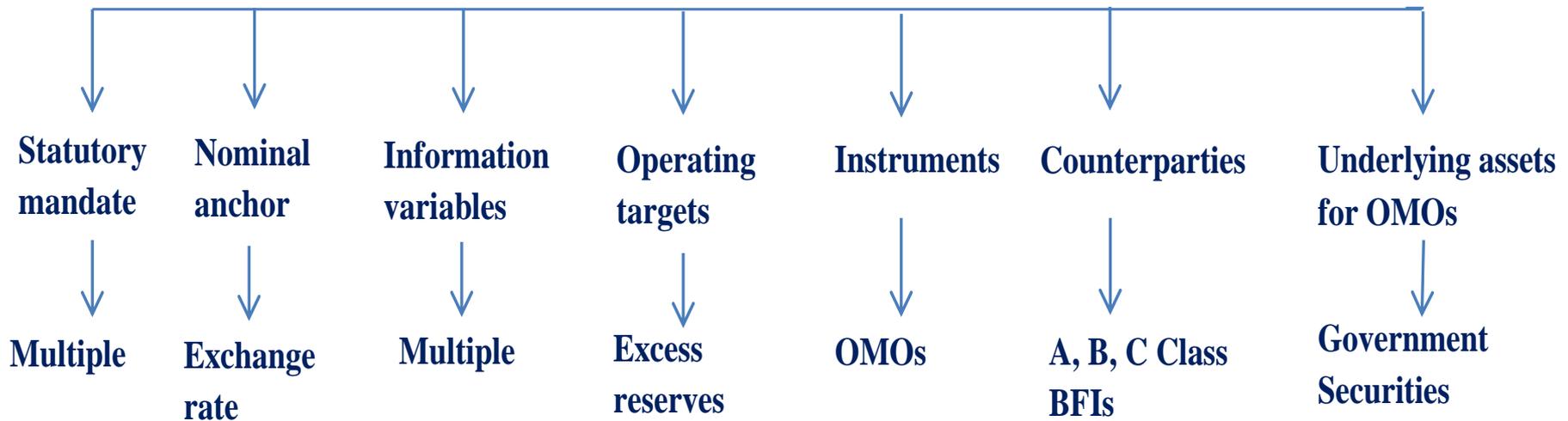
Current Monetary Policy Framework in Nepal

- Counterparties
 - A, B and C class financial institutions
 - Monetary operations takes place with them
- Monetary instruments:
 - i. Main instruments: OMOs. open market instruments are sale, purchase, repo and reverse repo auctions
 - ii. Underlying assets for OMOs are: Treasury bills, development bonds of the GON, NRB bonds in case they exist.
 - iii. OMO like instruments: deposit collection auction, NRB bonds if they are issued.
 - iv. Other instruments are : (a) CRR, (b) SLR, (c) SLF, (d) refinancing facilities

