

Capital Account Convertibility: Experiences, Lessons and preconditions

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Abstract

A country is said to have attained full convertibility of its currency when residents and nonresidents are allowed to convert the currency, at prevailing exchange rates, into foreign currencies and to use the latter freely for international transactions. During the 1990s, the financial crises in Brazil, East Asia, Mexico, and Russia demonstrated that CAC carries the potential for currency crises. Still, the mainstream view holds that capital account liberalization can be advantageous when a country moves in tandem with a strong macroeconomic policy framework, sound financial system, supported by prudential regulatory and supervisory policies. India's steps towards fuller CAC as per the roadmap of Tarapore II are bound to have repercussions on the Nepalese economy. The paper concludes that since the economic fundamentals of Nepal are not robust enough, the move towards fuller CAC should take a gradual pace with priority accorded to the preconditions.

Introduction

A working definition of capital account convertibility (CAC) is "the freedom to convert local financial assets into foreign financial assets and *vice versa* at market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by the rest of the world. CAC can be, and is, coexistent with restrictions other than on external payments. It also does not preclude the imposition of monetary/fiscal measures relating to foreign exchange transactions which are of a prudential nature."¹ Hence, an open capital account does not necessarily imply unfettered capital account liberalization, and in practice some capital controls and significant prudential regulations are consistent with CAC.

CAC is generally considered as one of the hallmarks of a developed economy. It is also seen as a major comfort factor for overseas investors since they know that anytime they change their mind they will be able to re-convert local currency back into foreign currency and pull out their money. In a bid to attract foreign investment, many developing countries

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¹ This definition is taken from RBI (2006), p. 6.

moved towards CAC in the 1980s not realizing that free mobility of capital leaves countries open to both sudden and huge inflows as well as outflows, both of which can be potentially destabilizing.

The early 1990s experienced a boom in capital flows followed by the reversal of such flows especially in the second half of the 1990s. The first reversal happened after Mexico's currency crisis in December 1994. It was, however, limited to some Latin American economies and capital flows resumed soon after. The second reversal, which was more severe and enduring, came in 1997 and resulted in the East Asian crisis. This was preceded by the Russian default in August 1998 and the Brazilian crisis in 1998-99, followed by the collapse of the Argentine currency in 2001 and the spate of corporate failures and accounting irregularities in the US in 2002. Most of the developing countries faced major crisis due to such vagaries of finance capital, whereas the only gainers were the handful of financiers who control the flows of such capital.

In the aftermath of the East Asian crisis and the crises in Brazil and Russia many economists argued that globalization had moved too far and argued for the return of capital controls.² Krugman maintained that "sooner or later we will have to turn the clock at least part of the way back: to limit capital flows for countries that are unsuitable for either currency unions or free floating."³ Others argue that in a world with imperfect information, existing distortions get augmented in a world of free capital mobility, create situations of moral hazard, encourage excessive risk taking and generate major and costly crises.⁴ A voice of concern was also raised by Stiglitz who concluded that "volatile markets were an inescapable reality. Developing countries need to manage them. They will have to consider policies that put some limit on capital flows."⁵ Even strong proponents of capital account liberalization have acknowledged that many countries that avoided the worst effects of recent financial crises were also those that used capital controls, including China, India, Malaysia and Chile. Also the IMF, which once advocated movement towards total convertibility on capital account, now cautions developing countries to move slowly.⁶

² In some of the historical episodes, capital controls have been resorted to by either the monetary or fiscal authorities in order to pursue the following objectives: a) to constrain and re-direct financial flows in/out of the country (for instance, with the goal of preventing inflationary pressure from capital inflow or restricting currency proceeds from export sales of commodities); b) to restrict investments with unfavorable financial characteristics (e.g., high risk assets or short-term assets); c) to prevent fluctuations of and changes in the BoP owing to external factors beyond the control of authorities; d) to strengthen competitive advantages of certain sectors in the economy or of the national economy on the global markets; e) to improve the predictability and controllability of the exchange rate and inflation rate; f) to ensure stability of the banking system, stock and financial markets; g) to prevent certain "undesirable", from the public policy point of view, transactions (e.g., money laundering, tax evasion, and financing of illegal operations). For a detailed discussion, see Golikov (2005).

³ See Krugman (1999), p. 74.

⁴ These arguments are provided in Bhagwati (1998) and Cooper (1998).

⁵ See Stiglitz (1999), p. 6.

⁶ This caution is given in IMF (2000) for details.

The perspective on CAC has, thus, undergone some changes following the experiences of EMEs in Asia and Latin America that went through currency and banking crises in the 1990s. A few countries backtracked and re-imposed some capital controls as part of crisis resolution. While there are economic, social and human costs of crisis, it has also been argued that extensive presence of capital controls, when an economy opens up the current account, creates distortions, making them either ineffective or unsustainable. These developments have led to considerable caution being exercised by EMEs in opening up the capital account.

Hence, debate persists about the relative advantages of a rapid transition to full CAC (the so-called "big bang" approach) and a more gradualist approach which emphasizes reforms in the real economy and financial system and liberalizing the current account before opening the capital account.⁷ Practical experiences have emphasized caution.

Moreover, the link between capital account liberalization and growth has not yet been firmly established by empirical research. Nevertheless, the mainstream view holds that capital account liberalization can be beneficial when countries move in tandem with a strong macroeconomic policy framework, sound financial system and markets, supported by prudential regulatory and supervisory policies.

The rest of this paper is structured as follows. The next section spells out the pros and cons of CAC. The experiences of the crises-stricken countries of the 1990s together with the lessons drawn are also highlighted. This is followed by a scrutiny of measures for India based on the *Report of the Committee on Fuller Capital Account Convertibility*. The reform measures initiated by Nepal as well as some issues pertaining to CAC are then discussed. Before concluding, some plausible preconditions for Nepal prior to moving towards a fuller CAC regime are discussed.

