

# Implementation of Full Convertibility of the Nepalese Rupee in the Capital Account\*

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## General Background

Nepal has been opting for an open, liberal and market-oriented economic policy since later 1980's and particularly after the restoration of multiparty democracy in 1990. In this respect, several liberal measures have been taken in the areas of trade, industry, foreign exchange and financial system. Implementation of partial convertibility of the Nepalese rupee in the current account in March 1992 was a crucial step in this regard. The erstwhile system of partial convertibility, however, continued to impose tax on exports and subsidize official imports thereby allowing anti export bias in the economy. Moreover this system could not discourage the existence of parallel market in convertible currencies as was expected at the outset. The continuation of parallel market was the reflection of the high margin set by the commercial banks between buying and selling rates of such currencies. On the other hand, the likely move of the Indian government towards full convertibility of the Indian rupee in the current account generated the apprehension that Nepal would be able to keep her foreign exchange policies in divergence with India's. As a result, the Nepalese currency was made fully convertible on the current account in February, 1993. To pursue with the commitment for further liberalization of the economy, the government has shown its intention to open the capital account as well (NPC, 1998).

But opening capital account is not an easy task as is the opening of current account. This is also evident from the fact that so far only 9 industrial and 21 developed countries have achieved full capital account convertibility. The problems of capital flight and exchange rate volatility are the most pronounced issues related with capital account convertibility. The problem is accentuated by the structure of the Nepalese economy which has a unique type of relationship with the Indian economy. As Nepal has to

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harmonize willingly or unwillingly her economic policies with those of India, opening of the capital account also be examined from the same perspective.

It is argued that full convertibility of the capital account leads to improving efficiency through facilitating specialization in provision of financial services, introduces competition from abroad in the financial industries, stimulates innovation and improves productivity, helps countries gain access to international financial markets and encourages enterprises to diversify their activities abroad and to adopt new technologies and managerial techniques. Equally important, liberalization of the capital account would imply complete dismantling of the restriction or regulations imposed on current account by direct or indirect means and thus would ensure full convertibility in the current account in true sense of the term. To cite examples from Nepal; there are indicative floor prices for the export of carpets which are imposed only for the sake of controlling under-invoicing of exports and hence, capital flight or diversion of the earnings in the parallel market. Similarly, there are some controls on service and transfer payments as well due to the possibility of capital flight from these channels. If capital account is opened, such regulations will cease to exist and current account will be convertible in the true sense. Further, capital account convertibility will encourage foreign direct investment which is supposed to be a crucial factor in an economy like ours where domestic resource mobilization is at the lower ebb and foreign loan has already indicated a problem of debt servicing in the near future. Although, foreign direct investment is guided by a host of policies and structure factors, opening of the capital account signals credible commitment in the form of foreign exchange to invite foreign capital.

Notwithstanding the attendant merits of free capital account transactions many countries, having open and liberal economic policies, have not gone to this extent. This is simply because opening of the capital account will not be sustainable unless some preconditions are made. These preconditions among others would be identified as: complete removal of restrictions that inhibit the flexibility of prices, limiting taxes in income, wealth and external trade, reduction of the difference between domestic and external financial market conditions establishing more flexible interest rate, restructuring and strengthening domestic financial institutions and most importantly reduction in the fiscal deficit and further tightening of monetary controls. All these indicate that capital account convertibility requires a more liberalized economic system with matured financial market and prudential monetary and fiscal policies. It also calls for a more flexible exchange rate regime. On the other hand, recent developments in the world economy indicate that more precautionary measures have to be adopted before introducing full convertibility in the capital account. All these issues can not be assessed without a detailed analysis and thorough review of relevant policies.

## **Preconditions for the Implementation of Capital Account Convertibility**

### **Importance of Capital Account Convertibility in a Globalized Economic System**

Along with fast integration of the world economy, almost all countries of the world are increasingly compelled to raise their competitive strength globally in order to sustainably accelerate their development process. For the same purpose, many countries of the world including Nepal are pursuing more open and liberal policies either through abolishing various forms of government controls or through encouraging market based pricing system in both product and factor markets in the belief that such a policy regime will eventually lead to realize the intended goals. For strengthening the market based system, various steps have been taken one after another in the financial sector also with the aim of making it more efficient and competitive in the globalized economic system. Accordingly, as noted in the previous section also, the Nepalese Currency was made fully convertible on the current account in February 1993 for a more open and liberal financial system. Although the overall impact of these various policies has yet to be fully assessed, in view of paucity of financial resources, underdevelopment in the midst of abundant water resources, technological backwardness, absence of competitive strength of Nepal in almost all fronts, persistence of parallel economy due to distortions in financial, product and factor markets as well as larger discrepancy continue in between world market prices and domestic prices, a necessity has arisen to look into the possibilities of making Nepalese Currency fully convertible on capital account so that the policy changes in these areas could help enhancing the competitive strength of the Nepalese economy. Similarly, a decision already taken to make free trade arrangements within SAARC region, new free trade and capital mobility provisions under the WTO and above all proposals from the International Monetary Fund to amend the articles of agreement to incorporate capital account convertibility as one of the obligations of Fund membership additionally indicate the necessity of exploring such a possibility. Moreover, in view of Nepal's close economic linkage with neighbouring country – India, Nepal may need close examination of new developments in policy front in the neighbouring country so that Nepal could be in a position to either avoid or minimize the delayed cost of policy adjustment.

Theoretically, it is argued that full convertibility on capital account would have four major benefits, namely (a) promote efficiency gains in the international economy by encouraging specialization in the production of financial service; (b) raise efficiency in a country's domestic financial sectors through increased competition from abroad; (c) improve the global intermediation of resources from savers to investors by ensuring that savings are allocated to the most productive investment; and (d) allow residents to hold

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an internationally diversified portfolio of assets, which would make their incomes less vulnerable to domestic shocks (Mathieson and Rojas – Suarez; 1992, 1993). In this way, it is pointed out that at first by getting the price right, capital convertibility facilitates efficient intermediation so that borrowers find lower funding costs and savers attain higher returns, giving allocative efficiency and competitive discipline to the economy. In this context, it is added that by exposing the domestic financial sector to global competition, capital decontrol simulates efficiency, innovation and specialization. It is also pointed out that by providing both savers and investors the opportunity of using the world market for risk diversification, capital convertibility reduced the vulnerability of their incomes and wealth to domestic economic shocks. In view of little successes achieved by many countries to attract foreign investment even after the introduction of full convertibility on current account, it is suggested that only the capital account convertibility by ensuring an economy's strong commitment to opening and globalizing will help acquire trust and confidence from potential foreign investors. In this context it is further added that only in such an environment, foreign investors can take more permanent ownership positions with significant positive externalities.

Based on these and other similar theoretical reasonings, every country is encouraged to introduce free convertibility system in a country's capital account. As many countries, notably the western capitalist countries to a larger extent and some emerging market economies to some extent, benefiting from such a policy shift owing to massive capital inflow and growing competitive strength, this has motivated many countries to explore the benefits of such a policy. Therefore, considering such developments in the world economy, a through review of economic conditions in the Nepalese context will be extremely useful to avoid any likely policy mistakes in the future in this critical area of capital account convertibility. Moreover, in view of India, a country with which our economic linkage is very strong, attempting to create favourable policy conditions for capital account convertibility, such a review is necessitated.

### **Capital Account Convertibility and Some Newly Emerging Issues**

Although one may strongly argue about a lot of benefits to a country due to the capital account convertibility, the experience does not support such an argument conclusively (Quick and Evans; 1995). Despite some countries, most notably developed, benefiting from such a policy move, the emerging market economies have the experience of both successes and failure. As it is evidently clear from the Latin American experience that their attempts to liberalize the Capital account in the early 1980s failed to accomplish the intended objectives. Now the recent experience of Southeast Asia, Russia and many Latin American Countries suggests that the problems with full financial



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liberalization and capital account convertibility are more complicated and serious than generally expected during the time of such policy prescriptions.

The problem becomes more complicated when it is found that, contrary to general expectation, a country may suddenly jump into deep economic crisis despite all macroeconomic fundamentals remaining strong. Such a phenomenon manifested in the Southeast Asian Countries (Azis: 1998). When the financial turbulence first started in Thailand in July, 1997 followed by similar turmoil in Malaysia, Indonesia and to a lesser extent in the Philippines, all macroeconomic fundamentals were very strong in all countries except the fact that the current account deficit was a bit higher in Thailand (8.1 to 8.2 percent of GDP). What lessons can we draw from the experience of South Asian Countries ? Although majority view about the crisis so far has been such that because of the lack of competency of financial system to cope with fully liberalized capital account transactions, the problem suddenly emerged and aggravated. But when the whole policies adopted by these countries in general and Thailand in particular from where the crisis started, are examined, it becomes far more clear that the policies allowing free movement of capital was pursued without any discrepancy between short-term and long-term private capital. Above all the biggest mistake from policy point of view was such that both exchange rate stability and inflation control were made policy targets without due consideration to both theoretical and empirical grounds that to achieve such conflicting targets simultaneously may be impossible. Although it is true that somewhat a flexible exchange rate policy was adopted by Thailand and other Southeast Asian Countries by introducing exchange rate band system, the band however, was limited to 3 to 4 percent at the most, thus following broadly a fixed exchange rate system in a regime of full convertibility in the capital account. Similarly, either to control inflation or to attract foreign private capital, the interest rate was maintained fairly high. In this way, the macroeconomic fundamentals were made strong rather artificially, without backup by the productivity gains and competitive strength of the economy. How such a policy may be regarded to be defective can be made amply clear by comparing these policies with standard theories in this area. In a standard Mundell-Fleming text book model, it is found that the massive flows of capital is translated into the shifting down of the balance of payment curve. These flows take the form of either increased share in the stock market or increased deposits in the home country's bank. Whichever the form, pressures on the exchange rate to appreciate builds up. It is the potential damage of such appreciation (on export competitiveness) that often led authorities of these countries (i.e. monetary authorities) to do the impossible i.e. defend the exchange rate while simultaneously maintaining the inflation target. As noted above, history and experience of countries suggest that the two cannot be met at a time.

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On the other hand, the liberal and open policies were carried out at such a faster rate that no attention was paid either to making institutions' support base strong or to evolve and implement strong rules and regulations to ensure the implementation of policies in a proper way so that any likely market distortions created by market players could be avoided. However, after knowing the underlying weakness of the Thai economy and widening current account deficit in the midst of declining export competitiveness, the foreign moneylenders including speculators and brokers withdrew their money massively in a very short span of time. In view of short-term capital injected in long-term projects that too without examining the project viability properly, the problem due to capital flight became quite serious, leading to virtual collapse of the Thai economy. More interestingly, despite strong macroeconomic fundamentals in Malaysia and Indonesia, the capital flight followed by sharp fall in share market prices, and currency depreciation took place in these countries in a same fashion as in Thailand. Indeed, it was a kind of contagion effect and therefore, these countries could not address these problems through policy steps and follow up actions internally.

