Estimating equilibrium exchange rate in Nepal: A BEER approach

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Abstract
Nepal has a large trade deficit with India, its main trading partner, and an overall negative trade balance. Its economy is growing slow relative to India, while its exchange rate is pegged with Indian rupee at a level that is believed to be overvalued. In this study, Nepal's real effective exchange rate and India-Nepal (INR/NPR) bilateral real exchange rate are considered in estimating a BEER based equilibrium exchange rate, in order to further study the possibility of exchange-rate misalignment. Estimation is carried out using Johansen (1988) cointegrated-VAR model. In both regressions, relative debt supplies, trade balance, money supply differential, and remittance flows are found significant. Productivity differential is significant only in explaining the real effective exchange rate.

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