Benefits, Costs and Lessons

The benefits of CAC, among others, comprise the following:

- An open capital account could bring with it greater financial efficiency, specialisation and innovation by exposing the financial sector to global competition.
- It could promote domestic investment and saving as global source of funds become available.
- It permits both savers and investors to protect the real value of their assets through risk reduction by offering the opportunity of using the world market to diversify portfolios.

Some of the limitations of CAC, on the other hand, consist of the undergoing:

- It could lead to the export of domestic savings, which would disrupt the financing of domestic investment for capital scarce developing countries.

⁷ This is elaborated in Gupta and Sathye (2004).

- It could expose the economy to greater macroeconomic instability emanating from the volatility of short-term capital movements and the risk of large capital outflows.
- There could be misallocation of capital inflows since such inflows may fund poor-quality investments (such as investments in stock markets and real estate).

Overall, the risks associated with CAC come primarily from insufficient preparedness prior to liberalization with respect to domestic and external sector policy consolidation, strengthening of prudential regulation and development of efficient financial markets. In this context, the experiences of East Asia and some of other EMEs are highlighted below.⁸

- The Mexican crisis in 1994–95 occurred owing to the weaknesses in Mexico's economic position from an overvalued exchange rate and current account deficit at 6.5 per cent of GDP in 1993, financed primarily by short-term capital inflows.
- The East Asian currency crisis that initiated in Thailand and affected other countries of the South East Asian region such as Malaysia, Indonesia, South Korea and the Philippines was due to current account imbalances with concomitant savings-investment imbalance, overvalued exchange rates and high reliance on potentially short-term capital flows. These macroeconomic factors were aggravated by microeconomic imprudence like maturity mismatches and currency mismatches, among others.
- Brazil was having problems from both the fiscal side and the balance of payments (BoP), and was affected in the aftermath of the East Asian crisis in early 1998 when inflows of private foreign capital quickly dried up. After the Russian crisis in 1998, capital flows to Brazil came to a standstill.
- In 1998, Russia faced a serious foreign exchange crisis due to concerns pertaining to its fiscal situation and had to introduce a host of emergency measures, including re-intensification of capital controls and the announcement of a debt moratorium. Russia lifted the last remaining restrictions on the rouble on July 1, 2006 clearing the way for making its currency fully convertible.⁹
- Argentina shifted to a currency board arrangement pegged to US dollar from April 1991 up to January 2002 which, coupled with the country's inability to lower its high public and external debts, led to a recession-turned-depression during 1998–2001. This caused Argentina to call off the peg in January 2002, first devaluing and later floating its currency.
- *Problems in satisfying huge requirements for public sector borrowing in 1993 and early 1994 was responsible for Turkey's currency crisis in 1994. As a result, output*

⁸ See RBI (2006), Roy et. al (2006), Schneider (2000) and Pant (1999) for a review of the country experiences. Some of the country experiences (Indonesia, Korea, Thailand and Mexico) as well as the lessons drawn from them are illustrated in Annex 1.

⁹ Details pertaining to the free convertibility of the rouble are provided in Jie (2006).

fell by 6 percent, inflation rose to three-digit levels, the central bank lost half of its reserves, and the exchange rate depreciated by more than 50 per cent. Turkey again faced a series of crisis beginning 2000 due to a combination of economic and non-economic factors.

Some lessons that can be extracted from the past currency crises are summarized below.

- Most currency crises arise out of prolonged overvalued exchange rates, giving rise to unsustainable current account deficits. As the pressure on the exchange rate increases, there is increasing volatility of flows and of the exchange rate itself. An excessive appreciation of the exchange rate causes exporting industries to become unviable, and imports to become much more competitive, leading to worsening of the current account deficit.
- Even countries that possessed comfortable fiscal positions have experienced currency crises and deterioration of the exchange rate. In many other economies, large unsustainable levels of external and domestic debt directly resulted in currency crises. Thus, a transparent fiscal consolidation is necessary and desirable to lower the risk of currency crisis.
- During currency crises short-term debt flows respond quickly and adversely. Receivables are normally delayed, and payables expedited, aggravating the BoP position.
- Domestic financial institutions, particularly banks, should be strong and resilient. The quality and proactive nature of market regulation is also crucial to the success of efficient functioning of financial markets during periods of currency crises.
- In certain instances, imposition of safeguards in the form of moderate controls on capital flows may be required.

India's Initiatives

India began liberalizing its capital account as part of wide-ranging economic reforms initiated in the early 1990s. It was the *Report of the Committee on Capital Account Convertibility* submitted by the Tarapore Committee (Tarapore I) that defined the framework for forex liberalization in May 1997. Tarapore I had chalked out three stages to be completed by 1999-2000. It had indicated certain signposts to be achieved for the introduction of CAC, the three most important being fiscal consolidation, a mandated inflation target and strengthening of the financial system. However, the timetable was put on hold in the wake of the 1997 East Asian financial crisis.

In April 2006 another committee (Tarapore II) was formed again under the chairmanship of former Deputy Governor of the RBI to revisit the issue of CAC. In the *Report of the Committee on Fuller Capital Account Convertibility*, Tarapore II recommended that India shift to fuller CAC in five years' time. It suggested the proposed regime be embraced in three phases: 2006-07 (Phase I), 2007-08 and 2008-09 (Phase II) and 2009-10 and 2010-11

(Phase III). It indicated that the concomitants for a move to fuller CAC would be fiscal consolidation, setting of medium-term monetary policy objectives, strengthening of the banking system, maintaining an appropriate level of current account deficit and reserve adequacy.