Consequently, Thailand and Indonesia had to make a big deal with the IMF for minimizing the crisis and preventing from the complete bankruptcy of these economies. However, whether the big capital inflow in these countries with the support of the IMF will help to overcome from the deepening crisis in the near future is not clear as the economic performance of these two countries indicates. The macro economic indicators of the last year 1998 indicated that not only the problem emanating from financial crisis will persist longer in these countries, but also the contagion effect spreading from these crisis on the global economy will be equally serious and damaging. Moreover, because of the contagion effect, Russia has already reintroduced fixed exchange rate system following some kind of exchange rate band system. This indicates that the reform programme so far carried out in Russia to transform its economy into market based capitalist system has by and large, been a failure. As the government in its unilateral move has completely banned the outflow of capital, for some time, this additionally shows the failure of market based system so far practiced in Russia after the capital control due to its inability to check the depreciation of the Malaysian currency and declining share market prices. Among the various measures undertaken include the establishment of a fixed exchange rate for the Malaysian ringgit and making the ringgit tradeable only in the country. The main elements incorporated in the new exchange control rules are:

- External accounts : approval is required for transfer of funds between external accounts. Transfers to residents' accounts were permitted only until September 30,

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1998; thereafter, approval is required. Withdrawal of ringgit from external accounts requires approval, except for the purchase of ringgit assets.

- Authorized depository institutions : all purchases and sales of ringgit financial assets can only to be transacted through authorized depository institutions.
- Trade settlement : all settlement of exports and imports must be made in foreign currency.
- Currency for travellers: with effect from October 1, 1998, travellers are allowed to import or export ringgit currency of not more than RM 1,000 per person. The export of foreign currencies by resident travellers is permitted, up to a maximum of RM 10,000 equivalent.
- There are no limits on the import of foreign currencies by resident and non-resident travellers. The export of foreign currencies by non-resident travellers is permitted, up to the amount of foreign exchange brought into Malaysia.

Due to similar contagion problem faced by many Latin American countries in general and Brazil in particular, these countries are trying to explore new policy measures for avoiding the likely financial crisis.

Thus, along with the manifestation of convergence process in the global economy due to introduction of capital account convertibility system accompanied by full fledged financial liberalization, almost in a similar speed, the contagion effect is becoming equally a most serious problem specially in the newly emerging market economies day by day. One danger signal given by the experience of those countries which followed financial liberalization policies more aggressively by means of conflicting policy targets with the aim of creating strong macroeconomic fundamentals is such that in the name of ensuring competitive edge over the potential rivals, countries may be compelled to employ some arbitrary means, which in turn will have equally serious damaging impact on the global economy. Now the growing share market and asset prices in some parts of the world have also started to become a cause of concern. Considering all pros and cons of recent developments in the global economy, even Paul Krugman, an advocate of free market economy, has suggested that some kind of exchange and capital control may be necessary to save the emerging market economies from collapse (Venketaraman, 1998).

These developments, at the same time, support those arguments that, in view of full fledged globalization compelling individual countries to become powerless in shaping even a single policy independently in the broader interest of their economies, some leeway

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should be provided to the individual countries in this regard. Likewise, very tight fiscal and monetary policies in a given situation of worldwide recession are also becoming controversial, more so due to high poverty and skewed income distribution implications. As a corollary of this, it is also argued that a country like Nepal having highly fragmented and agriculture based subsistence economy with a tiny organized sector, full fledge economic liberalization to become a sub system of the global economy may be counter productive in view of preconditions of such a system demanding dismantling the active role of the state completely. On the other hand, developing countries like Nepal facing rising saving and investment gap problem in the midst of continued underdeveloped conditions potentials. Such a necessity may arise further in view of declining official capital inflow in these countries recently.

These are some of the issues that will need consideration while examining the possibilities of introducing capital account convertibility system in Nepal.

#### **Preconditions for Capital Account Convertibility**

Although Nepal has continuously implemented economic reform programme since the mid-1980s, sweeping reforms in economic policies were undertaken since 1991/92 in line with economic liberalization policies prescribed by the IMF and the World Bank. Consequently, taxation, industrial, trade, financial, foreign investment and exchange rate policies have been substantially liberalized. The government has reduced budgetary deficit considerably. Inflation rate has gone down markedly. The interest rate has been deregulated and now it is determined broadly through market mechanism. Same is true in case of exchange rate determination of the Nepalese currency with all major international currencies. Along with sharp cut in tariff rates to make rates compatible with the global tariff rates, foreign investors have been granted facilities similar to the local investors. Foreign investors are now permitted even, to purchase 25 percent shares in the areas like industry, tourism and electricity.

However, despite some successes made in these fronts, the economic fundamentals are neither strong nor sufficient to move instantly towards capital account convertibility. In Nepal's context, despite reform measures pursued, both fiscal and current account deficits are on the rise with clear signal that unless they are reduced drastically in the near future, they would adversely affect both macroeconomic stability and desire to attain higher sustainable growth. The phenomenal rise in debt servicing liability in recent years in the midst of mounting external dependency is becoming a serious problem. Likewise, despite free convertibility of the Nepalese rupees with major international currencies on current account, exchange rate with Indian currency is still fixed. The fragile base of the

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exports compounded by high transit costs for both exports and imports together with economic fragmentation and weak market linkages pose additional challenges to the Nepalese economy in view of high export growth badly required for, among others, sustaining the capital account convertibility. The situation in financial and banking sector is also not very satisfactory. The public sector commercial banks which predominate the banking transactions in the country are passing through deepening bad debt and loan recovery problems. In the BOP front the miscellaneous capital inflow has risen enormously in recent years, helping Nepal to derive overall surplus. This, again cautions us to underscore the uncertainty prevailing in the foreign exchange reserve front. Under such circumstances sudden jump into capital account convertibility will obviously be a highly risky and costly affairs.

On top of these factors, recent experience of economic turmoil by the Southeast Asian countries and contagion effect subsequently felt by almost all countries of the world even in a situation of strong macroeconomic fundamentals suggests that more precautionary approach has to be followed while introducing capital account convertibility. In the Nepalese context, there are some unique features like close economic linkage with India, structural rigidity, institutional barriers, absence of dynamic, catalyst and competitive forces in the economy to generate growth impetuses and ensure competitive edge over the existing and potential rivals in a sustained manner. The existing situation of economic stagnation and underdevelopment indicate that a concerted effort is needed in a continuous manner to fulfill the preconditions required for capital account convertibility. Additionally, in Nepal's context, new developments and policy shifts in India will be critically important so far as timing and sequencing of capital account convertibility is concerned.

Taking all these various factors together with experience of various countries, Nepal needs the fulfillment of preconditions in the following areas: (a) Fiscal conditions, (b) Trade, BOP and Reserve Conditions, (c) Financial conditions; (d) Inflation control; and (e) Other conditions.

#### **Fiscal Conditions**

The most important macroeconomic precondition for the capital account convertibility is macroeconomic stability which, in turn, demands that the fiscal deficit is under control and limit. If this condition is not fulfilled and government expenses are met through inflationary processes, this not only leads to encourage people to avoid inflationary tax through moving money from home to abroad but also leads to create devitalizing effect in the economy. The later effect becomes more serious and damaging in

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Nepal's context due to three main reasons. First, as Nepal's fiscal deficit is met mostly through external borrowing, this not only increases debt outstanding overtime enormously but also generates debt-servicing problem more seriously, beyond Nepal's capacity to meet the rising debt service obligations. Second, given the excessive dependence of Nepal on imports to meet almost all kind of daily necessities, fiscal deficit financed mostly through internal borrowing from banking system generates excess liquidity in the economy and hence induces imports leading to widening trade and current account deficit. Similarly, part of the fiscal deficit financed through internal borrowing from banking system not only raises internal debt servicing rapidly but also by creating monetary base leads to generate inflationary pressures in the economy markedly. All these effects generated through fiscal deficit become counter productive from the standpoint of both macroeconomic stability and sustainable development, badly needed to fulfill the preconditions.

The available information indicate that although there has been slight reduction in the fiscal deficit in recent year. Such a deficit is still high and erratic without showing any standard pattern so as to confirm that the fiscal deficit is on the decreasing trend. The fiscal deficit (net of government revenue and foreign grant) which was about 8 percent of GDP in 1984/85 peaked up to 10 percent in 1988/89. It then went down steadily with some fluctuation and reduced further to 5 percent in 1994/1995. It has again risen to 6.7 percent in 1997/98. If the foreign grant is excluded, the overall deficit for 1997/98 comes to be 8.8 percent.

On the other hand, there is a clear signal that the budgetary deficit is in a decreasing trend, thanks to the tight monetary policy followed by the Nepal Rastra Bank. Similarly, fiscal reforms undertaken by the government either by stopping bank guarantee facility to the public enterprises or by either withdrawal or reducing of current and capital subsidy have helped reduce the budgetary deficit considerably.

Although some countries including India have fixed fiscal deficit targets (in India's context 3.5 percent by 1999–2000) as a precondition, it is difficult to fix such a target firmly with scientific precision in Nepal's context in view of much more vulnerability of the Nepalese economy and its highly underdeveloped conditions. But based on the experience of other countries and observing four fold rise in external debt outstanding within 7 years and equally growing debt servicing in the same period, it will be necessary to reduce fiscal deficit more sharply in Nepal's context. Therefore, it is suggested that it should be reduced to around 3 percent of GDP within next three year (i.e. by 2002) by reducing slightly more than by 1 percent per annum in these years. Such an action will be possible provided government makes serious attempts in two fronts. One front is the front of resource mobilization. Further expansion of direct tax base, better tax compliance through tax



education as well as better, efficient and non-corrupt revenue administration will help to raise revenue by as much as 50 percent additional so that reduction of fiscal deficit in the desired direction will be possible. This, at the same time, will enable to prevent any bit curtailment of ongoing or potential development programmes. Likewise, in order to narrow down the price differentials accruing due to high tariff rates in Nepal compared to developed and emerging market economics where average tariff rate is 3 to 6 percent, further reduction in the average tariff rate without jeopardizing the local industry will be needed. Without this, it will be impossible to raise the competitive strength of the Nepalese economy. Second, government needs massive reduction in non-productive expenses concealed deliberately in both regular and development expenditure. At the same time, substantial changes in sectoral resource allocation pattern will also be equally necessary so as to expedite the growth process by balancing resource allocation between infrastructure cum production and social services sector programmes. In Nepal, the competitive strength of the private sector is fragile, among others, due to infrastructure bottlenecks. That will also hamper the foreign direct investment in Nepal even after the initiation of policies that allow free mobility of foreign capital. Therefore, what is needed is additional policy shifts in fronts; (a) phasing out government subsidies except for the activities targeted to those who are deprived most socially and economically;; and (b) withdrawal of government involvement from those infractural works which could be either let to the private sector or handover to the foreign private investors on a BOT basis. All these measures will help to reduce the size of the government expenditure tremendously. Likewise, withdrawal of subsidy in a selective manner accompanied by privatization of non-strategic and commercial type public enterprises should get equal priority in the government agenda. At the same time, government should give topmost priority in imposing the performance of those public enterprises which will not be privatized. In addition, more autonomy to the Nepal Rastra Bank in determining monetary policy, by replacing a kind of subsidiary role so far assigned, has to be provided with specific mandates backed by legal provisions. Better budgetary management, more transparent and accountable financial rules and regulations, better project screening and monitoring system, initiation of physical auditing in construction works and above all good governance are additional areas of reforms that deserve special consideration. These measures will be essential from the standpoint of sustaining liberal policies.

#### **Trade, BOP and Reserve Conditions**

In developing countries like Nepal, the growing gap between saving and investment as reflected in current account deficit is met through external aid and other sources. Therefore, in Nepal, fiscal deficit and current account deficit are closely related with

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each other. One of the immense problems, that Nepal will be facing in the coming days, is to create suitable conditions in the balance of trade and payments front.

