

Nepal's Monetary Policy for the Sustainable Development

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This paper examines the current status of “Monetary policy for sustainable development of Nepal’s Economy”. The achievement of 13 th plan on millennium development goals (MDGs) and internal economic activity and their implication to the economy remain unexpected like high inflation , frequent volatility of interest rate ,liquidity issues , stagnant equity market , increasing unemployment and foreign immigration, incremental trade deficit and growth rate. Even after the settlement of insurgency and conflict the newly established government and elections where people, politician and authority claim for the dedication to development with a common mission of happy Nepali and prosper Nepal. The economy would have paved the way out for the speedy economic growth and social transformation. There are incremental growth in number of banks financial institutions , microfinance and cooperatives financial inclusion in Nepal is not satisfactory and still three fourth of the people have been excluded from the account penetration at formal financial institutions. Informal channel private companies, agency and individuals lending against collateral taking pre ownership transfer of land or property at high interest. Personal finance is grooming. The Government single intervention program is not adequate for the achievement of MDGs or SDGs and economic growth for Nepal. The monitory regulatory authority should develop inclusive financial system in the nation through the wider access of finance services that ensures a sound financial system and the socio-economic transformation to many people. There for the objective of the study is to examine effectiveness of monetary policy for sustainable development of Nepal’s economy will be looked from two perspective financial sector development and growth of macroeconomic indicators since the NRB brought monitory policy of Nepal into the effect .

Keywords: NRB Monetary Policy, Sustainable Development, Financial inclusion, MDGs& SDGs, micro-finance, socio-economic transformation.

1. Introdtion

Financial products and services include broad range of services having financial awareness, knowledge about banks and banking services and high access of financial services offered by the banking institutions such as savings, short and long-term credit, insurance, pensions, payments, local money transfers and international remittances. A central policy which governs the functional objectives of these monetary products and services to inculcate and uplift integrity of financial institution, socio-economic transformation and contribution to macroeconomic goal of the nation is called monetary policy . Monetary policy is a macroeconomic policy that every central bank carry out , the way these policy works around credit, not money (friedman,2012). As mandated by NRB act 2002, Nepal Rastra Bank (NRB) has been issuing monetary policy publicly since from the beginning of 2002/03. After the formation of Nepalese Monetary Policy Nepal’s Financial and Economic development activity has undergone tremendous change .It has really worked and become central policy to government, public and enterprises and drive other policy related to development and finance. So-far Nepal has not witness such major economic consequences or crisis which most of the countries have experienced even in 2008. However Nepal has experience two page of economy a liberal or flexible economy under the control of King’s rule when there was not much interference for political change. A tight economy – an unstable & unrest period for the establishment of democracy and Maoist conflict

settlement period . Now after a long, public movement have address & settled majority of public issues and through public constitution. This shift or transformation of Nepal, we may call aggressive economy where the public aspiration and expectations are very high and to be met with. Political leaders from all parties and economist have jointly made commitment to the development agenda “a common agenda” of country. After a long , things have changed . Some new projects are underline like superfast tunnel highways, large size energy projects water resource project. Hence to align with the this development mission and objective it is necessary to review the effectiveness existing monetary policy for the sustainable economic development is very necessary. In case of Nepal, an inclusive financial system for the wide access of financial services to the poor through socio- economic transformation is very important. The alignment of policy to objective to the socio- economic development and financial stability is very important in which finally increase the financial accessibility and participation by making contribution in the delivery of national macroeconomic output like Gross Domestic Savings or Income .

2. Brief Review of Relevant Literature

Theoretical literature consists of conceptual part of Monetary Policy that includes concept of monetary theory and theories of financial stability. The monetary theories comprises of Quantity Theory of Money, Keynesian Theory of Demand for Money, Friedmans Quantity Theory of Money, The Radcliffe report , and Gurley and shaw views similarly Theories of Financial Stability can be classified under three broad categories or approaches .They are (1) Monetarist Approach, (2) Non – Monetarist- Financial Fragility- Debt- Deflation Approach and (3) Asymmetric Information Approach. Money influence the economic activities of people. The utility of money for survival and better life require exchange of knowledge, time, money and labor for money and the out put of money investment is money because money got tangible and intangible values both therefore it can satisfy need and want along with intangible value like social respect, pride, prestige and prosperity which is the ultimate goal of human existence. One must invest money to grow money. Because it grows and multiply over a period of time money has attracted research scholar and they began to think over its influence on the economy. They began to express their thinking about money in the form of monetary theory. With the passage of time, the economic structures also changed and the research scholar developed their monetary theories incorporating new events.