Current Monetary Policy Framework in Nepal

The following chart encapsulates the current framework in Nepal

Chart 1: The Current MPF in Nepal

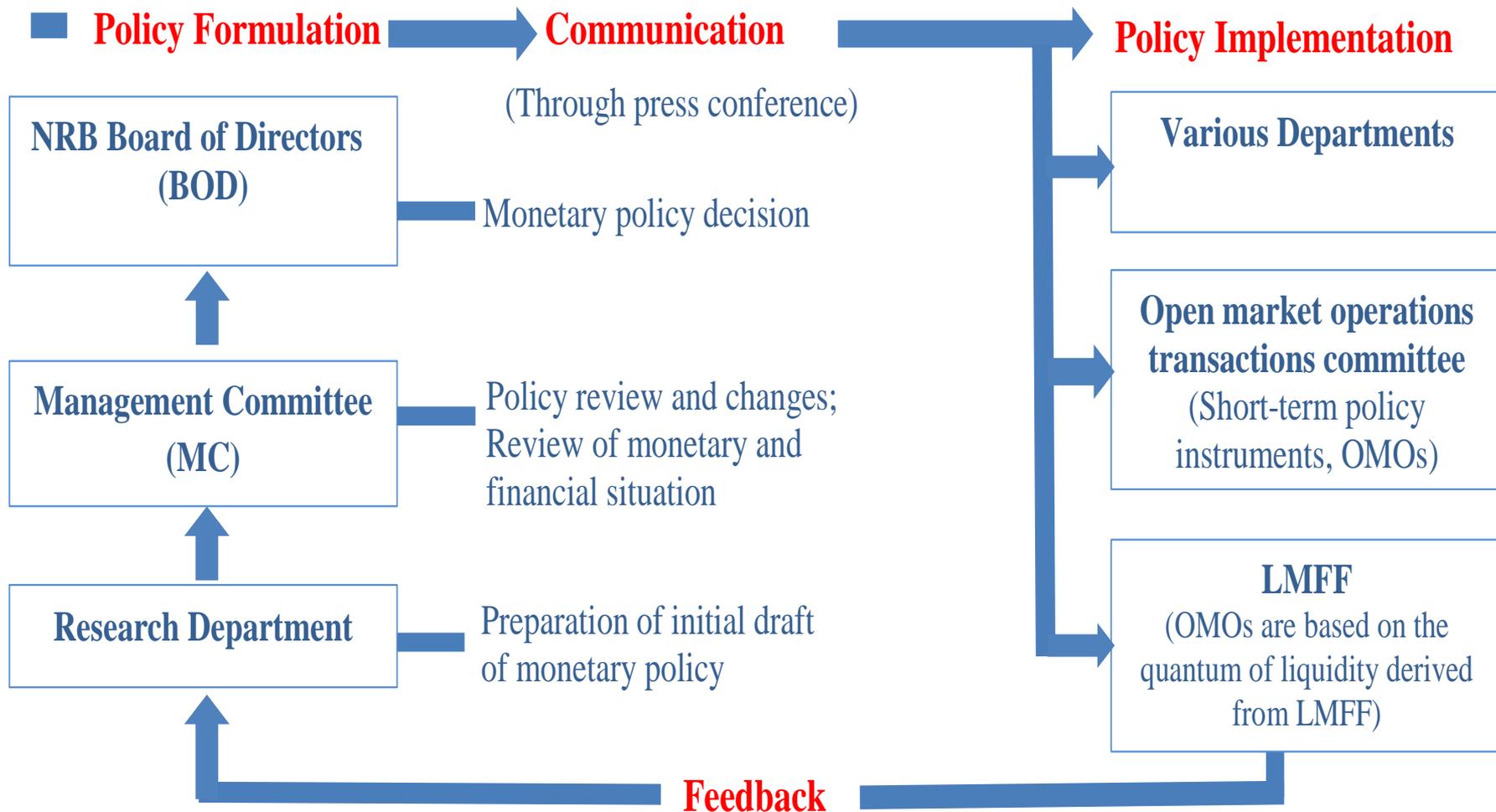


Current Monetary Policy Framework in Nepal

Formalization of the MPF

- Bits and pieces of the current MPF were there since 1960
- Currency peg introduced since 1960
- A host of monetary policy instruments introduced in 1966
- NRB bond issued in 1991
- Modern form of OMOs introduced since 2004/05
- The current framework formalized and implemented since 2004/05

Institutional Set-up of the Current MPF



Monetary Regimes at the Global Level

Monetary Regimes	No of Countries	Examples
Inflation targeting (IT)	34	New Zealand, UK, Ghana, India, Canada
Monetary targeting (MT)	25	Bangladesh, Sri Lanka, Ethiopia, China
Exchange rate anchor	89	
Conventional peg	44	Nepal, Bhutan, Namibia, Saudi Arabia, Qatar
Peg with Basket	12	Fiji, Libya, Singapore, Vietnam, Botswana
Other regimes (Multiple indicator approach)	43	Angola, Bolivia, Argentina, Belarus, Austria, Pakistan, Switzerland