The export has not only fluctuated widely during the period 1984/85 to 1997/98 but it has also more recently shown a stagnating trend, indicating serious problem in sustaining the current account deficit. The share of export which was 6.18 percent of GDP in 1984/85 rose to 10.45 percent in 1992/93, in a year when the impact of various reforms programmes including major devaluation of the Nepalese Currency was realized. But after such a windfall in export front, the export share in GDP started to decline and now it has fallen to 6.18 percent in 1997/98. This has happened due to poor export performance of carpet and readymade garment industries which contribute more than 80 percent of Nepal's export to third countries. Although in recent years, especially after new trade treaty with India, Nepal's export to India has slightly increased, however, the base is so low that so far it has been unable to make any significant contributions in total exports. In export front, Nepal lacks both commodity and country diversification despite strong export potentials of agro-based and other some industries.

Although commodity diversification in export has taken place in Nepal, this has been possible due to some shifts in exports from raw materials to consumer goods. But after the closer examination of export growth it is found that the export volume has not increased much so that the rising trade deficit leading toward widening current account deficit could be avoided. For instance in 1984/85 the total export was in the order of Rs 2,471.0 million against the imports of Rs 7,742.0 million equivalent. In 1996/97 total value of imports rose to Rs 96,006.0 million. In the same year total export was in the order of Rs 22,481.0 million only. Likewise, despite strong potentials of tourism industry, Nepal has been unable to tap such a potential to the maximum extent possible. Lack of adequate and reliable air transport, absence of well developed tourism centers outside Kathmandu and numerous other problems are preventing Nepal to boost services export. Similarly, despite tremendous export potential of water resource, in view of huge foreign investment and high gestation period required for its development, no immediate export growth through water resources development can be expected. Weak market linkages, absence of well-developed entrepreneurship, infrastructure bottlenecks and paucity of resources indicate that overnight commodity diversification and export promotion is unlikely in the Nepalese context. Moreover, Nepal's export promotion drive will be further circumscribed by the country's land locked position as this disadvantages condition raises transit cost enormously and accordingly Nepal's export competitiveness weakens markedly. Under these circumstances, Nepal's export growth potential seems less promising, at least, in the short run.

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On the other hand, as a result of phenomenal rise in imports, the imports jumped from 17.48 percent of GDP in 1984/85 to 31.41 percent in 1997/98 resulting in a trade deficit of 25.23 percent of GDP in 1997/98. Such a ratio was just 11.3 percent in 1984/85. The composition of commodity import shows an interesting trend with additional support to those arguments that Nepal's industrialization drive has been quite failure. The share of consumption goods in total imports was 36.61 percent in 1984/85. This ratio increased to 53.75 percent in 1996/97. On the other hand, the share of capital goods import reduced to 14.65 percent from 21.59 percent during the same period. This is why Nepal's trade imbalance has risen enormously in this period. Although services export, mostly tourism, together with remittances are helping Nepal to contain current account deficit to some extent, however, these sources may not be sufficient to meet the widening deficit in this area. Although, it is true that due to surge in miscellaneous capital inflow in a big way in recent years together with gradual rise in foreign aid, Nepal still posses adequate foreign exchange reserve, equivalent to more than 5 months equivalent of imports, however, due to non-reliability of miscellaneous capital inflow as a permanent and durable capital source and also necessity to reduce the dependency on external loan due to the reasons outlined above, the foreign exchange reserve can not be considered as a proxy of strong macroeconomic fundamentals. Therefore, Nepal badly needs the development of both medium and long-term comprehensive export plan so as to augment domestic resource base and other industries which will have competitive advantage in both Indian and third country markets. Unless such initiations are taken with some immediate actions to boost exports in near future, a hasty implementation of capital account convertibility will be risky and unsustainable. While initiating the policy planning, an alternative to the existing facilities to the domestic exporters in the areas of carpets, garments and raw materials imports must be evolved so as to make the existing policies consistent with the principles of current account convertibility. This will be necessary for discouraging the parallel market too, which is continuously undermining the ongoing reform programme with negative impact on resource allocation and use efficiency. Above all, given the volatility of export base and over dependency on miscellaneous capital to support growing current account deficit, immediate steps will be necessary on behalf of the government to boost commodity export, particularly high value added items, in a sustainable way. Likewise, Nepal has to concentrate on promoting tourism industry in a massive way given its competitive advantage and tremendous potentials. These steps will help Nepal to maintain foreign exchange reserve equivalent to at least four months of imports on a permanent basis. At the same time, in the course of formulating policy planning, priority should be given in reducing current account deficit, at least, by half of the present level (as a share of GDP) within next three years (i.e. by 2002).

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#### **Financial Conditions**

The financial turmoil in Southeast Asia and experience of other countries suggests that unless the financial sector is prepared through institutional and structural reforms to face the likely enhanced competition in this area, the objective of introducing capital account convertibility will not be fulfilled. Moreover, the Southeast Asian experience suggests that in the absence of alertness on the part of financial institutions about the nature of the capital inflow and its uses in different area and activities, no country should attempt to enter into capital account convertibility system. Therefore, as a precondition what is required is that topmost priority should be given in formulating financial policies in such a way that help minimize the differences between internal and external market conditions. This means that domestic interest rates on traded financial instruments (when adjusted for expected exchange rate changes) must be comparable to those prevailing in international financial markets (Mathieson and Roja – Suarez; 1992). For strengthening the domestic financial institutions to compete with international financial institutions, capability of domestic financial institutions have to be substantially increased. Among others, this demands restructuring of financial system by rebuilding the capital base of those domestic financial institutions which are facing bad debt and other problems seriously due to larger share of non-performing assets in their total assets. Unless new instruments and techniques are introduced similar to the method followed by international financial institutions, it is most likely that domestic institutions will be unable to enhance efficiency and reduce interest rate differences, the prerequisites for capital account convertibility. The efficiency of financial institutions to make compatible with international financial institutions, can not be enhanced without reducing other accumulated loss, minimizing the share of directed credit, creating alternative credit institution to be locally managed in rural area and altering the assets structure by limiting the size of the non-performing asset.

Considering from these various angles, a comprehensive reform programme of financial institutions under the direction of the Nepal Rastra Bank is warranted. Still the reserve requirement is very high in Nepal compared to the international level. In the areas of interest rate also the discrepancy between lending and deposit rate is very high. Likewise, there is no integration of the financial market. Therefore, restructuring and reform of financial institutions should be continued. For raising the competitiveness of the banking system, the commercial banks should be gradually left to undertake commercial activities only. As a precondition, more liberal policy in the areas of insurance will be required. Without this foreign investors will be least attracted even if other conditions are fulfilled. Therefore, new policy initiation in this area will be needed.

### **Inflation Control**

Many countries have been unable to introduce capital account convertibility, among others, due to inflationary situation, leading to economic instability and weakening of macroeconomic fundamentals. It is a common view based on both theoretical and practical grounds that in situation of higher inflation in the economy, it leads to appreciate the real effective exchange rate of domestic currency with adverse effect on export competitiveness. This again may lead to worsen balance of payments problems as a result of rising imports and declining exports. In general, high inflation generates expectations of the depreciation in the nominal exchange rate of the domestic currency which in turn, in addition to making exchange rate highly unstable leads encourage capital flight enormously. In such a situation, if the interest rate parity between domestic and foreign interest rate is not adequate to cover the expected rate of depreciation of the local currency, foreign financial assets will be attractive compared to domestic ones leading to investment not in domestic financial assets but in foreign financial assets. At the same time, it is needless to point out that in higher inflationary situation maintenance of positive real interest will be a difficult task specially for promoting saving mobilization in the country. On the other hand, if interest rate will be very high, that will lead to discourage the investment in the domestic economy. There is another dimension of inflation that needs equal attention. If prices are going up, in that situation the demand for goods, services and financial assets from abroad increases rapidly. This, under a situation of floating exchange rate, in addition to deteriorating balance of payments, leads to depreciate domestic currency continuously. This again, depreciating the real value of financial assets at home, encourages capital outflow rather than inflow.

The inflationary situation also works adversely in promoting financial development in the country. In addition to reducing real return on financial investment it encourages people to invest in physical assets thereby preventing financing deepening in the economy.

Thus, low inflation rate and price stability are prerequisites for exchange rate stability, financial-market development and ensuring better environment for industrial investment. On the other hand, unless these conditions are fulfilled it will be a great risk to open capital account. Therefore, one of the strong preconditions to be fulfilled for capital account convertibility is to bring down the inflation rate broadly at a par with the rate prevailing at the international level. Since last couple of years, the inflation rate at the international level is in between 2.5 to 3.0 percent on the average per annum whereas inflation rate in Nepal is now above 7.0 percent on the average. Therefore, as a

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precondition, Nepal has to set an inflation target of 5.0 percent, to be achieved within next three years (i.e. by 2002). Although inflation rate in Nepal is predominantly influenced by inflationary conditions in the neighbouring country, internal efforts through tight fiscal and monetary policy should be made in order to ensure that within next 3 years to inflation rate goes down to a level of 5.0 percent on the average.

#### **Other Conditions**

One of the important preconditions for capital account convertibility in Nepal is the timing and sequencing of capital account convertibility in India. Although a committee constituted by Reserve Bank of India has suggested three years time frame of fully implement capital account convertibility in India, the developments in Southeast Asia together with weakening economic fundamentals as well as political instability have compelled India to move slowly, contrary to the suggestions given by the Tarapore Committee (RBI, 1997). In view of many preconditions needing sufficient time to make them effective as well as high policy risk involved given the close economic linkage with India, it will not be appropriate to proceed ahead of India in this regard. Therefore, Nepal needs fulfillment of preconditions within 3 to 4 years so that Nepal could be in a position to introduce capital account convertibility as and when needed.

Similarly, a debate is going on in Nepal in view of continuation of fixed exchange rate system with Indian currency, contrary to the liberal policy regime adopted by Nepal since 1991/92. Because of fixed exchange rate system with India, exchange rate with international currencies is primarily determined by the cross exchange rate between the Indian currency and the US dollar despite full convertibility on current account with dollar and other international currencies. In such a situation, it is open secret that Nepal's has been unable to follow independent exchange rate and other policies thus preventing Nepal to reduce dependency on India and take full advantages of liberal policies. Therefore, one line of thinking in this context is that in order to overcome such a problem, exchange rate with India also should be fully liberalized during the time of fulfilling other preconditions. As the fixed exchange rate system in the context of capital account convertibility is considered to be a policy mistake, at least, on the theoretical ground, the logic behind introducing market based floating exchange rate system with India seems convincing. But in order not to jeopardize both short and long-term interest of the country, serious considerations has to be given about the timing before such a decision is taken. There is no doubt that if Nepal fulfills preconditions with equal emphasis on sustainability issues and enters into high economic growth path by promoting agro-based and tourism industry together with harnessing country's abundant water resources, in that situation market based exchange rate system with India also could be introduced and



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maintained. However, such a possibility is most unlikely in near future. Therefore, instead of thinking in those lines in immediate future, attempts should be made to enhance the competitiveness of the Nepalese economy, to be gradually able to absorb the shocks of the floating exchange rate with Indian currency.

