Abstract

The research work, *Effectiveness of Monetary Policy in Nepal – An Empirical Study*, examines the extent to which the monetary authority has become successful in formulating and implementing monetary policy in Nepal with regard to achieving price stability, maintaining exchange rate stability, stability in the balance of payments, and promoting and developing banking and financial systems during 1974/75 to 2003/04.

Nepal, a small landlocked country, has witnessed several political disturbances; hence, economic development has not been a smooth process. The Nepal Rastra Bank (the Central Bank of Nepal) was established in 1956 and two Acts were promulgated to guide the monetary authorities. Adoption of liberalization policies in 1980s, transition to a multi-party democracy in 1990, and devastating Maoists insurgency during 1990s have had big impact on the economy of Nepal. The findings of the study hence are influenced by these factors.

The CUMSUM-Squared test and the Chow’s $F$-test indicated a *structural break* in 1994. Hence, the empirical evidences of the study are presented both for *overall period* (1975-2004) as well as *normal period* (1975-1993) and *disturbed period* (1994-2004). The real income has had positive influence on both $M1$ and $M2$. The velocities of $M1$ and $M2$ witnessed a continuous fall. Net Foreign Assets, and Net Claims on Government influenced the growth in $M1$. Incremental money multipliers showed volatility.

Monetary variable had a significant influence on the economic activity, whereas fiscal variable failed to exert significant influence. Nepal adopted full convertibility in the current account in 1993, and the exchange rate between Indian Currency and Nepalese Currency was fixed implicitly. The Wholesale Prices in India had expansionary effect on inflation in Nepal. But, the ratio of Agricultural Income to *GDP* had a contractionary effect.

The Nepal Rastra Bank was provided with *de jure* independence in 2002 and the efforts made by it, in promoting the financial sector, implementing economic reforms, and ushering economic growth are commendable. The economy witnessed an increase in the monetization and gradual financial deepening over the years. However, it needs to strengthen the financial sector by adopting proactive approach to check financial instability, and promote and develop financial and banking systems in the under-represented rural areas of Nepal for the overall development of the economy.