Some of the recommendations of Tarapore II are listed below:¹⁰

- The Centre and states should graduate from the present system of computing fiscal deficit to a new measure of public sector borrowing requirement (PSBR).
- Substantial part of the revenue surplus of the Centre should be earmarked for meeting the repayment liability under the Centre's market borrowing programme, thereby reducing the gross borrowing requirement.
- Revenue deficits of the states should be eliminated by 2008-09 and fiscal deficits of the states should be reduced to 3 percent of GDP.
- The limits for banks' overseas borrowing should be linked to their paid-up capital and free reserves, and not to unimpaired tier I capital, and raised to 50 percent in Phase I, 75 percent in Phase II and 100 percent in Phase III.
- To make Indian corporates compete in the global arena on an equal footing, the limits for corporate investments abroad should be raised in phases from 200 per cent of net worth to 400 per cent.
- Other than NRIs who are allowed to invest in companies on Indian bourses, all individual non-residents should be allowed to invest in the Indian markets through SEBI-registered entities.
- Non-resident corporates should be allowed to invest in the Indian stock markets through SEBI-registered entities, including mutual funds and portfolio management schemes.
- The annual limit of remittance by individuals to open foreign currency accounts overseas be raised to US\$ 50,000 in Phase I from the current level of US\$ 25,000 and further raised to US\$ 100,000 in Phase II and US\$ 200,000 in Phase III.
- The limit for mutual funds to invest overseas should be increased from the present level of US\$ 2 billion to \$3 billion in Phase I, to US\$ 4 billion in Phase II and to US\$ 5 billion in Phase III and these facilities should be available to SEBI registered portfolio management schemes apart from mutual funds.

There are certain important lessons that Nepal can draw from India's approach to fuller convertibility¹¹:

- Capital account liberalization is regarded as a process and not an event.
- Capital account liberalization is maintained in line with other reforms.
- A hierarchy is set up in the sources and types of capital flows. The focus has been to liberalize inflows relative to outflows, but all outflows related to inflows have been

¹⁰ Details of the recommendations are provided in RBI (2006)

¹¹ Some of the lessons drawn from India's experiences are elaborated in Reddy (2007).

completely freed. Among the kinds of inflows, FDI is preferred for stability. A distinction is made between corporates, individuals, and banks.

- The speed and sequencing of liberalization is responsive to domestic developments.
- The political economy is also crucial for the success of reforms. Although there have been coalition cabinets and periodic elections both at the center and in several states, the overriding feature of India's political system is system stability.

In Nepal, one of the reasons for the renewed interest in CAC was the release of the *Report of the Committee on Fuller Capital Account Convertibility* by the RBI in September 2006. The move towards fuller convertibility taken by India as per the roadmap of Tarapaore II is bound to have repercussions on the Nepalese economy as the country has an open border with India and its exchange rate is fixed *vis-à-vis* the Indian currency.

Nepal's Initiatives

In Nepal, the rupee was made fully convertible for the current account transactions in February 1993. The Foreign Investment and Technology Transfer Act, 1992 amended in 1996 guarantees full repatriation of the amount received from the sale of equity, profits or dividend and interest on foreign loan. Though there is CAC for non-resident investors as per the provisions contained in Industrial Policy 1992, and Foreign Investment and One-Window Policy 1992, it still remains closed for the residents. Taking into consideration the possibility of economic crisis originating from the external shocks on the weak Nepali economy, the policy of opening capital account gradually has been adopted in a cautious manner.

In the process of gradual liberalization of capital account, Nepal has been initiating a host of measures. They include the following:

- Foreign exchange earners are permitted to retain 100 per cent of their foreign exchange earnings and are free to maintain foreign currency deposits with the local banks.
- The foreign exchange facility against passport has been raised up to US\$ 2,000 for all countries except India.
- Students no longer are required approval from NRB for forex facilities of living expenses. All the commercial banks are now allowed to make education related exchange facilities to the students as per the no-objection certificate from Ministry of Education and Sports (MOES).
- Anyone who wants to borrow from abroad, for a period of one year and above, without pledging any domestic asset as collateral, will simply have to notify the NRB instead of taking prior permission.
- Commercial banks are allowed to send any payment to India in foreign currency on behalf of any international organization having foreign currency account in the commercial banks.

Under the foreign exchange reform, some pressing issues pertaining to fuller CAC need to be assessed. Although foreign investment in Nepal is permitted in almost all the sectors, the Nepali individuals/institutions are not allowed to invest abroad as per the "Ban on Nepali Investment in Foreign Countries Act 1965." Another issue is the exchange rate of the Nepali rupee which is pegged to the Indian currency. This is a core issue for discussion as experiences of many EMEs demonstrate that countries were forced off pegs after sudden reversals of capital flows under open capital accounts (for example, Mexico at the end of 1994, Thailand in July 1997, and Brazil in early 1999).

Under the financial sector, it was in the mid-1980s that the process of financial liberalization in Nepal was actually initiated when the government allowed the entry of commercial banks in joint venture with foreign banks. The process of financial liberalization gained momentum in 1987/88 when Nepal entered into a three-year Structural Adjustment Program (SAP) with the IMF followed by the three-year Enhanced Structural Adjustment Facility (ESAF) in 1992/93. The broad aim was to increase the role of market forces in the financial system. Nepal also signed the Poverty Reduction Growth Facility (PRGF) Agreement with IMF in November 2003. This three-year arrangement was extended to November 18, 2007.

The Financial Sector Technical Assistance (FSTA) Project has been implemented since 1998. The second phase of financial sector reform has given priority to updating the information technology, supervisory capability and human resource management.

Some issues on the financial sector pertaining to CAC also demand attention. The participants in the financial markets with greater deregulation are prone to face greater risks arising out of market fluctuations. As risks in the financial system aggravate arising from more intensified competition, greater market volatility and uncertainty after deregulation and liberalization, it is necessary to strengthen prudential regulation and supervision practices. Another issue is the high level of non-performing loans (NPLs) which denotes a stumbling block to financial opening.