Similarly, there are other areas which need equal attention. More liberal, open and relatively free labour market policy is needed for enhancing the competitive strength of the Nepalese products. Generally, labour contract system in place of employment guarantee and minimum wage fixation system is encouraged in this respect. This is suggested with the aim of raising the productive capacity of the labour force through facilitating greater mobility in the labour market. In Nepal's context also, labour laws need reforms in the same light. This, however, will lead to create some problems to the labourers, in view of high unemployment rate and predominance of unskilled workers in the labour market. Therefore, more balanced labour market policy will be needed with equal emphasis on job training and skill development programmes to the employed workers and labour force entering into the labour market.

There are other areas like the areas of tax reform, subsidies and administrated prices that will need equal attention. Although various tax reform programs are going on in Nepal with substantial reduction in customs and corporate tax rate, more reforms in these lines will be needed. Widening of tax base of the direct taxes will also be necessary in this context to avoid more dependency on internal borrowing. The custom rate structure is still very high compared to the level prevailing in those countries where capital account convertibility system has been introduced. Nepal is also confronting with various problems that are associated with value added tax. In view of this, a comprehensive tax reform program will be needed to make the tax system internationally comparable and consistent.

Likewise, despite phasing out or abolition of subsidy programmes, the share of current and capital subsidy is very high, without benefiting intended beneficiaries. Therefore, more selective approach targeting to most needy people will be needed in this area so that not only budgetary pressure on subsidy could be minimized but also more competitive environment could be created across wider areas of the economy. Similar approach should be followed in the areas of administered prices too.

The experience of many countries suggests that without effective monitoring and supervision system, the introduction of free convertibility system on capital account will be risky and unproductive. Therefore, simultaneous effort should be made by the Nepal Rastra Bank and other concerned agencies to evolve and implement effective monitoring

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and supervision system so that better policy monitoring followed by quick action to prevent any market distortions could be made. Likewise, unless mutually consistent macro-policies are developed and implemented for strengthening macroeconomic fundamentals, attacks of the brokers and speculators can not be prevented as the experience of Southeast Asian countries suggests. Therefore, while fulfilling preconditions macro-policies should be implemented in a consistent and balanced way.

#### **Review of Existing Legal Framework**

Nepal's existing legal framework needs a review relating to the issue of capital account convertibility. The review will deal with the relevant provisions of the written law (Acts and Rules), but not with the questions of their implementation and enforcement. But it is certain that a sound and receptive legal framework is key issue for capital account convertibility.

The constitution of the kingdom of Nepal 1990, the fundamental law of the land, has a set of Directive principles and policies of the State. One of such principles and policies of the State on FDI has been enshrined under Article 26 (12) of the Constitution which provides that the State shall, for the purpose of national development, pursue a policy of taking measures necessary for the attraction of foreign capital and technology, while at the same time promoting indigenous investment. Based on this constitutional directives and the Industrial Policy and Foreign Investment Policy of 1992 and the rising trend of economic liberalization, the existing laws of FDI have been devised.

Foreign Investment and Technology Transfer Act (FTTA) 1992, The Industrial Enterprises Act (IEA) 1992, The Company Act 1997, The Privatization Act 1994 deal primarily with foreign direct investment that has implications on capital account convertibility. Besides those Acts relevant to energy sector such as The Electricity Act 1992, Nepal Electricity Act 1984, The Water Resources Act 1992 and Regulation 1993 have direct bearing with foreign investment. In the communication sector The Telecommunication Act 1997, and Rules 1997, Press and Publication Act 1990 and Post Office Act 1962, Motion Picture (Production, Projection and Distribution) Act 1969 and Regulation 1976 and National Broadcasting Act 1992 come under the domain of foreign investment.

Under transportation sector Civil Aviation Authority of Nepal (CAAN) Act 1996 has important bearings on foreign investment. Nepal Petroleum Act 1984, Mines and Mineral Act 1985 and potential areas of interest for external financial sources. Financial sector under services has emerged as a pioneering area to attract foreign capital in Nepal.

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On this basis the Commercial Bank Act 1974, The Nepal Rastra Bank Act 1955, Finance Companies Act 1985, Foreign Exchange (Regulating) Act 1961, International Financial Business Act 1998, Insurance Act 1961 have to be attended to in order to pave the way for capital account convertibility. Besides these hosts of Acts falling under the purview of investments either of indigenous entrepreneurs or foreign investors have to be rectified in line with the spirit of open economy.

#### **Areas of Legal Reform**

Restrictions have been imposed on capital account transactions not only by Foreign Exchange (Regulating) Act 1962, but also provisions made in different sectoral Acts or special charters enforced for the establishment and operation of various institution. According to those special Acts, these institutions can raise foreign financial resources in the form of equity or debt only with the approval of HMG in many cases and with the approval of NRB in some cases. Therefore, these institutions can not go for foreign capital market to meet their financial requirement unless amendment is made in their respective special Acts. There are about two dozens of such Acts to be amended in this regard.

In a globalized context, Nepalese financial institutions may need to open branches abroad to mobilize external financial resources. But Commercial Banks Act 1974 and Finance Company Act 1985 are silent about it. Only Development Bank Act 1966 gives clear authority to such banks to open branches abroad. Therefore, this is an area where legal reforms should be made to empower domestic financial institutions to open branches abroad as and when required to mobilize external financial resources.

Commercial banks are the main intermediaries that channel external resources in a globally integrated financial market. There is lack of clear-cut mention about raising external resources by commercial banks, in the Commercial Banks Act 1974. Controlling or decontrolling of capital movements through commercial banks have been exercised by NRB, using the power given to it by the Nepal Rastra Bank Act 1955 and the Foreign Exchange (Regulating) Act 1962. Similar is the case, as regards to accepting foreign deposits by the commercial banks. This type of legal arrangement will be inadequate when Nepalese currency is made convertible for capital account transactions too. Therefore, amendment in the Commercial Banks Act 1974 and the Finance Company Act 1985 with provision of power to raise external resources and its modalities will be required to make domestic financial institutions efficient and competitive in a globally interrelated financial market.

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Similarly, amendment in the prohibition on investment in foreign countries Act 1964 and Foreign Exchange (Regulating) Act 1962 will be required to acquire more rewarding financial assets from international markets or to acquire more competitive fund in different forms and maturities from abroad by the residents; individuals or corporate. Till now, capital outflow has been almost totally restricted by these Acts.

In the process of legal reform restrictive clauses of the sectoral Acts regarding outflow and inflow of capital should be removed. The outflow and inflows should be controlled or regulated only through Foreign Exchange Act and the Nepal Rastra Bank Act.

## **Sequencing and Speed of Capital Account Convertibility**

### **Sequencing**

Convertibility of capital account may cause devitalizing effects in the economy certainly if not accompanied by necessary structural reform and macroeconomic policies. The devitalizing effects occur via the effects on inflation, interest rate, foreign exchange reserves and exchange rates, consequent upon enhanced inflow (or outflow) of large resources. It is, therefore, important, to pursue sound macro-economic policies which prove necessary impetus to expansion of investment and production base and contribute to maintain a sustainable fiscal as well as current account balance. This would call for expenditure switching policies towards creating infrastructure and restraining unwarranted expenditure, controlling revenue leakages and mobilizing additional resources and promoting exports. There is also a need to maintain interest rates at internationally competitive level and constantly monitor the overall size of inflows, using instruments such as reserve requirements and taxation of profits to moderate these inflows, as and when necessary. These and other related issues have been thoroughly discussed in the previous chapter.

Country experiences suggest that appropriate sequencing accompanied by necessary structural reforms and macroeconomic policies would lead to large capital inflows. The experience of Chile, Indonesia, Korea and Thailand reveal that countries with developed financial markets and institutions are able to attract portfolio capital flows compared to other countries where such markets are just emerging. The relation may also go the other way round. Opening of capital account can lead to the development of deeper, more competitive and more diversified financial markets. However, there exists a risk of banking crisis if the banks are not able to control and cope with the situation of sudden inflows and sharp reversals in capital flows. The economy must also be in a position of

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efficiently use the capital inflows leading to sustained improvements in economic performance.

Although economists hold different views on sequencing of reforms, the majority view and country experiences appears to be in favour of liberalization of capital account at the later phase of the reform process. Opening of capital account early in the reform process is likely to result in five major adverse consequences. First, liberalization of capital account results in excessive capital inflows thereby appreciating the real exchange rate (RER). This goes contrary to the requirement of depreciated RER to give boost to the export sector and neutralize the effect of reduction in tariff on imports. Second, opening of the capital account makes the exchange rate management difficult. Third, since the asset markets adjust faster than the goods markets, early opening of capital account would entail difficulty in trade reform. Fourth, opening of capital account when there is a lack of credibility of reforms would result in excessive imports to be financed from international sources. Fifth, opening of capital account with weak macroeconomic fundamentals would plunge the economy into severe financial volatility.

In a comparative study of Chile, Argentina and Uruguay which implemented reforms in the mid and late 1970s McKinnon (1982) finds that Chile had a better performance compared to two other countries. This is attributed to adoption of capital account openness at the end of reforms process in Chile while Argentina and Uruguay embarked on capital account liberalization fairly early in the reform process. McKinnon further remarks that before the trade reforms are initiated, fiscal deficit has to be eliminated and turned into surplus so that government is not constrained to seek external finance to finance its deficit. Chile first introduced fiscal reforms followed by reforms in domestic financial and goods market and capital controls were removed in the last. On the contrary in Argentina the fiscal sector was last reformed and fiscal deficit was high at 11.3 percent of GDP in 1980. Implementation of trade reform was also very slow. But controls on domestic financial sector and capital movements were removed early in the process of reform. Exactly the same sequencing of reforms as in Chile was adopted by Uruguay.

One of the important issues which should merit serious attention in the reform process is the credibility of reform measures. If the agents in the economy do not have faith in the reform they will undertake such activities which will negate the very objectives of the reform process. For example if they think that trade liberalization is short-lived and likely to be reversed they will import consumer durable in large quantities. Such imports are facilitated by the presence of free capital mobility and the possibility of resorting to foreign credit to finance these imports. This will result in

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unsustainable current account deficit and falling reserves which would in turn force the authority to reverse the trade liberalization process. This highlights the need for trade reform program before the process of capital account liberalization can be started.

Yet another important issue to be taken seriously in the context of capital account convertibility is the exposure of the country's financial system to volatility. Although capital account convertibility makes investment more lucrative because of removal of restrictions on capital movements, but it would also, at the same time, sow the seeds of financial volatility. The risk of financial volatility can be reduced, if not completely eliminated, with strong macroeconomic fundamentals. A cross-section study of 21 developing countries over 1993–95 suggests that Thailand and Malaysia even in the context of strong macroeconomic conditions plunged into financial crisis (Marjit and Kar; 1998). The financial crisis in Thailand is mainly analyzed in terms of short-term currency speculation and a large current account deficit as percent of GDP (Rakshit; 1997). In Mexico, currency depreciation and consequently economic depression in December 1994, is analyzed to have been caused by 7–8 percent current account deficit (as percent of GDP). As such, the risks of financial volatility are very high when macroeconomic fundamentals are weak.

In view of the experience of Southern Cone and east Asian Countries, adequate attention needs to be paid to the sequencing of capital account convertibility in Nepal. Since Nepalese economy is at a lower ladder of development with its financial markets not yet fully integrated with the Indian not to speak of the world market, the country was insulated from the recent financial crisis in east Asian countries. The situation will, however, be completely reversed when liberalization of capital account is followed.

