

On foreign exchange accounts, convertibility and currency substitution:

A proposal for reform and monitoring in Nepal

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Nepal is characterized by a unique combination of a long-lasting pegged exchange rate regime with India, a tightly controlled domestic financial market, and a large annual inflow of foreign exchange from remittances and development aid. We argue that to reap the full benefits of foreign exchange inflows, Nepal should allow domestic foreign exchange accounts for all households and firms and make the Nepali Rupee fully convertible into other currencies. A process of currency substitution away from the Nepali Rupee is a possible reaction that should be monitored.

The institutional background

Nepal has a unique combination of institutional features in its financial architecture that need to be taken into account when formulating policy advice. Individually, these features are not unusual, but in combination they imply a welfare loss for the citizens, and a reform of the current arrangements appears to be warranted.

The first aspect is that Nepal has maintained a pegged exchange rate regime with India since the 1960s (Maskay 2002)¹. The initial motivation for this choice was to reduce NC-IC (Nepali currency-Indian currency) exchange rate instability and provide confidence to the Nepali currency. By itself, it appears to be a choice followed by other smaller countries with big neighbours, with benefits to the economy. An example is Austria in Europe, which maintained a fixed exchange rate with Germany for several decades before joining the European Monetary Union in the late 1990s. The choice also follows from a high degree of trade in goods, labour mobility and shared regional shocks.

The second aspect—that differs from the Austrian example—is that the Nepali Rupee is a (mostly) non-convertible currency and the Nepali financial market is tightly controlled by domestic authorities. The only exception is the Indian currency which is partly convertible to Nepali Rupees². The parallel use of the Indian currency, in particular in the bordering regions

of Nepal, has been a concern of policy makers for many years.

The third aspect is that Nepal is receiving annually very sizable capital inflows in foreign exchange that stem from development aid as well as from remittances. The latter of the two is the largest component and jointly, they amount to about one third of GDP annually (see Steinkamp and Westermann 2022). While Nepal has about 30 million citizens, nearly 2 million of them are living and working abroad³. These workers are sending money home every year in foreign exchange, but it is received by their relatives in Nepal largely in domestic currency. The central bank is in between the sender and recipient and converts the foreign exchange into Nepali Rupees (see Maskay et al. 2016).

The policy recommendation

The question arising in this particular institutional setting is: What is the best way to move forward, reaping the benefits of remittances while maintaining domestic stability?⁴

The benefits of allowing foreign exchange accounts have been empirically analysed in Maskay et al. (2018). The authors highlight the important contribution of foreign exchange accounts in relaxing credit constraints in the domestic economy that constitute an obstacle to economic growth. Furthermore, the present arrangements prevent an efficient allocation of capital. They reduce the welfare of domestic citizens derived from the earnings by their relatives abroad. They also put the central bank in a position where it is acting akin to a sovereign wealth fund that keeps control of an ever-increasing stock of foreign exchange reserves.

An example is the following: Suppose a citizen in Nepal receives remittances from relatives, or simply wants to use personal savings to import a good from abroad—say, medical goods, or goods for investment purposes, which are both urgently needed. Then they demand equation. Money demand depends on GDP, because money is used to pay for transactions, and it depends on the interest

need to request permission to exchange money for this purpose from the central bank. That is, the central bank makes essential economic decisions on the usage of foreign exchange, which in an economy with unrestricted domestic foreign exchange accounts as well as full convertibility would be taken by the individual households and firms themselves. The central bank, however, has no superior information on the best use of the foreign exchange, neither for investment nor for consumption purposes.

Therefore, the main policy recommendation is a timely lifting of any remaining controls on foreign exchange accounts and making the Nepali currency fully convertible vis-à-vis other currencies⁵.