2.1.0 Demand for Money

An accurate knowledge about the structure of money demand is also important for the conduct of monetary policy.” This knowledge enables the monetary authorities to ascertain the liquidity needs of the economy; hence, the knowledge regarding (i) the factors that affect the demand for money: and (ii) whether or not a stable and predictable relationship between these factors and money supply exists is essential. If the demand-for-money function is stable, a steady monetary expansion leads to a stable path for prices. The empirical evidences collected show that the demand for money is more stable than the money supply. In other words, velocity was behaviorally stable in Meltzer has its opposite relationship with the variation in the permanent income." conducted empirical study of the demand for money using the US data, covering the period from 1900 to 1949, and found the money demand function was stable; the parameters of the wealth model appeared to be more stable over time than those obtained from the estimates of the income and permanent income hypothesis; and the demand function definition inclusive of time or time-plus-saving deposits were no more stable in the long-run than the demand functions of money defined exclusive of these assets."

Rangarajan has stated the existence of a reasonably stable demand for money should not be denied. His assertion is applicable to India as well as most of the developing countries. According to Rangarajan”, based on data for the period 1970-71 to 1992-93, the implicit income elasticity of demand for money (M3) works out to 1.77, and the short- run and long-run price elasticity with respect to broad money are 0.31 and 1.03 respectively. Therefore conclude that the there should be stable demand for money it has to be reframed time and when based on the implicit income elasticity of demand for money (M3) with respect to broad money or income.

2.2.1 Velocity of Money

Economists generally agree that a close relationship exists between the quantity of money in circulation and aggregate income in the long run. The importance of this relationship, called income velocity of money, arises as it makes possible to determine the effect of changes in money growth on income. Whereas the classical economists assumed a constant velocity of money, the Cambridge equation held that the velocity of money would fall as money supply increased. According to monetarists, velocity of money, the reciprocal of demand for money, expressed as a ratio of income, is stable and predictable. Friedman and Schwartz⁹ observed a steady declining trend until late 1940s. In the United States of America, the velocity declined by 0.2 percent during 1960s, remained constant during 1970s and declined by 0.5 percent during 1980s.⁹ Institutional factors and financial innovation seem to have affected the money demand function, and, hence velocity of money is high-income countries.

Jadav has estimated velocity function for India using seasonally adjusted velocity series for broad money (M3). He found the velocity behavior in India being more predictable than in industrial nations.

2.2.2 Money Supply

Keynes assumed that the supply of money as exogenous variable, completely under the control of monetary authority. A historical study of the money supply in the United States carried out by Friedman and Schwartz revealed that the supply of money was a function of the high-powered money and the multiplier.

A central bank does not have full control over money supply because it consists of currency and bank deposits. The central bank determines the supply of high-powered money, comprising the reserves of the commercial banks and currency, through which the commercial banks amplify money supply. Although the central bank has control over the monetary base and base-money multiplier, it cannot have complete control over money multiplier: thus, its control over money supply is incomplete.

The money supply is influenced by the behavior of the people, commercial banks and monetary authorities. A move to reduce money supply by controlling monetary base could be thwarted by the commercial banks through building up their reserves by other means, such as borrowing or by reducing their reserve ratio. * Moreover, the changes in the money supply by open-market operations or by changes in legal reserve requirements will have different effects on resource allocation.

. The classical economists were of the view that money did not matter either in growth or in redistribution. The Quantity Theory viewed that changes in the money stock had no effect on the real income in the long-run but would produce fluctuations in the short-run. They did not regard the role of money in economic growth. According to the Keynesians, the quantity of money is only one determinant of the rate of interest and income. In the Keynesian view, the most important factor was aggregate demand; monetary factors had little importance, as they are unable to influence real factors like consumption, investment, etc. The rate of interest serves as the main link between money and economic activity. If the money stock increases, the rate of interest will go down and, as a result, more investment and total spending will take place.

The monetarists view is that the rate of monetary expansion is the main determinant of total spending, commonly measured by the GNP.⁹ They regard monetary changes affect the whole range of financial and real assets (including current consumption). They believe that the substitution between financial and real assets is large and important. The monetarists emphasize the following three points: (i) the monetary authority can dominate movements in the money stock; (ii) movements in money stock are most reliable sources of the thrust of money impulses; and (iii) monetary impulses are also transmitted to the real economy through a relative price process, which operates on a vast array of financial and real assets.

