

CAPITAL ACCOUNT CONVERTIBILITY IN NEPAL : A FEASIBILITY STUDY*

1. Introduction

The last two decades will be remembered for the rapid integration of financial markets located in the industrialized world and major offshore centers. Most industrial countries have removed capital controls. However, they are maintained in most of the advanced developing countries. Recently, many developing countries are also raising questions about fully opening the capital account.

The opening of capital account would mean that domestic residents and foreigners will be able to purchase or sell financial assets from or to foreign/domestic markets. In this sense, capital account convertibility ensures perfect mobility of financial assets such as currency, deposits, shares or debentures across the border without any restrictions.

As indicated above, many countries, however, are still applying some kind of capital account control. The most common restrictions on capital account convertibility are in terms of (i) quantitative restrictions on capital movement involving limitations on the external asset and liability positions of domestic financial institutions, on the domestic operations of foreign financial institutions, and on the external portfolio, real estate, and direct investment of non-bank residents; (ii) dual or multiple exchange rate systems involving separate exchange rates for commercial and financial transactions; and (iii) explicit and implicit taxes on external financial transactions and income.

The control on capital account has been motivated by following considerations: (i) to help manage balance of payments crises or unstable exchange rate generated by the volatile short-term capital flows; (ii) to ensure that the domestic savings are invested domestically; (iii) to strengthen the authorities' ability to tax financial activities, income, and wealth; and (iv) to prevent destabilising effects of capital flows to control inflation or to sustain trade reform.

Empirical evidences, however, suggest that capital controls have been ineffective to produce desired effects and there are potential benefits of open capital account. The potential benefits of capital account liberalization are due to (i) static efficiency gain created by possibility of specialization in the production of financial services; (ii) dynamic efficiency gain in financial sector that results from increased competition in domestic financial system; (iii) improvement in the global intermediation of resources from savers to investors; (iv) reduction of financial risks by allowing domestic residents to hold internationally diversified portfolios, and (v) improved capital inflow in the form of foreign direct investment. It should be noted that these benefits of liberalizing capital account can be achieved when domestic interest rates gravitate to world level. However, there is existence of various types of institutional imperfections in developing countries like Nepal that may lead to failures of domestic interest rate to come closer to world level. Such imperfections

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are likely to increase financial instability, raising the question of sustainability of capital account liberalization.

If one reviews the experiences of selected industrial countries (United Kingdom and New Zealand) and developing countries (Argentina, Chile, Uruguay, Mexico, Indonesia, Malaysia, Singapore, Korea, and Taiwan) with capital account liberalization, one finds that these countries have followed quite different strategies in liberalizing capital account in terms of their scope, speed, and sequence. While some countries removed most of their capital controls over a short period, most countries have proceeded with extreme caution. Both approaches have had their share of success and failure. In all cases, the lifting of capital controls was accompanied by a net inflow of capital and appreciation of the exchange rate. Some countries succeeded in sustaining currency convertibility, others, however, did not. The review of country experiences suggests that while there are important prerequisites to lifting control, their sequencing is also equally crucial for sustaining capital account liberalization. Although the government of Nepal has taken several reform measures since 1985 as part of entire economic reform package, it has failed to meet its target for various macro-economic indicators (such as fiscal deficit, inflation etc.) casting doubts on the credibility of reforms. Furthermore, more reforms are still needed in the trade front, product and labor markets, and financial sector. Nepal, therefore, should try to meet these prerequisites before going for capital account liberalization.

2 Preconditions for Capital Account Convertibility

As opening capital account has always the risk of massive capital outflow so it has the scope for its inflow as well. The Nepalese economy should, therefore, meet certain preconditions before successfully embarking on full convertibility of the currency in capital account. These preconditions are as follows:

2.1 Reduction in Fiscal Deficit

It is widely held that fiscal imbalances exert internal as well as external instability in the economy by creating excess demand at home. If the excess demand cannot be met through the supply of goods and services, either domestic prices go up or current account deficit deteriorates. This will ultimately destabilize the exchange rate and encourage capital outflow. An overview of fiscal deficit in Nepal manifests that the government has not yet been able to cope with this problem. This is evident from the internal financing of the deficit which, on an average, posted 3.34 percent of the GDP during 1991-93 as compared with 1.4 percent during 1986-88 and 2.74 percent during 1989-90. As major chunk of the internal borrowing has emanated from the banking sector, it has exerted highly expansionary effect on money supply and subsequent effects on prices and current account balance.