The lesson that Nepal can learn from the experience of the Southern Cone as well as east Asian countries is that Nepal should first concentrate on fiscal reform followed by trade reform and removal of controls on capital account at the end of the reform process. The present budgetary deficit of Nepal at 8.8 percent of GDP (1997/98) is quite high and until this is corrected, capital account liberalization should be postponed. There is also a need to complete the process of trade reform. In Nepal the trade reform process is not fully in place as is indicated by the persistent trade as well as current account deficits. The trade and current account deficits in 1997/98 were of the order of Rs 61,453.9 million and Rs 15,028.5 million respectively which were 27.3 percent and 7.1 percent of GDP respectively. In India the appropriate level of current account deficit/GDP ratio is taken as 1.6 percent under the assumption of a real GDP growth of 5.6 percent, export growth of 15 percent in U.S. dollar terms and an import growth of 12 percent. However, in the context of a higher GDP growth rate the current account deficit/GDP ratio does not seem to be sustainable.



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This highlights the need for achieving a sustainable level of current account deficit as the ultimate target for the external sector. An important policy consideration in this regard is the exchange rate policy in terms of a stable/non-appreciating real effective exchange rate with at  $\pm 5$  percent band centered around a neutral REER.

#### **Speed of Capital account Convertibility**

Economists hold divergent views of the speed of capital account convertibility. Researchers advocating gradual reform are of the view that speedy implementation of reforms would entail certain short-term costs, such as unemployment and bankruptcies in business. Gradualism gives time for introducing institutional changes required necessary for smooth transition from controlled to open capital account transactions, Bank, industries/corporations and other economic agents can not be expected to reorient their activities and operations to the liberalized capital account overnight. Cross-country studies also show that countries adopting gradual approach to financial sector reform are able to avoid short-term crisis whereas rapid liberalization has led to short-term crisis (Caprio, Gerard, Atiyas, Hanson' 1994). A comparative study of Mexico and India shows that India, which adopted gradual reforms, avoided currency crisis, even despite economic sanctions whereas Mexico, which went for the big bang type of reforms, ended up with a crisis. In India there was a rising trend in savings, whereas in Mexico the savings rates witnessed a steep fall (Nidugala; 1997). Economists holding opposite view argue that reform programs need to be rapidly implemented on welfare as well as credibility grounds. On welfare ground retention of certain controls on capital movement or other capital transactions induce resource distortions and create opportunities for rent seeking, thereby resulting in welfare losses. Gradual reform is also countered on the ground that it would give opportunity to the groups opposing reforms to lobby against the reforms and politicize the issue, thereby eroding credibility. In a study of east European countries, Sachs argues for a big bang reform than to build consensus as the process of building consensus could be a prolonged affair leading to political opposition and delay in the introduction of reforms (Sachs; 1996).

In the case of Nepal given the weak macroeconomic fundamentals and underdeveloped internal capital market, it is advisable to adopt a gradual reform strategy in making the capital account fully convertible. A gradual step-by-step reform would give scope for the institutional development to take place hand-in-hand with liberalization. Since short-term capital flows are the most destabilizing factors, controls on such flows should not be removed until the economic fundamentals are strong enough to move towards full convertibility of capital account. Further more, once capital is made convertible neutralizing outflows turns out to be much harder than controlling inflows.

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Controls on FDI could, however, be removed faster for strengthening the real sector. An important policy measure in this regard would be tying up inward FDI with export commitment, as this would provide a cushion to BOPs when controls are removed on import to start with, and short-term capital flows left for later phase. Several countries that have performed well (including China) have used this as an effective measure of export promotion.

#### **Timing and Sequencing of Capital Account Convertibility in India**

There has been a great deal of discussion on the issue of adoption of capital account convertibility in India. A significant effort in this direction is the constitution of a committee on capital account convertibility by the Reserve Bank of India to examine the possibilities of embarking on capital account convertibility. The committee has already brought out its report covering various issues associated with capital account convertibility including a detailed time frame for achieving the goal (Reserve Bank of India; 1997).

The committee has recommended that the implementation of capital account convertibility be spread over a three-year period 1997–2000. In this context the committee recommends various signposts/preconditions as processes rather than as one time indicators to be achieved over the period. These are:

- (i) The gross fiscal deficit as percent of GDP should be reduced from 4.5 percent in 1997/98 to 3.5 percent in 1999/2000.
- (ii) The mandated ratio of inflation for the three year period should be an average of 3–5 percent.
- (iii) The RBI should have a Monitoring Exchange Rate Band of  $\pm 5$  percent around the neutral real effective exchange rate (REER). The RBI should ordinarily not intervene when the REER is within the band.
- (iv) The debt service ratio should be gradually reduced from 25 percent to 20 percent.
- (v) Foreign exchange reserves should not be less than six months of imports.
- (vi) Banks should adopt best practices of risk management.

The committee recommends that the implementation of measures towards capital account convertibility should be sequenced along-with the authorities making as

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assessment of the progress made in achieving the preconditions. The measures could be accelerated or decelerated depending upon the progress.

The timing and sequencing of liberalizing with respect to both inflows and outflows are set out in relation to four major economic agents, viz., individuals, resident and non-resident corporate, banks and non-bank financial institutions. The committee proposes that the reform process should be started by liberalizing outflow by individual residents. This is believed to give credibility to the commitment for capital account convertibility and give confidence to both the residents and non-residents that their genuine requirement for capital transactions are adequately met.

The timing and sequencing of various measures proposed for removing capital controls in India draws a conclusion that the Indian strategy towards capital account convertibility is a gradual reform strategy rather than a big bang type of reforms. Some of the important measures proposed are as follows:

- (i) Direct investment in ventures abroad by Indian corporates should be allowed upto US\$ 50 million at the level of authorized dealers and beyond US\$ 50 million through the special committee.
- (ii) External commercial borrowing ceiling should not be imposed for loans with average maturity of 10 years and above gradually reduced to 7 years and above subsequently.
- (iii) Exporters/exchange earners may be allowed 100 percent retention of earnings. Export Earners' Foreign Currency Account with complete flexibility in operation of the accounts for current and permitted capital transactions and allowed cheque writing facility in these accounts.
- (iv) Foreign direct and portfolio investment and dis-investment should be governed by comprehensive and transparent guidelines and prior approval of Reserve Bank of India at various stages may be dispensed with subject to reporting by Authorized Dealers.
- (v) Banks may be allowed to borrow from overseas markets and deploy their funds outside India. The ceiling on borrowing (short and long-term) should be 50 percent of unimpaired Tier I capital in Phase I, 75 percent in Phase II and 100 percent in Phase III.

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- (vi) Securities and Exchange Board of India registered Indian investors may be allowed to set up funds for investment overseas subject to an overall limit of US\$ 500 million in Phase I, US\$ 1 billion in Phase II and US\$ 2 billion in Phase III.
- (vii) Individuals may be allowed to invest in assets in financial markets abroad to the extent of US\$ 25,000 in Phase I, US\$ 50,000 in Phase II and US\$ 100,000 in Phase III.
- (viii) Residents may be allowed to have foreign currency denominated deposits with corporates and banks (only rupee settlement).
- (ix) Residents be allowed to obtain loans from non-resident up to an amount of US\$ 250,000 on repatriation basis with interest at London Inter Bank Rate with no restriction on use of fund.
- (x) All India Financial Institutions fulfilling requests criteria should be allowed to become full-fledged Authorized Dealers.
- (xi) Banks and Financial Institutions should be allowed to participate in gold markets in India and abroad and deal in gold products.

According to Tarapore Committee report, India should have moved to capital account convertibility from 1997. But two years have already elapsed and the government of India has not made any commitment or indication towards moving into capital account convertibility. In these two years there has been a wave of new recommendations that India should not show great haste in initiating capital account convertibility. It is argued that India has not yet reached the stage for liberalization of capital flows. In support of this view it is pointed out that the Latin American as well as east Asian countries had crossed a certain threshold of per capita income and stage of industrialization to withstand and sustain the ramification of liberalized capital flows. The per capita income had ranged from \$ 580 to \$ 1,910 among east Asian countries and from \$ 2,210 to \$ 250 amongst the Latin American countries. These countries has also attained the level of industrialization ranging from 30 to 40 percent of GDP. India has per capita income of \$ 300 and industrial growth to total GDP ratio of 2 percent. It is suggested that India should have a per capita income of at least above \$ 600 and industrial GDP of at least 30 percent for freeing of short-term flows (Economic and Political Weekly; 7-13, 1997). The recent move by Malaysia to erect new barriers to the free flow of money across borders having already been on convertibility for some years has been taken as an eye opener to the hasty move towards liberalization of capital flows. Taking the Chinese experience it has also been suggested that capital flows, principally equity and direct foreign investment can

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and do take place without free currency convertibility if the economy is able to maintain macro economic stability and high rates of return on investment. On the top of all these World Bank chief economist John Williamson has opined that India should take twenty to thirty years before moving to full convertibility of the capital account. He has pointed out that institutional building will take much larger time than recognized in the "Tarapore Committee Report" and "core membership of the organization of Economic Co-operation and Development" as a major condition for capital account convertibility (Financial Express; November 14, 1998). The government of India seems to have well considered these suggestions and delaying its decision to embark upon capital account convertibility.

#### **Reform in Exchange Rate with India**

Nepal's exchange rate system with India has always been maintained at a fixed parity, subject to change only by devaluation. Since February 12, 1993 following a revaluation of NRs against IRs by 3.0 percent, the exchange rate has been fixed at NRs 160 = IRs 100. It is now a question in the context of capital account convertibility whether it would be sensible to continue fixed exchange rate system with India. There seem to be two main reasons for maintaining a fixed exchange rate with India. First, since a large chunk of Nepal's foreign trade is concentrated with India a stable exchange rate of NRs with IRs is necessary to avoid adverse consequences of frequent changes in exchange rate on trade and balance of payments. The essence of pegged rate system is that it forestalls fluctuations in foreign exchange rate and thereby preserves stability in exchange rate. This argument for fixed exchange rate with India, however, appears weak as Nepal's trade with India has declined considerably from over 50 percent up until 1984/85 to 26.5 percent in 1996/97.

Second, the high rate of inflation in Nepal necessitated a pegged exchange rate to provide a transparent nominal anchor to help establish the credibility of stabilization program. An exchange rate anchor is also advocated in a situation of instability in money demand as inflation is reduced sharply. However, since past few years, there has been a significant improvement in the domestic price situation from double digit to single digit inflation. The rate of price increase in 1996/97 was 7.8 percent, while it was 8.1 percent in 1995/96 and 7.6 percent in 1994/95.

As against these, the following reasons can be given in support of flexible exchange rate with India. First, the large and growing trade deficit with India suggests, among other things, unrealistic exchange rate of Nepalese rupee vis-a-vis Indian rupees. In 1996/97 the trade deficit with India was as high as Rs 20,477.5 million which was equal

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to 7.6 percent of GDP. The magnitude of trade deficit in the preceding year was also at the same level (Rs 20,800.7 million). Nepal mainly exports agricultural products to India, although since past few years a few manufactured items are also being exported. The relatively higher rate of inflation and lower growth rate in Nepal as compared to India suggest that Nepalese products have weaker competitive edge in the Indian markets. This clearly shows a situation of appreciated exchange rate of Nepalese currency vis-a-vis Indian currency. Given the situation, discrete adjustment in the nominal exchange rate may be not only essential but also imperative. Since managing discrete adjustments of a complex affair, it is advisable to opt for a flexible exchange rate.