On the external sector front, Nepal undertook extensive reforms during the early nineties to facilitate its integration with the global economy. A new Trade Policy was announced in 1992 which focused on promoting sustainable trade and by allowing wider participation of the private sector. The import licensing system was eliminated and tariff rates and structure were reduced and rationalized to make the trade sector competitive. On the regional front, the South Asian Free Trade Area (SAFTA) Agreement came into effect from July 2006. Nepal also became a member of the Bay of Bengal Initiative for Multi-sectoral, Technical and Economic Cooperation (BIMSTEC) and World Trade Organization (WTO) in 2004.

With respect to move towards fuller CAC, a crucial issue is the current account which has been witnessing continuous surplus for the last six years; however, looking at the historical experiences, it may not be possible to have such a comfortable position in current account in the years to come. The current account surplus as percent of GDP was 0.5 percent in 2006/07 compared to 2.2 percent in 2005/06.

Another concern is the Trade Policy of 1992 which is obsolete in the globalization

context. Again, market and product concentrations of exports have resulted in volatile export growth.

Preconditions

The list of preconditions cited below is based on experiences of EMEs and India together with the present position of Nepal.

The Financial Sector

An efficient and sound financial sector is an essential ingredient of CAC. As the country moves towards a fuller CAC regime, improvements are needed in the relevant regulatory and supervisory standards across the banking system to enable them to become more resilient and sustain their operations with greater stability. A supervisory regime has to be able to pick up warning signals and the weaker entities need to be monitored more closely and frequently.

Banks and financial institutions need to develop strong internal control systems to identify, measure, monitor and manage risks arising out of market fluctuations in context of further opening up of the capital account. With a greater degree of technology absorption, the market participants need to be in a position to build strong risk-management systems and management information systems. They should also upgrade their human resource skills by appropriate training inputs. In the long run, only skilled manpower can withstand vigorous competition and add value to the products and services rendered.

The NPAs of the banking system of Nepal, estimated at 9.65 percent as at mid-July 2007, is considered quite high. Drastic measures should be taken to reduce the NPAs. Although plans were made to set up an Asset Management Corporation in the recent past, not much progress has been made along this path. Before moving to a fuller CAC regime, in line with the recommendations suggested by the Tarapore Committee I for India, the NPAs of the banking system should be reduced to 5.0 percent or even lower.

Monetary & Exchange Rate Policy

As the Nepalese economy gradually shifts to a fuller CAC regime, monetary policy and exchange rate policy will be largely inter-twined. In the emerging context of greater integration of domestic and international markets, interest rate policy comes to the forefront. While interest rate policy has to take into account various factors, both domestic and international, more weightage needs to be given to international real interest rates in general and interest rates prevailing in India in particular.

Large and sudden capital inflows and outflows could be destabilizing to the economy and thus, the economy can encounter the problem of boom and bust. The Nepalese authorities need to rethink the kind of interest rate signals which are given to the system. With the

opening up of the economy and the development of financial markets, large changes in interest rates would be disruptive. A major objective of monetary policy is containing inflationary expectations and for meeting this objective, monetary policy action should be initiated well before the economy reaches the upper turning point of the cycle.

Presently, the exchange rate policy is adhered to supporting the peg to the Indian rupee. The peg has enabled the economy to benefit from its close economic ties with India. Especially, the peg abolishes exchange rate risk in the large volume of current and capital account transactions with India.

The exchange rate movement of the Nepalese currency is based on the movement of the Indian currency; an examination of the bilateral real exchange rate with India shows that there has not been a major misalignment as the inflation rates have been similar in both the countries. However, recent analysis indicates that inflation rates of both the countries could diverge implying that at the fixed exchange rate, the NC *vis-à-vis* the IC will become overvalued.¹² Moreover, if India moves to a fuller CAC regime as per the roadmap of Tarapore II, it would have significant implications for Nepal. This being the case, some adjustments in the exchange rate may be required.

Episodes involving EMEs, from the "tequila crisis" of 1995 through the Asian/Russian/Brazilian crises of 1997-98, have added to the evidence that a fixed exchange rate regime with an open capital account provides a fertile ground for crises. By contrast, emerging market economies that maintained greater flexibility in their exchange rate regimes have generally fared much better when faced with external pressures.¹³

Adopting a flexible exchange rate before liberalizing the capital account enables a country to absorb capital account shocks at a lower cost to the real economy than under a fixed exchange rate. The experiences of EMEs over the past decade highlight the risks of opening the capital account before adopting a flexible exchange rate.¹⁴ Overall, exchange rate management in the perspective of fuller CAC demands skillful operations.

Foreign Investment

The Foreign Investment and One Window Policy, 1992 and the decisions taken by the government subsequently allow 100 percent foreign investment in Nepal. The Foreign

¹² For details see NRB (2006).

¹³ For example, Chile, Mexico, Peru, South Africa, and Turkey all seem to have benefited from the flexibility of their exchange rates during periods of instability in emerging markets. China and India were less affected by the Asian crisis of 1997-98, and their relatively closed capital account regimes have been credited with helping to limit vulnerability to financial contagion, although other factors may have played a role as well, including comfortable foreign reserves positions. Details are provided in Prasad et al (2005).

¹⁴ Even if the economic conditions are favorable, opening the capital account prior to introducing some degree of exchange rate flexibility can threaten domestic liquidity, generate macroeconomic imbalances, and trigger speculative attacks. For details, see Duttagupta et al (2005).