The need for monitoring the use of currencies and a simple first proxy

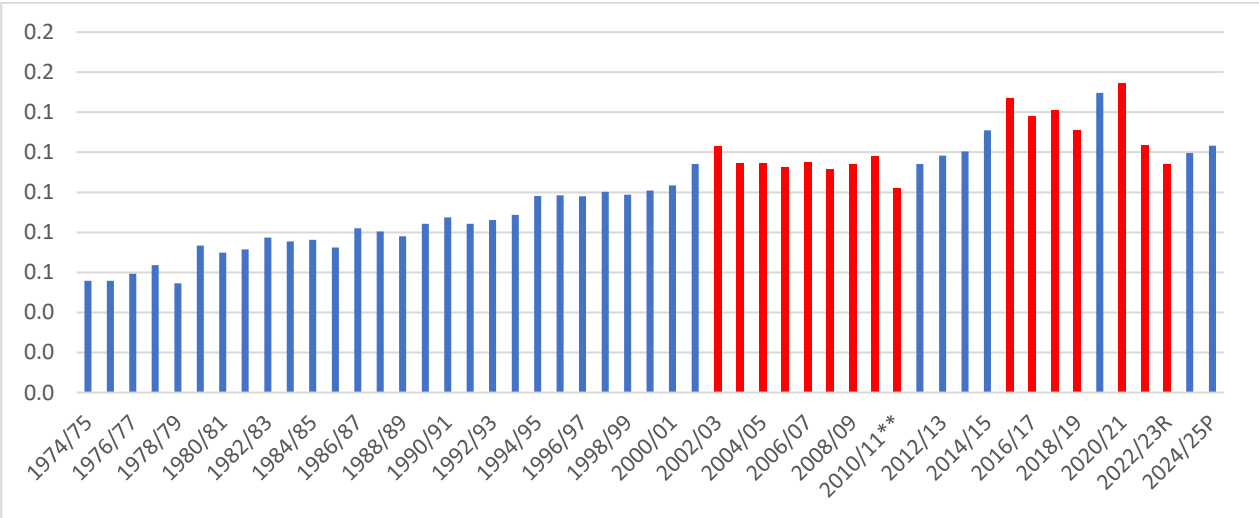
A possible side-effect of this policy decision could be that the fixed exchange rate with India would become harder to maintain⁶. For instance, citizens could lose confidence in the Nepali currency and use foreign currency to safeguard against inflation and depreciation. This reaction is called “currency substitution” in the literature and it could happen under both fixed and flexible exchange rates⁷. In principle, this reaction is not entirely negative. For the case of Europe, Melvin (1985) has argued that currency substitution could be an effective way to discipline domestic pressures on the central bank. But it should be monitored.

This monitoring, however, is not easy as no readily available data exists on the use of currencies in Nepal. Presently, only indirect proxies can be analyzed, and indeed they indicate that a certain degree of currency substitution may already be present in the Nepali economy. The two graphs below, on currency in circulation and interest rates, provide a first impression. The interpretation of these graphs is based on a simple money rate, because money is also a store of value. Instead of holding non-interest-bearing currency the citizens can hold short-term

bonds and earn interest. GDP should have a positive impact and the interest rate a negative one on the currency in circulation. Figure 1 displays the ratio of currency in circulation to GDP in Nepal. One can see three distinct periods, where currency in circulation, relative to GDP, was declining: (i) in the midst of the armed conflict in 2002, (ii) after the earthquake in 2015, and (iii) during the pandemic of 2020-2022. In principle, this decline could be explained by a rise in the interest rate. Therefore, Figure 2 displays the

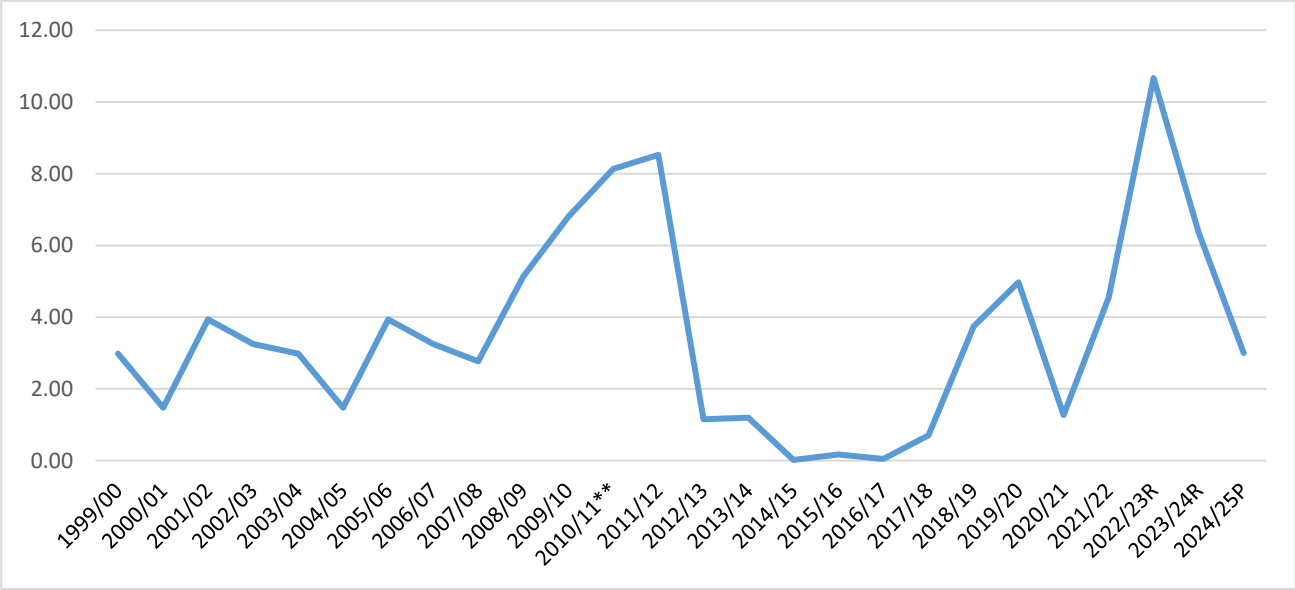
interest rate on three-month government bonds. There are a few periods in which the ratio of currency-to-GDP was falling, and the interest rate was not rising. These periods could be explained by, and are indicative of, a substitution away from Nepali Rupees and possibly towards Indian Rupees. These periods are 2002-2007 and 2015-2017. The pandemic period is less clear. Although the ratio has declined, there was a sharp rise in the interest rate in 2021-2022, so one expects currency holdings to fall.