The present trend of fiscal deficit indicates that unless the government consolidates revenue position or slashes less essential and unproductive expenditures, such a deficit cannot be contained without squeezing development expenditure and hence economic growth. If fiscal deficit continues, attaining macro-economic stability and ensuring a congenial atmosphere for capital inflow will be very difficult.

2.2 Tax Reforms

As inflow of foreign capital is susceptible to tax rate structure, the tax rates are to be kept minimum to ensure that capital outflow does not take place due to high taxes at home. In the recent years, the government has taken various tax reform measures. Noteworthy among them is the reduction in corporate tax rate from 50 percent to 35 percent. However, a surcharge of 12 percent for foreigners still exists, making effective corporate tax rate of 47 percent for foreigners. A comparison of corporate tax rate with that in other Asian countries competing for foreign direct investment shows the tax rate between 30 to 35 percent (except for India where the effective tax rate is more than 50 percent) Regarding corporate tax holidays, it ranges between 3 and 12 years for many Asian countries whereas the same in Nepal in between five to seven years.

Tax on financial instruments is another important aspect that needs reform before implementing capital account convertibility. Comparing the taxes on financial instruments in other countries with those in Nepal, it is found that Nepal is not a highly taxed country so far as financial instruments like dividend and capital gains are concerned. But the country would get a competitive edge in capital inflow if interest income on bank deposits is also made tax-free.

2.3 Controlling Inflation

Nepal has been facing a double digit inflation, on an average, during the last decade or so. During 1980's the rate of inflation stood at 10.6 percent and so far during 1990's at 13.3 percent, on average. Growth in money supply in excess of output growth, foreign prices, and the exchange rate have contributed to the high rate of inflation. This suggests that monetary policy alone would not be sufficient to contain inflation. Besides, monetary policy by itself may not be able to control money supply if fiscal deficit is not controlled. The past experience suggests that inflation can be contained only if domestic output growth is satisfactory along with stable prices in India and a stable exchange rate. If inflation remains uncontrolled, it will be a root cause of either capital flight or appreciation of the real exchange rate of the domestic currency which discourages exports. Inflation is also likely to retard financial development - a necessary condition for attracting portfolio investment from abroad.

2.4 Financial Sector Reforms

A vital element that should be taken into account while opening capital account is the efficiency and soundness of the domestic financial system. An efficient financial system implies that the cost of financial intermediation (the spread between deposit and lending rates) is low. A comparison of the simple spread between deposit and lending rates in Nepal with that of Asian countries which have already implemented capital account convertibility shows the spread comparatively high in Nepal. Although high deposit rates in Nepal are likely to attract foreign savings, the high lending rates are likely to induce domestic (or foreign) borrowers to opt for borrowing from foreign financial institutions in a situation of capital account convertibility, In such a situation, excess liquidity in the domestic financial system cannot be avoided. As the policy measure to reduce the spread through interest rate liberalization has not been working, the ultimate solution hinges on the restructuring, partly or fully, of the government-owned two large commercial banks.

Recovery of non-performing loans and prudential regulatory and supervisory system are other areas of financial sector reform needed before opening capital account. Although attempts have been made to recover the non-performing loans over the last couple of years, the share of bad debt to total outstanding credit stands at around eight percent in Nepal. If doubtful loans are also considered, the proportion goes up to as high as 25 percent for domestic banks. Taking into account the problem associated with non-performing loans and hence financial instability in the Latin American countries which had to abandon liberalized capital account on account of massive capital outflow, the existing loan performance of the domestic banks needs aggressive reforms before implementing full convertibility. Along with this, the regulatory and supervisory system needs a great deal of improvement. As opening capital account leads to diversified portfolio of the financial institutions dominated in foreign currencies, there are always exchange rate and interest rate risks on such investment. Hence, the supervisory authority should take care that the financial institutions do not take undue risk or do not lose their credibility in the financial market.