Investment and Technology Transfer Act of 1992, amended in 1996, opened up foreign investment in all sectors excepting some industries such as defence, cigarettes, bidis and alcohol. The Act guarantees 100% repatriation of equity invested, dividends obtained from foreign investment and amount received as payment of principal and interest on foreign loans in convertible currencies.¹⁵

Though foreign investment in Nepal is allowed in almost all sectors, Nepali individuals/institutions are not permitted to invest abroad due to 'Ban on Nepali Investment in Foreign Countries Act 1965.' In this perspective, a draft of the Bill entitled 'Regularizing the Foreign Investment Abroad Bill, 2006' has been prepared and sent to the Ministry of Finance for consideration. In the process of further opening up of the capital account, it is important that this Bill be enacted soon. Subsequent to the enactment of this Bill, the operational guidelines need to be formulated.¹⁶

External Sector

Prior to moving towards a CAC regime, Nepal need to undertake certain external sector measures to make the trade sector competitive. These include the following:

- The country should initiate measures to improve productive capacities and make significant gains in productivity and competitiveness through technological upgrading. The implementation of a successful technology policy, however, depends on a skilled and educated manpower to tackle the many issues relevant to acquisition, utilization, absorption and generation of technology. It also depends on the country's capacity to invest in research and development (R&D) especially to promote locally developed technologies.
- Quality control is integral to competitiveness. The current small number of industrial firms having ISO-9000 Certification is a glaring illustration of this problem, which subsequently is restricting the ability of domestic firms to penetrate in principal export markets such as the EU, the US, and Japan. Hence, there is a need to undertake quality standardization and improvement programs to maintain the quality of export products.
- Too much reliance on few low-value export items such as readymade garments and carpets has acted as an obstacle in enhancing trading opportunities. Nepal has not seriously taken efforts to develop products, identify product market and establish a link between the two. This is an area demanding urgent attention.

¹⁵ Moreover, the Interim Constitution, 2006 has prescribed the state policy of promoting domestic investment and attracting foreign investment and technology for national development.

¹⁶ In this connection, it has been indicated in the Budget Speech for 2007/08 that "a legal provision will be arranged with certain conditions to make the foreign investment open for those industries which transfer technology from Nepal, establish an auxiliary subsidiary company abroad by the Nepalese holding company under operation as a public limited company in Nepal, and the mutual fund investing in portfolios instruments of foreign capital market." (Ministry of Finance, 2007, pp. 24-25.)

- The Trade Policy of 1992 has been outdated. In the present context of globalization and liberalization and as Nepal has joined the WTO, the SAFTA and the BIMSTEC, it is exigent that a New Trade Policy be formulated.¹⁷ Moreover, clear goals in trade must be systemically implemented in order to revive and build business confidence. The drive to export must not encounter frequent policy reversals.

Current Account Deficit

While the current account helps in attaining the final target of growth, lessons from global experience manifest the need to fix prudent limits on expanding current account deficits. The current account deficit represents the use of external resources in a country. Capital inflows to finance such deficits are welcome for their role in financing investment, and thereby sustaining long-term development. At the same time, it should be apparent that a large current account deficit implies correspondingly a large dependence on such capital inflows.¹⁸ The issue is not whether there are inflows or outflows at a point of time, since a significant fall in inflows is enough to cause a crisis when there is large dependence.

Nepal has, however, been experiencing continuous surplus in current account for the last six years. However, looking at the historical experiences, it may not be possible to have such a comfortable position in current account in the years to come. The country has to focus on industrialization and infrastructure development to attain and maintain high rate of economic growth. Moreover, the country is susceptible to external shocks. Under this situation, it is difficult to pinpoint the exact level of current account deficit that is sustainable while opening up the capital account. Advanced nations such as the US have been facing large and continuous current account deficit but have maintained overall position due to the consistent inflow of foreign capital. However, for LDCs such as Nepal, one cannot be too optimistic with regard to the persistent capital inflows. Moreover, Nepal has already opened up most of the sectors for FDI. Further opening of capital account basically means the removal of restrictions imposed on Nepalese individuals and institutional investors for their investment abroad. In this context, it could be difficult to manage a large current account deficit. Looking at the economic structure of the Nepalese economy and the measures proposed by Tarapore II for India, it can be broadly suggested that the current account deficit to GDP should not be greater than 2 percent.¹⁹

¹⁷ In this context, India announced a detailed Foreign Trade Policy (2004-09), covering a period of five years in September 2004. The twin objectives include: a) to double India's percentage share of global merchandise trade by 2009; and b) to act as an effective tool of economic growth by according priority to employment generation, particularly in semi-urban and rural areas. Nepal could also follow this path by announcing a New Trade Policy valid for a specific number of years.

¹⁸ The level of normal capital flows or sustainable current account deficit is contextual-to the country concerned, level of development, extent of external sector and even geo-political considerations.

Foreign Exchange Reserves

Reserve adequacy is taken as a crucial variable in gauging an economy's ability to absorb external shocks. In the context of CAC, an adequate level of foreign exchange reserves is necessary to withstand cyclical changes in the BoP as well as unanticipated shocks. Adequate foreign exchange reserves bolsters the pursuit of a stable macroeconomic environment and anchors credibility in domestic policies which lead up to reversals of capital flows. However, specifying the adequate level of reserves in terms of a quantifiable norm is difficult as it is based on the structural aspects of the country's BoP, the nature of shocks, the degree of flexibility in the exchange rate regime and access to international capital markets. A rule of thumb with respect to developing countries with current account deficits is that foreign exchange reserves should be equal to at least three months of imports at any point of time. This rule prevailed prior to the onset of the crises in the 1990s. Now, it is generally agreed that official reserves should cover at least six months of imports.²⁰ In Nepal's case, being a LDC which is susceptible to shocks, it is recommended that official reserves should not be less than seven months of merchandise and service imports; this ratio would consider the uncertainties and volatility in capital flows.