In the Indian context, Kamala Prasad tested the quantity theory model following the Friedman-Miselman methodology and confirmed the validity of this approach. Nachane and Nadkarni conducted causality test covering a period of two decades (from 1960 to 81) and all their tests revealed money supply as the major determinant of GNI. N. R. Bhanumurthy studied nine developing countries to examine relation between money, output growth or inflation.* In the context of India, his finding is that the data satisfies

the monetarists claim that there is a positive correlation between money supply growth and output growth for both M1 and M2, but there exists a negative correlation between output growth and inflation growth.

3. Objectives, Data and Methodology and Remarks

The study has examined the current circumstances of monetary policy, assesses the critical issues, and provides policy implications to the concerned authorities that may help to build-up an efficient monetary policy and inclusive financial system in the country and promote undeveloped financial industry. The overall objective of the study is to examine the implication of monetary policy on socio-economic transformation of the people and confirming that whether monetary policy have played a significant role for the socio-economic transformation and establishing a stable financial system development for effective delivery of monetary policy or not.

To examine the impact of monetary policy of Nepal with regard to the Macroeconomic indicators and output like GDP, money supply(M1/M2), attaining price stability, balance of payment stability increased income and consumption for the development of efficient financial industry and sustainable development of Economy.

In Nepal fiscal year starts from mid July to mid July of the next year. The Bikram Sambat (BS) calendar is used for official purpose, It is 14th or 15th of April to 13th to 14th April next year of the Gregorian calendar. For the purpose of study data from Nepal Rastra Bank (NRB) and International Monetary Fund (IMF) on Nepalese Banks and Nepalese Banks Associations (NBA), Central Department of Statistic (CDS) & private Information Source Survey of Banking, Center for Monitoring of Nepalese Economy (CMNE) Report on Nepalese Economy and Banking ADB and World Bank are taken.

4. Methodology

For the econometric investigation of the impact of monetary policy on economic growth in Nepal. The econometric tools like the ordinary least square (OLS) regression analysis. The error correction method is used to ascertain if there is a static long run equilibrium relationship among the explanatory variables and subsequently derive an adequate dynamic model of the short run relationship.

Philip-Perron's unit root test may be used to test for the stationary or non stationary status of the data series, co integration test, over parameterized test, and parsimonious test can also be used to show the short run dynamics adjustments required for establishing long run equilibrium relationship among the variables in the model. The T' and F' tests will be used for individual and overall significance of variables included in the model.

Among these components banking sector is the leading sector and is the nerve center of Nepal's economy and financial system. Hence, the study will be confined to the Nepalese financial system, with special emphasis on banking sector development with respect to domestic credit and Money supply for the sustainable development of economy

Further, the major macroeconomic parameters are also analyzed for the better understanding of their role in the overall financial stability of the economy besides, various ratios for banking and financial sector is estimated post- Monetary policy & Banking Privatization period. Therefore the study covers the period from 2001-2002 to 2015-16 for quantitative analysis purposes. The starting period 2001/02 is chosen because of two reason : (a) the main study objective, effectiveness of Nepalese monetary policy after it came into the affect in the year 2001. Since then very less study is found about the Impact of MP in context of Nepal. (B) The major performance and changes in financial system took place and adequate availability of a data is the other reason too.

a) Data Collection Technique & Sample Size

This Impact study on Nepalese economy provides valuable insights to the factors affecting Money supply (M2) movement and its impact on GDP of Nepal. As already discussed in the chapter III secondary data from the period of 2001 to 2016 for 15 years have been used. Impact of monetary policy has been studied from two perspective i.e. perspective of financial sector development and its impact to the sustainable economic development and perspective of monetary instrument and their impact on

sustainable economic development .In which following variables GDP, CPI, inflation, interest rates, BOP and investments are selected under study

b) Statistical Test

The SPSS software is used to analyze the data by using Regression Model to find out the impact of money supply (M2) on the GDP of Nepal.

c) Characteristics of Variables

i. Dependent Variable GDP is the dependent variable. GDP is the total market value of all final goods and services which produced in a country in a given year are equal to total consumer, investment and government spending, plus the value of exports, minus the value of imports.

ii. Independent Variable

Interest Rate

The amount charged, formulate as a percentage of principal, by a lender to a borrower for the use of assets.