Framework in Neighboring Countries

Country	Nominal Anchor	Intermediate Target	Operating Target	Interest Rate Corridor	Monetary Policy Committee
Bangladesh	MT	Broad money	Reserve money	-	Yes
China	MT	Broad money	Reserve money	-	Yes
India	IT	Inflation forecast	Repo rate	Yes	Yes
Pakistan		Inflation (others)	Repo rate	Yes	-
Sri Lanka	MT	Broad money	Reserve money	Yes	Yes

MT=Monetary targeting, IT=Inflation targeting

Modernization Process of the MPF at the Global Level

The major building blocks of the emerging framework are:

a) Inflation targeting (IT)

- Initially adopted by New Zealand in 1989.
- Currently 34 countries have IT in place and India has flexible IT since February 2015
- Common features of IT framework include:
 - Clearly stated commitment (mandate) to price stability
 - Transparency in monetary policy settings
 - Explicit numerical target for inflation (with time horizon)
 - Accountability mechanism: MPC
- Preconditions of IT
 - Institutional independence, analytical capability and infrastructure (inflation forecasting and modeling capability, data for implementation) at the central bank.
 - Healthy financial system and economic structure (deregulated prices, low exchange rate pass-through)

Modernization Process of the MPF at the Global Level

- b) Moving to an interest rate-based operating framework (including the interest rate corridor)
- c) Greater exchange rate flexibility
- d) Developing analytical tools for policy making (including inflation forecasting and LMFF)
- e) Accountability through the collegial (monetary policy) committee : MPC
- f) Developing techniques for effective communication including forward guidance

Concerns Over Monetary Policy Framework in Nepal

On strategical part

- The overall growth concern: macro analysts argue that the current framework is not delivering on growth. Hence, the current strategy is not appropriate and should be changed
- International trade concern: it is argued that the framework is not addressing the issue of trade gap. The issue of export promotion is the major concern.
- Price stability concern: it is argued that inflation has remained relatively high and volatile in Nepal. Keeping inflation at a desired level has been challenging in Nepal.

Concerns Over Monetary Policy Framework in Nepal

On strategical part (Contd...)

- The focal point of all these concerns is the nominal anchor, that is, the currency peg.
- However, views on the nominal anchor differ: The donor community, especially the IMF is in favor of the currency peg.
- The IMF views that the peg has served Nepal well.
- Likewise, most of the policy makers in Nepal are in favor of the peg.
- In this context, can we change the strategy of the monetary policy in Nepal? Can we change the current nominal anchor?

Concerns Over Monetary Policy Framework in Nepal

Operational Aspect

- The counterparties have expressed their concern about the operational target of monetary policy.
- They favor interest rate rather than the quantity, that is, excess reserves as operational target of monetary policy.
- Counterparties argue for interest rate corridor. However, there are counter arguments:
 - Interest rate as operating targets can be relevant only when we have flexible exchange rate.
 - It will be relevant only when transmission mechanism, that is, interest rate channel of MP is certain. In the case of Nepal, transmission mechanism, especially, interest rate channel is uncertain.
 - Interest rate as operating target can be relevant for macroeconomic stability in case there is capital account liberalization, especially short-term capital flows.

Monetary Policy Environment in Nepal

Fiscal Policy

- Fiscal dominance is limited. NRB Act caps the government overdraft borrowing at 5 percent of the government revenue of the previous year.
- The public debt ratio is falling. Currently, it is 25.4 percent of GDP.

Exchange Rate Policy

- The currency peg with Indian Rupee limits the flexibility of monetary policy operation.

Monetary Policy Environment in Nepal

Financial globalization

- Regulated FDI inflows, restricted FDI outflows
- Short-term capital flows almost restricted
- Private sector foreign borrowing is limited

Monetary Policy Environment in Nepal

Transmission Channels

- The transmission mechanism of MP is uncertain in Nepal.
- The capital market is still in a developing stage with the dominance of BFIs' shares.
- Inflation forecasting is challenging.

Topics for Discussion

- The choice of nominal anchor of the monetary policy
- Monetary policy objective: multiple vs single
- Operating target: moving from reserve (quantity) to interest rate (price)
- The policy rate/corridor/floor/ceiling approach
- Monetary policy committee
- The forward guidance



Thank You Very Much !