Inflation

Inflation is generally accepted as one of the crucial indicators to be considered while taking decision on a country's move towards CAC. If a country is facing unstable price situation, the opening up of capital account may lead to further instability. As Nepal gradually opens up its capital account, an unduly high rate of inflation would be destabilizing and would demand very high nominal and real rates of interest which would have an adverse impact on the overall growth of the economy. If interest rates are maintained at artificially low levels, there would be an exodus of capital out of the country. Tarapore I had recommended that inflation rate on average for three years to be between 3 and 5 percent for India. As Nepal has strong economic ties with India (with India constituting about two-thirds of Nepal's total trade), Nepal's price stability is strongly associated with that of India. Hence, in an integrated and interdependent world economy and against the backdrop of a progressive liberalization of capital flows, it seems crucial to set in place a mechanism for achieving an inflation rate not too far out of alignment with inflation rate in India.

¹⁹ In India's case, Tarapore II has recommended that the current account deficit/GDP ratio should not exceed 3 percent; otherwise, policy actions are called for. Tarapore II also notes that generally the appropriate level of current account deficit is a "dynamic concept and cannot be fixed in time, or cast in stone." For details, see RBI (2006), p. 34. Another crucial indicator is the current receipts to GDP ratio. The size of this ratio is the important determinant of the ability of the economy to make current payments and satisfying the servicing of external debt. As the current receipts/GDP ratio increases, it would be possible for the economy to expand the current account deficit/GDP ratio without rendering the external debt sustainable. See RBI (1997) for further elaboration.

²⁰ For India, the figure was set at six months by Tarapore I in 1997.

Fiscal Consolidation

Consolidating the country's fiscal position has been a key component of successful efforts to liberalize the capital account.²¹ This not only helps ensure macroeconomic stability but also enhances the credibility of policy by easing debt-servicing obligations. Large fiscal deficits may keep interest rates high and thus contribute to interest rate differentials that induce large inflows of more volatile, short-term capital.

It should be noted that prudent fiscal behavior by itself is not sufficient to prevent a crisis. After all, most of the South-east Asian countries had "reasonable" level of fiscal deficits and contagion tends not to discriminate between those who are well behaved and those who are not. But the experiences of Argentina, Chile and Uganda show that with the government deficit under control the financial system can handle inflows better, and in Brazil fiscal profligacy did lead to a crisis.

As fiscal consolidation assists in attaining and maintain macroeconomic stability, Tarapore I had fixed maximum limit of gross fiscal deficit of the central government of India at 3.5 percent of GDP. In Nepal's case, the gross budget deficit has been gradually increasing over the last three years and exceeded 4 percent of GDP in 2006/07. Although it is crucial to contain the increasing trend in budget deficit prior to opening up of the capital account, an exact demarcating line is difficult to make. Still, considering the role of fiscal consolidation in attaining macroeconomic stability for a small open economy like Nepal, the gross budget deficit of the government should be contained below 3 percent of GDP before moving to a fuller CAC regime.

Conclusions

Since the economic fundamentals of the economy are not robust enough, the move towards fuller CAC should take a gradual pace with priority accorded to the preconditions in laying a strong foundation. Prudential regulation and supervision is a *sine qua non* for successful financial opening. Strong regulatory and supervisory policies are crucial for minimizing moral hazard in the banking system and ensuring the viability and health of the banking industry.

It is important to approach capital account liberalization as an integral part of more comprehensive programs of economic reform, coordinated with appropriate macroeconomic and exchange rate policies. At the same time, the measures initiated by India as per the recommendations of Tarapore II need to be monitored and assessed on a regular basis.

²¹ Large fiscal deficits that necessitate financing through money creation may destabilize the exchange rate and discourage both foreign and domestic investment. Limiting fiscal imbalances and preventing excessive build-up of domestic debt is essential to avoid chances of backtracking subsequent to capital account liberalization. Though fiscal consolidation may not by itself be a sufficient condition to prevent crises, it has been a necessary component of liberalization and its absence can lead to instability as the Brazilian experience demonstrates. For details, see Roy et. al (2006).

Annex 1 Country Experiences

Indonesia

Preamble	In 1985, Indonesia initiated a reform program for reorienting the economy away from its reliance on the oil sector and towards an internationally competitive industrial export sector that could help absorb the growing labor force. This goal required reform on a broad front, including the liberalization of direct investment flows to promote export diversification, maintenance of a competitive exchange rate, and strengthening the financial sector.
Sequencing of reforms	Indonesia accepted Article VIII of IMF obligations to liberalize payments for current international transactions in 1988. It maintained selective controls on both capital inflows and outflows. The financial sector was reformed in phases from interest rate reform in the early 1980s to a greater emphasis on accounting standards and prudential regulation in 1995-96.
Exchange rate policy	The rupiah floated freely in a trading band of +/-8 percent (immediately before rupiah floated in July 1997 this band was widened to +/-12 percent). Indonesia's real effective exchange rate remained remarkably stable over the 1987-1997 period.
Monetary policy measures	The central bank relied on direct measures to control monetary policy including differentiated credit ceilings and interest rate controls. In the late 1980s, the government sought to move to more indirect means of controlling monetary policy by abolishing credit ceilings and interest rate controls.
Capital controls	On the inflow side, selective controls were maintained on direct investment (domestic ownership requirements), portfolio investment (purchases of equity by foreigners was prohibited) and bank borrowing in foreign markets. While capital outflows by resident individuals were open in 1985, lending abroad by banks and financial institutions was not allowed.
Impact of controls	Over the 1990s, Indonesia imposed controls on both inflows and outflows. In 1990-91, in the context of overheating economy and a stable real exchange rate, large inflows (mainly composed of commercial bank borrowing) were perceived to be excessive and a threat to macroeconomic management. The authorities re-imposed quantitative controls on offshore borrowing by banks and state enterprises and introduced stricter limits on the open foreign exchange positions of banks. Indonesia imposed controls on capital outflows in response to the Asian crisis in July 1997. These controls took the form of restrictions on non-resident transactions in the forward market (\$5 million per customer) and limiting the net open position of banks in the forward market (\$5 million per bank).
Financial crisis	Indonesia initially seemed poised to weather the 1997 Asian financial crisis given its smaller current account deficit and decision to widen the trading band of the rupiah. Widespread concerns about the soundness of the banking sector, however, renewed speculative pressure on the rupiah and after its forced float promptly collapsed in value.
Lessons drawn	The Indonesian case demonstrates the problems generated by large inflows into a poorly regulated and supervised financial system. These problems were related to the nature of the interaction between the political elite and financial industry, which obscured the functioning of this system from outside investors and allowed insiders to socialize the risks of their behavior. Indonesia also reflected the general problem of Asian countries in 1997: short-term, dollar-denominated debt far in excess of international reserves. According to the BIS, \$34.2 billion of Indonesia's total private foreign debt of \$55 billion—equivalent to 16% of GDP—was due to mature in less than one year. In 1995 to mid-1997, Indonesian firms had doubled their exposure to take advantage of the spread between international and domestic interest rates. The government failed to curb or effectively monitor the inflow. Thus, the Indonesian experience points to the significance of the pre-conditions for CAC as well as failures of regulation, monitoring and enforcement.