Second, judged in terms of impact of capital inflows on the real exchange rate, the fixed exchange rate regime is no better than the flexible exchange rate. In the fixed exchange rate regime additional capital inflows will lead to increase in money supply, thereby causing a rise in prices and a fall in the real exchange rate. Whereas in the flexible exchange rate regime larger capital inflows will lead directly to a lower price for the foreign currency. Since the change in the real exchange rate will be in the same direction whatever the exchange rate regime may be flexible exchange rate would be more compatible with the liberalization of capital account.

Third, also in the context of open economy, as the financial systems or corporations are free to borrow externally the market participants are likely to remain complacent about their foreign exchange exposure and do not hedge their foreign exchange risks. In the event of change in foreign exchange rate through pressure, the country not only loses foreign exchange reserves but also the soundness of its financial system is impaired (Khatkhate; 1998).

Fourth, maintaining fixed exchange rate with Indian currency when the exchange rate with major currencies are floated is likely to give rise to certain serious consequences. If the Indian currency appreciates vis-a-vis dollar, the differential in cross rate will give rise to speculative hedges creating pressure on the Indian currency reserves. This will be destabilizing, forcing devaluation of Nepalese rupees vis-a-vis Indian rupees.

The discussion seems to indicate that the difficulties of persisting with a pegged exchange rate system with respect to Indian currency particularly in the context of capital account convertibility can be overcome by adopting flexible exchange rate regime. But the question is whether it should be free float or managed float. Abrupt shift from a fixed regime maintained for such a long period of time to market determined exchange rate could trigger chaos in the foreign exchange markets. Even though flexible exchange rate might work well enough after everyone become familiar with the new regime, when it is first



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introduced, people may visualize stabilizing speculation, reluctance to engage in foreign trade and general disruption. So it is suggested that the transition from fixed rate should be done gradually by adjusting the rate by small margins, eventually allowing the rate to be determined by the forces of demand and supply. As in the case of dollar, the Nepal Rastra Bank should, however, intervene in the market in case the exchange rate starts to shoot up too high or plummet too low.

#### **Suggested Timing and Phasing of Capital Account Convertibility in Nepal**

As explained elsewhere, the macroeconomic fundamentals in Nepal are neither strong nor sufficient to immediately move towards capital account convertibility. So the move towards capital account convertibility should be delayed until the macroeconomic, financial and exchange rate policies are put in place to sustain the open capital account. As explained earlier, experience of liberalizing countries shows that the enhanced inflow (or outflow) of large resources causes temporary imbalances and aggravates imperfections in the economy. The immediate impact on inflation, interest rates, foreign exchange reserves and exchange rate may be destabilizing. Any premature attempt to capital account convertibility could also simulate capital inflows get absorbed into a lesser priority and non-tradable sectors. This may eventually invite a debt crisis since additional exports may not be generated in the process. Even if additional exports are to be realized, these would come with a lag and current account deficit may expand uncontrollably during the interim period. It is therefore vital that the preconditions are fulfilled before moving to capital account convertibility. The most important among these are a strengthened fiscal position and domestic financial reforms. The thrust of the financial sector reform should be to ensure that interest rates are internationally competitive, thus reducing pressures on the balance of payments and the exchange rates. It is also important to bring about an initial adjustment of the exchange rate of Nepalese currency with respect to Indian currency to a realistic level, followed by the pursuit of an appropriate policy mix for sustaining the capital account liberalization.

In view of the large gap between the current and desired macroeconomic fundamentals, it can be said that Nepal would require a minimum of 2 to 3 years for fulfilling the preconditions of liberalizing capital account transactions. This ignores the political fluidity that is in place since 1994. Political stability is vital to keep credence to the reform process. However, if India moves to capital account convertibility before the preconditions are fulfilled in Nepal, it would be imperative that Nepal should also go for capital account convertibility. If it is not so, Nepal would be logging the benefits accruing from the integration of domestic economy with the international financial system. As discussed earlier, India is delaying its move to capital account convertibility perhaps

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keeping in view the crisis in east Asian countries and the advise tendered by the World Bank. But this should not mean that Nepal should remain complacent in correcting the macro economic fundamentals and strengthening the institutional framework which would prepare the ground for initiating capital account convertibility in case of India's move towards this direction.

The task of hackling out the process of capital account convertibility is a difficult one and some degree of subjectivity is unavoidable. Keeping in view the time needed for fulfilling the preconditions, it is proposed that Nepal should make a start to liberalize capital account transaction from 2002 with a time frame of 3 years for completing the process. A three-year time span seems to be a reasonable period of time for fine tuning of policies as the country proceeds further towards full convertibility of capital account. But this is, however, only tentative and a longer time span may be considered in cognizance of performance in domestic reforms as well as changes in the world economic scenario. The start may be made by liberalizing outflows and inflows in a balanced manner so that the pressure on exchange rate and money supply that could arise from inflows could be minimized. It will also mitigate the damage that the short-term inflows bring in and which are considered as potentially more destabilizing. Liberalization of long-term inflows such as inward direct investment are viewed as being more stable and productive.

The various measures and the timing and sequencing thereof proposed for opening capital account are presented below in a tabular form. These measures to open the capital account should, however, be introduced in consonance with the performance in the macroeconomic fundamentals. The Nepal Rastra Bank should closely monitor, review and analyze the developments consequent to introduction of each measure undertaken in Phase I, and decide the measures to be undertaken in Phase II, and consequently in Phase III.

Item	Present Provision	Year I	Year II	Year III
<b>1. Individuals</b>				
Foreign Currency Deposits in Nepal	Permitted only in the case of foreign exchange earned in the form of salary remuneration, commission royalty, grant, fees etc.	To be permitted to all foreign exchange earned through capital account transactions without ceiling	Same as Phase I	Same as Phase II
Opening of Account in Foreign Banks	Not permitted	To be permitted upto \$ 25,000 per annum with NRB approval.	\$ 50,000 per annum with NRB approval.	\$ 100,000 per annum with NRB approval.

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Loan from Foreign Individuals	Not permitted	To be permitted upto \$ 25,000 with NRB permission	\$ 50,000	\$ 100,000
Investment in Foreign Stock Exchange	Not permitted	To be permitted upto \$ 25,000 per annum with NRB approval	Upto \$ 50,000 with NRB approval	Upto \$ 100,000
<b>2. Corporate/ Business</b> Investment in foreign securities	Not permitted	To be permitted upto \$ 50,000 per annum	Upto \$ 75,000	Upto \$ 100,000
Opening of \$ account abroad	Not permitted	To be permitted upto \$ 25,000 per annum	Upto \$ 50,000	Upto \$ 100,000
Borrowing abroad	Not permitted	To be permitted (loans with maturity of less than 10 years should be subject to approval by NRB)	Same as Phase I (but maturity conditions to be reduced to 7 years)	Same as Phase II (but maturity condition to be reduced to 5 years)
Issue of foreign currency denominated bonds to foreigners	Not permitted	To be permitted upto \$ 50,000 per year	Upto \$ 100,000 per year	Upto \$ 150,000 per year
<b>3. FDI (Corporates/ Business/ Individual)</b> (i) Foreign	DOI authorized to grant permission for investments upto Rs 500 million, Investments above Rs 500 million require permission of Industrial Promotion Board.	DOI should be authorized to grant permission upto Rs 1,000 million	DOI authority to be raised to Rs 2,000 million.	DOI authority to be raised to Rs 3,000 billion.

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(ii) Domestic	Not permitted	To be permitted upto Rs 500 million with the approval of NRB	Upto Rs 1,000 million with the approval of NRB	Upto Rs 2,000 million with the approval of NRB.
<b>Banks (Domestic)</b>				
(i) Investment	Permitted to invest their \$ deposits in foreign time deposits, certificate of deposit, call money and bonds issued by govt. and international financial institutions with maturity of one or less than one year.	To be permitted to deposit 50 percent of their foreign currency deposits in various foreign financial instruments of longer than 1 year duration	Same as Phase I	Same at Phase II
(ii) Borrowing	Not Permitted	To be permitted upto \$ 25,000 per annum with NRB permission.	Upto \$ 50,000 per annum with NRB approval	Upto \$ 100,000 per annum.

### **Impact on Inflow and Outflow of Capital**

#### **General Background**

Capital flows basically are of two types: short-term and long-term. Short-term capital flows occur in a situation when there is a high interest differential in favour of the host country. Also for short-term capital inflows, a well-developed stock market is needed. Long-term capital, on the other hand, mainly comprises in the form of the external debt of the public sector, foreign direct investment and/or external borrowing by the private sector. For long-term capital inflows, in addition to sound macroeconomic fundamentals and well-developed financial system, good investment climate is also required.

The likely impact of capital account convertibility in terms of short-term and long-term inflow and outflow of capital in Nepal is made here by considering various factors such as interest rate, exchange rate system and investment opportunities in Nepal relative to India and third countries. While assessing the probable impact on short and long-term

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capital inflow, three options viz. (a) opening capital account ahead of India; (b) opening capital account after India; and (c) opening capital account when India does so, have been examined again considering two different exchange rate regimes fixed and floating with India.

#### **Short-term Capital Inflow**

Although factors responsible to influence a country's capital inflow and outflow vary from one country to another, prudent macroeconomic policies accompanied by policies facilitating free movement of capital have played important role in the inflow of short-term capital (Shadler/1993 and Khan and Reinhart/1995).

Among others, the interest rate differential between Nepal and other countries on the fixed and savings deposits will be one of the major factors that will determine the flow of short-term capital in outward or inward direction. Exchange rate system of Nepal vis-a-vis other countries in another factors. Similarly, the measures taken to promote and expand market and investment climate and opportunities available in the country will also be instrumental in determining the pace of capital inflow in Nepal.

Nepal Rastra Bank has also recently adopted certain measures to lower the interest rate structure, reducing interest spread and to help accelerate bank credit to private sector. However, the interest rate still failed to cover towards the world level. Lack of competition in the banking sector lending towards the oligopolistic price behaviour, lack of investment in the productive and trading sector, inefficiency in the banking sector and accumulation of non-performing assets in the banks are some of the deep rooted causes, which have raised the level of interest rate structure in Nepal.

In general, if Nepal's interest rate on bank deposits is less than that in India, there is greater change of capital outflow from Nepal to India. Reverse may be the situation when Nepal's interest rate on bank deposits is higher than that in India. For this to happen, however, interest rate differential should be favourable even after the deduction of transaction cost. Interest rate in Nepal is slightly low than that of India. Yet if the opening of capital account in Nepal is ahead of India a huge amount of capital is likely to flow into Nepal in the form of Indian currency. Such situation arises due to two main reasons: (i) motivation for the Indian residents to convert their black money into white and (ii) free mobility of capital along long open border with India. This will however, create serious problems of withdrawal after sometimes as Indian investors start taking the capital in banks in white form. But, if the opening of capital account is accompanied by the floating of Nepalese currency against Indian rupee, the capital inflow from India

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may remain for longer period in Nepal so as to reap the exchange gain resulted from probable appreciation of Nepalese rupee vis-a-vis Indian rupee. On the other hand, if India introduces capital account convertibility before Nepal, again in a situation of Nepal continuing the fixed exchange rate system with India, in that situation a big capital outflow from Nepal to India will take place. This will happen due to more earning opportunities and quick benefits to be available in India.