CPI

It measures the level of prices in the economy. It comprise transport, food, medical, education, fuel, house rent etc.

Inflation Rate

The rate at which the ordinary level of prices for goods and services is rising and afterwards, purchasing power is falling.

BOP

Money supply leads to increase in demand which cause shortage of goods and services finally import and this leads to trade difference where as $X=I$ at equilibrium economy. and

Investments

Investments are future savings for prosperity. Generally Investment and saving should be equal in the equilibrium however the volatility of saving causes volatile investment.

d) Analytical Results

The data were analyzed by using Regression Model to find out the relationship between variables with respect to GDP of Nepal.(Table no: 1) The value of mean show the average values, standard deviation shows the variability in the values and N represents number of years in the model.

Descriptive Statistics			
	Mean	Std. Deviation	N
NepalGDP	1159191.733 3	625502.09746	15
Inflation	7.5267	2.71674	15
IntRate	5.9533	1.06007	15
CPI	65.1800	23.48848	15
BOP	52743.3067	63903.71465	15
Investment	353103.6733	256540.74821	15
Consumption	927026.1133	509932.13323	15

Table no : 2
Correlations

		NepalL GDP	Inflation	IntRate	CPI	BOP	Investment	Consumption
Pearson Correlation	NepalL GDP	1.000	.610	.693	.998	.872	.992	.995
	Inflation	.610	1.000	.167	.621	.412	.544	.570
	IntRate	.693	.167	1.000	.684	.694	.678	.703
	CPI	.998	.621	.684	1.000	.880	.991	.998
	BOP	.872	.412	.694	.880	1.000	.889	.888
	Investment	.992	.544	.678	.991	.889	1.000	.994
	Consumption	.995	.570	.703	.998	.888	.994	1.000
Sig. (1-tailed)	NepalL GDP	.	.008	.002	.000	.000	.000	.000
	Inflation	.008	.	.276	.007	.063	.018	.013
	IntRate	.002	.276	.	.002	.002	.003	.002
	CPI	.000	.007	.002	.	.000	.000	.000
	BOP	.000	.063	.002	.000	.	.000	.000
	Investment	.000	.018	.003	.000	.000	.	.000
	Consumption	.000	.013	.002	.000	.000	.000	.
N	NepalL GDP	15	15	15	15	15	15	15
	Inflation	15	15	15	15	15	15	15
	IntRate	15	15	15	15	15	15	15
	CPI	15	15	15	15	15	15	15
	BOP	15	15	15	15	15	15	15
	Investment	15	15	15	15	15	15	15
	Consumption	15	15	15	15	15	15	15

Model Summary^b

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	1.000 ^a	1.000	.999	17311.81712	1.000	3044.801	6	8	.000	1.814

a. Predictors: (Constant), consumption, Inflation, IntRate, BOP, Investment, CPI

b. Dependent Variable: NepalLGDGP

Table no : 3

Variables Entered/Removed^a			
Model	Variables Entered	Variables Removed	Method
1	consumtion, Inflation, IntRate, BOP, Investment, CPI ^b	.	Enter

a. Dependent Variable: NepalLGDGP

b. All requested variables entered.

Table no : 4
Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	95.0% Confidence Interval for B		Correlations			Collinearity Statistics	
	B	Std. Error				Beta	Lower Bound	Upper Bound	Zero-order	Partial	Part	Tolerance
1 (Constant)	-12310.72	14711.5		-8.368	0	-2E+06	-89182.4					
Inflation	-19628.1	5756.139	-0.085	-3.41	0.009	-32902	-6354.47	0.61	-	-	0.088	11.424
IntRate	26163.12	7573.91	0.044	3.454	0.009	8697.65	43628.59	0.693	0.774	0.026	0.332	3.011
CPI	57753.65	7335.178	2.169	7.874	0	40838.7	74668.6	0.998	0.941	0.058	0.001	1386.673
BOP	-0.603	0.166	-0.062	-3.647	0.007	-0.986	-0.22	0.872	-	-	0.19	5.256
Investment	0.942	0.197	0.386	4.791	0.001	0.488	1.395	0.992	0.861	0.035	0.008	118.741
Consumption	-1.815	0.318	-1.48	-5.712	0	-2.548	-1.082	0.995	-	-	0.001	1226.996