Source: Schneider (2000).

Korea

Preamble	Throughout its period of rapid industrialization from the 1960s to the late 1980s, the Korean economy was characterized by extensive government intervention. A key instrument of policy control was its use of the nationalized financial system to provide directed credits to certain industrial sectors, while monetary policy was pursued mainly through direct instruments, including ceilings on lending rates. Over the course of the late 1980s, Korea pursued a policy of gradually liberalizing the domestic financial system and the capital account, although this was accelerated under the Kim Young Sam administration in 1993.
Sequencing of reforms	In 1988, Korea accepted Article VIII obligations ensuring full convertibility for current account transactions. Liberalization of the capital account was gradual and selective and a comprehensive liberalization plan was not adopted until 1993. Korea's policy towards capital account transactions was guided by developments in the current account. In response to a significant current account surplus in 1986-89, authorities moved to curtail net capital inflows, whereas in the early 1990s as the current account weakened, they moved to encourage inflows. Policy thereafter was towards gradually liberalizing capital account transactions.
Exchange rate policy	As part of the reform process, Korea moved from pegging the won to a basket of currencies to the Market Average Exchange Rate (MAER) system in order to allow exchange rates to be determined more by market forces. The exchange rate is determined on the basis of the weighted average of interbank rates for the won-dollar spot transactions of the previous day. During each business day, the won rate against the dollar in the interbank market is allowed to fluctuate within margins of +/- 2.25 percent against the market average of the previous day.
Impact of capital account liberalization	One key consequence of the increased access of Korean financial institutions to external financing was a rapid expansion of foreign debt, which nearly trebled from \$44 billion in 1993 to \$120 billion in September 1997. While this level of foreign debt accounted for only 25 percent of GDP in 1997, which was considerably lower than that of other comparable countries, a critical dimension was the maturity structure of the debt. The share of short-term debt rose from an already high 43.7 percent in 1993 to an extremely high 58.3 percent at the end of 1996. Newly licensed merchant banks assumed a very large share of this short-term debt. Thus, persistent weaknesses of oversight and regulation remained which helped propel the country into crisis in late 1997.
Financial crisis	Korea was hit by the Asian financial crisis of 1997. The sharp rise in the short-term debt to reserves ratio and concerns about the stability of the financial sector (especially the finance companies) encouraged continual pressure against the won. When the won was forced out of its trading band its value promptly collapsed. From an average of 804 won per US\$ in 1996 the rate had depreciated to an average of 1401 won per US\$ in 1998.
Lessons drawn	Korea's experience suggests the danger of liberalizing the capital account in the context of inadequate prudential regulation and an unreformed financial system. The failure to monitor the activities of the finance companies was a serious gap in the regulatory regime that greatly increased the vulnerability of the country to sudden flow reversals. With the absence of state coordination and poor financial intermediation, funds flowed into low quality investments in sectors which already had serious problems with overcapacity. Korea's experience thus highlights the appropriate preconditions for CAC (liberalization of the real sector), financial reform and improved regulation. It also points to the lessons of failed sequencing.

Source: Schneider (2000).