Similarly, short-term capital inflow to Nepal from third countries would again depend upon the degree of interest rate differential between them. Since the exchange rate system in Nepal is not fully flexible, nominal exchange rate would play very limited role in reducing the expenditure cost. Therefore, surge in non-official capital flows may not be fully attained even with full convertibility of the capital account. More importantly, the inflow of capital from third countries would depend upon the import intensity of spending associated with that inflow. Moreover, the flow from third country will depend upon the extent of development to take place in the areas of share and stock market in Nepal. Also to the extent, the real sector development takes place in Nepal that will also have tremendous effect on the short-term capital inflow.

In countries like Nepal, the real interest rate, which had been a policy variable in the past, was found widely fluctuated. Although in recent years a big policy shift has taken place in this front as with the attempt by concerned authorities to deregulate the interest rate, successes have not been achieved fully so far. Assuming that in a situation of full capital account convertibility the interest rate is fully market determined in that situation still Nepal will face some difficult problems given the real interest rate trends in Nepal, India and some selected countries. There is marked difference between inflation in Nepal and some selected advanced countries. Although the inflationary trend in Nepal and India is broadly similar, a significant variation from the average trend is observed when year to year data is analyzed. If similar trend will persist in the coming days, that will have some negative impact on capital inflow to Nepal from both India and third countries. Although high interest rate in Nepal compared to advanced countries will help attracting short-term capital from third countries this will not be the case in every circumstances as the world experience suggests. In Brazil when the capital flight started to take place, government increased rate of interest up to fifty percent. But this did not help Brazil to check the capital inflow. Almost same was true in case of Southeastern countries. Unless countries like Nepal bring down the inflation rate at par with the global inflation rate, in the fear of macroeconomic instability and greater exchange rate risk, foreign investors will be least interested to invest. This will be true in a situation of positive real interest rate also.



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In sum, there will always to some degree of uncertainty in maintaining the regular inflow of short-term capital even in a situation of full capital account convertibility due to host of internal and external factors influencing the international transactions. However, if capital account convertibility in Nepal takes place along with India and a positive real interest rate with low inflation is maintained, this will additionally help Nepal to attract short-term capital in the country. But from the policy point of view, some problems will be encountered. In a situation where interest rate is market determined, maintenance of higher interest rate will be difficult. Therefore, some type of policy mix influencing interest rate will be desirable. Likewise, in view of great risk with floating exchange rate with India, a gradual approach will be beneficial for Nepal provided other policies promoting Nepal's real sector development are simultaneously pursued. So far as interest differential with India is concerned, higher rate than India will neither be possible nor desirable particularly in view of highest interest rate leading to discourage local investors to invest in the domestic economy. This likely effect also indicates the necessity of giving adequate attention in other areas too.

#### **Long-term Capital Flow**

Long-term capital inflow is mainly determined by the investment opportunities available in the country there are very limited investment opportunities in Nepal compared to the possibilities. If Nepal gives priority on developing tourism industry accompanied by harnessing abundant after resources of the country besides concentrating on promotoral and services industries where Nepal has comparative advantages, that will additionally help Nepal to attract foreign capital in a situation when there is a capital account convertibility. Similarly, a country's financial structure and macroeconomic conditions also affect long-term capital inflow. Recently, in Nepal, stock market has also been liberalized to the foreign participation to the extent that up to 25 percent of the paid up capital of institutions or companies in some specific areas. Likewise, foreign securities, companies and firms are also allowed up to 40% participation in joint investment in the securities market with local brokers and securities firms. Yet it is worth mentioning that the stock market in Nepal's under developed and hence its performance is less satisfactory as compared to those in India and third countries. In addition, various factors such as exchange rate instability, inadequate infrastructure, and unavailability of skilled manpower and legal provisions are likely to hinder the inflow of capital particularly from the third countries if adequate attention is not given in these areas.

Nevertheless, it is expected that capital account convertibility will facilitate immediately Nepalese residents abroad to make long-term investment in Nepal at a

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faster rate. Although the measures taken recently to allow Nepalese industries borrow from foreign banks in convertible currencies including those from India will help to increase the capital flow in the country, a larger flow will not take place after major policy shift takes place in this front. This will be true in cases where some new facilities of issuing debenture to foreign investors against securities or collateral have been provided in the areas of infrastructure, industry and export sector. Since Nepal has been perpetually biased towards the dependence of external borrowing to meet its public expenditure, with the new regime of capital account convertibility, the long-term capital in the form of external debt is likely to increase. This may create problems in sustaining the long-term capital inflow in the long-run when the principle and debt servicing reaches at the peak level. In view of this, it will, therefore, be necessary to devise the strategies to make better use of capital inflows.

In sum, it is expected that third countries will have higher percentage of official long-term capital while India will have large proportion of private capital in the form of foreign investment after the capital account convertibility in Nepal. This, in turn, will help to maintain the balance of payments situation in Nepal's favour. As noted above also, the capital investment from Nepalese residence from abroad will additionally facilitate this process.

### **Impact on Balance of Payments and Foreign Reserves**

Position of the balance of payment will depend to a larger extent on the choice of exchange rate regime. Consider the case where Nepal is to continue the adoption of fixed exchange rate regime with India. Under such a situation, there will be no change in nominal exchange rate and current account situation despite the likely surge in non-official capital inflows. The inflow is likely to be persistent as the foreign investors are ascertained of almost zero currency risk. Thus, there will be greater accumulation of foreign exchange reserves. The accumulation of increased foreign exchange reserves, however, would complicate the operation of monetary stance.

On the other hand, if Nepal follows the flexible exchange rate regime along with the full convertibility on capital account, the surge in the capital would place upward pressure on the exchange rate. In that situation the nominal exchange rate will appreciate. This will lead to decline in relative prices of traded goods vis-a-vis non-traded goods. As a consequence of this, expenditure on foreign produced goods will tend to increase leading towards the worsening of the trade balance. In addition, it will also stimulate an increase in domestic demand producing a rise in imports. The magnitude of rise in domestic demand and the degree of appreciation of the exchange rate and the

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resulting current account deficit will depend upon the import intensity of spending. Under floating exchange rate regime, however, capital inflows will rise due to an increase in the expected return on capital investment. Accordingly, balance of payment and foreign exchange reserves are likely to attain a comfortable level in the beginning of the full convertibility of capital account. However, the later period will be risky as and when the repatriation period and amortization schedule of official capital comes closer to the due date. Furthermore, the economy will also be characterized by higher levels of demand, output, interest rates and inflation. To guard in advance the possibility of worsening of balance of payment and foreign exchange reserves, care should be given from the beginning to follow such external and internal policies that help improving trade and current account balance. Such a strategy will assist in timely offsetting the possible adverse consequences induced by the capital account convertibility on the position of balance of payments and foreign exchange reserves.

#### **Impact on the Composition of Foreign Exchange Reserves**

At present, Nepal's foreign exchange reserves holding comprises three fourth share of convertible and remaining one fourth share of non-convertible foreign exchange reserve. The non-convertible currency is mainly composed of the Indian Rupees. In view of growing export trade with India, non-convertible reserves also play important role in the Nepalese economy. With the convertibility of capital account in full-fledged manner, a significant change may occur in the composition of foreign reserves. If full convertibility of capital account is realized in India ahead of Nepal, it is likely that foreign exchange reserves will have less share of non-convertible currency. This is because trade transactions with India will start increasing in convertible currency as it enjoys more tax exemption facilities. Besides, inflow of long term capital (both official and private) will assist in piling up the greater share of convertible currency in the composition of foreign exchange reserves. The situation will be reversed if Nepal enters into capital account convertibility before India. Massive inflow of black money from India will take place in this situation. This will happen due to the free mobility of unrecorded capital through the long open border. Such a situation will help in triggering the massive outflow of convertible currency and lead towards extensive depletion of convertible foreign exchange reserves. In order to avoid such capital flight, certain control mechanism has to be pursued through external as well as internal policies.

In the existing situation of the Nepalese Rupees being pegged to the Indian currency where, any change in the Indian currency vis-a-vis the green dollar has to be offset by moving the Nepalese currency in the same direction vis-a-vis US dollar for nullifying the generated broken cross rates, capital account convertibility in Nepal may exert due to

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massive inflow of Indian currency as noted above heavy pressure on Nepalese currency to appreciate vis-a-vis Indian currency unless the surged inflow is sterilized to avoid negative impact on inflation and current account deficit. Sterilization is often effective in insulation and economy for short periods from some of the unwanted effects of surges in inflows. It is easy to implement quickly and in several countries appears to have prevented a widening of the current account deficit while looking in large increases in official reserves. But countries that sterilized aggressively benefited least from the effects of inflows on investment and growth (Schedler, Carkovic, Bennett and Kahn/1995). Thus sterilization may not be sustainable in the long run. If Nepalese Rupees is floated it will be automatically appreciated partially with the Indian rupees and depreciated partially with the US dollar when Indian currency is depreciated with the US dollar. This situation will affect the export trade with India. Unless Nepal diversifies its exports to third countries, it may face the problem in the external sector account. Thus, Nepalese currency's stability will depend much on the movement of Indian currency vis-a-vis US dollar.

### **Impact of Capital Account Convertibility in Capital Market**

The opening of capital account provides opportunities to the Nepali investors to invest their savings in bonds, shares, debentures etc. in foreign capital markets as direct and portfolio investment which is not legally permitted now. In this case, Nepali investors may invest outside if the rate of return on investment is higher, future business prospect is bright and the exchange rate of Nepali rupee is expected to devalue further. Frequent changes in the government policies and continuous devaluation of the Nepali rupee with convertible currencies shows the high chances of capital flight for investment abroad after the opening of the capital account. Within a period of seven years (1990-97) Nepali rupee have been devalued by 79.25 percent with the American dollar showing an average of 11.32 percent per annum. Likewise, the Indian rupee devalued by 84.93 percent (12.13 percent average per annum). The South Korean Yuan and German Mark has been devalued by 18.69 percent. (2.67 percent annual average) and 2.11 percent (0.30 percent annual average) during the review period. This shows that Indian and Nepali rupee had been devalued by higher percentage. During the same review period the Japanese Yen and Pound Sterling have been re-evaluated by 20.6 percent and 3.19 percent respectively. This shows that investment in Japanese Yen and Pound Sterling denominated securities are safe and high yielding. With such information at hand a rational investors will put his investment in strong and re-evaluating currency dominated securities rather than the Nepali rupee dominated securities. This shows the strong possibility of capital flight from the country.

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The interest rate structure of different countries is another indicator to the investors to decide where to invest the capital. The interest rate structure of the above countries including the United States of America for the last seven years shows that interest rate in India and Nepal has always remained higher than other countries. The interest rates differential between Nepal and India is not that different. Nepal has the high interest rate than other countries, therefore investors may compare the interest rate differential and exchange rate loss and net out the total effect. The interest rate differential of 4 to 6 percent does not offset the average annual devaluation of the Nepali rupee at the rate of 11.32 percent. There is strong pressure to reduce the interest rate in the country. Therefore it provides incentives to the investors to invest in foreign currencies.

The annual rate of return in most of the shares of manufacturing and processing industries is negative and the price of the shares is also declining or stagnant. In this case investors of such companies are reluctant to hold such shares, hence, they may sold their shares and invest abroad with the opening of the capital account. The amount of such shares is 41.75 percent of the total paid-up capital.