a. Dependent Variable: NepalLGDP

Table no : 5
Collinearity Diagnostics^a

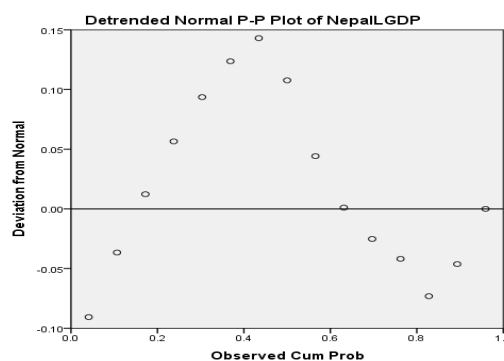
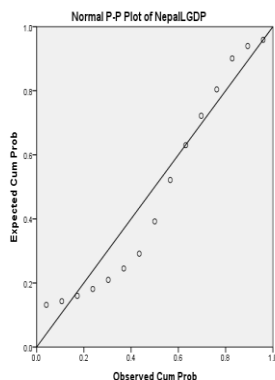
Model	Dimension	Eigenvalue	Condition Index	Variance Proportions						
				(Constant)	Inflation	IntRate	CPI	BOP	Investment	consumption
1	1	6.361	1.000	.00	.00	.00	.00	.00	.00	.00
	2	.508	3.540	.00	.00	.00	.00	.10	.00	.00
	3	.077	9.110	.00	.05	.03	.00	.17	.00	.00
	4	.047	11.660	.00	.06	.00	.00	.68	.01	.00
	5	.007	30.753	.06	.03	.69	.00	.04	.01	.00
	6	.001	72.335	.01	.08	.27	.01	.00	.97	.06
	7	5.248E-005	348.138	.93	.76	.00	.99	.01	.01	.94

a. Dependent Variable: NepalLGDP

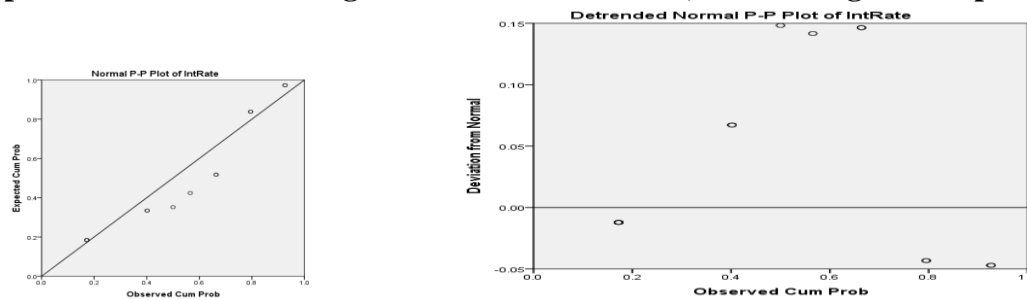
Graphical Analysis of Nepalese Macroeconomic Indicators

Expected cum Probabilities v/s Deviation from Normal

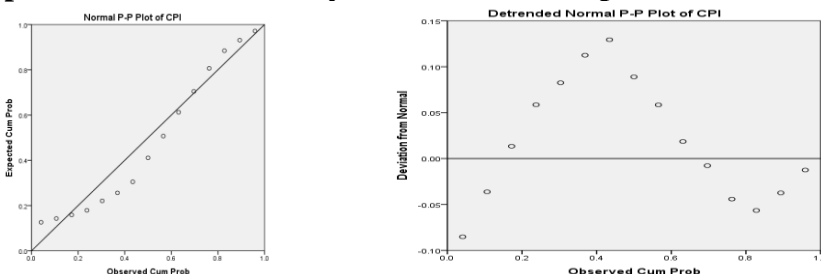
Graph 1: Nepal's GDP - It is recovering to normal after a decade of gradual fall.



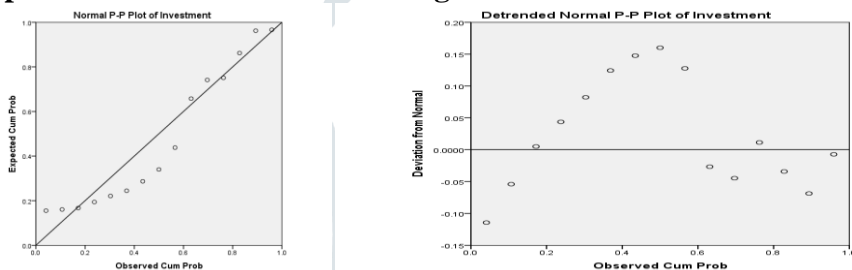
Graph 2: Interest Rate- though it is below the normal , looks unregulated upward pressure.