2.5 Relaxing Administered Exchange Rate Regime with Indian Currency

The fixed exchange rate regime with Indian currency has resulted in various distortions like excess devaluation of the Nepalese rupee vis-a-vis convertible currencies, existence of broken cross rates, and over-valuation of Nepalese rupee vis-a-vis Indian rupee in real terms. In essence, the fixed exchange rate regime has transmitted every shock that India is getting in the external sector to the Nepalese economy.

There is a stronger ground to argue that if Nepal extends to attain capital account convertibility, the fixed NR-IR (Nepalese rupee-Indian rupee) exchange rate regime should be abandoned. The reasons can be mentioned as following. First, opening capital account will make short-run capital flow a frequent phenomenon which tends to make exchange rate of NR vis-a-vis convertible currencies more fluctuating. In such a situation, the fixed NR-IR exchange will generate broken cross rates more frequently. Second, if NR-IR fixed exchange rate regime is to be abandoned sooner or later to make the exchange rate regime compatible with the overall liberalization measures, it is appropriate to take up the measure before capital account convertibility is implemented. Freeing this exchange rate together with opening capital account may accentuate instability in the foreign exchange market. Third, if Nepal opens capital account before India does so, Nepalese market will have to supply the foreign exchange demand of the Indians in a fixed NR-IR exchange rate and depreciation of the IR vis-a-vis NR in a situation of over supply of IR in the domestic market or vice-versa cannot take place. So the foreign exchange market may not be able to attain equilibrium through market forces. Last, as NR-dollar and IR-dollar exchange rates have remained stable for at least few months, it can be expected that the NR-IR exchange rate will not fluctuate widely even after freeing the exchange rate.

One need not elaborate the probable implications of floating NR-IR exchange rate for Nepalese economy, considering the wide ranging economic interactions with India including the open border. As the necessary groundwork for such measure, it is desirable to commission, at the earliest, an in-depth study to assess the possible impact on export-import trade, domestic price, domestic industries, and, above all, on border trade about which very little reliable and factual information is readily available. Such study has been a long overdue.

2.6 Capital Account Convertibility in India

As Nepal has to synchronize its external sector policies with those of India, opening capital account in Nepal is no exception to this compulsion. If Nepal opens capital account without India opting for the same, the result will be a spill-over of the unmet foreign currency demand in India into the Nepalese market. As a result, there will be a glut of Indian rupee in the financial system at the cost of convertible currencies. So far as Indian currency remains non-convertible, the excess Indian currency reserves will change the direction of trade as well. On the other hand, if Nepal does not open capital account even after India does so, Nepal will have no advantage of capital control, and, at the same time, Nepal will be continuously facing all the disadvantages associated with such system. In such a situation, it will be a wise step to open capital account along with India.

3. India's Likely Move Toward Capital Account Convertibility

The aggressive economic reform measures in India started since early 1990's when the country was passing through severe crises in the balance of payments along with low growth rate, high inflation, and dwindling credit-worthiness of the country. A program of macro-economic stabilization was initiated since 1991/92 to correct these distortions and, subsequently, various reform measures in the fiscal, financial, and external sectors were taken to liberalize the economy along with ensuring its stability. The achievement has, however, remained mixed. Although fiscal deficit declined from 8.4 percent of the GDP in 1990/91 to 5.6 percent in 1992/93, the same is likely to increase to 6 percent of the GDP in 1993/94.

Regarding tax reform measures, the government has been able to reduce customs duty rates along with consolidating sales tax and excise duty rates. However, corporate tax rates are still amongst the highest in the world, 51.75 percent for widely-held companies and 57.50 percent for closely-held ones.

A series of market-oriented corrections in the value of rupee through devaluation and convertibility brought about improvements in trade and current account balance. As a result, current account deficit has declined from 3.3 percent of GDP in 1990/91 to 0.5 percent in 1993/94. The correction in current account deficit along with substantial capital inflow in the form of institutional and direct foreign investment has improved the foreign exchange reserves position to more than \$10 billion in January 1994 from less than a billion in 1990/91. But taken into account the huge debt servicing requirement, the reserve position cannot be considered very comfortable.