Thailand

Preamble	A pegged exchange rate, an open capital account and large interest rate differentials induced large and often volatile short-term inflows in Thailand in the early 1990s. The establishment of the Bangkok International Banking Facility (BIBF) in 1993, with incentives to borrow through it, accelerated short-term capital inflows. In 1995, through monetary, prudential and market-based capital control measures, the authorities sought to deal with the large inflows. Continued strong inflows required an extension of the control program in 1996. In 1997, Thailand was struck by substantial speculation against the baht in the wake of a deteriorating current account deficit and financial sector problems. To combat this problem, the authorities imposed capital controls in May 1997.
Sequencing of reforms	Thailand accepted Article VIII obligations in 1990. The country has always maintained a fairly open capital account, particularly with respect to capital inflows. While inflows were liberalized early in the reform effort (1985-1986 and 1990-1995) outflows were liberalized only gradually (1990-1992, 1994).
Exchange rate policy	Thailand pegged the baht to a basket of currencies (primarily weighted towards the US dollar) since 1984. In the aftermath of the crisis, the control regime resulted in the creation of a two-tier currency market, with separate exchange rates for investors who purchase baht both in domestic and overseas markets.
Controls	Through raising interest rates and the prudential reduction of loan-deposit ratios in vulnerable banks, Thailand introduced more direct controls aimed at capital inflows in August 1995. These included: a) reporting requirement for banks on risk control measures in foreign exchange and derivatives trading; and b) a seven percent reserve requirement on non-resident baht accounts with less than one-year maturity and on finance companies' short-term foreign borrowing. In mid-1997, the baht came under speculative pressure in the face of declining reserves and a costly interest rate defense of the baht. To stabilize the foreign exchange market and stem speculative attacks, the authorities adopted a set of capital controls in June 1997: a) financial institutions were required to suspend transactions with non-residents that could lead to a build-up of baht positions in the offshore market; b) the prohibition on purchasing before maturity baht denominated bills of exchange and other debt instruments requiring payment in US dollars; and c) foreign equity investors were prohibited from repatriating funds in baht (but were free to repatriate funds in foreign currencies).
Impact of controls	The 1995 measures contributed to a slowdown in economic activity and decelerated the pace of foreign borrowing but it was only with the extension of the measures in 1996 that total net flows fell and shifts in their composition were seen. The mix of measures designed to address large capital inflows seem to have attained their objectives: a) net capital inflows were reduced; b) short-term net inflows declined as a percentage of total inflows between 1995 and 1996; c) the maturity of BIBF loans increased; and d) the share of short-term debt in total debt declined. The controls did not prevent Thailand from experiencing the devastating experience of a reversal of inflows a year later. The 1997 controls temporarily halted speculative attacks on the baht by segmenting the onshore and offshore markets. However, controls did not prevent outflows through other channels and also could not prevent the devaluation of the baht in July 1997 that initiated the Asian crisis. Controls served to undermine investor confidence further and discouraged capital inflows. In January 1998, as the economic environment improved, controls were removed and the baht appreciated along with rising stock market prices.
Financial crisis	Thailand witnessed weakening fundamentals during the course of 1997 and increasing speculative pressure against the baht. The devaluation of the baht in July 1997 signaled the start of the Asian financial crisis.
Lessons drawn	Thailand's experience with capital account liberalization highlights some crucial points. While the liberalization of short-term inflows in the context of high domestic interest rates and a pegged exchange rate led to a substantial increase in short-term liabilities of banks and financial companies, the controls implemented before the crisis of July 1997 were ineffective as they failed to halt the speculative pressure against the baht. The experience demonstrates that controls cannot be a substitute for sound macroeconomic policies, financial sector reform and effective prudential regulation and enforcement.

Source: Schneider (2000) and Pant (1999).

Mexico

Background	Mexico was undergoing a host of political upheavals which resulted in the collapse of the peso and later of the economy. In January 1994, a big-armed rebellion by a peasant organization called the Zapatistas in the southern State of Chaipas in Mexico occurred. The Zapatistas were protesting against the NAFTA and Mexico's neo-liberal economic policies. On December 20, 1994 the Mexican peso was devalued. It has been alleged that on December 18, President Zedillo hinted to a few rich businessmen that a peso devaluation was on the cards. The following day rich Mexicans converted billions of pesos into dollars. Two days later, a 13 percent peso devaluation was announced by the Mexican authorities.
Sequencing of reforms	Mexico had the tradition of relatively open capital account for residents co-existing with quantitative restrictions on imports. After the crisis of 1982 there was a reintroduction of capital controls with a very gradual process of capital account liberalization. A host of exchange controls were liberalized and limits on FDI were eased in 1989. Few controls on short-term capital flows were retained. Now, the government has eliminated restrictions on capital inflows, abolishing limits on commercial borrowing from abroad and foreign investment in Mexican securities. Controls on capital outflows have been abolished.
Exchange rate policy	Beginning in 1989, the fixed exchange regime was replaced by a crawling peg. Initially, the crawl was fixed at one peso per day (equivalent to the annual depreciation rate of 16 percent), in 1990 this was reduced to 80 centavos daily (11 percent annual depreciation) and, in 1991, the crawl was fixed at 40 centavos daily (5 percent annual depreciation). In November 1991, the crawling peg was replaced by a band at which the exchange rate was allowed to fluctuate. The ceiling of the band was adjusted daily by 0.0002 new pesos (or 20 cents of the old pesos). This adjustment was raised in October, 1992 to 0.0004 new pesos daily while the floor was kept at 3.0512 new pesos per dollar. On December 20, 1994 the ceiling of the band was raised by 15 percent while its subsequent daily rise of 0.0004 new pesos was maintained. This policy proved to be ineffective and was abandoned two days later when the Mexican authorities were forced to adopt a floating exchange rate regime because they had run out of international reserves (Bank of Mexico, 1995 and 1994). Mexico has a floating exchange rate system since December 22, 1994. The country has an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.
Impact of capital account liberalization	The effect of capital account liberalization was dramatic. The deficits recorded since 1982 were reversed into huge surpluses right after capital account liberalization in 1989, and resurfaced only at the crisis of 1994.
Financial crisis	The December 1994 devaluation triggered a financial crisis because foreign investors felt tricked and feared a default. Investors were angry for a very simple reason: the devaluation and its mishandling created substantial losses. Part of the investors' disappointment arose from the perception, which turned out to be correct, that the fiscal and monetary policies pursued by the government in 1994 were ultimately inconsistent with the exchange rate rule. Another important contributing factor to the debacle of the peso was the replacement of almost the entire short-term government debt from peso-denominated to dollar-denominated instruments (the Tesobonos) because it increased the risk of default.
Lessons drawn	A few lessons can be drawn from Mexico's experiences. One, the current account is major variable that should not get 'out of line'. Two, the composition of capital inflows is very important. Maintaining short-term capital under control while encouraging long-term investment is the correct step. Three, there is an inherent risk in employing fixed exchange rates as a stabilization device. Four, the structure, and particularly the maturity of government debt, is very important.

Source: Pant (1999).

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