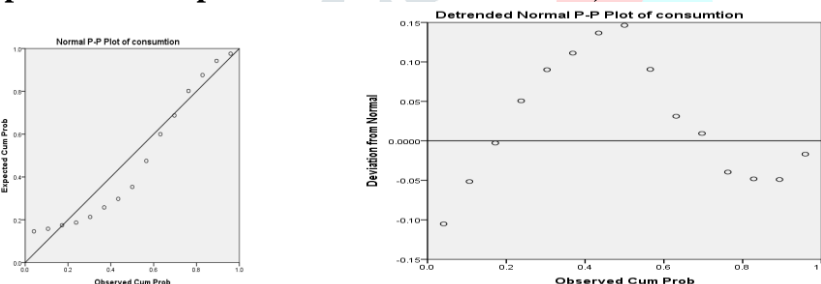
Graph 3: CPI- Influenced by Domestic Consumption



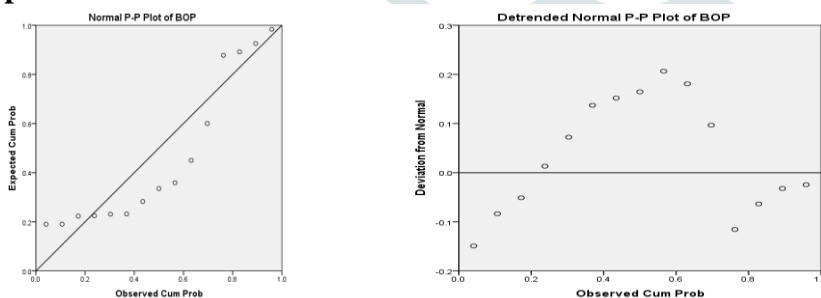
Graph 4: Investment Pattern – Irregularities and occasional investment



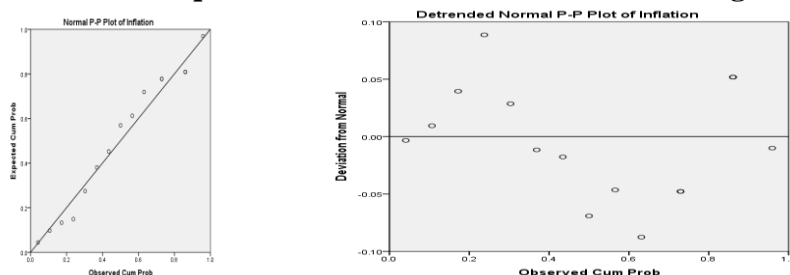
Graph 5: Consumption Pattern- Low demand , it is closer to normal

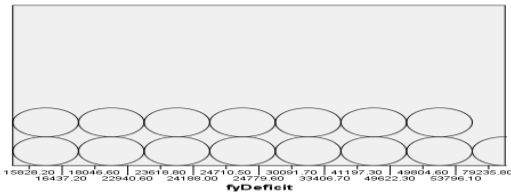


Graph 6: BOP



Inflation – A frequent scattered from Normal shows insignificant inflationary effect



Fiscal Deficit ..A continuous multiple folding fiscal growth deficit effect.**c) Hypothesis Testing and Results**

H₀: There is no significant relation between inflation rate and GDP.

H₁: There is a significant relation between inflation rate and GDP.

Result

The significant value of inflation rate is 0.008, which is less than 0.05. We reject the null hypothesis. This means that the inflation rate has significant relation with GDP of Nepal

H₀: There is no significant relation between Interest rate and GDP.

H₂: There is a significant relation between Interest rate and GDP.

Result

The significant value of interest rate is 0.000, which is less than 0.05. We reject the null hypothesis. This means that interest rate has a significant relation with GDP of Nepal.

H₀: There is no significant relation between CPI and GDP.

H₃: There is a significant relation between CPI and GDP

Result

The significant value of CPI is 0.000, which is less than 0.05. We reject the null hypothesis. This means that CPI has a significant relation with GDP of Nepal.