Indian financial system is still highly regulated. The regulation of interest rates, among others, has caused a very high spread between deposit and lending rates. Such a high spread is likely to hinder the competitiveness of Indian banking to cope with the situation that comes up with liberalized capital account. High statutory liquidity and cash reserve ratios have also been responsible for the inefficiency of the Indian banking system.

A cursory review of the fiscal, financial, and external sector performance of the Indian economy and the measures that are still to be taken to further liberalize the financial and external sectors signal that India may not implement full convertibility of the rupee in the capital account. At the most, it is likely to completely liberalize current account along with freeing some institutional borrowing from abroad. The business and industrial group and independent intelligentsia also hold similar views. The views expressed by Reserve Bank of India officials also suggest that the country

is not yet prepared for full convertibility of the rupee in capital account. Nepal need not, therefore, take a hasty decision to implement capital account convertibility, as this step may turn out to be counter-productive in case India delays in implementing the same.

4. Sequencing of Reform Measures for Capital Account Convertibility

- i) So far as the sequencing of the reform measures is concerned, the first and foremost step that the government should take for attaining capital account convertibility is to contain fiscal deficit because controlling money supply and, hence, stabilizing price and correcting current account imbalance hinge on the extent of deficit financing by the government through bank borrowings. Containing fiscal deficit is possible only with the overhauling or restructuring of the government budget. The process of budget restructuring should start with pruning unproductive expenditures or at least freezing such expenditures. This should be accompanied by targeting and/or gradually phasing out subsidies, decontrolling prices of public enterprises, improving their financial position, privatizing them, and prioritizing development expenditures. Some additional measures to be taken to contain expenditure growth are: (i) freeze the implementation of new development projects to be fully financed from domestic sources, (ii) identify and weed out less productive or low priority projects, (iii) reduce internal debt servicing through swapping debt into equity, and (iv) do not implement projects which are unsustainable from the viewpoint of maintenance cost and debt servicing requirement.
- ii) In the tax front, reform measures have to begin with the reduction in customs duty on capital goods, followed by abolition of surcharge to foreigners in income tax rate, adoption of value added tax system for domestic production, and withdrawal of tax on interest income from bank deposits.
- iii) In the financial sector, the reform should start from the restructuring of the two large government-owned banks along with phasing out of the system of directed credit programs, reducing cash reserve requirement, repaying government-guaranteed loans, writing-off bad loans, expedition recovery, improving supervision, ensuring free entry of new financial institutions, and widening credit and deposit insurance activities.
- iv) Improving current account deficit position comes next to other reform measures for the implementation of capital account convertibility. Identification of exportable goods on a case by case basis and diversification of merchandise as well as service exports should constitute the hard cone of any measure for correcting such deficit. Moreover, as remittance is also emerging as the significant source of foreign exchange earnings, there should be no official or political resistance to Nepalese citizens-civilian or military-working abroad.
- v) Before embarking on capital account convertibility, the authorities can further liberalize current account convertibility, particularly in the areas of service and transfer. In this regard, the facility against passport may be expanded and foreign exchange facility for education, medical, and other service payments may be deregulated for upto a certain amount, say 1,000 U.S. dollars.

- vi) In the capital account, the first thing to do should be complete liberalization of foreign exchange facility for direct foreign investment. There should be no restriction to repatriate either profit or investment capital or dividend in any amount for the foreign investors. Before completely opening capital control, the official regulation of such flow could be maintained only for record purpose but not for quantitative restriction. Besides, the public enterprises, and particularly the financial institutions, can be allowed to make investment abroad or borrow short-term capital from the international market.
- vii) Finally, some institutional and legal reforms are needed before opening capital account. Among them are the provision of licensed money changers, strengthening of the financial regulatory and supervisory institution, amendments in the Foreign Exchange Regulation Act, Commercial Banking Act, Securities Exchange Act, and even in the Industrial Enterprises Act.