With the opening of the capital account the development bonds and national saving certificates issued by the government and held by the individuals and other private companies may be sold it and invest abroad. The amount of government bonds held by the private sector is Rs. 4814 million (14.04 percent) of the total.

After opening the capital account, Nepal Stock Exchange Market will be fully opened for foreign investors. However, a significant surge in inflow of portfolio investment from convertible currency areas is not likely mainly due to weaker position of Nepalese currency, as noted above. Removal of capital control may rather induce outflow of capital. Portfolio investment from Indian investors may, however, increase to some sectors. Thus, the capital account convertibility will have modest impact on capital market growth in Nepal. Furthermore, the experience of East Asian countries has taught that stock market should be opened for foreign investors in a very cautious way.

#### **Experience of East Asian Countries**

When exchange rate starts depreciating and speculative trends persist, then foreign investors start withdrawing their investment. The first attack is then in the stock market because this is the market where investment withdrawal can be immediate. Disposing share holding through the stock market creates the problem of overselling of shares which helps depleting share prices. Declining share prices creates another series of selling pressure in the stock market which further creates demand for foreign currencies

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causing exchange rate to depreciate further. This deepens exchange rate crisis and leads to financial and economic crisis. This is what happened in East Asian Countries in 1997. When Thai Baht lost its confidence, the first attack was in the stock market where there was panic selling of shares for converting the investment into foreign currencies. This further caused the depreciation of Baht and intensified crisis. The contagion effect of the crisis in other East Asian Countries was then through the stock market itself. The crash in the Kuala Lumpur, Jakarta and Singapore stock markets was the contagion of the stock market crash in Bangkok.

What lessons should we learn from this episode ? The first and foremost lesson is that stock market may be a catalyst for exchange rate and then for financial crisis. If stock market is open for foreign investors, then any signal of exchange rate instability would perpetuate the problem through the stock market. So, in the process of opening stock market for foreign investors as part of the capital account liberalization, we should build up a mechanism whereby speculation in the exchange market could be decimated and the instability averted. The following measures could be adopted in this regard.

- i) The stock market should be opened in a selective basis-only those areas where domestic investment is not sufficient for tapping the opportunities should be opened for foreign investors. Big infrastructure projects, export oriented projects, big manufacturing and tourism, and selected services other than the financial sector should be the areas for initial opening of the stock market.
- ii) There should be a ceiling on the proportion of foreign participation in the stock market. In no case, more than 50 percent share participation for foreign investors should be allowed.
- iii) Provision of lock-in-period for foreign investment could be introduced. If foreign investment in the shares of a company take place, for at least three months the investors should not be allowed to dispose the shares, at least at the beginning of the evolution of the market.
- iv) **Monitoring of the stock market by the central bank is a must if foreign investment in the stock market is allowed. This is to keep abreast the foreign currency liability of the country. For this, a coordinating mechanism among the Central Bank, Securities Exchange Board, and the Stock Exchange should be evolved.**
- v) **Legal system should be strengthened so as to ensure transparency in the balance sheets of the companies, information disclosure system, floor trading and brokerage activities.**



### **Challenges to the Domestic Financial Institutions**

The opening of the capital account can have important implications positive or negative for domestic financial institutions. An increased competition, due to capital account liberalization, may be a challenge for previously protected domestic financial institutions. Such competition may be of two kinds: (a) increased competition due to establishment of more institutions with foreign capital in the country and (b) increased competition due to increased demand for any supply of financial resources from abroad.

So far first type of competition is concerned, Nepal has already opened Foreign Direct Investment in financial sector in the form of joint venture. However, perhaps due to small size of the market, big and high-class banks or other financial institutions have not been attracted to Nepal. The present policy of NRB on bank establishment neither allows operation of full fledged foreign bank branches nor provides any room for investment by individual non-residents as a foreign collaborator. In view of these circumstances, a marked change in entry of foreign banks or foreign collaborated banks in the banking sector of Nepal can not be expected, at least in short run, even after opening of capital account. Decontrol of capital account may expand absolute market of banking business. However, even such added market may not be attractive enough for big and standard foreign banks to enter into Nepalese market by means of collaboration.

Inflow and outflow of capital to and from a country is largely determined by interest rate prevailing in home and abroad, and change in exchange rate. Past experience shows that interest rate in Nepal is generally higher than the interest rate prevailed in international market, even after complete deregulation of interest rate in Nepal. Interest rate was completely deregulated in Nepal in Fiscal Year 1989/90.

Although deposit rate in Nepal for both short and long maturity is higher than that of LIBOR on U.S. dollar deposit for corresponding periods, the depreciation of Nepalese currency is even greater than the difference between interest rates of home and abroad. This indicates that foreign depositors may not be interested to deposit their money with Nepalese banks even after opening of capital account due to probable exchange loss. On the other hand, outflow of capital may take place to reap the benefit of exchange loss by Nepalese investors. Such outflow of capital can be checked either by maintaining stable exchange rate or increasing deposit rates. Thus with capital account convertibility, banks in Nepal will have to face challenges of increasing deposit rates through improved efficiency to raise deposits and to maintain at the same-time the spread of five percent as directed by the authorities.

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So far interest spread is concerned, it is very high in Nepal as compared to the level of international market. Despite government's direction to limit it at 5 percent, the interest rate spread in Nepal as at middle of Poush, 2055 B.S., is estimated to be as high as 8.75 percent. The internationally comparable data on interest rate spread of Nepal is not available. However, the interest rate spread for the year 1996, was calculated on the basis of average of highest deposit rates and highest lending rates and estimated to be 7 percent. The interest rate spread for this year was less than 3 percent in developed countries such as Singapore, Japan, United Kingdom and USA.

To improve efficiency of banking system in Nepal, it is required to reduce the level of non-performing loans, which is as high as 17.9 percent of the total loan in the fiscal year 1995/96. The ratio of non-performing loan to total loan has been declined during the period from fiscal year 1991/92 to 1993/94. However, fiscal year 1994/95 onward, this ratio moved up again. As compared to joint venture banks with foreign collaboration, the volume of non-performing loan is much bigger in hundred percent domestic banks viz. Nepal Bank Ltd. and Rastriya Banijya Bank. Therefore, drastic reform is needed in these two banks. Also it indicates the need of speeding up the process of establishing Banking tribunal and loan recovery agency as stated in the budget speech of fiscal year 1998/99 in order to expedite clearance of overdue loans and to clean up the bank balance-sheet. Default of trade related loans and misuse of foreign exchange increased after trade and exchange liberalization. Large scale misuse of foreign exchange like L/C scam of fiscal year 1994/95, took place after full convertibility of the Nepalese currency in current account. The L/C investigation commission pointed out ineffective supervision system of the Nepal Rastra Bank as on the factors responsible for occurring the scam. Thus, it is necessary to strengthen supervision system to improve efficiency of Nepalese banking system.

Although there is little scope for Nepalese banks to mobilize foreign deposits, borrowing from foreign financial market by Nepalese entrepreneurs is likely after the capital account convertibility because as it is evident from the wide difference between lending rate at home and interest rate abroad even after adjustment of exchange loss. However, borrowing depends also upon credibility and skill of the borrower. Therefore, only big entrepreneurs and enterprises with foreign equity may be able to use foreign resources in the form of medium and long-term borrowing. Short-term finance like trade credits may be used, however even by small but well established import firms.

Whatever be the form, capital inflow expands bank balance sheets as the money received from abroad is ultimately deposited with the banks. Unless sterilized by the

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Central Bank, capital inflow thus increases credit capacity of domestic banks. On the other hand, as credit worthy firms tap international market directly, domestic banks may need to lend to second tier, high-risk customers. Furthermore, large and volatile capital flows can exaggerate the risk exposures. Risk management becomes critical in such a situation.

An efficient and effective regulatory and supervisory system plays vital role in strengthening banking system to manage risks adequately. It is important to ensure that the regulation and supervision of banks are strong enough to ensure that credit quality does not deteriorate. Also it is important to ensure adequate provision for reversal of capital and loss of loans. In Nepal a wide range of regulations related to credit exposure limit, capital adequacy, loan loss provision etc. are already in effect. However, it is difficult to ensure that these regulations are strictly followed. Adequate capital banking is more important to maintain credibility of bank at a time when a bank is in huge loss due to provisioning requirement for enhanced level of non-performing loans. Though Nepal's capital adequacy norm of eight percent of risk weighted assets is in accordance with international standard set by the BASLE accord, it is important to be sure that the capital base of the banks, particularly of Nepal Bank Limited and Rastriya Banijya Bank, is adequate by strengthen. The supervisory strength is enough to meet the challenges likely to pose by the opening of capital account.

### **Recommendations**

1. As the economic fundamental of Nepalese economy are not yet strong and efficient enough to move instantly towards capital account convertibility, it is recommended that the move towards capital account convertibility be delayed until the macroeconomic, financial and exchange rate policies are put in place to sustain the capital account convertibility.
2. In the process of strengthening economic fundamentals or fulfilling preconditions for capital account convertibility, it is suggested to set a time bound target of reducing fiscal deficit to 3 percent of GDP, inflation rate to 5 percent and current account deficit to around 5 percent of GDP within next three years i.e. by 2002.
3. Keeping in view the time needed for fulfilling the preconditions, it is proposed that Nepal should make start to liberalize capital account transaction from 2002 AD with a time frame of 3 years for completing the process. However, if India moves to capital account convertibility before the preconditions are fulfilled in Nepal, it would be imperative that Nepal should also go for capital account convertibility.

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4. Given the weak macroeconomic fundamentals and underdeveloped internal capital market, it is advisable to adopt a gradual reform strategy in making the capital account fully convertible. Since short term capital flows are the most destabilizing factors, controls on such flows should not be removed until the economic fundamentals are strong enough. Controls on FDI could, however, be removed faster for strengthening the real sector. An important policy measure in this regard would be tying up inward FDI with export commitment.
5. The start of capital account convertibility should be made by liberalizing outflows and inflows in a balanced manner so that the pressure on exchange rate and money supply could be minimized. It is also desired to limit short-term inflows which are considered as potentially more destabilizing. Various measures towards gradual opening of capital account should be introduced in phase-wise manners and in consonance with the performance of macroeconomic fundamentals and development in India.
6. It is important to bring exchange rate of Nepalese rupee vis-a-vis Indian rupee to a realistic level to make capital account convertibility sustainable. The difficulties of persisting with a pegged exchange rate system with respect to Indian currency, particularly in the context of capital account convertibility, can be overcome by adopting flexible exchange rate regime. But abrupt shift from a fixed regime maintained for a long period of time to market determined regime could trigger chaos in the foreign exchange market. So it is suggested that the transition from fixed rate should be done gradually by adjusting the rate by small margins.
7. As it is risky to introduce currency convertibility on capital account without strong monitoring and supervision system, the Nepal Rastra Bank and other concerned agencies should prepare themselves to be able to implement effective and efficient monitoring and supervision before capital account convertibility is introduced.
8. There are about two dozens of acts to be amended to make Nepalese enterprises able to raise foreign financial resources and to acquire foreign financial assets. Thus, a substantial legal reform is required for effective implementation of capital account convertibility.
9. The effectiveness of capital account convertibility depends largely on the efficiency of the financial institutions at home. Therefore, efforts should be made to enhance efficiency of these institutions so as to bring the interest rate at par of the rate prevailed in abroad.

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