H₀: There is no significant relation between BOP and GDP.

H₄: There is a significant relation between BOP and GDP.

Result

The significant value of BOP is 0.000, which is less than 0.05. We reject the null hypothesis. This means that BOP has a significant relation with GDP of Nepal.

H₀: There is no significant relation between Investment and GDP.

H₅: There is a significant relation between Investment and GDP.

Result

The significant value of Investment is 0.000, which is less than 0.05. We reject the null hypothesis. This means that Investment has a significant relation with GDP of Nepal.

H₀: There is no significant relation between Consumption and GDP.

H₆: There is a significant relation between Consumption and GDP.

Result

The significant value of Consumption is 0.000, which is less than 0.05. We reject the null hypothesis. This means that Consumption has a significant relation with GDP of Nepal.

4. Concluding Remarks

Empirical study is done for the whole period, from FY 2001/02 to 2015/16. The current period is not a liberal or transitional period this study is conducted at the end and beginning of the Aggressive economy, the policy prescriptions are required to be different to suit to accommodate provincial multistate economic situation.

Monetary policy is associated with quantity of money and credit of financial institutions. Both move simultaneously but to which variable should the authorities give emphasis to positively influence the economy depends on which of two variables provide good empirical value of its effectiveness. The Quantity of Money is a fully developed theory but there is no specific theory of credit demand, Money is the liability and credit is the asset of the bank. Money deals with the quantity of money of the banking system whereas credit policy deals with cost, availability, and credit allocation. The empirical results show that domestic credit exerted positive influence on both the economic activity and monetary account of the balance of payments even in the disturbed period (FY 2001/02 to FY 2016/17). At the same time, it appears that M1 and M2 could not play any meaningful role. Therefore, the authorities should use domestic credit variable to influence the economy and international reserves of the balance of payments account. Credit policy seems to be more effective and important in Nepal at present. As the credit policy affects the cost, availability and allocation of credit, the NRB should use these instruments to influence the above variables in the present situation though it may appear odd in the period of deregulation. However, the benefit to the economy should be the top priority in such a difficult period. After getting out of difficulty, more liberal policy could do well. As the liquidity ratio of the commercial banks always remained higher side of total deposits after FY 2001/02, one or two percent increase in the Compulsory Reserve Requirement (CRR) does not decrease or stop the increment in credit. The commercial banks can draw reserves to meet the CRR and continue to extend credit. Therefore, it calls for suitable credit policy to be used to influence the economy. It may be used by increasing or decreasing the lending rate or by imposing credit ceiling.

The Nepal Rastra Bank Act, 2002 mandates the NRB to maintain price stability as one of the responsibilities. An attempt has made to examine the causes of consumer price movement in Nepal by using the OLS (Ordinary Least Square) method. The empirical results show that structural variable, i.e. ratio of Agricultural output to GDP, has dampening effect on price rise, whereas the Wholesale Prices of India (WPI) has significant influence on price rise in Nepal. There is no way to shield or reduce the effect of WPI on the Consumer Price Index (CPI) in Nepal for many years to come even by taking reasonable monetary measures. Rise in CPI can be dampened by increasing the agricultural production. For this to happen, both the government and the NRB should work together. The NRB has to endeavor to create a sound inclusive financial institutions that covers the rural areas and should influence the government to create a good supervision network and credit rating network for efficient delivery and outcome.

Though there is positive expectation and probabilities of normal distribution and growth of macroeconomic indicators, The Graphical representation and analysis clearly state the immediate need of drafting sustainable monetary policy as there is unexpected deviation and irrational relationship among variables. It is also raise serious concern about efficient implementation and execution mechanism of regularity authority to wards achieving development mission of the country.

Where has from the perspective of Monetary instrument and their interaction it is concluded that so far inflation has no adversely affect on the economy of Nepal which is a result of controlled or effective supply of money (M2) by NRB. This study reveals the impact of money supply (M2) on the GDP of Nepal whereby we have seen inflation rate is hovering towards double digits. We have considered few of the macro indicators they are interest rate, CPI, inflation rate, investment and consumption because money supply is affected either one of them. By using regression model, it is proved that almost all the variable have significant relation with GDP of Nepal. It is also noticed that change in change in interest rate has also not caused for the increase or decrease of Inflation has significant relation with the GDP of Nepal. Thus, money supply needs similar efficient and little aggressive control to boost the economy in the days to come.

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