Figure 1: Currency in circulation/GDP



Source: Nepal Rastra Bank and own calculations

Figure 2: Interest rates on three-month government bonds



Source: Nepal Rastra Bank

Overall, despite the ups and downs of the economy and the political challenges, money demand for Nepali Rupees appears to have been quite stable in the past. Although there are periods of decline, this decline is only of a moderate magnitude.

A more systematic approach

The analysis above only gives an imprecise and early assessment of the degree of currency substitution. It is presently not possible to make a more detailed assessment with publicly available data sources. We suggest that a more systematic monitoring should be implemented, to raise awareness on the topic and to uncover possible side-effects of future policy decisions. Beyond the removal of remaining constraints on foreign exchange accounts, and convertibility of the Nepali Rupee into other currencies, future policy decisions could include the choice of a flexible exchange rate, or a further tightening of the

present fixed rate into a currency board (see World Bank 2025).

A more systematic analysis could include, but is not limited to, the following further steps:

- i) A continuous monitoring of the Nepal Rastra Bank's monetary survey, as well as Banking and Financial Statistics. Currently, only a small part of deposits of banks are reported in foreign currency. This share is likely to increase after the proposed reforms.
- ii) An expansion of household and enterprise surveys, including the National Living Standard Surveys, as not all foreign currency use might be reflected in official statistics.
- iii) A particular focus should be on the use of Indian currency. Also, other major currencies, such as the US Dollar, British Pound, Euro, Swiss Franc, Japanese Yen and Renminbi, should be included and reported in all surveys.

Notes

¹ Nepal has maintained a pegged exchange rate regime since 1960. There have only been seven movements, the last adjustment occurred in 1993.

² IC is convertible both ways. While travelling physical cash limit is IC equivalent to US\$5,000. In 200 and 500 notes it is up to IC 25,000 only both ways.

³ Note that these are estimates and there is no record for Nepali people living and working in India. As most seasonal Nepali workers are generally unskilled, they have no bank accounts and send remittances to Nepal largely by informal channels.

⁴ See also World Bank (2025) for a broader overview of the policy debate. A few steps to liberalize foreign exchange accounts have been taken in the past years, but in particular for domestic citizens, they still are largely unavailable. Our contribution is intended to highlight two

aspects that so far have received only little attention in this debate: The importance of foreign exchange accounts and the need to monitor currency substitution.

⁵ Note that this is not equivalent to a more general liberalization of the current and capital account. This could follow, but is part of a broader debate on the pros and cons of trade and financial liberalization.

⁶ Furthermore, with the domestic financial system modernizing—particularly through the integration of United Payments Interface of India and the National

Payment Interface of Nepal—capital controls may be gradually losing effectiveness, implying increasing capital flows. International experience suggests that in such circumstances, exchange rate pegs can become more fragile and prone to speculative pressures.

⁷ A similar reaction could be triggered by an increased use of digital currencies and payments. See also Girton and Roper (1980) for a theoretical model of currency substitution.

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